Sharia Economic and Management Business Journal (SEMBJ)

| Volume 7, Issue 2, 2026 | Page 166-183 |
https://doi.org/10.62159/sembj.v7i2.2223
ISSN-Online: 2774-2679

https://siducat.org/index.php/sembj

Financial Deepening on Sharia Finance Perspective: Analysis in Indonesia and Malaysia

Kurniawati Meylianingrum[1], Tiara Juliana Jaya[2], Kholilah[3], Mariam Ait Ahmed[4]

[123]Universitas Islam Negeri Maulana Malik Ibrahim Malang, Indonesia
[4]Ibn Tofail University, Kenitra, Morocco.

meylianingrum@uin-malang.ac.id *✉

ARTICLE INFO

Keywords:
Corporate sukuk; Sharia Stock; Third Party Funds; Total Assets; Financial Deepening;

ABSTRACT

Background: This study examines the dynamic relationship between the Islamic financial sector and financial deepening in Indonesia and Malaysia by integrating two key components of the sharia financial system: the sharia capital market and Islamic banking.
Method: This study employed a quantitative. Using monthly pooled data from 2014-2024 and employing the Autoregressive Distributed Lag approach, the research investigates both short-term and long-term effects of corporate sukuk, sharia stocks, third-party funds, total assets, interest rates, and exchange rates on financial deepening
Results: The findings reveal that corporate sukuk exert a negative influence on financial deepening in the short run, primarily due to their illiquidity and dominance by institutional buy-and-hold investors, while showing no significant long-term effect in either country. Sharia stocks positively affect financial deepening only in the short run, whereas long-term effects remain insignificant because of market volatility, limited liquidity, and structural constraints within the sharia capital market. Third-party funds demonstrate a contrasting pattern, showing negative short-run effects but a strong and positive long-run impact, indicating their growing role in supporting Islamic banking intermediation. Total asset contributes positively to financial deepening in the short term; however, their long-term effect becomes negative, reflecting inefficiency in translating asset growth into real-sector financing. Robustness test using Malaysia support the main model's conclusion
Conclusion: The study underscores the importance of enhancing liquidity, strengthening intermediation efficiency, and improving cross-sector sharia financial integration to maximize the contribution of Islamic finance toward sustainable financial deepening in dual banking systems.

Received: 4/19/2026 **Revised:** 5/24/2026 **Accepted:** 5/29/2026

How to cite this article:
Meylianingrum, K., Jaya, T.J., Kholilah, Ahmed, M.A. (2026). Financial Deepening on Sharia Finance Perspective: Analysis in Indonesia and Malaysia. Sharia Economic and Management Business Journal (SEMBJ), 7(2), 166-183. https://doi.org/10.62159/sembj.v7i2.2223

INTRODUCTION

There is a close relationship between the advancement of the financial sector and the implementation of financial deepening (Subkhan & Hutajulu, 2023). The development of the financial

sector to its fullest can promote the growth of economic activities. On the other hand, if the financial sector fails to develop, the economy will be saddled with a liquidity shortage and will fail to achieve growth that is sustainable over the long term. This means that the development of the financial sector is fundamental to maintaining high and sustained economic growth over time. Financial deepening is a measure of the development of the financial system within a country. The higher the ratio of financial deepening, the more effective the financial system will be in the distribution and mobilization of resources to promote growth acceleration.

A country's economic performance is partly determined by its activities within capital markets. As for Sharia securities, they consist of Sharia mutual funds, State Sharia Securities (Sukuk and Sharia Bonds), and Sharia Stocks (Nabila, 2020). Latifah (2016), from within the country, it determined the contribution of corporate sukuk to financial deepening positively. It is contrasts with some research results where, within Indonesia and Malaysia, corporate sukuk were determined to negatively influence financial deepening (Yıldırım et al., 2020). It is contrasts with some research results where, within Indonesia and Malaysia, corporate sukuk were determined to negatively influence financial deepening (Ridwan, 2018). Also, in the short term and within the country, the impacts of corporate sukuk issuances were not financially deepening in a significant proportion (Mary et al, 2019). Also Asysyifa (2018) determined that corporate sukuk has no impact in negative impact on financial deepening. These results illuminate the need for future research focused on the financial Sharia or related underutilized financial services, which could assist in deepening the financial levels in these countries. Alamgir et al. (2024) elucidate that the contribution of corporate sukuk, Islamic stocks, and the broader Islamic capital market to the deepening of the Islamic financial system goes beyond promoting investment financing to include the enhancement of the Islamic financial system's literacy within communities. Osanmaz et al. (2025) demonstrate that corporate sukuk also facilitates financial deepening by expanding the market for asset-backed sukuk. For entities and public sector bodies to access long-term financing aligned with Sharia law, which prohibits the payment of interest, sukuk becomes instrumental.

The development of sharia-compliant stocks positively impacts financial sector advancement and construction, as ethically oriented sharia stocks develop financially stable and inclusive markets. Such growth will promote resilience and facilitate economic advancement in Muslim-majority countries. The availability of sharia-compliant shares, which complement existing financial products as they are ethically shunned, allows practitioners of ethical sharia finance to position themselves as ethical investors within Islamic markets, thus encouraging positive ethical shifts within Islamic financial markets. Sharia-compliant stocks strengthen the financial system as they broaden the investor base and improve confidence in the capital markets by fostering risk-sharing and social construction (Pepis & Jong, 2018). Sharia finance has been shown to promote risk aversion and financial crises and periods of market instability, which strengthens the financial system (Kenourgios et al., 2016; Hassan, 2022). Such stability strengthens the system resilience, which, in turn, will attract risk-averse investors, thereby supporting financial system resilience, a required cornerstone on which financial deepening is built (Hassan, 2022; Jahromi, 2025). While in certain situations the direct effect on GDP may remain somewhat constrained, sharia stocks can still contribute to the expansion of market engagement, which in turn, enables the sustained economic development of a more inclusive market, especially in countries with substantial Muslim demographics. While in certain situations the direct effect on GDP may remain somewhat constrained, sharia stocks can still contribute to the expansion of market engagement, which in turn, enables the sustained economic development of a more inclusive market, especially in countries with substantial Muslim demographics (Saleem et al., 2021; Hassan, 2022; Anwar, 2024).

The primary activities performed within the Islamic banking sector are integral to its financial deepening, specifically the gathering of Third Party Funds (TPF) from the community to be redisbursed as financing (Mary et al., 2019; Rofa et al., 2023). Islamic banks as providers of financial services practice the intermediary role through funds allocation, whether for investments or other purposes, thus meeting the intermediation requirement (Lismawati, 2020). The operational core of Islamic banks is Third Party Funds, as they allow the banks to expand financing to the real sector, thus deepening and widening intermediation (Mary et al., 2019; Mauluddi & Nugraha, 2022). Third funds tap a wider society, inclusive of Sharia product seekers, thus promoting financial inclusion. Financial deepening is fostered with positive shifts performed in the productive financing of economically viable projects, which in turn stimulates economic activities, as more funds are raised by Islamic banks.

In assessing Islamic banking growth, total assets is also a significant factor (Putri & Rachmawati, 2022). This is because total assets indicate the ability of the bank to manage, distribute, and balance finances to different financial instruments and various investments. The higher the total assets, the higher the capacity of the bank to manage a wider range of financial instruments and investments, which in turn translates to increased financial transactions in the economy (Ali et al., 2021). This translates to greater financial deepening because the bank has more instruments, and it increases the system's liquidity and long-term stability and infrastructure. Total assets growth also means that Islamic banks have more financial resources to be allocated to MSMEs, infrastructure, and other productive sectors, thereby improving the volume and quality of financial intermediation. This, in turn, increases the economic activity and coverage of financing available (Nugraha et al., 2024). Having more total assets translates to deepening the financial system and increasing overall economic activity (Nugraha et al., 2024). For instance, in Indonesia, total assets account for 77% of the financial deepening, illustrating their strength in comparison to third-party funds and financing (Mulyadi & Suryanto, 2022). Being in possession of substantial assets increases the confidence of the public, the trust in the Islamic banks' stability and resilience, and the stability of the financial system as a whole. This results in even more strengthening of the financial system because there is even more participation and investment.

The question posed concerns how the two parts of the sector, Islamic banking and the sharia capital markets, could continue to maximize their contribution to the development of a more integrated financial system. This study as a new conceptual approach for the first time, analyzes the two primary components of the sharia financial sector simultaneously, the sharia capital market and Islamic banking. This study was undertaken in a Muslim-majority, dual banking system country, which provides the opportunity to examine the manner in which the sharia financial system operates, particularly how the sharia financial system contributes to financial deepening in a predominantly conventional framework. System deepening is expected to support growth in the real sector, which, at the end of the day, should improve the overall economic growth of the country. This study, therefore, aims to revise and provide more in-depth analysis in terms of the time, and the Sharia financial sector, which encompasses both the capital market and Islamic banking, affects the level of financial deepening in the short and long run. This research expands the Islamic Financial Deepening framework by proving that sharia finance is not merely a substitute for the conventional financial system but a significant contributor to financial deepening, financial inclusion, and financial stability, both in the short and long run. The results of this research can be utilized by monetary authorities along with sharia financial institutions in crafting sharia financial instruments development strategies that effectively deepen the financial sector.

The Role of Corporate Sukuk in Financial Deepening

For both countries, corporate sukuk facilitates the development of the sharia capital market and contributes positively to the long-term trajectory of financial deepening (Rofa et al., 2023). Also, corporate sukuk broadens the range of sharia-compliant financing and investment opportunities by virtue of selling asset-based financing. Nevertheless, corporate sukuk's potential in rapidly advancing financial deepening is constrained in the short run by market liquidity, investor education, and, most of all, the heterogeneous legal environments of Indonesia and Malaysia. Such factors contribute to differences in the impact of corporate sukuk in each country (Nurhanifah, 2024).

Corporate sukuk have become one of the cornerstones of the development of sharia finance and capital markets and have played an important role in the long-term financial deepening (https://jurnal.kdi.or.id/index.php/eb/article/view/588). Nurhanifah (2024) states that with corporate sukuk, sharia-compliant corporate financing, and demand from sharia investors are met, which helps to expand the country's financial reach and inclusiveness. The capital positioned in sukuk helps to improve the overall capital adequacy, positively impacting financial stability. Nevertheless, with respect to the sukuk market, there are still limitations as cited by Kazak & Okka, (2022) These, including an underdeveloped and less liquid market, and a fundamental lack of understanding of the product. Last Kazak & Okka, (2022) states that sukuk in Malaysia's sharia financial market faces restrictive regulation and poor understanding, especially from an operational and tactical perspective in the short term.

Influence of Sharia Stocks on Financial Deepening

According to the Shariah stock market adds to the Shariah financial market as well as to financial deepening in Indonesia and Malaysia (Khalid et al., 2019). The growth of Shariah investors and issuers

accelerates financial inclusion and broadens the spectrum of investment opportunities compliant with Shariah principles. Still, Ismail (2022) points out that stock market fluctuations, a shortage of Shariah equities, and macroeconomic conditions will, in the short run, constrain the impact of Shariah equities. The global economic environment is unpredictable, and it adds to the risk that will impede investors in the two countries (Rofa et al., 2023).

The importance of Sharia stocks lies in the deepening of the Sharia capital market and the increasing participation of investors in capital markets. Yusoff dan Rahman (2024) show how the growth of the number of Sharia stocks and the liquidity of Sharia stocks bolster long-term growth in the deepening of the financial system. A Sharia stock market that remains stable will help reinforce the Sharia financial system and aid in greater inclusion of the population within the financial system (Khalid et al., 2019). Nonetheless, in the short run, extreme price volatility of the stocks and the small number of Sharia stocks that are compliant and on offer in the market will reduce the potential of Sharia stocks on market growth and inclusion (Rofa et al., 2023b). The potential growth of Sharia stocks and the deepening of the financial system are also limited by risks of macroeconomic factors, which are a major determinant of the perception of investors and financial market deepening (Rofa et al., 2023).

The Role of Third-Party Funds in Financial Deepening

In Indonesia and Malaysia, Third-Party Funds (TPF) aid the liquidity of Islamic banking and also assist in the process of financial deepening (Rofa et al., 2023). TPF has also been increasing in both countries, and the increased TPF leads to a strengthened capacity for funding and a decreased constraint on sharia financing, thus aiding in the advancement of financial inclusion (Hilmawati & Kusumaningtias (2021). Each country's monetary policies, especially short-run macroeconomic uncertainty, and TPF-related regulations and policies contribute to impacting TPF differently because of its effectiveness and its variations, especially in the short run (Afgani et al., 2024). Macroeconomic instability, politically and economically also are considered in unison to more directly assess the restraint of TPF on financial deepening (Afgani et al., 2024).

The contribution of Third-Party Funds to Islamic banking liquidity is critical, especially for advancing financial deepening in the long run. Third-party funds enhance banking stability and financial accessibility, and thus, long-term deepening of the finances, as reiterated in the report of the Malaysian Financial Sector 2020. This report aligns with the results of Mohd et al. (2022), which notes the rise in demand deposits and savings is a considerable factor stimulating growth among Malaysia's sharia financial sector. However, TPF in Malaysia is susceptible to external political and macroeconomic-induced short-term fluctuations (Hasibuan et al., 2021). In conditions of market weakness, the capacity for fund absorption falls, worsening the short-term effectiveness of TPF in achieving dynamic and sustained financial deepening, as noted by Afgani et al. (2024).

Influence of Total Assets on Financial Deepening

During periods when financial service capacity grows, financial deepening is also supported directly and grows alongside the rise of Islamic bank assets in Indonesia and Malaysia (Sari et al., 2024). Institutions with large total assets gain greater stability, and the capacity to finance the real sector increases, thus consolidating financial inclusion within these countries (Abdullah & Ling, 2023). In addition, Ali et al., (2021) describe how short-term and especially during times of economic downturns, assets' influence tends to be variable because of how efficiently the assets are being managed and differing economic conditions. Different external conditions affect the impact of asset expansion on financial deepening in each country (Ali et al. 2021).

The impact of the rising total assets of Islamic banks is positively influencing the advancement of financial deepening. Well-managed large assets enhance the stability of institutions and market confidence while accelerating financial inclusion, thereby positively influencing the lasting deepening of finance within the system (Abdullah & Ling, 2023). Malaysia's Islamic banking sector has large total assets and is increasingly able to provide sharia-compliant products to a large segment of the population. On the other hand, Ali et al. (2021) explain that credit risk within asset management, combined with emerging frameworks for the regulation of total assets, will provide short-run, deepening finance, inconsistently. In addition, the economic and macroeconomic environment's uncertainty causes variation and will impede the positive impact asset growth has on the accelerated deepening of finance.

METHOD

The data analysis technique used was Structural Equation Modeling (SEM) based on Partial Least Squares (PLS). SEM was chosen for its ability to model complex relationships among latent variables (such as branding elements and government's role) and observed variables (such as tourists' decisions to stay at a halal accommodation). The analysis was performed using SmartPLS 4.0 software. PLS-SEM is advantageous for its ability to handle non-normal data and asymmetric distributions, and it can provide accurate predictions even with a small sample size (El Ayoubi & Radmehr, 2023; Miah et al., 2022; Ming et al., 2021).

This research adopts a quantitative approach with an exploratory research design, particularly addressing the long-term and short-term implications of both firm and country macroeconomic factors on financial deepening in Indonesia and Malaysia. The population for this research consists of Sharia Commercial Banks (BUS) and Sharia Business Units (UUS) as well as the entities under Bank Negara Malaysia (Romli, 2022). and registered with the Indonesian Financial Services Authority (IFSA). The sample from the Indonesian and Malaysian Islamic banking and Sharia capital market was done using a saturated sampling (census) approach, given that the population was relatively small. The data is pooled quarterly for 10 years from January 2011 to December 2024 and was collected from IFSA, Jakarta Islamic Index, Bank Negara Malaysia, Securities Commission Malaysia, and Bond and Sukuk Information Exchange (BIX), and included a total of 112 observations.

Analysis for this study utilized the Autoregressive Distributed Lag (ARDL) framework (Pesaran et al., 2001). As some of the study variables will produce a model with mixed levels of stationarity, this technique fits the study's objectives best. It incorporates the autoregressive (AR) aspect of using the historical values of the independent variables, while also, to a limited extent, applying the concept of distributed lag (DL) via the contemporary and historical values of the dependent variable (Saleem et al., 2021). It, therefore, has the capacity to model the short-run and long-run dynamic interdependencies of the dependent variable on a set of independent variables.

According to Pesaran et al., (2001), Saleem et al., (2021), and Gana et al. (2021), the estimated ARDL model comprises five steps. In the first step, to analyze the short- and long-term relationship between the dependent and independent variables, the stability of the data needs to be confirmed through a stationarity test that assesses whether a unit root is present. The tests administered are the Augmented Dickey-Fuller (ADF) and the Phillips-Perron tests. The second step involves determining the optimal lag length to be used for the model based on the information criteria outlined for the Akaike Information Criterion (AIC). The output of this step will produce a sequenced test lag order, for example, (1, 0, 0, 4, 0, 4), where 0 means no lag. In the third step, the Bounds Testing Approach is used to perform a cointegration test on the variables. The Bounds approach is based on two critical bounds within which cointegration is assumed to occur, the lower bound I(0) and the upper bound I(1). In the fourth step, the short-term ARDL model will be estimated, where the model is integrated with an Error Correction Model (ECM) in order to estimate the uncorrected error of the previous period. Estimation of the long-term ARDL model to analyze long-term effects of corporate sukuk, sharia stocks, third-party funds, assets, interest rates, and exchange rates on financial deepening closes this section. The following are the models in the research.

Full Sample Model

1. Equation (1) –Long Run Equation

$$\begin{aligned}\Delta\text{FINDEEP}_{\,t} = \pi_0 &+ \sum_{q=1}^{P_1} \theta_{1q}\,\Delta\text{FINDEEP}^{(j)}{}_{t-q} + \sum_{q=0}^{P_2} \theta_{2q}\,\Delta\text{CORSKK}^{(j)}{}_{t-q} + \sum_{q=0}^{P_3} \theta_{3q}\,\Delta\text{SYARSTOCK}^{(j)}{}_{t-q} \\ &+ \sum_{q=0}^{P_4} \theta_{4q}\,\Delta\text{TPF}^{(j)}{}_{t-q} + \sum_{q=0}^{P_5} \theta_{5q}\,\Delta\text{TTLASSET}^{(j)}{}_{t-q} + \sum_{q=0}^{P_6} \theta_{6q}\,\Delta\text{BIRATE}^{(j)}{}_{t-q} \\ &+ \sum_{q=0}^{P_7} \theta_{7q}\,\Delta\text{EXCRATE}^{(j)}{}_{t-q} + \omega_1\Delta\text{FINDEEP}^{(j)}{}_{t-1} + \omega_2\Delta\text{CORSKK}^{(j)}{}_{t-1} \\ &+ \omega_3\Delta\text{SYARSTOCK}^{(j)}{}_{t-1} + \omega_4\Delta\text{TPF}^{(j)}{}_{t-1} + \omega_5\Delta\text{TTLASSET}^{(j)}{}_{t-1} + \omega_6\Delta\text{BIRATE}^{(j)}{}_{t-1} \\ &+ \omega_7\Delta\text{EXCRATE}^{(j)}{}_{t-1} + \varepsilon t\end{aligned}$$

Legend:

Δ	: First difference operator, indicating the change in a variable from the previous period.
J	: {ID, MY} → country indices (Indonesia and Malaysia).
FINDEEP	: Financial Deepening
CORSKK	: Value of Corporate *Sukuk*
SYARSTOCK	: Value of Sharia stock Index
TPF	: Third Party Funds
TTLASSET	: Total Banking Assets
BIRATE	: Benchmark interest rate
EXCRATE	: Exchange rate USD/IDR
MY	: Malaysia
∑	: Sigma (summation) for each variable
T	: time/ Period
ω	: Fixed value
q	: lag index (time delay), e.g., t−1 is one period prior.
Π	: short-run constant (intercept).
Θ_{iq}	: short-run coefficient for the i-th variable at lag q.
ε_t	: error term (disturbance)

2. Equation (2) –Short Run ARDL Form

$$\Delta\text{FINDEEP}_{\text{t}} = \pi_0 + \sum_{\text{q}=1}^{P_1} \gamma_{1\text{q}}\, \Delta\text{FINDEEP}^{(j)}{}_{\text{t}-\text{q}} + \sum_{\text{q}=0}^{P_2} \gamma_{2\text{q}}\, \Delta\text{CORSKK}^{(j)}{}_{\text{t}-\text{q}} + \sum_{\text{q}=0}^{P_3} \gamma_{3\text{q}}\, \Delta\text{SYARSTOCK}^{(j)}{}_{\text{t}-\text{q}} + \sum_{\text{q}=0}^{P_4} \gamma_{4\text{q}}\, \Delta\text{TPF}^{(j)}{}_{\text{t}-\text{q}} + \sum_{\text{q}=0}^{P_5} \gamma_{5\text{q}}\, \Delta\text{TTLASSET}^{(j)}{}_{\text{t}-\text{q}} + \sum_{\text{q}=0}^{P_6} \gamma_{6\text{q}}\, \Delta\text{BIRATE}^{(j)}{}_{\text{t}-\text{q}} + \sum_{\text{q}=0}^{P_7} \gamma_{7\text{q}}\, \Delta\text{EXCRATE}^{(j)}{}_{\text{t}-\text{q}} + \mu_t$$

Additional legend:

π_0 : long-run constant (intercept).

γ_{iq} : long-run coefficient for the i-th variable at lag q.

μ_t: error term (disturbance) at period t.

3. Equation (3) – ECM Form using ECT

$$\Delta\text{FINDEEP}_{\text{t}} = \pi_0 + \sum_{\text{q}=1}^{P_1} \varphi_{1\text{q}}\, \Delta\text{FINDEEP}^{(j)}{}_{\text{t}-\text{q}} + \sum_{\text{q}=0}^{P_2} \varphi_{2\text{q}}\, \Delta\text{CORSKK}^{(j)}{}_{\text{t}-\text{q}} + \sum_{\text{q}=0}^{P_3} \varphi_{3\text{q}}\, \Delta\text{SYARSTOCK}^{(j)}{}_{\text{t}-\text{q}} + \sum_{\text{q}=0}^{P_4} \varphi_{4\text{q}}\, \Delta\text{TPF}^{(j)}{}_{\text{t}-\text{q}} + \sum_{\text{q}=0}^{P_5} \varphi_{5\text{q}}\, \Delta\text{TTLASSET}^{(j)}{}_{\text{t}-\text{q}} + \sum_{\text{q}=0}^{P_6} \varphi_{6\text{q}}\, \Delta\text{BIRATE}^{(j)}{}_{\text{t}-\text{q}} + \sum_{\text{q}=0}^{P_7} \varphi_{7\text{q}}\, \Delta\text{EXCRATE}^{(j)}{}_{\text{t}-\text{q}} + \sigma_t ECT_{t-1} + \mu_t$$

Additional legend

π_0 : long-run constant (intercept).

γ_{iq} : long-run coefficient for the i-th variable at lag q.

μ_t : error term (disturbance) at period t.

θ_{iq} : short-run coefficient for the i-th variable at lag q.

A model robustness test is conducted by performing the same test, but only for Malaysia. This is because its sharia financial industry is more developed, along with mature implementation and regulation.

RESULT AND DISCUSSION

The data from your analysis, as shown in the table, confirms a high level of convergent validity. All outer loading values for the indicators (Y.2, Y.3, Y.4, and Y.5) are well above the 0.7 threshold, with values ranging from 0.919 to 0.955. This provides strong evidence that your measurement model is robust and that the survey questions are effectively capturing the concepts they were designed to measure. Consequently, we can proceed with a high degree of confidence in the validity of the relationships being tested in the structural model.

Table 1. Average Variance Extracted Value (AVE)

Variable	Average Variance Extracted (AVE)	Description
X1 (Brand Identity)	0.785	Valid
X2 (Brand Meaning)	0.844	Valid
X3 (Brand Response)	0.781	Valid
X4 (Brand Resonance)	0.870	Valid
X5 (The Role of the Government)	0.830	Valid
Y (Halal Tourism Development)	0.882	Valid

Source: Data processed with Smart PLS 4 (2025)

This table presents the results for discriminant validity. The values show that the correlation of a variable with itself is not smaller than its correlation with other variables, meeting the required criteria.

Descriptive statistical analysis yielded a total sample of 112 observations, wherein the dependent variable is Financial Deepening and the independent variables are Corporate Sukuk, Sharia Stocks, Third Party Funds, and Total Assets, alongside control variables Interest Rate and Exchange Rate. This study uses the quarterly data for the period 2011-2024. Table 1 present the result:

Table 2. Descriptive Analysis

	FINDEEP	CORSKK	SYARSTOCK	TPF	TTLASSET	BIRATE	EXCRATE
Mean	3.354	2.063	1762.325	77.63	102.835	0.042	0.129
Median	3.205	1.838	1272.725	60.215	75.205	0.034	0.105
Maximum	6.480	9.746	4583.400	207.110	284.840	0.078	0.330
Minimum	1.270	0.542	98.700	9.150	11.630	0.018	0,000
Std, Dev	1.847	1.391	1664.528	59.569	80.309	0.016	0.132
Observation	112	112	112	112	112	112	112

Source: Data processed (2025)

Based on the data provided, the variables for Financial Deepening (FD), Corporate Sukuk, Sharia Stocks, Third Party Funds (TPF), Total Assets, as well as the control variables Interest Rate and Exchange Rate are stationary at the first difference level. This means that both the main variables and the control variables fulfill the stationarity conditions and can be used for further analysis. Table 2 present the stationery test.

Table 3. Stationarity Test

Variable	Level			First Difference		
	Stat. ADF	p Value	Result	Stat. ADF	p Value	Result
FINDEEP	16.184	0.002***	Stationary	86.321	0.000***	Stationary
CORSKK	21.186	0.000***	Stationary	61.179	0.000***	Stationary
SYARSTOCK	5.998	0.199	Not Stationary	52.143	0.000***	Stationary
TPF	0.202	0.995	Not Stationary	53.739	0.000***	Stationary
TTLASSET	0.079	0.999	Not Stationary	61.417	0.000***	Stationary
BIRATE	5.442	0.244	Not Stationary	23.427	0.000***	Stationary
EXCRATE	7.672	0.104	Not Stationary	56.497	0.000***	Stationary

Source: Data processed (2025)

Among the examined ARDL models, the one identified by the shortest Akaike Information Criterion (AIC) value is ARDL (4,4,4,4,4,4,4), which is -1.506. Thus, the preferred specification is ARDL (4,4,4,4,4,4,4). This indicates that the ARDL model performed on Financial Deepening and the independent variables are Corporate Sukuk, Sharia Stocks, Third Party Funds, and Total Assets,

alongside control variables Interest Rate, and Exchange Rate lags 4 times as well as the rest of the control variables.

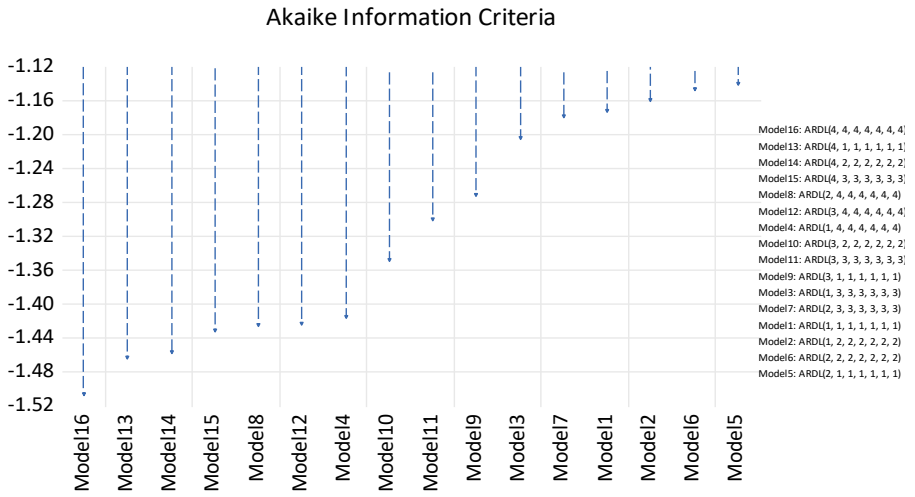

Figure 1. Akaike Information Criteria

The result is 0.000 for the Kao residual cointegration test. Since this is less than the significance level of $\alpha = 5\%$, the null hypothesis (H0) is rejected. Thus, cointegration is confirmed. As such, a long-term relationship exists within the regression model. Since a relationship of cointegration is confirmed, it implies that both short-term and long-term relationships coexist with the variables being studied.

Table 4. Short Run Equation

Variable	Coefficient	Std. Error	t-Statistic	Prob.
COINTEQ01	-0.679	0.26405	-2.571	0.013
D(FINDEEP (-1))	-0.123	0.005	-23.061	0.000
D(FINDEEP (-2))	-0.284	0.001	-219.849	0.000
D(FINDEEP (-3))	-0.254	0.094	-2.705	0.009
D(CORSKK)	-0.054	0.019	-2.798	0.007
D(CORSKK (-1))	-0.046	0.015	-27.413	0.000
D(CORSKK (-2))	0.064	0.0779	0.836	0.407
D(CORSKK (-3))	-0.031	0.059	0.637	0.527
D(SYARSTOCK)	0.000	4.760	8.849	0.000
D(SYARSTOCK (-1))	-0.000	0.000	-0.813	0.420
D(SYARSTOCK (-2))	-0.000	0.000	-1.006	0.313
D(SYARSTOCK (-3))	-0.000	0.000	-1.491	0.142
D(TPF)	-0.015	0.011	-1.374	0.175
D(TPF (-1))	-0.016	0.006	-2.392	0.020
D(TPF (-2))	-0.012	0.002	-4.838	0.000
D(TPF (-3))	-0.006	0.003	-1.917	0.061
D(TTLASSET)	0.007	0.013	0.579	0.564
D(TTLASSET (-1))	0.015	0.003	4.806	0.000
D(TTLASSET (-2))	0.010	0.007	1.349	0.183
D(TTLASSET (-3))	-0.006	0.008	-0.722	0.473
D(BIRATE)	-34.470	33.329	-1.034	0.306
D(BIRATE (-1))	-14.798	16.537	-0.894	0.375
D(BIRATE (-2))	-9.207	3.755	-2.451	0.017
D(BIRATE (-3))	-36.405	33.171	-1.097	0.277
D(EXCRATE)	1,135.811	1,143.248	0.993	0.325
D(EXCRATE (-1))	509.410	519.185	0.981	0.321
D(EXCRATE (-2))	1,195.943	2,003.458	0.996	0.324
D(EXCRATE (-3))	3,349.174	3,340.274	1.002	0.321
C	1.975	1.345	1.468	0.148

Source: Data processed (2025)

Following the estimation of the ARDL model, the short-run relationships were established with the use of the Short Run Equation. The ARDL approach indicates the estimation of several variables that affect financial deepening is significant: FINDEEP (-1), FINDEEP (-2), FINDEEP (-3), CORSKK, CORSKK (-1), SYARSTOCK, TPF (-1), TPF (-2), and TTLASSET (-1). As for the control variables of this research (Interest Rate and Exchange Rate), it is only the Interest Rate at the second lag BIRATE (-2) that exerts a significant impact. The Exchange Rate lacks significant influence, as demonstrated by its p-value exceeding 0.05.

The COINTEQ01 variable represents the correction variable that captures any errors from the previous cycle. COINTEQ01 shows a value of -0.679. which is valid and negative. and it is also statistically significant at 0.013. Consequently, this entails that the ARDL model demonstrates cointegration with validity between the dependent and independent. Since there is cointegration, the value of the Error Correction Term must be included, since it measures the adjustment of value. The incorporated exchange 0.679 indicates the model adjusts toward equilibrium, 67.9% per annum.

Table 5. Long-Run Equation Results

Variable	Coefficient	Std. Error	t-Statistic	Prob.
CORSKK	0.002	0.024	0.097	0.922
SYARSTOCK	-0.000	0.000	-1.151	0.255
TPF	0.0327	0.009	3.401	0.001
TTLASSET	-0.021	0.007	-2.983	0.004
BIRATE	0.734	2.063	0.355	0.723
EXCRATE	6.571	1.874	3.505	0.001

Source: Data processed (2025)

The results of the long-run regression indicate the variables Third Party Funds and Total Assets have a considerable effect on the deepening of finance. Along with the control variables included in this study, the Exchange Rate has a significant effect. Therefore, in the long run, the variables impacting the deepening of finance are threefold: TPF, Total Assets, and the exchange Rate.

Robustness Test

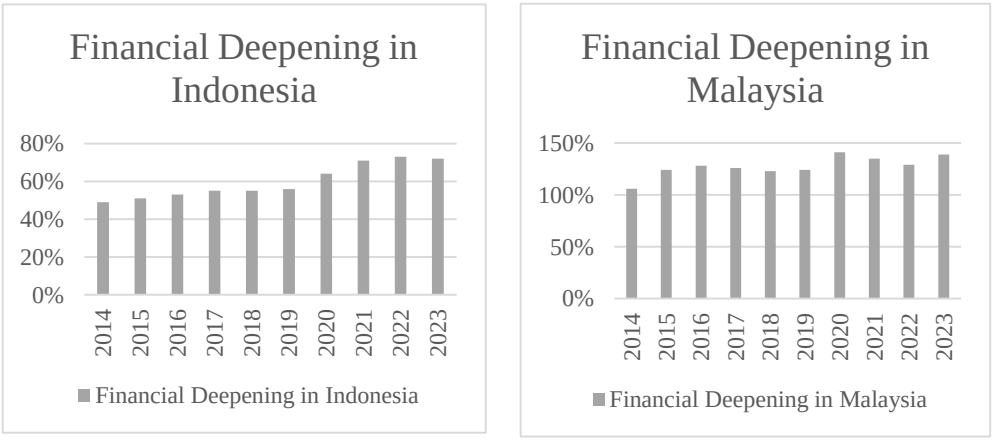

Figure 2. Financial Deepening Development in Indonesia and Malaysia

Robustness Test has been done in Malaysia only due to the maturity in implementation and regulation. Malaysia has been applying sharia financial instruments for a relatively longer time than Indonesia (Ridwan, 2018). While Indonesia only introduced its sharia financial system in the early 1990s, Malaysia had already done so since the 1940s. This difference in time of implementation gave Malaysia ample opportunity to acquire valuable experience and develop the sharia financial infrastructure. Malaysia has also established a more comprehensive and sophisticated regulatory framework and a wider range of sharia products, which have positively influenced the overall development of its sharia financial sector.

Table 6. Stationarity Test

Variable	Level			First Difference		
	Stat. ADF	P Value	Result	Stat. ADF	P Value	Result
FINDEEP _MY	-4.323	0.001	Stationary	-8.092	0.000	Stationary
CORSKK_ID_MY	-8.594	0.000	Stationary	-8.321	0.000	Stationary
SYARSTOCK_ID_MY	-1.746	0.402	Not Stationary	-7.827	0.000	Stationary
TPF_ID_MY	-0.387	0.903	Not Stationary	-7.814	0.000	Stationary
TTLASSET_ID_MY	-0.176	0.934	Not Stationary	-7.344	0.000	Stationary
BIRATE _ID_MY	-1.940	0.311	Not Stationary	-4.962	0.000	Stationary
EXCRATE _ID_MY	-1.733	0.409	Not Stationary	-7.457	0.000	Stationary

Source: Data processed (2025)

Based on the data provided, the variables for Financial Deepening, Corporate Sukuk, Sharia Stocks, Third Party Funds, Total Assets as well as the control variables Interest Rate and Exchange Rate are stationary at the first difference level. This means that both the main variables and the control variables fulfill the stationarity conditions and can be used for further analysis. This result consistent with the main model result.

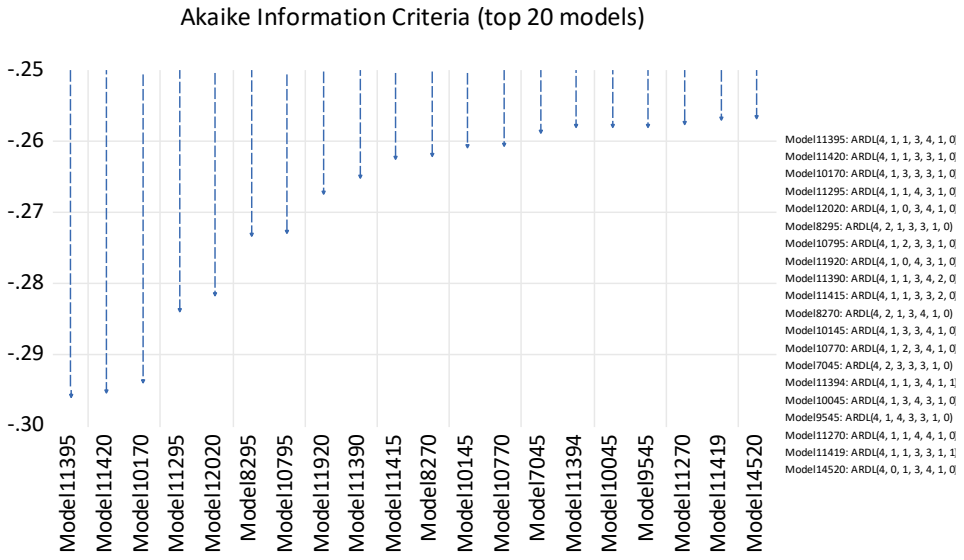

Figure 3. Akaike Information Criteria

Out of different ARDL models, the ARDL (4,1,1,3,4,1,0) model generates the least AIC score, which is -0.295. As a result, the ARDL (4,1,1,3,4,1,0) is considered the most appropriate model. In this case, the Financial Deepening variable is with 4 lags and the other variables are in this order with lags (total assets = 4, Third Party Funds = 3, Sharia Stocks = 1, Corporate Sukuk = 1, and control variables Interest Rate = 1, and Exchange Rate = 0 are also in the model.

The results of the cointegration bounds test indicate an F-statistic value of 5.929. This exceeds the upper bound I (1) value of 3.28 at the 5% significance level. Thus, the null hypothesis (H0) is rejected. This means the test results support the existence of cointegration. Therefore, a long-term relationship exists within the regression model. A relationship has been confirmed, demonstrating that the variables in the study have a relationship in the short run and the long run.

Table 7. ARDL Model Estimation Results

Variable	Coefficient	Std. Error	t-Statistic	Prob.
FINDEEP (-1)	-0.169	0.131	-1.284	0.208
FINDEEP (-2)	-0.231	0.120	-1.915	0.064
FINDEEP (-3)	-0.060	0.129	-0.470	0.641
FINDEEP (-4)	0.272	0.111	2.446	0.020
CORSKK	-0.033	0.025	-1.313	0.198
CORSKK (-1)	-0.033	0.020	-1.583	0.123
SYARSTOCK	0.000	0.000	1.019	0.315
SYARSTOCK (-1)	-0.000	0.000	-1.296	0.204

TPF	0.011	0.010	1.083	0.286
TPF (-1)	0.013	0.011	1.235	0.225
TPF (-2)	0.012	0.010	1.143	0.261
TPF (-3)	0.021	0.010	2.114	0.042
TTLASSET	-0.006	0.007	-0.926	0.361
TTLASSET (-1)	-0.008	0.009	-0.933	0.357
TTLASSET (-2)	-0.008	0.009	-0.872	0.389
TTLASSET (-3)	-0.025	0.008	-2.833	0.008
TTLASSET (-4)	0.005	0.0049	1.112	0.274
BIRATE	-101.542	19.588	-5.183	0.000
BIRATE (-1)	64.961	21.161	3.069	0.004
EXCRATE	0.960	1.952	0.492	0.626
C	7.123	1.717	4.146	0.000

Source: Data processed (2025)

The coefficient of determination enables one to see the extent of the influence of the independent variables in relation to the dependent variable. In which the Adjusted R-squared value of 0.693 was derived which denotes that 69.3% of the variation in financial deepening is explained by the combination of the variables; corporate sukuk, sharia stocks, third-party funds, total assets and the control variables interest rate and exchange rate in this research. This means the rest 30.7% is explained by other model outside factors.

The result of the F-statistic is 6.770 with a p-value of 0.000. Since $0.000 < \alpha = 0.05$, this means that the null hypothesis (H0) is rejected. Thus, it is concluded that independent variables (corporate sukuk, sharia stocks, TPF, total assets) along with the control variables (interest rate and exchange rate) significantly influence Financial Deepening.

Table 8. Short Run (ECM)

Variable	Coefficient	Std, Error	t-Statistic	Prob,
D(FINDEEP (-1))	0.019	0.120	0.163	0.871
D(FINDEEP (-2))	-0.211	0.092	-2.285	0.029
D(FINDEEP (-3))	-0.272	0.089	-3.026	0.004
D(CORSKK)	-0.033	0.014	-2.367	0.024
D(SYARSTOCK)	0.000	0.000	1.484	0.147
D(TPF)	0.011	0.007	1.229	0.225
D(TPF (-1))	-0.033	0.009	-3.503	0.001
D(TPF (-2))	-0.021	0.008	-2.667	0.012
D(TTLASSET)	-0.008	0.005	-1.180	0.246
D(TTLASSET (-1))	0.018	0.005	3.609	0.001
D(TTLASSET (-2))	0.019	0.006	3.067	0.004
D(TTLASSET (-3))	-0.005	0.003	-1.560	0.128
D(BIRATE)	-101.542	15.916	-6.379	0.000
CointEq (-1)*	-1.189	0.155	-7.625	0.000

Source: Data processed (2025)

The results about short-run estimations disclose the impact of several variables on the phenomenon of financial deepening, Noteworthy among these factors are FINDEEP (-2), FINDEEP (-3), CORSKK, TPF (-1), TPF (-2), TTLASSET (-1), TTLASSET (-2) and the control variable BIRATE. The threshold of significance is established at $p < 0.05$, and each of the variables identified as impactful meets this condition.

As to the Coint Eq (-1), which has been referred to as an error correction variable, it reflects the error of a preceding period. The Coint Eq (-1) figure of -1.189 is negative (and valid) and has a p-value of 0.000, which indicates statistical significance. This suggests that the ARDL model validly captures cointegration pertaining to dependent and independent variables. As there is cointegration, the ECT value is utilized to establish the degree of the Adjustments that will be realized after a shock. The result of this ECT is 1.189, which suggests that the model will move toward equilibrium at an annual rate of 118.9%.

According to the long-run regression results, the variables Third Party Funds and Total Assets influence financial deepening to a considerable degree. Of the control variables used in this study, which are the Interest Rate and the Exchange Rate, only the Interest Rate is found to have a considerable impact, since the Exchange Rate is not significant, passing a value of 0.05. Therefore, in the long run, there are three variables which affect financial deepening: TPF, Total Assets, and the Interest Rate. The result consistent with the main model, except for the control variable.

Table 9. Long Run Test

Variable	Coefficient	Std, Error	t-Statistic	Probability
CORSKK	-0.055	0.030	-1.855	0.073
SYARSTOCK	-0.000	0.000	-0.272	0.786
TPF	0.049	0.015	3.325	0.002
TTLASSET	-0.036	0.011	-3.137	0.003
BIRATE	-30.760	6.455	-4.765	0.000
EXCRATE	0.807	1.701	0.474	0.638
C	2.704	08.353	7.170	0.000

Source: Data processed (2025)

Discussion

Corporate Sukuk on Financial Deepening

Estimates suggest that the corporate sukuk variable significantly and adversely affects financial deepening in the short term, with a magnitude of -0.0540. This indicates that a 1-unit change in corporate sukuk translates to a 0.0540 decline in financial deepening. As such, corporate sukuk instruments perform limited functions as financial intermediation tools to aid in the deepening of the finances. Moreover, in Indonesia, the corporate sukuk issuances are still limited to a few sectors and a shallow investor base, which indicates that lower volumes of intermediation in the financial system are correlated with lower volumes of issuances. Conversely, even in Malaysia, where the sukuk market is more mature, a recent study (Roslen et al., 2024) indicates that sukuk market development is predominantly driven by debt market sukuk financial underperformance, primarily driven by risk. Increased risk and subsequent withdrawal of investors are posited to drive the negative influence of sukuk on financial deepening.

Over time, the issuance of corporate sukuk in Indonesia and Malaysia has not significantly impact financial deepening. This is inferred from the Skew probability that is greater than the alpha at 0.05. This indicates that increased corporate sukuk financing does not encourage financial deepening. Although corporate sukuk issuance grows year on year, it suggests that sukuk are primarily used as medium to long-term financing as opposed to instruments that directly facilitate the deepening of the financial system. This is consistent with the conclusions Khan & Zahid (2020) that highlight the indirect and dependent contribution of sukuk to economic development on the institutional dimension and the integration of financial markets. It appears, therefore, that the corporate sukuk instruments, while providing an important sharia-compliant and ethically acceptable financing, remain a limited factor in financial deepening in the long term. This is because of the gap in liquidity, the concentration of the financial market, the lack of participation from retail investors and market fragmentation.

According to the main model, corporate sukuk negatively impacts Malaysia's financial deepening in the short term. The coefficient is -0.0331, implying that a 1% increase in corporate sukuk issuance is likely to reduce financial deepening by 0.0331%. Malaysia's sukuk market is more developed than Indonesia's, yet there is still a lack of liquid instruments and variety. Purchaser circulation does not lead to an increase in the financial system's depth during the short run. Market conditions can be illiquid when investors adopt a buy-and-hold mentality and let the sukuk mature. This is often the case in actively traded markets, where there is a yield hub, and sukuk are traded (Hanafi et al., 2018). If levels of illiquidity in the sukuk secondary market are coupled with a lack of sufficiently thin governing frameworks to support diversification, recent sukuk issues will not optimally enhance financial intermediation (Tan et al., 2021).

In other words, the impact of corporate sukuk on the financial deepening in Malaysia seems to be lagging, and in the short run, it negatively reflects the impact. Furthermore, corporate sukuk in the long

run seems not to significantly impact on financial deepening in Malaysia, because the probability value is $> \alpha = 0.05$, meaning any expansion of corporate sukuks will not impact on financial deepening. This is consistent with the findings of (Tan et al., 2021), which suggested that although sukuk in Malaysia has a positive impact, however, it remains insignificant in facilitating economic growth via the capital market integration.

Sharia Stocks on Financial Deepening

The short-run effect of Sharia-compliant stocks on financial deepening is positive and significant for both Indonesia and Malaysia. This is evidenced by a coefficient of 0.0004. So a rise of Sharia-compliant stocks will increase financial deepening by 0.0004. This is a sign that the Sharia-compliant stock market will encourage financial intermediation in the short run due to increased investor activities and transactions. This is consistent with Hamsah (2024) who documents that Sharia-compliant stocks positively and significantly affect economic growth. The reason for this is that the Sharia stock market is a relatively liquid market and gives investors quick access to several sectors to allocate their funds. The Sharia-compliant stock market is active with both retail and institutional investors. Investors increase the active and available funds for financial intermediation and intermediation.

Over time, sharia stocks are not expected to have a marked effect on financial deepening in Indonesia and Malaysia given that the relevant probability value exceeds $\alpha = 0.05$. This suggests that increases in sharia stocks have no bearing on financial deepening. According to Sahabuddin et al. (2023) in the context of developing countries, including Malaysia and Indonesia, sharia stocks are characterized by considerable volatility and a dynamic interrelation to a considerable degree with conventional stocks. Consequently, while within the short term the sharia stocks may have a beneficial impact, there are structural deficiencies such as the aforementioned volatility, a shallow market, a small number of potential investors, and a disparity in liquidity that preclude sharia stocks from contributing in the long term.

As with corporate sukuk, robustness tests indicate that, in both the short and long run, the sharia stocks variable has no substantial impact on financial deepening in Malaysia, as its p-value is above the 0.05 confidence level. The implication here is that the movement of Sharia stocks has failed to make any real contribution to the advancement of financial deepening. This agrees with (Musa et al., 2020) in that Sharia stocks do not exhibit a substantial direct impact on real economic variables. The development of sharia stocks is often hampered by a lack of both liquidity and investor participation, resulting in a negligible influence on financial development. Therefore, the conclusion that sharia stocks do not influence financial deepening, in both the short and long run, is a result of the sharia capital market's structural deficiencies, which are not yet operationally optimal.

TPF on Financial Deepening

In the short-term, Third-Party Funds negatively affects financial deepening, with a value of -0.016. This suggests that, during the current period, a 1-unit growth in TPF from the previous period will negatively affect financial deepening by 0.016. The reason for this condition is that the collected funds are not yet optimally directed toward the real sector through productive financing, and therefore, they do not yet expand financial access. In addition, the TPF characteristics of short-term deposits, including savings and time deposits, tend to function more as internal bank liquidity rather than as effective apparatuses for expanding the accessibility of financial services to the public.

Over an extended period, however, the variable Third Party Funds has an effect which is positive and statistically relevant, with a coefficient of 0.032. This implies that a 1unit increase in TPF contributes to a 0.032 increase in the level of financial deepening in Indonesia and Malaysia. This is consistent with (Gani & Bahari, 2021), where Third Party Funds positively impact real economic growth through financial intermediation. Hence, these results support the argument that TPF over the extended period is one of the basic instruments necessary for the positive adjustment of the sharia financial architecture, even though it contributes the least in the short run.

The outcomes of robustness checks concerning the impact of Third Party Funds (TPF) on financial deepening align with the primary model for all time horizons tested, that is, short-run and long-run. In the short run, the estimations indicate that TPF has a considerable and negative impact on financial deepening in Malaysia, which is exemplified by the lag 1 and lag 2 coefficients of -0.0337 and -0.0213,

respectively. Therefore, there is a decrease in the level of financial deepening in the current period, when there is an increase in TPF collection in the previous period. Gani and Bahari (2021) state that the increase in total Islamic bank deposits, which is measured by deposits, has a positive impact on real economic growth through financial intermediation. The difference in outcome may be a result of different periods of observation and the Malaysian macro dynamics, which can affect the TPF collection and the growth of the financial sector. In the long run, TPF has a positive and significant impact on financial deepening with a coefficient of 0.0498, meaning that an increase of 1 unit of TPF will increase 0.0498 of financial deepening in Malaysia. This finding is consistent with Gani and Bahari (2021). This consistency reassures the understanding that although the short-term effects of deposits are active and growing, they do not contribute a significant difference. Over time, the TPF is a key resource for Islamic banks to perform productive financing and ultimately improve the intermediation process and the financial system with its increased depth.

Total Assets on Financial Deepening

Assets total movement is relatively quick positive impact of 0.015. This indicates that every previous period increases in the total assets of Islamic banking, financial deepening will increase at 0.015. This demonstrates how the accumulation of assets expands the Islamic banking intermediation construction. This goes with the wire of Saleem et al. (2021) which states that the Islamic banking system's positive intermediation growth influences economic stability short run. Conceptually, the Islamic banks' asset volume determines the intermediation construction volume, and more inclusive financial services are equitable. This shows how accumulation of assets and/or construction intermediation serves as an instrument towards the deepening and or acceptance of financial system structure.

In the long run, the total assets' influence is negative and significant, with a coefficient of -0.021. In this case, it may be interpreted as, for every unit increase in total assets, it decreases financial deepening in Indonesia and Malaysia by 0.021. The gap between the short run and the long run reveals the difference in dynamics. In the long run, more accumulated assets indicate less financial deepening. This may suggest a gap between the size of the assets and the efficiency of channelling the funds to the real sector. An increase in assets that is not accompanied by effective intermediation aimed at productive economic growth may undermine the structural contribution of Islamic banking to financial deepening (Sholihah, 2022). Therefore, although assets and their respective growth have been proven to drive financial deepening in the short run, it is necessary to implement a higher-quality long-run strategy in asset management to ensure that the substantial growth of assets will positively impact the financial inclusion and stability of both countries.

Empirical results affirm the robustness of the inclusion of total assets in the short- and long-term assessments of financially deepening Malaysia. Short-run total assets positively affect financial deepening in Malaysia. This is substantiated by the first lag and second lag of total assets' coefficients of 0.0182 and 0.0196, respectively. An increment in the total assets of Islamic banking in the earlier period is set to spark a growth in financial deepening in the contemporaneous period. This corroborates (Aryanti & Wahyudi, 2022) as to the growth of Islamic banking assets, which ascertains internal and external relationships, whereby larger assets are indicative of more intermediation potential and contribution to financial deepening in the short term. Long-term total assets, in contrast, negatively and significantly, with a coefficient of -0.0367, produced long-run results. This means that a unit increase of total assets, deepening finances in Malaysia stagnates 0.0367. Findings illustrate that more of the total assets are resources and more of the controls are factors to finance deepening. Sahay et al., (2015) It has been indicated that despite Malaysia's financial depth index being twice as high as that of the emerging market average, Malaysia's financial institutions continue to lag in access provision. This illustrates the point that an increase in the size of a financial system does not correlate with increased access and inclusion within the system.

CONCLUSION

During the beginning period of the study, corporate sukuk adversely and considerably impacted the deepening of the financial markets in both Indonesia and Malaysia. This was due to the characteristics of corporate sukuk, which tend to be illiquid, medium-to-long-term investment assets. It seems that corporate sukuk investors use a "buy and hold" strategy as corporate sukuk's secondary market activity

appears to be negligible, thus hindering financial deepening in the short run. In the long run, corporate sukuk also lacks the ability to significantly impact financial deepening in the respective markets as the volume of corporate sukuk issued tend to be financing instruments, and not in the issue of financial intermediation, which deepens the financial sector. This was due to the corporate sukuk's illiquidity, segmented markets, and the presence of institutional investors. Sharia-compliant equity has a neutral impact in the long run as well since they are fundamentally volatile, has a narrow investor base, and are highly correlated with conventional equities. As a result, these factors preclude sharia-compliant equities from contributing to financial deepening.

The findings from this study show that Third Party Funds have an important negative impact on financial deepening in the short run. Liquidity Islamic banks hold tends to stay unused for productive financing in the longer run. TPF shifts to positive. This shows that the accumulation of public funds, which remains core Sharia financial intermediation in layered financing, deepens public funds accumulation for financial intermediation subsequently. In the short run, the total assets position positively and significantly, meaning that Islamic banking assets enhance the intermediation capacity and consolidation of financial services and stability of the financial system. In the long run, the total assets position is negative and significant, meaning that the growth of assets without proper channelling to the real sector shows a gap between asset growth and financial deepening.

The research findings strongly imply that Islamic banks must enhance the efficacy of their intermediation functions. This is crucial for successfully leveraging financial access across the broader economy, particularly in relation to Third Party Funds and total assets. Furthermore, stabilizing the Sharia stock market and promoting financial deepening necessitates building a robust Sharia investor ecosystem. Finally, to maximize the beneficial impact of Sharia instruments and ensure a greater contribution to the economy, policymakers must prioritize the integration of cross-sector Sharia finance policies. This comprehensive approach, addressing banking efficiency, market stability, and policy coherence, is essential for realizing the full potential of Islamic finance.

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