

**BANKING COMPETITION AND ITS RELATIONSHIP
WITH BANKING STABILITY:
EVIDENCE FROM INDONESIA**

1980 - 2010

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ABSTRACT

A competitive banking industry is essential to enhance financial system efficiency. An efficient financial system contributes to accelerated economic growth through its role in payment service delivery, macroeconomic policy transmission and safeguarding of financial stability. This thesis estimates competition in Indonesian banking covering all commercial banks in the recent three decades by using the recent refinement of the Panzar-Rosse method by Bikker, Shaffer and Spierdijk (2011). Furthermore, this study examines the determinants of competitive banking based on the contestable theory of Baumol (1982) by investigating the impact of state intervention, comparing the competitive behaviour of banks across different sizes and ownerships and researching the role of foreign penetration, market concentration and the macroeconomic environment. This thesis also studies the relationship between competitive banking and banking stability. The impact of competitive banking on banking stability has been recently discussed extensively both in the academic literature and media following the international banking and financial crises.

The empirical estimation of Fixed Effect panel data shows that Indonesian banking worked in a monopolistically competitive market. The yearly estimations of H-statistics of the Panzar-Rosse method reveal that the industry was very competitive during the periods of banking reforms and liberalization between 1988 and 1994. The estimation of the impact of structural changes on competition presents evidences that the introduction of reforms in 1983 and 1988 and banking liberalization in 1988 and 1992 created a contestable market because the industry was open for new entrants and had less restrictions and controls. The estimation of the competitive behaviour of banks across different sizes and ownerships demonstrates that small banks, private banks and *de novo* banks are the main drivers of competition in the Indonesian banking industry. Whereas, the estimation of competitive behaviour of large banks indicates that market power facilitates collusion between large banks. The estimation of a Vector Error Correction Model (VECM) in chapter five suggests that the larger access of foreign firms to the market, the lower market concentration and a favorable macroeconomic environment promoted competition in the banking industry. Regarding to the relationship between competitive banking and stability, the estimations based on the Generalized Method of Moment (GMM) methodology suggest that competitive banking promotes banking stability

by lowering insolvency risk in the Indonesian banking industry. In a competitive environment, banks are more efficient and better capitalized to enable them in generating higher profits.

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