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From the Desk of...

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## Surge or No Surge? Indonesia is at a Crossroads. Dr Yuwa Hedrick-Wong provides a comprehensive analysis of Indonesia's economic progress as a fast-emerging market

So far so good. A convergence of increasingly credible macroeconomic management, rising foreign direct investment, decreasing risk premiums, improving political stability, robust household consumption, and a favourable demographics is pushing growth in Indonesia to a level unseen since the 1997 financial crisis. Even as the global economic recovery remains problematic, Indonesia is showing impressive signs of resilience. The question is whether Indonesia can surge forward to push annual growth to beyond 6% real GDP on a sustainable basis over the coming decade, with far reaching positive impacts in Asia/Pacific and possibly the global economy.

**So far so good ... If Indonesia can achieve such a surge in growth, then it will secure a place alongside China and India as one of the rising economic giants in Asia**

So far Indonesia has had a good crisis, with its economy expanding through the 2008/09 global recession. This performance contrasts sharply with most of its Asian economic peers except China and India. Two elements in GDP contributed to this resilience. First, more than half of the growth recorded in the six months ending March 2010 came from domestically-oriented activities such as transport, communications and construction, accounting for 3% of the 5.7% growth rate. Second, the mining and quarrying sector has been enjoying a good run over the last two years as a result of the renewed mining boom, driven by rising global commodity prices.

Recent developments point to Indonesia's economy sustained upward acceleration, despite concerns over the state of the global economic recovery. Resilient investment and import expenditures suggest that the corporate sector remains confident and is willing to take bets on the future. Consumer confidence has also remained high despite the global crisis. An important element in the strength in Indonesia's consumer confidence is the fact that political developments throughout the crisis have been mostly positive, including but not limited to the re-election of President Yudhoyuno in 2009.

President Yudhoyuno has often been criticised for being slow moving and overly cautious. On many counts, this criticism seems accurate. Being cautious has its virtues, however, especially in terms of fiscal management. Under SBY (as President Yudhoyuno is popularly known), fiscal policy has been kept on an even keel. Fiscal balance as a % of GDP has stabilised in recent years, hovering around -1% to -2%, which is appropriate for a developing country such as Indonesia. Furthermore, upon closer examination, much of the deficit is a result of productive spending that will help boost long term growth. Indonesia also runs a surplus on current spending – routine government expenditures are more than adequately funded by domestic sources of revenue.

The case for Indonesia's economic surge is then founded on several positive developments; demographics, the pay-off to reforms, a falling cost of capital, rising foreign direct investment (FDI) and continued benefits from the global boom in commodities. Let's take these one at a time.

Indonesia is enjoying the pay-off from its long term efforts to control population growth, with the rate of population growth declining steadily over time. Meantime, the working population has expanded from 55% of the total in the 1980s to 65% in 2008. Hence. Hence Indonesia is now benefiting simultaneously from declining population growth overall and an expanding working population; a demographic sweet spot. One of the consequences of such a demographic sweet spot is that the domestic consumer market will be expanding fast in the coming decade, even with a modest level of growth. This will provide a strong incentive for producers, both domestic and foreign; to set up operations in Indonesia, especially if the political climate and business environment continues to improve.

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Beyond demographics, the reform process in Indonesia, however slow and inconsistent, is starting to pay dividends. In common with many other reforming economies, Indonesia paid a very high price upfront when it went through a forced pace of economic and political liberalisation starting in 1998. Since the benefits of such liberalisation only flow in over long periods of time, the first few years of reforms typically see the entire system reeling as the costs of reforms tend to outweigh the benefits. But at some point benefits would begin to offset the costs. Indonesia has now reached this stage. Democratisation has now reached a point where the initial period of unsettled and disruptive politics is giving way to a more mature and constructive political process. Similarly, the initial phase of decentralisation was highly disruptive as local officials were not trained in basic administrative functions such as budget formulation and disbursement while regulations were unclear. These issues have been gradually resolved and decentralisation is now beginning to yield more positive results.

As a consequence, Indonesia has enjoyed steadily improving political stability and policy credibility in the last decade. While it has faced huge challenges over the same time period such as the terrorist bombings, the tsunami, a mini-economic crisis in July 2005 and the recent global financial crisis, Indonesia has weathered them well and continued to make progress. A long enough period of stability enables businesses and households to reduce their estimates of risk that are built into their expectations. As risk premiums fall, for instance, more investment projects are becoming attractive. The continuity in government policies promised by the re-election of SBY in 2009 further reinforces this sense of improving political stability, notwithstanding the concerns raised by the recent departure of reforming Finance Minister Ms Indrawati Sri Mulyani (more on this below).

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Closely associated with the pay-off to reforms is the likely improvement in price and currency stability – which will manifest itself in the form of declining cost of capital. The central bank, Bank Indonesia (BI), has substantially improved its credibility over the past ten years. It now follows an inflation-targeting monetary framework based on targets for gradually declining inflation. BI's monetary discipline is seen in its ability to keep monetary conditions relatively tight, for example. There is, therefore, considerable scope for the cost of capital to fall further in Indonesia as inflationary expectations come down over time, and as risk premiums associated with debt levels fall. For example, the overall external debt to GDP ratio has fallen from as high as 156% during the 1998 financial crisis to a low of 27% in 2009, levels not seen since the early 1980s. At the same time, the decline in non-performing loans (NPL) in the banking sector has reduced financial inefficiencies, contributing to higher lending rates. The NPL ratio has been falling from its peak of 27% in 2000 to as low as just 3.8% in December 2009. .

These positive developments have helped revive FDI inflow in Indonesia. Historically FDI has played a relatively smaller role in Indonesia compared to other Asian economies, with annual FDI inflows averaging a mere 0.3% GDP in the 1980s, picking up in the 1990s to 1.0% before falling back post-Asian crisis as confidence in the Indonesian economy collapsed. But FDI has started to rise in Indonesia. The government is also making a concerted effort to attract investment. Indonesia's investment promotion agency (BKPM) is creating a "one-stop shop" to make it easier for foreign investors to receive investment and other regulatory approvals swiftly while the so-called "negative list" of areas restricted for foreign investors is also being revamped as well. Sectors such as healthcare, education, agriculture and creative industries are all expected to be opened up to foreign investors.

Gita Wirjawan, head of the board, has said he expects Indonesia to hit a "sweet spot" of total investment of US$25 billion to US$35 billion a year, much higher than the most recent World Bank data of US$8.7 billion in 2008. This may just be another ambitious boast by a government official, or not. Some recent rankings actually put Indonesia above countries like Philippines and Malaysia as an investment destination. In fact, judged by the ability to extract relatively higher returns on capital compared to other countries, Indonesia is remarkably competitive. Data compiled by the Bureau of Economic Analysis in the US, for instance, shows that US firms operating in Indonesia out-perform the average returns for US firms in Asia, including those in India.

It is well known that Indonesia has been a key beneficiary of the commodity boom. The simultaneous rise of China, India, Brazil, Turkey, Vietnam and other large emerging economies entering the intensive phase of economic development will continue to drive the commodity boom. Take for example the crude palm oil (CPO) market, of which India and China comprised some 36% of Indonesia's exports in 2007. Indonesia has been the world's largest producer of CPO since 2006 and with prices up more than 50% since then, palm oil can be expected to remain an important industry to the economy. Based on historical trend analysis it is expected that world consumption of CPO will increase by 6% over the next five years, reaching 60 million tons in 2014. If Indonesia maintains its current market share of approximately 45% production (as of 2008), that works out to be 27 million tons of CPO, some 8 million tons higher than current production levels of 19 million tons. However, with production capacity expected to scale up at a rate of 2 million hectares per year as seen since 2006, production is expected to be strong enough to expand Indonesia's current market share to 47%, putting Indonesia in a very dominant position in this market.

Among the array of positive developments, however, the role of manufacturing is glaringly absent. With about 55% of the labour force with primary education and another 20% with secondary education, Indonesia can, in theory, expand quickly in labour-intensive manufacturing. Yet in 2009 the manufacturing sector employed only about 13 million workers, less than 10% of the labour force. The dismal performance of Indonesia's manufacturing sector can be brought into sharper relief by breaking down Indonesia's exports into commodities and manufacturing and comparing these with other emerging markets in Asia.

Between 1Q 2004 and 1Q 2010, China's manufacturing exports grew by 158% and Thailand's by 49%. In contrast, Indonesia's manufacturing exports grew by an anaemic 18%. It is Indonesia's inability to leverage labour intensive manufacturing as a growth engine that constitutes its Achilles' heel in its quest to achieve an economic growth surge. Without a rapid expansion of the manufacturing sector, the large and largely underemployed labour force will be denied the opportunity to becoming more productive with rising incomes, especially for the vast majority in the under-performing rural sector. This will in turn slow the growth of the urban middle class, hindering the expansion of the consumer market and consequently all the new business opportunities associated with its expansion.

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Indonesia is handicapped by this Achilles' heel because of three interlocking problems; first its highly unsatisfactory state of the rule of law; second the dire state of its infrastructure; third its mind-bogglingly expensive and counter-productive labour law. They are interlocked in Indonesia's messy domestic politics with constantly shifting alignment of vested interests and are not amenable to straight forward and rational policy debate and resolution. For SBY to make real progress in unlocking and dealing with these problems, he has to fight and win in the battlefield of Indonesia's political economy.

**Indonesia's democratisation process has been a tremendous success, working better than in many other large, populous countries**

<u>It's the Political Economy, Stupid</u>

Let's begin with the good news: Indonesia's democratisation process has been a tremendous success, working better than in many other large, populous countries as shown by the two key elections in 2009. A parliamentary general election was held in April 2009 which produced a victory for the secular nationalist parties. Indonesia also held its second democratic presidential election in July 2009 which resulted in the re-election of the incumbent, SBY. The conduct of both elections provided encouraging evidence of further maturing of Indonesia's political system.

The pattern in voting trends is also encouraging on the whole. They show secular-nationalist parties that broadly share a similar ideology and commitment to secular values significantly raised their share of the vote compared to 2004, winning 57.7% of the votes, up from 47.6% in 2004. In contrast, the collective votes secured by the major Islamist parties declined from 32.4% in 2004 to 24.1% in 2009. Even the fragmentation in the ranks of the secular-nationalists is less worrying than it first appeared. It is actually a positive development. Even though that vote is now split among three and not two large secular parties as in the past, this gives more choices to voters who want a secular-nationalist government but might want to punish individual secular parties from time to time due to voter dissatisfaction. Thus, if a secular-nationalist government under-performs, voters now have more choices in shifting to another secular-nationalist party rather than switching to an Islamist party and risk a more fundamental change in the nature of the system.

**The stakes are high ... With increasing democratisation, demand for better employment opportunities from the majority of the labour force that is unemployed or underemployed will become more intense.**

The political system has also demonstrated it can address serious challenges. For example, the long drawn-out separatist insurgency in Aceh was resolved peacefully; former guerrillas are now participating in the democratic system and some of them now hold political office. The violent clashes between Muslims and Christians in the Maluku islands have also been largely overcome. Religious terrorism has been brought under control, with major known terrorist cells and important leaders killed or captured. What is even more encouraging was how this terrorist threat was resolved; security force action was combined with clever political strategies to turn the population against religious extremists, making the entire approach more sustainable. Unlike many countries in the Middle East which used brute force and repression to suppress Islamic terrorism, Indonesia's more well-rounded and comprehensive approach appears to be more successful.

The good news does not end here either. A competent and balanced cabinet has also been put in place after SBY's re-election, in spite of some earlier concerns that his second term may be less committed to reforms. Many of the key appointments have gone to competent technocrats with substantial administrative and reform experience.

In spite of all these laudable achievements, the fact remains that entrenched vested interests continue to wield powerful influence in the political system in Indonesia. Cronyism and corruption continue to be daunting challenges that Indonesia is resolving only slowly. The recent resignation of the highly regarded Finance Minister, Indrawati Sri Mulyani, a champion of reform, is a sober reminder that the path forward remains rocky and uncertain. (The good news, however is that she was replaced by another well regarded technocrat, Agus Martowardojo, who demonstrated his reformist credentials and competent administrative skills in the way he reformed Bank Mandiri.)

And as much as things have improved in the past years, Indonesia remains a difficult market for investors, putting at risk the rise in domestic and foreign investment needed to boost Indonesia's growth. The World Bank's ranking of countries in terms of "ease of doing business" shows that Indonesia's ranking, while having improved, remains one of the worst in the world. In 2009, Indonesia ranked 129, improving to 122 in 2010 (#1 being the best, #169 the worst). In 2010, Indonesia is ranked far behind China at 89, Vietnam at 93, Malaysia at 23, and Thailand at 12. In the sub-ranking of corruption, Indonesia ranks 111, also far behind China at 79, but beating Vietnam at 120. (Indonesia however is ranked above India at 133) overall, but behind India in terms of corruption at84.)

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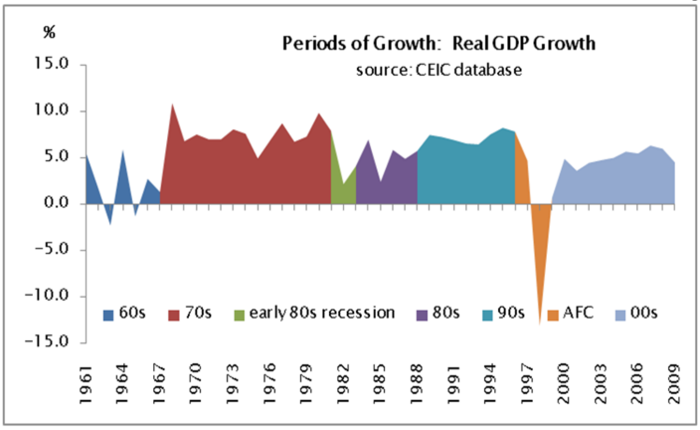
So SBY has his job cut out for him and it is not an easy one. In order to win, SBY has to navigate carefully in the treacherous waters of Indonesia's political economy, relying on different allies in different battles, while a foe in one battle could turn out to be an ally in another. Let's look again at the three interlocking problems of the state of the rule of law, infrastructure and the labour law. In trying to reform the notoriously corrupt and unreliable judiciary, SBY is up against the powerful civil service which, ironically, has become even more powerful due to the decentralisation of government (and potentially important as an ally for achieving better regional governance and economic growth).

**As daunting as these challenges are, SBY will have no choice but to win the battle of Indonesia's political economy in order to make the growth surge happen.**

In order to fast-track infrastructure development, SBY has to ensure that the most contentious road block, land acquisition, can be adjudicated impartially and expeditiously. This would require not only reforming the judiciary as mentioned earlier, but also dealing simultaneously with pro-poor activists in the civil society on the one hand and powerful business conglomerates on the other. To repeal the current labour law, which imposes one of the highest costs for dismissing a worker in Asia, and is therefore a highly detrimental deterrent to FDI in the manufacturing sector, SBY is up against organised labour and their powerful political allies.




As daunting as these challenges are, SBY will have no choice but to win the battle of Indonesia's political economy in order to make the growth surge happen. The stakes are high. Failure to launch the growth surge does not mean things would simply stay where they are today. With increasing democratisation, demand for better employment opportunities from the majority of the labour force that is unemployed or underemployed will become more intense. Matters are also made more complicated and potentially more challenging, because most of the unemployed and under employed are found in Java, the most populous island where Jakarta, the seat of the government, is located. In 2008, for instance, it is estimated that Java accounted for 58% of Indonesia's population, but 66% of the country's unemployed. Democratisation, coupled with urbanisation, will render the unemployed a much more potent political force and an opportunistic rallying point for the opposition in the future. It is in this sense that Indonesia is at crossroads; either a successful growth surge with a rapid expansion of the manufacturing sector and real annual GDP growth breaking the 6% ceiling to create millions of new and better paid jobs; or a worsening unemployment and under-employment situation with highly undesirable political consequences.

In assessing whether Indonesia is able to surge successfully in the coming years, it is useful to remind ourselves that historically Indonesia is actually a high growth economy, as illustrated in the following chart. Indonesia's economy grew at an average of 6.8% between 1968 (following President Suharto's rise to power and stabilisation of the economy) and 1996 (just before the Asian financial crisis). The chart also shows that in the past 50 years two periods of high and sustained real GDP growth can be identified; along with one period of low and sustained real GDP growth, two periods of short economic downturns and two periods of sustained, but average real GDP growth. The initial period of high growth is in the 1970s, which came on the back of the reforms introduced by the late Suharto. Under his authoritarian but relatively effective rule (at least in those early days), Indonesia saw improved ties with the West, allowing USAID and other relief agencies to operate within the country, for instance, and more investment friendly business conditions. Opportunities in the mining and construction sectors were also opened up to Western multinationals. The introduction of the so called "New Order" saw Suharto aggressively push for higher economic growth, promoting a new generation of foreign-educated technocrats into key positions. A series of Five Year Development Plans (Repelita) were introduced, starting with Repelita I in 1969-1973 and ending with Repelita VI in 1994-1999. This, combined with a surge in oil prices during the early 1970s made possible for Indonesia to enjoy high growth for many years under Suharto. Since the Asian financial crisis, Indonesia's real GDP growth has averaged just over 5%, very similar to that seen in the mid-1980s, the other period of sustained, but average growth. The difference however, is that while the average growth in the 1980s lasted five years, it has been going on for close to a decade now in the post-Asian crisis era. A growth surge today would merely return Indonesia to where it had been in the 1970s, albeit in the context of a vibrant and stable democracy.

SBY is, of course, no Suharto, and thank heavens for that. But SBY is a Javanese, and an adept practitioner of what a Javanese proverb describes as “leading from behind”. In spite of his plodding and often seemingly indecisive ways, he may yet beat the odds and win the battle of Indonesia’s political economy, and surprise with a successful economic growth surge.


## About Dr Yuwa Hedrick-Wong and The Insight Bureau

**Yuwa Hedrick-Wong is a global economist and business strategist, based in Singapore. He is an independent economic advisor to MasterCard, ICICI and Southern Capital Group. Along with other leading economists, journalists and business commentators, Dr Hedrick-Wong belongs to The Insight Bureau’s resource network, providing speeches and presentations at business conferences and also delivering confidential, in-house briefings to senior executives and boards.**

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