What's Holding Indonesia Back

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Byline: Michael Schuman

The country has all the ingredients for success: a stable democracy, a wealth of natural resources and a large consumer market. But Indonesia is not keeping pace with Asia's booming economies

Dave Morrison sits on top of an estimated $800 million in gold but can't get his hands on any of it. The 42-year-old Australian engineer went to the tropical island of Sulawesi in Indonesia's east five years ago to open a gold mine on a palm-studded hillock outside the provincial capital, Manado. He has yet to overturn one shovel of ore. A half-built processing plant sits idly alongside a dirt track. Among the only signs of activity to be spotted are in the picturesque bay nearby, where fishermen paddle wooden canoes. The mine's operator, Perth-based Archipelago Resources, has faced delays because of a political battle that has raged from the villages outside the mine's gate to the ministries of the Indonesian capital of Jakarta. So Morrison, the project's chief operating officer, waits with as much patience as he can muster. "It is literally a gold mine," Morrison says, but "that doesn't stop social and political issues from coming up. That's Indonesia."

The story of Morrison's buried treasure--and the reasons why he can't get it out of the ground--says a lot about the current state of Indonesia, the world's fourth most populous country. On one level, it is actually a good-news tale of the vibrancy of the nation's democracy and the growing power of its citizens just 10 years after the fall of the dictator Suharto. On another level, however, it is a story that explains why Indonesia has slipped in status from roaring economic tiger to chronic underachiever. Considering the country's population of 225 million, its large consumer market and the abundance of natural resources, Indonesia ought to be a rising Asian powerhouse, mentioned in the same breath as China and India. But its economic-development policies are vague and scattershot; a devolution of political power from the central government to the provinces has created an unpredictable business environment rife with corruption, competing interests and confusing regulations. This not only thwarts the plans of would-be investors like Archipelago Resources but also tends to hold back ordinary Indonesians, who can do little but look with envy upon the upwardly mobile residents of Beijing and Bangalore. The percentage of Indonesia's population living below the poverty line in 1996 was 17.1%, according to the government. There was little improvement by July 2008, when 15.4% of the population lived in poverty. "Indonesia's potential is there," says Luiz de Mello, an economist at the Organization for Economic Cooperation and Development (OECD) in Paris, "but they don't deliver on it."

In fact, it was once Indonesia that showed Asia the way out of the poorhouse. In 1980, when Deng Xiaoping was first nudging China toward the free market, Indonesia's per capita GDP was more than double China's. Throughout the 1980s and early 1990s, Indonesia's fast-growing manufacturing sector was a magnet for foreign investment, and rural development schemes were so successful that the nation became self-sufficient in rice for the first time. The government even had ambitions to build commercial jets and cars. But since the 1997 Asian financial crisis, Indonesia has been virtually marching in place while its neighbors hit their strides. Last year China's GDP was nearly 30% higher than Indonesia's on a per capita basis. While annual economic growth rates in China and India averaged 10.6% and 8.7% respectively over the past five years, Indonesia's has averaged 5.5%.

Indonesia's relatively sluggish performance can be traced to the fall of Suharto--an autocrat who repressed political dissent but who, like other Asian strongmen of his era, was able to guide the country toward prosperity. After he was forced to step down in 1998 amid an economic meltdown, a new government set about erasing his dictatorial imprint; in 1999 an effort began to decentralize the once all-encompassing power of Jakarta, giving provinces and cities more influence over local affairs. Today, Indonesia's political system is more inclusive and remarkably stable. Some 34 political parties will participate in next year's parliamentary elections and, unlike in Thailand and the Philippines, where election results have been contested on the streets, Indonesians have peacefully accepted election results.

This democratic flowering has a downside: it has sparked seemingly endless turf warfare between Jakarta and the country's provincial and local governments. The sparring often results in conflicting regulations, uncertain lines of authority and onerous tax burdens. Contributing to this hostile environment are corruption, a capricious legal system and local suspicion of foreign companies, which are often viewed as carpetbaggers rather than investment partners. Not that Indonesia is a complete pariah to outside investors. Foreign direct investment (FDI) has increased in recent years as the economy has improved. But reform is required, economists say, if Indonesia is to become more competitive regionally and globally. China in 2007 attracted seven times more FDI than Indonesia, India almost twice as much. Indonesia "has to be at par with what its neighbors are doing," says Ifzal Ali, chief economist at the Asian Development Bank in Manila, "or foreign investment won't flow in."

Indonesia's failure to launch can be seen as all the more frustrating because the country appears to be missing out on an epic global commodities boom. The archipelago of 17,500 islands is rich in natural gas, copper, coal, gold and other sought-after resources. Yet while some sectors, like palm oil, have seen exports surge, others have stagnated despite soaring commodity prices. A dearth of investment combined with aging fields has reduced the country's once formidable oil industry to near insignificance. Production has plummeted by one third in the past eight years. There may be undiscovered oil still in the ground. But funding for exploration has been scared off by a 2001 law that created a confusing regulatory framework for the sector and imposed taxes on companies before the start of production, which effectively increased the financial risk of searching for new fields. In 1998, oil companies drilled 145 exploratory wells in Indonesia; in 2007, as oil prices soared, only 39 were sunk, according to the Center for Petroleum and Energy Economics Studies in Jakarta. Once a major oil exporter and East Asia's sole member of the Organization of Petroleum Exporting Countries (OPEC), today Indonesia can no longer meet domestic demand without imports; Jakarta this month suspended its membership in OPEC.

The mining sector has been plagued by similar obstacles, among them a longstanding lack of regulatory clarity because the country has been in the process of overhauling its mining laws for the past seven years. In a survey of mining companies released earlier this year by the Fraser Institute, a Canadian research organization, Indonesia tied for No.1 out of 68 countries and regions for its mineral potential, but ranked 62nd in the clarity and friendliness of its policy and regulation. Investor sentiment has also been dampened by high-profile conflicts between miners and Jakarta. This year, the government threatened to cancel the contract of Newmont Mining to operate a copper and gold mine on the remote island of Sumbawa, claiming the Denver-based firm failed to honor an obligation to divest shares in the mine to Indonesian investors. Newmont says it has offered the shares to the government but they were never purchased. (The matter is now in arbitration.) The current spat follows an incident when the president of one of Newmont's local operations was summoned by police for questioning in 2004 and later put on trial on allegations that a gold mine in Sulawesi had polluted a nearby bay; the executive was later acquitted of any wrongdoing. Says Fred McMahon, the director of the Fraser Institute's Center for Trade and Globalization Studies: "Miners don't feel they can trust the Indonesian government."

Who's in Charge?

For the past five years, Terkelin Purba, a director at Archipelago Resources' local subsidiary, has had the unenviable task of negotiating with Indonesia's government to get the Sulawesi gold mine up and running. Purba can recount in excruciating detail all of the documents filed, approvals received and steps taken that should, by his reckoning, allow the gold mine to start production. "There is no reason for the project not to proceed," Purba claims.

But across town, in an office overlooking Sulawesi's spectacular coastline, Sinjo Hari Sarundajang, the 63-year-old governor of North Sulawesi province and the mine's chief opponent, says Purba has it all wrong. In the old Suharto order, a local politician like Sarundajang would likely have played almost no role in Archipelago's affairs. But in the new Indonesia, he is a formidable figure with far greater authority. Sarundajang whips out his own documentation listing the regulations he has followed in his effort to block the mine from opening. Though he says he's happy to welcome foreign firms into his province, he fears that mining could bring environmental degradation to Sulawesi and derail his vision for the province as a tourist hot spot. The local people, with their rich fisheries and farmland, don't require a gold mine to earn a good living, he contends. Dubbing himself the "Green Governor," Sarundajang proclaims: "I am with the people."

The result of this confrontation has been a series of claims and counterclaims, with each party fully confident that the law is on their side. The main point of contention has been the project's plan to dispose of the mine's waste and control its environmental impact. Without government approval for this plan, Archipelago cannot begin mining. Opposition from the provincial governor has caused lengthy construction delays. Earlier this year, the company announced its plan was approved. But the Minister of Environment, Rachmat Witoelar, who has final authority, supports the governor and says he hasn't given his approval and that the company is misreading the regulations. The problem, Witoelar says, is that the mine "doesn't have the support of the people." (Archipelago insists it has public support.) Even the Minister of Energy and Mineral Resources, Purnomo Yusgiantoro, hasn't been able to sort out the mess. Purnomo says he fully backs Archipelago's project and he has told Sarundajang that "we signed the contract, we have to respect the contract." Meanwhile, Purba fumes that Archipelago and the mine's preceding owners have spent about $100 million on the project so far without result. "Yes, I'm angry," Purba says. "Because we've lost a lot of money and we can't understand why. I do believe that (the national leaders) are trying to do everything from their side to get investment, but other government ministers don't get it."

Falling Short

The man who was supposed to fix Indonesia is Susilo Bambang Yudhoyono, Indonesia's President. The former general was elected by an overwhelming landslide in 2004 based on his reputation as a can-do administrator and levelheaded political broker--a refreshing change after six years of often dithering leadership. In some respects, Yudhoyono hasn't let his nation down. He has successfully defused the country's Islamic terror networks and peacefully resolved a longstanding conflict with a separatist movement in Aceh province. The economy is performing solidly if unspectacularly: GDP grew 6.3% in 2007, the fastest in 11 years. Yudhoyono's government has also made progress on some of the sticky regulatory issues that have hamstrung international businessmen. A new investment law, passed last year, overhauled the country's foreign-investment rules and, according to a recent study by the OECD, Indonesia now imposes less red tape on potential investors than many other emerging markets, including China. The government is also expected to introduce business-friendly tax reforms that would set the corporate tax rate at a flat 25% by 2010. Indonesia has seen a resurgence of investor interest. India's Tata Power last year paid $1.1 billion for stakes in several coal-mining operations. Steel giant ArcelorMittal is looking into investments that could reach as much as $10 billion, and mining firm Rio Tinto is negotiating with the government to open a $2 billion nickel mine. Overall, FDI reached $10.3 billion in 2007, up 73% from the year before.

Yet economists contend that Indonesia's performance could match that of India and China if Yudhoyono presses reforms further. The most damaging, and most politically sensitive, issue dampening investment is the nation's oppressive labor law. Passed in 2003, it requires companies to get government approval to lay off staff and mandates heavy severance payments. The stipulations were a misguided attempt to protect local workers that instead has made Indonesia uncompetitive in the kinds of labor-intensive industries--like textiles and footwear manufacturing--that could help reduce the country's lofty unemployment rate, currently at about 8.5%. Political analysts complain that Yudhoyono doesn't exhibit the necessary decisiveness on economic matters--and with a presidential election looming in 2009, they fear he has little hope of achieving much more ahead of the vote. "He's become more focused on not making mistakes than doing anything positive on potentially controversial issues," says John Arnold, president director of consulting firm APCO Indonesia in Jakarta.

Channeling Chavez

There are limits to what any elected President can accomplish in the diverse and far-flung island nation. To many Indonesians, the wrangling over economic policy is a sign of a healthy democracy. Sarundajang, the North Sulawesi governor, points out that the original contract allowing Archipelago to dig for gold in his province was signed in 1986, during the Suharto years, when citizens' wishes were disregarded. The struggle against the mine, he contends, is a struggle to correct the sins of the past. By opposing the mine, he says he wants to "give a salute to [Hugo] Chavez," Venezuela's radical socialist President. Says Bert Supit, founder of Manado-based NGO Majelis Adat Minahasa and one of the gold mine's chief opponents: "We want to remain Indonesian, but we don't want to be dictated to by the elites in Jakarta. We need to find a system that allows the local people to have a voice in their affairs."

Indonesians these days are definitely making themselves heard, even in the thatch-hut hamlets surrounding the Archipelago mine. Some in the community, like village headman Marten Katiandagho, believe that preserving the environment is all well and good, but that the area also badly needs the jobs and the tax dollars the mine will bring. "People need to eat," he says. But other villagers have battled Archipelago ferociously, even forming their own NGO, called the Alliance of People Against Mining Waste, to stage protests and lobby in Jakarta. Says Tajudin Hema, one of the leaders of the antimine group: "We don't want to have waste in the sea, on the land or in the air." Tajudin last year was sentenced to 18 months in jail for inciting a violent 2006 protest during which a mob of 1,000 villagers attacked and burned down a guard post at the mine's jetty. (Tajudin says his conviction was overturned on appeal.)

With passions running so high, resolving Indonesia's economic ills won't be easy--although economists and officials say the cure is straightforward enough: the government has to demarcate federal, provincial and local powers, and reconcile conflicting laws. "We have to make regional governments aware that their regulations must comply with the higher regulations," says Purnomo, the mineral-resources minister. Indonesia also has to further liberalize its economy to encourage greater investment from both foreign and local enterprises, by, for example, loosening up the labor market and lifting remaining restrictions on foreign investment in certain sectors, such as transport and telecom.

Indonesia is heading in the right direction, says the OECD's de Mello. "But what they need to understand is that the world is moving faster." Real progress can come only if there is a national consensus to make economic development a priority. And in the country's fractious political environment, not everyone is willing to take the politically uncomfortable steps to achieve high growth, such as scaling back labor rights and encouraging foreign investment.

Still, there are those who see too much opportunity to quit the country. At the Sulawesi gold-mine site, Dave Morrison has begun hiring contractors to complete facilities construction. Archipelago hopes to start digging next year. "Everyone is telling the truth from their own aspect," Morrison says of the controversy surrounding the mine. "I'm confident that things will move forward." If Indonesia's leaders did more to reinforce that confidence, perhaps the country's promise, like its gold, won't always seem out of reach.