# Business Strategy & Performance in Indonesia's Service Sector

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**Abstract:**

**Purpose:** The relationship between strategic choices and performance in service firms in emerging markets has remained largely under-researched. We address this issue by studying the performance of financial institutions in the context of Indonesia's political, institutional and socio-cultural environment.

**Design/Methodology/Approach:** Using institutional theory, we analyzed data collected using surveys and interviews with senior managers in Indonesian financial institutions.

**Findings:** We find that the regulative and normative elements have forced organizations to incorporate the values set by the external institutional bodies. The organizations have undertaken structural isomorphism in response to culture-cognitive elements, and differentiate themselves by focusing on the provision of quality customer service and enhanced customer satisfaction.

**Originality/Value:** We provide new insights by studying how the political and institutional environment and choice of strategy influences performance in the services sector in emerging economies.


**Keywords:** *business strategy; emerging economies; financial services, Indonesia, institutional theory; strategic alignment*


**Article Classification:** *Research paper*.

# Business Strategy & Performance in Indonesia's Service Sector

## 1. Introduction

Organizations can outperform competitors if they pursue either a cost-leadership or differentiation strategy that is aligned to, and complements, its internal dynamics. Pursuing both strategies can be a challenge due to the inherent contradictions organizations face in attempting to produce either low-cost standardized goods and services or offering high-cost differentiated products (Porter, 1985). Unlike manufacturing firms, which use intangible assets and organizational know-how to complement the use of their physical assets (Teece, Pisano and Shuen, 1997), service firms attempt to find a competitive advantage by finding efficiency in their use of human resource and information technology. Measuring efficiency and output is harder in service firms, as organizations within the sector tend to differentiate themselves from competitors by altering their product offering, and through improved service quality (Huang, 2008).

While there have been some recent studies on the use of business strategy and service quality, most of these research organizations in developed economies (London and Hart, 2004), where the use of technology is more prevalent than in emerging markets (Teece, 2010). The liberalization of the service sector has resulted in increased competition, and today the sector has become the major source of employment in most developed countries, and many emerging countries. However, extant literature on emerging markets has primarily focused on the manufacturing sector with the emphasis on exploring the strategy of multinational firms in seeking competitive advantages from the application of business strategy (Khanna, Palepu, and Sinha,

2005). Hence, little is known about the strategic choices made by service firms in these markets, or how the regulative environment influences the operations of organizations (Cavusgil, Ghauri and Akcal, 2013). We address this gap by studying the relationship between business strategy and organizational performance in Indonesia's financial services sector.

One of the fastest growing emerging markets; Indonesia's politico-economic environment has transitioned from a highly centralized military dictatorship to a more-open democratic economy (Rosser, 2002). This political and economic transition is similar to what other emerging economies in Asia, Eastern Europe, Africa, and South America have experienced. Therefore, the findings of this study also have implications for other countries that share similarities with Indonesia.

The rise of the middle-class and growing entrepreneurial activities has resulted in increased competition in the financial services sector in Indonesia, which until the recent de-regulation attempts was dominated by government-held banks. The banking sector in particular has had to find ways to differentiate their product offerings in order to increase the size of their customer base. Thus, this study answers the following questions:

> *How does business strategy and strategic alignment influence organizational performance of financial service firms in Indonesia?*

> *What influence does the institutional/regulative environment have on the choice of business strategy of financial service firms in emerging markets?*

The paper is divided in eight sections. Following the introduction, the paper provides a review of the literature and details the development of the hypotheses. We then

provide an overview of the case of the Indonesian banking sector, followed by a description of the institutional perspective used in this study to analyse the Indonesian regulatory environment. The methodology section details the data collection and analysis techniques used in this study. The findings of the study are then discussed before the paper concludes by providing implications for managers, and identifying areas for future research.

## 2. Literature review and hypotheses development

### 2.1. Strategic alignment

Strategic alignment is the vertical linkage within a firm that helps support and realize the organization's objectives, and facilitates the integration of internal resources at all levels in ways that are consistent with the overall strategy (Ravasi and Phillips, 2011; Ward, McCreery and Anand, 2007). However, organizations that are unable to mobilize their resources to attain organizational objectives may fail to achieve a competitive advantage (Dyer, Kale and Singh, 2001; Walter, Kellermanns, Floyd, Veiga and Matherne, 2013).

In the service sector, performance indicators are more closely connected to issues of service quality, and are therefore less tangible than those in manufacturing. Thus, to be more competitive, an organization should place emphasis on providing higher quality performance than other firms, and the value chain, information technology (IT) and human capital should be aligned with the overall strategy (Meuter, Ostrom, Roundtree and Bitner, 2000; Roth and Van Der Velde, 1991). Building the IT capacity to align with the organization's strategy is not only useful to make the work of employees easier; it also facilitates interaction between organizations and its

customers through self-service technologies such as online banking (Kajalo, Rajala and Westerlund, 2007; Weijters, Rangarajan, Falk and Schillewaert, 2007). Similarly, management of human resources is vital in strategic alignment, and can include working on processes that focus on employee recruitment based on the needs of the organization; improving employee knowledge and skills through learning and training; establishing top-down coordination regarding products, market acuity and service process interaction, and managing these interactions across functions; and improving internal service quality to stimulate better working conditions throughout the organization (Brady and Cronin Jr, 2001; Canel, Rosen and Anderson, 2000; Heskett, Jones, Loveman, Sasser Jr and Schlesinger, 1994; Iglesias, 2009).

Based on whether the production and consumption processes occur simultaneously or can be decoupled, services are categorized as hard or soft services. Those services where the production and consumption can be decoupled are referred to as hard services. For those services where the production and consumption occurs simultaneously, such as medical services, the tradability of services is not possible and these services are referred to as soft services (Ekeledo and Sivakumar, 2004; Erramilli, 1991). Therefore, for soft services the consumption experiences vary from one consumer to another, which can be a challenge for organizations attempting to achieve standard outputs. Hence, it is necessary to have standard operational procedures to control quality in the service sector (Easingwood and Mahajan, 1989). As a result of technological innovation, cross-border supply of banking and financial services is now possible through phone and electronic forms. However, in many emerging markets like Indonesia, banking and financial services continue to be provided physically in bank branches and offices of financial service companies, and in this study they are treated as soft service (Rammal and Rose, 2014).

## 2.2. Hypotheses development

Based on the review of literature on business strategy and service, we have developed the following hypotheses for this study.

### 2.2.1 Relationship between business strategy and strategic alignment

Low-cost business strategy can be applied in organizations if efficient service processes are coordinated among its units. Strategic alignment is a way to create this coordination among the units, and the resulting business strategy can create synergy among these functions that in turn leads to more competition to achieve efficiency in its implementation (Dess and Priem, 1995; Kaplan and Norton, 2005). Once alignment of business strategy is achieved, an organization may be able to pursue a low-cost strategy since it is then able to achieve efficiency that in turn leads to reduced costs. Hence, we posit that:

*H1a: there is a positive relationship between low-cost strategy and strategic alignment*

Improved strategic alignment can also create effective decision-making within organizations, which are implemented across all functional boundaries through appropriate organizational design (Chenhall, 2005). Additionally, Chenhall (2005) suggests that the differentiation strategy and strategic alignment have a close relationship. Therefore, we postulate that:

*H1b: there is a positive relationship between differentiation strategy and strategic alignment*

Since low-cost and differentiation strategies can be effectively and efficiently achieved through the enhancement of strategic alignment, a joint strategy may enable an organization to become more competitive. Studies in manufacturing firms have found a positive relationship between joint business strategies and manufacturing strategy (Amoako-Gyampah and Acquaah, 2008; Ward and Duray, 2000). However, there is a scarcity of similar studies in the service sector. According to this consideration, we hypothesize that:

*H1c: there is a positive relationship between a joint business strategy and strategic alignment*

## 2.2.2. Relationship between strategic alignment and organizational performance

It is argued that organizational performance can be achieved if an organization is able to align its internal resources with business strategy (Dyer et al., 2001). Porter (1991) claimed that strategic alignment is a way for organizations to ensure that all internal resources are consistent with the overall business strategy. Alignment among organizational departments may improve operational effectiveness by creating pressures and incentives (Porter, 1990), whereas a lack of alignment makes organizations weaker in competition with their rivals in the market place. Similarly, competitive advantage cannot be sufficiently achieved unless the company can link all strategy outcomes with functional processes and information systems. This is because alignment requires the same commitment among individuals at various levels to support the organizational goals and objectives, whatever their individual roles in the organization (Kathuria, Joshi and Porth, 2007). Hence, strategic alignment is a prominent factor in achieving the business strategy including allocation of resources

to support the organizational performance (Papke-Shields and Malhotra, 2001). Based on this argument, we hypothesize that:

*H2: there is a positive relationship between strategic alignment and organizational performance*

### 2.2.3. Relationship between business strategy and organizational performance

Unlike the outputs of manufacturing sector, service offerings are intangible and include mainly actions, experiences, performances or promises (Cloninger and Oviatt, 2007; Spohrer, Maglio, Bailey and Gruhl, 2007). Hence, successful action and performance in the service sector depends on the organizational ability to provide superior quality to customers.

As discussed earlier, the characteristics of low-cost strategy tend to focus on cost efficiency in the market place. However, focusing on this strategy can reduce the organization's spending on service selling or advertising (Dess, Lumpkin and Covin, 1997). This decision may be useful when applied in manufacturing, but since the service sector emphasis is on building relations with consumers through marketing and personal selling, we consider that the low-cost strategy would reduce service quality, which is a measure of performance:

*H3a: There is a negative relationship between low-cost strategy and organizational performance*

Hyvönen's (2007) study on the relationship between business strategy and organizational performance found that customer-focused differentiation strategy could enhance performance. More specifically, in the banking sector, a company can have a competitive advantage and be a market leader if it differentiates itself by providing

excellent service quality to customers (Heineke and Davis, 2007). We therefore contend that:

*H3b: There is a positive relationship between differentiation strategy and organizational performance.*

Prior studies by have found that a joint strategy has a positive effect on organizational performance (Kim, Nam and Stimpert, 2004a, b; Parnell, 2010; Spanos, Zaralis and Lioukas, 2004). These studies demonstrate that organizations can overcome the "stuck in the middle" problem associated with the joint business strategy by initiating innovations in system improvements that result in decreased cost and an increase in differentiation (Wright, Kroll, Chan and Hamel, 1991). Supporting this argument, Gates and Lengevin (2010) state that that a joint strategy can have a positive outcome if top management can facilitate employees to be more innovative and to manage costs. Thus, we posit that:

*H3c: There is a positive relationship between competitive advantage and organizational performance.*

The hypothesized relationships between business strategy, strategic alignment and organizational performance are illustrated in the conceptual framework in Figure 1.

[INSERT FIGURE 1 HERE]

Before discussing the methodology of the study, we provide an overview of the Indonesian financial services sector and the theoretical lens used in this study.

### 3. Indonesia's Financial Service Sector

The Indonesian economy is the largest in South East Asia, and the 16th largest in the world (UK Trade & Investment, 2013). The country's financial services sector has historically faced a number of challenges due to regulatory and political pressures, and was heavily impacted during the financial crisis of 1997 that affected the economies of the South East Asian region. In the 1970s, the Indonesian banking sector was dominated by state-owned commercial banks, which owned 80 per cent of the total banking assets. However, these market shares were determined bureaucratically with the government controlling the sector through the operations of Bank Indonesia, the country's central bank. The government decided which projects would be funded, and the state-owned commercial banks provided subsidized lending programs (McLeod, 1999).

Banking sector reforms commenced in 1983 and continued until 1997, the year of the Asian financial crisis. During this period, the government attempted to curtail the subsidized lending program. In 1988, after a 17-year period, new entrants were allowed to enter the banking sector. Foreign banks were also allowed to enter the market as long as they did so as joint venture with a local bank (Pangestu, 2003). However, these reforms were short-lived as the Indonesian government reversed much of the reforms and curtailed the activities of foreign banks by lending money to state-owned banks to improve their liquidity (Pangestu & Habir, 2002). These banks continued to provide loans to companies supported by the government, without seeking collateral. This led to weaknesses in the financial services sector, which were exposed during the Asian financial crisis and led to the closure of 16 banks in Indonesia (Enoch, Baldwin, Frecaut and Kovanen, 2001; McLeod, 2004).

In the aftermath of the crisis, the government attempted to restore trust by undertaking reforms to improve the management of the sector. This included de-regulating the sector and opening it up for more competition. At present 120 banking organizations operate in Indonesia, of which four are state-owned (HSBC Global Connections, 2014). According to the World Bank and International Monetary Fund (IMF), the Indonesian financial sector has improved substantially due to the establishment of supervisory frameworks and methodologies by Bank Indonesia and the Financial Institutions Supervisory Agency (Bapepam-LK) (Srinivas, 2013). However, some weaknesses remain in the sector, in particular, absence of legal protection for supervisors in the banking sector has been highlighted as a serious shortcoming that may in the long-term affect the ability of the sector to identify harmful banking practices (Srinivas, 2013; World Bank, 2014).

The choice of Indonesia for this study is based on a number of reasons. Indonesia represents one of the fastest growing emerging economies, yet it has historically received little attention in the mainstream business management literature. As discussed earlier, the political transformation of Indonesia in the post-colonization period from military dictatorship to democracy, and economic transformation from a high-regulated centralized economy to a more open-market economy has many similarities with other emerging economies in Asia, Africa, Europe and South America such as Bangladesh, Egypt, and Pakistan (Crouch, 1976; Lindblad, 2013). Hence, the Indonesian financial services sector provides us with the opportunity to study the various factors that influence business strategy and performance of service firms in emerging markets (Ghauri, 2004; Hartley, 2004; London and Hart, 2004).

## 4. Institutional Theory

The institutional theory explains institutions as social structures that are composed of regulative, normative, and cultural-cognitive elements that provide stability and meaning to social life (Scott, 2001). According to Scott (1987; 2001; 2008), the regulative elements include rules, laws, governance and power system, while the normative elements include values, expectation and authority systems. Finally, the cultural-cognitive elements include structural isomorphism and other objects that reflect symbolic value.

Firms are embedded in their own internal institutional environment (structures, systems and practices) and the external institutional environment, which it shares with other organizations operating in the industry and the country (Chizema and Buck, 2006). The institutional perspective for firm behaviour states that organizations will attempt to respond to both market and institutional pressures. These pressures force organizations to attempt to incorporate norms from the institutional environment to gain legitimacy in the society. DiMaggio and Powell (1983) refer to this change in organizational behaviour as isomorphism; a process through which organizations attempt to resemble the practices of other similar organizations.

The use of the institutional theory perspective in this study allows us to analyse the strategic choices made by organization in the light of the government control in Indonesia. The issue of government related institutional perspective has been under-researched in the emerging markets (Tihanyi, Devinney and Pedersen, 2012), and we attempt to explain how managers develop and execute strategy in an

environment influenced by the unique regulative, normative, and cultural-cognitive elements that exist in Indonesia.

The nationalization of the banking sector during the military backed Suharto era influenced competition in the industry and management of the affected organizations. The role of Bank Indonesia, the central bank of the country, in regulating the sector and providing patronage to state-owned nationalized banks has also been a critical factor in the development of, and innovation by the financial institutions. In addition to the laws and centralized control system, the social, cultural, and economic background of the consumers has also influenced the way banks and other financial institutions offer their products, and expectations of customer service.

## 5. Methodology

### 5.1.Data collection

We employed a two-stage process to collect data for this study: a self-administered survey, and semi-structured interviews. In the first stage, we conducted a survey of middle level managers in Indonesian financial institutions. As the focus of the study is on business strategy and strategic alignment, we targeted managers in the head-office rather than in branch offices, as they would be familiar with the organization's strategy. To enhance the survey's response rate, we used techniques such as pre-notification contact, initial mailing of survey instrument, and follow-up messages. Pre-notification contact was made by phoning, sending an email or visiting the head-office of the organizations in Indonesia, and asking managers to participate in this study. After we obtained information from pre-notification, questionnaires with a cover letter and a postage-paid envelope were sent to the selected participants. The

first follow-up involved phoning respondents to ensure that they had received the mail, and to remind them to participate in this study by filling out the questionnaire. The second follow-up was a reminder, and a replacement questionnaire was sent to those who had not yet answered or were missing the questionnaire.

We sent two copies of the questionnaire to 355 organizations, a total of 710 questionnaires. The purpose of sending two sets of questionnaire to each company was that it allowed our results to be generalizable to different function areas, and to reduce common method bias (Chin, Thatcher and Wright, 2012). A total of 176 responses were received, with 157 useable questionnaires, giving us a response rate of 22.11 per cent. Table 1 provides demographic information about the respondents.

[INSERT TABLE 1 HERE]

In the second stage of data collection, we conducted interviews with 14 senior managers from 12 banks in Indonesia. These sample banks consisted of 10 private and 2 state-owned banks. These face-to-face semi-structured interviews were undertaken to seek further explanations about our survey findings from experts in the industry, and gain a better understanding of the factors that influences the operations of the banking sector. As discussed earlier, the Indonesian context and operational environment is representative of many emerging economies, and conducting interviews allowed us to gain insights into how the regulative and competitive environments in Indonesia influence the operations of the organizations on the financial sector. Table 2 provides information about the interviewees.

[INSERT TABLE 2 HERE]

The interviews were conducted in the office of the interviewees, and were audio recorded, with the permission of the interviewees. On average, the interviews lasted 30 minutes each.

## 5.2. *Variable measurement*

### *Business strategy*

We chose cost-leadership or differentiation business strategy typology to study the operations of the financial institutions in Indonesia. The typology is chosen for several reasons. First, cost-leadership and differentiation are appropriate to be used as the basis of strategic positioning (Porter, 1985). Second, the typology has been has successfully been used in previous studies, and has found to be easily understood by respondents (Auzair and Langfield-Smith, 2005). Third, this typology 'is inherently tied to performance' (Kim et al., 2004a, p. 571). Using the business strategy instrument developed by Auzair and Langfield-Smith (2005), we asked respondents to indicate to what extent each characteristic is provided by the organization using a seven-point Likert scale anchored by 1 (not at all) and 7 (very important). The descriptive statistics of the variables are presented in Table 3.

[INSERT TABLE 3 HERE]

### *Strategic alignment*

The strategic alignment questions were developed from extant literature (Brady and Cronin Jr, 2001; Chenhall, 2005; Schneider et al., 2003), and consisted of seven items: Congruence; Long-term technology developments and trends; Interaction and management of products, market acuity, and service process across functions; Internal service quality; Employee recruitment; Learning & training; and Employees'

activities. Respondents were asked to rate the extent to which the strategic alignment described their organization using a seven-point Likert scale anchored by 1 (not at all) and 7 (great extent).

## *Organizational performance*

Four common indicators of organizational performance – rate on assets (ROA), rate of income/revenues, return on investments (ROI), and profitability are used in this study. These measures have been used in the previous studies (see for example Henri, 2006; Yee, Yeung and Cheng, 2010). Respondents were asked to rate their company's performance compared to the previous year using a seven-point Likert scale ranging from 1 (far below average) to 7 (far above average).

## *5.3    Data Analysis*

We conducted exploratory factor analysis to establish unidimensionality. Table 4 shows the exploratory two-factor analysis of 11 items of business strategy under the labels of low-cost strategy and differentiation strategy. Strategic alignment and organizational performance are represented into one-factor analysis each. According to the results, all factor loadings are above average.

[INSERT TABLE 4 HERE]

We used Partial Least Squares (PLS) to test the structural equation model. The advantages of PLS are that it has less restriction in terms of assumptions of measurement scales and is suited to test a small sample size (Chin, Marcolin and Newsted, 2003). Similar to Hulland (1999), we applied two sequential processes to analyse data: the measurement model and the structural model. As the main objective

of this study is to investigate what types of business strategy provide more benefit in improving organizational performance, we created two models. The first model (Model 1), is a testing analysis with separate business strategies: low-cost and differentiation strategy. The second model, Model 2, is an analysis with a combination of both business strategies: low-cost and differentiation is grouped into one model. We also conducted tests of reliability and validity.

We also used the PLS test to generate the psychometric properties of variables, and tested factor loading for each variable. We used Tucker and Lewis' Reliability Coefficient, where reliability is measured between a value of 0 and 1 with a larger value indicating better reliability (Tucker and Lewis, 1973). For Model 1, all items of business strategy ranged from 0.646 to 0.914. Thus, factor loading for all items was deemed to be acceptable. Similarly, all factor loadings of strategic alignment and organizational performance are adequate in Model 1. However, in Model 2, Low-cost (LC 01 and LC 02) had a lower factor loading, and these items were dropped from further analysis (Hair, Sarstedt, Pieper and Ringle, 2012).

We then undertook a reliability test of individual items as assessed by Cronbach's alpha and composite reliability (internal consistency). Table 5 presents Cronbach's alpha and the composite reliability for Model 1 and Model 2 ranging between 0.743 and 0.933. As a rule of thumb, a reliability coefficient of 0.7 or higher is considered acceptable (Bonett and Wright, 2015). Thus, the Cronbach's alpha and composite reliability for Model 1 and Model 2 are within the acceptable levels.

[INSERT TABLE 5 HERE]

The test for validity was conducted using PLS to enhance additional statistic results. The assessments of validity as explained by Henseler, Ringle and Sinkovics (2009)

are usually examined using convergent validity and discriminant validity. Convergent validity occurs when there is uni-dimensionality, a set of indicator represents just one underlying construct (Henseler et al., 2009). Convergent validity was conducted to ensure that the set of observable indicators measured the latent variable, and that the indicators are significantly fit and highly correlated (Camisón and López, 2010). A sufficient convergent validity is demonstrated by the value of the average variance extracted (AVE), which is considered acceptable at 0.5 or higher (Henseler et al., 2009). Table 5 shows adequate convergent validity with AVE values for all variables for Model 1 and Model 2 are higher than 0.5.

We also tested for discriminant validity to ensure items are unique and not similar to other constructs within the model (Hulland, 1999). We used the Fornell-Larcker measure where the discriminant value is calculated by comparing the square root of the AVE with the latent variables correlations (Henseler, et al., 2009). Discriminant validity is acceptable if the square root of the AVE along the diagonal is higher than correlations between constructs. Tables 6 and 7 show the results for discriminant validity. The tables show that all square roots of the AVE of Models 1 and 2 are higher than the off diagonal both rows and columns, and are therefore acceptable.

[INSERT TABLES 6 & 7 HERE]

The next step in the PLS analysis is the assessment of the specified structural model. The structural model was assessed by means of the R-square ($R^2$) for dependent variables and path coefficient tests. Further, a $R^2$ value with minimum level of 0.1 is acceptable (Camisón and López, 2010). As shown in Figure 2, $R^2$ of the endogenous constructs for Model 1 is more than the minimum recommended value. Similarly, $R^2$ for Model 2 shows that the score is above the recommended value (see Figure 3).

[INSERT FIGURES 2 & 3 HERE]

In addition, the structural model was also assessed by testing Path coefficients ($\beta$). As shown in Figures 2 and 3, the path coefficients for Model 1 and 2 are above 0.050, which is considered significant.

In order to conduct analysis of the qualitative data, we transcribed the interviews, and followed a step-wise approach of manual coding of the transcript (Hubermann and Miles, 1994; Miles and Huberman, 1994). These codes were then applied in the NVivo qualitative data analysis software, which resulted in the identification of themes that were placed under associated categories (Bazeley, 2007). These themes and patterns were developed from the review of the literature on strategy, emerging markets, and the service sector. The data coding process was undertaken after every interview, ultimately leading to the development of categories through the process of comparison, where data codes were compared for similarities and differences (Grbich, 2007).

## 6. Findings

### *Survey Results*

#### *Testing hypotheses H1a, H1b, H3a and H3b using Model 1*

Using the findings of the data from the survey, and applying our analysis models, we tested our hypotheses. Hypothesis 1a (H1a) suggests that there is a positive relationship between low-cost and strategic alignment. Based on the survey results, it shows that a negative relationship exists between low-cost strategy and strategic alignment ($\beta$= -0.043, t = 0.519, p < 0.1).  Thus, H1a is not supported.

Hypothesis 1b (H1b) suggests that there is a positive relationship between differentiation strategy and strategic alignment. Based on the results shown in Table 4 there is a positive relationship between differentiation strategy and strategic alignment ($\beta$= 0.613, t = 9.179, p < 0.01). Thus, H1b is supported.

Hypothesis 3a (H3a) suggests that there is a negative relationship between low-cost and organizational performance. Based on the statistical results, it shows that there is a negative relationship between low-cost strategy and organizational performance ($\beta$=0.033, t =0.324, p < 0.1). Thus, H3a is supported.

Hypothesis 3b (H3b) suggests that there is a positive relationship between differentiation strategy and organizational performance. As shown in Table 8 there is a positive relationship between differentiation strategy and organizational performance ($\beta$=0.194, t=1.838, p < 0.05). Thus, H3b is supported.

[INSERT TABLE 8 HERE]

*Path analysis test for Model 1*

A path analysis of the relationship between low-cost and differentiation strategies and organizational performance are both directly and indirectly through strategic alignment (Model 1). The findings indicate that low-cost has no positive relationship with organizational performance both directly and indirectly. In contrast, differentiation has a strong relationship with organizational performance both directly and indirectly. The direct effect is higher than the indirect effect.

*Testing hypotheses H1c, H2 and H3c using Model 2*

Hypothesis 1c (H1c) suggests that there is a positive relationship between a joint strategy and strategic alignment. As explained earlier, the factor loading for LC1 and

LC2 were below standards suggested by Hulland (1999), and both constructs were dropped from the analysis. As a result of the deletion of these constructs, this study suggests that the joint strategy does not exist and is instead only a differentiation strategy. Thus, H1c and H3c cannot be tested. The relationships between differentiation strategy and strategic alignment (H1b) as well as organizational performance (H3b) were tested using Model 1; these also were tested twice in Model 2. From the results presented in Table 9, we can see that differentiation has a positive effect on strategic alignment ($\beta$= 0.594, t = 11.123, p < 0.01). Thus, H1b is not supported.

Additionally, Hypothesis H2 suggested that there is a positive relationship between strategy alignment and organizational performance. The statistical findings illustrate that there is a weak relationship between strategic alignment and organizational performance ($\beta$= 0.210, t = 1.839, p < 0.5). Therefore, H2 is supported.

[INSERT TABLE 9 HERE]

Hypothesis 3b (H3b) suggests that there is a positive relationship between differentiation strategy and organizational performance. Based on Table 6, there is a positive effect between differentiation strategy and organizational performance ($\beta$= 0.165, t = 2.206, p < 0.01). Hence, H3b is supported.

*Path analysis test for Model 2*

A path analysis of the relationship between a joint strategy and organizational performance is both directly and indirectly through service strategic alignment (Model 2). According to path analysis, it shows that a joint strategy has no direct or

indirect effect through strategic alignment. But in Model 2, the differentiation strategy has both a direct and indirect effect through strategic alignment.

In conclusion, the findings from Model 1 and Model 2 indicate that only differentiation strategy has an effect on organizational performance both directly and indirectly through strategic alignment rather than low-cost or joint business strategy.

*Interview Results*

Our survey findings show that the differentiation strategy helped enhance the organizational performance of Indonesian financial institutions. To better understand the reasons for the selection and effectiveness of the differentiation strategy, we interviewed senior managers from Indonesian banking sector. Our analysis of the interview data identified two keys explanations for the business strategy choices: highly regulated sector, and emphasis on service quality and customer satisfaction.

<u>*Highly Regulated Sector*</u>

As discussed earlier, the Indonesian financial sector was historically high centralized and regulated. However, in the aftermath of the Asian financial crisis of 2007-2008, the Indonesian government has attempted to decentralize the sector, and reduce the control of Bank Indonesia over the operations of the financial institutions. However, our findings reveal that decision-making in the sector remains highly centralized, and the financial institutions have limited control over product offerings.

Unlike the manufacturing industry or other hard services, the financial sector is heavily regulated to protect consumers. Despite the fact that the regulative environment was blamed for the weaknesses in the system during the Asian financial

crisis, the Bank of Indonesia's rules restrict product differentiation. These rules relate to minimum capital requirements, and interest rates. The minimum capital requirement may well be part of the overall strategy to provide protection against banking collapse, but they can also be deterrence for the establishment of micro-financing institutions. Hence, it has implications for the promotion of entrepreneurial activities in the country, and the establishment of small and medium enterprises. This requirement also adds a layer of bureaucracy as the Bank of Indonesia directly monitors the minimum capital requirement of banks, rather than relying on internal and external auditors.

In addition to the minimum capital requirement, the Bank of Indonesia also regulates the interest rates offering by the banking sector. Unlike the banking sector in many countries where banks are free to offer higher interest return on deposits or lower rates on loans, the Indonesian banks are forced to offer products at the same interest rate. This requirement reduces the opportunity for banks to differentiate themselves from competitors. Any change in the rate proposed by a bank requires permission from the Bank of Indonesia, which is another layer of approval and bureaucracy that is time-consuming and seen to be difficult to achieve:

> *[...] Bank business is highly regulated by the Bank of Indonesia.*
> *Hence, we cannot set, for example, interest rates without getting*
> *permission from the Bank of Indonesia.* [Risk management
> manager of Bank F, M7]

*Service Quality and Consumer Satisfaction*

The restriction on interest rate variation means that product differentiation between banks is difficult to achieve. The interviewees in our study explained that in order to attract customers and to distinguish their operations from those of the competitors, the banks focused on innovation in both products and service quality. For example, the interviewee from Bank D explained that to become a winner, his bank focused on three indicators: good human resources, good systems and attractive premises. It is important that the staff and the systems have a strategy to enhance service quality.

> *Our strategy focuses on human resources because service is executed by front-line staff. We also need a good service system that is independent of times and premises. Finally, the premises themselves must show good layout, queue lines, cleanness, and comfort. Then all factors will enhance service quality.* [Vice-President, corporate services, Bank F, M5]

Another manager (M9) explained that his bank concentrates on service quality rather than offering higher interest deposits to customers. He said that if the bank competes on interest rates, it would lose money.

> *At this time, we specialize in service. However, if we* [sought permission, and] *offered low-interest loans, we would lose because our funding is mostly from fixed-term deposits.* [Senior manager of Bank H, M9]

The managers explained that banks in the sector focus on enhancing consumer satisfaction and the quality of service experienced by the bank clients. Bank customers in Indonesia are not used to paying for account keeping fees, and are exempt from such costs if they maintain a certain level of funds in their account. Thus,

the cost of enhanced customer satisfaction, including investing in the décor of the bank premises, is an additional expense that the banks have to bear in order to win the business.

## 7. Discussion and Implications

We discuss the findings of this study in the context of Indonesia's economic environment using the Institutional theory perspective. We find that the regulatory, institutional and socio-cultural environment of the country influences the strategic choices of the organizations in the Indonesian financial sector. Our results show that Indonesian firms tend to use a combination of both low-cost and differentiation strategy. However, only the differentiation strategy creates value for the organization. The low-cost strategy reflects the demands of the consumer base that wants low fees for services but requires a highly personalized service due to lower level of technology use. Hence, while in many developed countries the use of Internet banking and other similar digital-technology based delivery platforms has helped transform some financial services to hard services, in Indonesia and many other emerging markets consumers continue to demand low-cost personalized 'soft' service.

The Indonesian government has historically controlled the financial services sector, and the level of competition between private and State-owned firms; lending practices; loan guarantees; capital adequacy and other related issues have been regulated by the State. While this level of control has been reducing through reforms in the sector, the government still dictates what interest rate will be offered by banks, and any request by an individual bank to provide a higher rate of interest on savings or a lower rate on lending requires approval from Bank Indonesia. Thus, we can see the influence of

*regulative* and *normative* elements in the way the financial sector operates in Indonesia. The government through Bank Indonesia continues to regulate the operations of the organizations in the sector, and the demographics and behaviour of consumers dictate the norms expected from the firms.

The financial institutions have responded to these issues by attempting to create value through *cultural-cognitive* elements that provide stability through *structural isomorphism*. This includes investing in the human resources of the organization to deliver superior service to clients, and using symbols and designs in the corporate logo and buildings that reflect the core value and cultural beliefs of the society. Hence, these firms are attempting to create tangible value for customers through physical assets by using their dynamic capabilities via their human resources. Thus, we find that despite regulatory and socio-economic barriers, financial institutions continue to create value for their clients through innovative use of their human resource capabilities and raising customer satisfaction (Naceur and Omran, 2011).

The study makes three key contributions to the literature on strategy in service sector organizations. First, this study demonstrates that the joint strategy provides incremental performance benefits to an organization. Second, many studies have investigated the role of strategic alignment in the manufacturing industries (see for example, Brown, Squaire and Blackmon, 2007; Chenhall, 2005; Decoene and Bruggeman, 2006; Gomes, 2010; Joshi, Kathuria and Porth, 2003), however, there have only been limited number of such studies in the service sector, especially in financial institutions. This provides us with better insights into how organizations use their dynamic capabilities without the use of physical output to create value for customers, and differentiate themselves from competitors. Finally, the study

demonstrates how service sector firms respond to regulative challenges in emerging markets.

There are a number of managerial implications that emerge from this study. We find that firms in the service sector in emerging markets can achieve value by pursuing the differentiation strategy. The differentiation is found in customer service, with emphasis on ensuring and enhancing consumer satisfaction. For managers this means that consumers are willing to bank with financial institutions that can match the low-cost industry standards but also personalized service in the bank branches. Although product innovation may not be at a level that the banks would like due to government intervention and control, there is the possibility to innovate and find new ways to enhance customer satisfaction. This could include a strong network of branches to provide better access for the customers; improving the training of the staff to ensure the best possible level of customer satisfaction, and responding to the demands of their growing youth market by investing in IT services, and online banking products.

## 8. Conclusion and Future Studies

Previous studies have suggested that joint business strategies yield inconsistent results for organizational performance (see: Salavou, 2010). While some researchers argue that a pure strategy contributes positively to a firm's performance (Parnell, 2010; Thornhill and White, 2007), others believe that a joint business strategy produces a significant improvement in business performance (e.g., Parnell, Lester, Long and Koseoglu, 2012). In this current study on Indonesian financial institutions, we have attempted to investigate whether a joint strategy position provides an incremental performance benefit for service sector organizations. Our findings reveal that

Indonesian financial institutions apply the joint strategy, but only the differential strategy improves performance directly and indirectly through strategy alignment.

In this study we have highlighted the similarities found in the historical development of Indonesia's political and economic systems, and those of other emerging countries. Hence, we argue that the findings of this study can be generalized for other emerging economies. However, other emerging markets such as Malaysia have had different political and economic conditions, and control of their central bank in the operations of financial institutions. Future studies could attempt to investigate the choice of business strategy and its influence on organizational performance in such countries.

**Figure 1:** Conceptual Framework: Relationship between business strategy, strategic alignment and performance.
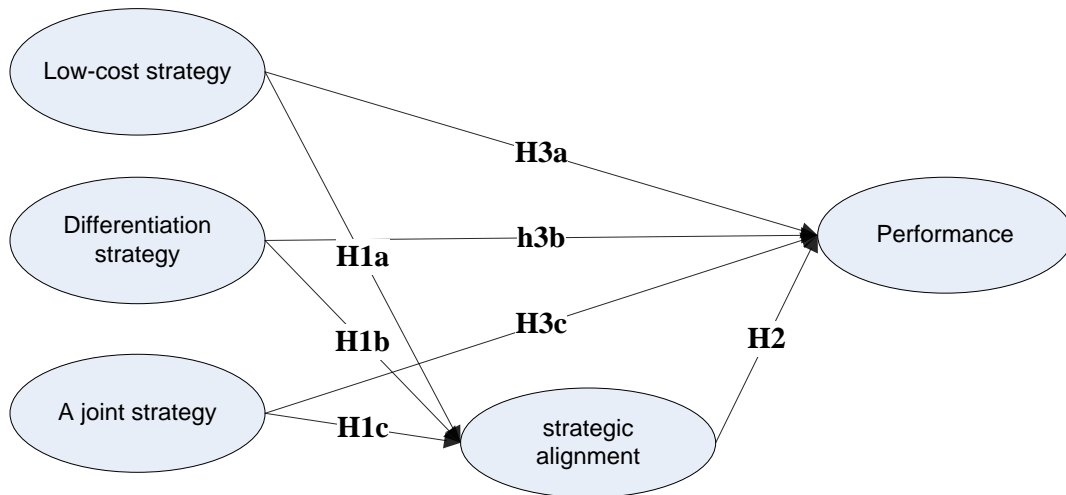


Low-cost strategy

Differentiation strategy

A joint strategy

Performance

strategic alignment

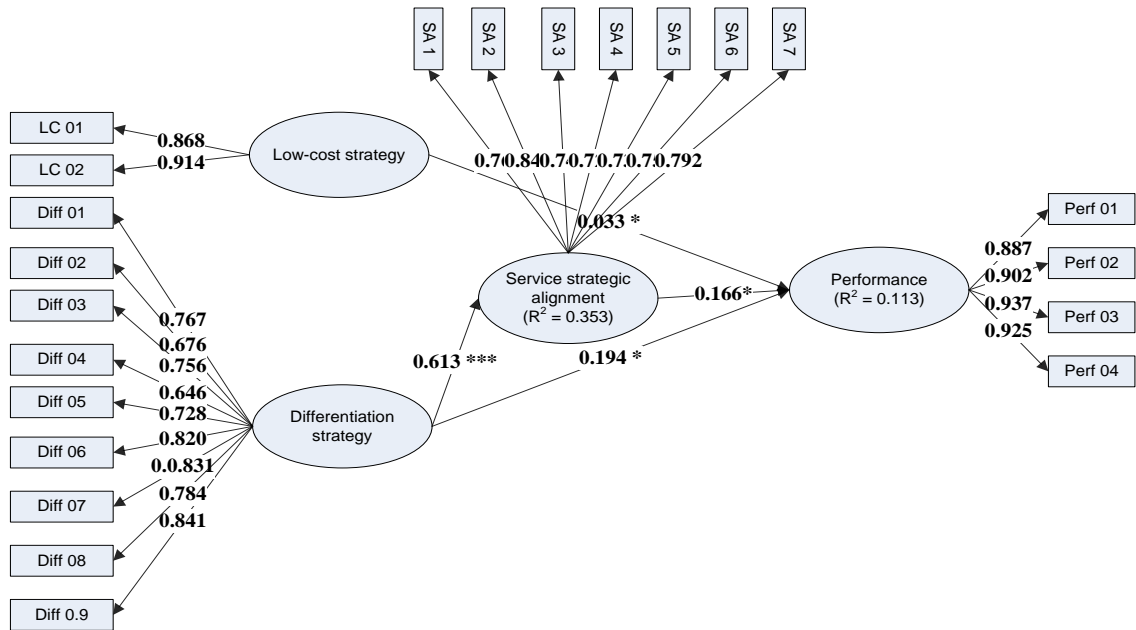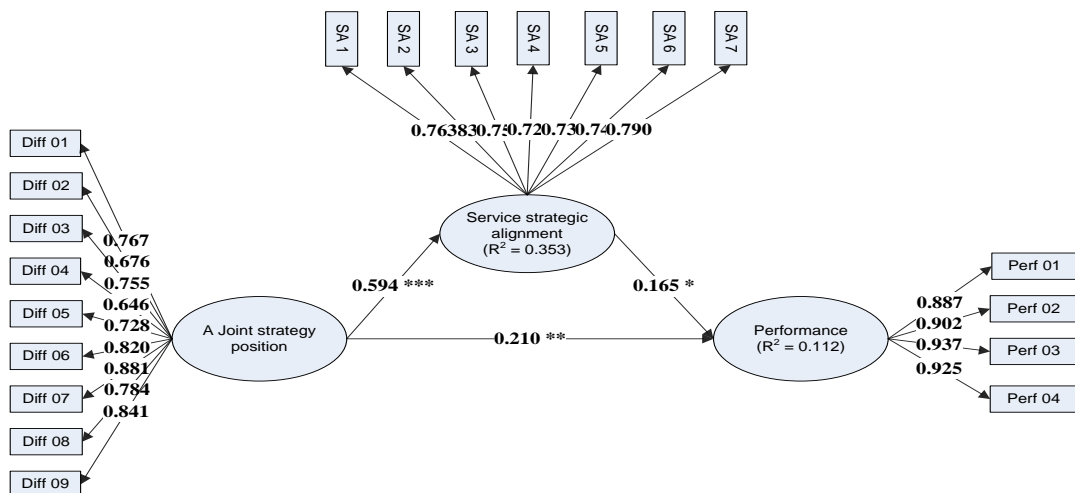H3a

h3b

H3c

H1a

H1b

H1c

H2

**Figure 2:** PLS model with significant path coefficients for Model 1



*** Significant at 1%
** Significant at 5%
* Significant 10%

**Figure 3:** PLS model with significant path coefficients for Model 2



*** Significant at 1%
** Significant at 5%
* Significant at 10%

**Table 1:** Demographic information of survey respondents

|  |  | *n* | *Cumulative* | *%* | *Cumulative (%)* |
|---|---|---|---|---|---|
| *Gender* | Men | 94 | 94 | 59.9 | 59.1 |
|  | Women | 63 | 157 | 40.1 | 100 |
| *Age* | < 35 | 49 | 49 | 31.2 | 31.2 |
|  | 36-40 | 43 | 92 | 27.4 | 58.6 |
|  | 41-45 | 36 | 128 | 22.9 | 81.5 |
|  | > 46 | 29 | 157 | 18.5 | 100 |
| *Division* | Accounting & finance | 52 | 52 | 33.1 | 33.1 |
|  | General | 24 | 76 | 15.3 | 48.4 |
|  | Human resources | 43 | 119 | 27.4 | 75.4 |
|  | Marketing | 15 | 134 | 9.6 | 85.4 |
|  | Others | 23 | 157 | 14.6 | 100 |
| *Business Type* | Banking Industry | 60 | 60 | 38.2 | 38.2 |
|  | Financing | 28 | 88 | 17.8 | 56.1 |
|  | Insurance | 56 | 144 | 35.7 | 91.7 |
|  | Others | 13 | 157 | 8.3 | 100 |

**Table 2:** Profile of interviewees

| Interviewee Code | Bank Code | Position in Bank | State-Owned or Private |
|---|---|---|---|
| M1 | Bank A | Vice-president Director | Private |
| M2 | Bank B | Head of Compliance Representative | Private |
| M3 | Bank C | Operation and Accounting Division Head | Private |
| M4 | Bank D | Vice-president Corporate Planning | Private |
| M5 | Bank D | Vice-president of Corporate Services | Private |
| M6 | Bank E | Senior Manager of Finance Division. | Private |
| M7 | Bank F | Risk Management Manager | State-Owned |
| M8 | Bank G | Head of Legal Division | Private |
| M9 | Bank H | Head of Human Resources | Private |
| M10 | Bank I | Corporate Secretary & Legal Manager | Private |
| M11 | Bank I | Head of Human Resource Management | Private |
| M12 | Bank J | Manager of Finance Division | Private |
| M13 | Bank K | Manager of Performance Measurement | State-Owned |
| M14 | Bank L | Head of Risk Management | Private |

**Table 3:** Descriptive statistic of the variables in the study

| Variable | n | Theoretical range | | Actual score | | Mean | SD |
|---|---|---|---|---|---|---|---|
| | | Min | Max | Min | Max | | |
| *Business strategy* | 157 | 1 | 7 | 1 | 7 | 5.51 | 1.08 |
| *Strategy alignment* | 157 | 1 | 7 | 1 | 7 | 5.61 | 1.06 |
| *Organizational performance* | 157 | 1 | 7 | 2 | 7 | 5.55 | 1.09 |

**Table 4:** Factor loading for business strategy, strategic alignment and organizational performance

| No | Factor | Items | Factor loading | |
|---|---|---|---|---|
| *1* | Low-cost strategy (Eigenvalue=5.697, % of variance = 51.790) | LC1 | 0.138 | **0.878** |
| | | LC2 | 0.211 | **0.859** |
| *2* | Differentiation strategy (Eigenvalue=1.257, % of variance = 11.428) | DIFF1 | **0.668** | 0.425 |
| | | DIFF2 | **0.674** | 0.143 |
| | | DIFF3 | **0.790** | 0.023 |
| | | DIFF4 | **0.649** | 0.131 |
| | | DIFF5 | **0.696** | .0229 |
| | | DIFF6 | **0.748** | 0.344 |
| | | DIFF7 | **0.791** | 0.240 |
| | | DIFF8 | **0.788** | 0.097 |
| | | DIFF9 | **0.765** | 0.323 |
| *3* | Service strategic alignment (Eigenvalue=4.115, % of variance =58.785) | SSA1 | 0.743 | |
| | | SSA2 | 0.816 | |
| | | SSA3 | 0.735 | |
| | | SSA4 | 0.738 | |
| | | SSA5 | 0.766 | |
| | | SSA6 | 0.778 | |
| | | SSA7 | 0.788 | |
| *4* | Organizational Performance (Eigenvalue=3.335, % of variance =83.367) | Perf1 | 0.883 | |
| | | Perf2 | 0.907 | |
| | | Perf3 | 0.932 | |
| | | Perf4 | 0.929 | |

**Table 5:** AVE, composite reliability and Cronbach's alpha for Models 1 and 2

| Variable | Model 1 | | | Model 2 | | |
|---|---|---|---|---|---|---|
| | AVE | Composite reliability | Cronbach's alpha | AVE | Composite reliability | Cronbach's alpha |
| *Low-cost strategy* | 0.795 | 0.885 | 0.743 | | | |
| *Diff strategy* | 0.583 | 0.926 | 0.910 | | | |
| *A joint strategy* | | | | 0.583 | 0.926 | 0.910 |
| *Strategic alignment* | 0.586 | 0.908 | 0.882 | 0.586 | 0.952 | 0.883 |
| *Performance* | 0.833 | 0.952 | 0.933 | 0.833 | 0.908 | 0.933 |

**Table 6:** Discriminant validity of latent variables correlations for Model 1

| Latent variables | Correlation | | | |
|---|---|---|---|---|
| | Low-cost strategy | Differentiation strategy | Strategy alignment | Performance |
| *Low-cost strategy* | **0.892** | | | |
| *Differentiation strategy* | 0.471 | **0.764** | | |
| *Strategic alignment* | 0.246 | 0.593 | **0.766** | |
| *Performance* | 0.165 | 0.308 | 0.289 | **0.913** |

**Table 7:** Discriminant validity of latent variables correlations for Model 2

| Latent variables | Correlation | | |
|---|---|---|---|
| | A joint strategy | Strategy alignment | Performance |
| *A joint strategy* | **0.764** | | |
| *Strategic alignment* | 0.593 | **0.766** | |
| *Performance* | 0.308 | 0.290 | **0.913** |

**Table 8:** Result of PLS structural model: path coefficient, t-statistics and $R^2$ for Model 1

| Dependent variables | Independent variables | | | $R^2$ |
| --- | --- | --- | --- | --- |
| | *Low-cost strategy* | *Differentiation strategy* | *Strategic alignment* | |
| *Strategic alignment* | -0.043 (0.519)* | 0.613 (9.179)*** | | 0.353 |
| *Performance* | 0.033 (0.324)* | 0.194 (1.838)** | 0.166 (1.888)** | 0.113 |

\*\*\*    Significant at 1%

\*\*    Significant at 5%

\*    Significant at 10%

**Table 9:** Result of PLS structural model: path coefficient, t-statistics and $R^2$ for Model 2

| Dependent variables | Independent variables | | $R^2$ |
| --- | --- | --- | --- |
| | *Differentiation strategy* | *Strategic alignment* | |
| *Strategic alignment* | 0.594 (11.123) *** | | 0.455 |
| *Performance* | 0.165 (2.206)** | 0.210 (1.839)** | 0.338 |

\*\*\*    Significant at 1%

\*\*    Significant at 5%

\*    Significant at 10%

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