



# INDONESIA'S FRAGILE FUTURE

INDONESIA has had a very good run over the past decade. But, just as the world is beginning to recover from the worst global crisis in nearly a century, the economy has begun to lose momentum, a victim of flat commodity prices and poor policy choices.

As the World Bank has noted in its latest quarterly review, "In 2014 Indonesia is likely to record slower economic growth... and faces significant economic risks."

Indeed, 2013 was a brutal year that exposed years of weak monetary management and restrictive investment policies. This year, Indonesia's financial markets—bonds, equities and currency—have been the region's worst performers.

While some of this poor performance has been due to the prospect of US fiscal tapering and the end of an unprecedented decade of easy money, it is important to understand that fear of tapering was only the catalyst of the accelerated second half decline of Indonesia's capital markets, not the cause.

Just a few years ago, the country was the darling of investors. Now it faces a very difficult future unless it can undertake some sharp policy reversals. What happened?

The first nine years of this century offered emerging markets one of the greatest opportunities of all time. A decade-long commodity boom lasted until the global crisis erupted with frightening speed in late 2008. During this period the advanced economies flooded the world with cheap financing, and many developing economies, particularly strong commodity producers like Indonesia, Brazil, South Africa and Russia, grew rapidly. This boom, rather than savvy policy responses, was at the heart of most emerging market growth stories during this period including Indonesia's.

Sustained economic success, however, is dependent on strong performance in three critical policy areas: monetary, fiscal and investment, not on over-dependence on easy money or commodity booms.

Indonesia has a long tradition of conservative, prudent fiscal management. This was a hallmark of the autocratic New Order and has continued in democratic Indonesia.

Monetary and investment policy over the past five years have both been particularly weak, however, and the medium and long-term growth outlook has become fragile and uncertain due to questionable policies that have retarded growth in the real sector and private investment. While Indonesia should be able to maintain four to five percent annual GDP growth over the next decade even in the current scenario, and there will be great opportunities for investors who can crack the complex policy code, this will not be enough to move Indonesia up the value chain.

Weak investment flows will blunt the impact of good fiscal

and monetary policies, stifle job creation and ultimately land the country in the dreaded middle-income trap where productivity declines and incomes stagnate.

Indonesia continues to have one of the best government balance sheets of any large economy with low debt and a small budget deficit. But two major worries about Indonesia's fiscal policy environment are clouding the future: the large fuel subsidy and uncertain prospects for policy continuity.

The country's love affair with its fuel subsidy has accounted for 10 to 15 percent of government expenditure for many years, even though it has long since ceased to fulfill its only legitimate objective as a social safety net for the poor. It has instead turned into a subsidy for middle class consumption at the expense of investment in education, health care and infrastructure.

Market pricing seems to be out of the question for the country's policy establishment and the failure to implement regular, small price adjustments insures frequent budget crises and acrimonious political debates whenever oil prices rise or the rupiah weakens. Indeed, the country has endured raucous political struggles over the fuel subsidy resulting in sudden, disruptive price adjustments four times in the last nine years.

The latest battle distracted parliament and the administration for several months earlier this year. The price was raised 40-44 percent in July. This was after parliament rejected a similar increase in 2012, a 33 percent increase in 2008 that was later rescinded and two increases in 2005 totaling over 130 percent.

No sooner had this latest increase been implemented, however, than the rupiah swooned. The 20 percent decline of the rupiah against the US\$ increased the subsidy cost to the budget and wiped out most of the savings from the July increase. There is a little doubt that further price increases will be debated no later than mid-2014 as Indonesia goes to the polls for its national elections.

The other major fiscal concern is policy continuity. Can democratic Indonesia maintain fiscal discipline in the face of increasingly populist policies and aggressive state spending for political objectives? The current government has seen three finance ministers in the past four years. The market believes the first two were pushed out because they were unwilling to accommodate imprudent political spending. While young and untested, the current finance minister has equally good technical and integrity credentials, so the market has remained calm.

The question, then, is who will be appointed when a new government comes to power next October. If the new president appoints another solid technocrat with a reputation for integrity,



JAMES CASTLE\*

the market will rest easy. If, however, the new leader opts for a more malleable personality, markets will shudder.

Bank Indonesia (BI) now seems back in safe hands after five years of idiosyncratic management that confused the market and deterred new investors. The new leadership seems committed to maintaining currency flexibility and willing to take hawkish stances to combat inflation despite political pressure to keep interest rates dangerously low.

The new leadership also seems to be much more self-confident and willing to work transparently with its counterparts in the Finance Ministry, the new Financial Services Authority (OJK) and its stakeholders in the private banks. The term of the current governor runs until 2018, so monetary policy seems in good hands. Its credibility will remain crucial in a time of high current account deficits and slowing growth.

The weakest link over the past decade has been Indonesia's investment policy. Despite much official rhetoric in favor of increased investment and campaigns to attract more foreign investment, the space for the private sector in general and the foreign sector in particular has been steadily narrowed since the re-codification of the infamous Negative Investment List (DNI) in 2005.

Instead of liberalizing conditions, welcoming investment with open arms and establishing a strong base to challenge China as the world's primary source of manufactured goods, over the past decade the administration and the parliament have worked together to:

- Pass legislation that has virtually killed mining exploration
- Implement policies that have driven oil production to 30-year lows
- Expand the role of state-owned enterprises in capital investment and construction services, squeezing out domestic and private players and reducing domestic competitiveness
- Discourage increased foreign investment in the country's under-capitalized banking sector
- Tighten the restrictions of the employment of expatriate managers at a time of an acute shortage of experienced management and limited technology transfer
- Force the repatriation of over US\$550 million of foreign investment capital to Japan, replacing it with state funds at a time when liquidity is tight.

While some see the foreign direct investment (FDI) as an essential and permanent feature of a healthy economy, necessary to withstand the challenges of the increasingly competitive world economic order, others view it as an unfortunate necessity to be permitted only in limited areas for limited pe-

riods.

At the extreme end of the spectrum, some see the FDI as a rapacious threat, particularly in resource development sectors, and would like the foreign presence to be severely restricted if not totally eliminated.

There is a belief in some quarters that foreign investment is already too high despite the fact that according to World Bank data it languishes around two percent of the GDP, well behind such highly nationalistic economies as Russia, Brazil, Malaysia, India, Vietnam and, amazingly, Argentina.

In the early years of recovery after the Asian Crisis devastated the economy in 1997/98, Indonesia generated a host of pro-market reforms that attracted capital, stabilized the banking system and enabled economic recovery.

Many of these reforms were simply a continuation of pro-market reforms of the late Suharto period that also produced high growth. The fatal flaw in the 1990s reform processes was that the growth was hijacked by the Suharto clan and its cronies, leading to the economic abuses that brought the country to its knees in 1998. This liberalization was totally compatible with the drive for a more open, democratic political system. Neo-liberal economic reform, however, was not the only force driving democratization. There were and remain larger social forces that support democracy, but are at best suspicious of or even hostile to the private sector and believe the state should control the allocation of resources and the methods of production.

This second group has much in common with the economic policy views of a third force of rent-seekers who objected not so much to the authoritarianism of the Suharto regime as to the fact that they were not able to penetrate its most lucrative inner circles. The greater the bureaucratic control, the better opportunities for rent seeking.

These latter two groups have slowly but steadily come to dominate economic policy-making over the past decade. Those who continue to advocate more of the neo-liberal reforms that have saved the country twice—in 1967 and 1998—have been cowed into silence. To publicly embrace pro-market reforms is now seen as political suicide.

If this trend continues, growth will flatten. The country will be unable to make a major move up the economic growth ladder over the next decade. Indonesia will continue to be a pretty but troubled underperformer where some businesses can prosper but not produce enough to raise living standards substantially. Poverty will not be significantly reduced and democratic progress will remain fragile.

The state cannot do it alone. ●

\*JAMES CASTLE IS FOUNDER AND CEO OF JAKARTA-BASED CASTLEASIA