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MEMORANDUM FOR: William H. Bray
Department of the Treasury
Office of National Security
Room 4400
Washington, D.C. 20220

SUBJECT : Briefing Notes on Current Economic Situation in Indonesia

1. In keeping with our earlier agreement, I am forwarding the attached briefing notes on the Indonesian economy for Mr. Simon's use. These materials, presented earlier as an oral briefing for Ambassador-Designate Newsom, are intended to present some of the highlights of recent economic trends. They are not intended as analysis in depth of any particular sector but simply to convey a broad impression of the most striking recent developments.

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Economic Trends in Indonesia

I. Recent History

The present Indonesian administration, which assumed power in July 1966, faced the task of rehabilitating an economy left virtually in ruin after 20 years of Sukarno rule. Sukarno's last seven years -- the years of the so-called "guided economy", beginning with the final ousting of the Dutch in 1958 -- had particularly disastrous effects on all economic sectors. Nationalization left a once progressive and efficient estate sector in a state of decline. Irrational pricing policies and a failure to maintain the irrigation system resulted in food production increases far below the rate of population growth. Manufacturing showed no growth after 1961, as no attempt was made to replace Dutch and other expatriate investments. Virtually nothing was done to tap the country's rich mineral resources. Transport and communications facilities -- never adequate -- were allowed to deteriorate, thus reinforcing a nationwide pattern of market isolation. Meanwhile budget deficits increased enormously. The combination of declining revenues from a stagnating private sector, and increasing expenditures both for chauvinistic display and expanding military and civilian bureaucracies created inflationary pressures of almost unbelievable proportions. The price index rose from a base of 100 in 1953 to nearly 4,000 by the end of 1965. The foreign trade sector in which the Dutch and other foreigners had been predominant, and which had produced a large share of government revenue, showed steady deterioration over the 7-year period. Medium- and long-term foreign debt necessary to finance growing international payments deficits expanded enormously by 1965 to $2.4 billion, 60% of which was owed to Communist countries.

After Suharto's takeover, the government's priority objective became stabilization, a goal that has been consistently and on the whole successfully pursued. Immediate relaxation of exchange controls and the introduction of a more realistic exchange rate were followed in successive years by credit stringency and budget balancing. Public sector investment was concentrated on the most urgent reconstruction needs. Transport services were quickly restored to meet minimal requirements. An internal policy of decontrol, which established near normal market conditions, and intense efforts at restoration of the irrigation system were important factors in boosting agricultural and industrial output. The balance-of-payments position showed steady improvement aided by new measures to encourage foreign investment which drew substantial funds into oil, mining and timber, and large amounts of program and project aid provided through the IGGI, a 9-nation consortium organized to rescue Indonesia from economic collapse. A rescheduling of debt to Western nations was also made possible through the IGGI while similar arrangements were made with Communist countries.

Although many Indonesian officials are inclined to take refuge in the supposed limitless supply of petroleum when the difficult question arises as to development prospects, none would deny the enormity of the problems the country has yet to face. Nonetheless, recent economic performance shows a dramatic improvement over the last years of the Sukarno era. While Indonesian statistics are notoriously unreliable, the following tabulation is adequate as a broad indicator of this progress in recent periods.

Selected Economic Indicators:
Average Annual Rates of Growth

(1960 prices)

	1960-64	1964-68	1968-72
Gross Domestic Product	2.1	3.7	7.3
Private Consumption	2.8	4.6	4.7
Gross Domestic Investment	3.2	3.9	24.6
Exports of Goods and Non-Factor Services	1.2	3.0	19.0
Imports	1.4	4.8	18.1
Agriculture	1.5	1.0	5.3
(Food Crops)	(-0.7)	(3.7)	(2.5)
Mining	2.0	2.0	10.6
Manufacturing	2.5	3.3	10.5
Construction	-5.0	9.1	24.0
Trade	0.5	3.7	12.7
Services	2.5	2.6	5.8
Transport and Communications	0.5	1.3	9.0

II. Current Trends

A. Agriculture

The agricultural sector has played an important role in the economic recovery, but still has managed only to keep pace with population growth. The government's principal long-term problem is to increase food production. Rice, which accounts for 50% of the value of agricultural production and 40% of employment, had shown significant increases in production before the drought-afflicted crop in 1972. Output increased at an average rate of 9% annually from 1967 through 1971, compared to an average annual rate of 3.3% for the previous 4-year period. Growth stemmed mainly from restoration of minimum levels of transport, input supply, credit, and marketing. Fishing and forestry also have shown sizable jumps in output. Secondary crops, however, have grown only slowly, nearly all of the increase occurring in the Outer Islands. Production increases of estate crops, palm oil, sugar, rubber, tea, coffee, and cocoa have been only modest due to the lack of management and trained personnel, the lack of government extension services, and a credit policy focused nearly exclusively on rice.

The Indonesian food problem is almost entirely a Javanese problem. Java, roughly the size of New York State, accounts for about 6% of the nation's land area and for about 65% of its 126 million people. A population density of some

1,300 persons per square mile makes it one of the most over-crowded places on earth. Opportunities for increasing cultivated acreage have long been exhausted. Indeed, rice acreage has not increased in ten years. All production increases have had to depend on raising yields. This has been accomplished in recent years by the rehabilitation of irrigation systems, more intensive use of high yielding varieties, and more liberal agricultural credit policies. Although enthusiastic acceptance of family planning programs is a hopeful sign, some observers believe that the Java situation poses nearly insurmountable problems of poverty, land fragmentation, and pressure on natural resources. There is little doubt that denuding of forest lands in Java for production of dryland crops, such as corn and cassava, has already resulted in serious erosion and watershed damage. A decline in inland fish production has been attributed to more intensive use of insecticides. Efforts at land reform have met with little success. Although there is no reliable data on the extent of land tenancy, a 1960 Ministry of Agriculture estimate put it at 60% countrywide, and even higher on Java. An Agrarian Reform attempt in 1970 was doomed at the start, however, since an owner retention limit of 5 hectares was permitted and, according to one later estimate, only 0.4% of land owners held more than 5 hectares. Thus virtually no land was available for distribution. The average size holding on Java is now put at only 0.7 hectares, which must support an average of 6-7 family members.

Rice -- The country has more or less recovered from the serious production shortfall in 1972 and the subsequent rice shortages in late 1972 and early 1973. Aggressive rice purchases abroad allowed for substantial injections into urban markets through the first half of 1973. Initial government efforts to obtain rice locally from the April-June crop were in vain, however. In July 1973, after it became apparent that the considerable pressures on farmers being exerted through the BUUD (village cooperatives) were ineffective, internal procurement quotas were abandoned.* The government then withdrew restrictions on domestic movement of rice and shifted its release policy to one of stabilization at higher price levels. Shortly thereafter rice finally began flowing to market and the government was able to sharply curtail release operations. The 1973 dry season crop was a good one and by the end of the year private stocks had been substantially replenished.

The 1974 rice outlook is clouded by uncertainty about fertilizer supplies. Preliminary estimates of planting for

* Use of the BUUD to pressure farmers may have seriously harmed the whole concept of cooperatives in Indonesia. Rather than strengthening the bargaining position of farmers as originally purported, the BUUD were used by outside authorities to force extra concessions from them.

the wet season crop (April-June) were favorable, but there is now some doubt as to whether the substantially higher fertilizer import targets -- 1,500,000 tons in FY 74/75 (April-March) compared with 866,000 tons in FY 73/74 -- will be met. Delays and defaults on imports previously contracted for have already been a factor in the current planting season -- though how significant is uncertain. Officials are counting on the oil lever to insure sufficient imports of Japanese fertilizer and are hopeful that adequate supplies will be available for the dry season crop (September-November). In any case, higher domestic rice prices have boosted farmers incentives sufficiently to compensate at least in part for fertilizer shortfalls.

B. Industry

Industrial growth since 1968 has been rapid. Up to this time many problems inhibiting growth under Sukarno had continued to plague industry, mainly a scarcity of foreign exchange and low productivity, partly the consequence of restrictions on laying off surplus labor. This was especially the case in state enterprises that contribute a large proportion of total output in chemicals, fertilizer, cement and basic metals. Growth averaged 15.6% annually between 1968-71, according to national accounts data, but slackened to 9% in 1972, due at least in part to the shortage of raw materials from the agricultural sector. Expansion has been most rapid in import replacing industries such as fertilizer, paper, yarn and assembly operations. Some industries, notably cement and textiles, were hampered by capacity constraints in 1972. The country is still on the threshold of industrial development and growth has been from an extremely low base. Manufacturing accounts for only 9% of GNP and is dominated by a few industries. In 1970 87% of value added was generated in only four sectors: food and beverages, tobacco, textiles and rubber.

High industrial growth rates are virtually assured for the next few years simply on the basis of planned investments, those in progress, and others in train that have yet to reach normal output levels. Government measures also contribute to a favorable outlook. Recent adjustments in credit policy will insure availability of funds to small investors, licensing procedures have been simplified, and industrial estates are now being established. Planned investments indicate most rapid growth will be in textiles, fertilizer, cement, rubber, tires and assembled products. A boom in the construction industry is also apparent from the trend in project approvals.

Extractive industries are also expanding very rapidly. Forestry continues to attract sizable foreign investment, mostly Japanese. Three foreign companies have been granted licenses to mine tin in the Bangka area. Bauxite deposits will also be exploited more intensely; two huge aluminum plants -- a combined $750 million investment -- are now scheduled for construction. Large foreign investments have also been made recently in nickel and copper mining.

C. Fiscal Policy

Until recently stabilization measures imposed severe constraints on the government's ability to mount a strong development program. Inflationary pressures have weakened tax administration and eroded standards of compliance. The potential tax base was thus not realized. A balanced budget meant expenditures had to be trimmed to meet receipts, but the necessity of increasing routine expenditures left insufficient funds available for development purposes.

In the last two years revenues increased as a proportion of GNP from 10.5 to 12.8% due entirely to doubling of receipts from corporation taxes on oil companies. Government receipts from import tariffs declined over the past two years as the composition of imports shifted towards low duty or exempt items (there are generous exemptions on capital goods). Taxes on luxuries are low and conspicuous consumption in Jakarta attests to the fact that high incomes are not taxed effectively. If oil is excluded, receipts as a portion of GNP were stable at 8.4%.

Routine expenditures increased from 8.7% to 9.9% of GNP over the same period. These expenditures have been inflated by salary demands and by the need for heavy subsidies. Since taxes on domestic consumption are less than total subsidies which account for 8% of routine expenditures (18% if petroleum sold domestically at well below world market prices and program aid valued at domestic prices are included), there is a net subsidization of domestic consumers. Provision of rice to government servants is a particularly heavy burden, amounting to some 700,000 tons annually.

Domestic financing of the development budget rose from 37% in FY 1970/71 to 46% in FY 1972/73. The balance was financed by counterpart funds and project aid.

FY 1974/75 prospects are somewhat brighter. Although subsidies required to maintain the price of fertilizer (urea) to farmers under the BIMAS program will increase, rice subsidies should decline substantially. In addition, oil revenues will be sharply higher, increasing the room for expansion in the development budget.

D. <u>Money Supply and Prices</u>

Government measures over the last several years were extremely effective in bringing rampant inflation under control by the end of 1971.* Inflation is once again, however, the government's most serious short term problem. Since mid-1972 monetary expansion has been excessive. Money supply expanded by 50% in the last half of 1972 and by an additional 34% in the first three quarters of 1973. The external sector has been the predominant factor in the expansion. Additional resources flowed into Indonesia at an annual rate of over

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$1 billion during the second half 1972 and the first half of 1973 due to higher prices for oil and other primary exports, rapidly expanding foreign investment and large inflows of short term capital (including Pertamina borrowing). Bank credit to the private sector and to state enterprises became a significant expansionary factor in early 1973 when the demand for funds increased markedly as a result of buoyant construction and other investment activity and the need for larger working balances due to price rises.

The huge growth of the money supply did not appear to be a significant influence on prices until mid-1973. The general price index rose 23% in the last quarter of 1973, but most of the increases were concentrated in food items, particularly rice, which was in very short supply. Imports helped stabilize rice prices through 1973 but a second more broadly based wave of price increases began in May 1973. The consumer price index rose another 23% during the first 11 months of 1973 partly attributable to higher import costs but certainly owing in some measure to monetary expansion.

The government has taken measures to limit the effects of foreign capital inflows on the credit base by raising reserve requirements on non-resident time deposits from 5% to 30% and has made the ceiling on these deposits applicable to non-resident banks. Beyond this, credit control will continue to rely on an Indonesian variant of moral suasion, which has already resulted in the replacement of several bank managers, presumably owing to their performance in executing government policy on credit restraint.

E. Balance of Payments

Indonesian trade has shown an enormous increase over the last two years. Higher production and prices of crude oil, sharply higher prices of other exports, and currency realignments contributed to estimated export earnings of $3.4 billion in 1973, a 150% increase over the 1971 level. Earnings from timber exports were triple their 1971 value due to both increases in volume and higher prices, and the declining trend in rubber exports was sharply reversed in early 1973 due mainly to higher prices. Total earnings from rubber for the year will be nearly double the 1971 level. Earnings for tin and palm oil will also show substantial increases due to higher world market prices.

Imports show a nearly commensurate increase over the two year period due partly to higher prices but also to large volume increases in imports of both food (rice and wheat) and capital goods, the latter reflecting higher levels of project aid and private investment activity.

In 1973 higher payments for non-oil services, primarily investment income and freight charges for the higher level of imports resulted in an overall deficit on net goods and services of $800 million, double the 1971 level. However, an

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appreciable increase in aid receipts (higher project aid more than offsetting the loss of funds under the US PL-480 program) and a considerable jump in direct investment resulted in a substantial improvement in the Indonesian reserve position. Gross reserves, amounting to less than $200 million at the end of 1971, rose to $900 million by October 1973, equivalent to about 4 months of imports.

The outlook for 1974 is quite favorable. Net receipts from the oil sector will rise substantially as a result of the increase in the selling price of crude from $6 to $10.80 per barrel effective 1 January 1974. Prices of rubber should remain high due to world shortages of petroleum-based synthetic rubber. Imports of capital goods and fertilizer will increase but food imports will be substantially less. While debt service payments will be somewhat larger -- these amounted to about 8% of gross exports in 1973 -- increases in foreign aid and private capital inflows will ensure an overall balance of payments surplus of at least $200 million.