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[redacted]

9 January 1974

MEMORANDUM FOR: [redacted]

THROUGH :

SUBJECT : Memorandum on Indonesian Stabilization

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1. In response to your request of mid-December, [redacted] of this branch has put together the attached blind memorandum on the Indonesian stabilization experience. I believe, given my understanding of the use to which you intend to put it, that this is about the appropriate scope and depth of coverage. [redacted]

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2. There has been considerable published research on aspects of stabilization policies for Asian and other countries, [redacted] For example, the matter of positive interest rates on savings has been dealt with in some detail by Robert Emery of the Federal Reserve Bank, as have facets of the control of money supply expansion in the private sector. The IMF <u>Staff Papers</u> (available by subscription) have included numerous articles on stabilization experience in particular countries throughout the world, as have issues of the IMF's free publication <u>Finance and Development</u>. You may want to check into these items.

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/ Chief
Economic Branch

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Stabilization in Post-Sukarno Indonesia: 1966-73

Introduction

1. Price inflation was a chronic problem in Sukarno's Indonesia during most of the years from 1949, when Indonesia achieved independence from the Dutch, until 1966. The rate of inflation became most severe during the last years of the Sukarno administration and the years immediately following the accession to power of General -- now President -- Suharto in 1966. Although the overall rate of inflation is difficult to quantify in the years prior to 1965 because of insufficient data, the prices of four major consumer goods categories (food, fuel, clothing, housing) at least doubled in each year from 1962 to 1965. The aggregate consumer price index for Indonesia as compiled by the IMF rose from a level of 76 at the beginning of 1966 (September 1966 = 100) to 206 in 1967 and 470 in 1968. By 1969, the policies instituted by the Suharto government had begun to take effect and inflation began to level off.

2. Government policies during the Sukarno administration were the principal fuel of inflation. A swollen national budget, unsupported by any significant increases in real domestic saving, reflected the expenses necessary for keeping the various political factions in line; and this led to

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extravagant military expenditures and the easy extension of credit through an expanded money supply The level of government deficits was also increased by the government policy of attempting to keep the prices of certain consumer commodities (notably rice, fuel, and transportation services) at a level below what would have been reflected by their cost of production.

3. Complicating the attempts to control inflation in Indonesia was the underdeveloped banking system and the thinness of monetization. In a way, this facet of underdevelopment was an implicit "strength" of the Sukarno era because it meant that many of those living in rural areas were attuned to staying out of the rapidly inflating monetary sector and bartering for their needs.* Errors in national policy judgment, however, could -- and did -- produce prompt, large changes in prices; and the small base of financial savings provided no substantial reccurse for subsequent adjustments. When the new government took the reins, it was faced with rationalizing the financial and monetary system in such a way that more of the nation's production and commerce was linked to monetary transactions, a process that, given Indonesia's relative backwardness, was necessarily difficult and slow.

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* Of course, even the farmers suffered the effects of inflation because it required sporadic efforts to reduce imports, and this cut off some of the goods they would otherwise have been able to buy.

4. At the same time, the absence of real growth in the countryside -- caused in part by the disintegration of national commerce under rapid inflation -- combined with increasing public provision of underpriced services to lure many more people into the cities. Given the unattractiveness of Indonesian politics for foreign investors and the paucity of domestic saving, this urbanization only exacerbated the problem of getting production growth in line with that of population. In these circumstances, any sudden move away from consumer subsidies and toward greater saving from income was inevitably going to be a wrench that would cause considerable grumbling against the reformers.

Key Problems Facing the Reformers

5. The government formed under Suharto in 1966 was faced with creating order out of the chaotic situation that had contributed to its accession. The abortive Communist overthrow attempt of 1965 -- in which an estimated 80,000 people were killed -- was symptomatic of the deep-seated ills that had long plagued Indonesia beneath the thin veneer of national unity and mission created by the Sukarno administration. The rampant inflation that had moved out of control by the beginning of 1966 and the pervasive lack of confidence exhibited by the public toward the government made it imperative that the new administration take prompt, strong measures if it were to maintain its base of support. To cope with the years of

mismanagement under Sukarno, the new government would have to address itself to these key economic imperatives: 1) restoring domestic confidence, particularly in regard to money and financial assets; 2) stimulating domestic production; and 3) coping with the nation's position of international bankruptcy.

6. The economic policies of the Sukarno era had driven the nation's primitive monetary system into dysfunction. The long-standing government deficits and the resulting ballooning of the supply of money had discredited the rupiah both as an instrument in trade and as a store of value. Moreover, as speculation drove prices higher and higher, a serious liquidity problem emerged for domestic producers and traders that the banks could not handle. In this vicious circle, the first priority of the new government was to gain control of the budget and to reverse the deficit-spending policies of the previous administration. This was only part of the problem, however; of equal importance was the necessity to encourage domestic saving to finance investment. In an inflationary milieu such as had been created by 1966, the holding of monetary assets was unthinkable because of the inevitability that their value would fall. What saving did take place was in the form of gold or other commodities expected to remain stable in value or to depreciate at a rate somewhat below that at which the purchasing power of the currency was falling.

7. Lagging domestic production -- partly a function of the shortage of domestic investment in anything other than commodity hoards and real estate -- was a prime contributor to inflation. With rapid growth in both population and labor force, the acute shortage of arable land and productive investment on Java and advanced age of existing capital equipment meant that the marginal productivity of labor had fallen to close to zero in a wide range of activities. Equipment and facilities originally installed by the Dutch had long since deteriorated, and the foreign investment that might otherwise have been available was kept out by the policies of the Sukarno government and the high degree of insecurity faced by a potential foreign investor. In agriculture and some other sectors, unrealistic government-controlled prices had been key disincentives to investment and production increases. Thus, control of government expansionary finance*, incentives for foreign investors, inducements to domestic savers, and new price policies stood out as key issues for policy decisions on stimulating production.

8. Finally, the nation had backed itself into a corner in its trading/debt position with the rest of the world and by 1966 was essentially in a state of international bankruptcy.

* The investment problem would have been somewhat alleviated had the government directed a significant part of its spending to the public-sector placement of productive capital. This did not happen, however, and much of what the government spent outside of civilian salaries, the military, and price-subsidization programs went to monuments and other unproductive projects aimed at creating a facade of well-being.

The massive foreign debt that the nation had accumulated over the years meant that foreign exchange earnings were generally preempted from the purchase of much-needed capital equipment. Rather than capital goods, most of Indonesia's imports were foodstuffs and other consumer non-durables. Many of these, of course, reflected pure commodity speculation by merchants and others long conditioned to inflationary expectations. What would be needed here was some respite from debt service and assurance of continued inflows of foreign capital to help break into the spiral of deepening poverty created by the years of Sukarno-initiated mortgages on Indonesia's future to support national union and political adventurism.

The Indonesian Program

9. The stabilization program, instituted through measures enacted in July and September 1966, was an ambitious, comprehensive plan that appeared to make good economic and social sense. The economic aspects of the program centered around the creation of a balanced budget, interest-rate reforms aimed at increasing financial savings and investable funds, the rescheduling of the foreign debt, and the introduction of a flexible exchange regime that permitted more frequent and realistic devaluation of the rupiah. In addition to these measures, the program took cognizance of the necessity to increase food production, promote exports, and rehabilitate public works and utilities as a vital part of the overall attack on the inflationary problem.

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10. Budget planning for the fiscal year 1967 provided the first real test of the determination of the new government to counter inflation. Given the long history of government deficits having fueled inflation, fiscal/monetary goals would be an important clue to stabilization success. An encouraging feature, therefore, was the choice of a target of only 65% for the increase in the money supply, as compared to an actual increase of nearly 800% between 1966 and 1967. Real government expenditures were projected to remain essentially the same as in 1966, however, and most subsidy programs were to remain intact.

11. Supporting the general thrust of the budgetary measures were programs to create some order out of the chaos of private-sector credit. The first priority in this field, as in the public sector, went to stemming the flow of funds into commodity speculation. At the same time, it was important to effect some meaningful readjustment between banking system interest rates for loans and the prevailing curb rates. This necessitated a raising of loan interest rates; but, because of the need to exercise some hold over the rate of expansion of the money supply, it was not possible to raise rates on savings at the same time. Accordingly, financial policies instituted in October 1966 raised the interest rates on loans from a range around 9 percent per annum to 6.5 to 9 per cent

per month and were supplemented by administrative fees that raised the effective cost to 14 percent per month. In response to alleged credit needs and demands, interest rates were subsequently reduced to the range of 3-5 percent per month.

12. To encourage the inflow of foreign capital the government used both monetary and legal measures. Institution of a more flexible exchange marketing/control procedure permitted effective devaluation of the rupiah during 1967 to about 1/2 - 1/3 of the 1966 official exchange rates* and allowed for easier subsequent adjustments to more accurately reflect Indonesian price performance. This was an important stimulant to exports and a clear sign of more hard-headed attitudes on the part of national leaders. Another important encouragement to potential foreign investors was a law passed in December 1966 that provided liberal incentives and assurances to new investment from abroad**, a reversal from the previous policy. With respect to other foreign interests, most non-Dutch, foreign-owned industrial and trading properties that had been nationalized in 1965 were to be returned to their owners

* Indonesia has had a multiple-rate exchange system throughout the period discussed in this paper.

** These included tax holidays (for corporation taxes, dividend taxes on profits, and import duties on equipment and material needed for the enterprise), assurances on tenure, profit remittances and repatriation of capital, as well as a number of more specific incentives relating to the petroleum and extractive industries.

(a compensation agreement had already been reached for nationalized Dutch properties).

13. The heavy burden of foreign debt that Indonesia had accumulated under Sukarno was also rescheduled. Debt service payments to Western nations falling due during 1967 alone amounted to $250 million. Along with other scheduled payments on old debt, these were spread out on a new time table that extended to 1999. Additionally, the means to facilitate new foreign aid was provided by the formation in 1966 of a consortium of nations known as the Inter-Governmental Group for Aid to Indonesia (IGGI). The consortium closed a foreign exchange gap estimated at $212 million in 1967 and has since been the principal vehicle for supplying Indonesia's foreign exchange requirements.

Early Results

14. Many of the new measures required some recognition time from domestic and foreign private interests or the working out of sharp fundamental changes in the economy and society. Under these circumstances, some lag in policy impact was inevitable. Further, some of the most sensitive programs were judged necessary when the government was not completely sure of its strength at home and were only undertaken because of pressure from creditors or foreign advisors. Inevitably, there was some early heel-dragging, although the Indonesians

generally showed more determination in making reforms than any student of the Sukarno era could reasonably have expected. There was ample evidence that the short inflationary spiral during late 1967 had been precipitated by a rice shortage and had been aggravated by the usual panic and speculative buying. The incident, however, was indicative of other factors, the most important of which were that the government had failed to limit the growth of money supply and had made severe miscalculations in its domestic rice program. Rather than the targeted 65% increase, the money supply ended up growing by over 120% during fiscal year 1967.

15. In April 1968, the government made its move to terminate the policy of administering consumer commodity prices. The break was not complete, as the option was preserved to protect the price of rice to consumers and to continue to make wage payments for military members and government employees in rice. The prices of petroleum products were raised substantially; and, immediately following this action, the prices for transportation services and electricity rose. In addition, realistic adjustments were made to the rice program. These comprised measures to obtain accurate forecasts of yearly production for planning purposes and to pay farmers a price for paddy that took cognizance of current fertilizer prices and provided sufficient incentive and the funds necessary to purchase the inputs for production. The rice program has been

increasingly successful since, although Indonesia remains dependent on PL-480 aid and substantial rice imports each year.

16. It was also apparent that further controls were needed to limit monetary expansion. Early in 1968, well-defined limits to central bank credit expansion were worked out as part of an agreement between the Indonesian government and the International Monetary Fund for a stand-by line of credit amounting to $52 million. Measures were also taken to strengthened the central bank's control over the level of commercial credit in the economy.

17. With better controls over private-sector credit, it proved possible to act on measures to increase both savings in financial institutions and the saving rate itself. After the interest rates on loans had been increased in late 1966, the central bank attempted to muster support within the government to raise the rates being paid on time deposits. A number of government agencies feared, however, that this would push lending rates up further and increase the brake on business activity that the high rates were already causing. Plans for a compromise increase were temporarily shelved in November 1967 following the rice crisis and attendant inflation. By October 1968, the economy had begun to stabilize and the central bank obtained comprehensive changes in time deposit regulations.

Interest rates were raised from 2% to 6% per month for 12 month deposits and from 1.0% to 1.5% per month for deposits under three months. The effective yield to savers was increased by making earnings on savings tax free, and the central bank subsidized the rates by paying one-third of the interest on 12 and 6 month deposits.

Stabilization Progress Since 1969

18. The Suharto economic reforms met with substantial success by 1969. A most heartening sign was a doubling of savings deposits that year, which was followed by further meteoric growth thereafter.* Moreover, after years of stagnation and then decline, exports rose a solid 10 percent in 1968 and a resounding 17 percent in 1969.** During the first six months of 1969, domestic prices and exchange rates were virtually stable and there was widespread feeling that the corner of the inflationary

* The annual savings deposits series is:

	(Billions of rupiahs)
1967-68	1-1.2
1969	2.5
1970	9.1
1971	10.1
1972	12.6
1st Quarter 1973	15.2

** Today Indonesia's exports are running at an annual rate in excess of $1.5 billion as compared to less than $700 million in 1966-67. Through 1971 this export growth was fairly evenly distributed among commodities, but since then the rapid development of oil has pushed it ahead of other lines.

trend had finally been turned. Since that time, the level of prices in Indonesia has been rising at a moderate rate, and the nation's trading position with the rest of the world has been steadily strengthening.

19. On the surface it would appear that the Indonesian anti-inflationary program was largely the application of traditional principles of economic policymaking to a fairly simple sort of inflation in a backward society.* In particular, some aspects of the stabilization measures -- such as positive real interest rates -- represented education of officials to devices that had scarcely or never been applied before in Indonesia. Others -- such as reduction of subsidies -- were sharp changes in existing institutions that proved possible because of frankly unexpected Indonesian administrative vigor and responsiveness to policy advice from creditors. The petroleum case, under the nationalized oil company Pertamina, is most well-known, but as a general rule the Indonesians have been exceptionally adroit at soliciting foreign investment, particularly from Japan and the United States, and assistance from the IGGI. This has been an important facet of the overall program of stabilization.

20. The internal and external stability enjoyed by Indonesia during the last five years has been highly dependent on substantial amounts of foreign assistance, and future

* A notable feature of the Indonesian case is that the labor force, being primarily agricultural, was not cohesive enough to exert pressure for wage and price adjustments.

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economic success will require similar large-scale aid, at least through the current decade. The willingness of the nations comprising the IGGI to extend this aid has been founded upon Indonesia's potential development and the foresight that has been exercised by its leaders in the area of economic policy. The natural resources and investment potential of Indonesia seem to assure the continuance of this aid.