Is Indonesia Bound for the BRICs?

How Stalling Reform Could Hold Jakarta Back

Karen Brooks

Indonésia 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 Fórum on East Asia the same month, and the Association of Southeast Asian Nations (**asean**) in July. With each event, Indonésia 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 U.S. President Barack Obama and world leaders from 17 other countries will attend. As attention turns to Indonésia, the time is ripe to assess whether Jakarta can live up to ali the hype.

A little over ten years ago, during the height of the Asian financial crisis, Indonésia looked like a state on the brink of collapse. The rupiah was in a death spiral, protests against President Suhartos regime had turned into riots, and violence had erupted against Indonésias ethnic Chinese community. The chãos left the country—the fourth largest in the world, a sprawling archipelago including more than 17,000 islands, 200 million people, and the worlds largest Muslim population—without a clear leader.

Today, Indonésia is hailed as a model democracy and is a darling of the international financial community. The Jakarta Stock Exchange

Karen Brooks is Adjunct Sênior Fellow for Asia at the Council on Foreign Relations.

has been among the worlds top performers in recentyears, and some analysts have even called for adding Indonésia to the ranks of the bric countries (Brazil, Rússia, índia, and China). More recent eíforts to identify the economic superstars of the future—Goldman Sachs' "Next 11," PricewaterhouseCoopers' "e-7" (emerging 7), *TheEconomish* **"ciVETs**"(Colombia, Indonésia, Vietnam, Egypt,Turkey, and South África), and Citigroup s "3G"—ali include Indonésia.

To be sure, Indonésias track record has been impressive. In just a few short years following Suhartos 1998 fali from power, Indonésia 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 polis. With sweeping political and fiscal decentralization, Jakarta devolved real power and resources to the countrys 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 by its Indonesian acronym, kpk). An ambitious constitutional reform formalized 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), Indonésias voting system is among the most democratic in the world.

The police attempted to frame two of the corruption commissions members for, of ali things, corruption.

The countrys economic turnaround has been no less dramatic. In 1998, Indonésias economy suífered a contraction of more than 13 percent. Since then, it has grown at an average rate of more than five percent per year, including 4.5 percent in 2009, when gdps in much of the rest of the world shrank. This year, the Indonesian economy is expected to grow 6.5 percent. Indonésias debt-to-GDP ratio has declined from a high of 100.3 percent in 2000 to 26 percent today, which compares favorably to those of the countrys neighbors: Malaysias is 54 percent, Vietnams is 53 percent, the Philippines' is 47percent, andThailands is 44 percent. Inflation, which spiked to 77 percent in 1998, now hovers

just under five percent. 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 percent since 2008 alone. Other asean currencies generally appreciated by between 15 and 20 percent in the same period.

Indonésia 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, Indonésia has started to play a larger role on the international stage. When the **g**-20 was established in 2008, Indonésia was the only Southeast Asian nation offered membership. That same year, Indonésia launched the Bali Democracy Fórum, a yearly regional conference to promote democracy in Asia. In recent months, the fórum has become a platform for Indonésia to share lessons from its own democratic transition with some of Egypts aspiring democrats.

looming constraints

Yet despite ali the fanfare, the Indonesian score contains some decidedly discordant notes. Indonésias 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 Indonésia than in almost every other asean nation. On the World Banks 2010 Logistics Performance Index, which is based on a worldwide survey of shippers and carriers combined with data on the performance of each countrys supply chain, Indonésia ranked 75 out of 155, well below its neighbors.

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 administratiorís planned development through **2014.** Without the new development, Indonésia will not meet its target of **7-8** percent **gdp** growth by the same year.

Much of the burden of paving roads and providing power and water nationwide will thus fali to the private sector. However, Indonésias 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. Bureaucratic chãos at the National Land Agency, where plots are often recorded as being owned by multiple parties, has not helped. Yudhoyono has pledged to tackle these problems, but his credibility on the issue is fading.

Endemic corruption further adds to Indonésias high-cost economy. At the beginning of his first term, Yudhoyono named combating corruption a top priority. Since then, the **kpk** has sent dozens of politicians and former government ofíicials to jail. Still, corruption runs deep at ali leveis of government, since the devolution of power after Suhartos fali brought with it the decentralization of graft. Now, ofíicials from Jakarta down to the village levei demand bribes and kickbacks, and such payments no longer ensure that things get done.

A number of high-profile scandals during Yudhoyonos second term have showcased the breadth and depth of the problem. Investigations into the **2008** collapse and subsequent **$700** million government bailout of Bank Century, a midsize bank with politically connected depositors, revealed that individuais from ali elements of law enforcement—sênior police officers, ofíicials from the attorney generais office, lawyers, judges—had attempted to profit from the government bailout.

Since then, the police and others have tried to weaken the **kpk**, including by attempting to frame two sitting members of the commission

BEAWIHARTA BEAWIHARTA/REUTERS

In Jakarta, Februaryu, 2011

for, of ali things, corruption.The episode paralyzed the **kpk** for months and made a mockery of Indonésias judicial system. Although the commission emerged from this episode intact, it has since been focused on lower-profile cases.

Perhaps most damning, the president's own political party has been at the center of an escalating series of corruption scandals in recent months. Muhammad Nazaruddin, the party's former treasurer, and other sênior party members stand accused of rigging bids to fulíill government contracts worth more than $1 billion. Nazaruddin fled the country in May and spent three months on the Iam before he was arrested in Colombia. Such public drama has undermined domestic and international confidence in the administrations supposed fight against corruption. Perhaps more important, no major political party now credibly carries the anticorruption mantle.

The Yudhoyono administrations promotion of Indonésia 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. Indonésia has also backslid on some of its international commitments. The **asean**-China Free-Trade Area, which came into effect in January 2010, is

one such case. As part of the pact, Indonésia and China agreed to reduce or eliminate tariffs on thousands of goods. But since the agreement came into force, Indonésias domestic industries have pressed for more time to implement its commitments and for the creation of new non-tariíf barriers, such as burdensome labeling requirements that would affect a wide range of imports, and not just those from China.

To make matters worse, Yudhoyono announced just days before this years World Economic Fórum in Jakarta that the government would review and revise ali its contracts with foreign companies, particularly in the natural resources sector. Underlying the move is an assumption that Indonésias 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. Indonésias 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 Indonésia lags far behind portfolio inflows to the country.

Indonésias relative lack of integration with the world economy protected it from the worst of the global financial crisis in 2008. As a result, Yudhoyonos government seems to have concluded that maintaining some insulation from externai shocks is more important than allowing rapid growth through foreign investment or through an export-oriented growth strategy. Although the value of Indonésias exports is up 36.5 percent in 2011 (through July), the increase is overwhelmingly a function of a rise in the price and volume of commodities, namely, gas, coal, palm oil, rubber, and metal. Even with the commodity boom, Indonésias exports total only around 24 percent of **gdp,** much less than Malaysias (96.4 percent), Thailands (68.4 percent), and the Philippines' (31.7 percent).

The real driver of the country's recent economic growth has been the Indonesian consumer, with consumption accounting for roughly 60 percent of **gdp.** Indonesian policymakers seem content to keep it that way, and some degree of inward focus may well be appropriate. But Indonésia must strike a balance between protecting itself from externai 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.

storm clouds

Labor and human resource issues are particularly pressing problems for Indonésia, a country of 245 million with five percent 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 aging 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, Indonésia 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.

Indonésia 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 percent of Indonesians were unemployed and 12.5 percent were living under the poverty line. Unemployment and poverty have both decreased since Yudhoyono took ofíice in 2004—unemployment from over nine percent and poverty from over 16 percent. But these numbers do not tell the whole story; over 65 percent of Indonésias workers are employed informally, most of them in agriculture. Moreover, the number of university-educated unemployed has increased, from 3.6 percent in 2005 to 8.5 percent in 2010. As for poverty, the World Bank estimates that more than half the population lives on less than $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 Indonésia is neither training its work force nor creating the investment climate it needs to attract value-added and labor-intensive industries. Indonésia lags behind both key **asean** states and ali 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,

Indonésia 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 Forums 2011-12 *Global Competitiveness Report*, Indonésia scores in the bottom 30 percent of the 142 economies surveyed on labor rigidity.

Meanwhile, Indonésia 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 ali, and few perpetrators have been held to account. Yudhoyono has deflected responsibility by calling on local ofíicials to deal with the clashes. His failure of leadership sets a dangerous precedent in a diverse country that is home to at least five diíferent religious traditions and dozens of ethnicities. As its founding fathers understood, Indonésia 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 Indonésias 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 Indonésia will continue to enjoy the political stability that has allowed for its considerable economic gains.

yudhoyono s weak hand

Indonésia 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. Yudhoyono was elected with more than 60 percent 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 Indonésias 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, Indonésia passed ali its landmark reforms nearly a decade ago.

To be fair, the fault is not ali Yudhoyonos. For a presidential system, Indonésia has an uncommonly large number of political parties—nine in ali. The ruling Democrat Party is the single largest in the country s legislature, but it still commands only 26 percent of the seats. As a result, out of the 70 bills proposed at the start of Yudhoyonos second term, only a handful have passed—and largely insignificant ones at that. Indonésia 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 percent plurality can no longer protect Yudhoyono from attempts to oust him. The court s ruling seems to have exacerbated his indecisiveness—unsurprising given that Indonésias first elected president after Suharto, Abdurrahman Wahid, was impeached. Yudhoyonos failure to reshufíle his cabinet, despite making repeated threats to remove nonperforming ministers, has exemplified his paralysis.

As a result, the president is increasingly captive to politicians at odds with his stated reform programs, and Indonésias 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 Yudhoyonos term. At worst, Indonésia 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 Indonésias 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 Indonésia moves further away from its authoritarian past, reformers need to recalibrate the balance

of power. The legislature needs fewer political parties; independent institutions, such as the Constitutional Court and the **kpk,** need more power; and constitutional reform may be needed to raise the threshold for impeachment of the president. Generational change will hopefully be part of this process.The current political and economic elites are largely a product of the Suharto period. The 2014 electoral cycle might offer an opportunity for new leaders to come to the fore.

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 África to Europe, and as Chinas economic rise without political liberalization challenges the Western democratic model, Indonésias continued success as an open, moderate, tolerant, multiethnic, multireligious democracy with a booming economy is of huge importance as a model for the developing world. Indonésia 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 falls summit meetings are over, it will be time for Indonésias reformers to get back to work.

Fonte: Foreign affairs, New York, v. 90, n. 6, p. 109-118, Nov. / Dec. 2011.