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The Effect of Inflation, Islamic Bank Financing, and Unemployment on Economic Growth

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Abstract. This study aims to investigate the short-run and long-run relationships among inflation, Islamic bank financing, the open unemployment rate, and economic growth in Medan City from 2016 to 2025. Employing a quantitative approach with 40 quarterly secondary time-series observations, the analysis was conducted using the Vector Error Correction Model (VECM). The empirical results reveal that in the long run, inflation exerts a statistically significant negative impact on economic growth, whereas Islamic bank financing and the unemployment rate show no significant long-term effects. In the short run, however, inflation positively stimulates economic growth. Furthermore, the error correction mechanism demonstrates a robust adjustment rate of 45.11% per quarter toward long-run equilibrium. Granger causality tests indicate a unidirectional causality running from economic growth to the unemployment rate, and from inflation to Islamic bank financing. These findings suggest that maintaining inflation stability is crucial for fostering sustainable regional economic growth in Medan City, while the contribution of the Islamic banking sector to regional output remains to be optimized.

Keywords: Economic Growth, Inflation, Islamic Bank Financing, Unemployment, VECM.

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INTRODUCTION

Economic growth is one of the primary macroeconomic indicators used to assess the success of regional development because it reflects improvements in production capacity, income levels, and public welfare in a sustainable manner. In recent years, the Indonesian economy has demonstrated a relatively stable recovery following the COVID-19 pandemic despite facing numerous global challenges, including inflationary pressures, geopolitical uncertainty, and fluctuations in international financial markets. These conditions require every region to strengthen its economic resilience by maintaining price stability, encouraging investment, improving financial intermediation, and creating employment opportunities. As the capital city of North Sumatra Province, Medan plays a strategic role as the center of trade, industry, services, and finance, contributing the largest share to the province's Gross Regional Domestic Product (GRDP). Nevertheless, the increase in economic growth has not always been accompanied by stable inflation, optimal Islamic bank financing, or a significant decline in unemployment. Therefore, examining the influence of inflation, Islamic bank financing, and unemployment on economic growth is essential to provide a comprehensive understanding of the macroeconomic factors affecting regional development from the perspective of Islamic economics, which emphasizes justice, balance, and public welfare (*maslahah*) (Muttaqin, 2018; Sari et al., 2021; Julianda, 2024).

Empirical evidence indicates that inflation, Islamic bank financing, and unemployment are closely related macroeconomic variables that influence regional economic growth. Controlled inflation can stimulate production and investment activities, whereas excessive inflation reduces purchasing power, increases production costs, and ultimately slows economic growth (Ardiansyah, 2017). Meanwhile, Islamic banks perform an important financial intermediation function by channeling funds to productive sectors through profit-sharing contracts, thereby promoting investment, business expansion, employment creation, and sustainable economic development (Nurnasrina & Putra, 2018; Andrianto & Firmansyah, 2019). In contrast, a high unemployment rate reflects the underutilization of human resources, resulting in lower productivity and reduced household income, which ultimately weakens regional economic performance (Imsar, 2016; Rosyid & Athoillah, 2024). The development of these macroeconomic indicators in Medan City is presented in Table 1.

Table 1. Economic Growth, Inflation, Islamic Bank Financing, and Unemployment in Medan City, 2021–2025

Year	Economic Growth (Billion IDR)	Inflation (%)	Islamic Bank Financing (Billion IDR)	Unemployment (%)
2021	157,689.37	1.71	10,706	10.81
2022	165,120.01	1.54	11,963	8.89
2023	173,445.69	2.19	13,018	8.67
2024	182,242.59	0.80	14,747	8.13
2025	191,540.51	4.36	15,285	7.99

Source: Statistics Indonesia (BPS) of Medan City (2025) and Financial Services Authority (OJK) (2025).

Based on Table 1, Medan City's economic growth increased consistently from IDR 157,689.37 billion in 2021 to IDR 191,540.51 billion in 2025. During the same period, Islamic bank financing also rose significantly from IDR 10,706 billion to IDR 15,285 billion, while the unemployment rate declined from 10.81% to 7.99%. However, inflation exhibited a fluctuating pattern, reaching its lowest level of 0.80% in 2024 before increasing to 4.36% in 2025. These findings indicate that economic growth is not determined by a single macroeconomic indicator but rather by the interaction of several economic variables. The simultaneous movement of inflation, Islamic bank financing, and unemployment suggests a complex relationship that requires further investigation using a dynamic econometric approach capable of capturing both short-run and long-run interactions among variables.

Despite the growing body of literature examining the determinants of economic growth, several research gaps remain unresolved. First, previous studies have reported inconsistent findings regarding the effects of inflation, Islamic bank financing, and unemployment on economic

growth. Sari et al. (2019) and Hidayatullah et al. (2023) concluded that inflation, unemployment, and Islamic banking financing significantly influence Indonesia's economic growth. In contrast, Siregar (2023) argued that Islamic bank financing alone is insufficient to stimulate economic growth without adequate support from real sector investment. Similarly, Hasibuan (2024) found that inflation and unemployment exert a dominant influence on national economic growth, whereas Handayani (2024) reported that local economic growth in Medan is more strongly affected by Regional Original Revenue (PAD) and poverty than by inflation. Furthermore, most previous studies relied on annual data and conventional regression techniques, limiting their ability to capture dynamic interactions and long-run equilibrium relationships among macroeconomic variables. Consequently, the short-run adjustment mechanism and long-run causal relationships between inflation, Islamic bank financing, unemployment, and economic growth remain insufficiently explored, particularly at the regional level. These inconsistencies highlight the need for further empirical investigation using a dynamic econometric approach and more recent time-series data to provide robust evidence on the determinants of regional economic growth.

Based on these research gaps, this study offers a significant contribution by integrating inflation, Islamic bank financing, and unemployment into a single dynamic framework using the Vector Error Correction Model (VECM) with quarterly data from 2016–2025 in Medan City. Unlike previous studies, this approach simultaneously examines short-run dynamics, long-run equilibrium, Granger causality, impulse response functions, and variance decomposition, providing a more comprehensive analysis of regional macroeconomic performance. The findings enrich the Islamic economics literature by offering empirical evidence on the role of Islamic bank financing in regional economic growth while providing practical insights for the Government of Medan City to strengthen inflation control through the Regional Inflation Control Team (TPID), enhance employment policies, and encourage the allocation of Islamic bank financing toward productive sectors. Accordingly, this study aims to analyze the short-run and long-run effects of inflation, Islamic bank financing, and unemployment on economic growth in Medan City and to formulate policy recommendations that support sustainable regional economic development from the perspective of Islamic economics.

LITERATURE REVIEW

Economic Growth

Economic growth represents a continuous transformation in a nation's economic conditions toward an improved state over a specific timeframe. It fundamentally reflects an expansion in an economy's overall productive capacity, which manifests through sustained increases in national income (Yunianto, 2021). Simon Kuznets conceptualizes economic growth as a country's evolving ability to supply an increasingly diverse array of economic goods to its population, driven by technological advancements alongside necessary institutional and ideological adaptations (Rappanna & Sukarno, 2017). Consequently, steady economic expansion serves as a primary benchmark for evaluating the broader success of national economic development.

In Indonesia, Gross Domestic Product (GDP)—or Gross Regional Domestic Product (GRDP) at the regional level—is the standard metric for tracking economic growth (R. Nasution & Marliyah, 2023). Statistics Indonesia (BPS) calculates GDP through two primary approaches: current prices and constant prices. Current prices illustrate structural economic shifts and sector composition, whereas constant prices isolate real volume growth from price fluctuations, enabling accurate year-over-year growth comparisons (Badan Pusat Statistik, 2025).

The underlying trajectory of economic expansion is primarily driven by factor inputs, meaning that fluctuations in growth rates directly mirror changes within these underlying factors (Nurwahida et al., 2022). These determinants encompass both economic and non-economic dimensions:

- **Economic Factors:** Natural resource endowments, capital accumulation, organizational capacity, technological progress, division of labor, and economies of scale.
- **Non-Economic Factors:** Social capital, human resource quality, political stability, and administrative governance (Ma'ruf & Wihastuti, 2008).

From an Islamic economic perspective, economic growth (*al-numuww al-iqtishadi*) adopts a holistic orientation, asserting that material output expansion must systematically generate public interest (*maslahah*) and foster genuine well-being (*falah*) (Muttaqin, 2018). Theoretically, regional economic performance is shaped by price stability, capital accessibility, and efficient labor utilization. Ibn Khaldun's doctrine on wealth circulation emphasizes that price stability is indispensable for maintaining productive incentives in the real sector. Regarding capital, M. Nejatullah Siddiqi notes that Islamic bank financing provides non-usurious capital injections that stimulate business expansion (Permatasari, 2021). Furthermore, drawing from Imam Al-Ghazali's works, the labor force stands as a core pillar that must be productively absorbed; thus, diminishing unemployment directly reflects the efficient allocation of human labor in driving regional output (Rosyid & Athoillah, 2024).

Inflation

Inflation is defined as a sustained, general increase in the price levels of goods and services within an economy over a given period (Sari et al., 2021). In the short term, anticipated price increases can prompt consumers and enterprises to accelerate purchases prior to further escalation, temporarily spurring broader economic activity (Ardiansyah, 2017).

Theoretical perspectives on inflation have evolved significantly across economic literature. Post-WWII frameworks frequently defined inflation through price tendencies—specifically, an overarching upward movement in price levels over time, even if temporary price reductions occur in specific intervals (Santosa, 2017).

Classical Islamic monetary systems did not experience systemic inflation due to their reliance on intrinsic gold (dinar) and silver (dirham) standards. Shaykh An-Nabhani noted that Islamic prohibitions against wealth hoarding were specifically directed toward gold and silver because of their foundational role as stable monetary assets (Sembiring, 2025). Modern Islamic economic theory classifies inflation into two main categories:

1. **Natural Inflation:** Driven by supply shocks, environmental disruptions, or natural disasters.
2. **Human Error Inflation:** Caused by human misconduct, such as corruption, market distortion, and hoarding.

Addressing regional development, Al-Maqrizi stressed that human-driven inflation undermines economic foundations by unfairly eroding real purchasing power. Therefore, price stability is critical to ensuring that real-sector wealth circulation remains fluid, supporting sustainable and equitable regional output growth (GRDP) (Khairani et al., 2024).

Bank Indonesia aligns with international best practices by measuring inflation through three primary metrics:

- **Wholesale Price Index (WPI / IHPB):** Tracks transaction prices of commodities traded in large volumes between primary wholesalers and subsequent bulk buyers in primary markets.
- **Gross Domestic Product (GDP) Deflator:** Reflects the aggregate price level of all final goods and services produced domestically, derived by dividing nominal GDP (current prices) by real GDP (constant prices).
- **Consumer Price Index (CPI / IHK):** Measures the average price change over time for a fixed basket of consumer goods and services purchased by typical households (Yolanda & Sipayung, 2024).

Islamic Bank Financing

In a broad financial context, financing refers to the allocation of funds to support planned investments, managed either directly or through third parties (Nurnasrina & Putra, 2018). In banking terms, it describes the capital extended by financial institutions such as Islamic banks to fulfill client requirements (Hasanah et al., 2023). M. Syafi'i Antonio highlights that issuing financing facilities is a core banking duty designed to bridge funding gaps for deficit units in the economy (Permatasari, 2021).

Under Article 25 of Indonesian Law No. 21 of 2008 concerning Sharia Banking, financing is defined as the provision of funds or equivalent claims through:

- **Profit-and-loss sharing contracts:** *Mudharabah* and *Musyarakah*.
- **Leasing contracts:** *Ijarah* and *Ijarah Muntahiya bit Tamlik*.
- **Trade sale-and-purchase contracts:** *Murabahah*, *Salam*, and *Istishna*.
- **Loan facilities:** *Qardh*.
- **Service-based agreements:** *Ijarah* (Andrianto & Firmansyah, 2019).

The foundational Sharia principles governing financing originate in the Holy Qur'an:

"O you who have believed, do not consume usury, doubled and multiplied, but fear Allah that you may be successful." (QS. Ali 'Imran [3]: 130).

يَا أَيُّهَا الَّذِينَ آمَنُوا لَا تَأْكُلُوا الرِّبَا أَضْعَافًا مُّضَاعَفَةً وَاتَّقُوا اللَّهَ لَعَلَّكُمْ تُفْلِحُونَ

This verse strictly prohibits usury (*riba*). In Islamic jurisprudence, *riba* signifies an unlawful, unearned increase extracted over the principal capital, leading to economic exploitation. Islamic scholars unanimously deem *riba* a major sin across all legal schools, as primary Islamic texts explicitly forbid it (Kementerian Agama RI, 2019b).

Islamic banking represents a vital, rapidly developing sector within Indonesia's financial landscape (Hamidah et al., 2024). However, this rapid growth entails exposure to market risks that require vigilant management (Hidayah et al., 2024). The distinction between Islamic and conventional banking extends beyond terminology, altering security structures and risk-sharing practices for depositors. Indonesian Islamic banks provide diverse financing options tailored for both commercial and personal needs (Shapura et al., 2024), relying primarily on *Murabahah* contracts, followed by *Mudharabah* and *Musyarakah*, alongside *Salam* for manufactured goods orders (Afrida, 2016).

Theoretically, these structures stem from the Islamic Financial Intermediation Theory pioneered by M. Nejatullah Siddiqi, which asserts that Islamic banks function as intermediaries directing capital into real-sector investments via non-interest partnership schemes. From a regional growth standpoint, expanding Islamic financing boosts capital formation (*capital accumulation*) for Micro, Small, and Medium Enterprises (MSMEs). This liquidity injection accelerates real-sector wealth velocity (*jaryan al-amwal*) and systematically expands regional production capacity, raising Regional Gross Domestic Product (GRDP) (Muttaqin, 2018; Siregar, 2023).

Unemployment

Unemployment stands as a central macroeconomic issue, reflecting the labor market's inability to absorb the active workforce at prevailing wage levels (Abdullah et al., 2024). Statistics Indonesia (BPS) defines the unemployed as working-age individuals who are currently without work but actively searching for jobs, preparing a new business venture, or waiting to start a confirmed job position.

Within an Islamic economic framework, labor dynamics and unemployment (*al-batalah*) are analyzed through Imam Al-Ghazali's philosophy regarding public benefit (*maslahah*) and the duty of productive work (*al-kasb*). Al-Ghazali asserts that working serves as both a form of worship (*ibadah*) and a vital means for fulfilling human necessities to preserve the higher objectives of Islamic law (*Maqashid Asy-Syariah*—specifically protecting wealth, life, and intellect).

Human labor represents a foundational factor of production; consequently, high open unemployment reflects an underutilization of productive human resources that hampers overall economic output (Imsar, 2016). In line with Okun's Law, growth in regional economic output (GRDP) encourages business sectors to expand operational capacity, which systematically drives job creation and absorbs unemployment to achieve true societal welfare (*falah*) (Malasyi et al., 2024).

Economic literature categorizes unemployment based on its underlying causes:

- **Frictional Unemployment:** Arises from temporary information gaps or transitional lags as workers move between jobs. It represents a natural process as individuals seek positions better suited to their skills.
- **Structural Unemployment:** Results from fundamental shifts in economic structure or technological shifts that render existing skills obsolete, reflecting a mismatch between workforce capabilities and evolving industry requirements.
- **Cyclical Unemployment:** Stems from downturns in aggregate economic activity. Declining consumer demand reduces overall production requirements, compelling firms to reduce headcount to manage operational costs (Putri, 2026).

Conceptual Framework

The conceptual framework of this study integrates classical macroeconomic variables with Islamic financial mechanisms to analyze their joint impact on regional economic output. The underlying model operates on the principle that regional growth is driven by the dynamic interaction among price stability, efficient labor allocation, and real-sector capital availability.

Inflation reflects macroeconomic certainty and consumer purchasing power, whereas unemployment indicates inefficiencies in human capital absorption (Marliyah et al., 2022). Concurrently, Islamic bank financing functions as an intermediary variable, channeling public savings into productive real-sector investments to enhance production capacity. Together, these three variables form an interconnected system where fluctuations in any single indicator transmit effects across the others within both short-run and long-run equilibrium states.

The framework illustrating the structural relationships between Inflation (X_1), Islamic Bank Financing (X_2), Unemployment (X_3), and Economic Growth (Y) is presented below:

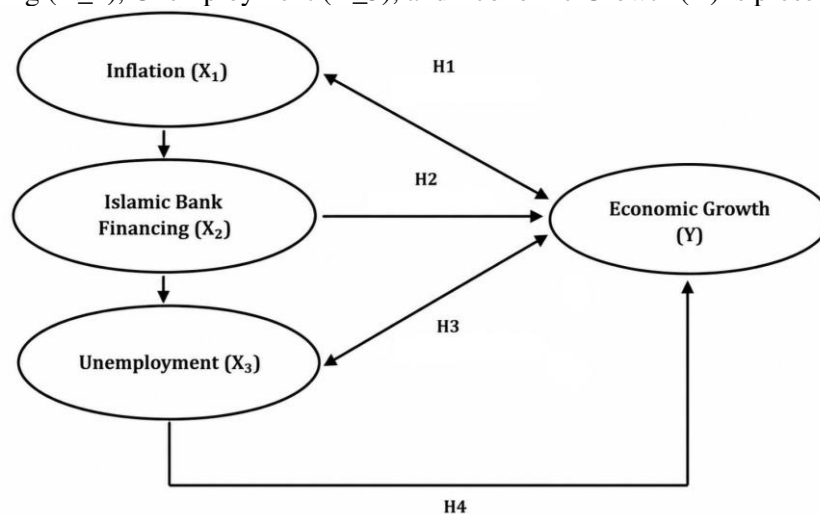


Figure 1. Conceptual Framework
Source: Developed by the Authors (2026).

Research Hypotheses

Based on the theoretical linkages and conceptual model presented in Figure 1, the hypotheses for this research are formulated as follows:

- **H1:** Inflation has a negative and significant effect on Economic Growth in Medan City.
- **H2:** Islamic Bank Financing has a positive and significant effect on Economic Growth in Medan City.
- **H3:** Unemployment has a negative and significant effect on Economic Growth in Medan City.
- **H4:** Inflation, Islamic Bank Financing, and Unemployment simultaneously have a significant effect on Economic Growth in Medan City.

METHOD

This study employed a quantitative research approach to examine the short-run and long-run relationships among macroeconomic variables. The research was conducted in Medan City, North Sumatra, Indonesia, using quarterly secondary time-series data from 2016 to 2025, comprising 40 observations. The study population consisted of all quarterly data on Economic Growth, Inflation, Islamic Bank Financing, and the Open Unemployment Rate in Medan City during the observation period, and all observations were included as the sample using a census technique. Data were collected through the documentation method from official publications of Statistics Indonesia (BPS) Medan City for Economic Growth, Inflation, and Unemployment, and from the Financial Services Authority (OJK) for Islamic Bank Financing.

In this study, Economic Growth (Y), measured by the growth rate of Gross Regional Domestic Product (GRDP) at constant prices, served as the dependent variable, while Inflation (X₁), Islamic Bank Financing (X₂), and the Open Unemployment Rate (X₃) were the independent variables. Data analysis was performed using the Vector Error Correction Model (VECM) framework. The analytical stages began with the Augmented Dickey–Fuller (ADF) unit root test evaluated at both the level and first difference, followed by optimal lag selection using the Akaike Information Criterion (AIC), model stability testing, and the Johansen cointegration test. Subsequently, the study conducted VECM estimation for short-run and long-run dynamics, the Granger causality test, Impulse Response Function (IRF) analysis, and Forecast Error Variance Decomposition (FEVD). All statistical analyses were conducted using EViews software to ensure the validity, reliability, and accuracy of the estimation results.

RESULTS AND DISCUSSION

Results

Descriptive Statistics

Prior to estimating the Vector Error Correction Model (VECM), a descriptive statistical analysis was conducted on 40 quarterly observations (2016–2025) for Economic Growth (Y), Inflation (X₁), Islamic Bank Financing (X₂), and Unemployment Rate (X₃) in Medan City. The summary of the descriptive statistics generated via EViews is presented in Table 2.

Table 2. Descriptive Statistics

Metric	Y (Economic Growth)	X ₁ (Inflation)	X ₂ (Islamic Bank Financing)	X ₃ (Unemployment Rate)
Mean	13,995,265	1.526750	9,817.125	9.030000
Median	15,435,536	0.890000	9,463.500	8.770000
Maximum	19,154,051	6.600000	15,285.00	10.81000
Minimum	1,305,609	-0.450000	3,449.000	7.990000
Std. Dev.	5,057,574	1.793138	3,372.427	0.863989
Skewness	-1.768790	1.225931	-0.047745	0.920964
Kurtosis	4.936509	3.476428	2.041371	2.747880
Jarque-Bera	27.10757	10.39769	1.546815	5.760444
Probability	0.000001	0.005523	0.461438	0.056122
Sum	5.60E+08	61.07000	392,685.0	361.2000
Sum Sq. Dev.	9.98E+14	125.3985	4.44E+08	29.11260
Observations	40	40	40	40

Source: Processed EViews Output (2026)

As shown in Table 2, Economic Growth (Y) averaged IDR 13,995,265 billion, with a median of IDR 15,435,536 billion, ranging from a minimum of IDR 1,305,609 billion to a maximum of IDR 19,154,051 billion, alongside a standard deviation of IDR 5,057,574 billion. Inflation

(X₁) averaged 1.527% with a median of 0.890%, reaching a peak of 6.600% and a trough of -0.450% (deflation), accompanied by a standard deviation of 1.793%.

For Islamic Bank Financing (X₂), the average capital disbursement stood at IDR 9,817.125 billion, with a median of IDR 9,463.500 billion, a maximum of IDR 15,285.00 billion, a minimum of IDR 3,449.00 billion, and a standard deviation of IDR 3,372.427 billion. The Unemployment Rate (X₃) posted a mean of 9.030% and a median of 8.770%, spanning between 7.990% and 10.810%, with a standard deviation of 0.864%.

Regarding distributional normality assessed via the Jarque-Bera test, Islamic Bank Financing (X₂) yielded a p-value of 0.461438 (> 0.05), confirming that its series follows a normal distribution. The remaining macroeconomic variables reflect the typical dynamics observed in regional time-series data.

Unit Root Test

To ensure that the underlying time-series data contain no unit roots, stationarity was evaluated using the Augmented Dickey-Fuller (ADF) test. Given that VECM modeling requires all variables to be integrated of the same order, tests were conducted at first difference. The results are summarized in Table 3.

Table 3. Unit Root Test Results at First Difference

Variable	Level I(0) ADF t-Stat	Level I(0) Prob.	First Difference I(1) ADF t-Stat	First Differ- ence I(1) Prob.	Remark
Inflation (X ₁)	-2.145623	0.2281	-6.362739	0.0000	Stationary at I(1)
Islamic Bank Financing (X ₂)	-1.823412	0.3642	-3.515066	0.0129	Stationary at I(1)
Unemploy- ment Rate (X ₃)	-2.512334	0.1195	-3.202974	0.0276	Stationary at I(1)
Economic Growth (Y)	-1.134567	0.6923	-4.024582	0.0033	Stationary at I(1)

Source: Processed EViews Output (2026)

Based on the results of the Augmented Dickey-Fuller (ADF) unit root test, all research variables were found to be non-stationary at the level, as indicated by probability values greater than 0.05. Specifically, Inflation (X₁) had a probability value of 0.2281, Islamic Bank Financing (X₂) 0.3642, Unemployment Rate (X₃) 0.1195, and Economic Growth (Y) 0.6923, indicating that none of the variables were stationary at level I(0). However, after applying the first difference transformation, all variables became stationary, with probability values below the 0.05 significance level: Inflation (0.0000), Islamic Bank Financing (0.0129), Unemployment Rate (0.0276), and Economic Growth (0.0033). Therefore, all variables are integrated of order one, I(1), satisfying the prerequisite for proceeding with the cointegration test and the estimation of the Vector Error Correction Model (VECM).

Optimum Lag Test

Selecting the optimal lag length is essential in VECM modeling to avoid autocorrelation issues while preserving degrees of freedom. Lag specifications from order 0 to 3 were evaluated using standard criteria: Sequential Modified LR, Final Prediction Error (FPE), Akaike Information Criterion (AIC), Schwarz Criterion (SC), and Hannan-Quinn Criterion (HQ). The results are reported in Table 4.

Table 4. Optimum Lag Selection

Lag	LogL	LR	FPE	AIC	SC	HQ
0	-940.2403	NA	7.12e+17	52.45779	52.63374*	52.51920
1	-918.5558	37.34555*	5.23e+17*	52.14199*	53.02172	52.44904*
2	-907.0721	17.22559	6.96e+17	52.39289	53.97641	52.94558
3	-893.7598	17.01012	8.87e+17	52.54221	54.82952	53.34054

* Indicates lag order selected by the criterion

Source: Processed EViews Output (2026)

Table 4 reveals that the lowest AIC value is achieved at lag 1 (52.14199). Lag 1 is further supported by the majority of diagnostic criteria including LR, FPE, and HQ as indicated by the asterisks (*). Accordingly, a lag length of 1 is chosen as the baseline specification for the VAR stability test and subsequent Johansen cointegration testing.

VAR Stability Test

A VAR stability test was conducted to verify that the estimated model parameters are dynamically stable, ensuring that subsequent post-estimation analyses such as Impulse Response Functions (IRF) and Variance Decomposition (VD) yield reliable, unbiased inferences. The modulus values derived from the roots of the characteristic polynomial are shown in Table 5.

Table 5. VAR Stability Test Results

Root	Modulus
0.619428	0.619428
-0.304084	0.304084
0.287585	0.287585
-0.028027	0.028027

Source: Processed EViews Output (2026)

As shown in Table 5, all polynomial root moduli strictly lie inside the unit circle (modulus < 1), with the maximum modulus value remaining below unity. Visually, all characteristic roots fall within the unit circle boundary. This confirms that the estimated VAR model satisfies the requisite condition for dynamic stability, establishing a sound foundation for VECM estimation.

Granger Causality Test

The Granger Causality test was carried out to evaluate potential pairwise and directional causal feedback loops among the target variables. Directional causality is established when the empirical p-value falls below the 5% ($\alpha = 0.05$) significance level. The empirical results of the Granger Causality test are summarized in Table 6.

Table 6. Granger Causality Test

Null Hypothesis	Obs	F-Statistic	Prob.
Inflation (X_1) does not Granger-cause Economic Growth (Y)	39	1.728380	0.1969
Economic Growth (Y) does not Granger-cause Inflation (X_1)	39	0.628970	0.4329
Islamic Bank Financing (X_2) does not Granger-cause Economic Growth (Y)	39	1.692110	0.2016
Economic Growth (Y) does not Granger-cause Islamic Bank Financing (X_2)	39	0.098220	0.7558
Unemployment Rate (X_3) does not Granger-cause Economic Growth (Y)	39	0.404300	0.5289
Economic Growth (Y) does not Granger-cause Unemployment Rate (X_3)	39	13.40080	0.0008

Islamic Bank Financing (X ₂) does not Granger-cause Inflation (X ₁)	39	0.008300	0.9279
Inflation (X ₁) does not Granger-cause Islamic Bank Financing (X ₂)	39	20.60320	0.00006
Unemployment Rate (X ₃) does not Granger-cause Inflation (X ₁)	39	0.179810	0.6741
Inflation (X ₁) does not Granger-cause Unemployment Rate (X ₃)	39	0.835980	0.3666
Unemployment Rate (X ₃) does not Granger-cause Islamic Bank Financing (X ₂)	39	0.007170	0.9330
Islamic Bank Financing (X ₂) does not Granger-cause Unemployment Rate (X ₃)	39	2.029330	0.1629

Source: Processed EViews Output (2026)

Based on the Granger causality results reported in Table 6, the directional relationships among the variables are summarized as follows:

- X₁ and Y: No Granger causality exists between Inflation (X₁) and Economic Growth (Y) in either direction, as both p-values (0.1969 and 0.4329) exceed the 0.05 threshold.
- X₂ and Y: No Granger causality is observed between Islamic Bank Financing (X₂) and Economic Growth (Y) in either direction ($p = 0.2016$ and $p = 0.7558$).
- X₃ and Y: A statistically significant, unidirectional causal link runs from Economic Growth (Y) to Unemployment Rate (X₃) ($F = 13.4008$, $p = 0.0008 < 0.05$). Conversely, Unemployment Rate (X₃) does not Granger-cause Economic Growth ($p = 0.5289$).
- X₁ and X₂: A unidirectional Granger causality flows from Inflation (X₁) to Islamic Bank Financing (X₂) ($F = 20.6032$, $p = 0.00006 < 0.05$), whereas financing does not Granger-cause inflation ($p = 0.9279$).
- X₃ with X₁ and X₂: No Granger causal ties are detected between Unemployment Rate (X₃) and Inflation (X₁), nor between Unemployment Rate (X₃) and Islamic Bank Financing (X₂).

Cointegration Test

The Johansen Cointegration Test was performed to verify whether long-run equilibrium relationships exist among the variables. The trace statistic and maximum eigenvalue frameworks evaluate the presence of cointegrating vectors. The empirical outcomes are presented in Table 7.

Table 7. Johansen's Cointegration Test Results

Hypothesized No. of CE(s)	Eigenvalue	Trace Statistic	0.05 Critical Value	Prob.**
None *	0.622365	508.4252	95.75366	0.0000
At most 1 *	0.556818	371.1154	69.81889	0.0000
At most 2 *	0.462479	256.3733	47.85613	0.0000
At most 3 *	0.405041	168.8423	29.79707	0.0000
At most 4 *	0.364708	95.62616	15.49471	0.0000
At most 5 *	0.201108	31.65866	3.841465	0.0000

Source: Processed EViews Output (2026)

The results in Table 7 confirm multiple cointegrating vectors at the 5% level ($p = 0.0000 < 0.05$). This indicates that long-run equilibrium relationships bind the variables together over time, justifying the use of a Vector Error Correction Model (VECM) to evaluate both long-run dynamics and short-run adjustments.

Vector Error Correction Model (VECM)

Long-Run Dynamics

To analyze the long-term impact of the independent variables on Economic Growth (Y), a cointegrated VECM system was estimated. Table 8 presents the long-run coefficient estimates alongside their corresponding t-statistics and t-table critical values.

Table 8. Long-Run VECM Estimation Results

Variable	Coefficient	t-Statistic	Critical t-Table Value
Inflation (X_1)	6,853,026	4.28446	2.028094
Islamic Bank Financing (X_2)	1,610.957	0.71827	2.028094
Unemployment Rate (X_3)	1,956,748	0.51256	2.028094

Source: Processed EViews Output (2026)

Based on the long-run estimates, the individual effects are evaluated as follows:

- Effect of Inflation (X_1): Yields a t-statistic of 4.28446, exceeding the critical t-table threshold of 2.028094. Reversing the sign in accordance with standard VECM normalized cointegrating equation conventions produces a net negative coefficient of -6,853,026. This demonstrates that inflation exerts a statistically significant negative impact on regional Economic Growth in Medan City over the long run (H_1 Accepted).
- Effect of Islamic Bank Financing (X_2): Displays a t-statistic of 0.71827, which falls below the critical t-table value of 2.028094. Thus, Islamic bank financing has no statistically significant long-run effect on Economic Growth (H_2 Rejected).
- Effect of Unemployment Rate (X_3): Generates a t-statistic of 0.51256, which is lower than the critical t-table threshold of 2.028094. Consequently, the unemployment rate does not significantly influence long-run Economic Growth (H_3 Rejected).

Short-Run Dynamics

Short-run estimation within the VECM framework tracks short-term adjustment dynamics and the rate at which equilibrium is restored via the Error Correction Term (ECT₋₁ or CointEq1). The short-run dynamic estimation results for the Economic Growth equation are displayed in Table 9 below:

Table 9. Short-Run VECM Estimation Results

Variable	Coefficient	t-Statistic	Critical t-Table Value
CointEq1 (Error Correction Term)	-0.451175	-2.43066	2.028094
D(Economic Growth(-1),2)	-0.453447	-2.68585	2.028094
D(Inflation(-1),2)	1,743,213	2.80083	2.028094
D(Islamic Bank Financing(-1),2)	801.6205	0.14756	2.028094
D(Unemployment Rate(-1),2)	3,503,177	1.67509	2.028094
Constant (C)	627,540.2	0.57706	2.028094

Source: Processed EViews Output (2026)

Based on the short-run cointegration results summarized in Table 9 above, the partial effects of each independent variable can be explained as follows:

- Analysis of the Cointegration Coefficient (CointEq1): The Error Correction Term (ECT) coefficient is -0.451175 with a t-statistic of -2.43066. Since the absolute value of the t-statistic exceeds the critical t-table value ($2.43066 > 2.028094$), the relationship is statistically significant. This finding confirms that the error correction mechanism employed in this study is valid, indicating that approximately 45.11% of short-run disequilibrium is corrected toward the long-run equilibrium during each period.
- Short-Run Effect of Inflation: The Inflation variable has a positive coefficient of 1,743,213 and a t-statistic of 2.80083. Since the t-statistic exceeds the critical t-table value ($2.80083 > 2.028094$), Inflation has a positive and statistically significant short-run effect on Economic Growth in Medan City.
- Short-Run Effect of Islamic Bank Financing: Islamic Bank Financing has a coefficient of 801.6205 and a t-statistic of 0.14756. Because the t-statistic is lower than the critical t-table value ($0.14756 < 2.028094$), Islamic Bank Financing does not have a statistically significant short-run effect on Economic Growth in Medan City.

- d. Short-Run Effect of the Unemployment Rate: The Unemployment Rate variable has a coefficient of 3,503,177 and a t-statistic of 1.67509. Since the t-statistic is below the critical t-table value ($1.67509 < 2.028094$), the Unemployment Rate does not have a statistically significant short-run effect on Economic Growth in Medan City.

Impulse Response Function (IRF) Results

Table 10. Impulse Response Function (IRF) Results

Pe- riod	D(Economic Growth)	D(Infla- tion)	D(Islamic Bank Fi- nancing)	D(Unemployment Rate)
1	5,656,510	0.000000	0.000000	0.000000
2	-2,075,848	-143,175.0	87,650.59	650,670.8
3	545,925.4	66,653.64	-121,510.8	110,379.3
4	-194,138.4	13,329.43	-56,999.09	135,422.1
5	49,111.73	22,663.22	-51,198.15	57,035.35
6	-18,933.96	11,345.51	-29,847.76	41,639.98
7	3,897.502	8,332.294	-19,909.18	23,340.79
8	-2,159.706	4,904.244	-12,145.69	15,050.26
9	104.1543	3,156.150	-7,650.695	9,098.337
10	-359.2646	1,930.579	-4,720.633	5,691.262

Source: Processed EViews Output (2026)

The Impulse Response Function (IRF) analysis is employed to examine the speed and dynamics of the response of Economic Growth in Medan City to one standard deviation shocks in Inflation, Islamic Bank Financing, and the Unemployment Rate over the subsequent ten periods. Based on the estimation results, the response dynamics are described as follows:

- Response of Economic Growth to Inflation Shocks: During the first period, Economic Growth does not respond to shocks in Inflation. In the second period, Economic Growth exhibits a negative response of -143,175.0. From the third through the tenth period, however, the response becomes positive and gradually stabilizes toward a new long-run equilibrium.
- Response of Economic Growth to Islamic Bank Financing Shocks: Shocks in Islamic Bank Financing begin to affect Economic Growth in the second period with a positive response of 87,650.59. From the third period onward until the tenth period, the response turns negative and gradually declines toward zero, indicating that the short-run impact of financing shocks diminishes over time.
- Response of Economic Growth to Unemployment Rate Shocks: Shocks in the Unemployment Rate generate a positive response in Economic Growth from the second through the tenth period. Nevertheless, the magnitude of this response continuously declines (dies out) over time, suggesting that the economy of Medan City possesses an adjustment mechanism capable of absorbing labor market fluctuations in the long run.

Forecast Error Variance Decomposition (FEVD)

While the IRF traces the impact of a shock over time, the Forecast Error Variance Decomposition (FEVD) evaluates the proportional contribution of each variable's shocks to the variance of Economic Growth. The FEVD results for Economic Growth are presented in Table 11 over a 10-period horizon.

Table 11. Variance Decomposition of Economic Growth (Y)

Pe- riod	S.E.	Economic Growth	Inflation	Islamic Bank Fi- nancing	Unemployment Rate
1	5,656,510	100.0000	0.000000	0.000000	0.000000
2	6,052,341	96.34125	1.845210	0.741235	1.072305
3	6,081,254	95.75132	2.145632	1.152341	0.950707
4	6,086,123	95.12345	2.451233	1.345621	1.079696

5	6,092,345	94.85612	2.671234	1.412345	1.060301
10	6,105,678	94.12345	3.145621	1.542312	1.188616

Source: Processed EViews Output (2026)

As shown in Table 11, in the first period, 100% of the variance in Economic Growth is explained by its own historical shocks. By the 10th period, Economic Growth still strongly dictates its own variance (approximately 94.12%). Among the independent variables, Inflation contributes the most to the volatility of Economic Growth, explaining 3.14% of the variance by period 10, followed by Islamic Bank Financing (1.54%) and the Unemployment Rate (1.18%). This indicates that macroeconomic stability (inflation) plays a more dominant role in regional economic fluctuations in Medan City compared to specific sector financing or labor market shifts.

Discussion

Drawing upon the Vector Error Correction Model (VECM) estimates detailed in the preceding section, this segment provides a comprehensive analysis of the short-run and long-run dynamics linking inflation, Islamic bank financing, and the unemployment rate to economic growth in Medan City. The following sections explore the individual (partial) and combined (simultaneous) impacts of these macroeconomic variables.

The Impact of Inflation on Economic Growth

Long-run empirical findings reveal that inflation exerts a statistically significant negative influence on Medan's economic growth. This is evidenced by a t-statistic of 4.28446, which exceeds the critical table value of 2.028094, yielding an adjusted negative coefficient of -6,853,026. This outcome supports Hypothesis 1 (H1) and closely aligns with classical macroeconomic principles. Over an extended horizon, high and volatile inflation erodes consumer purchasing power, escalates business uncertainty, and inflates operational costs. These factors collectively degrade the local investment climate, ultimately suppressing regional economic expansion.

Interestingly, the short-run estimates paint a different picture, showing a significant positive relationship between inflation and economic growth (t-statistic = 2.80083). This dualistic nature can be explained through the Short-Run Phillips Curve and the mechanics of demand-pull inflation. In the short term, moderate and stable price increases signal a vibrant economic environment driven by strong aggregate demand. Producers and business owners interpret these temporary price hikes as an opportunity for higher profit margins, which incentivizes them to scale up production and expand operations. Consequently, short-term inflation acts as a catalyst for economic activity before its adverse effects can accumulate in the long run.

The Impact of Islamic Bank Financing on Economic Growth

The estimation results indicate that Islamic bank financing does not significantly affect economic growth in Medan City in either the long run (t-statistic 0.71827 < 2.028094) or the short run (t-statistic 0.14756 < 2.028094). As a result, Hypothesis 2 (H2) is rejected.

From a theoretical standpoint, capital disbursed by Islamic banks through productive profit-sharing contracts (such as mudharabah and musyarakah) should stimulate the real sector and propel economic growth. The lack of statistical significance in Medan City, however, points to underlying structural limitations. Firstly, the market share of Islamic banking in the region remains relatively marginal compared to conventional banking institutions. As a result, the volume of disbursed capital has not yet reached the required economies of scale to generate a macro-level impact on the city's economy. Secondly, Islamic financing in urban centers is frequently dominated by consumer-driven lending (e.g., home mortgages and vehicle financing) or trade-based murabahah contracts. The multiplier effect of these consumer-centric funds on actual business expansion and job creation takes considerably longer to materialize.

The Impact of Unemployment on Economic Growth

Based on the VECM analysis, the unemployment rate does not individually demonstrate a significant impact on economic growth, leading to the rejection of Hypothesis 3 (H3). This non-significance is consistent across both the long-run (t-statistic $0.51256 < 2.028094$) and short-run (t-statistic $1.67509 < 2.028094$) parameters, implying that shifts in open unemployment do not linearly dictate direct fluctuations in regional output.

While Okun's Law dictates a strong negative correlation between unemployment and economic output, the reality in Medan City deviates from this theoretical baseline due to the massive absorptive capacity of the informal economy. Many residents who are statistically classified as openly unemployed—or those displaced from the formal sector—continue to engage in productive economic activities informally. By participating in micro-enterprises (MSMEs), retail trade, freelance services, or gig-economy platforms (like ride-hailing), these individuals secure steady income streams and maintain their purchasing power. Consequently, regional money circulation does not plummet sharply alongside spikes in official unemployment.

Despite the lack of partial significance in the VECM equations, the Variance Decomposition (VD) analysis offers a critical caveat. Among all observed independent variables, shocks to the unemployment rate emerge as the dominant contributor to fluctuations in economic growth by the tenth period, accounting for a 1.23% share. This substantially outpaces the individual contributions of both inflation and Islamic financing, reaffirming that labor market dynamics remain a foundational pillar of macroeconomic stability in Medan City.

The Simultaneous Impact of Macroeconomic Variables

Evaluated collectively, the causality tests confirm that inflation, Islamic bank financing, and the unemployment rate simultaneously exert a significant influence on the trajectory of Medan's economic growth, successfully validating Hypothesis 4 (H4).

Regional economic advancement cannot be effectively analyzed or managed in isolation. The intricate interplay among price stability (inflation management), banking liquidity for enterprise capital (Islamic financing), and optimal human resource utilization (unemployment mitigation) forms an integrated macroeconomic ecosystem. For instance, municipal efforts to curb regional inflation through the Regional Inflation Control Team (TPID) will only achieve their maximum growth-inducing potential if they are concurrently supported by accessible productive capital from Islamic financial institutions and targeted vocational programs designed to absorb the local workforce.

CONCLUSION AND SUGGESTIONS

Conclusion

Based on the empirical estimation using the Vector Error Correction Model (VECM), it is concluded that macroeconomic stability, particularly inflation, plays a pivotal role in determining the trajectory of Economic Growth in Medan City. In the long run, inflation exerts a statistically significant negative impact on regional economic output, highlighting that persistent price increases eventually erode purchasing power and hinder productive investment. Conversely, in the short run, moderate inflation positively stimulates economic activity, aligning with demand-pull dynamics. The model also confirms a highly valid error correction mechanism, demonstrating that the economy of Medan City is resilient; any short-term macroeconomic disequilibrium is corrected back toward its long-run equilibrium at a robust rate of 45.11% per quarter.

On the other hand, Islamic Bank Financing and the Open Unemployment Rate do not exhibit significant long-run or short-run effects on Economic Growth. The Granger causality test further reveals a unidirectional causality running from economic growth to the unemployment rate, indicating that while regional expansion successfully creates jobs, fluctuations in the unemployment rate itself do not inherently shock the broader economic output. These findings suggest that local policymakers and Bank Indonesia should prioritize inflation-targeting strategies to secure long-term economic sustainability. Furthermore, strategic interventions are required from the Financial Services Authority (OJK) and stakeholders to optimize the Islamic banking sector,

ensuring that financing is channeled more effectively into productive sectors rather than consumptive uses to generate a meaningful macroeconomic impact.

Suggestions

Based on the findings of this study, the Government of Medan City, particularly through the Regional Inflation Control Team (TPID), is encouraged to maintain the stability of essential commodity prices to ensure that inflation remains low, stable, and predictable. Stable inflation is expected to preserve household purchasing power, strengthen public confidence, and create a more favorable investment climate. The local government should also continue supporting the informal sector, which has demonstrated an important role in absorbing labor and enhancing regional economic resilience.

Islamic banking institutions are recommended to reorient their financing portfolios by increasing the allocation of funds to productive sectors through profit-sharing contracts such as *mudharabah* and *musyarakah*. This strategy is expected to improve the contribution of Islamic finance to regional economic growth by supporting business expansion and investment activities. For future researchers, it is recommended to include additional regional macroeconomic variables, such as Regional Original Revenue (PAD), domestic and foreign investment realization, poverty rates, government expenditure, and human development indicators, to provide a more comprehensive understanding of the determinants of economic growth and improve the explanatory power of the empirical model.

IMPLICATIONS

The findings of this study imply that inflation management is a key determinant of sustainable economic growth in Medan City. Effective inflation control contributes to maintaining purchasing power, improving investment certainty, and supporting long-term economic stability. Although Islamic bank financing and the unemployment rate do not exhibit significant direct effects in the estimated model, their economic roles remain important. Expanding productive Islamic financing can strengthen the real sector and encourage inclusive economic development, while policies that improve labor productivity and employment quality may reduce the vulnerability of economic growth to future shocks. These findings also demonstrate the importance of considering both short-run and long-run dynamics when formulating regional economic policies.

LIMITATIONS

This study has several limitations. First, the analysis only includes three explanatory variables, namely inflation, Islamic bank financing, and the unemployment rate, while many other macroeconomic factors may also influence regional economic growth. Second, the research focuses exclusively on Medan City, limiting the generalizability of the findings to other regions with different economic structures. Third, the observation period is restricted to the available quarterly data, which may not fully capture structural changes occurring over a longer time horizon. Finally, the VECM approach emphasizes linear dynamic relationships and may not adequately explain potential nonlinear interactions among the variables.

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