INDONESIA'S YEAR OF LIVING PROSPEROUSLY

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The mineral-rich nation once dominated by a dictatorship may grow faster than Brazil this year. It's poised to become an emerging-market giant—if it can finally shake off crony capitalism. If al-Qaeda-linked terrorists thought they could drive foreign investors out of Indonesia, they didn't reckon with the likes of Jim Castle. Seven years ago, Castle, a Michigan-born consultant for 100 multinational companies—including Citigroup Inc., Exxon Mobil Corp. and Nestlé SA—was having lunch at Jakarta's JW Marriott hotel when a truck bomb detonated outside the building, killing 12 people and injuring 150. Castle walked away unhurt.

Last July, he was less lucky while hosting a breakfast meeting at the same hotel. Two suicide bombers struck in near-simultaneous blasts at the Marriott and the nearby Ritz-Carlton. Nine people died in the attacks, and Castle clambered from the rubble grazed, dazed and with temporary hearing loss. A year after that second escape, Castle, 64, continues to do business in Jakarta and shrugs off the dangers he faces, Bloomberg Markets reports in its July issue. "More people here die from dengue fever than from terrorist attacks," he says.

The resilience displayed by Castle, founder of CastleAsia, is paying off as the world's fourth-most populous nation—home to the single largest Muslim population—basks in a consumer and resources-driven boom. "Indonesia's potential is dramatic," says Hugh Young, who helps manage $260 billion, including Indonesian shares, at Aberdeen Asset Management Plc in Singapore. "It is resource-rich, has lots of people and some of its companies are as good as any you will find in Asia." Indonesia's $514-billion economy, the biggest in Southeast Asia, will grow at 6 percent this year, up from 4.5 percent in 2009, the International Monetary Fund forecast in April. That would make the nation of 240 million the best-performing economy after China and India among the Group of 20 countries—outpacing both Brazil and Russia, the two other emerging giants grouped with China and India as the so-called BRIC economies. Now, both Goldman Sachs Group Inc. and Morgan Stanley say Indonesia is a contender to be included in the BRIC club. Yet analysts disagree on exactly when the acronym will get an extra "I". Chetan Ahya, a Singapore-based managing director at Morgan Stanley, says Indonesia should be considered for BRIC status if gross-domestic-product growth nears 7 percent next year. Jim O'Neill, the London-based Goldman Sachs chief global economist who came up with the emerging-nation designation, says it will take much longer because he believes a

true BRIC economy should be near to 3 percent of global GDP, while Indonesia currently accounts for just 1 percent. “Indonesia has the ultimate potential,” O’Neill says. “It has done well postcrisis and is showing signs of sustainable demand growth.”
Investors say Indonesia—a lush archipelago of 17,500 islands that stretches like a 5,100-kilometer chain of stepping stones from the Southeast Asian mainland to northern Australia—is finally unlocking its full potential. The country is the world’s No. 1 exporter of coal used in power stations and contains the largest gold mine and the single largest recoverable copper reserve.

It’s also the biggest supplier of palm oil—used in one-third of the world’s frying pans and woks—and the third-biggest exporter of natural gas. Indonesia is also geographically blessed due to its proximity to Japan and China, its two biggest export markets. Both US President Barack Obama, who lived in Indonesia as a child, and China’s premier, Wen Jiabao, scheduled visits to Jakarta to strengthen relations this year. Trade between Indonesia and China more than doubled to $25.5 billion from 2005 to 2009. During the same period, US-Indonesia trade rose about 20 percent to $18 billion.

At home, an emerging middle class is driving economic growth. Although 33 million Indonesians live in poverty, the World Bank says, the country has a middle class of 35 million. Unlike in many export-dependent Asian countries, private domestic consumption accounts for 61 percent of Indonesia’s GDP. “It looks to us that more wealth is trickling down than in the past,” says Eugene Galbraith, chairman of PT Bank Central Asia, Indonesia’s biggest financial services company by market value. “There are tens of millions of households on the edge of making the leap into the bankable class.” President Susilo Bambang Yudhoyono, a retired general first elected in 2004, heads a government sprinkled with Western-educated technocrats that has halved interest rates and signed a free-trade agreement with Japan. Under his Vision for Change program, he pledged to boost foreign investment, raise living standards, fight endemic corruption and fix crumbling roads and power grids. His initial efforts lured investors and lifted more people out of poverty.

Under Yudhoyono, 60, foreign direct investment reached $14 billion last year compared with $4.6 billion in 2004. Per-capita income has doubled to $2,300, while interest rates are at a record low 6.5 percent. The pace of prosperity has quickened. Indonesia’s currency, the rupiah, gained 10.4 percent against the US dollar in the 12 months ended on May 21, making it the best performer among 26 leading emerging markets. On March 12, Standard & Poor’s raised Indonesia’s credit rating to BB from BB-, two levels below investment grade. London-based Standard Chartered Plc predicts Indonesian debt will reach investment grade by 2012.

Yudhoyono is fighting back against Islamist terror factions. Since the attack on Jim Castle’s business breakfast, Indonesian security forces have arrested or killed scores of suspected terrorists. Among the dead: Noordin Mohammad Top, the al-Qaeda-linked terror chief who the US says masterminded both Jakarta hotel attacks and the 2002 nightclub bombings on Bali in which 202 people died. On May 12, Indonesia's anti-terror squad killed five suspects who were plotting an attack on Yudhoyono at the country's August 17 Independence Day ceremonies.

Now, the challenge for Western investors is to decide whether Indonesia's $234-billion stock market is overheated. Indonesian shares have outperformed those of all their BRIC rivals. The Jakarta Composite index, which soared 87 percent in local currency terms in 2009, has risen another 3.5 percent by the same measure this year as of May 21. By comparison, Indian stocks were down 5.8 percent for the year through May 21 as measured by the rupee; Russian shares were down 10.2 percent in Moscow's dollar-measured index; while Brazilian shares were down 12.1 percent and China's Shanghai composite index plunged 21.2 percent in their local currencies. Last month, the central bank said that Jakarta shares were in a bubble. "The actual stock price now is actually exceeding the fundamental value," Perry Warjiyo, the bank's head of economic research and policy, said on April 8.

Older investors know how quickly things can change in Indonesia, a former Dutch colony that declared its independence in 1945. In 1967, the dictator Suharto became president after crushing a coup attempt, an era immortalized by both Christopher Koch's novel The Year of Living Dangerously and the Mel Gibson movie of the same title. Under Suharto's rule, government-aligned businessmen exploited an economy reliant on crude oil exports, which hummed along at a pace of 7 percent annual growth in the 10 years from 1987. That came to an abrupt halt in 1997, when financial turmoil spread south from debt-ridden Thailand. The crisis devastated the Indonesian economy: From July 4, 1997, to June 17, 1998, the rupiah plunged 85 percent against the dollar. Loaded with debt borrowed in dollars, hundreds of Indonesian companies, including more than a dozen banks, became insolvent. In October 1997, the IMF stepped in with a $43-billion rescue package that forced the breakup of some Suharto-controlled monopolies. Within a year, prices for basic food items such as rice and cooking oil jumped by more than 200 percent, triggering street protests. Suharto, then 76, was pressured by his own allies to resign in May 1998.

IMF crisis management measures in Indonesia—which delivered long-term fiscal responsibility at a cost of short-term political unrest—are similar to those being imposed on Greece. In April, Greece agreed to raise taxes, reduce pension rights and cut public worker pay to slash a budget deficit estimated by the government to be 14 percent of GDP. In return, the European Union and the IMF are providing €110 billion ($134 billion) in emergency loans. "Indonesia after the financial crisis was where Greece is today," says Shane Oliver, head of investment strategy at AMP Capital Investors in Sydney, which oversees the equivalent of $90 billion. "The transformation has been amazing." Indonesia's external debt, which hit 150 percent of GDP in 1998, was 27 percent in March.

The political transformation from dictatorship to democracy took less than a decade. Three presidents presided over the country in the four years after Suharto's departure. Yudhoyono won office in the first direct presidential elections in 2004. Four years later, he pulled his country out of OPEC, the bloc of oil-producing nations, after lack of investment and domestic energy demands transformed Indonesia into a net importer of crude. Yudhoyono won a second five-year term in 2009 after promising to more than double foreign investment to $35 billion within five years. To do so, he'll have to confront internal power struggles among Indonesia's political elite. "It is hard to exaggerate the importance of the fights taking place in government today," says Kevin O'Rourke, Jakarta-based author of Reformasi: The Struggle for Power in Post-Soeharto Indonesia (Allen & Unwin, 2002). "It is a continuation of tensions between reformers and the remnants of the elite who prospered under Suharto-era patronage."
Those fault lines were evident in March when Indonesia's parliament, including some members of parties that support Yudhoyono, voted for a police investigation into alleged mismanagement of a 6.7-trillion-rupiah ($723 million) bank bailout in 2008. The deal was approved by then-Central Bank Governor Boediono—one of millions of Indonesians who have only one name—and former Finance Minister Sri Mulyani Indrawati, the most senior woman in the government. Both have said the deal was necessary to save the financial system. Sri Mulyani, 47, who has a doctorate in economics from the University of Illinois, resigned from the government in May to be a managing director at the World Bank. Yudhoyono replaced her with Agus Martowardojo, 54, president director of PT Bank Mandiri, the country's biggest lender by assets. Boediono, now Indonesia's vice president, says the government is targeting annual GDP growth of 7.3 percent by 2014. "Growth must be accelerated, and this is our resolve," says Boediono, who has a Ph.D. in economics from the University of Pennsylvania's Wharton School. "We are lucky. Our commodities are in great demand at the moment, but we should not be complacent."

Some wealthy Indonesians fret that income disparities could spark instability.
"I have become richer, but not the people," says Sofjan Wanandi, chairman of the Employers Association of Indonesia and head of the closely held Gemala Group. "The country needs to grow faster." Indonesia bulls such as Patrick Walujo, founder of Jakarta-based private equity firm Northstar Pacific Partners, are betting that the government will deliver greater growth. Since 2006, Indonesian-born Walujo, 35, has teamed up with Fort Worth, Texas-based TPG Capital and other international fund managers to invest more than $1 billion in companies such as PT Bank Tabungan Pensiunan Nasional, a lender whose shares have risen 74 percent this year to May 21, and PT Delta Dunia Makmur, a coal mining services company. "When we started out in 2003, nobody wanted to look at Indonesia," says Walujo, who studied in the US at Cornell University and worked as an associate at Goldman Sachs in New York. "Now, we are seeing much more competition." Many key investment opportunities stem from the government's effort to modernize by spending $140 billion on public works.
"It boils down to two things: building 20,000 kilometers of roads and adding 15,000 megawatts of power generation over the next five years," says Gita Wirjawan, a

Harvard-educated former banker who is chairman of Indonesia's Investment Coordinating Board. "I believe in the old Chinese adage that if you want to get rich, you build a road."

Among US investors lining up to win contracts: General Electric Co., the world's biggest maker of power-plant turbines and railway locomotives. The Fairfield, Connecticut-based company aims to make an additional $1 billion in revenue by 2014 from new infrastructure projects in Indonesia, according to David Utama, GE's Jakarta-based country president. GE won't disclose how much it currently earns in Indonesia.

The surging demand for Indonesian resources is perhaps most apparent on the remote east coast of Borneo, the world's third-largest island, where former headhunters still live in longhouses and orangutans build nests in a diminishing jungle. One recent Monday just north of the equator, nine bulk carriers are anchored in shimmering heat off the palm-fringed port of Sangatta in East Kalimantan province, waiting to fill their hatches with coal from the world's biggest thermal coal mine. Twelve kilometers inland, inside pits up to 400 meters deep and 2.5 kilometers wide, trucks with tires twice the size of the men and women who drive them cart coal to conveyor belts that whisk the haul through the jungle to the port. Last year, owner PT Bumi Resources dug 60 million tons of coal from Sangatta and other mines it owns in Borneo. By 2012, it aims to have almost doubled exports to 111 million tons. Last year, Beijing's sovereign wealth fund, China Investment Corp., loaned Bumi $1.9 billion to help it reschedule debt. "Operationally, Bumi has some of the best mines in the world," says Adam Worthington, a Singapore-based analyst at Macquarie Capital Securities Pte, a unit of Australia's biggest investment bank, who has an "outperform" rating on the stock. "Extraction, transport and labor costs are low, and the coal quality is very good."

Bumi's potential may be blunted by a lack of corporate transparency that shadows too many Indonesian businesses. The mining company is controlled by the family of billionaire politician-businessman Aburizal Bakrie, a former Suharto associate.
When the global credit crunch hit in 2008, the Bakrie family holding company, PT Bakrie & Brothers, had $1.1 billion of debt that had been raised by pledging shares in Bumi and other listed units. Bumi shares plunged 32 percent on October 6, 2008, and then were suspended from trading for a month—at a time when Aburizal Bakrie was serving as welfare minister. Since then, the loans have been restructured by the company's lenders and the stock has risen fivefold from its lows. "For those investors willing to bear the corporate governance risks, Bumi is attractive," Worthington says. Aburizal Bakrie didn't respond to requests for an interview.

Investors will soon have the chance to bet on arguably Indonesia's least-likely success story: PT Garuda Indonesia, the state-owned airline with a once miserable safety record. In 2007, the EU banned the airline from Europe's airspace on safety grounds after flights operated by Indonesian carriers suffered three fatal air crashes that killed 272 over two years.

In 2004, one Garuda passenger was even murdered in flight. Munir Said Thalib, 39, a human-rights lawyer who had investigated abuses by Indonesia's military, was on his way to Amsterdam when he died midair from arsenic poisoning. An off-duty Garuda pilot who had been sitting in the next seat was jailed for 20 years for the crime in 2008, which prosecutors said during the trial was carried out for Indonesia's intelligence agency. Five years ago, Yudhoyono gave Emirsyah Satar, a Paris-educated diplomat's son, the job of rescuing the airline. "We were losing money on 85 percent of our routes, and our planes were always late," Satar says. He called in foreign experts to audit Garuda's safety practices, retrained pilots and retired old planes. Regaining customer confidence helped the airline make a profit of 1 trillion rupiah in 2009, just three years after getting a 1-trillion-rupiah cash injection to stay in business. The EU flight ban was lifted in July 2009. Now, Garuda is preparing to sell as much as $300 million worth of shares in the third quarter as it seeks to double the fleet to 116 planes by 2014.
The transformation of an outcast airline into an investment opportunity may be the surest sign yet that Indonesia is ready to join the emerging-market big leagues.