The recent election of reform-minded Joko Widodo, the first businessman to become president of Indonesia, has crystallized optimism about Southeast Asia’s biggest economy. But there is another side to this story: Give an ear to Indonesia’s (still numerous) critics and you might think that it is equally likely to become the latest victim of what economists have dubbed the “resource curse,” with corrupt oligarchs thriving off rent-seeking, foreign investors ready to flee at the first hint of instability and the poor doomed to more of the same.

From Brazil to Vietnam, emerging market countries struggle to live up to the grand expectations of starry-eyed global investors and self-congratulatory governments. However, the problem is particularly acute in Indonesia, argues Chatib Basri, who stepped down from his post as finance minister in October when the new government took power.

A forthright economist with a fondness for pithy dictums, Basri used to tell investors that Indonesia “always disappoints.” “We disappoint the optimists, but we disappoint the pessimists too,” he quipped. And the events of the past decade underline this propensity to muddle through.

When former president Susilo Bambang Yudhoyono was elected in 2004, the economy had only recently recovered from the devastations of the 1997-98 Asian financial crisis, and many feared that a succession of regional conflicts could turn the world’s biggest Muslim-majority nation into a Balkanized mess. Happily, these pessimists were proved wrong. Yudhoyono presided over a decade of political stability that allowed democracy to settle in (the long-ruling autocrat Suharto had only fallen in 1998). The economy grew at an average of 5.8 percent per year between 2004 and 2013 – short of Asian-tiger rates, but fast enough, for long enough, to nourish a burgeoning middle class.

The feather for Indonesia’s cap arrived in 2011 and 2012, when the ratings agencies Fitch and Moody’s upgraded Indonesia’s sovereign debt to “investment grade” – a symbol for many investors, foreign as well as domestic,
President Joko Widodo after his inauguration.
that Southeast Asia’s biggest economy was fi-
nally getting the attention it deserved. Yet, 
while billions of dollars’ worth of investments 
were pouring in from Singapore, Japan, China, 
Europe and the United States, beneath the 
surface all was not well. The boom had pa-
pered over deep structural problems: en-
demic corruption, woefully inadequate physi-
cal infrastructure, uneven law enforcement 
and underinvestment in health and educa-
tion. Indeed, the World Bank’s Ease of Doing 

**TRENDS**

Business index ranks Indonesia 114th, behind 
undistinguished competitors including Nepal, 
Ukraine and the Kyrgyz Republic.

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able mix of domestic consumption 
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Growth, it is now clear, was fueled by an unsustain-
able mix of domestic consumption 
and China’s appetite for imported commodities. Indonesia became the world’s biggest ex-
porter of coal for electricity generation and palm oil for use in everything from shampoo 
to instant noodles. Together with other com-
modities, notably rubber and tin, natural resources make up around 60 percent of In-
donesia’s exports. So when the Chinese gov-
ernment reined in its economy’s breakneck 
expansion, Indonesia was shaken.

The IMF estimates that each percentage 
point fall in China’s GDP growth rate cuts as 
much as 0.5 percentage points from the cor-
responding figure for Indonesia. It’s not sur-
prising, then, that when China’s growth eased 
from 10.4 percent in 2010 to 7.7 percent last 
year, Indonesia’s pace of expansion slowed 
from a peak of 6.5 percent in 2011 to 5.8 per-
cent in 2013. The World Bank forecasts the 
rate will slip again this year, to 5.2 percent.

What’s more, the tides of Indonesia’s 
growth have not carried all boats. An economy 
driven by buoyant commodity prices, along 
with highly profitable consumer goods and 
real estate sectors, is not structured to share 
the benefits of growth evenly. Indeed, as mea-
sured by the Gini coefficient (a commonly 
used index of inequality), between 1990 and 
2010 Indonesia saw the biggest increase in in-
come inequality in Asia outside of China.

While tens of millions have risen above the 
government’s modest definition of poverty, 
more than 40 percent of the county’s 250 mil-
lion people still live on less than $2 a day. Even 
in the economic heartland around the capital 
Jakarta, many are without access to good jobs, 
clean water and adequate nutrition.

More striking yet, Indonesia has actually 
gone backward on important development 
indicators. Some 37 percent of Indonesians 
under the age of five are stunted (pathologi-
cally short for their body weight) because of 
bad diets and a lack of health care. That is up 
from 28.5 percent in 2004. Today, Indonesia 
fares worse by this measure than wretchedly 
poor Myanmar, which limps along at a frac-
tion of Indonesia’s GDP per capita.

Cristobal Ridao-Cano, an economist in 
the World Bank’s Jakarta office, calls this a 
“national emergency.” Not much, he notes, can 
be done after a child’s first thousand days of 
life to reverse the brain damage caused by 
malnutrition.

The changes needed to reduce malnour-
ishment are much the same as the ones that 
investors want to see: better infrastructure, 
higher quality health and education services, 
and smoother coordination among govern-
ment ministries and between the central and
local governments. But while laying out what needs to be done is easy, getting from here to there is not.

THE ELUSIVE OPENING

Gustav Papanek, president of the Boston Institute for Developing Economies (a private consulting firm), has been advising Indonesian governments on economic policy since the 1960s. Papanek argues that Indonesia is now facing a “once-in-a-century” opportunity, an inflection point of sorts at which it can either buckle down for economic reform and ensure substantial growth for decades to come or languish near the low end of middle-income status.

Global consumer goods makers may be giddy with anticipation at conquering a huge new market, but Papanek is more concerned about the two million youths entering the workforce every year. “If there are not enough jobs for them, this demographic dividend will turn into a demographic disaster,” he says.

Around 60 percent of Indonesians already work in what economists euphemistically call the “informal” sector, hawking noodles on street corners and fixing flat tires at makeshift garages, far from the view of the government bureaucracy. The work is usually low-paid and insecure. But Papanek’s latest analysis, “The Economic Choices Facing the Next President,” underwritten by Transformasi, a business-oriented think tank in Jakarta, concludes that Indonesia has a window in which it can fix this problem by attracting international manufacturers who are leaving China in search of cheaper labor.

To reel in these prospects, however, Indonesia will have to boost its competitiveness
significantly by revamping ailing infrastructure, reforming byzantine labor laws and lowering the myriad other costs of setting up and running businesses. According to the World Bank’s Ease of Doing Business index, Indonesia now ranks a miserable 153rd out of 189 countries in ease of obtaining construction permits and a ghastly 172nd in facility in enforcing contracts. It should not be surprising, then, that in the race to fill the manufacturing vacuum left by rising costs in China, Indonesia is already losing out to the likes of Bangladesh and Vietnam, which offer lower wages and/or a friendlier business environment.

The window of opportunity is narrowing, with minimum wages having already risen sharply in the greater Jakarta area and trade unions pushing for further increases to offset the high cost of living in and around the capital. The average monthly wage for a factory worker in Jakarta is around $240, not far behind China’s ($328).

Prospects are better for Central Java, where the average wage is still only $120 a month. That wage advantage has prompted Pan Brothers, a big Indonesian garment maker, to expand its manufacturing base rapidly in this province of 33 million, investing in seven new factories in a joint venture with Mitsubishi, the Japanese trading house.

But Central Java’s attraction as a place from which to export clothes produced for Adidas, Nike and Uniqlo depends as much on infrastructure as wages. A new toll road for a factory is the infrastructure bottleneck. The infrastructure bottlenecks don’t end there.

The state-owned port operator at Semarang has tried to improve efficiency and reduce ship dwelling times as the volume of container cargo – mostly garment exports – increases. Still, once a day road access to the port is cut by tidal seawater incursion, and during heavy rains last January it was inaccessible for a week. Meanwhile, the agency that runs the port is powerless to fix the problem without the cooperation of local government.

This problem of overlapping jurisdiction – and competing bureaucracies and vested interests – stymies many infrastructure projects across Indonesia. Elsewhere in central Java, a plan to build a $4 billion, Japanese-funded coal-fired power plant at Batang deemed vital to meet the region’s ballooning energy needs has stalled for two years because of disputes over land acquisition. No one from the central or local government has so far chosen to use political capital to force through a solution.

The list goes on. Outside Medan, Indonesia’s fourth-biggest city, a shiny new $500 million airport has been built, showcasing the best of Indonesian architecture and construction. The only catch: the government has yet to build a highway connecting it to Medan, thanks once again to disputes over land ac-
TALES FROM THE TWO INDIonesias

In economic terms there are, in effect, two Indonesias. One is composed of the fast-growing middle class, which is buying apartments and cars, sending its children to university, and paying for private health care. Boston Consulting Group, a management consultancy, predicts that this nascent consuming class will double to 140 million people by 2020.

To see this Indonesia, drive about an hour (two in traffic) west of central Jakarta along the toll road to the port of Merak. When you spot the familiar blue-and-yellow logo of Ikea, the world’s biggest furniture retailer, you have arrived.

Situated in Alam Sutera, a privately developed satellite city, this is the furniture giant’s first store in Indonesia. Business has been brisk since it opened in October, as Indonesian families have rushed to kit out their homes with flat-pack shelving and funky Swedish-designed lights with made-up Scandinavian names. No wonder: Mark Magee, Ikea’s general manager, estimates there are 9.5 million people in greater Jakarta who can afford to shop at Ikea – the same number who live in all of Sweden, where there are 19 stores.

The inhabitants of Alam Sutera (and other satellite towns springing up around major Indonesian cities) live in their own prosperous, hermetically sealed world, with paved roads, access to clean water, private schools and health care. The hope has long been that the success of this emerging middle class would “trickle down” to those at the bottom. But this is happening far too slowly where it’s happening at all.

To see the other Indonesia, drive about an hour east of central Jakarta to a place called Bantar Gebang. When you are close, you will know by the smell. Here, 40-year-old Rastinah, her family and the members of 1,500 other households experience trickle-down economics Indonesian-style, eking out a living as scavengers on one of Asia’s biggest landfills. And they do not just work here; they live amid the rotting mountains of rubbish.

Laboring with her husband and two young children, Rastinah (who like many Indonesians goes by only one name) earns around $180 a month picking and selling plastic and cans for recycling. That is barely enough to survive, and certainly not enough to ensure that her children can finish primary school. Only 40 percent of the children at the local school get to the sixth grade, with many of their parents pulling them out early to join them for toil on the trash pile.

Many of the families are stuck in a cycle of poverty and lost opportunities. Rastinah did not complete her education because she had to work with her parents. She wants her...
children to finish school and have a better life. But she is already drafting her 12-year-old son to help find the recyclable material in the perilous gaps between the Komatsu machinery that shapes the ever-growing mountain at Bantar Gebang.

**ENTER THE FURNITURE MAKER**

If anyone can unite the two Indonesias and help the country deliver on its promise, it should be President Widodo, whose remarkable rise from obscurity has been compared to that of Barack Obama. Having grown up in a riverside shack and worked to improve the lives of slum-dwellers as mayor of Solo (a city of half a million) and then as governor of Jakarta, he says that he understands the struggles of the poorest Indonesians.

By the same token, the other, upwardly mobile Indonesia can identify with his success: He transformed his family’s small carpentry business into a furniture-exporting factory. As he told a group of investors during his hard-fought election battle against former general Prabowo Subianto, “I may have the face of someone who comes from the village, but I have an international brain.”

The first president to come from outside the narrow political and military elite, he was swept into power because of his down-to-earth style, corruption-free reputation in a corruption-ridden society and track record of getting things done. Since he took office in October, the 53-year-old and his team have reiterated a campaign pledge to accelerate economic growth to 7 percent. And in November, he implemented his first concrete reform toward that end, nearly halving the $20 billion-plus fuel subsidy program that is both wasteful and ferociously regressive and vowing to reallocate the reclaimed funds to social security and infrastructure.

Constrained by the fact that his political party – the Indonesian Party of Democratic Struggle – controls less than one-fifth of the seats in the parliament, Pres. Widodo has had to compromise on his ministerial selections. But he did manage to include a few mavericks hewn in his own image. Chief among them are transport minister Ignasius Jonan, an acerbic former investment banker at Citigroup who turned around the failing national rail company, and fisheries minister Susi Pudjiastuti, a tattooed, chain-smoking high school dropout who founded her own airline to serve Indonesia’s remote islands.

Those who know Widodo well agree that he is likely to move slowly but surely to implement his ambitious reforms, taking time to canvass multiple views before acting. But time is fleeting. Wijayanto Samirin, an economic advisor to Vice President Jusuf Kalla (the seasoned politician who became Widodo’s running mate), argues that the new government has a honeymoon period of perhaps a year in which it will have the political capital to push through unpopular reforms like hiking the heavily subsidized fuel price. If it does not move quickly, public support will dissipate, and Pres. Widodo’s political opponents, who control the majority of seats in parliament, are likely to become emboldened.

In addition to pressing for improved infrastructure and streamlined regulation, international investors hope that Widodo will buck the trend toward economic nationalism stoked by the Yudhoyono government. Widodo’s predecessor oversaw the introduction of a succession of protectionist measures designed to appeal to populists and to shore up support from homegrown crony capitalists and their allies in the bureaucracy. The trend won’t be easy to reverse.

Despite this and the slowing growth rate, international investors remain supportive.
That is crucial, because the recent fall in the value of Indonesia’s commodity exports exposed a structural shortfall in Indonesia’s foreign currency account (forecast at about 3 percent of GDP this year) that leaves the country reliant on huge amounts of foreign capital to cover the deficit in trade.

Foreign investors from Ikea to the Spanish bank BBVA have continued to storm the ramparts. The large, growing economy is still very attractive to corporate investors, especially compared to the stagnant Eurozone and faltering emerging markets from Brazil to Russia and South Africa to Turkey. As Indonesian private equity guru Gita Wirjawan once told querulous foreign investors when he was the trade minister, if they were leery of Indonesia, they were free to put their money in Afghanistan or the Democratic Republic of Congo.

Without reforms, Indonesia can probably continue to attract investors and grow at 5 percent a year through mere inertia. But the 100 million poor Indonesians, who have seen their incomes rise by just 1 percent annually over the past few years, will be left behind unless Indonesia moves to a broader-based growth model that creates quality jobs and drives innovation.

One senior Asian diplomat who met Pres. Widodo recently said he was impressed by his no-nonsense style. But he worries that Indonesian policymakers have misunderstood the examples of the Asian tigers like South Korea and Taiwan, which transformed their economies in a generation through export-led manufacturing. “They know they need to upgrade [the business environment], but they always try to force investors to do things, rather than offering them incentives,” he says. “That’s why many manufacturers who have been leaving China have been going to Vietnam rather than coming here.”

To escape from its current predicament, Indonesia will have to move from “rhetorical nationalism to substantive nationalism,” argues Jeffrey Winters, a political scientist at Northwestern University, in the introduction to Papanek’s recent study. “Indonesia will not be able to achieve rapid gains in prosperity without embracing the international world and engaging international actors.”

If Indonesia is to stop disappointing the optimists, now may be the best time, according to another favored adage of Chatib Basri, the former finance minister, “The good times, he notes, “make for bad policy, and the bad times make for good policy.”