Indonesian stock market plunge indicates deepening economic turmoil

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The Indonesian stock market plunged last Wednesday and Thursday in what has been characterised as the most severe fall since the Asian financial crisis in 1998. There was a slight rally on Friday, but the market fell nearly 5 percent yesterday.

Last week's fall, which wiped off around $80 billion from the market, was sparked by an adverse report from the global index provider Morgan Stanley Capital Investment (MSCI) which sets ratings for markets.

It warned that it may downgrade Indonesia from an "emerging" to a "frontier" market. The designations cover issues like good corporate governance, fair dealing in financial markets and transparency in the ownership of assets.

"Emerging" market status sits between "frontier" and "developed," indicating that the country has a better system than the lowest grade but still carries risks.

The MSCI said it could carry out the downgrade in May if problems were not rectified by then after finding that there were "fundamental investability issues" in its structure.

An article in the *Financial Times* yesterday cast some light on the issues behind the MSCI decision which centred on the operations surrounding so-called "deep-fried stocks" which have highly restricted ownership that contribute "to rallies that can lift their tycoon owners into the ranks of Asia's richest people overnight."

In its announcement the MSCI cited "opacity in shareholding structure and concerns about possible co-ordinated trading behaviour that undermines proper price formation."

In the wake of the MSCI report, the heads of both the Financial Services Authority and the Indonesia Stock Exchange resigned from their posts on Friday.

A statement from the financial regulator said the resignation of its chief, Mahendra Siregar, was a "form of moral responsibility to support the creation of the necessary recovery steps." The stock exchange said its head, Iman Rachman, was stepping down as a form of "accountability over the condition of the Indonesian capital market over the past few days."

One of the chief reasons for the sharp fall was that major large investment funds which scour global markets for profitable opportunities are not permitted to hold assets in countries with a "frontier" status.

Bloomberg reported that according to analysts at Goldman Sachs in an extreme scenario the outflow of such funds in the event of a downgrade could be as much as $13 billion.

"The exit of such a large chunk of capital would put pressure on Indonesia's rupiah currency and make Indonesia more dependent on domestic savings and official funding sources."

The concern of the MSCI agency centres on the structure of the market and Indonesia's very low "free float"—that is the proportion of a company's shares that are freely available for public trading.

This means that a large proportion of the shares are in the hands of company founders, family groups and large conglomerates and thereby more subject to price manipulation, making it more difficult to large investors to enter and exit markets safely.

There have long been concerns about the concentration of share ownership in Indonesia, especially the control exercised by conglomerates owned by billionaires. In its report the MSCI said investors had expressed concerns over Indonesia's shareholder reporting rules and opaque ownership structures that created conditions for improper trading and market manipulation.

In response to the sell-off, Indonesian regulators said they would double the minimum free float level to 15 percent and would undertake an overhaul of stock market ownership to encourage greater diversification.

The MSCI warning came at a very “unfortunate time,” in the words of one asset manager in Singapore, because of growing problems in the economy and a weakening currency. No doubt investors also have their eye on the prospect of further social upheavals following the demonstrations and protests last August.

The immediate trigger for the protests, which extended from the capital, Jakarta, to major cities throughout the country, was the decision to pay an accommodation allowance to parliamentarians as much as 10 to 20 times the minimum wage paid to millions of workers.

It was a catalyst for the eruption of social anger over deepening inequality, expressed not least in the elevation of the stock market tycoons.

In the wake of the protests, which led to death of at least 11 people in clashes with the police and military, president Prabowo announced some changes in economic policy.

He sacked the finance minister Sri Mulyani Indrawati, who insisted on so-called fiscal prudence. Prabowo then declared he was on a pro-growth course aimed at lifting annual growth to 8 percent—a rate last achieved in the 1990s—from its present level of 5 percent.

Sri Mulyani was replaced by Purbaya Yudhi Sadewa, who claimed, on taking office in September, that with the right fiscal and domestic policies “we can build the foundation to faster growth relatively easily.”

But there is concern in financial markets over this assertion and the policies that have followed in conditions of a slowdown in consumption spending and a weakening jobs market—youth unemployment is around 16 percent, and many young people are in poorly paid causal work.

Investors are concerned that an expansion of the government deficit beyond a 3 percent limit will lead to market turmoil.

Those concerns were heightened with the decision last month by Prabowo to appoint his nephew, Thomas Djiwandono, as deputy governor of the central bank. The rupiah, which has been trading at lows approaching the levels seen in the 1998 crisis, fell on the news as it was seen as compromising the independence of the central bank.

In response, finance minister Purbaya said the appointment has no connection to central bank independence. But, in a remarks the following day, he said the government would “maintain the independence of the central bank to the maximum extent possible.”

Financial and economic analysts have likened the situation to that in the US where president Trump is insisting that the central bank pursue a more pro-growth monetary policy.

But economists maintain that even the growth of 5 percent may be difficult to sustain in present conditions.

There is also concern in financial circles that populist economic measures undertaken by Prabowo in the effort to quell social opposition, in particular the $28 billion free lunch program for school children, will blow out the fiscal deficit under conditions where government revenue is failing to grow.

Commenting on the market selloff, Purbaya said: “This is surely just a temporary shock because there is no issue in our fundamentals.”

But the movements in financial markets and the lowering of the value of the rupiah point in the other direction and the potential for the emergence of further economic and financial turmoil, leading to the re-emergence of the social struggles which erupted last August on a wider scale.