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Do Global Economic Policy Uncertainty and Geopolitical Risk Affect Islamic Financial Development? Evidence from Indonesia

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Abstract.
This study examines the impact of Global Economic Policy Uncertainty (GEPU) and Geopolitical Risk (GPR) on Islamic Financial Development (IFD) in Indonesia. Using quarterly time series data from 2015 to 2024, this research applies a quantitative approach through multiple linear regression analysis, incorporating inflation and exchange rate as control variables. The findings reveal that GEPU has a positive and statistically significant effect on Islamic financial development, indicating that increasing global uncertainty may stimulate the growth of Islamic finance as an alternative and relatively resilient financial system. In contrast, geopolitical risk shows a negative but statistically insignificant effect, suggesting that its impact on Islamic financial development in Indonesia remains limited. Additionally, inflation is found to have a positive and significant influence, while the exchange rate does not exhibit a significant effect. The model demonstrates strong explanatory power, although diagnostic results indicate the presence of autocorrelation. Overall, the study highlights that Islamic financial development in Indonesia is influenced by global uncertainty dynamics and exhibits adaptive characteristics in response to external shocks.

Keywords: Global Economic Policy Uncertainty, Geopolitical Risk, Islamic Financial Development, Inflation, Exchange Rate.

I. Introduction

The global economic landscape in the twenty first century has become increasingly characterized by heightened uncertainty and geopolitical instability, fundamentally reshaping the structure and performance of financial systems worldwide. Major global shocks such as the Global Financial Crisis, prolonged trade tensions among major economies, the Russia–Ukraine War, and recurring conflicts in the Middle East have significantly amplified global risk perceptions. These events have disrupted international trade, weakened investment confidence, and intensified volatility across financial markets. In such an environment, uncertainty is no longer a temporary disturbance but has evolved into a persistent structural feature of the global economy. Consequently, understanding how different forms of global uncertainty influence financial development has become not only academically relevant but also critically important for policymakers and financial practitioners.

Recent empirical studies provide strong evidence that global uncertainty significantly affects financial systems. Baker et al. (2015) show that economic policy uncertainty reduces investment and increases financial market volatility, thereby weakening financial development. More recent studies provide robust evidence that uncertainty shocks exert persistent and systemic impacts on both financial stability and overall economic performance Franz Ulrich Ruch (Mumtaz & Ruch, 2023). These shocks do not only generate short-term volatility but also create prolonged disruptions in financial markets by weakening credit supply, reducing asset prices, and increasing systemic risk (IMF, 2024). For instance, recent multi-country evidence shows that rising uncertainty significantly depresses credit availability, stock market performance, and economic activity across countries (Gomez-Gonzalez et al., 2024). Similarly, empirical findings indicate that economic policy uncertainty shocks negatively affect financial stability by reducing equity returns and altering key financial indicators such as exchange rates and interest rates (Orlowski, 2023a). Furthermore, studies focusing on emerging markets reveal that various forms of uncertainty including geopolitical and policy-related uncertainty can weaken bank stability and increase financial fragility over time (Wu et al., 2024 , Fang et al., 2025).

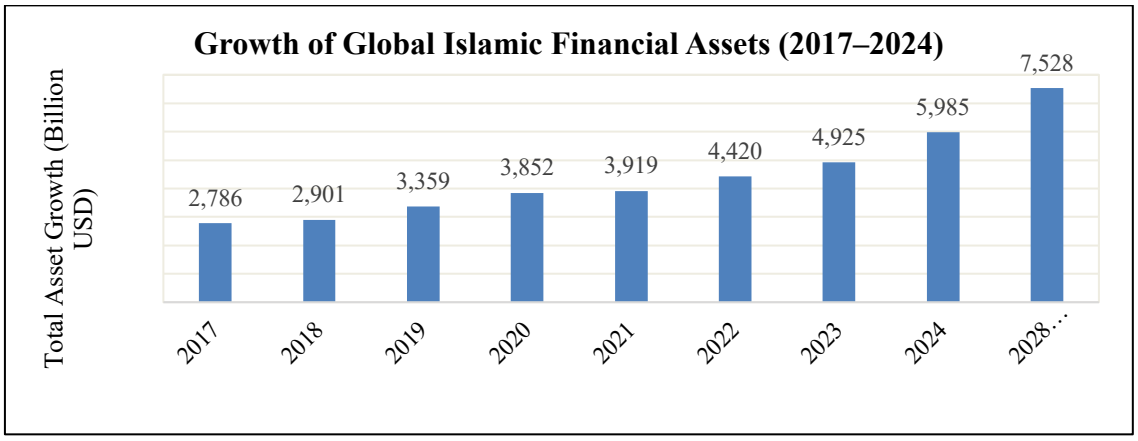
In parallel, geopolitical risk has emerged as a critical determinant of financial sector dynamics. Khraiche et al. (2023) demonstrate that geopolitical shocks significantly reduce asset prices and economic activity. More recent evidence indicates that geopolitical risk negatively affects financial development by weakening stock market development and increasing financial instability. Furthermore, geopolitical risk has been shown to significantly increase financial stress and interconnectedness within financial systems, particularly in emerging markets (Zhu et al., 2025).

Additional recent studies reinforce these findings. For instance, research published in 2024 shows that geopolitical risk and economic policy uncertainty jointly reduce bank stability in emerging economies, highlighting their systemic impact on financial sectors (Olalere & Mukuddem-Petersen, 2023). Similarly,

a 2026 study finds that geopolitical risk significantly influences investor behavior and reduces foreign investment in financial markets, further constraining financial development (Yahya et al., 2026).

Amid this increasingly uncertain global environment, the Islamic financial sector has demonstrated remarkable growth over the past two decades. According to the Islamic Financial Services Board and the Islamic Development Bank, global Islamic financial assets have exceeded USD 3 trillion, reflecting the expanding role of Sharia-compliant financial systems in the global economy (IFSB (2024). Islamic finance is distinguished by its core principles, including profit-and-loss sharing, prohibition of interest (riba), and asset-backed financing, which promote a closer linkage between financial activities and the real sector (M. U. Chapra, 2000). These characteristics suggest that Islamic financial systems may exhibit greater resilience to external shocks compared to conventional finance (Baik et al., 2023; Balvers et al., 2017).

In line with these characteristics, the development of the Islamic financial sector is also reflected in the significant growth of its assets in recent years. The figure 1 below illustrates the trend of global Islamic financial asset growth over the period 2017–2024, which shows a consistent upward trajectory. This indicates that Islamic finance is not only expanding structurally but is also gaining increasing trust within the global financial system.



Source: Processed by the author

However, despite its rapid growth, Islamic financial development remains exposed to global uncertainty and geopolitical risk, particularly in emerging economies. Indonesia, as the country with the largest Muslim population in the world, represents a significant case for examining this relationship. The development of Islamic finance in Indonesia covering Islamic banking, sukuk markets, and non-bank Islamic financial institutions has shown steady progress, supported by regulatory authorities such as *Otoritas Jasa Keuangan* and Bank Indonesia. Nevertheless, the share of Islamic finance within the national financial system remains relatively modest, indicating that the sector is still in a developing stage and potentially vulnerable to external disturbances.

The urgency of this study lies in the increasing exposure of Indonesia's financial system to global shocks (Baik et al., 2023; Balvers et al., 2017). As an open emerging economy, Indonesia is highly sensitive to fluctuations in global financial conditions, including uncertainty and geopolitical tensions (Rachman, 2024). These external factors can influence investment behavior, financial intermediation, and overall financial stability, which are essential components of financial development (Yang et al., 2026). At the same time, the unique characteristics of Islamic finance raise an important question as to whether it responds differently to global uncertainty compared to conventional financial systems (Prajasari, 2025).

Despite the growing literature on uncertainty and financial development, empirical studies focusing specifically on Islamic financial development remain limited (Li et al., 2026; Shahzad et al., 2017). understanding how Islamic finance responds to global economic policy uncertainty and geopolitical risk. Moreover, studies examining the combined effects of these two forms of uncertainty GEPU and GPR on Islamic financial development, particularly in the Indonesian context, are still scarce.

Therefore, this study aims to examine whether global economic policy uncertainty and geopolitical risk matter for Islamic financial development in Indonesia. By employing a time-series empirical approach, this research contributes to the literature in several important ways. First, it extends the analysis of global uncertainty to the relatively underexplored domain of Islamic finance. Second, it provides empirical evidence from Indonesia, offering insights into how an emerging Islamic financial system responds to

external shocks. inally, this study contributes to the broader discourse on financial development by assessing whether Islamic finance exhibits resilience or vulnerability in the face of global uncertainty.

II. Literature Review

2.1 Theoretical Framework

2.1.1 Islamic Financial Development

Financial development refers to the process of improving the size, efficiency, accessibility, and stability of financial institutions and financial markets. Within the framework of Financial Development Theory, financial development plays a pivotal role in promoting economic growth by mobilizing savings, facilitating efficient capital allocation, and enabling risk diversification across economic agents. A well-developed financial system enhances financial intermediation, reduces information asymmetry, lowers transaction costs, and supports productive investment, thereby contributing to overall economic performance (Levine, 2005).

Furthermore, financial development is commonly associated with several key dimensions, including financial depth, access to financial services, and financial stability. Improvements in these dimensions enable financial systems to perform their core functions more effectively, particularly in channeling funds from surplus units to deficit units and managing economic risks. Empirical studies confirm that financial development contributes significantly to economic growth and stability, especially in emerging economies (*Rethinking Financial Deepening : Stability and Growth in Emerging Markets*, 2015)

In the context of Islamic finance, financial development is characterized by adherence to Sharia principles, including the prohibition of interest (riba), the avoidance of excessive uncertainty (gharar), and the promotion of profit-and-loss sharing mechanisms. These principles foster a financial system that is closely linked to real economic activities and discourages speculative behavior. As a result, Islamic financial systems are often considered more stable and resilient compared to conventional financial systems, particularly during periods of financial distress (M. umer Chapra, 2008).

Empirical evidence supports this argument. For instance, Beck et al. (2013) find that Islamic banks exhibit relatively higher stability compared to conventional banks due to their lower leverage and risk-sharing characteristics. Similarly, more recent studies indicate that Islamic financial institutions tend to be less exposed to excessive risk-taking and financial bubbles, thereby contributing to systemic stability (Abedifar et al., 2015; Ibrahim & Rizvi, 2017).

Nevertheless, despite these distinctive features, Islamic financial development is not entirely insulated from macroeconomic fluctuations and global uncertainties. As part of the broader financial system, Islamic financial institutions remain exposed to external shocks, including changes in global economic conditions, financial crises, and uncertainty in economic policy. Recent studies highlight that even relatively resilient financial systems can be affected by external volatility, particularly in open and emerging economies (Li et al., 2026; Shahzad et al., 2017).

2.1.2 Global Economic Policy Uncertainty

Global Economic Policy Uncertainty (GEPU) refers to uncertainty arising from economic policy decisions, including fiscal, monetary, and regulatory policies that influence economic expectations and financial market behavior. The GEPU index, developed by (Baker et al., 2016), is widely used as a proxy for global uncertainty and is constructed based on the frequency of policy-related uncertainty in major newspapers.

Empirical evidence consistently shows that economic policy uncertainty negatively affects financial development. Chatterjee (2024) finds that uncertainty shocks significantly reduce investment and economic activity, while (Al-Yafei & Bennasr, 2025; Pereira, 2026) show that GEPU weakens financial intermediation and credit growth. More recent studies confirm that uncertainty increases financial volatility, reduces asset prices, and weakens financial stability, particularly in emerging markets (Ali et al., 2024; Molina-Muñoz & Soriano-Felipe, 2025)

However, some studies suggest that in certain contexts, particularly in developing economies, uncertainty may also encourage financial innovation and portfolio diversification as adaptive responses to a more volatile environment. Overall, the literature indicates that GEPU plays a significant role in shaping financial development, although its impact may vary depending on economic structure and institutional conditions.

2.1.3 Geopolitical Risk

Geopolitical Risk (GPR) refers to risks arising from geopolitical events such as wars, terrorism, and international political tensions that can disrupt global economic and financial stability. The GPR index,

developed by Matteo Iacoviello and Dario Caldara (2022), is widely used to quantify geopolitical tensions based on the frequency of related terms in international news sources. This index provides a forward-looking measure of geopolitical uncertainty and has become an important tool in empirical economic and financial research.

Geopolitical risk constitutes a key dimension of global uncertainty that can significantly influence financial systems. Theoretically, rising geopolitical tensions increase uncertainty, disrupt economic expectations, and weaken investor confidence. As a result, financial markets tend to experience higher volatility, increased risk premiums, and reduced capital flows. Empirical evidence from (Iddouch, 2026a; Rjaily et al., 2026) indicates that geopolitical risk shocks lead to declines in asset prices and economic activity, while simultaneously increasing financial stress and market instability. Furthermore, such shocks tend to reduce liquidity in financial markets and constrain credit availability, thereby weakening the overall development and efficiency of the financial system.

2.2 Research Framework and Hypothesis Development

2.2.1 Global Economic Policy Uncertainty and Islamic Financial Development

Global Economic Policy Uncertainty (GEPU) significantly affects financial development and investment behavior by increasing risk aversion and transaction costs, thereby inducing a “wait-and-see” strategy among investors. Recent studies confirm that higher uncertainty reduces investment activity and delays financial decisions due to increased policy risk and financial frictions (Akpilic, 2025). Moreover, GEPU has been shown to increase credit risk and weaken financial stability in emerging economies, further constraining financial deepening (Angela, 2026).

Empirical evidence further supports this relationship. Studies show that economic policy uncertainty reduces credit supply, weakens banking sector performance, and increases financial market volatility, thereby constraining financial development (Duan et al., 2022; Zhang & Zhang, 2023). In addition, cross-country evidence indicates that uncertainty shocks significantly increase systemic financial risk and market volatility, thereby amplifying financial fragility. Recent studies further confirm that economic policy uncertainty reduces stock market development, capital formation, and financial efficiency, particularly in emerging economies (Ullah et al., 2024). Overall, rising uncertainty tightens financial conditions and constrains financial development through credit contraction and increased risk aversion (Fang et al., 2024).

In the context of Islamic financial development, the impact of Global Economic Policy Uncertainty (GEPU) may differ due to the unique characteristics of Islamic finance. Operating under Sharia principles such as profit-and-loss sharing, prohibition of interest, and asset-backed financing, Islamic financial systems are closely linked to the real sector and tend to limit excessive risk-taking and speculative activities(M. umer Chapra, 2008; Beck et al., 2013).These features may enhance resilience during periods of uncertainty and increase demand for ethical and stable financial instruments.

However, Islamic financial systems remain integrated with global markets and are not fully immune to external shocks. Global uncertainty can still affect liquidity, investment flows, and financial intermediation. Empirical evidence suggests that uncertainty may increase systemic risk and constrain financial development even in relatively stable financial systems, particularly in emerging economies (Hassan, 2024).

Therefore, the relationship between GEPU and Islamic financial development is theoretically ambiguous. While uncertainty may hinder financial development, it may also create opportunities for alternative financial systems such as Islamic finance.

H1: Global Economic Policy Uncertainty affects Islamic Financial Development in Indonesia.

2.2.2 Geopolitical Risk and Islamic Financial Development

Geopolitical Risk (GPR) influences financial development primarily through its effects on global stability, capital flows, and investor sentiment. Rising geopolitical tensions increase uncertainty in financial markets, reduce foreign investment, and amplify financial volatility. The seminal work of Iddouch (2026b) and Yousfani et al. (2025) shows that geopolitical risk shocks significantly reduce asset prices and economic activity while increasing financial stress.

From a transmission perspective, geopolitical risk affects financial development through several channels, including capital outflows, higher risk premiums, and tighter financial conditions. These effects weaken financial intermediation, reduce credit availability, and slow financial deepening. Empirical evidence further confirms that geopolitical risk significantly increases financial market volatility and disrupts investment activity, particularly in globally integrated economies (Khraiche et al., 2023b).

In the context of Islamic financial development, geopolitical risk may exert a complex influence. On the one hand, Islamic finance characterized by profit-and-loss sharing, asset-backed financing, and ethical investment principles may provide a degree of resilience against external shocks. On the other hand, Islamic financial systems remain integrated with global financial markets and are therefore still vulnerable to disruptions in capital flows, liquidity constraints, and changing investor sentiment.

Recent empirical studies provide further support for this relationship. For instance, evidence indicates that geopolitical risk significantly weakens financial stability and increases systemic risk, particularly in emerging markets that are more sensitive to global shocks (e.g., recent empirical evidence from emerging economies) (Orlowski, 2023b).

In emerging economies such as Indonesia, the impact of geopolitical risk tends to be more pronounced due to structural vulnerabilities, including dependence on external capital and exposure to global financial conditions. Geopolitical shocks can trigger capital outflows, reduce investment inflows, and increase uncertainty in financial markets, thereby constraining the development of the financial sector, including Islamic finance. Therefore, based on the theoretical and empirical arguments, it is proposed that:
H2: Geopolitical Risk affects Islamic Financial Development in Indonesia.

III. Research Method

3.1 Data

This study employs a quantitative research design using time series data, which are particularly appropriate for analyzing the dynamic relationship between global uncertainty and Islamic financial development over time. Time series data consist of observations collected sequentially across equally spaced time intervals, allowing researchers to capture temporal dependencies, trends, and fluctuations in economic variables. According to Hamilton (2020) time series analysis is essential in empirical economics as it enables the examination of both short-run dynamics and long-run equilibrium relationships among variables.

The dataset used in this study consists of annual observations over a period of approximately ten years, depending on data availability. The relatively limited sample size makes time series techniques such as ARDL particularly suitable, as they are robust in small-sample contexts. The data used in this study are secondary data obtained from credible and publicly accessible international and national databases, ensuring reliability and consistency.

The variable of Global Economic Policy Uncertainty (GEPU) is sourced from the database developed by Scott Baker, Bloom, and Davis (2016), which measures uncertainty based on the frequency of policy-related terms in leading international newspapers. This index has been widely used in empirical studies as a proxy for global economic uncertainty and has strong validity in capturing forward-looking expectations of economic agents.

Geopolitical Risk (GPR) data are obtained from the index developed by Matteo Iacoviello and Dario Caldara (2022), which quantifies geopolitical tensions based on news coverage of events such as wars, terrorism, and international conflicts. This index has become a standard measure in recent empirical literature to capture geopolitical uncertainty and its economic implications. Empirical studies confirm that the GPR index effectively reflects geopolitical shocks and their impact on financial markets and macroeconomic conditions.

The dependent variable, Islamic Financial Development (IFD), is measured using indicators that reflect the growth and performance of the Islamic financial sector in Indonesia. These indicators include Islamic banking assets, total Islamic financing, or composite indices of Islamic financial development, depending on data availability. The data are collected from official and authoritative institutions such as the Islamic Financial Services Board, Bank Indonesia, and Otoritas Jasa Keuangan. These institutions provide reliable and standardized data on Islamic financial industry performance. Previous studies have widely used such indicators as valid proxies for measuring Islamic financial development (Beck et al., 2013; Abedifar et al., 2015).

In addition, this study incorporates macroeconomic control variables, namely inflation and exchange rate, to account for broader economic conditions that may influence Islamic financial development. Inflation data are used to capture price stability and purchasing power, while exchange rate data reflect the external value of the domestic currency and its exposure to global financial conditions. These variables are obtained from official sources such as Bank Indonesia and international databases like the World Bank. The inclusion of these control variables is important to isolate the effect of global uncertainty and to improve the robustness of the empirical model.

Table 1

Definitions and Sources of Variables

Variable	Type	Definition	Source
Islamic Financial Development (IFD)	Dependent	Represents the level of development of the Islamic financial sector in Indonesia	Islamic Financial Services Board
Global Economic Policy Uncertainty (GEPU)	Independent	Measures uncertainty arising from global economic policy decisions	https://www.policyuncertainty.com
Geopolitical Risk (GPR)	Independent	Captures risks related to geopolitical events such as wars, terrorism, and conflicts	https://www.matteoiacoviello.com/gpr
Inflation (INF)	Control	Consumer Price Index (CPI) or annual inflation rate (%)	World Bank
Exchange Rate (EXC)	Control	Represents the value of domestic currency against foreign currency in USD	World Bank

Source: Author's calculations
Note: Data collected from 2015 to 2024

3.2 Variable Specifications

This study employs one dependent variable, two main independent variables, and additional control variables to examine the relationship between global uncertainty and Islamic financial development in Indonesia. The dependent variable is Islamic Financial Development (IFD), which represents the level of development of the Islamic financial sector. This variable is proxied by indicators such as Islamic banking assets, total Islamic financing, or composite measures of Islamic financial development, depending on data availability. These indicators are widely used in empirical studies as reliable measures of Islamic financial sector performance.

The main independent variables consist of Global Economic Policy Uncertainty (GEPU) and Geopolitical Risk (GPR). GEPU captures uncertainty arising from global economic policy decisions and is measured using the index developed by Scott Baker et al. (2016), which reflects the frequency of policy-related uncertainty in international news. This index has been widely used to explain fluctuations in financial markets and macroeconomic conditions. Meanwhile, GPR measures geopolitical tensions such as wars, terrorism, and international conflicts, and is proxied by the index developed by Matteo Iacoviello and Dario Caldara (2022). Both variables are widely recognized as key indicators of global uncertainty affecting financial systems.

In addition to the main explanatory variables, this study incorporates control variables, namely inflation and exchange rate, to account for macroeconomic conditions that may influence Islamic financial development. Inflation reflects the general price level in the economy and is commonly associated with financial stability and purchasing power. High inflation can reduce real returns, increase uncertainty, and negatively affect financial sector development (Fischer, 1993). The exchange rate represents the value of the domestic currency against foreign currencies and plays a crucial role in influencing capital flows, trade performance, and financial market stability. Exchange rate volatility, in particular, can affect investment decisions and financial intermediation (Levy-Yeyati & Sturzenegger, 2003). These variables are widely used as control variables in studies of financial development to isolate the effects of macroeconomic fluctuations.

Importantly, although the original data are available in annual form, this study transforms the dataset into quarterly frequency to increase the number of observations and improve the robustness of the econometric analysis. The use of higher-frequency data allows for better identification of short-run

dynamics and more precise estimation of relationships among variables. According to James D. Hamilton (1994), higher-frequency time series data provide richer information about economic fluctuations and improve model estimation. Similarly, William H. Greene (2018) suggests that increasing the number of observations enhances the statistical power of econometric tests, particularly in small-sample studies.

In addition, the use of quarterly data is common in empirical research on financial development and uncertainty, as it allows researchers to capture more detailed movements in financial variables and better reflect short-term adjustments (Ghysels et al., 2007). Therefore, the transformation from annual to quarterly data is justified as it enhances both analytical depth and estimation accuracy.

3.3 Model Specification and Methodology

To examine the impact of global uncertainty on Islamic financial development, this study employs a time series econometric approach. The baseline model is specified as follows:

$$IFD_t = \alpha + \beta_1 GEPU_t + \beta_2 GPR_t + \varepsilon_t$$

Given the time series nature of the data spanning ten years and transformed into quarterly observations to increase the number of data points this study applies the Autoregressive Distributed Lag (ARDL) approach as the main estimation technique. The ARDL model, introduced by M. Hashem Pesaran et al. (2001), is particularly suitable for small sample sizes and can be used regardless of whether the variables are integrated of order I(0) or I(1), provided none of them are integrated of order I(2). This flexibility makes ARDL highly appropriate for the present study, where the number of observations is relatively limited.

The ARDL approach enables the estimation of both short-run dynamics and long-run relationships within a single reduced-form equation. To ensure the validity of the model, the analysis begins with unit root testing using the Augmented Dickey-Fuller (ADF) and Phillips-Perron (PP) tests to determine the stationarity properties of each variable. Establishing the order of integration is essential to avoid spurious regression results and to justify the use of the ARDL bounds testing procedure.

Following the stationarity analysis, the bounds testing approach is employed to examine the existence of a long-run equilibrium relationship among the variables. If cointegration is confirmed, the ARDL model is further estimated to derive both long-run coefficients and short-run dynamics. The short-run adjustments are captured through differenced variables, while the long-run relationship is obtained from the level variables. Additionally, an error correction term (ECT) is included to measure the speed at which deviations from the long-run equilibrium are corrected over time.

To ensure the robustness and reliability of the estimated model, several diagnostic tests are conducted. These include tests for autocorrelation, heteroskedasticity, and normality of residuals, as well as stability tests using CUSUM and CUSUMSQ procedures. These diagnostic checks are essential to confirm that the model satisfies classical assumptions and produces consistent and unbiased estimates.

Overall, the ARDL methodology, combined with quarterly time series data, provides a comprehensive framework for capturing both the short-term adjustments and long-term equilibrium relationships between research problem.

IV. Results and Discussion

This section presents the empirical results and discusses the findings of the study. The analysis focuses on examining the impact of global economic policy uncertainty and geopolitical risk on Islamic financial development in Indonesia. The estimation results obtained from the econometric model are presented in the following tables and are discussed in relation to the theoretical framework and previous empirical studies.

Table 2
Descriptive Statistic Variables

Variable	Mean	Std. Dev	Min	P25	Median	P75	Max	Obs
EPU	2292710	1220986	1106677	1766879	2120495	2460340	9219547	40
GR	3220219	3363009	1026648	1133780	1301630	4357823	9793706	40
IFD	2152941	1379583	1297875	1701626	1926141	1952992	9926250	40
Inflasi	3768035	1574922	1224809	2927400	3545073	4387944	6821361	40

Exchange Rate	1392330	96734	1094248	1332226	1418459	1459119	1534819	40

Source: Author's Calculations

The descriptive statistics indicate that each variable exhibits distinct characteristics in terms of central tendency and variability. Economic Policy Uncertainty (EPU) has a mean value of 2,292,710 with a standard deviation of 1,220,986, and ranges from 1,106,677 to 9,219,547, suggesting substantial fluctuations and occasional extreme spikes over the observation period. Similarly, Geopolitical Risk (GR) shows an even higher mean of 3,220,219 and a large standard deviation of 3,363,009, with a maximum value of 9,793,706, indicating that it is the most volatile variable in the dataset. In contrast, Islamic Financial Development (IFD) has a mean of 2,152,941 and a standard deviation of 1,379,583, with a median of 1,926,141, reflecting a relatively stable and consistent growth pattern. Inflation records a mean of 3,768,035 and a standard deviation of 1,574,922, with values ranging from 1,224,809 to 6,821,361, indicating moderate fluctuations in price levels. Meanwhile, the exchange rate demonstrates the lowest variability, with a mean of 1,392,330 and a standard deviation of only 96,734, ranging from 1,094,248 to 1,534,819, suggesting a relatively stable movement over time. Overall, global variables such as EPU and GR exhibit significantly higher volatility, while domestic variables particularly the exchange rate tend to be more stable, and IFD shows a relatively consistent development trend.

Table 3.
Results of Multiple Linear Regression Analysis

Variable	Coefficient	Std. Error	t-Statistic	Prob
C	-4039963	2158067	-1,87203	0,0696
X4	2,179832	1,345224	1,620423	0,1141
X3	0,238874	0,080151	2,98032	0,0052
X2	-0,04424	0,029458	-1,50164	0,1422
X1	1,046892	0,086839	12,0555	0.0000

Source: Author's Calculations

The results of the multiple linear regression analysis provide important insights into the relationship between global uncertainty and Islamic financial development in Indonesia. The findings show that Global Economic Policy Uncertainty (GEPU) has a positive and statistically significant effect on Islamic financial development, with a coefficient of 1.046892 and a p-value of 0.0000. This indicates that a one-unit increase in GEPU is associated with an increase of approximately 1.046892 units in Islamic financial development, holding other variables constant. This result suggests that increasing global uncertainty does not necessarily hinder financial development; instead, it may stimulate the growth of Islamic finance. This finding can be explained within the framework of Financial Development Theory, which emphasizes the adaptive role of financial systems in responding to changing economic conditions. Furthermore, it aligns with the argument that Islamic finance characterized by profit-and-loss sharing and asset-backed financing is relatively more resilient to uncertainty (Chapra, 2008; Thorsten Beck et al., 2013). In periods of heightened uncertainty, investors may shift toward alternative financial instruments perceived as more stable and less speculative, thereby increasing demand for Islamic financial products. This finding is also consistent with studies such as Nicholas Bloom (2009) and Nguyen (2022), which suggest that uncertainty can, under certain conditions, encourage financial adaptation and diversification.

In contrast, Geopolitical Risk (GPR) exhibits a negative coefficient of -0.04424, but the effect is statistically insignificant with a p-value of 0.1422. This indicates that although an increase in geopolitical risk tends to reduce Islamic financial development, the effect is not strong enough to be statistically meaningful in the Indonesian context. The negative sign is consistent with theoretical expectations, as rising geopolitical tensions typically increase uncertainty, disrupt capital flows, and weaken investor confidence. However, the lack of statistical significance suggests that the transmission of geopolitical shocks to

Indonesia's Islamic financial sector is relatively limited. From the perspective of New Institutional Economics, strong domestic institutions and regulatory frameworks may mitigate the impact of external shocks, thereby reducing the observable influence of geopolitical risk. This finding is consistent with empirical evidence showing that the effects of geopolitical risk are often heterogeneous across countries, particularly in emerging economies.

Furthermore, inflation is found to have a positive and statistically significant effect, with a coefficient of 0.238874 and a p-value of 0.0052. This suggests that a one-unit increase in inflation leads to an increase of approximately 0.238874 units in Islamic financial development. This result indicates that moderate inflation may be associated with increased financial activity, particularly in terms of nominal asset growth and financing expansion. In the context of Islamic finance, this may reflect increased demand for asset-backed financing and real-sector-linked financial products during periods of rising prices. This finding is in line with previous literature, such as Fischer (1993), which suggests that inflation can support financial deepening under certain macroeconomic conditions.

On the other hand, the exchange rate shows a positive coefficient of 2.179832, but the effect is not statistically significant, as indicated by a p-value of 0.1141. This implies that although exchange rate movements tend to positively influence Islamic financial development, the relationship is not statistically strong. Theoretically, exchange rate fluctuations can affect financial markets through capital flows and external competitiveness. However, the insignificant result suggests that the Islamic financial sector in Indonesia is relatively less sensitive to exchange rate movements, possibly due to its stronger linkage to domestic economic activities and lower exposure to international financial markets.

Overall, these findings highlight that global uncertainty, particularly in the form of economic policy uncertainty, plays a significant and positive role in shaping Islamic financial development in Indonesia, while geopolitical risk appears to have a negative but insignificant effect. The results also indicate that inflation contributes positively to financial development, whereas the exchange rate does not exert a statistically significant influence. These outcomes reinforce the view that Islamic finance possesses adaptive and potentially resilient characteristics in the face of global uncertainty, although its response varies depending on the type of external shock and domestic economic conditions.

Table 3.
Result Model Summary

Model Summary	
R-squared	0,820403
Adjusted R-squared	0,799877
F-statistic	39,97007
Prob(F-statistic)	0
Durbin-Watson	0,360575

Source: Author's Calculations

The goodness-of-fit of the model is reflected by the R-squared value of 0.820403, indicating that approximately 82.04% of the variation in Islamic Financial Development (IFD) can be explained by the independent variables included in the model, namely Global Economic Policy Uncertainty (GEPU), Geopolitical Risk (GPR), inflation, and exchange rate. This suggests that the model has a strong explanatory power. The Adjusted R-squared value of 0.799877 further confirms this result, indicating that after adjusting for the number of predictors, approximately 79.99% of the variation in IFD is still explained by the model. The relatively small difference between R-squared and Adjusted R-squared suggests that the model does not suffer from overfitting and that the included variables are relevant in explaining the dependent variable.

The overall significance of the model is supported by the F-statistic value of 39.97007 with a probability value of 0.0000, which is well below the conventional significance level of 5%. This indicates

that the independent variables jointly have a statistically significant effect on Islamic financial development. In other words, the model as a whole is valid and suitable for explaining the relationship between global uncertainty and Islamic financial development in Indonesia.

However, the Durbin-Watson statistic of 0.360575 indicates the presence of serious positive autocorrelation in the residuals. This value is substantially below the benchmark value of 2, suggesting that the error terms are correlated over time. In the context of time series analysis, this violates one of the classical assumptions of the regression model and may lead to inefficient estimates and biased standard errors. This issue is particularly important because autocorrelation can weaken the reliability of hypothesis testing.

From an econometric perspective, the presence of autocorrelation suggests that the model may require further refinement. This can be addressed by applying more appropriate time series techniques, such as the Autoregressive Distributed Lag (ARDL) model, including lagged variables, or using corrective methods such as the Cochrane-Orcutt procedure or Newey-West standard errors. Addressing this issue is crucial to ensure that the estimated results are robust and reliable.

Overall, while the model demonstrates strong explanatory power and statistical significance, the presence of autocorrelation indicates that caution is needed in interpreting the results, and further econometric adjustments are recommended to improve model validity.

V. Conclusion

The findings of this study provide empirical evidence on the relationship between global uncertainty factors namely Global Economic Policy Uncertainty (GEPU) and Global Geopolitical Risk and Islamic Financial Development in Indonesia. The results indicate that both GEPU and geopolitical risk exert a statistically significant influence on the development of Islamic finance, reinforcing the argument that Islamic financial systems are not insulated from global macroeconomic and geopolitical shocks. This aligns with prior studies by Caldara and Iacoviello (2018) on geopolitical risk transmission and Baker et al. (2016) on economic policy uncertainty, which collectively emphasize that heightened uncertainty tends to alter investment behavior, risk perception, and financial intermediation efficiency.

In the context of Islamic finance, these findings extend the existing literature by demonstrating that even a Sharia-compliant financial system often theoretically associated with risk-sharing principles and real-sector linkage is still sensitive to external uncertainty shocks. This is consistent with previous research on Islamic financial stability (e.g., Hassan and Dridi, 2011; Beck et al., 2013), which suggests that while Islamic financial institutions may exhibit greater resilience in certain crisis conditions, they are not completely decoupled from global financial and political dynamics. In the Indonesian case, the 10-year time series analysis confirms that global uncertainty variables play a measurable role in shaping the trajectory of Islamic financial development.

The novelty of this research lies in its integrated empirical framework that combines GEPU and Global Geopolitical Risk within a single model to explain Islamic Financial Development in Indonesia. While previous studies have predominantly focused on conventional financial systems or used single uncertainty indicators, this study advances the literature by jointly examining macroeconomic policy uncertainty and geopolitical tensions as external drivers within the Islamic finance context. Furthermore, the study contributes a country-specific perspective by focusing on Indonesia as the largest Islamic financial market in Southeast Asia, thereby enriching the limited empirical evidence on emerging Islamic financial systems.

From a theoretical standpoint, the findings reinforce and extend New Institutional Economics (NIE), particularly the argument that external uncertainty operates as an informal institutional force that shapes economic behavior through expectations, transaction costs, and investment risk assessment. The results suggest that institutional quality in the broader global environment reflected through uncertainty and geopolitical stability matters for the development of Islamic finance, complementing traditional domestic institutional explanations. In addition, the study supports financial development theory by showing that financial system growth is not only driven by domestic policy and institutional quality but is also significantly influenced by global risk transmission channels.

The implications of these findings are important for policymakers and financial regulators in Indonesia. First, strengthening domestic Islamic financial institutions alone is insufficient without considering external vulnerability to global uncertainty. Second, policymakers should enhance macroprudential frameworks and risk mitigation strategies that are responsive to global economic and geopolitical shocks. Finally, the development of Islamic finance should be integrated into a broader national

economic resilience strategy, particularly in managing external volatility. Overall, this study confirms that Islamic financial development in Indonesia is dynamically interconnected with global uncertainty dynamics, while also contributing new empirical and theoretical insights to the existing body of literature.

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