

Research Report September 2018

INDONESIA INVESTMENTS

“Beautiful Yet Violently Dangerous Nature”



Indonesia Investments Research Report

Beautiful Yet Violently Dangerous Nature

September 2018



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* The picture on the cover of this research report is owned by Biro Pers Setpres (photographer: Laily Rachev)

Preface

Indonesia Investments' monthly research report is written and published by Van Der Schaar Investments B.V. - located in Delft, the Netherlands. The report aims to inform the reader of the latest most relevant political, economic and social developments in Indonesia as well as those key global developments that are impacting on the Indonesian economy or politics.

Our research reports are intended for a wide audience, including individual and corporate investors, financial market participants, policy makers, journalists, academics, and analysts.

The website Indonesia Investments is the reference and access point for gaining knowledge about Indonesian markets, economy and cultures. The website is owned by Van Der Schaar Investments B.V., a privately-held investment company (Ltd.) which was established in 2009 but stands in a tradition that stretches back to urban development in the Dutch capital city of Amsterdam in the early 20th century.

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Lastly, we would like to emphasize that - although we strive to present accurate, up-to-date, and objective information to the reader - Indonesia Investments cannot guarantee the accuracy of all data that is included in this report.



Introduction

Unfortunately Indonesia has - again - become victim of a major natural disaster. At the time of writing this introduction, search and rescue teams are still trying to find survivors of the 7.4-magnitude earthquake and subsequent tsunami that occurred on Friday 28 September 2018 in Central Sulawesi. The death toll has already reached 1,500 and this figure is believed to rise markedly in the days, weeks - or even months - ahead as various regions along the western coastline of Central Sulawesi are inaccessible. Moreover, there are plenty of reports about the lack of heavy equipment in the affected area which makes search and rescue efforts a tough and hazardous affair. Meanwhile, it is difficult to transport heavy equipment to the region as local infrastructure (ports, roads and bridges) have been damaged by the forces of nature.

After a series of earthquakes killed nearly 600 people on the island of Lombok in the months of July and August, disaster now struck at Central Sulawesi. It is yet another reminder that life on the Pacific Ring of Fire, an area with a high degree of tectonic activity, is not risk-free and therefore it is the task of both the central and local governments to have specific programs and policies (such early warning systems) ready for when disaster strikes. Moreover, authorities should encourage the establishment of good quality infrastructure and property. It is known that money is often saved in infrastructure and property projects across Indonesia by using low-quality materials, while the lack of expertise among construction workers and managers leads to construction fails that are exposed when the structure comes under (heavy) pressure. Poor maintenance is also a persistent problem in Indonesia. It may feel good to save some money on construction or maintenance. However, eventually costs are likely to be higher, while lives are shed. Obviously, programs and quality control cannot prevent an earthquake or tsunami from happening; they will strike at any given moment. However, good preparation will reduce the impact and should save many lives.

While Indonesia has so much natural beauty to offer to people - including beaches, volcanoes, and mountains - nature occasionally turns itself against the people - in the form of tsunamis, volcanic eruptions and landslides - and therefore we titled the September edition of our monthly research report "**Beautiful Yet Violently Dangerous Nature**".

Although most attention in local media is rightfully centered on the disaster in Central Sulawesi, there are other important stories that need attention as well. One interesting story is the rupiah exchange rate. At the time of writing this introduction, the Indonesian currency nearly reached IDR 15,200 per US dollar, a 20-year low that brings back memories of the Asian Financial Crisis in the late 1990s, and it is also a level that makes policymakers nervous. Rupiah weakness and Indonesia's wide current account deficit also make investors cautious, thus we see new capital outflows in September 2018.

Problematically however, Indonesia is actually highly dependent on foreign capital to fund its deficits, partly because the country failed to develop a (high-technology) manufacturing industry (in the 1990s growth of Indonesia's manufacturing industry was promising but this development was cut short by the Asian Financial Crisis). It means that in terms of exports Indonesia remains highly dependent on (volatile) commodity prices. Meanwhile, Indonesia's appetite for fuel has risen drastically, while domestic oil output remains in a state of decline. Thus, costly oil imports are putting pressure on the rupiah.

Furthermore, a significant chunk of Indonesia's government bonds are in the hands of foreign investors. With rising interest rates in the USA (while there exists a high degree of uncertainty in global financial markets) part of these investors return to the USA. Despite Bank Indonesia's aggressive monetary tightening (raising the benchmark interest rate by 150 basis points to 5.75 percent in a series of rate hikes over the past couple of months) these investors are not enticed by Indonesia's higher interest rate environment. It could be a sign that Bank Indonesia needs to become even more aggressive in terms of rate hikes (even though it would impact negatively on the nation's economic growth).

Bank Indonesia needs to remain fully transparent and give very clear signals to markets about where it is going monetary policy-wise, while pointing at the fact that Indonesia's economic and financial fundamentals are sound (Indonesia is surely no Turkey or Argentina).

But with relatively small yet open financial markets, Indonesia does find itself in a risky position as it is vulnerable to capital outflows in times of global economic turmoil. Indeed, in good times foreign capital inflows will give an additional boost to emerging economies. However, when the global economic environment does a 180 degree turn, this effect reverses quickly as foreigners rapidly withdraw their funds from these markets. In other words, Indonesia's money and capital markets are more accessible to speculators.

Research Department

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Delft & Jakarta, 4 October 2018




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