PPi Indonesia

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PERSONAL FINANCE

IS THERE ANY SAFE PLACE FOR OUR SAVINGS?

We were always taught that banks were the safest place for our savings. Admittedly we had to accept that in the long term our savings would be eroded by inflation, but at least the cash would always be there.

Such illusions have now been shattered by events in Cyprus where thousands of people who entrusted their savings to banks have been told they will lose between 30% and 60% of their deposits and may have further difficulty in accessing the remainder. This was the price they had to pay to ensure the banks received bailout funds from Europe. The alternative would have been bankruptcy for the banks and for the country.

But how can a bank, with all its vast resources go bankrupt? - Very easily if it is not properly managed. Deposits taken from customers are for the short term, ranging from immediate access to up to a year. The bank then makes money by lending out the money for longer terms. Housing loans constitute a large part of their loan business.

This is fine provided that income is sufficient to meet depositors' interest payments and any withdrawals. But when loans start to default and a large number of depositors want access to their cash the bank can suddenly find it is running out of money and becomes technically insolvent. Prior to the financial meltdown of 2008 if such a situation arose at a single bank, the situation could have been resolved by the bank borrowing from other banks. But when property values collapse by up to 50%, as in parts of Europe, and when all banks find they are in the same boat the problem shifts to government. And when the government doesn't have the resources to prop up the banks, it means the country is broke and it either goes into bankruptcy itself, as in the case of Iceland a few years ago or, if it's lucky as with Cyprus, it gets bailout funds from other countries. But such bailouts come at a price and it is the bank account holders who have paid the price in the latest instance. This is a worrying precedent; in previous cases of bank failures in Europe and elsewhere the taxpayer has usually footed the bill.

Could the same thing happen in Indonesia?

There do not appear to be any immediate threats although there is a housing boom, much of it fuelled by relatively easy loans. Cars and motorcycles are also pouring onto the roads at an alarming rate, again fuelled by easy loans and aggressive sales. While house prices are rising and the economy is strong the banking sector should remain healthy. But if there were a sudden and serious economic downturn, there will always be the possibility of a repeat of the banking crisis of 1997, although in that instance it was brought about by dubious loans not related to the retail housing market.

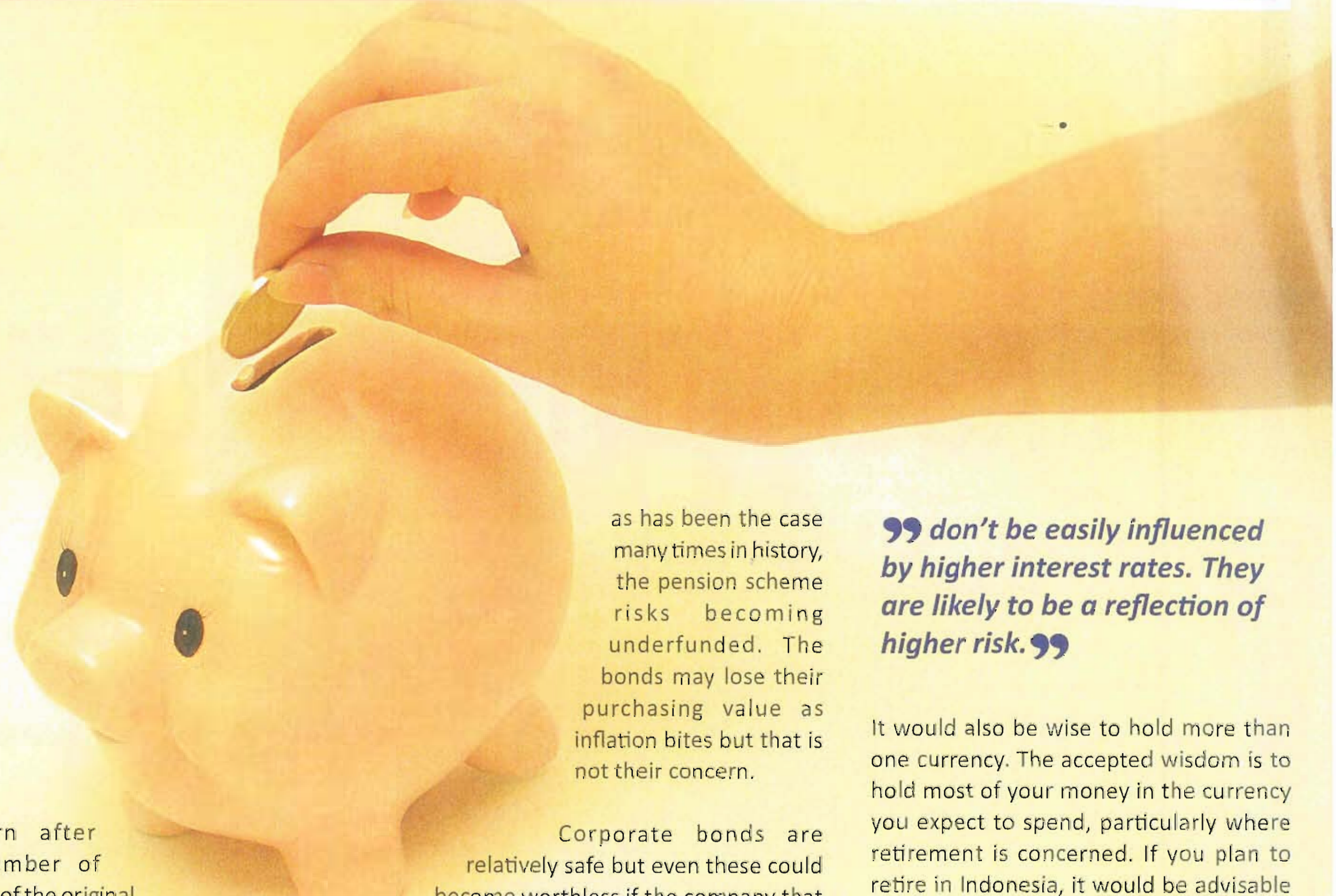
Since 1997, the government has put a number of safeguards in place including stricter controls on loans and a requirement to hold higher capital reserves. The banking sector is now much stronger than it was in the 1990's when deregulation led to a free-for-all. But if lending gets out of hand it would be the depositors who suffer.

But aren't bank deposits guaranteed?

Yes, they are up to certain limits but the guarantee, as with any guarantee, is only as good as the strength of the ultimate organisation behind it, in this case, the respective governments. As the 2008 banking crisis unfolded in Europe the Irish government tried to stabilise the outflow of funds by announcing a blanket guarantee covering all bank deposits. It then had to issue a swift disclaimer qualifying the guarantee.

Caution should be exercised by depositors in Indonesia as anywhere else. While the level of deposit guaranteed is quite generous, there are conditions. Banks have to keep interest rates for depositors for example within approved limits. Failure to do so could compromise the government guarantee.

Many other financial products come with 'guarantees' or 'capital protection'. Structured Notes are a good example. These are products that 'guarantee' the



return after a number of years of the original investment plus a possible additional return usually linked to a stock market index. The additional return is invariably inferior to any actual rise in the index but it does offer the comfort of the guarantee. It is important to understand that these products also are only as safe as the institution providing the guarantee. As Benjamin Franklin, one of the Founding Fathers of the United States said: "The only things certain in life are death and taxes."

So where can we safely put our money?

Under the mattress is not a good option. What about bonds? Government bonds are generally considered safe because a government can always print money to meet its obligations. That is, unless it is a country within the Eurozone since only the European Central Bank has that right. Consequently there is a huge variance in bond yields in Europe as weak countries have to offer higher rates of interest to combat the higher risk of default. In the UK, gilts as they are called there have a huge market as they constitute a large portion of pension schemes. The scheme managers have to meet their obligations to pensioners. Stocks could make more money than bonds but should they fall, as has been the case many times in history, the pension scheme risks becoming underfunded. The bonds may lose their purchasing value as inflation bites but that is not their concern.

Corporate bonds are relatively safe but even these could become worthless if the company that issues them should go under.

A number of investments pay relatively high regular returns with little risk of any negative years. Examples are asset-backed lending, property funds, student accommodation funds and so on. These are very popular during periods when stock markets are doing badly. After all, people are still paying their rents irrespective of what is happening in the markets. The funds can work well but problems arise when a lot of people want to exit at the same time. Since the bulk of the fund is invested in long term assets, it is not possible to raise cash in a hurry and so the fund has to shut its door to redemptions until it becomes liquid again. There have been a number of such cases recently. So while the returns may be good you may have a long wait for your money.

So what is the best strategy?

Since financial disasters can surprise us at any time, the best defense is to diversify. If you have significant cash holdings, it would be wise to distribute your savings across a number of banks and in different jurisdictions. Where cash is concerned, don't be easily influenced by higher interest rates. They are likely to be a reflection of higher risk.

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It would also be wise to hold more than one currency. The accepted wisdom is to hold most of your money in the currency you expect to spend, particularly where retirement is concerned. If you plan to retire in Indonesia, it would be advisable to hold plenty of dollars or pounds as they are more likely to hold their value over time against the Rupiah. This may be less noticeable in the short term but the historical figures are compelling. When I first came to Indonesia in 1983 the exchange rate was Rp600 to the US Dollar. Today it is approaching Rp10,000. Where will it be in another 30 years? Who knows, but my guess is it will be much higher than 10,000!

So is there a safe place for your savings?

Not for absolute certain, although some places are safer than others. Despite all the guarantees that may be in place, no investment is entirely risk-free. Even not investing is a risk due to the loss in real value of cash over time. But since there is no 100% safe home for your money the only sensible strategy is to spread your eggs around as many baskets as you can afford. With a bit of luck some of your baskets will prosper and make up for the odd one two that fall. And be prepared to see the odd one fall; remember there is no gain without pain!