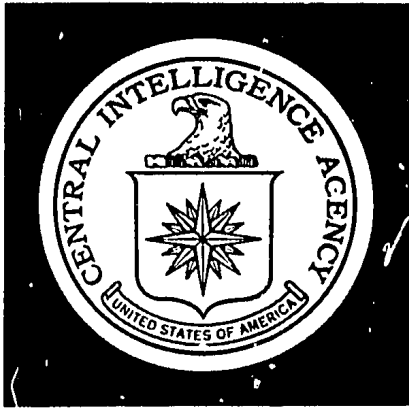


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DIRECTORATE OF
INTELLIGENCE

Intelligence Memorandum

Indonesia: Prospects for Economic Stability

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July 1968

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
July 1968

INTELLIGENCE MEMORANDUM

Indonesia:
Prospects for Economic Stability

Summary

The economy of Indonesia is slowly recovering from the severe damage wrought by more than a decade of mismanagement under Sukarno. The Suharto regime is attempting to control runaway inflation and to stabilize the economy by tighter fiscal control, deferment of foreign debts, and large imports of consumer and industrial goods under new foreign aid. If the government could continue the progress made in 1967, when the rate of inflation was reduced from 600 to 100 percent, there would be good prospects for economic recovery and growth over the long run.

Progress is not assured, however, and the next few years will be crucial. The level of foreign aid that has been promised thus far by major donors will be minimal for stabilization purposes, and Suharto has no powerful new fiscal and monetary weapons to continue the fight on inflation. While over the next year or two there could be slow and uneven progress, the possibility of increasing frustration and political disaffection in the cities also exists.

Political stability and economic progress would have been extremely difficult after independence even under the best of circumstances, but President-for-life Sukarno amassed a foreign debt of more than \$2

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billion and left the country in ruinous inflation by his years of adventurism in foreign policy and political activism. In 1966 the Suharto government invited the International Monetary Fund to help develop policies and marshal funds to bring the economy under control. A two-fold program was formulated by the Fund and a consortium of Western aid donors: to stabilize and then to rehabilitate the economy. There has been slow progress toward the first goal but relatively little toward the second. All Western creditors and the USSR have granted moratoria on debt repayments, and the consortium is providing new economic aid of about \$300 million this year. This aid is used primarily to finance imports of consumer goods or of materials for consumer goods industries in order to stem inflation; relatively small amounts remain to provide equipment needed for rehabilitation.

One of Indonesia's fundamental economic problems is a slower growth of food production than of the population. The government plans to import 600,000 tons of rice in 1968, about 6 percent of domestic production. Yields in Indonesia can be greatly increased by stepping up irrigation and the use of more fertilizer, pesticides, and modern seeds. Although the government is encouraging greater production of rice, many years will be required to eliminate rice imports.

Indonesia's annual exports have declined since 1960 by more than \$150 million, or nearly 20 percent, partly because of adverse terms of trade but also because investment in export industries fell. The Suharto regime is now restoring to their foreign owners some plantations and mines taken over by Sukarno. This move and the provision of attractive terms for foreign investors have already brought some new investment in oil, tin, copper, and rubber and copra plantations. In time, if Indonesia adheres to its present economic policies, foreign investment can contribute substantially to development, particularly in the export sector.

The Indonesian transport system, essential to maintain control and promote development among the several thousand islands of the archipelago, is in poor condition (see the map). New equipment and

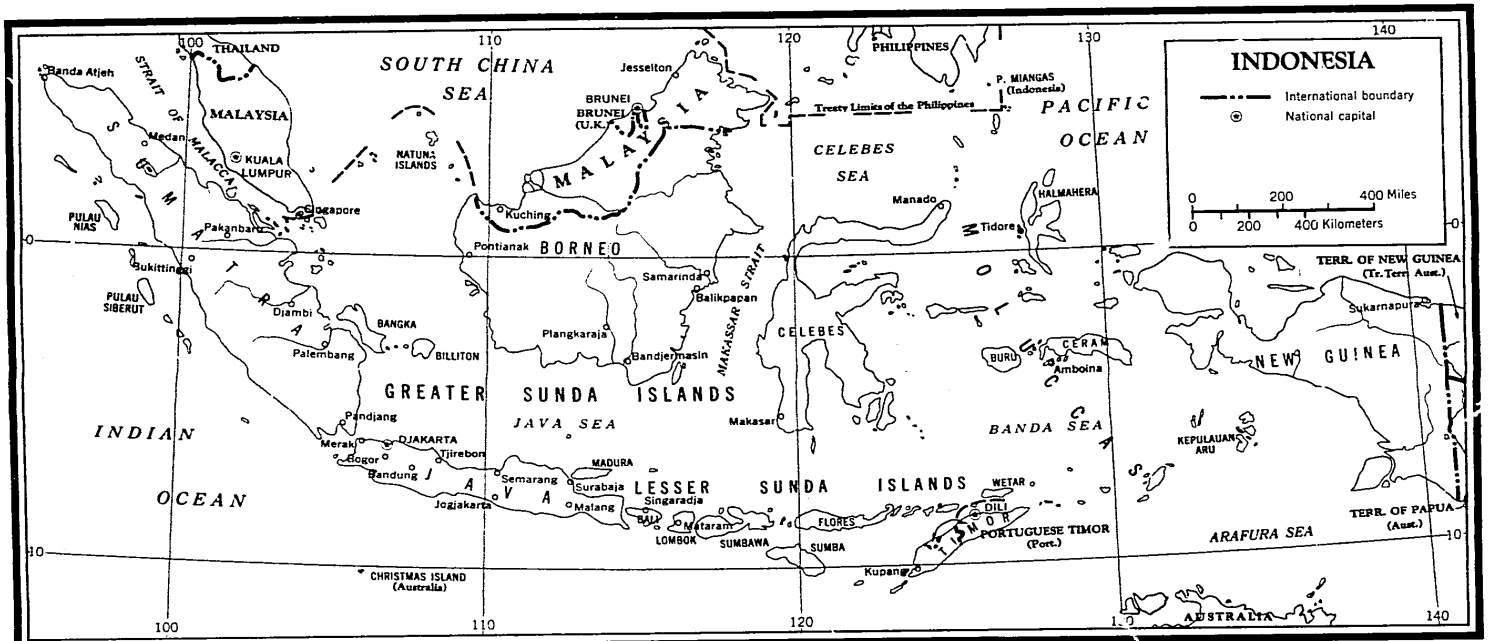
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improved administration are needed. Almost one-half of the \$75 million in project aid requested for 1968 will go to transportation, but at this rate three to five years will be required merely to rehabilitate existing transport facilities.

Even if economic progress under Suharto is slow, the consequences for domestic welfare would not be serious. Most of the approximately 112 million Indonesians live in a non-monetary, subsistence environment and do not expect radical improvements in their living standards. Famine is not likely to become a problem. As a result, the population probably will weather the path toward slow progress expected under Suharto just as they did the years of deterioration under Sukarno. If progress is halted and uncertain over the next few years, however, dissatisfaction in the cities would be widespread and could lead to increasing political difficulties for the Suharto regime.

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The Setting

1. Indonesia's legacy from more than 300 years of Dutch colonial rule was an extremely weak base for political and economic development. The Dutch long viewed Indonesia primarily as a source of raw materials -- rubber, copra, and tin. They established some consumer goods industries on Java, the main island, primarily to reduce the colony's demands for imports, but at the beginning of World War II four-fifths of the population was still engaged in traditional agriculture while a mere 3 percent, primarily Dutch and Chinese, received most of the money income. Administrative responsibility was denied to all but a few Indonesians, and after independence the country was ill-equipped to provide administration for either economic or political affairs. This has been the root cause of many of Indonesia's current problems.

2. The Indonesian economy incurred little physical war damage when the Japanese arrived in March 1942, but it was severely weakened by the Japanese occupation. Foreign trade was restricted to Japan, interisland trade was halted, plantations were converted to food production, and facilities for processing exports were left idle or converted to other uses. Transport and distributive facilities were eroded, and the productive apparatus in the small, modern sector deteriorated.

3. During the years immediately following the Japanese occupation, the Indonesian fight for independence not only prevented reconstruction of the economy but also resulted in direct losses of productive capacity. Under a "scorched earth" policy the Indonesian nationalists destroyed a large number of foreign-owned sugar mills and damaged foreign-owned estates. Recovery did not begin until 1949, but it then proceeded rapidly during 1950 and 1951 under the stimulus of the Korean War boom. Most industrial plants were reconstructed, export agriculture and mining were expanded, and there was some rehabilitation of the transport system. Increased production of such strategic raw materials as rubber and petroleum provided Indonesia with a large surplus in the balance of payments during most of the early 1950's.

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4. The majority of the Indonesian people now live on the small but fertile island of Java, supported primarily from intensive cultivation of irrigated food crops for home consumption and from small, cottage industry (see Figure 1). But population pressure on Java has long been excessive, and nearly all cultivable land is under crops. As a result, expansion of agricultural production in Java can be attained only by raising yields. In marked contrast to Java, the outer islands have only one-third of the population of 112 million but account for about nine-tenths of the total land area. These islands, primarily Sumatra, contain the plantations, mines, oilfields, and refineries that produce for export, but there are also large areas where primitive shifting agriculture still prevails. The differences in economic orientation between Java and the outer islands have bred differences in political and social outlook and have led to occasional outbreaks of violence and lingering animosity and distrust.

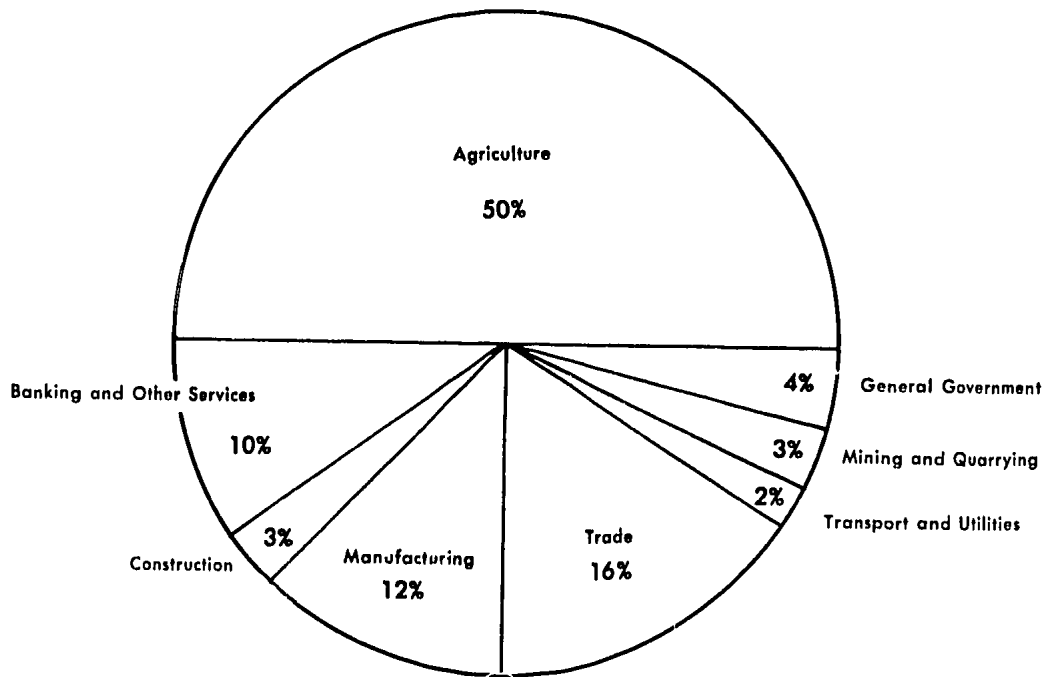
The Time of Troubles

5. Indonesia's current problems reflect the troubles of the Sukarno era, which was marked by a steady economic deterioration. Although most Indonesian statistics are hardly better than conjecture, they imply that per capita income fell during the period 1950-65 and that standards of living were lower when Sukarno was ousted in 1965 than they were in 1939. The level of production in most sectors of the economy was little higher than that of the prewar period; and agricultural production, the mainstay of the great majority of Indonesians, was actually lower. The petroleum industry, largely dominated by Western-owned oil companies, showed the only significant growth during the period, but Sukarno's policies kept its growth substantially below what it could have been. The general stagnation in domestic production, however, does not adequately reflect the economic disorder wrought during Sukarno's administration. Inflation, endemic in the early independence years, got out of control towards the end of Sukarno's rule and the rupiah became virtually worthless. Government borrowing to finance recurring budget deficits was the most important factor contributing to the declining value of the rupiah.

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Figure 1

INDONESIA
ESTIMATED COMPOSITION OF NATIONAL INCOME
1967



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6. Indonesia's dismal economic performance reflects government policies which could hardly have been better planned to impede development. Adventurism in foreign policy and political activism preempted nearly all of the government's energies and resources. Sukarno took over foreign-owned plants and plantations without compensation and squelched private initiative. After paying for the large, modernized armed forces and the bloated bureaucracy, there were practically no state funds for investment, except on a few prestige projects.

7. During the late 1950's, one of the most serious deterrents to economic development was the failure of the government to unify the country. The population of the outlying islands, always latently hostile, became increasingly estranged from the Javanese government. These islands produced most of the country's exports and tax revenues and received relatively little in return. Most government spending was on Java. In reaction, the outlying islands set up semi-autonomous governments in 1957. Military rebellion broke out a year later. These events seriously disrupted production, and the consequent loss of exports reduced government revenues. At the same time, government expenditures rose in the process of quelling the rebellion and restoring a measure of security to the archipelago.

8. Also during the late 1950's, the government was attempting to wrest West Irian from the Dutch. When the Hague refused in 1957 to cede the territory, Djakarta seized all Dutch business interests and ousted most Dutch technicians, thus losing an important source of entrepreneurial talent and capital investment. Indonesia also began to build up its armed forces in anticipation of military action against the Dutch. With Soviet credits, the Indonesians acquired vast amounts of military materiel, a major source of their tremendous foreign debt. By mid-1962 the dispute had been settled largely in Indonesia's favor with intervention by the United Nations and assistance from the United States. Economically, however, the campaign was very costly. In addition to the loss of Dutch investment and the potential burden of repaying military credits, the Indonesians incurred the cost of administering the territory.

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9. The successful if costly acquisition of West Irian complete, Sukarno precipitated a confrontation with Malaya in 1963 to stop the formation of Malaysia, which Indonesia claimed to be a neo-colonialist plot. Here he was unsuccessful. Malaysia was officially formed on 16 September 1963. There followed a "Crush Malaysia" campaign which included an embargo on all trade with Malaysia. This ill-conceived move dealt a serious blow to the Indonesian economy, however, because about 30 percent of the country's exports had been channelled through Malaysian ports. Still more important was the loss of \$350 million in economic credits, which Western countries had pledged to support a proposed economic stabilization program but which they withdrew as a result of the confrontation. In addition, the military costs of confrontation represented a drain on the economy. Once again, the Sukarno government had chosen to pursue political adventures rather than rational economic programs.

The Suharto Era

10. The army under Suharto assumed a degree of political power in October 1965 and established a cabinet in March 1966. It publicly acknowledged the country's severe economic problems. Nevertheless, its initial attempts to undo the damage wrought by years of mismanagement under Sukarno were largely unsuccessful, in part because the economic problems were so formidable but primarily because the regime lacked effective political power. Numerous economic directives were issued during late 1965 and early 1966 -- including those designed to raise new taxes, reduce subsidies, and depreciate the rupiah exchange rate -- but not all were implemented because of political repercussions. For example, the reduction in subsidies and subsequent increase in public utility rates were retracted following widespread public demonstrations in early 1966. The hyperinflation begun under Sukarno gathered speed. Output remained stagnant, government services continued to be virtually paralyzed, and the disorder in urban areas, if anything, increased. A disaster of major proportions was averted only because the Indonesian economy is predominantly rural and much of it is relatively unaffected by what occurs in the modern, urban sector. The situation began to improve slowly in 1967 as a combination of foreign aid receipts and a smaller budget deficit reduced the rate of inflation.

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11. Despite the ineffectiveness of its domestic policies, the Suharto regime made major progress in restoring Indonesia to the world economy. The new government persuaded creditor countries to ease debt repayments and provide additional economic assistance, and rejoined the United Nations, the International Monetary Fund (IMF), and the World Bank. Suharto officially ended Sukarno's confrontation with Malaysia and resumed trade with Singapore. The government also created a more favorable atmosphere for private foreign investment, partly by returning some nationalized properties to Western owners. The fruits of these efforts have been substantial. Estimates by the IMF and the World Bank of the requirements for stabilization and recovery were used by major Western countries as the basis for extending economic assistance. The receipt of foreign aid during 1967 and a tightening of government expenditures permitted a substantial reduction in the rate of inflation, although it remains high.

Inflation

12. One of the most pressing of all the economic problems inherited by Suharto is runaway inflation. Indonesian price indexes, which are far from adequate, indicate that during the 18-month period ending in June 1966, prices increased by more than 2,500 percent. Inflation was caused primarily by large-scale government budget deficits and subsequent rapid increases in the money supply. Government expenditures under Sukarno grew much more rapidly than revenues and were used primarily to finance military adventures, to build unproductive prestige projects, and to maintain the excessively large government bureaucracy.

13. Most Indonesians live in the rural sector and are therefore not greatly affected by inflation primarily because they consume most of what they produce and make minimum use of money. The greatest adverse effects are in urban areas where the real wages of industrial workers have declined substantially while food prices in real terms have been fairly stable. Some of the sting of inflation has been removed for urban workers through price controls and through payment of part of their wages in rice. Inflation has substantially reduced the incentives to save and invest. Rupiah notes are quickly exchanged

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for goods when people see that the currency is fast depreciating. Moreover, much private investment has been diverted to building up inventories for speculation. At the same time, Sukarno let government investment in real terms fall substantially, particularly in infrastructure, as government revenues failed to keep pace with price increases.

14. Although the national budget under Sukarno was in deficit continually from 1952, the largest deficits were incurred during 1963-66 when deficits actually exceeded revenues in each year. In 1965, Sukarno's last year of rule, the budgetary deficit reached its peak, exceeding revenues by nearly four-fifths. The budgetary imbalance was less severe in 1966, but the deficit still exceeded revenues by more than one-fourth. These huge budgetary deficits resulted primarily from the massive military expenditures incurred under Sukarno's "Crush Malaysia" campaign and the failure of government revenues, derived primarily from custom duties, to increase as rapidly as expenditures under inflationary conditions. Most of these budgetary deficits were financed by borrowing from the central bank. As a result, the money supply increased more than 150 times between December 1962 and December 1966, from 136 million rupiahs to 21,000 million rupiahs. During the same period, the general price level increased nearly 260 times, reflecting not only the increase in the supply of money but also an acceleration in the speed at which money changes hands. (See Figure 2).

Fiscal Policy Under Suharto

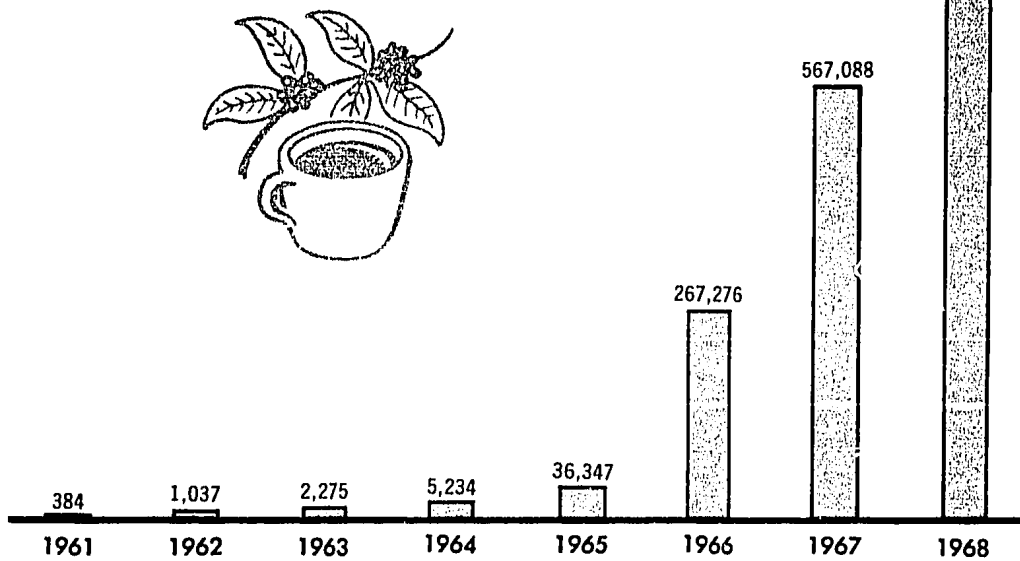
15. A team of Western-trained economists working with Suharto's blessing has succeeded in bringing the government budget under control. A tighter administrative procedure has been installed, particularly for expenditures. Subsidies to nationalized enterprises have been reduced, and subsidies have been cut on some consumer items such as kerosine. The proportion of total expenditures allocated to the military has been gradually reduced from 50 percent in 1965 to 33 percent in 1967 and to a planned 28 percent in 1968. There has also been some reduction in government civilian employment. In 1967, tax collections increased moderately because of higher customs

Figure 2

INDONESIA CONSUMER PRICE INDEX FOR DJAKARTA

1961-68

Year ending February 1958 = 100



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receipts, and foreign aid support to the budget amounted to one-fifth of total revenues. As a result of this improved fiscal performance and a substantial inflow of new foreign aid, there was a sharp reduction in inflation from 635 percent in 1966 to 112 percent in 1967. The rate of inflation accelerated during the last quarter of 1967 and the first two months of 1968, largely because of rice shortages. During the first quarter of 1968, prices increased by more than 50 percent, clearly indicating Indonesia is far from solving its severe problem of inflation. (See Figure 3).

16. The government is expected to continue its present fiscal policy, but probably cannot eliminate budget deficits entirely over the next few years. Some of the reduction in budget subsidies to nationalized enterprises in 1967 were offset by bank loans to these enterprises, and it may be many years before most of them can operate free of government assistance. Military expenditures might be reduced in time. But Suharto's political base is the army, and military cuts may not be possible for several years. Civilian government employment in Indonesia is not excessive by comparison with other Asian countries. Government investment expenditures need to be increased rather than cut if rehabilitation is to get under way. On the revenue side, import and export duties will grow slowly as trade recovers. Large new taxes cannot be imposed for political reasons, however, or even administered adequately in the short run. Tax holidays have been promised new investors, and thus new revenue cannot be expected from these investments for several years.

The Foreign Debt Problem

17. A relatively massive foreign debt with a repayment schedule clearly beyond Indonesia's capability is one of the most obvious marks of Sukarno's years of mismanagement. In June 1967, this debt totaled about \$2.3 billion, or three times Indonesia's annual export earnings (see Figure 4). The debt to Western countries, \$1.3 billion, was incurred almost wholly for such items as transportation equipment, power and irrigation projects, foodstuffs, and textiles imported under long-term credit

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agreements; whereas almost 80 percent of the Communist debt of \$1.0 billion represented military equipment, and much of the remainder was spent on grandiose prestige projects.

18. When the new regime took over in the fall of 1965, Indonesia was already in default on some of its debt and during 1966 was unable to make any further debt service payments. To forestall further defaults, Western creditors agreed, in December 1966, to reschedule the payment of all medium-term and long-term debts due before the end of 1967. Under the agreement, payments totaling some \$330 million were rescheduled and were to be repaid in eight years, with an initial three-year moratorium. Actual payments would begin on 1 January 1971.

19. In October 1967, Indonesia's major Western creditors met again and agreed to reschedule the \$130 million due in 1968 in the same manner as the previous debts. They also agreed to recommend that creditor countries reschedule debts due in 1969 and 1970 on terms no less favorable than those granted for 1967 and 1968.

20. While the Communist countries were not parties to these agreements, the USSR and the East European countries, except Poland and Rumania, agreed in bilateral negotiations to reschedule Indonesia's debt due them. The terms reached, however, are less favorable than those granted by Western creditors.

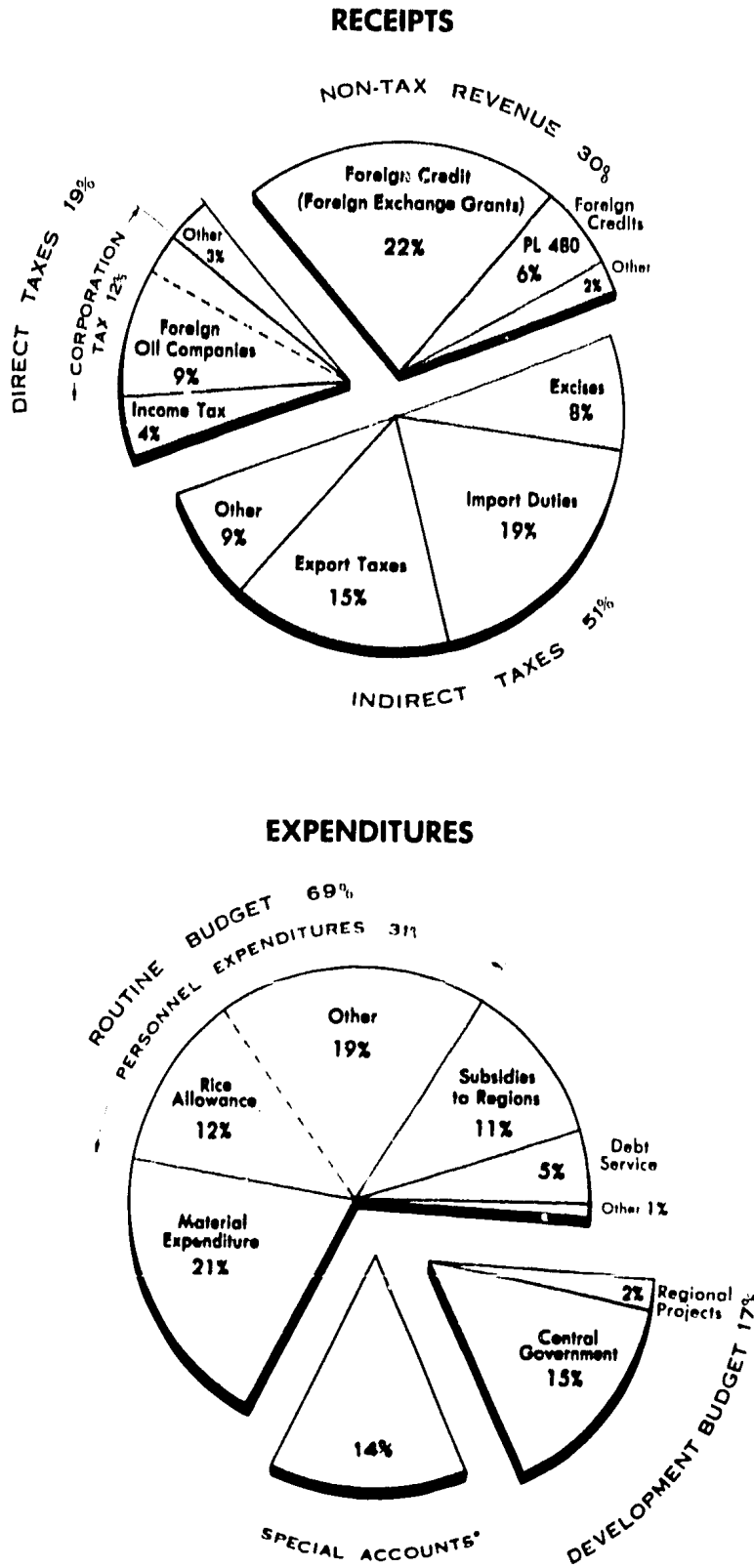
[redacted] The Indonesians can expect little additional assistance from the Communist countries and, therefore, probably will not feel compelled to meet even this repayment plan. Since the 1965 coup, Soviet military assistance has been limited to cash sales of \$10 million of spare parts and technical help to rehabilitate some of the Soviet equipment. The Indonesians need Soviet spare parts to keep most of their air force and navy operating. But the army, which uses mainly Western weapons and equipment, is the important service to maintain internal order. Moreover, the Soviet government probably would not wish to burn its remaining bridges to Indonesia. Consequently, substantial Indonesian repayments of

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Figure 3

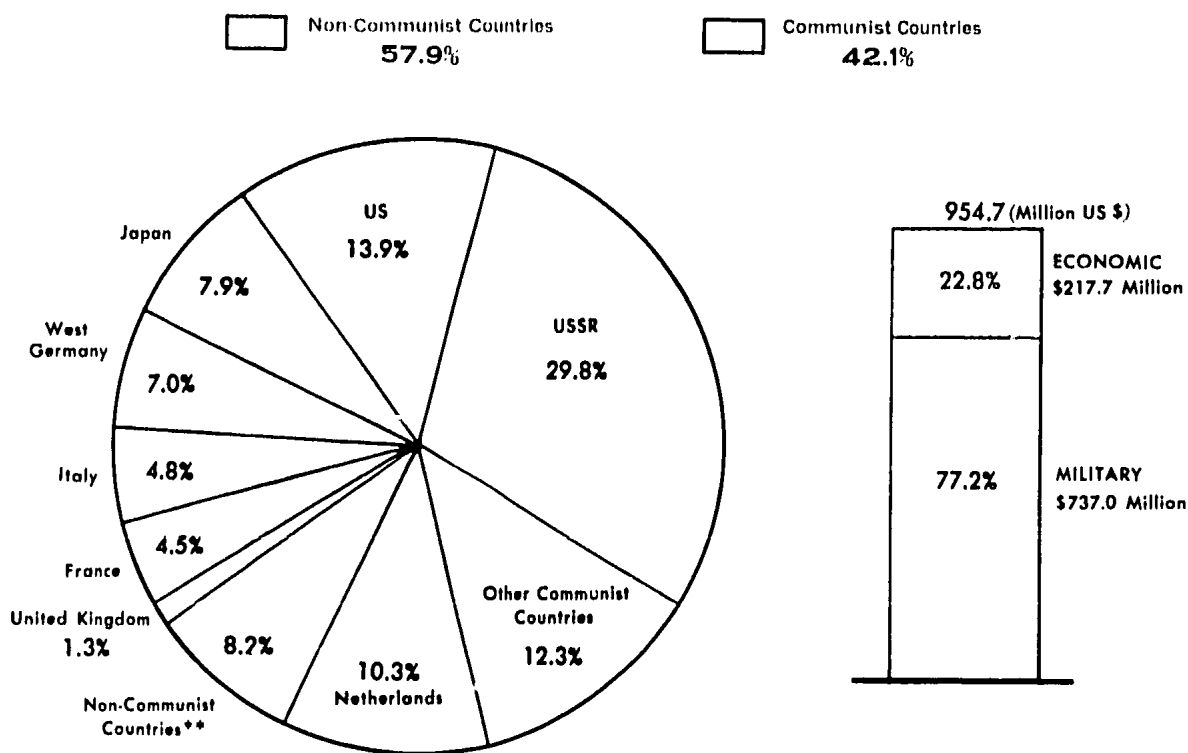
INDONESIA: GOVERNMENT BUDGET RECEIPTS AND EXPENDITURES, 1967



*Includes special allocation of 13.6 billion rupiahs for purchase of rice in fourth quarter.

Figure 4

INDONESIA: MEDIUM-AND LONG-TERM INTERNATIONAL DEBT
As of 30 June 1967*



*Net of interest owing to arrears.

**Austria, Belgium, Denmark, Sweden, Switzerland, Panama, United Arab Republic, Tanzania, Hong Kong, India, Pakistan, and Yugoslavia.

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the Soviet military debt -- which in effect would represent diversion of Western aid for that purpose -- are highly unlikely.

21. No agreement has been reached on Indonesia's debts to Communist China, estimated to total \$60 million, but it seems unlikely that any payments will be made in the next few years. Relations between the two countries have been sharply curtailed since the 1965 coup attempt. Diplomatic relations have been suspended and the Chinese aid program in Indonesia has been halted.

Economic Aid

22. The foreign debt problem is closely interwoven with the issue of new foreign aid. Repayments on the current debt of \$1.3 billion to Western countries are particularly a large burden on the balance of payments and greatly increase Indonesia's requirements for new aid. While debt rescheduling has substantially reduced payments to be made in the period through 1969, payments in 1970 are to amount to about \$70 million and in 1971 to more than \$200 million. (For further figures on the debt repayment, see the Appendix.)

23. In 1966, the first full year of the Suharto regime, the need for foreign assistance was obvious. The economy was in shambles; inflation was completely out of control and there was probably a decline in output. In an effort to stabilize the economy, the IMF and an aid consortium of Western countries mounted an emergency program which provided Indonesia about \$130 million in 1966. The consortium agreed on a stabilization program to provide enough foreign exchange or its equivalent (for example, PL 480) to achieve a level of imports which will stem inflation. The IMF calculated the 1967 foreign exchange gap at \$200 million, and the Western countries agreed to extend \$160 million in new aid and to continue about \$40 million in aid pledged in 1966 but not utilized (see Table 1). The stabilization program has helped to reduce the annual price increase from 635 percent in 1966 to only 112 percent in 1967.

24. Indonesia's aid requirements for 1968 were estimated by the IMF to total \$325 million -- \$250

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million for general-purpose imports and \$75 million for rehabilitation programs. Even this figure is far below Indonesia's actual requirements, but it reflects basic political judgments as to how much aid can reasonably be expected from Western countries. The United States is committed to provide one-third of the \$325 million if other countries provide the remainder. Thus far, however, the amount offered by other countries is far below the amount requested, and Indonesia may actually receive no more than \$300 million.

Table 1

Foreign Aid Available in 1967

	Million US \$		
	<u>Unutilized Balance from 1966</u>	<u>New Offer</u>	<u>Total</u>
West Germany	4.0	25.0	29.0
India	8.0		8.0
Netherlands	18.3	15.0	33.3
United States	8.0	57.0	65.0
United Kingdom		1.4	1.4
Japan		60.0	60.0
Others	3.0		3.0
<i>Total</i>	<i>41.3</i>	<i>158.4</i>	<i>199.7</i>

The Problem of Transportation

25. Even without the economic disruptions of the Sukarno years, transportation would present formidable problems in developing Indonesia. There are several thousand islands in the Indonesian archipelago, ranging from tiny, uninhabited islets to some of the world's largest islands. The archipelago extends about 3,000 miles from east to west, roughly the distance across the continental United States, and is about 1,000 miles from north to south. The major islands are extremely mountainous, and more than 60 percent of the land area is covered with tropical forests while swamps cover much of the coastal area.

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26. The transport system was developed by the Dutch to link producing areas with population centers and ports and to facilitate political and military control. Most transportation facilities were confined to the main island of Java, where improved highways, railroads, and deep water ports were constructed. To a lesser extent, transport facilities were constructed in Sumatra to service the export-oriented plantation and mining economy. The other islands were almost completely neglected, although they were linked to Java by shipping and air service which the Dutch needed to maintain essential communications and control.

27. The transportation system suffered extensive damage during World War II and the immediate post-war conflicts preceding Indonesian independence. Although Indonesia greatly increased its inventories of transportation equipment, especially of trucks, in the years following independence, the actual performance fell below the prewar level because of the failure to provide facilities for servicing and maintaining the equipment. In fact, much of the new equipment fell out of service because of poor maintenance or was used far below capacity because of poor management.

28. At present, about 30 percent of the inter-island shipping network is awaiting repair, and part of it should be scrapped. There is a large backlog of maintenance dredging for the ports and their access channels, and most port equipment needs repair or replacement. Railroad tracks and bridges suffer from deferred maintenance and need strengthening. Many of the locomotives and most of the rolling stock are overage and the rest need rehabilitation. About 50 percent of the motor vehicles are over 10 years old. Nearly all roads are in poor condition with some sections completely impassable. Most of the domestic aircraft need to be replaced. In addition, there is even more need for improvement in administration, organization, operation, and financial arrangements. For example, there is overstaffing in nearly all transport agencies -- the railroads appear to be overstaffed by at least 50 percent.

29. Although transportation facilities are generally adequate for the present low level of

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economic activity, it will be essential to restore most of the capacity before rehabilitation and economic expansion place new burdens on the system. Almost one-half of the \$75 million in project aid requested for 1968 has been earmarked for transport and communications projects. At the rate of progress planned for 1968, it will take three to five years to rehabilitate completely the existing transport facilities.

Stabilization and The Rice Problem

30. The need to reduce rice imports by increasing local production is another pressing problem facing the Suharto regime. Although rice is the basic foodgrain of most Indonesians, domestic production has failed to keep pace with population growth, as indicated below:

	<u>1960</u>	<u>1961</u>	<u>1962</u>	<u>1963</u>	<u>1964</u>	<u>1965</u>	<u>1966</u>	<u>1967</u>	<u>Increase 1960-67</u>
Rice production (thousand metric tons)	8,767	7,263	8,898	7,933	8,419	8,830	9,140	9,300	
Percent increase in rice production		-17	22	-11	6	5	4	2	6
Percent increase in population	2.6	2.6	2.6	2.6	2.6	2.6	2.6	2.6	20.8

As a result the government imported 350,000 tons of rice in 1967 and plans to import 600,000 tons in 1968. Although imports are small in terms of total supply, rice imports are a major drain on the country's foreign exchange resources. Rice imports in 1968 would represent about 15 percent of total planned imports, which is the equivalent of nearly one-half of the economic aid expected for stabilization purposes. With Indonesian population growth averaging 2.6 percent per annum, the need to expand domestic production is critical.

31. Indonesia could increase rice production substantially, but not quickly. Yields in Indonesia can be increased greatly with large inputs of water, fertilizer, pesticides, and new seed strains.

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Inputs such as fertilizer and pesticides could be provided through foreign aid, but time and technicians are needed to teach the peasants how to use them properly. Moreover, domestic distribution facilities need to be improved substantially, to facilitate both the movement of inputs to the farm and the flow of production from the rural areas. The prospects at best are for slow but steady increases in rice production, and the subsequent benefits of reduced rice imports will be realized only over a number of years.

The Performance of the Export Sector

32. The poor performance of Indonesia's export sector also reflects the adverse effects of government policies. Indonesian exports, after increasing substantially during the Korean War and then falling sharply in 1953, generally stagnated during the mid and late 1950's. While the stagnation partly reflected lagging world demand, an overvalued rupiah exchange rate which reduced export incentives was the primary cause. A sharp decline in the prices of Indonesia exports between 1960 and 1966 further aggravated this underlying problem, and exports fell from \$840 million to about \$680 million. Much of the decline was accounted for by the fall in the world price for rubber, Indonesia's most important export (see Figure 5). The world price of natural rubber has fallen by about 50 percent since 1960; and although the volume of Indonesian rubber exports increased from 578,000 metric tons in 1960 to 664,000 metric tons in 1966, the value of these exports declined from \$377 million to \$217 million. Petroleum and petroleum products, nearly as important as rubber, also have increased in volume but declined in value since 1960, reflecting the increasing proportion of lower priced crude oil that has been exported because of Sukarno's insistence that greater amounts of refined products be channeled into the domestic economy. Other exports, including copra, tea, tobacco, and tin, have declined in both volume and value since 1960.

33. While Djakarta can do nothing about the fall in world market prices, the problem has been made worse by the lack of investment in export

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industries during the past decade. Since 1957, when the government began nationalizing foreign-owned plantations and mines, investment in such industries as rubber, copra, and tin has been minimal, and in some cases even maintenance has been neglected. As a result, a substantial part of Indonesia's rubber trees and coconut palms are well beyond their prime productive age and many mining facilities have deteriorated badly.

34. Under the Suharto government, many of the previously nationalized foreign investments have been returned to their former owners. Both Good-year and Uniroyal have returned to their rubber plantations and are making new investments. International Nickel, Kaiser, and Freeport Sulphur are making new investments in the country's mineral resources. While many of these investments will involve considerable time before actual production takes place, some investment in rehabilitation will soon result in increased production. Moreover, the investment brings an inflow of foreign exchange.

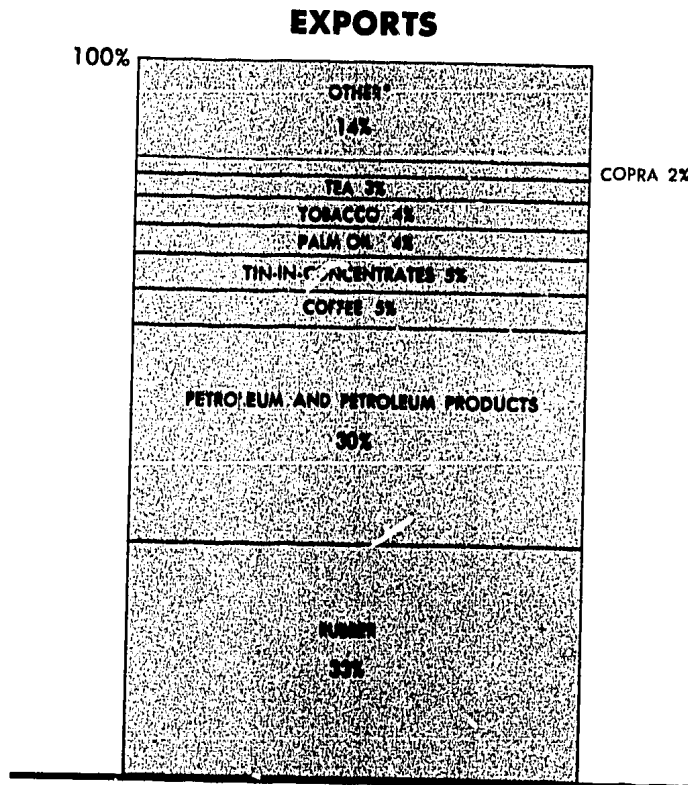
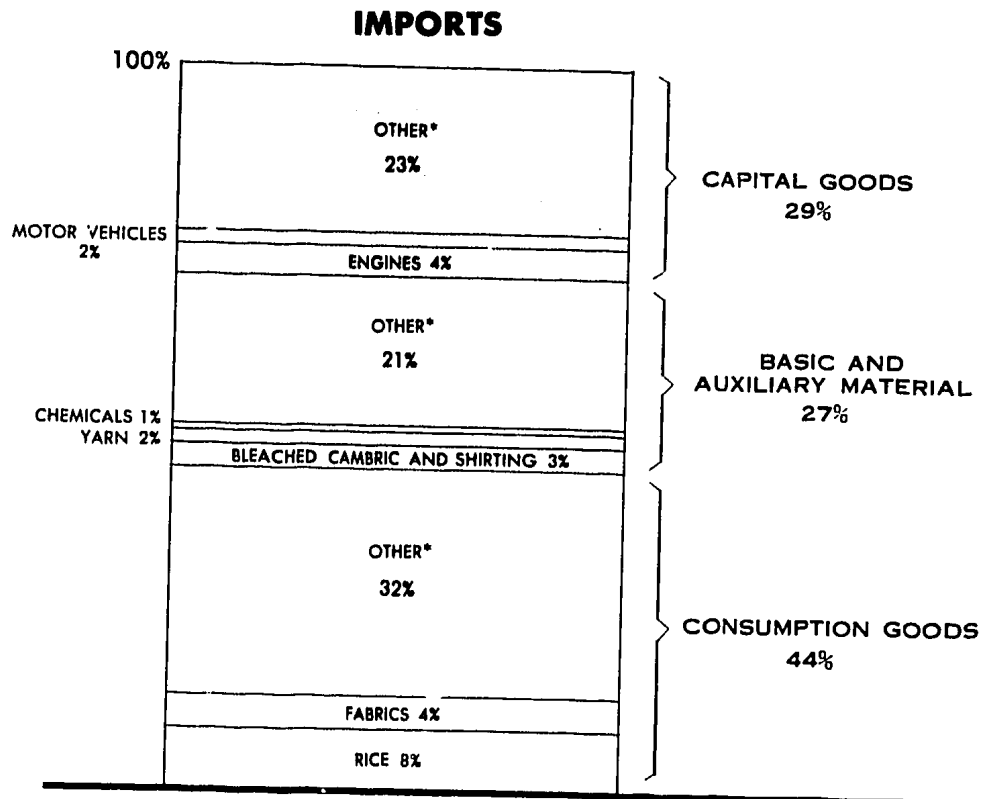
Implications for the Future

35. Indonesia needs large-scale foreign aid to complete its stabilization program and set the stage for economic development. Failure by Suharto to stabilize prices quickly may increase public resistance to those measures needed for lasting stabilization, such as elimination of subsidies and a consequent rise in public utility prices. Some relief from inflation may come this year through a further reduction in the budget deficit, but in the short run there is little more the government can do to increase revenues or to reduce expenditures. An expected rise in export earnings in 1968 would contribute to stabilization by financing more imports, but the impact would be small in relation to needs. Thus foreign aid is a key element in stabilization, but adequate aid may not be forthcoming. The goal of \$325 million in 1968, which the IMF estimated as a minimum requirement, probably will not be reached. The shortfall, amounting to perhaps \$25 million, will only make more difficult the government's job of increasing the supply of goods in order to hold down prices.

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Figure 5

INDONESIAN IMPORTS AND EXPORTS, 1966



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36. Shortfalls in the expected foreign aid level are not likely to be offset entirely by private foreign investment. Foreign investors have been encouraged by a series of laws passed in 1966 and 1967, but most of the prospective investments are in extractive industries such as mining, forestry, and oil production, where survey and exploratory work often precedes operations and the gestation period normally runs several years. As a result, the substantial progress made toward stabilization in 1967, when prices only doubled compared with an increase of 600 percent in 1966, may not be repeated this year. Inflation, although clearly under control, remains a serious problem for Indonesia in 1968.

37. Rehabilitation of the economy will inevitably be slow, especially since foreign aid will scarcely be adequate for stabilization. Several years will be required to renovate the transportation system, to restore basic government services, and to overcome the neglect of investment in export industries. But at least four-fifths of the Indonesian people live in a non-monetary, subsistence environment and do not expect radical improvements in their living standards. They will endure the slow progress expected under Suharto just as they did the years of deterioration under Sukarno. If progress is too slow and uncertain, however, it could lead to more public unrest in the cities and to a resurgence of extreme nationalism that might cause increased political trouble for Suharto and threaten the promising inflow of private foreign investment.

38. In the long run, Indonesia needs a significant rise in export earnings to alleviate its balance-of-payments burden and to secure large-scale capital imports necessary for sustained economic development. Indonesian exports will grow slowly, however, and will not be substantially larger until perhaps the mid-1970's. Most Indonesian export industries are run-down and will take large-scale investment and several years to rehabilitate and expand. The prospect for expanded exports and more rapid economic growth are reasonably bright in the long run, but much depends on Suharto's immediate program to

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stabilize the economy and prepare it for more rapid development. The next year or two represent the critical period for Indonesia, and only if Suharto can demonstrate some progress in stabilizing the economy during this period will he gain the time and confidence needed to push ahead with economic development.

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Appendix

During the next few years, it seems unlikely that Indonesia will receive sufficient economic assistance to make much progress toward economic growth. The major Western aid donors have their own financial problems and there are many other less developed countries competing for the available aid. Furthermore, much of the new aid extended to Indonesia will be quickly offset by repayments on past debts (see Tables 2 through 5). About \$250 million probably is a reasonable level of aid to expect from donor countries, the average aid level during the last two years. This level of new aid would result in about \$210 million in net aid (gross aid minus debt repayments) being available in both 1968 and 1969, but in 1970 only \$183 million would be available. In 1971 and 1972, net aid would be less than \$50 million annually. These are the years, however, when Indonesia expects rehabilitation to be largely completed and actual development efforts to begin. In 1975, repayments on past debts are scheduled to amount to about \$275 million, or more than the level of new aid that may be expected. Thus, by that time, Indonesia not only will have to finance its development entirely from its own resources but also will have to use some domestic resources to repay foreign debts.

While Indonesia probably could effectively utilize about \$250 million in net aid during the next ten years, aid donors would have to give extremely large levels of new aid or else wipe out most existing debts to attain this level of net aid. Donors would have to gradually increase the flow of gross aid from \$290 million in 1968 to over \$600 million in 1977. The total flow during the ten-year period would be \$4,580 million. Few less developed countries have received aid of this magnitude, and given the present attitudes of the Indonesia aid consortium, Indonesia is not likely to join this group.

Assumptions

To make the following calculations it has been necessary to make broad assumptions concerning the structure of existing debts and the terms under which

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new assistance will be extended. The following are the most important of these assumptions:

1. Debts rescheduled through 1970 on terms of the Paris Club, a consortium of major Western aid donors, for all donors except Communist countries.
2. All debts to Communist country rescheduled on the pattern of the Soviet rescheduling agreement.
3. Future US aid is extended with a ten-year grace period during which interest of 1 percent is payable, 30 years to repay at 3 percent interest.
4. Japan, the Netherlands, West Germany, the United Kingdom, international institutions, and other countries extend future aid on DAC terms -- seven years grace, 18 years for repayment, and 3 percent interest.
5. France and Italy give aid repayable in ten years, following a seven-year grace period, at 5.5 percent interest.
6. Aid from Communist countries is repayable in ten years, following a five-year grace period, at 2.5 percent interest.

Table 2

Indonesia: Total Gross Aid from All Countries
Assumed to Be \$250 Million, All Countries Participating a/
1968-77

Thousand US \$

<u>Year</u>	<u>Gross Aid</u>	<u>Repayments</u>			<u>Net Aid</u>
		<u>Principal</u>	<u>Interest</u>	<u>Total</u>	
1968	250,000	37,336	6,142	43,478	206,522
1969	250,000	28,323	11,546	39,869	210,131
1970	250,000	49,217	17,487	66,704	183,296
1971	250,000	160,636	43,148	203,784	46,216
1972	250,000	165,718	50,581	216,298	33,702
1973	250,000	169,094	58,400	227,494	22,506
1974	250,000	177,604	65,655	243,259	6,741
1975	250,000	205,137	68,574	273,711	-23,711
1976	250,000	221,776	70,495	292,270	-42,270
1977	250,000	243,849	71,851	315,700	-65,700

a. Donor participation: United States, 33 percent; Japan, 33 percent; Netherlands, 10 percent; West Germany, 5 percent; France, 2 percent; Italy, 2 percent; United Kingdom, 1 percent; Communist countries, 5 percent; international institutions, 5 percent; and other countries, 4 percent.

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Table 3

Indonesia: Total Gross Aid from All Countries
Assumed to Be \$250 Million, All Countries Participating
Except Communist Countries a/
1968-77

Thousand US \$

Year	Gross Aid	Repayments			Net Aid
		Principal	Interest	Total	
1968	250,000	37,336	6,142	43,478	206,522
1969	250,000	28,323	11,609	39,932	210,068
1970	250,000	49,217	17,612	66,829	183,171
1971	250,000	160,636	43,336	203,972	46,028
1972	250,000	165,718	50,831	216,548	33,452
1973	250,000	169,094	58,712	227,806	22,194
1974	250,000	176,354	66,030	242,384	7,616
1975	250,000	202,637	69,043	271,679	-21,679
1976	250,000	218,720	71,088	289,809	-39,809
1977	250,000	240,238	72,580	312,818	-62,818

a. Donor participation according to either of the following schedules: (1) United States, 33 percent; Japan, 25 percent; Netherlands, 10 percent; West Germany, 5 percent; France, 2 percent; Italy, 2 percent; United Kingdom, 1 percent; Communist countries, 0 percent; international institutions, 15 percent; and other countries, 7 percent; or (2) United States, 33 percent; Japan, 33 percent; Netherlands, 10 percent; West Germany, 5 percent; France, 2 percent; Italy, 2 percent; United Kingdom, 1 percent; Communist countries, 0 percent; international institutions, 10 percent; and other countries, 4 percent.

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Table 4

Indonesia: Total Net Aid from All Countries
Assumed to Be \$250 Million, All Countries Participating a/
1968-77

Thousand US \$

Year	Gross Aid	Repayments			Net Aid
		Principal	Interest	Total	
1968	293,478	37,336	6,142	43,478	250,000
1969	290,919	28,323	12,596	40,919	250,000
1970	318,743	49,217	19,525	68,743	250,000
1971	457,483	160,636	46,846	207,483	250,000
1972	475,007	165,718	59,290	225,007	250,000
1973	491,637	169,094	72,543	241,637	250,000
1974	513,455	177,822	85,633	263,455	250,000
1975	550,468	205,559	94,910	300,468	250,000
1976	578,192	224,116	104,076	328,192	250,000
1977	611,997	248,709	113,287	361,997	250,000

a. Donor participation: United States, 33 percent; Japan, 33 percent; Netherlands, 10 percent; West Germany, 5 percent; France, 2 percent; Italy, 2 percent; United Kingdom, 1 percent; Communist countries, 5 percent; international institutions, 5 percent; and other countries, 4 percent.

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Table 5

Indonesia: Total Net Aid from All Countries
Assumed to Be \$250 Million, All Countries Participating
Except Communist Countries a/
1968-77

Year	Gross Aid	Repayments			Net Aid
		Principa	Interest	Total	
1968	293,478	37,336	6,142	43,478	250,000
1969	297,993	28,323	12,670	40,993	250,000
1970	318,891	49,217	19,673	68,891	250,000
1971	457,714	160,636	47,078	207,714	250,000
1972	475,359	165,718	59,641	225,359	250,000
1973	492,115	169,094	73,021	242,115	250,000
1974	512,601	176,354	86,246	262,601	250,000
1975	548,304	202,637	95,667	298,304	250,000
1976	575,407	220,416	104,991	325,407	250,000
1977	607,900	243,533	114,368	357,900	250,000

a. Donor participation according to either of the following schedules: (1) United States, 33 percent; Japan, 33 percent; Netherlands, 10 percent; West Germany, 5 percent; France, 2 percent; Italy, 2 percent; United Kingdom, 1 percent; Communist countries, 0 percent; international institutions, 10 percent; and other countries, 4 percent; or (2) United States, 33 percent; Japan, 25 percent; Netherlands, 10 percent; West Germany, 5 percent; France, 2 percent; Italy, 2 percent; United Kingdom, 1 percent; Communist countries, 0 percent; international institutions, 15 percent; and other countries, 7 percent.