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Indonesia: Grappling With the International Economic Slowdown

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An Intelligence Assessment

State Dept. review completed

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EA 82-10126
November 1982

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Indonesia: Grappling With the International Economic Slowdown [redacted]

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An Intelligence Assessment

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This assessment was prepared by [redacted] of the Office of East Asian Analysis. Comments and queries are welcome and may be addressed to the Chief, Southeast Asia Division, OEA, [redacted]

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This report was coordinated with the National Intelligence Council. [redacted]

Secret
EA 82-10126
November 1982

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Indonesia: Grappling With the International Economic Slowdown [redacted]

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Key Judgments

Information available as of 28 October 1982 was used in this report.

The abrupt decline in Indonesia's export earnings that began with the world oil glut and the downturn in commodity markets in 1981 forced Jakarta to adopt fiscal belt-tightening measures in the midst of parliamentary and presidential election campaigns. Although the government has been willing to cut back on consumer subsidies, government wage increases, and other current outlays, President Soeharto and his economic advisers have been reluctant to slow import growth because such a move would threaten the country's ambitious industrialization program and weaken employment prospects for the rapidly growing labor force. Continuing softness in export markets, however, is forcing the Soeharto government to reevaluate its development strategy and to consider the need for more stringent financial measures.

Indonesia will be able to cushion the export slump temporarily by drawing down reserves and increased foreign borrowing. We believe Jakarta will be able to obtain sufficient foreign financing at favorable terms to cover current account deficits of $7-8 billion annually in 1982 and 1983 despite the current turbulence in international financial markets. Bankers look favorably on Jakarta's conservative approach to foreign debt, its willingness to take austerity measures, and the country's long-term economic prospects. Furthermore, we believe that the government will opt to slow import growth further if necessary to avert a short-term financial crisis, relying on the armed forces to suppress any popular reaction to new austerity measures.

Jakarta's financial stringency in the next few years probably will lead to disagreement with Washington on a number of issues, such as US policy on export commodities of importance to Indonesia. But in our judgment, such frictions will not change the basic mutually beneficial relationship. US aid and investment will remain crucially important to Indonesia. US technology and management expertise will continue to be needed in important sectors of the economy, particularly the oil and gas industry. If Indonesia's external accounts do not improve, however, we expect Jakarta to be more assertive in seeking to boost its exports or finding ways to increase its share of multinational firms' earnings.

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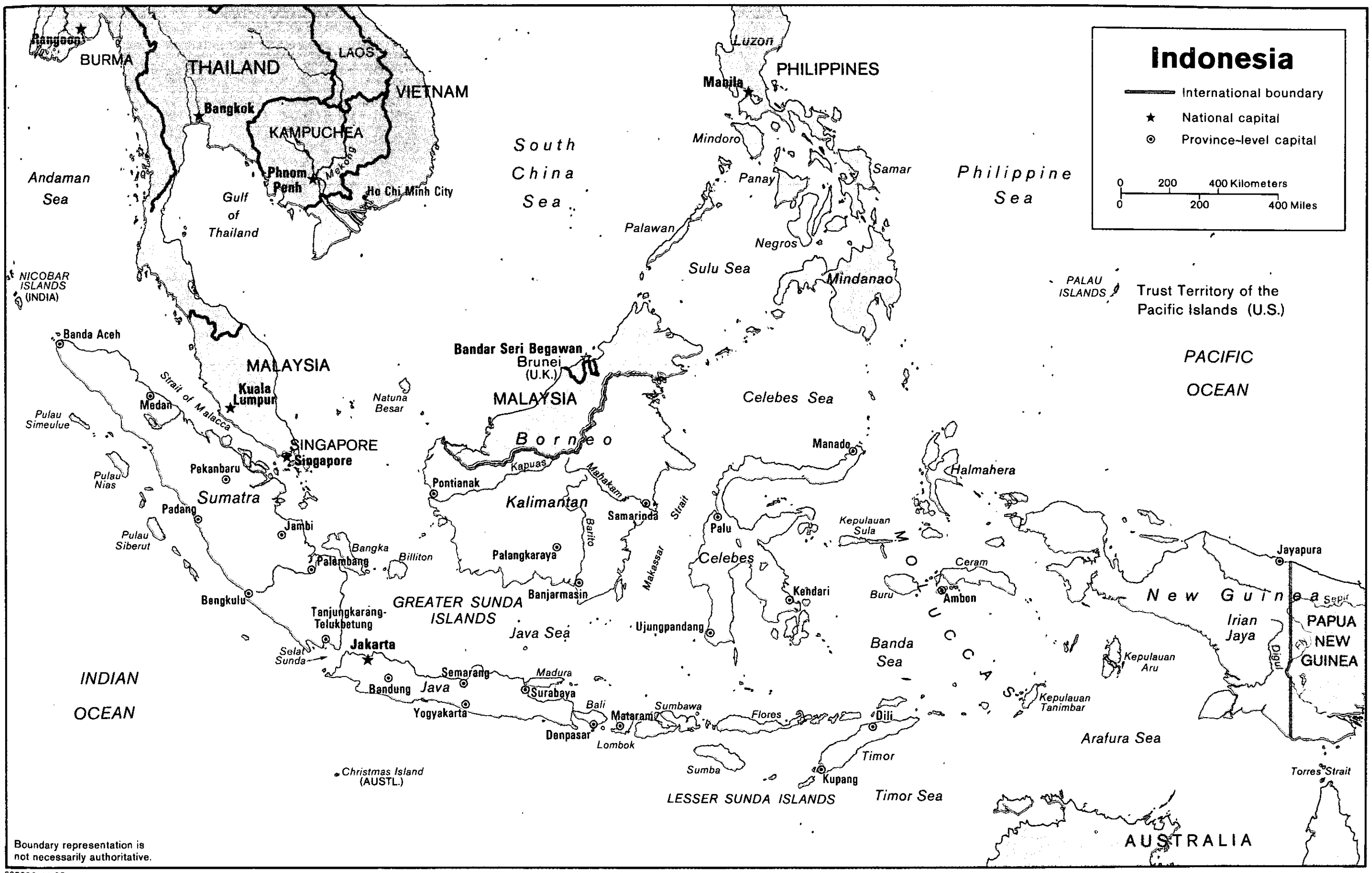

Indonesia
International boundary
National capital
Province-level capital
0 200 400 Kilometers
0 200 400 Miles
BURMA
Rangoon
THAILAND
LAOS
VIETNAM
Bangkok
KAMPUCHEA
Phnom Penh
Ho Chi Minh City
Mekong
Andaman Sea
Gulf of Thailand
South China Sea
Luzon
PHILIPPINES
Manila
Mindoro
Panay
Samar
Palawan
Negros
Sulu Sea
Mindanao
Philippine Sea
PALAU ISLANDS
Trust Territory of the Pacific Islands (U.S.)
PACIFIC OCEAN
NICOBAR ISLANDS (INDIA)
Banda Aceh
MALAYSIA
Kuala Lumpur
Strait of Malacca
Medan
Pulau Simeulue
Natuna Besar
Bandar Seri Begawan
Brunei (U.K.)
MALAYSIA
Borneo
Celebes Sea
Manado
Halmahera
SINGAPORE
Singapore
Pekanbaru
Pulau Nias
Sumatra
Padang
Pulau Siberut
Jambi
Bangka
Palembang
Billiton
Pontianak
Kapuas
Kalimantan
Mahakam
Samarinda
Barito
Palangkaraya
Makassar Strait
Palu
Kepulauan Sula
Celebes
Ceram
Jayapura
Bengkulu
Banjarmasin
Kendari
Buru
Ambon
MOLUCCAS
New Guinea
Sepik
Irian Jaya
PAPUA NEW GUINEA
Digul
Fly
Tanjungkarang-Telukbetung
GREATER SUNDA ISLANDS
Java Sea
Ujungpandang
Banda Sea
Kepulauan Aru
Selat Sunda
Jakarta
INDIAN OCEAN
Semarang
Madura
Bandung
Java
Surabaya
Kepulauan Tanimbar
Yogyakarta
Bali
Sumbawa
Mataram
Flores
Dili
Denpasar
Lombok
Arafura Sea
Christmas Island (AUSTL.)
Sumba
Timor
Kupang
Torres Strait
LESSER SUNDA ISLANDS
Timor Sea
AUSTRALIA
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Indonesia: Grappling With the International Economic Slowdown [redacted]

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A Financial Crunch ?

The halt in export growth in 1981 ended Indonesia's export boom of 1979-80 and is bringing on financial strains much sooner than Jakarta had previously expected. Although Indonesia managed to register real growth of 7.6 percent in 1981, this performance was overshadowed by the deterioration in its external accounts. [redacted] 25X1

Developments in 1981-82

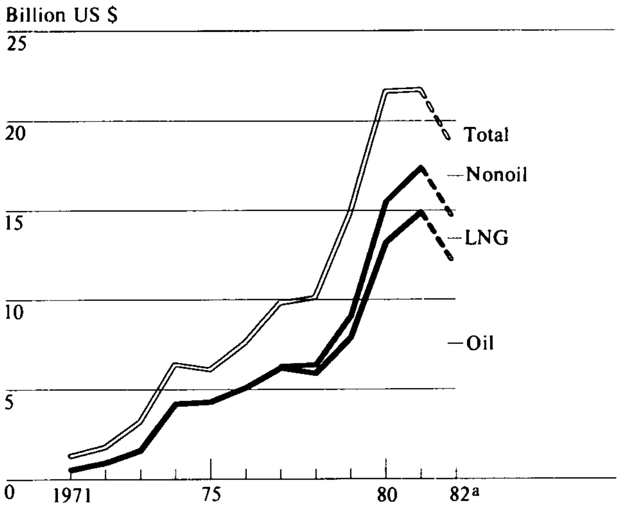
Indonesia's current account fell from a $5 billion surplus in 1980 to roughly zero in 1981. Official statistics showed exports stagnating at $22 billion while imports continued to grow rapidly to reach nearly $17 billion and the net deficit on services approached $5 billion. Oil earnings rose only 13 percent as OPEC price increases leveled off, while commodity exports (excluding oil and liquefied natural gas) plummeted 30 percent as weak markets depressed sales of wood, rubber, tin, coffee, and other commodities. Export declines of several commodities, such as wood and palm oil, were partly the result of deliberate government policies aimed at satisfying domestic needs, but a reversal of these policies probably would not have changed the results very much. [redacted] 25X1

Indonesia's export performance has eroded further this year. Oil output, which surpassed 1.6 million barrels per day last year, fell below 1.5 million b/d in the first quarter of 1982 as foreign demand for Indonesian crude softened. In the second quarter, Indonesia's production ceiling was set at 1.3 million b/d in accord with the OPEC decision to allocate production among its members. Output fell below even that level in some months and Jakarta's hoped-for third quarter recovery in foreign demand had not materialized by October. Indeed, press reports indicated that Jakarta was being increasingly pressed by the Japanese, Indonesia's largest customer, to cut prices just to avoid further reductions in export volumes. Although the reports indicated Jakarta planned to cut prices, in August President Soeharto refused to do so. According to State Department reporting, Judo Sumbono, president of Pertamina, Indonesia's state oil company, was still trying to convince Soeharto of the need for a modest price cut for the Japanese during Soeharto's visit to the United States in early October—with only limited success. In early November, Jakarta announced modest price cuts which [redacted] were not enough to bring the price of Indonesian crude into line with competing crudes, but were a move in the right direction. [redacted] 25X1 25X1

Nonoil exports are faring as badly. Sales for the first five months of 1982 were more than 25 percent below the previous year's level and showed little sign of recovery by autumn. The two most important commodities, wood and rubber, depend on recovery in the depressed housing and auto industries in the United States, Japan, and Western Europe. The International Coffee Organization's 34-percent reduction in Indonesia's quota has dimmed prospects for coffee earnings. The tin market remains in disarray, with world supplies continuing to outstrip demand. [redacted] 25X1

For 1982 and 1983, we project current account deficits averaging $7-8 billion a year even if Jakarta slows import growth from the 35 percent annual pace of the past two years to 15 percent. We believe Jakarta is financing the 1982 deficit through a combination of drawing down reserves and borrowing abroad; indeed, Jakarta has drawn down its official reserves by more than $3 billion from the $7.4 billion peak of October 1981. Bank Indonesia Governor Rachmat Saleh told reporters in early November that official reserves had fallen to $4.3 billion by the end of October 1982. Continuation of this rate of decline would quickly run them down to levels we believe Jakarta would find unacceptable and threaten to damage the country's international creditworthiness.

Figure 1
Indonesia: Exports (f.o.b.)



a Projected.

[redacted]

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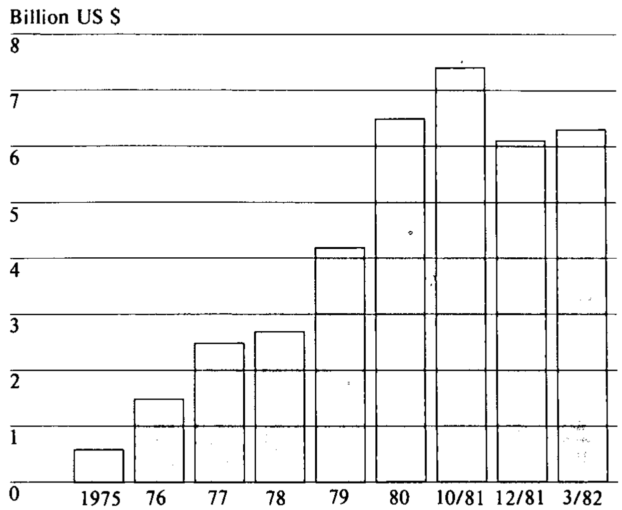
Figure 2
Indonesia: Official Foreign Exchange Reserves[a]



a End of period.

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[redacted]

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[redacted]

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Reevaluating Development Strategy

The sharp reversal in Indonesia's export performance is forcing the government to review its policy options. The outcome will be determined by President Soeharto, but we believe his technocrat economic advisers and the World Bank will strongly influence his decision. Soeharto has based his "New Order" government on the premise that economic development would provide the basis for political stability. The technocrats, a group of mostly US-trained economists, are the architects of the policies followed by Soeharto since he came to power. The World Bank, Indonesia's largest aid donor and leader of the country's international aid consortium, the Intergovernmental Group on Indonesia (IGGI), exerts strong influence on Jakarta's strategy through its evaluations of policy options and its advocacy of policies the Bank staff deems appropriate for Indonesia. [redacted] 25X1

The Technocrats' Position. Leading technocrat Widjojo Nitisastro, Coordinating Minister for Economics, Finance, and Industry, has long advocated policies designed to achieve rice self-sufficiency, transform Indonesia from an agricultural to an industrial economy, and create jobs for the rapidly growing labor force. According to US Embassy and press reporting, Widjojo was the driving force behind the November 1978 devaluation of the rupiah aimed at reducing the country's overwhelming dependence on

Table 1
Indonesia: Current Account Balance

Billion US $

	1974	1975	1976	1977	1978	1979	1980	1981	1982 [a]	1983 [a]
Trade balance	1.8	0.6	0.8	2.3	1.7	5.5	8.9	4.8	−1.8	−1.9
Exports, f.o.b.	6.4	6.1	7.6	9.8	10.1	14.8	21.6	21.7	17.4	19.9
Oil	4.2	4.3	5.1	6.2	5.9	7.9	13.2	14.9	10.9	12.9
Nonoil, including LNG	2.2	1.8	2.5	3.6	4.2	6.9	8.4	6.8	6.5	7.0
Imports, f.o.b.	4.6	5.5	6.8	7.5	8.4	9.3	12.7	16.9	19.2	21.8
Net services and private transfers	−1.1	−1.6	−2.2	−2.5	−3.0	−3.5	−3.9	−4.8	−5.6	−6.5
Freight and insurance	−0.6	−0.7	−0.9	−1.0	−1.0	−1.1	−1.5	−2.0	−2.3	−2.6
Investment income receipts	0.1	0.1	0.1	0.1	0.2	0.3	0.5	0.8	0.4	0.1
Other	−0.6	−0.9	−1.4	−1.6	−2.2	−2.7	−3.0	−3.5	−3.7	−4.1
Current account balance	**0.7**	**0.9**	**−1.3**	**−0.1**	**−1.2**	**2.1**	**5.0**	**0**	**−7.3**	**−8.3**

[a] Projected.

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oil exports. US Embassy officials reported that the move met with strong disapproval from Soeharto's top military advisers because of its inflationary impact and potential threat to domestic tranquillity. Further disputes were averted, however, when the OPEC oil price boom—while it made Indonesia even more dependent on oil revenues—eased the financial pressure on the Soeharto government to enact followup measures to diversify the economy away from oil. 25X1

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The oil boom also encouraged the technocrats to press ahead with an ambitious industrialization program even while the government was increasing spending on consumer welfare, rural development, and military modernization. In 1981-82 alone, the government signed contracts for projects valued at $9.5 billion, bringing the value of industrial plants currently under way or in advanced planning stages to more than $15 billion. 25X1

The current phase of the industrialization strategy emphasizes resource-based heavy industry which provides a competitive edge that we believe could enable Indonesia to expand exports or reduce imports of industrial goods. Liquefied natural gas (LNG) plants in North Sumatra and East Kalimantan have made Indonesia the world's largest LNG exporter and work is already under way to double capacity at both plants by the mid-1980s. Expansion of three petroleum refineries will double the country's refining capacity to more than 800,000 b/d and eliminate the need to ship crude oil to Singapore for processing into refined products for Indonesia's domestic market. The petrochemical and fertilizer plants under construction in Sumatra and Kalimantan will use Indonesia's abundant natural gas or naphtha produced by the oil refineries as feedstock and supply their output both to domestic and export markets. In the metals industries, we believe the Krakatau Steel Mill and the Asahan Aluminum Plant will act as magnets for private investment in downstream machinery and metalworking industries. 25X1

Based on World Bank projections of Indonesia's export prospects, we believe the technocrats had counted on several more years of payments surpluses

Long-Term Constraints on Policy Options

Beyond the current financial strains, Jakarta must deal with two intractable problems as the decade progresses. One is the need to create jobs for a rapidly growing labor force; the other is the near certainty of declining crude oil exports.

Nearly half of Indonesia's population of 158 million is under age 16. We estimate labor force growth will approach 2 million annually in the 1980s compared with about 1.4 million a year in the 1970s. Indonesia's labor force of about 60 million currently shares less than 40 million full-time job equivalents. Even under the best of circumstances, we believe the economy would be unable to provide full-time jobs for more than about two-thirds of the new entrants to the labor force during the next few years. In the longer term the government must devise a strategy to create enough jobs for the growing labor force or face growing domestic unrest.

Most of Indonesia's crude oil resources are found in small fields that are quickly depleted, requiring a large-scale exploration effort just to maintain output levels. The exploration boom under way since 1978 has succeeded in reversing the decline in output from the 1977 peak and restored output to 1.6 million b/d in 1981 for the first time since 1978. Although output could temporarily exceed 1.6 million b/d, we believe maximum sustainable production will remain at 1.6 million b/d. In contrast to the probable stagnation in production, domestic consumption, which has been rising some 12 percent annually in recent years, almost certainly will continue to erode the exportable surplus. Reduction of consumer subsidies, conservation measures, and shifts to alternate energy sources such as coal, gas, or geothermal energy probably will not slow consumption growth much below 10 percent annually before the late 1980s. As a result, the volume of crude oil available for export could fall from 1.1 million b/d in 1981 to 600,000 b/d by 1990, thus sharply reducing the financial resources available to the government to fund investment projects.

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to help finance the development program before an expected long-term decline in oil exports would result in a financial gap. By then, the new industrial facilities would help to reduce import requirements or supplement traditional exports. With foreign aid and borrowing to cover the payments gap, the government could then concentrate on more labor-intensive investments in such industries as electronics, textiles, consumer goods, and other light manufactures.

Soeharto's Perspective. We believe President Soeharto will be loath to slow the development program. He is proud of Indonesia's economic achievements under his leadership and has permitted his political supporters to conduct a publicity campaign during the past year to designate him the "Father of Development." His restoration of the economy from the chaotic conditions of the Sukarno years—bolstered by oil earnings—led Indonesia to attain growth rates averaging over 7 percent annually in the 1970s. 25X1

While Soeharto has opened the country to foreign investors, he has not hesitated to impose stringent conditions on them to expand employment opportunities for native Indonesians. He has issued presidential directives limiting the employment of expatriate employees and requiring foreign firms to use Indonesian subcontractors even at the cost of discouraging some investments and increasing costs of others. 25X1 25X1

Soeharto, in our view, probably considers a slowdown in the development program a last resort, but undoubtedly is still acutely aware of the difficulties

Table 2
Selected Industrial Projects

Million US $

Krakatau Steel Mill expansion	2,700
Asahan aluminum plant expansion	2,000
Arun LNG plant expansion	850
Badak LNG plant expansion	995
Dumai Refinery hydrocracker	1,450
Balikpapan Refinery expansion	1,480
Cilacap Refinery expansion	1,160
Aceh olefins complex	2,850
Aceh urea plant	400
Pladju aromatics center	1,500
Badak urea and ammonia plant	210
Leces newsprint plant	210
Six other pulp and paper plants	1,100
Suralaya electric powerplant	800
Musi Oil Refinery	1,020

25X1 [redacted]

Indonesia faced in restoring its international creditworthiness after the Pertamina financial crisis in 1975. Should he opt for further austerity measures, we believe he can rely on the armed forces to suppress any public outbursts or overt opposition to his policies. [redacted] 25X1

The World Bank View. Although less influential than it was during the early years of Soeharto's rule, the World Bank remains the leader of Indonesia's international aid consortium. The Bank publishes assessments of Indonesia's economic performance, often focusing on specific development issues, that strongly influence the outcome of the annual aid meetings. The Bank's most recent annual report, in May 1982, concluded that the socioeconomic costs of a slowdown in industrialization in terms of unemployment and unfinished projects would be so great that the government should press ahead with its development efforts despite the deterioration in the current account. The Bank considered prospects for recovery in Indonesia's traditional export markets and for boosting crude oil output promising enough to make such a recommendation. Although the Bank warned that any shortfall from its assumptions would require some downward revision in its projections, we believe the assumptions are excessively optimistic, particularly with respect to crude oil output. The Bank assumed output would climb steadily to nearly 1.8 million b/d in 1983 and 2.0 million b/d by 1990—projections well above our estimate of maximum sustainable capacity of 1.6 million b/d. The Bank also projected recovery in nonoil exports to begin in late 1982, a prospect that subsequent developments have dimmed. [redacted] 25X1

The Government's Response

Jakarta has floated the rupiah this year, permitting a modest 5 percent depreciation since November 1981 to encourage exports. It also moved aggressively on two other fronts—the budget and export promotion—with promising, though limited, results. Bolstered by the recommendations of the World Bank, however, government planners up to now have shown no willingness to risk slowing the industrial development program by slowing imports, over 75 percent of which are capital and intermediate goods. International bankers also remain willing to lend to Indonesia at more favorable rates than to most Third World countries; in April 1982, Jakarta obtained a $300 million syndicated loan at 0.38 percentage point over LIBOR (London Interbank Offered Rate), the best spread it obtained in the 1979-80 boom years. [redacted] 25X1

During the past several months, Jakarta has continued to shop around for the best possible terms. According to a September press report, Bank Indonesia Governor Rachmat Saleh met with major Western banks to discuss terms of a possible $300-500 million general purpose loan. The US Embassy in Jakarta reported in September that Bank Indonesia "seems obsessed with obtaining a 3/8 percent spread over LIBOR." Although recent press reporting indicates that foreign banks would prefer to tie part of any loan to LIBOR and part to the US prime rate, which currently is 1 to 2 percentage points over LIBOR, Jakarta obtained a $250 million 10-year loan at its desired terms. Furthermore, Jakarta continues to maintain close contact with foreign bankers and undoubtedly is monitoring their attitudes toward increased lending. [redacted]

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[redacted]

The Budget—Investment Over Consumption

In a speech in November 1981, Finance Minister Ali Wardhana warned of the need for budget austerity. [redacted] Indeed, domestic fuel price increases averaging more than 60 percent were imposed on the eve of Soeharto's budget speech in January 1982 rather than waiting for the start of the fiscal year on 1 April. In the budget message, Soeharto announced other, surprisingly austere, belt-tightening measures. For the new fiscal year, total government spending was pegged to rise only 12 percent, considerably slower than the 45 percent and 19 percent increases of the previous two years. A 34-percent jump in development spending was made possible only by slashing subsidies for fuel, food, and fertilizers, freezing government civilian and military wages, and cutting other current outlays. [redacted]

In addition, Soeharto announced plans to tighten tax administration, a potentially painful reform for both domestic and foreign investors, which Jakarta seems determined to implement. Implementation will probably be slow because of Indonesia's shortage of competent administrators, but Finance Minister Wardhana has made several speeches revealing his intention to push efforts to improve corporate income tax administration to spread the tax burden more efficiently and equitably throughout the industrial and commercial sectors. [redacted]

So far, the austerity moves have not generated any concerted opposition, although the number of strikes is nearly double the total in 1981. Additional tightening, such as further cuts in consumer fuel subsidies, import cutbacks, or a devaluation, in our view runs the risk of increasing popular dissatisfaction with rising consumer prices, slower job creation, or even increasing unemployment in construction and other industries affected by the government's actions. Besides the perennial possibility of anti-Chinese urban riots, discontent could easily manifest itself in a growing number of strikes. [redacted] 25X1

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Trade Promotion 25X1

Speeches by leading technocrats in late 1981 on the deterioration in nonoil exports helped to convince Soeharto to introduce a comprehensive set of export-promoting measures in January, including long-overdue policy reforms that we believe go a long way toward reducing the antiexport bias of Indonesia's current tax and regulatory systems and could in time strengthen Indonesia's export performance. The measures are designed to diversify Indonesia's exports away from oil by easing payment and credit terms for nonoil commodities, reducing export credit interest rates, and simplifying customs and port procedures. Although the financial measures provide incentives to export, we believe reform of the notoriously corrupt Customs Service almost certainly is falling short of the government's goal. [redacted] 25X1

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In another move, the government announced a controversial new counterpurchase policy which, according to press and Embassy reports, has met with strong disapproval from Indonesia's leading foreign trading partners and suppliers. Under this arrangement, a disguised barter technique similar to methods used by European Communist and Third World countries that pay for their imports with goods rather than cash, foreign suppliers would be obliged to accept Indonesian goods equivalent in value to their sales to Indonesia. US and West European companies have complained that the scheme gives an unfair advantage to Japanese firms that have ties to large Japanese trading firms. One result of the scheme could be to push up the cost of investment projects, if suppliers simply raise their prices to cover the cost of disposing of Indonesian goods they otherwise would not buy. Thus far, no major project has been delayed by the new policy, but Jakarta has had only limited success 25X1 in implementing it. Foreign firms operating in Indonesia recognize that apparently rigid policies can often be softened by negotiations. Consequently, they are taking a cautious approach in making offers until they have a clearer view of how Jakarta intends to implement this policy. 25X1

Since January, the government has announced several maritime restrictions aimed at boosting Indonesia's foreign exchange earnings at the expense of foreign shipowners. Jakarta has issued directives restricting government-financed cargoes to Indonesian-owned ships, a move that could affect up to 50 percent of Indonesian imports from the United States alone. The government is also proposing to lower port fees for Indonesian ships, but foreign steamship companies are protesting this action as discriminatory and several OECD governments are negotiating with Jakarta. Jakarta is also continuing efforts to bypass Singapore as a transshipment port by prohibiting steamship companies from charging higher freight rates for cargoes shipped from Indonesian ports than from Singapore. 25X1

Tough Choices Ahead

An August press report based on leaks from Indonesian Cabinet meetings indicated that government officials are debating whether to devalue the rupiah, an option reportedly gaining favor with leading technocrat Widjojo, Soeharto's chief economic adviser. In his August Independence Day speech, however, President Soeharto sought to stem devaluation rumors by saying such a move is not necessary at present and that the exchange rate would continue in a controlled float, a choice that enables Jakarta to permit a gradual depreciation of the rupiah. 25X1 25X1 25X1

With official foreign exchange reserves equivalent to about three months imports, Indonesia can withstand a short-lived slump in exports. We believe, however, that export prospects in the next year or two are not very promising. We estimate oil exports would do well to recover to 1981 levels. LNG exports will remain less than one-fifth of the value of oil exports until LNG plant expansions are completed by the mid-1980s. Nonoil export prospects are clouded by the likelihood of sluggish growth in demand for traditional exports. 25X1

Without a slowdown in import growth, we believe further deterioration in Indonesia's financial position will lead foreign lenders to demand larger spreads on loans. If the austerity and export promotion measures already taken are not effective in strengthening Indonesia's financial position, we believe Soeharto will cut import growth by stretching out the industrial development program to avoid a financial crisis even though this policy will weaken the economy's ability to absorb the nearly 2 million new entrants to the labor force annually, and almost certainly will contribute to growing popular discontent. 25X1

We believe Soeharto will slow construction of some large industrial projects, such as the expansion of steel and aluminum plants and construction of new petrochemical projects. He probably will not slow the LNG plant expansions because of their immediate impact on foreign exchange earnings. Even so, the long lead times involved in the industrial development program could postpone the financial impact of a decision to slow imports by as much as a year. 25X1

We believe Soeharto will put financial considerations ahead of politics because he is confident that the security apparatus is capable of quelling any outbursts of public anger that may arise in the near future. Economics Minister Widjojo told US Embassy officials in September that Jakarta needs to take advantage of the current situation to rethink its priorities and plans. The Embassy also reported that some prominent Indonesian officials are asserting that the current world recession demonstrates the futility of export-oriented, labor-intensive development.

The Downside Risk–Warning Signals

Soeharto's decisions to raise domestic fuel prices 60 percent and to announce a government wage freeze last January—four months before parliamentary elections—suggest that he is willing to take the austerity measures necessary to avoid the pitfalls other LDC borrowers have fallen into. Nonetheless, he will be under strong pressure to expand government spending for both development and welfare even while the world recession continues to tighten the government's financial resources. There is a danger that these pressures, combined with an overly optimistic view of export prospects and his commitment to Indonesia's industrial development program, could lead Soeharto to overspend. Developments such as the following would signal that Soeharto might be moving away from prudent financial management and that Indonesia could be in danger of a financial crisis in the not-too-distant future:

- *Downgrading the role of chief economic adviser Widjojo and other leading technocrats because of policy disputes with Soeharto's military and political advisers.*
- *Further deterioration in the country's export performance unaccompanied by a slowdown in the country's ambitious industrial development program or in imports.*
- *Any significant relaxation of the austerity measures taken in 1982 or, indeed, a failure to further reduce domestic fuel subsidies.*

External or sudden and unexpected developments over which Jakarta has no control would also throw Indonesia's financial planning into turmoil. These could include:

- *A sharp drop in international oil prices.*
- *A concerted move by international bankers to cut back sharply on lending to all Third World countries.*
- *A failure of Indonesia's 23-million-ton rice crop that would require massive imports.*
- *A further downward spiral in world economic activity.*

Further deterioration in the current account and in foreign exchange reserves, or a sharp rise in external borrowing without improved exports would suggest that Indonesia is living beyond its means. In that case, foreign banks and international financial institutions such as the IMF and the World Bank would almost certainly demand politically painful austerity measures as the price for additional assistance.

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Appendix

Frictions With the United States

Overall economic relations between Indonesia and the United States are not likely to change drastically in the next few years. US aid and investment will remain crucially important to Indonesia. US firms produce over 80 percent of Indonesia's crude oil and all of its LNG. US firms also have major investments in forestry, rubber, mining, manufacturing, banking, and financial services. US capital, technology, and management expertise will continue to be needed in the development of important sectors of Indonesia's economy, particularly the oil industry. 25X1

Nonetheless, given the prospect of sluggish export growth, frictions with the United States are likely to arise over a number of issues. Indonesian officials have already expressed their disappointment with US positions on Third World issues, especially on export commodities important to Indonesia. They have complained that US tin sales are depressing international tin prices and US ceilings on imports of Indonesian textiles are contradictory to our avowed adherence to free trade principles. If Indonesia's external accounts do not improve, Jakarta can be expected to be more assertive in seeking to boost its exports or finding ways to increase its share of export earnings that now accrue to multinational firms operating in Indonesia. 25X1

Efforts by Pertamina to secure a larger share of oil revenues will cause disputes with US oil companies. In the most important negotiation currently under way—talks with Caltex over conversion of its Contract of Work to a Production-Sharing Contract in November 1983—Pertamina has adopted a three-tiered approach to boost its share of Caltex's output without damaging the exploration climate for other oil companies. Pertamina chief Judo Sumbono announced that the standard 85-15 percent production-sharing formula would apply only to the first 150,000 b/d of crude oil output. The ratio would rise to 90-10 percent for the next 100,000 b/d, and to 95-5 percent for amounts in excess of 250,000 b/d. Sumbono said that no single Pertamina contractor had yet reached a production level over 150,000 b/d except Caltex, which produced 700,000 b/d in 1981. According to official Indonesian statistics, the next three leading producers were Inpex, a Japanese consortium (140,000 b/d), Arco (128,000 b/d), and IIAPCO (112,000 b/d). 25X1

Indonesian officials had said previously that they intended to obtain a better deal from Caltex than the standard 85-15 percent production split currently in force for all the other production-sharing contractors. The three-tiered approach is intended to avoid repeating the drop in exploration that occurred after 1976 when Jakarta unilaterally changed all the production-sharing contracts. At that time, Jakarta forced all the oil companies to change the terms of their contracts from 65-35 percent in its favor to 85-15 percent in an effort to boost Indonesia's oil income in the wake of Pertamina's near bankruptcy. The result was a three-year decline in exploration until turmoil in the Middle East and new contract sweeteners offered by Jakarta once again made Indonesia attractive to foreign oil companies. 25X1

Besides the Caltex negotiations, however, oil companies are concerned about Pertamina's hardening attitude in other contract disputes. Arco, for example, was forced to stop producing crude oil in an onshore East Kalimantan field and relinquish its block when Pertamina determined that the field was too small to be produced commercially.

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