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The Structural Fragility of Indonesia's Equity Market

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The sharp fall of Indonesia's stock market in late January 2026 was widely attributed to global sentiment shifts and technical adjustments related to MSCI indices. Yet, to treat the episode as a transient confidence shock misses its deeper significance.

What unfolded was a stress test of Indonesia's capital market architecture. It reveals long-standing structural weaknesses that have existed for years but only become visible under pressure. The episode reminds us that market volatility is often less about news and sentiments, but more about structure.

Despite its growing size, Indonesia's capital market remains economically shallow. With more than 900 listed companies, millions of retail investors, and a fast-growing asset management industry, Indonesia appears to embody financial deepening. In reality, however, liquidity, price discovery, and risk absorption remain highly concentrated.

A small group of large-cap stocks—primarily banks, commodity-linked firms, and select conglomerates—accounts for the bulk of market capitalization, trading value, and index weight. Beyond this core, hundreds of listed firms are thinly traded, illiquid, and largely disconnected from the market's price-forming process.

This concentration creates an illusion of breadth, generating fragility. In structurally deep markets, shocks are absorbed through diversified participation and thick order books. In Indonesia, similar shocks quickly translate into sharp price dislocations, because effective liquidity is limited.

When large investors adjust positions, prices tend to gap rather than adjust smoothly. Volatility thus appears outsized relative to the underlying information shock. Fragility, in this sense, is not episodic, it is embedded.

The rapid growth of index funds and exchange-traded funds has interacted with this structure in destabilizing ways. In theory, passive instruments should improve efficiency by lowering costs and minimizing discretionary bias. In Indonesia's context, however, indices themselves are highly concentrated and composed of stocks with limited free float.

Passive capital thus becomes mechanically powerful and inherently price insensitive. During inflow periods, funds are compelled to buy the same index-heavy stocks regardless of valuation, pushing prices upward through sheer demand. During outflows, they must liquidate those same stocks simultaneously, overwhelming already thin liquidity. Rather than dampening volatility, passive instruments amplify it.

Active equity mutual funds do little to counteract this effect. Although formally active, many funds operate as closet indexers. They maintain portfolios that closely track benchmarks, such as the IHSG or LQ45, with small tracking errors and limited deviation from benchmark weight. Genuine stock selection is limited.

This behavior reflects the asymmetric incentives faced by fund managers. Underperforming the benchmark carries immediate reputational and commercial penalties, while modest outperformance yields limited upside.

In a shallow market with a narrow investable universe, herding behavior becomes the equilibrium strategy. As a result, active management contributes little to price discovery and instead reinforces correlation across portfolios and concentrates risk in the same set of widely held stocks.

When redemptions occur, discretion evaporates. Fund managers are forced to sell the same securities at the same time, intensifying downward price pressure. What appears as diversification across funds is, in reality, a highly synchronized exposure to a small segment of the market.

These structural conditions also facilitate value extraction by controlling shareholders, particularly within large conglomerates. This is less a matter of illegality than of governance arbitrage.

Many initial public offerings function primarily as mechanisms for refinancing, deleveraging, or partial exits rather than as vehicles for productive capital formation. Free float is often kept deliberately low, preserving control over liquidity and price dynamics.

Subsequent corporate actions, such as rights issues, private placements, and intra-group asset injections, may comply with formal disclosure rules while systematically diluting minority shareholders.

In such an environment, retail investors and benchmark-driven funds effectively serve as exit liquidity. Wealth transfer occurs through legally permissible structures that exploit information asymmetries and market thinness.

The cumulative effect is a capital market that redistributes value upward rather than allocating capital efficiently toward productive investment. Fragility, here, is not merely financial. It is institutional and distributive.

It would be mistaken to assume that regulators are unaware of these dynamics. The challenge lies in the institutional and political constraints under which they operate. Regulatory mandates emphasize short-term stability over long-term market quality.

Reforms that could improve governance or deepen liquidity often carry immediate costs in the form of lower trading volumes, fewer listings, or adverse headlines. In a market already perceived as fragile, such outcomes are institutionally unattractive.

Moreover, many problematic practices reside in legal grey areas rather than clear violations. Proving manipulation or abusive intent is resource-intensive and legally uncertain, especially when powerful economic actors are involved.

Regulators, acting rationally, tend to avoid enforcement actions they may not win. This caution is reinforced by the broader political economy, in which large conglomerates are closely tied to employment, investment, and national development narratives, raising the implicit cost of confrontation.

International experience suggests that these challenges are not Indonesia's unique. Korea, Taiwan, and India have faced similar issues, but responded differently. Korea limited the role of equity markets in financing large business groups, relying instead on banks and directed credit while enforcing minority shareholder protections.

Taiwan emphasized dispersed ownership, strong domestic institutional investors, and tight constraints on dilutive corporate actions. India, after years of market abuse, opted for highly visible and punitive enforcement, accepting short-term disruption to restore credibility and long-term trust.

In each case, successful industrializers recognized the limits of shallow equity markets and avoided assigning them roles they were ill-equipped to perform.

Indonesia’s capital market was never designed as an engine of industrial upgrading. Historically, it has served as a platform for privatization and asset monetization. Manufacturing and technology-intensive firms remain underrepresented, while holding companies and resource-based businesses dominate listings.

Consequently, expectations that the stock market can finance structural transformation are misplaced. When capital markets are shallow, financial sophistication does not deepen them. It amplifies existing weaknesses.

Reorienting the market toward value creation, therefore, requires stronger free-float rules, tighter disclosure of related-party transactions and post-IPO actions, as well as stricter liquidity standards for benchmark-driven funds. Credible enforcement and a greater role for long-term institutional investors are essential to counter short-term liquidity cycles.

All in all, the events of January 2026 were a warning, not an anomaly. Funds and instruments have outpaced reforms in ownership dispersion, liquidity, governance, and institutional capacity. Until this gap is closed, Indonesia’s capital market will continue to reflect existing power structures rather than transform them.

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