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Is Indonesia Bound For the BRICs?

Karen Brooks

It is hailed as a model democracy and is a darling of global financial community, but stalling reform could hold it back INDONESIA is in the midst of a year-long debut on the world stage. This past spring and summer, it hosted a series of high-profile summits, including for the Overseas Private Investment Corporation in May, the World Economic Forum on East Asia the same month and Asean in July. With each event, Indonesia received broad praise for its leadership and achievements. This coming-out party will culminate in November, when the country hosts the East Asia Summit, which US President Barack Obama and world leaders from 17 other countries will attend. As attention turns to Indonesia, the time is ripe to assess whether Jakarta can live up to all the hype.

A little over 10 years ago, during the height of the Asian financial crisis, Indonesia looked like a state on the brink of collapse. The rupiah was in a death spiral, protests against president Suharto's regime had turned into riots and violence had erupted against Indonesia's ethnic Chinese community. The chaos left the country – the fourth largest in the world, a sprawling archipelago including more than 17,000 islands, 200 million people and the world's largest Muslim population - without a clear leader.

Today, Indonesia is hailed as a model democracy and is a darling of the international financial community. The Jakarta Stock Exchange has been among the world's top performers in recent years, and some analysts have even called for adding Indonesia to the ranks of the BRIC countries (Brazil, Russia, India and China). More recent efforts to identify the economic superstars of the future - Goldman Sachs' 'Next 11', PricewaterhouseCoopers' 'E-7' (emerging 7), The Economist's 'CIVETS' (Colombia, Indonesia, Vietnam, Egypt, Turkey and South Africa) and Citigroup's '3G' - all include Indonesia.

To be sure, Indonesia's track record has been impressive. In just a few short years following Suharto's 1998 fall from power, Indonesia transformed from a tightly controlled authoritarian system to one of the most vibrant democracies on earth. The elections in 1999 were widely praised as a triumph of democracy; the military stayed on the sidelines, and independent civil-society groups and the media blossomed in the run-up to the polls. With sweeping political and fiscal decentralisation, Jakarta devolved real power and resources to the country's hundreds of districts and municipalities.

The government created new, independent political institutions to provide for additional checks and balances, including a constitutional court, a judicial commission and a corruption eradication commission (known as KPK). An ambitious constitutional reform formalised a presidential system and established a one-man, one-vote process. With no mechanism to filter the results (as the Electoral College does in the United States), Indonesia's voting system is among the most democratic in the world.

The country's economic turnaround has been no less dramatic. In 1998, Indonesia's economy suffered a contraction of more than 13 per cent. Since then, it has grown at an average rate of more than 5 per cent per year, including 4.5 per cent in 2009, when GDPs in much of the rest of the world shrank. This year, the Indonesian economy is expected to grow 6.5 per cent.

Indonesia's debt-to-GDP ratio has declined from a high of 100.3 per cent in 2000 to 26 per cent today, which compares favorably to those of the country's neighbors: Malaysia's is 54 per cent, Vietnam's is 53 per cent, the Philippines' is 47 per cent, and Thailand's is 44 per cent. Inflation, which spiked to 77 per cent in 1998, now hovers just under 5 per cent. The rupiah, which lost over four-fifths of its value that same year, is the strongest it has been since 2004 and is up 31 per cent since 2008 alone. Other Asean currencies generally appreciated by between 15 and 20 per cent in the same period.

Indonesia has also made great strides in improving its security. In 2004, the government negotiated a peace settlement with Javanese separatists in the region of Aceh, ending a three-decade-long conflict that claimed thousands of lives. Elsewhere, Indonesian security forces have killed or captured hundreds of Islamist militants and have uncovered and shut down major terrorist hideouts and training camps, including one in Aceh in February 2010 that led to a number of high-profile arrests. The government has also implemented important structural reforms, including the creation of a national counterterrorism agency, tasked with forming and enforcing new domestic security laws. Against this backdrop, Indonesia has started to play a larger role on the international stage. When the G-20 was established in 2008, Indonesia was the only Southeast Asian nation offered membership. That same year, Indonesia launched the Bali Democracy Forum, a yearly regional conference to promote democracy in Asia. In recent months, the forum has become a platform for Indonesia to share lessons from its own democratic transition with some of Egypt's aspiring democrats.

Yet despite all the fanfare, the Indonesian score contains some decidedly discordant notes. Indonesia's ports are overstretched, its electrical grid is inadequate and its road system is one of the least developed in the region. These conditions make the Indonesian economy inefficient and will stifle its future growth. In some regions, the price of basic commodities is up to three times as high as on the main island of Java. Meanwhile, manufacturers are squeezed by exorbitant transportation costs, which are higher in Indonesia than in almost every other Asean nation.

Jakarta is well aware of these problems, yet it currently spends only half as much on infrastructure development as it did in the 1990s. Seeking to address almost constant criticism on this issue, in May, Indonesian President Susilo Bambang Yudhoyono issued a new economic 'master plan' with an emphasis on infrastructure projects. He also called for higher infrastructure spending in the 2012 budget. But even this budget would cover only about half of the administration's planned development through 2014. Without the new development, Indonesia will not meet its target of 7-8 per cent GDP growth by the same year. Much of the burden of paving roads and providing power and water nationwide will thus fall to the private sector.

However, Indonesia's inadequate regulatory framework and weak enforcement of existing regulations have muted private-sector interest. The absence of meaningful eminent domain regulations has proved particularly problematic; the inability to acquire land has prevented many projects from ever getting off the ground.

Endemic corruption further adds to Indonesia's high-cost economy. At the beginning of his first term, Dr Yudhoyono named combating corruption a top priority. Since then, the KPK has sent dozens of politicians and former government officials to jail. Still, corruption runs deep at all levels of government, since the devolution. of power after Suharto's fall brought with it the decentralisation of graft.

A number of high-profile scandals during Dr Yudhoyono's second term have showcased the breadth and depth of the problem. Investigations into the 2008 collapse and subsequent US$700 million government bailout of Bank Century, a mid-size bank with politically connected depositors, revealed that individuals from all elements of law enforcement - senior police officers, officials from the attorney-general's office, lawyers, judges - had attempted to profit from the government bailout.

The Yudhoyono administration's promotion of Indonesia as an open, investor-friendly economy is another area in which the gap between rhetoric and reality is particularly large. The government's most recent Investment Negative List, which lays out limitations on foreign investment, is more restrictive than in the past. Indonesia has also backslid on some of its international commitments.

To make matters worse, Dr Yudhoyono announced just days before this year's World Economic Forum in Jakarta that the government would review and revise all its contracts with foreign companies, particularly in the natural resources sector. Underlying the move is an assumption that Indonesia's newly robust economy should give the government the bargaining power to negotiate better terms with foreign firms. Although Indonesian lawmakers applauded the move, foreign investors did not. Indonesia's poor track record on the sanctity of contracts, including, for example, a 2010 regulation that unilaterally changed the economics of previously negotiated oil and gas contracts, helps explain why foreign direct investment in Indonesia lags far behind portfolio inflows to the country.

Indonesia's relative lack of integration with the world economy protected it from the worst of the global financial crisis in 2008. As a result, Dr Yudhoyono's government seems to have concluded that maintaining some insulation from external shocks is more important than allowing rapid growth through foreign investment or through an export-oriented growth strategy.

The real driver of the country's recent economic growth has been the Indonesian consumer, with consumption accounting for roughly 60 per cent of GDP. Indonesian policymakers seem content to keep it that way, and some degree of inward focus may well be appropriate. But Indonesia must strike a balance between protecting itself from external shocks and generating jobs and taking advantage of regional and global growth. If vested business interests continue to drive policies that protect certain sectors from foreign competition, they will create inefficiencies and jeopardize critically needed job creation.

Labor and 1human resource issues are particularly pressing problems for Indonesia, a country of 245 million with 5 per cent of the population now under the age of 30. This means that the proportion that is of working age will rise significantly over the next decade. Indonesian government officials often point to this coming 'demographic dividend' as a comparative advantage over ageing societies such as China. They argue that a younger generation will consume more and will provide a more productive labor pool. But for the demographic dividend to, in fact, be a dividend, Indonesia would have to create more jobs, including higher-quality and better-paying ones. Extractive industries are capital-intensive, not labor-intensive, and they cannot be counted on to fulfill this role.

Indonesia already faces significant underemployment and poverty, so additional labor force pressures would be a serious concern. According to the most recent official data, in 2011, 6.8 per cent of Indonesians were unemployed and 12.5 per cent were living under the poverty line. Unemployment and poverty have both decreased since Dr Yudhoyono took office in 2004 - unemployment from over 9 per cent and poverty from over 16 per cent. But these numbers do not tell the whole story; over 65 per cent of Indonesia's workers are employed informally, most of them in agriculture. Moreover, the number of university-educated unemployed has increased, from 3.6 per cent in 2005 to 8.5 per cent in 2010.

Answer to challenges

As for poverty, the World Bank estimates that more than half the population lives on less than US$2 per day. For upward of 120 million people, then, any disturbance in monthly income could be devastating. The answer to these challenges is to create jobs. But Indonesia is neither training its workforce nor creating the investment climate it needs to attract value-added and labor-intensive industries. Indonesia lags behind both key Asean states and all the BRIC countries in access to high-quality education and thus lacks the skilled labor to move up the value-added chain. And even as skilled workers are in short supply, Indonesia maintains one of the most rigid labor regimes in the world, with among the most generous severance packages and most cumbersome layoff procedures. According to the World Economic Forum's 2011-12 Global Competitiveness Report, Indonesia scores in the bottom 30 per cent of the 142 economies surveyed on labor rigidity.

Meanwhile, Indonesia has seen an increase in the intensity and frequency of ethnic and religious violence in recent years. From communal clashes in Kalimantan to religious violence in Java, the police have been slow to react or unwilling to step in at all, and few perpetrators have been held to account. Dr Yudhoyono has deflected responsibility by calling on local officials to deal with the clashes. His failure of leadership sets a dangerous precedent in a diverse country that is home to at least five different religious traditions and dozens of ethnicities. As its founding fathers understood, Indonesia can survive as a single nation only if tolerance and respect for different ethnicities and religions remain at its core.

In addition to casting a shadow over Indonesia's newfound international leadership role, the failure of the state to protect its people and uphold the constitutionally mandated freedom of religion raises the question of whether Indonesia will continue to enjoy the political stability that has allowed for its considerable economic gains. Indonesia needs a combination of leadership and a renewed push for structural reform to overcome its many challenges. So far, however, both remain in short supply. Dr Yudhoyono was elected with more than 60 per cent of the vote in 2004 and again in 2009.

Yet despite his strong popular mandate, he has never felt comfortable governing on the basis of popular support. Instead, he has repeatedly tried to use Cabinet appointments to create legislative coalitions (as one might in a parliamentary system), despite the absence of any such concept in Indonesia's legal and constitutional framework. This strategy has come at the expense of continued reform, as Cabinet appointments are made to gain allies rather than recruit reformers with genuine expertise. Indeed, Indonesia passed all its landmark reforms nearly a decade ago.

To be fair, the fault is not all Dr Yudhoyono's. For a presidential system, Indonesia has an uncommonly large number of political parties - nine in all. The ruling Democrat Party is the single largest in the country's legislature, but it still commands only 26 per cent of the seats. As a result, out of the 70 bills proposed at the start of Dr Yudhoyono's second term, only a handful have passed - and largely insignificant ones at that. Indonesia needs fewer parties to overcome this gridlock, but the smaller parties have resisted even modest proposals to increase the threshold of votes required before a party can enter the legislature, and there is little hope of meaningful change before the 2014 legislative elections.

Meanwhile, the Constitutional Court recently lowered the number of votes required to initiate a presidential impeachment process from three-fourths of the legislature to two-thirds. This means that the Democrat Party's 26 per cent plurality can no longer protect Dr Yudhoyono from attempts to oust him. The court's ruling seems to have exacerbated his indecisiveness - unsurprising given that Indonesia's first elected president after Suharto, Abdurrahman Wahid, was impeached. Dr Yudhoyono's failure to reshuffle his Cabinet, despite making repeated threats to remove non-performing ministers, has exemplified his paralysis.

As a result, the president is increasingly captive to politicians at odds with his stated reform programs, and Indonesia's competent core of technocrats in government has less room to advance meaningful change. At best, this could portend stasis for the remaining three years of Dr Yudhoyono's term. At worst, Indonesia could see its hard-won gains evaporate. In June, for example, the legislature rolled back key powers of the Constitutional Court - the only court seen as being beyond the reach of corrupt politicians. The legislature is similarly poised to strip the KPK of important authorities.

After decades of authoritarian rule, Indonesians have been reluctant to allow power to concentrate in the hands of any one person or institution. In fact, most of Indonesia's reforms after 1998 were explicitly designed to decentralize power. But the pendulum has swung too far, producing a system with real structural impediments to coherent policy implementation. As the political restructuring of the Middle East tests whether Islam and democracy can coexist, as pluralism and religious tolerance come under attack in countries from Africa to Europe, and as China's economic rise without political liberalization challenges the Western democratic model, Indonesia's continued success as an open, moderate, tolerant, multiethnic, multi-religious democracy with a booming economy is of huge importance as a model for the developing world. Indonesia deserves plaudits for its progress to date, but some gains are under threat, and its continued success requires a new wave of reform. Indonesians proved they were capable of extraordinary things at the turn of this century. Once this fall's summit meetings are over, it will be time for Indonesia's reformers to get back to work.

The writer is adjunct senior fellow for Asia at the Council on Foreign Relations