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Indonesia's Economic Malaise: Chronic or Curable?

A USINDO Special Open Forum with

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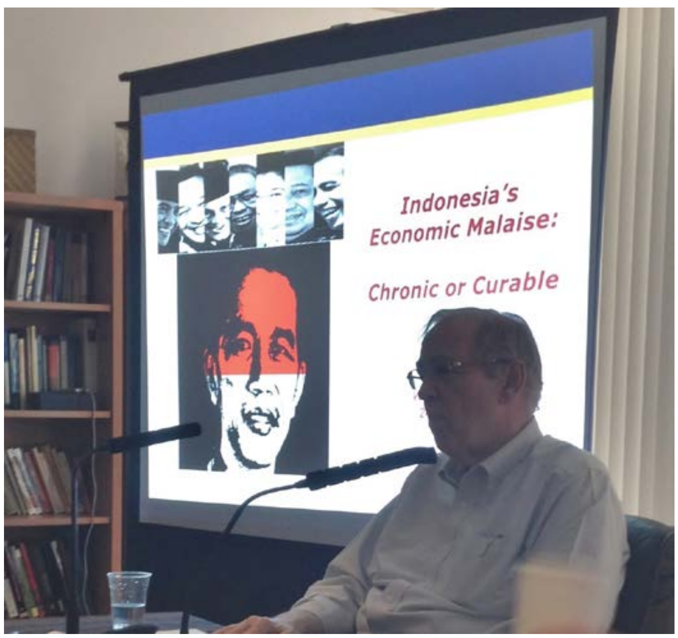

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On June 25, USINDO hosted a Special Open Forum with James Castle, Founder of Castle Asia and USINDO Advisor, discussing Indonesia's economic performance and outlook. This brief is USINDO's summary of the talk. The photos of this event can be accessed here.

James Castle's Remarks

Mr. Castle provided his insights on the challenges he believes President Jokowi's administration must overcome to address the recent reduction in Indonesia's annual rate of GDP growth and restore it to the higher rate of growth levels it is capable of attaining.

Economic trajectory: potential strengths; current challenges

The Economist's recent global report for 2050 projects Indonesia to be the world's fourth largest economy by 2050. A few years ago, McKinsey & Company wrote a report anticipating that Indonesia will become the world's seventh largest economy by 2030. In Mr. Castle's view, both forecasts are attainable provided Indonesia's government shifts its economic philosophy towards making Indonesia's economy more open.

In Indonesia, politics and the economy are tied. Mr. Castle believes that the popular press underestimates Jokowi's strength and ability to navigate his admittedly difficult relationships vis-à-vis parliament, Megawati, and his own party. Though popular perceptions may vary, the President has for the most part been winning his major battles thus far. The ground has shifted politically in his favor. His former Presidential opponent, Lt. Gen. Prabowo, has become one of Jokowi's strongest supporters.

When President Jokowi first took office, he faced five main challenges: isolationism, resistance to reform, protectionism, deficits, and a country headed towards a resource trap. Other issues affecting Indonesia's economy at the time included the weakening global economy, slower growth in China, the weakened Rupiah, and the inherited fiscal burden of extreme fuel subsidies. At the same time, many of Indonesia's key exports such as coal and palm oil, are facing much softer prices than in the previous decade.

Indonesia's economy hit its 21st century peak in 2010 when GDP growth was at 6.4%. But since then its growth has slowed steadily. While the budgeted rate of growth for this year is around 5.7%; most independent analysts believe Indonesia will be fortunate to make 5.0%. Of course, relative to Western economies, numbers in the 5's sound good, but Indonesia can and has done better.

The principal cause of Indonesia's slowdown in its rate of GDP growth, Mr. Castle believes, is that Indonesia's policy responses have been narrowing and restrictive, discouraging international trade and international investment. China, India, Vietnam and the Philippines are all growing faster than Indonesia because their governments have delivered more positive and open policy responses to global challenges, particularly mobilizing private capital, both foreign and domestic.

Mr. Castle explained that Indonesia's GDP per capita has also slowed steadily since 2011. Although the investment board has recently posted positive statistics, Mr. Castle believes a country can't have the level of investment growth reported while capital equipment imports, cement consumption, auto and motorcycle sales and the GDP are all slowing. Mr. Castle suggested that the discrepancy may have come from converting U.S. dollars to Rupiah at current value; with the Rupiah depreciating at 15%, the dollar investment value would go up 15%, thus showing a 15% increase in investment. This could be a sign bureaucrats may feel pressure to report rosy scenarios despite declining performance.

Mr. Castle said BKPM has no direct control over investment because it does not have regulatory authority, but feels it is important to deliver positive news. He was particularly concerned about the high GDP estimates that have been forecast by the Ministry of Finance. Most independent analysts feel that Indonesia would be fortunate to hit five percent growth this year, which is well below the government's estimated growth of 5.7%.

Japan Bank International Cooperation Survey

Mr. Castle reported some good news on the investment environment from the Japan Bank for International Cooperation (JBIC), which produces a global survey of Japanese corporations' views of countries' business environments. Their surveys ranked Indonesia as number one in 2013 and number two in 2014 of the most promising countries for overseas investment. JBIC's report on Indonesia noted that Indonesia has growth potential in local markets, an inexpensive source of labor, and a supply base for assemblers. Some of JBIC's concerns for increasing business in Indonesia included Indonesia's rising labor costs, underdeveloped infrastructure, unclear laws which are often inconsistent with practices, and difficulty in securing management level staff.

Two Myths

Mr. Castle's particular concerns about policy trends over the past decade revolve around the quality of dialogue. He believes that Indonesia's economic policy decisions during this period have been based on two myths: (a) that there is too much Foreign Direct Investment (FDI); (b) there is too much involvement in international trade.

According to World Bank data, foreign direct investment accounts for only about two percent of GDP, a ratio which lags far behind Vietnam, China, Malaysia, and Thailand. Mr. Castle believes that the myth that there is too much foreign investment most likely originates from focusing on the natural resources sector, which does have a large foreign presence. If policy makers were to expand their view to the broader economy, they would find that the percentage of foreign presence is very light in Indonesia.

The second myth has to do with international trade. Indonesia is canceling most of its bilateral investment treaties as they come up for renewal. It became the policy and perception under the SBY government that the international business, legal and trade norms are harmful to Indonesia. This sentiment has been the underlying and unspoken theme of virtually all regulatory changes from 2005 to the present. Mr. Castle contends that it is difficult to find any regulatory change that does not reflect this fear. To illustrate his point, Mr. Castle talked about how the Negative Investment List has steadily added more restrictions, further curbing Indonesia's FDI.

"Jihad Konstitusi"

Mr. Castle noted the Indonesian private sector is finally starting to complain because they are being squeezed out of most infrastructure projects by state-owned enterprises. Mr. Castle believes Indonesia needs to revise its current policies if it is to fulfill its infrastructure goals.

Mr. Castle said the term "jihad konstitusi" emerged a few years ago and was initially led by a number of socialists and elements of the Muhammadiyah religious organization. The goal of "jihad konstitusi" is gradually to reverse privatization and return even more control to the government. Because of this group's successful legal challenges at the Constitutional Courts, laws such as the Oil & Gas Law of 2001 or the Water Law of 2004 are being overturned so that private companies in these areas must work through state-owned enterprises. Similarly, the 1999 Foreign Exchange Law, the 2007 Investment Law, and the 2009 Electricity Law are being reviewed by the Constitutional Court due to cases filed by this group. Mr. Castle said that even though none of the political parties supports this small group of people, they have won the only two court cases they have filed.

Many other regulations that have come out of the Indonesian parliament and the bureaucracy are also geared toward micro-managing the economy and limiting the choices of private investors and traders, such as requiring that onshore data centers be set up, making companies use domestic content for smart phones, requiring expatriate workers to pass a language test, and the recent ban on contracts using foreign currency.

The Promise of Decentralization

Mr. Castle stated Indonesia historically had a highly centralized government, with Jakarta being the clear epicenter of power, extracting the lion's share of the national wealth. But since the implementation of strong decentralization laws in 2000 and 2001, Indonesia has made important strides in strengthening other parts of the country through delegating more power and funding to local governments. Mr. Castle stated that he is a huge fan of President Joko "Jokowi" Widodo, and praised his strong advocacy for decentralization. The decentralization process is helping redistribute resources and income.

He is particularly encouraged by the number of new young political leaders that have emerged throughout Indonesia, such as Ridwan Kamil from Bandung, Tri "Risma" Rismaharini from Surabaya, and Basuki "Ahok" Purnama from Jakarta. These people are making their mark as individuals and helping loosen the amount of power that all of Indonesia's large political parties hold, which is very promising.

Question and Answer Session

Q: Can you talk about the energy sector and President Jokowi's goal of producing 35,000 megawatts in four years? Is he going to get there?

A: This is the third 10,000 megawatt program and they haven't finished the first 10,000 megawatt program. Part of the problem is their inability to get good public-private partnerships. The Chinese did most of the first program and the government is in the middle of the second one and now they are starting a third one. Where is the money going to come from? They need great public-private partnerships. If they can complete one, then that will be a template that the others can follow. If by the end of this year, they get some infrastructure going, and if by the end of next year they show they can get a public-private partnership going, then they will make progress. However it is highly unlikely.

Q: Does the law you mentioned about the court decision ruling that foreign companies are not allowed to extract anything from the ground, apply to geothermal energy for example?

A: One would think so, but this is really terra incognita. For the past 50 years the government has ruled that a proper model is for the state to subcontract to private companies, e.g. Freeport, Exxon Mobil, Chevron, Medco in the oil sector. The Constitutional Court (MK), however, has recently taken the view that such sub-contracting is unconstitutional. The MK subsequently took the same view on water – private companies may not extract it directly. The government on its part is almost pretending that these court decisions were never made and/or trying to find some “work-arounds”, which are highly likely to lead to some complex legal battles down the road.

Q: My initial question is who are these “jihadi constitutionalists” and why do they have so much power; how can they stop things from happening? Are there any economists who have any influence over Jokowi or Kalla?

A: Even if the answer to the second question were yes, the opinions of the president, the vice-president or their advisors don’t matter when the constitutional court rules, much like here in the US when the Supreme Court rules on Constitutional questions.

Basically there is a certain view of the social welfare state that Indonesia is founded on, and it is deeply held by most Indonesians, especially the elite who trace their ancestry back to the revolution. The current court has taken a different view than previous courts and governments.

In the 40s and 50s, Indonesia’s political and economic thinkers were global and they were at the cutting-edge of the battle for post-colonial rule. Most newly independent countries formed types of social welfare states simply because the government was the only institution within the capital.

Indonesia’s first vice president, Mohammad Hatta, was a leading socialist thinker and he came down on the side that while the government owned all natural resources, it could sub-contract their exploitation to third parties including private entities. The current court (MK) has ruled, however, that such sub-contracting violates the constitution and is prohibited.

Q: Another thing that Jokowi has staked his political legitimacy on is reducing unemployment. Have you been looking at unemployment numbers? Can you find reliable data?

A: Jokowi is certainly concerned about employment. On the data side, I’m going to quote one of my all-time favorite bureaucratic lines from a study the World Bank did in the 1980’s on labor in Indonesia. “The data is so bad that only the importance of the subject justifies using it.”

The data are really soft. The informal economy is so robust in Indonesia and is outside the employment data. The official unemployment figure is around 6%. They don’t manipulate the numbers and they’re consistent in the way that they collect it, following ILO methodology. But underemployment is very high. The number you see most frequently quoted by development organizations is about

45% of Indonesians live on less than two dollars a day. It's really hard to have a policy that can accommodate all the gaps.

When you have rigid labor laws, all the data show that this hurts employment. It's a problem we have everywhere. The government is following 1950's social welfare and development models. "We want to meet the future by protecting the past." There are always losers; the trick is you want to make sure you have more winners than losers. The studies show that formal employment with some protection however weak the laws might be, gives people more options and more training and a stronger economy. Anything to encourage that is a good thing. We must acknowledge the difficulty of letting go of these strongly held beliefs, but they lead to failure.

Q: You said people seem to need to subscribe to an anti-foreign ideology in order to enter the powerful inner group in government. But, President Jokowi has been pushing for more foreign investment. Has President Jokowi revealed what he believes personally?

A: I hate to say anti-foreign; I would rather say people are afraid of foreign investment and foreign dominance. President Jokowi is not an economist; he's a practical person; and I hope that as time goes on, he will see the obstacles these protectionist and restricting laws create and will say "let's change this." SBY was all for foreign investment, but he didn't address the legal and regulatory obstacles and so foreign investment slowed substantially.

Q: You didn't mention security issues. It seems to me that President Jokowi doesn't have much control over BIN and TNI. Can you comment on what appears to be President Jokowi's lack of control not only of the military but also his ministers?

A: Several things are happening there. First, I think that the army has behaved really well in the transition from Suharto to where we are now. My view is that the problem comes from the police who are interacting with people. They have a lot of issues, especially with integrity and corruption.

One problem between the military and the police is that the military is very jealous of the police's success in the anti-terrorist brigade and they want to get a larger onshore role. If you look at it from a true defense role, Indonesia doesn't need such a big army, but they need a much stronger navy and a stronger air force in order to advance President Jokowi's maritime security agenda. So there are a lot of issues that stem from a system-wide phenomenon, but I wouldn't read too much into Jokowi's reluctance to confront the army at this point.

Q: Can you talk about President Jokowi's relationship with Megawati? Second, how does that relate to Jokowi's seeming unwillingness to strongly support the KPK in the fight with Gunawan?

A: In the bigger picture, Jokowi does run a minority government and so he can't fight every battle and triumph on every issue. I think the KPK thing is still playing out. I see the bigger issue being Jokowi as the reformer against the establishment, of which Megawati is an important member. But Megawati's issues may be a little different in the sense that she has dynastic motives as well as patronage motives. There may be a cabinet reshuffle later this year, but my personal view is that Jokowi won't have a shuffle until the Golkar conflict is cleared, because he's going to want to bring them into the government, but can't do this when they are squabbling with one another.

Q: What do we know about the younger generation? Is there any sign that they are more outward looking?

A: I'm glad that you asked that question. There are so many young Indonesians who are so inspirational and are thriving in the international arena, especially in the IT sector and movie industry. The interesting thing is that if they had been born in an earlier generation, they would have all been destined to be civil servants, pursuing careers in the different ministries. But now few of them are going into the public sector because they don't find it appealing when you can do even better in the private sector. In the private sector, they have reasonable hours, nice pay, and there isn't so much corruption and patronage pressure.

There is also a worrying element to this overall positive trend. We should be concerned by this trend because the bottom line is these young talented people are going to the private sector and don't want to go into government service. This will weaken the government service over time. The thing that the new bright young people are going to have to figure out is what their political role will be, because as of now, they disdain politics because of the corruption and that leaves the field wide open for those who are enticed by the corruption to be the leaders in government. They really need reform in the education sector to inspire the future generation to consider going into politics and the civil service. So I hope that the bright young people are becoming inspired by the newly emerging political individuals such as Jokowi, Ahok and Ridwan Kamil.