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INDONESIA: A BLACK SWAN?

Ladies and gentlemen,

First of all, I would like to thank John Hamre, President of the CSIS, and Mike Green, Japan Chair, for inviting me to speak here. It is an honor to address such a distinguished audience in one of the world's leading think tanks.

Nassim Nicholas Taleb published a book recently called *The Black Swan*.

The *New York Times* bestseller by this prominent literary essayist and epistemologist explores the emergence of highly improbable and unpredictable events in the world.

Taleb argues that scientists, economists and historians place too much weight on the odds that past events will repeat themselves. Instead, the really important events are rare and unpredictable. Taleb calls them black swans.

In Europe, all anyone had ever seen were white swans; indeed, "all swans are white" had long been used as the standard example of scientific truth. So, what was the chance of seeing a black one? Impossible – until 1697, when explorers discovered them in Australia.

Generalizations are useless in a sea of raging uncertainty. The black swan is the unexpected event. The astonishing success of Google was a black swan; so was September 11 and the recent stock market crashes. Consider another black swan, or the potential to be one: Indonesia.

Bell-curve predictability would brush aside this suggestion. The violence of 1998 and the turmoil of the post-Soeharto era has been etched indelibly into the memory of the world. Consider the Indonesian images of yesteryear: mobs rampaging through the streets of Jakarta and other major cities, looting shops and malls; places of worship being attacked and razed to the ground, their charred skeletal remains lying stark against the sky, stabbing the bruised conscience of Indonesia; religious zealots parading with swords and machine guns while calling for a holy war in the Maluku islands; public decapitations in Kalimantan; and gruesome killings in Banyuwangi.

Indonesia appeared to be imploding under the forces of social anarchy. This perception – magnified by the rise and fall of successive regimes, Islamic militancy, and an economy that at the height of the financial crisis contracted by 15 per cent – remained a constant for much of the last decade.

But Indonesia presents a markedly different picture in 2009. It is an image of a country getting back on its feet: gleaming malls showcasing Louis Vuitton, Bulgari and Prada are sprouting all over Jakarta and other major cities; modern high-rise apartments and buildings dotting the skyline; and an affluent middle class emerging. Whatever its critics might say, the reality is that Indonesia has changed. Today, Indonesia enjoys relative peace and economic development, and is increasingly being compared to middle-income developing nations like Brazil, India and Mexico.

A number of indicators point to a greater sense of normalcy.

Political stability

One such indicator is political stability. Indonesia remains structurally stable, the administration is moderate, and the pro-reform leadership is likely to remain in place after the 2009 elections.

President Susilo Bambang Yudhoyono is perceived as a reformer that has put together a competent economic team that is fiscally conservative. Political institutions are still weak but a process is underway to build them.

Significantly, the genie of violence is back in the bottle. Concerns of country breaking up is a thing of the past. There is no evidence today that active centrifugal forces can bring about "balkanization". There are simmering tensions in Aceh and Papua from separatist elements but do not seem to have the demographic weight or military force to challenge Jakarta.

The growing gap between rich and poor could be a powder keg in an election year. But Indonesia has gone past the stage where it can be held ransom to wild swings of volatility across the distended archipelago.

Consider another fact: the dramatic decline in terrorist attacks in Indonesia. There has been no incident since 2005. The Al-Qaeda linked Jemaah Islamiah has been emasculated with several of its ring leaders killed or arrested by security forces. There are certainly other radical Islamic groups but they lack the leadership or resources to carry out a major attack.

And Indonesia is the only country in the region that has bucked the trend of a democracy in trouble. Despite being a messy experiment at times, democracy is blossoming in a country that was once ruled with an iron hand for 30 years.

The Economist, in a recent article titled The Indonesian Surprise, maintained that "the world's biggest Muslim country has changed from an authoritarian basket to regional role model... It has a fair claim to be Southeast Asia's only fully functioning democracy".

Global Financial Crisis

Politics cannot but help carry a weight of significance. But economic stability, the second indicator of normalcy, remain the principal driver in the grand scheme.

As the world heads into a deep economic winter, Indonesia appears to be riding out the storm. Certainly the slump in the stock market and the pronounced weakness of the rupiah shows Indonesia is not immune.

The tangled web of complex financial products created to bankroll America's housing boom has unleashed the world's worst financial crisis since the Great Depression. Major corporate failures will induce pressures powerful enough to slow down the US financial system and a painful global economic slump.

Markets have entered a vicious cycle of asset deleveraging, price declines and investor redemptions. They have had a tempestuous effect, causing what Alan Greenspan described as a "once-in-a-century credit tsunami".

Consider the effect it has had on the world's largest economies. Volvo truck sales in the US in the third quarter of 2007 were 42,000. During the same period last year, they crashed down to 75. Instructively, the US industrial output was down 7.8 percent last month. Construction of new homes fell 15.5 percent from November to December last year, to an annual rate of 550,000, the slowest pace on record.

The pace of new-home construction was 45 percent below its level of a year earlier. The American unemployment rate has risen to an alarming 9.5 percent, taking into account a 33 hour work week, as opposed to 40 hours, 18 months ago.

Asian countries like China, Japan and Singapore are clearly facing the full wrath of credit tsunami. But others in the region, especially Indonesia, appear to be coping better. There are two broad reasons. Firstly, several of these countries are not dependent on exports for economic growth. And secondly, the financial systems of several of these countries are relatively safe from any immediate crisis.

The underlying reason for Asia's seeming insulation is that the region's financial institutions, unlike their European counterparts, have only limited exposure to toxic assets — subprime and related products.

Post-1998 reform and restructuring have significantly improved these institutions. Empirical evidence supports this: The low incidence of non-performing loans, high capital adequacy ratios, rates of return on assets, and other key indicators. Indonesian banks, in particular, have one of the best risk-weighted capital adequacy ratios in Asia. They also have the lowest ratio of loans to domestic deposits in the region after China and the Philippines.

Indonesia: a shining light?

Against this backdrop, Indonesia is fast emerging as a shining light in the region. Indonesia appears to be riding out the storm. Certainly, the slump in the stock market and the pronounced weakness of the rupiah shows Indonesia is not immune.

The government has said that growth might be lower in 2009, hovering between 4.5 to 5.5 percent. Bank Indonesia projects a drop in economic growth in 2009 to around 4.0 per cent with downside risk if the global economic downturn is greater than predicted. But this is still much better than most other Asian countries.

In part, relative economic success is a result of the effectiveness of the government which has focused on tight fiscal discipline and debt reduction. Today, Indonesia has a healthy balance sheet with US\$58 billion in reserves and a government debt representing less than 35 per cent of GDP – compared to 77 per cent of the GDP in 2001. This is the lowest among Asean countries, aside from Singapore which has no government debt.

BI has cut its key interest rate by a total of 2.5 per cent since December last year to 6.75 percent in a bid to spur lending and investment. As such, Indonesia offers a healthy 6.75 percentage-point premium over the US fed funds rate, which should help maintain confidence in Southeast Asia's biggest economy.

These initiatives have allowed Dr Yudhoyono and his economic team to push forward a large fiscal stimulus that would ease some of the pressure on unemployment. He has announced plans to spend more than Rp 72 trillion on infrastructure and other projects to boost growth and create jobs in a country where the unemployment rate is the highest in Asia. But government spending, along with a resilient FDI ensures that the Indonesian economy appear to be on the front foot.

Compared to other regional states, Indonesia today boasts the highest consumer confidence index in the world, according to a survey by the Nielsen Company. The recent survey showed Indonesia topped Nielsen's global consumer confidence index with 104 points, followed by Denmark (102 points) and India (99 points).

Indonesia is still vulnerable to external finances though. Efforts to raise foreign direct investment and export competitiveness will likely remain a challenge against a backdrop of palpable weakness in resource-based activities, as well as poor investor appetite for risk. These risks, however, are offset by the strength of Jakarta's fiscal conservativeness which has been instrumental in buffering the system from external shocks.

It is also explained by the fact that Indonesia is not export-dependent. China, Japan, South Korea, Singapore, and to a lesser extent Malaysia and Thailand, are reeling as exports evaporate. Just a small chunk of Indonesia's GDP – 22 percent – relies on exports. As a result, Indonesia is doing much better than its neighbors.

An emerging middle power?

Political stability and economic growth have engendered a growing confidence as Indonesia moves to reclaim its regional leadership. It is the only country in Asean today to be represented at the G-20. And Dr Yudhoyono is feted by fellow leaders who welcome his moderate Muslim credentials and sound economic policies for Indonesia.

There is a view in Jakarta that Indonesia and the US are entering a new phase in the bilateral relationship. It is no surprise that Indonesia was one of four Asian countries US Secretary of State Hillary Clinton chose for her first trip abroad. The visit in February was an early signal to Jakarta that Washington recognized Indonesia's growing international clout.

It has built a firm foundation for future cooperation. If anything, relations have been on the upswing in recent years. Although, the wars in Iraq and Afghanistan and US approach to the Middle East were not popular in Indonesia, disagreements over these issues did not stand in the way of a productive relationship on the things both nations did agree on.

President George W. Bush's policies improved US-Indonesia relations. Indeed, President Yudhoyono called him "one of the most pro-Indonesia presidents" in history. Mr Bush normalized military relations with Indonesia. He secured their highly valuable cooperation in the war on terrorism. In 2006, Indonesia was included in the Millennium Challenge Account Threshold Program. He also initiated a widely heralded five-year effort to improve the Indonesian education system.

Today, Dr Yudhoyono is calling for a strategic – or comprehensive – partnership with the US. Washington might just heed that call for two major reasons. For one, Indonesia can be seen by US defense planners as a countervailing force to China in Southeast Asia. As China's influence in the region grows, only Indonesia has the critical mass necessary to anchor Asean in an independent and outward-looking orientation.

Indonesia serves a second – and perhaps more important – strategic aim for the United States: it could play a major role in repairing America's strained ties with the Muslim world, helping the US reduce the soft power deficit the Bush administration had created with its policies in the Middle East.

Mr Obama highlights the difficulty of the US and the Middle East "communicating effectively" in his speech to the Muslim world in Cairo last month. Indonesia could be the honest broker between the two. Indonesia, the world's most populous Muslim nation, has the right credentials to be a bridge to the Islamic world. Its experience with economic development, political reform and Islamic terrorism gives it the authority to speak on the challenges Muslim nations face.

Crystal ball aint rosy

Major challenges remain for Indonesia, however.

The most glaring is poverty. The benefits of macroeconomic growth have not trickled down. Despite Jakarta's economic vitality and the booming growth in other big cities, much of Indonesia remains poor. The World Bank says almost one in five live in poverty. That is almost 50 million Indonesians. Poverty is measured by those who have less than US\$1.55 in purchasing power parity terms per day.

The good news is that the government appears to have bucked the downward trend. In 1976 the poverty head-count was at 40 percent, declining to about 11 percent in 1996. The economic crisis which began in late 1997 saw the poverty rate jump up to 23 per cent in 1999 but it began falling after that, and reached 16 percent in 2005. It has been hovering around that figure ever since, and there is a danger that it could rise. Some 42 per cent of Indonesian households earn between US\$1 and US\$2 a day, putting them at the mercy of economic shocks and in danger of falling into "technical" poverty.

Here are some other facts to consider:

- A quarter of children under five years old are malnourished, with malnutrition rates stagnating in recent years despite reductions in poverty.
- Indonesia's maternal mortality rate (307 deaths in 100,000 births) is three times that of Vietnam and six times that of China and Malaysia; only about 72 per cent of births are accompanied by skilled personnel.
- Among 16 to 18 year olds from the poorest quintile, only 55 per cent completed junior high school, compared with 89 per cent from the richest quintile.
- Only 48 per cent of the lowest quintile have access to safe water in rural areas, as against 78 per cent in urban areas.
- Eighty per cent of the rural poor and 59 per cent of the urban poor do not have access to septic tanks, while less than one per cent of all Indonesians have access to piped sewerage services.

A second problem is corruption. It hangs like an albatross around the government. Endemic corruption has long dragged on Indonesia's economic development and taken a heavy toll on foreign investor confidence.

In Suharto's Indonesia, corruption was centralised and predictable. Corruption was controlled by the first family and the top military leadership, in partnership with ethnic Chinese conglomerates.

Although businesses complained about it, investors could accurately predict the costs associated with corruption and bureaucratic red tape and factor it into the cost of doing business. Many of them involved Suharto's children in their private businesses in an effort to reduce the uncertainties that might be created through harassment by lower level bureaucrats. The pattern was repeated in the provinces.

Corruption in post-Suharto Indonesia is quite different. Indonesia launched an ambitious regional decentralisation program in 2001. Instead of being centralised, power and authority are now more diffuse. Centralised corruption – one-stop shopping – is also gone, replaced by a more fragmented bribe collection system.

Today, many players, from central ministry and other government officials, through legislative members at the national and local levels, to local officials, soldiers, and police officers, are demanding bribes. Their failure to coordinate their bribe-taking behaviour will likely result in a higher total level of bribes. The number of bribe-takers has increased to such an extent that it is now more detrimental to economic efficiency than in the Suharto era. Corruption means businesses cannot take the sanctity of contracts for granted.

Indonesia's anti-corruption watchdog has been making headlines with a spate of high-profile investigations. But the fact remains that it is still ranked as one of the world's most corrupt nations. Indonesia ranked 143 out of 179 countries surveyed in Transparency International's 2007 Corruption Perception Index, while the Hong Kong-based Political and Economic Risk Consultancy ranked Indonesia third, trailing only the Philippines and Thailand in a survey of Asia's most corrupt economies.

Two other problems stand in the way. Archaic labor laws are reducing Indonesia's attraction as a center for labor-intensive manufacturing. Indonesia is known as the country which applies the biggest severance pay. Indeed, the severance pay in Thailand, Vietnam, the Philippines and even the US is much lower. The other is fixing our land laws.

All these reinforce perceptions that Indonesia is still stuck in a rut. But we need to give the country its due worth by taking a long-term view.

The long view

In his new book *Common Wealth*, Jeffrey Sachs writes about a historic shift in the center of gravity in the world economy. Since 1800, the North Atlantic economies have been the world's dominant economies and political powers. The cataclysms of World War I, the Great Depression, and World War II did not shake the dominance of the North Atlantic economies, although they did shift the balance of geopolitical influence away from Europe, especially the British Empire, to the United States. Now, after many centuries, the unquestioned economic and geopolitical dominance of the North Atlantic seem to be weakening.

It is natural that Asia should be the center of gravity of the world economy, since it is the center of gravity of the global population. In 1820, Asia constituted perhaps 56 percent of the world economy. With the onset of industrialization in Europe and North America, Asia's share declined to 28 per cent by 1900. With Asia in turmoil in the first half of the 20th century, its share declined further, to reach a low point of around 18 percent of the world's output in 1950. Then began the great convergence. Asia's share of world income recovered to around 23 percent in 1970 and 38 percent by 2000. According to Sachs, Asia's share of the global income would rise to around 49 percent by 2025 and to around 54 percent by 2050.

The assessment is that the global world product will rise by 6.3 percent, from around US\$67 trillion in 2005 to around US\$420 trillion in 2050. Asia's share will be about US\$220 trillion. China and India, given their massive population – and growth trajectory – will undoubtedly command a large share of this pie. But consider another rising regional power Indonesia. Today, it has a US\$550 billion economy. If it grows at 6-7 percent in real terms, and 13-14 percent in nominal terms, then it is looking at an economy worth US\$6-7 trillion in 20 years' time — the size of the current Japanese economy. If history is a linear progression, in 2050, Indonesia might well be a US\$40 trillion economy.

Certainly, fighting rampant corruption and revising labor and laws will help spur growth in Indonesia. Infrastructure development is also key. One of the reasons for China's growth over the past 20 years has been massive spending in infrastructure. And it is not over. Over the next two

years, China will spend more than US\$260 billion on highways, bridges, ports and airports. In the past 20 years, China has built 60,000 km of toll roads. Indonesia has built just 800 km in the last 30 years.

Land reform, a large dedicated budget and single-minded government focus could set the stage for an unprecedented surge in infrastructure development in Indonesia. Incentivizing the private sector to participate in this revolution could attract additional capital and allow for better management. Net foreign direct investment (FDI) in Indonesia was US\$1.1 billion in 2007, which stands at just 0.3 percent of GDP. This compares to US\$121.4 billion in China, or 3.7 percent of GDP. In India, net FDI was 1.4 percent of GDP, Thailand 3.2 percent, Singapore 7.3 percent, and Vietnam 9.3 percent.

In all this, education will be key. Producing the best minds and achieving universal education enrollment are imperatives. It will build human capital so that Indonesia can play a greater leadership role in the world, commensurate with its size and history. Drawing on China as an example again, Beijing has produced 240,000 PhDs over the last 30 years. By 2010, it will have more doctorates than any other country in the world. And this includes the United States. Besides PhDs, the Chinese have also been awarded 1.9 million master's degrees, and 14.1 million bachelor's degrees during the same period.

Indonesia has produced just a tiny fraction of these numbers. A study by McKinsey suggests that Indonesia needs 22,000 leaders to ensure prosperity for the next 20 years. We need more, about 100,000. We can do this through a two-pronged approach. First, we need to develop a *creme de la creme* who will ultimately become instruments of change for Indonesia. We should also seek to provide basic education across the distended archipelago. Over time, this will widen and deepen the country's talent pool when the two approaches converge.

I might sound a wee bit optimistic but the future is bright for Indonesia. There is enough wealth creation here to ensure there will be some degree of refinement in the political process. Increasingly, the wealthy in the country are taking ownership of public services. This is more good than bad. It fosters better policy making and implementation with respect to wealth distribution. This can only lead to better education, healthcare, and infrastructure. All this will multiply economic growth.

Singapore transformed itself from a swampy Third World seaport into a First World financial dynamo in 30 years. In 1965, the odds were stacked against it. With the passage of time, Indonesia might also well surprise the world with the impossible: to be a black swan.

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