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CIA-RDP85T00875R00160003

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DIRECTORATE OF
INTELLIGENCE

Intelligence Memorandum

Indonesia: Export Prospects for the New Extractive Industries

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ER IM 70-89
July 1970

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
July 1970

INTELLIGENCE MEMORANDUM

Indonesia: Export Prospects
For The New Extractive Industries

Introduction

Indonesia's new extractive industries include nickel, bauxite, copper, fisheries, and timber. In contrast to petroleum and tin, which traditionally have been the major non-agricultural exports, active exploitation of these resources was neglected until recently because of the general chaos of the Sukarno years. Now these resources hold considerable interest for foreign investors, who are being attracted by the greatly improved business climate under the present government. This memorandum reviews the prospects for growth in these industries in the short and long term and indicates their possible contribution to Indonesia's much needed foreign exchange earnings.

Background

1. At present, Indonesia's foreign exchange earnings are grossly insufficient to pay for imports needed to develop the economy and improve living standards. In 1969, exports were valued at \$975 million, but there remained a deficit in goods and services transactions of more than

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\$300 million. Petroleum accounted for a little more than one-third of the export earnings in 1969 and rubber slightly less than one-fourth. The remainder was derived mainly from tin and a host of minor agricultural products, such as copra, tobacco, coffee, palm oil, and spices.

2. Prospects for expanding most of these traditional exports other than petroleum are not favorable. This situation has resulted mainly from the excesses of the Sukarno era, during which agricultural plantations and production facilities were run down and world markets lost. Indonesia, for example, was the leading world exporter of tin in the early 1950s, but mining equipment was allowed to deteriorate and known deposits were depleted. Similar problems face the rubber industry because foreign-owned plantations taken over by the Sukarno regime were allowed to deteriorate. The petroleum industry, unlike the other foreign-owned interests in Indonesia, was not nationalized. Its equipment remained in fairly good condition, and the recent major inflow of new investment gives the petroleum industry excellent prospects for expansion. Even so, the foreign exchange gap may grow if other export commodities are not developed rapidly.*

3. In order to expand exports quickly, the Suharto government since 1966 has invited foreign investors to help develop new industries and resources. By the end of 1969 the government and foreign business had agreed on the eventual investment of more than a billion dollars in industries other than petroleum and banking (see Table 1). Foreign interest is high in the development of timber, fisheries, and three minerals -- nickel, bauxite, and copper. In total, these industries account for about 80% of the intended new foreign investment. Until recently, their production has been small, with output accounting for only 1%-2% of GNP and about the same share of total export earnings. Production in forestry and fisheries can expand rapidly in the short run. Minerals, on the other hand, require time-consuming surveys

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Table 1

Indonesia: Approved Foreign Investment
by Sector
1967-69

Sector	Intended Capital Investment <u>a/</u>		Disbursements by December 1969 on Approved Contracts <u>b/</u>	
	Million US \$	Number of Contracts	Million US \$	Number of Contracts
Forestry	352.8	35	8.0	25
Fisheries	8.5	6	2.6	4
Mining (excluding oil)	463.2	8	1.6	5
Manufacturing and processing	156.0	97	19.8	48
Others	50.1	31	3.1	10
<i>Total</i>	<i>1,030.6</i>	<i>177</i>	<i>35.1</i>	<i>92</i>

a. As shown in the Letter of Intent, excluding petroleum and banking investments.

b. Excluding domestic capital invested in joint enterprises.

and in some cases the construction of extensive facilities for extracting and processing the ores before production can be increased.

Short-Run Prospects -- Timber and Fisheries

4. During the present five-year plan, which ends in 1974, a rapid increase in exports of forestry and fisheries is expected. Even without full surveys of these resources, it is clear that Indonesia has extensive reserves. The country has about 300 million acres of timber, or about 40% of the forest area in all Southeast Asia. This is ten times the forest area of the Philippines and five times that of Malaysia, the two leading exporters of wood products in Asia.

5. Indonesia has many types of wood that are in world demand. The major portion of the forest

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area consists of tropical or semitropical rain forests located on the islands of Kalimantan, Sumatra, and West Irian. These tall, dense forests contain literally thousands of tree species, mainly evergreen broadleaf species which yield hard, heavy timbers (see the map). About one-half of the trees on Sumatra and Kalimantan are hardwoods of high commercial value. These two islands are said to be the last frontier in Southeast Asia of the Lauan-type wood that has been in great world demand from the Philippines. In addition, as much as one-half of the forests of the Celebes, Moluccas, and West Irian consist of giant damars which are suitable for veneer, plywood, pulp, and matches. Among the less abundant but better known species are rattan, bamboo, ebony, sandalwood, and oak as well as extensive stands of pine on Sumatra and teak plantations on Java.

6. The government, which owns most of the forest area, has opened 100 million acres for exploitation, most of which is judged to be relatively accessible. Present logging activities cover less than 12 million acres. Of the 100 million acres, 60 million acres are categorized as productive forests and the rest as suitable for clearing and subsequent agricultural production. The government has also designated a major share of the forest area as protected forests in order to conserve watersheds and prevent floods and erosion, such as have occurred in Java and the Philippines as a result of overcutting in certain areas.

7. The timber industry of Indonesia is booming at present, mainly because of private foreign investment which is coming in at an increasing rate. During 1967-69, 35 foreign investment contracts were signed involving about one-third of all intended foreign private investment in Indonesia other than that in petroleum and banking (see Table 1). Of the 35 contracts, 22 were signed in 1969. From 1 January to 31 March of this year, another 22 contracts were signed, bringing the total to 57 with an eventual investment of over \$500 million in both extractive and processing facilities. Indonesia has still more requests under consideration. Most of the contracts have gone to Far Eastern countries, with the US companies getting five and European countries seven. Philippine companies have been the most active -- some 15 contracts going to ten companies, with

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one contract alone accounting for about half of the total investment. Japanese companies have also obtained a number of contracts (see Table 2).

Table 2

Indonesia: Private Foreign Investment
in Forestry
January 1967 - March 1970

<u>Number of Companies</u>	<u>Country of Origin</u>	<u>Number of Contracts</u>	<u>Value (Million US \$)</u>
10	Philippines	15	276
10	Japan	12	54
7	Malaysia	8	18
5	United States	5	88
4	France	4	2
3	South Korea	5	56
3	Hong Kong	3	10
2	Singapore	2	2
2	United Kingdom	2	1
1	Netherlands	1	1
<i>Total</i>			
47		57	508

In total, contracts already signed involve about 25 million acres, or about one-fourth of the exploitable area. Most contracts are joint enterprises between foreign and domestic firms, both public and private, but a substantial number are straight foreign investments. In addition to foreign contracts, there have been about an equal number of contracts allocated to domestic companies since the new Domestic Investment Law was passed in 1968.

8. Indonesia is having no trouble finding markets for its timber products, particularly in Japan, and its exports have increased sharply in the past two years. World exports of broadleaf roundwood increased more than tenfold in the past decade and are expected to continue increasing at a high rate. Yet Philippine exports have stagnated

in recent years, partly because of concern about overcutting and attempts to restrict certain logging operations. Indonesian operations are just getting under way -- about \$8 million had been invested in 25 contracts by the end of 1969, as indicated in Table 1, and at least ten companies exported timber by the end of the year. In 1969, Indonesia's exports went to Australia, Taiwan, and South Korea as well as to Japan, which had been Indonesia's sole external market in 1967. Although Indonesian export data are not exact or complete, it appears that exports of teakwood and junglewood climbed from a declining volume during the early 1960s, as shown in the following tabulation:

	<u>Export Volume of Teakwood and Junglewood (Thousand Cubic Meters)</u>	<u>Value of All Forestry Exports (Million US \$)</u>
1960-65 annual average	110	1.5
1966	N.A.	6.5
1967	800	16
1968	1,500	25
1969	3,300	66
1973 Plan	5,000	120

9. With this production record and excellent investment prospects, timber exports should far exceed the planned output by 1973. New investments in timber in 1970 are estimated at \$50 million to \$75 million, and the total will continue to increase rapidly. In addition, the five-year plan (April 1969-March 1974) includes expenditures of ten billion rupiahs (\$25 million), or about 1% of the development budget, for surveys, research, training, and marketing projects in forestry, with emphasis on expanding processed forestry products for domestic and foreign markets. By 1973 the Indonesian plan also calls for exports to include some higher value sawn lumber, which has been insignificant in the past. Already, exports in 1970 are expected to reach \$75 million to \$95 million.

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In total, timber exports could reach ten million cubic meters of roundwood worth perhaps \$200 million to \$250 million by the end of the plan period.

10. The prospect for increased fish exports is less dramatic in absolute terms, but the increase could be substantial in the short run. The major problem is the industry's technological backwardness. Marine fishing is now mainly carried on by single fishermen using small sail boats and primitive methods. The country also lacks modern equipment to transport, preserve, and process the catch. At present the annual catch amounts to about 15% of the estimated potential catch. It is estimated that six million tons* (valued at \$600 million) of marine fish, including large amounts of tuna and shrimp, could be taken from the millions of square miles of seas surrounding the Indonesian islands. In addition, various marine products such as mollusks, seaweed, pearls, and mother-of-pearl are abundant in these waters. Marine fishing in recent years has yielded only about 800,000 tons and inland fishing less than 500,000 tons. Domestic consumption is estimated at only 25 pounds per capita annually, and exports in 1968, amounting to about 7,500 tons, exceeded imports for the first time. Exports again increased in 1969, to \$2.3 million, of which \$2 million was shrimp, compared with total fish exports valued at \$1.3 million in 1968.

11. The increased exports in 1969 reflect the initial inflow of foreign capital and technology, although this inflow has been beset with difficulties. Administrative delays and protests from local fishermen have hampered foreign and joint investors, but four of the six approved contractors had invested nearly \$3 million by the end of 1969 (see Table 1). Of the six approved projects and of the numerous proposals still awaiting approval, shrimp fishing is the most popular (already involving Japanese, Philippines, and US interests), and other approved projects include pearl, lobster, and tuna fishing and a cold storage plant. Indonesian government officials forecast that foreign investment in fisheries will total \$30 million by the end of 1973. So far, however, foreign investors have made few onshore disbursements, their

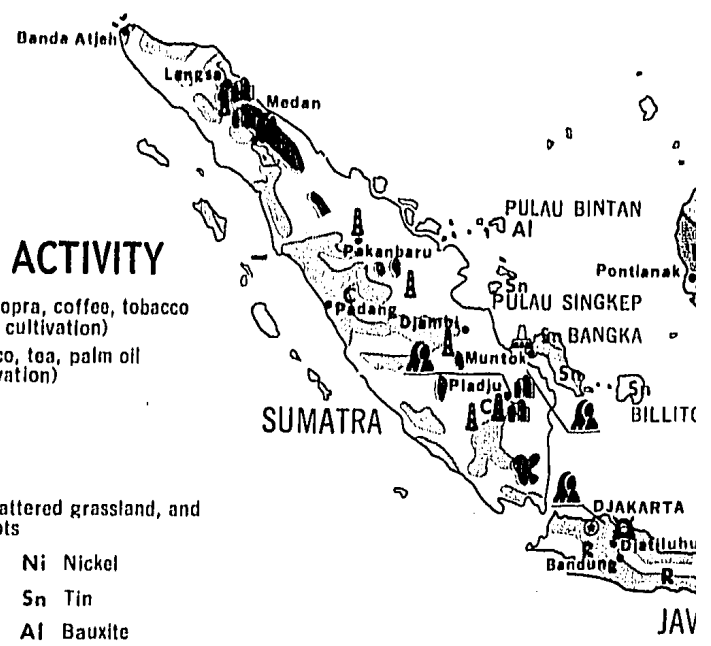
* *Metric tons are used throughout this memorandum.*

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ECONOMIC ACTIVITY

- Rubber, rice, copra, coffee, tobacco (smallholder cultivation)
 - Rubber, tobacco, tea, palm oil (estate cultivation)
 - Rice
 - Rice and corn
 - Copra
 - Forest, with scattered grassland, and cultivated plots
- | | | | |
|---|--------------|----|-----------|
| R | Rubber | Ni | Nickel |
| C | Coffee | Sn | Tin |
| | Oilfield | Al | Bauxite |
| | Oil refinery | C | Coal mine |
| | Tin Smelter | Cu | Copper |
- Thermo electric powerplant
 - Hydroelectric powerplant



VEGETATION

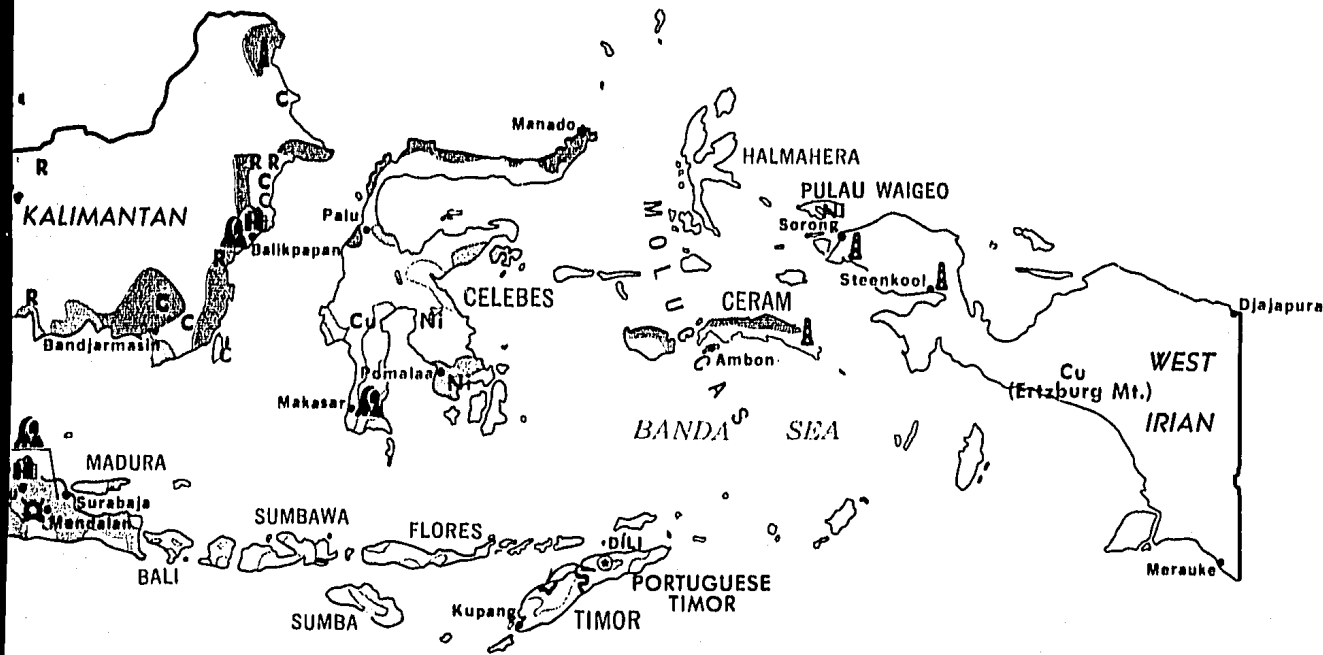
- Broadleaf evergreen forest
- Broadleaf deciduous forest
- Swamp forest
- Mangrove and nipa palms
- Alpine vegetation
- Grassland
- Cultivated area



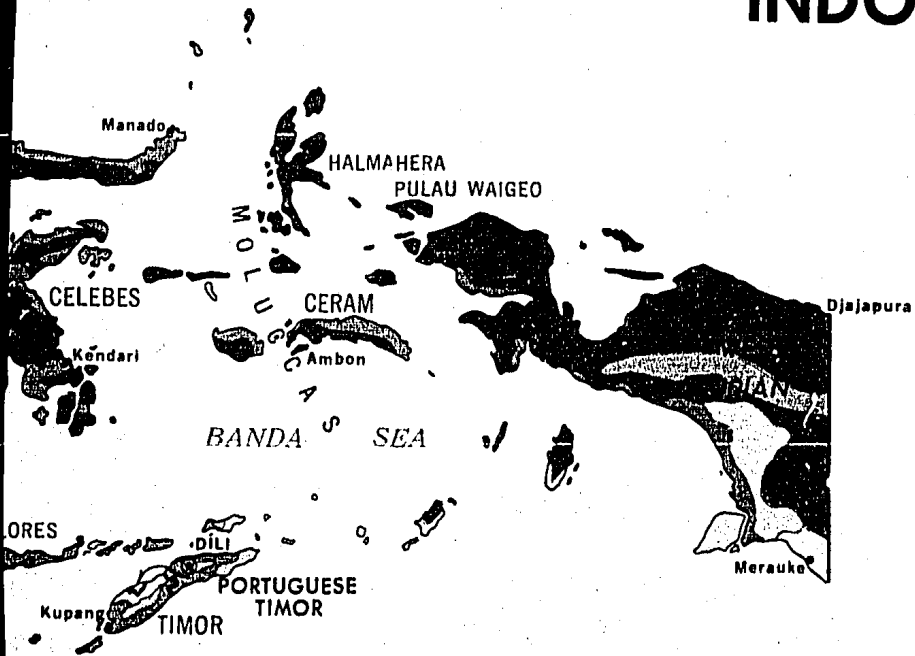
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activities being largely limited to catching and freezing at sea for deliveries to foreign ports.

12. Indonesian development expenditures and foreign grants will also improve the fishing industry. The five-year plan scheduled ten billion rupiahs (\$25 million) for sea fishery development, with emphasis on research, education, processing, distribution, and marketing. Appropriations from domestic sources for the first two years have been equivalent to about \$1.5 million each year. Foreign grants are an important addition. The United Nations Development Program gave \$2.2 million for fishery training; and the World Bank has made a survey in preparation for a \$4 million grant. The Dutch and French governments have made grants for fishery research, and very recently the Japanese government also agreed to a \$5 million loan for fisheries projects in three areas of Indonesia in exchange for lucrative fishing rights in the Banda Sea. Altogether, it seems quite possible that fish production will increase rapidly and that exports could very well grow by several million dollars each year, making fish a significant export commodity.

Long-Run Prospects -- Copper, Nickel, and Bauxite

13. Prospects are good that by about 1973 mineral exports will also begin to make a substantial contribution to export earnings. Indonesia has been exporting small quantities of bauxite and nickel for many years, but it is development of new reserves of these and other minerals, particularly copper, that holds big prospects for the long run. At present, bauxite is produced by a single mining venture on Bintan Island near Singapore where equipment, inherited from the Dutch, is old but well maintained. Nickel is produced in the Celebes, mainly as the result of a production-sharing contract signed with the Japanese in 1962. Crude ore production in 1969 amounted to 225,000 tons of nickel and 780,000 tons of bauxite; together the exports were valued at about \$7 million and went mainly to Japan. Additional deposits of these and other minerals, including tin, are known or suspected (see the map), but much surveying and testing needs to be done. The Dutch made extensive surveys and explored only about 10% of the prospective mineralized area in detail; only half of this is being exploited.

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14. As in the case of forestry and fisheries, new foreign investments are the major reason for the improved outlook. So far, domestic investment and foreign aid are insignificant in this field. From January 1967 through May 1970, nine foreign investments were approved, five of them in 1969 and one in 1970 (see Table 3). Seven of the nine projects call for straight foreign investment of about \$75 million each, mainly for exploration. If commercial deposits are found, the amount of the investment could go higher. This has already happened in the case of the Freeport Sulphur project which was the first foreign investment approved by Indonesia in 1967. The company is now undertaking investment of some \$120 million to exploit copper in the Ertsburg Mountains of West Irian, where engineering surveys proved reserves of about 32 million tons of good-quality copper ore as well as substantial quantities of gold and silver. Early this year, the company signed a contract to supply a Japanese consortium with 55,000 to 60,000 tons of copper concentrates annually for 13 years, beginning in 1973. At current world prices, Indonesia's copper exports could reach \$75 million in 1973.

15. Nickel appears to have an equally bright but slightly more distant future. The first of the three projects in nickel exploration was awarded in 1968 to the International Nickel Company of Canada (55% US-owned). The area involved, located just north of the presently exploited area in the Celebes, is believed to contain 50 million to 150 million tons of ore of at least 2% nickel content. If so, this ore will constitute an exceedingly valuable deposit. The company estimated shortly after signing the contract that annual production beginning in 7-12 years would be worth \$50 million at 1968 prices. Two other nickel development projects are located in areas of known nickel deposits. There are also two developments favorable to Indonesia in its current nickel mining operation. The price of nickel in Japan, which receives all Indonesia's production, was raised by 50% in late 1969, and the Japanese company doing the mining in Indonesia is studying deposits near the present mine and is expected to announce soon whether it considers these deposits exploitable.

16. Exploration for bauxite in Indonesia and studies of known deposits are now under way by Alcoa.

Table 3
Indonesia: Mineral Projects
Approved by the Foreign Investment Board

<u>Name of Enterprise</u>	<u>Type of Financing</u>	<u>Year Approved</u>	<u>Mineral</u>	<u>Area of Operations</u>	<u>Intended Capital Investment (Million US \$)</u>
Freeport Sulphur Company (US)	Straight	1967	Copper	West Irian	76.5
N.V. Billiton Mij. (Netherlands)	Joint	1968	Tin	Offshore	7.0
PT International Nickel (US-Canada)	Straight	1968	Nickel	Celebes	75.0
PT Pacific Nickel (US-Netherlands)	Straight	1969	Nickel	Waigeo, West Irian	76.5
Alcoa (US)	Straight	1969	Bauxite	Various	76.5
Indonesia Nickel Development Company (Japan)	Straight	1969	Nickel	Molucca Islands	75.8
Kennecott Copper Corporation (US)	Straight	1969	General	Principally West Irian	75.8
Overseas Mineral Resources Development Company (Japan)	Straight	1969	General	Western Sumatra	0.2
Rio Tinto-Bethlehem Steel (UK-US)	Straight	1970	General	Western Sumatra	75 <u>a/</u>

a. Estimated.

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After negotiations lasting about two years, the Alcoa company won rights in 1969 to explore for bauxite reserves in nearly all of Indonesia except on Bintan Island, the site of present production. If Alcoa finds as much as 50 million tons of bauxite reserves and if mining operations go well, they will consider building processing plants within a time schedule of about ten years. Even if the Indonesian ores do not prove out, Alcoa is reportedly considering the construction of a smelter in northern Sumatra to process Australian ores, if the Indonesian government can offer cheap electricity rates from the proposed Asahan dam project. The Japanese are also cooperating with an Indonesian company on Bintan in the study of low-grade ores there to determine the feasibility of a processing plant. In addition to these contracts covering specific minerals, three of the contracts are for general exploration. All three contracts specify that the contractors must pay taxes, land rent, and royalties, and will have a total of eight or nine years to start exploitation of any minerals found in their respective areas.

Problems for Investors

17. While the amount of approved foreign investment and prospects for these industries are impressive, the situation would be improved if there were fewer difficulties for investors. These difficulties have resulted in the withdrawal of some applications, and long delays between application and approval and between approval and inflow of investment. The major difficulties that block the flow of goods and capital fall into two broad categories: first, legal difficulties which are gradually being rectified by government regulations; and, second, physical and human difficulties rooted in Indonesia's economic conditions. Inadequate and antiquated legislation in such fields as laws concerning companies, land, labor, and taxes, and uncertainty surrounding the interpretation of these laws lie at the heart of the first category of difficulties. Among the major obstacles in the second category are the problems of finding local partners and sites, inadequate communication within the government apparatus, and corruption and bureaucratic inefficiency. To some extent, these problems are understandable and expected by investors in most developing countries,

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and in Indonesia in particular. After years of doctrinaire hostility to private foreign investment, the new government has needed time to gain experience in handling foreign investment and has exercised legitimate caution in trying to find the right balance between development, using foreign investment, and protection of national aspirations and resources. Nevertheless, these problems have retarded growth.

18. Procedures required of a forestry applicant, for example, are indicative of the tremendous amount of time and money involved. The main problem in this case is the lack of coordination between regional officials and central government officials processing the application. The applicant first contacts a technical team in the Forest Directorate. After initial discussion and approval, a letter of intent is submitted by the company to the Director-General of Forestry. Before any further action is taken, the applicant must submit proof of his bona fide status and the firm's financial capacity and technical knowledge; provide a statement of the relevance of the project to "society and economic development"; and letters of recommendation, especially from the provincial governor, must be obtained. If the proposed area of operation proves to have no survey records (as is usually the case), the applicant is then required to enter into an agreement with the Director-General to conduct a joint survey. No further action is taken until the final report on the survey is obtained. If the area also happens to be partly under the jurisdiction of the Director-General of Agriculture, the applicant must also present his case to that agency and obtain its prior approval. The number of applications from new investors, despite this lengthy procedure, as well as the number of approved investors applying to expand their concessions, is an indication of the high level of returns to investment in this field.

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Conclusions

19. Export earnings from the new extractive industries will continue to grow rapidly and possibly make a sharp jump about 1973. Forestry and fisheries will be the major growth industries for the immediate future, and their gross foreign exchange earnings may be about \$250 million in 1973, compared with about \$20 million in 1967. Copper exports, scheduled to begin in 1973, could boost the gross export earnings of the new industries to more than \$300 million annually, or about equal to the 1969 deficit on Indonesia's transactions on goods and services. Net earnings, however, are likely to be small at first because of profit repatriation by foreign firms that will account for most of the development of the new industries. The returns to the government will also be limited at first because of generous tax provisions. Nevertheless, exports will continue to expand after 1973, and other minerals resources, particularly nickel and bauxite, will be developed and begin to make their contribution. Net earnings from these industries should be substantial by the end of the 1970s, and thereby reduce Indonesia's dependence on foreign aid.

20. Expansion in these extractive industries will have only limited direct impact on the domestic economy in the short run. Initially at least, the exports will consist of unprocessed raw materials. Most of this activity will be located in isolated self-contained enclaves in the outer islands. Only in these areas will communications, transportation, schools, and other public facilities be developed. Less than 10% of the labor force is now employed in these industries, and the numbers probably will not increase significantly in the short run. Not until processing plants and mills are established, possibly in the late 1970s, will there be significant new employment and an impact on the economy in general. In the long run, developing these industries should be of major economic benefit.