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Directorate of Intelligence

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Indonesia's External Finances and Domestic Stability: The Threat From Low Oil Prices

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An Intelligence Assessment

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EA 86-10016
April 1986

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Indonesia's External Finances and Domestic Stability: The Threat From Low Oil Prices [redacted]

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An Intelligence Assessment

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

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Indonesia's External Finances and Domestic Stability: The Threat From Low Oil Prices 25X1

Key Judgments

Information available as of 21 March 1986 was used in this report.

A key problem facing Jakarta during the remainder of the decade, we believe, will be to maintain economic growth so as to dampen social discontent without jeopardizing Indonesia's sound external finances and strong international credit rating. US commercial banks play a major role in lending to Indonesia, holding about 10 percent of that country's $37 billion medium- and long-term foreign debt. The Soeharto government's reluctance to allow foreign investors to move significantly beyond the petroleum industry to play a larger role in the economy, we believe, means that Jakarta will be relying even more on US and other foreign commercial creditors to sustain growth in the next few years in the face of low oil prices. In our view:

- Financial austerity and other prudent economic policies would enable Jakarta to cope with oil price declines to as low as $10 to $15 per barrel without having to reschedule its foreign debt during the next few years.

- However, even oil at $20 per barrel would create serious problems since low oil prices will dramatically slow growth while the growth of the labor force is accelerating, thereby intensifying an already serious unemployment problem.

- A faltering economy and rising unemployment bode ill for domestic stability, although these conditions do not directly pose a serious threat to the Soeharto government. Local suspicions of the Chinese-dominated business class—with its lucrative ties to key government officials—will intensify, and radical Muslim leaders will continue to exploit deteriorating economic conditions. 25X1

We expect the Soeharto government to continue its policy of austerity in the near term, despite parliamentary elections in 1987 and a presidential election in 1988. We believe the regime is willing to run the risk that more fiscal austerity could lead to social unrest because it is confident it can quell any outbreaks before they spread. This confidence stems from Jakarta's control of the country's key political institutions—including political parties, organized labor, and major religious groups—and the reliability of the military and security forces. Entrenched government interests in heavy industry, in our view, make it unlikely that Jakarta will significantly shift its development strategy toward more labor-oriented, export-led growth. Instead, we expect Jakarta to intensify its efforts to expand nonoil exports—even though this course, in our judgment, is flawed because of stiff competition from other regional exporters and incipient trade protectionism in industrial markets. 25X1

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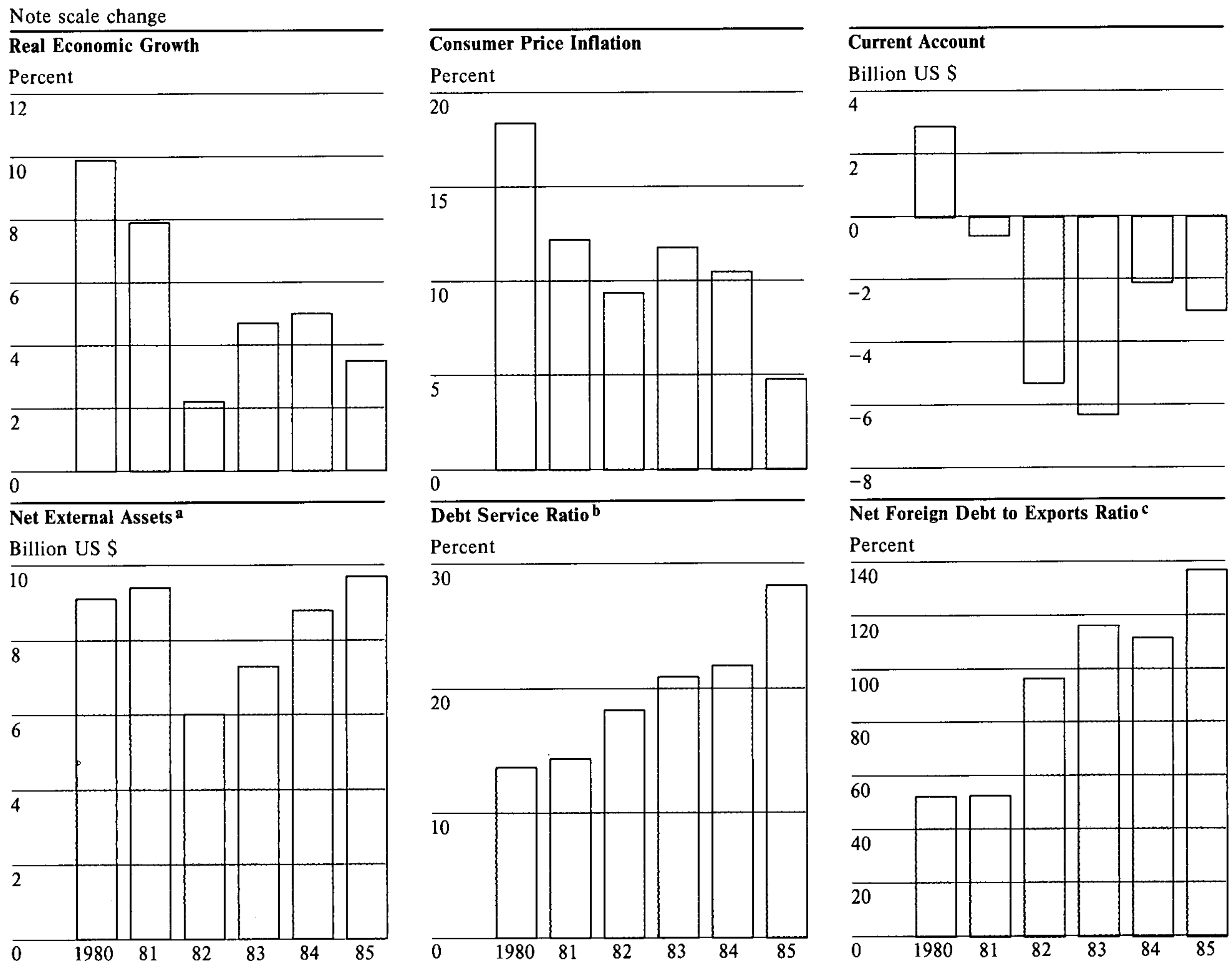
Figure 1
Indonesia: Selected Economic Indicators, 1980-85



[a] External assets include official and unofficial international reserves.
[b] The ratio of interest payments and principal repayments of foreign debt to exports of goods and services.
[c] The ratio of long- and short-term foreign debt less external assets to exports of goods and services.

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Indonesia's External Finances and Domestic Stability: The Threat From Low Oil Prices [redacted]

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Recent Developments

Falling oil prices and anemic export revenues are making it difficult for Indonesia to sustain economic growth, generate employment opportunities, and restrain its massive foreign debt, which we estimate reached $37 billion by January 1986 and placed Indonesia fifth among the largest LDC debtors.[1] Since 1981, the country's external accounts have reeled following oil price declines amounting to $6 per barrel through the end of 1985. As a result of the declines, export revenues have been trimmed significantly, resulting in foreign trade deficits totaling about $13 billion in just four years. A further deterioration of export performance is certain this year following the sharp declines in world oil prices. [redacted]

Because oil and liquefied natural gas account for nearly 70 percent of total export earnings and almost 60 percent of government revenues, a key casualty of weak oil revenues is the country's economic growth, which has declined from an average of 8 percent annually in the period 1973-81 to an average of only 4 percent during 1982-85, according to our estimates. Riots in Jakarta's port district in September 1984 and a spate of terrorist bombings and fires since then, moreover, have put the government on notice that rising unemployment translates quickly into popular dissatisfaction. Unofficial estimates placed the full-time urban unemployment rate in 1984 at over 20 percent and underemployment (workers who are employed fewer than 35 hours per week) at 30 to 40 percent. Of particular concern to Jakarta, [redacted] is that, as in the port riots, unemployment can combine with Islamic fundamentalism to produce sudden and spectacular political fallout. [redacted]

[redacted]

Table 1
Indonesia: Current Account Balance [a]

Billion US $

	1982	1983	1984	1985 [b]
Merchandise exports (f.o.b.) of which	**19.7**	**18.7**	**20.8**	**18.9**
Crude petroleum	12.0	11.9	10.2	9.0
Petroleum products	0.6	1.0	1.3	1.5
Liquefied natural gas	2.9	2.6	3.5	4.0
Wood and wood products	0.8	1.1	1.2	1.2
Rubber	0.6	0.8	0.9	1.0
Coffee	0.3	0.4	0.6	0.7
Textiles and garments	0.2	0.3	0.5	0.6
Merchandise imports (f.o.b.) of which	**17.9**	**17.7**	**15.3**	**14.0**
Consumer goods	1.2	1.7	0.8	1.0
Raw materials	12.5	11.7	10.5	10.6
Fuels	2.7	3.1	2.3	2.5
Agricultural	0.8	0.7	0.5	0.6
Industrial	5.8	5.2	5.1	4.9
Capital goods	3.0	2.9	2.6	2.4
Industrial	2.3	2.5	2.0	1.8
Transport	0.7	0.4	0.6	0.6
Trade balance	**1.9**	**1.0**	**5.5**	**4.9**
Service receipts	1.5	1.2	1.4	1.5
Service payments	8.9	8.6	9.1	9.4
Interest payments	1.5	1.8	2.6	2.9
Service balance	**−7.4**	**−7.4**	**−7.7**	**−7.9**
Transfers (net)	**0.1**	**0.1**	**0.1**	**0.1**
Current account balance	**−5.3**	**−6.3**	**−2.1**	**−3.0**

[a] Because of rounding, components may not add to the totals shown.
[b] Estimate.

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Indonesia's Foreign Debt: Assessing the Burden

Although Indonesia's foreign debt ranks it as the fifth most heavily indebted developing nation in the world, the servicing and repayment burden is, by most standards, relatively manageable. In terms of the ratio of total foreign debt to exports, for example, Indonesia ranks 13th of the 20 most heavily indebted developing nations. Unlike non-oil-producing developing countries, Indonesia's foreign debt exploded in the wake of the first and second oil price shocks in the middle and late 1970s as government development expenditures outpaced surging petroleum revenues. New foreign borrowings were targeted for investment purposes to build up the country's production base, thereby laying the groundwork for economic growth and further increases in exports.

The burden of servicing the debt is nevertheless heavy. In 1985, we estimate that Indonesia's total debt service payments amounted to $5.6 billion, almost twice what was registered just five years earlier. Although this increase was not out of line with the rise in the country's total external debt, there has been some deterioration in Indonesia's overall repayment profile. In 1980, for example, 52 percent of the country's medium- and long-term debt was in the form of concessional financing from official sources—multilateral and government-to-government borrowing. By 1985 this figure had fallen to 45 percent. By comparison, in the four largest LDC debtor nations in 1984 (Brazil, Mexico, South Korea, and Argentina), the percentage of medium- and long-term debt from official sources was 13, 7, 32, and 6 percent, respectively. 25X1

The smaller percentage of Indonesia's foreign borrowings from official sources is mirrored in the pattern of its debt servicing obligations. The average term to maturity on medium- and long-term debt in 1985 was just under five years, compared with over six years in 1980. In addition to accelerated principal repayments, there has also been an increase in the percentage of total debt servicing devoted to interest payments—despite the generally downward trend in nominal international interest rates since 1980. As a result, we judge that in 1985 Indonesia's debt servicing requirements reached 28 percent of its goods and services exports, almost twice that of three years earlier. Net external debt (total external debt less net international reserves) climbed to one-third of GDP, compared with one-fourth in 1982. 25X1

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What Different Oil Prices Mean

The path the economy takes will continue to reflect both the international oil market and economic policy decisions made in Jakarta. To gauge how rapidly the Indonesian economy can grow in different international economic environments and to estimate the likelihood that Jakarta will seek to reschedule its external debt—rather than engage in radical departures in economic policy—we have examined three oil price scenarios.[3] Our conclusions are based on econometric simulations of the Indonesian economy through 1989. We have supplemented our analysis with a logit index of debt rescheduling (see the appendix for a description of this index) that attempts to quantify the probability that the government will seek external debt relief under various oil price and policy assumptions. 25X1

Indonesian crude oil is sold to refiners on a long-term contracts basis; thus, in the first quarter of this year, we estimate that Jakarta earned approximately $24 per barrel on most of its oil, substantially above commonly quoted spot market prices. Accordingly, our best case scenario assumes oil prices of $24 per barrel prevail through the end of the decade. 25X1

In such a case, we judge that Indonesia would retain considerable financial leeway managing its external accounts. Most indicators of debt repayment capacity would be favorable when compared with those regis-

[3] We assume in each scenario that Jakarta will continue its course of debt management, tax policy, and financial reform, and pursue a conservative foreign exchange rate policy in which the value of the rupiah against the US dollar is allowed to depreciate by an average of 7 percent annually through 1989. We suppose modest real increases in total capital expenditures over the next four years in response to sharply reduced government investment expenditures in 1984 and 1985. In addition, we assume modest growth in nonoil exports and global economic recovery by mid-to-late 1987.

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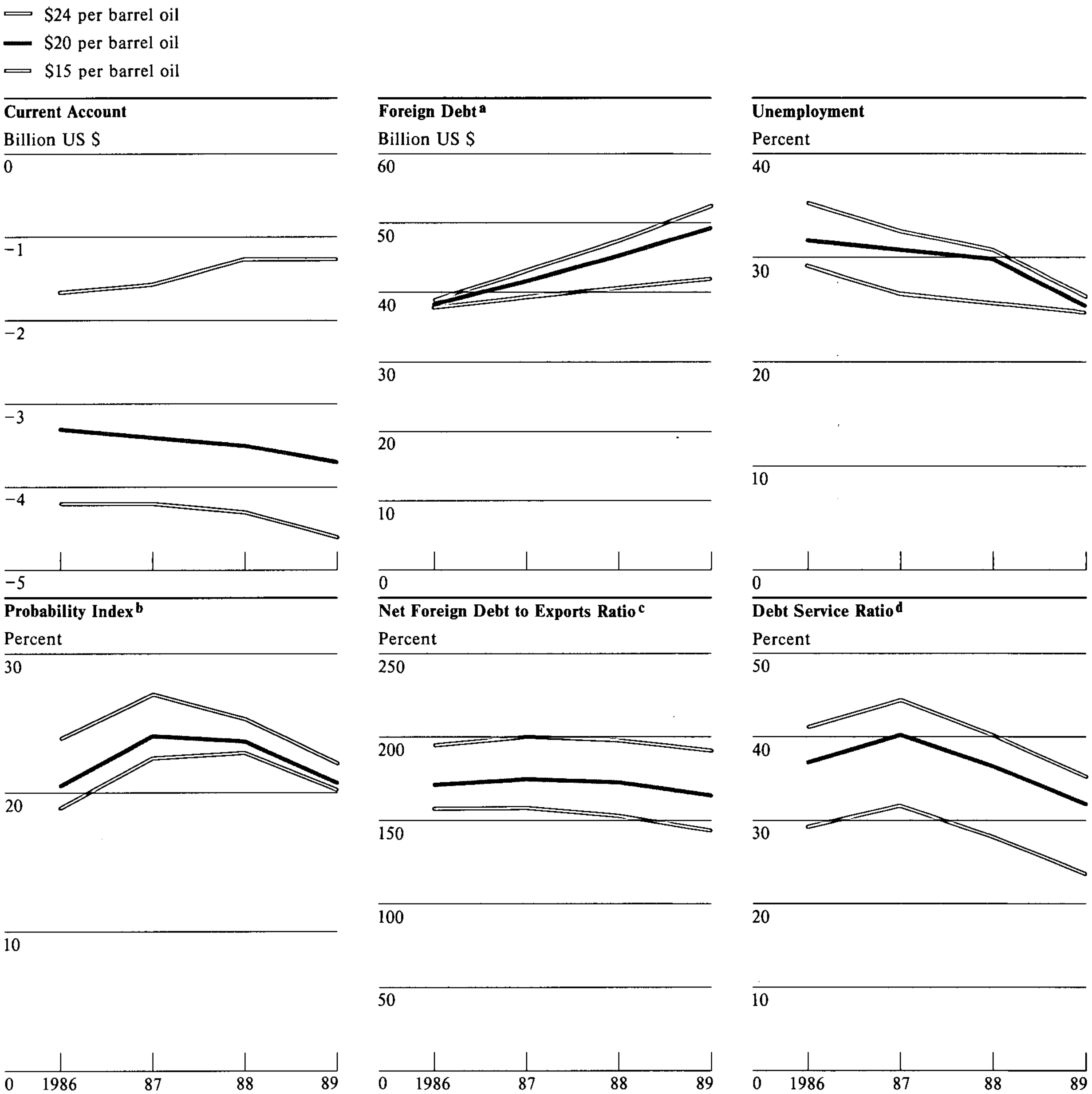
Figure 2
Indonesia: Impact of Changing Oil Prices, 1986-89

Note scale change



[a] Includes long- and short-term foreign debt.

[b] This index is a measure of the likelihood that Indonesia will reschedule its foreign debt.

[c] The ratio of long- and short-term foreign debt less total international reserves to exports of goods and services.

[d] The ratio of interest payments and principal repayments on foreign debt to exports of goods and services.

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World Oil Prices: Downward Pressures

In 1981 the average official OPEC sales price peaked at $34.50 per barrel. Since then, prices have declined by an average of $2 per barrel annually, so that by the end of 1985 the average price was approximately $28 per barrel. The sharp decline in world oil prices at the beginning of 1986 points to continued weakness in world oil markets this year, but the real question from Jakarta's perspective is how far oil prices will fall and where they will stabilize. Whatever the outcome, Pertamina (the state oil monopoly) President Abdul Ramly last December ordered foreign oil companies to boost crude oil production to its limit—roughly 1.6 million b/d, including condensate output, to offset lower prices, according to US Embassy reporting. Jakarta, however, also will need to adjust its pricing policies to remain competitive. Until February 1986, Indonesia had been slow to react to the fierce competition for market share, and this failure has caused oil exports to remain sluggish [redacted] *Moreover, Jakarta's failure to provide adequate investment incentives to foreign companies has reduced exploration in recent years. As a result, Indonesia's capacity to produce petroleum will fall rapidly to 1.2 million b/d by 1990, according to industry estimates.* [redacted]

tered in 1970, Indonesia's last rescheduling episode.[4] Given modest improvements in nonoil export growth, we calculate that 4.5-percent real economic growth would be possible through the end of the decade—only moderately lower than the 5- to 6-percent real growth judged necessary by the World Bank and IMF to stem the growth of unemployment. [redacted]

[4] Examination of numerous other rescheduling episodes over the past decade suggests that countries begin to encounter balance-of-payments difficulties leading to external debt problems when the probability of a rescheduling rises into the neighborhood of 40 to 45 percent. The critical value, however, varies somewhat depending on the underlying economic strengths of the individual case as well as the government's attitude toward its overseas debt commitments. For further details see the appendix. [redacted]

Prior Bouts With Debt Rescheduling

Indonesia has experienced four foreign debt reschedulings in the past two decades, each of which can be attributed to the economic mismanagement of the Sukarno era (1945-65). In 1965, for example, Indonesia's balance of payments was in shambles with the current account deficit reaching $260 million—half of GNP—while net official international reserves were only $17 million—roughly equivalent to nine days' worth of imports. Short-term debt relief measures were adopted by the country's creditors in 1966 to avoid a major rescheduling. It was recognized, however, that the decade of the 1970s would be an extremely difficult period without additional relief. Following a debt restructuring in 1970, in which $2.1 billion in repayment obligations were deferred, Indonesia undertook a conservative policy of foreign debt management. Measures were adopted to spur economic growth, encourage foreign investment, bolster exports, and bring the country's inflation under control. [redacted]

Probably the best remembered debt crisis, however, was the near financial collapse in 1975 of Pertamina. At the time of its reorganization, Pertamina ranked among the world's 200 largest corporations. The company had been caught in a cash bind by overcommitting itself to short-term credits to finance long-term projects. Total estimated debt of the corporation stood at about $11 billion, of which one-third was owed to foreign banks. Although the Indonesian Government undertook to meet all of Pertamina's outstanding foreign obligations, the episode is not generally viewed by international financial analysts as a sovereign rescheduling exercise because Pertamina's debt problems arose from corporate mismanagement rather than from fundamental weaknesses in the balance-of-payments accounts. [redacted]

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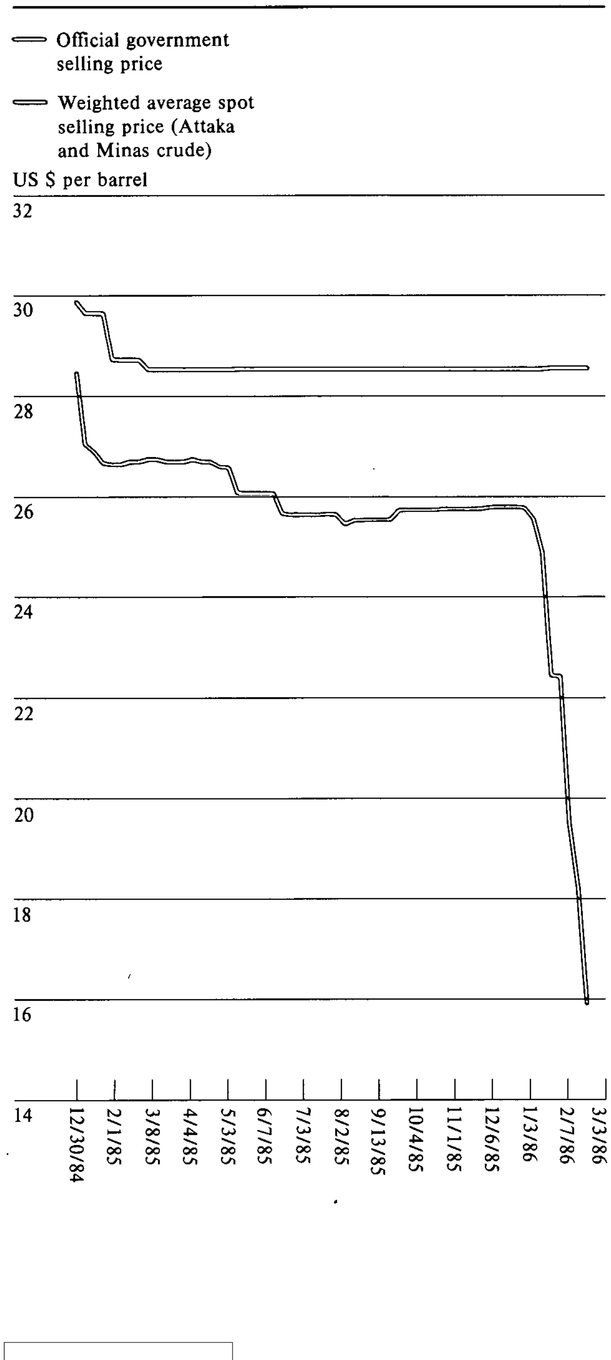
Figure 3
Indonesia: Official Government and Spot Selling Prices



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The real squeeze on Indonesia's external accounts, in our judgment, would begin if oil prices became stuck at $20 per barrel. Our baseline scenario suggests that at this price the country's petroleum earnings would seriously erode, resulting in large and persistent current account deficits, a rapid expansion of Indonesia's foreign debt, and a sharply growing burden of debt servicing. The probability of an external debt restructuring would rise to 24 percent in 1987, before exhibiting gradual improvement as nonoil exports continue normally expected growth.[5] We also expect, however, that real economic growth would begin to slip noticeably, probably to 4 percent annually without expansionary government spending policies, which would aggravate Indonesia's already severe unemployment problem. 25X1

Assuming $15 per barrel oil through the end of the decade, oil revenues would nose-dive, causing a further deterioration in Indonesia's current account. With no dramatic economic policy changes by Jakarta, the result would be an abrupt increase in total external indebtedness, a dramatic slowdown in economic growth, and a sharp rise in the full-time unemployment rate. Jakarta's choice of economic policy in such a case would be between slowing the economy to shore up its balance of payments or risking its debt servicing ability and international credit rating as a result of heating up the economy. In our judgment, Jakarta would be able to cushion the impact of falling oil prices through expansionary fiscal policy, provided that it is willing to accumulate additional foreign debt to fund the inevitable widening of the budget deficit. However, such a policy could set the stage for a rescheduling crisis by the early 1990s. 25X1

How Low Is Critical?

Even Indonesia's normally sanguine Finance Department is assessing the potential impact of $10 per barrel oil on the government's budget accounts, according to US Embassy reporting. In our judgment,

[5] These results are modest when compared with the 1982 debt rescheduling episodes of, for example, Mexico and Brazil, when the probabilities of a debt rescheduling were 72 percent and 68 percent, respectively. 25X1

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Table 2
Indonesia: External Debt [a]

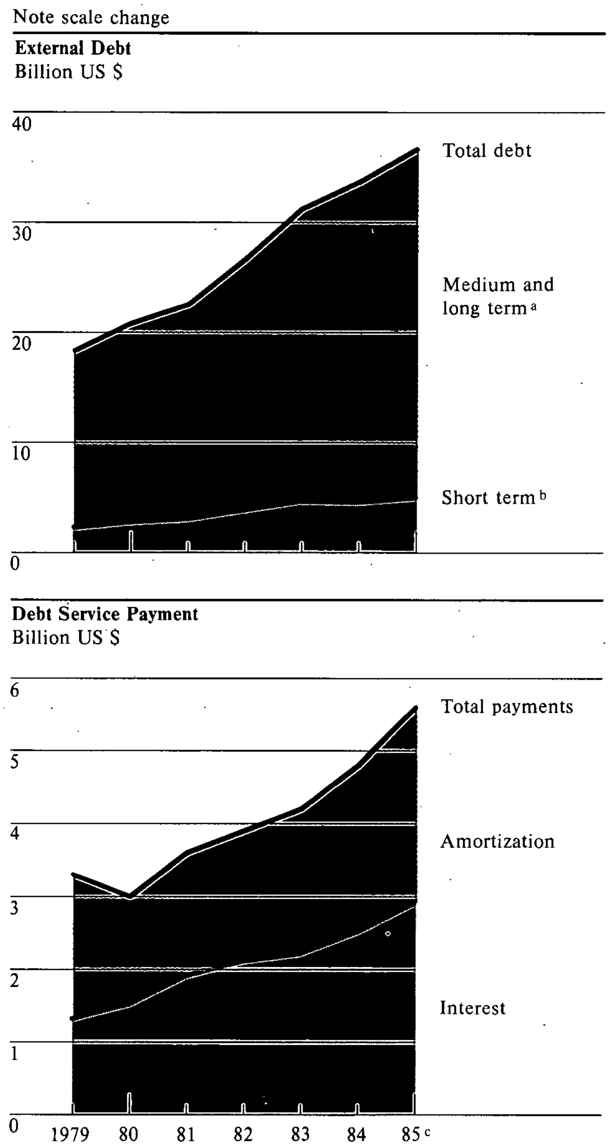
Billion US $
(except where noted)

	1982	1983	1984	1985 [b]
Total external debt (yearend)	**26.6**	**31.2**	**33.6**	**36.6**
Long term	22.8	26.5	29.1	31.7
Public and guaranteed	18.5	21.7	23.4	25.5
Official lenders	11.1	12.0	13.0	14.2
Financial markets	5.4	7.2	7.8	8.5
Other private lenders	2.0	2.5	2.6	2.8
Private nonguaranteed	4.3	4.8	5.7	6.2
Short term	3.8	4.6	4.5	4.9
External assets (yearend)	**7.0**	**8.3**	**9.9**	**10.0**
Monetary authorities	4.2	4.8	5.8	5.9
Commercial banks (net)	2.8	3.5	4.1	4.1
Gold (in million ounces)	3.1	3.1	3.1	3.1
Net external debt	**19.6**	**22.9**	**23.7**	**26.6**
Total debt service	**3.9**	**4.2**	**4.8**	**5.6**
Amortization (actual)	1.8	2.0	2.4	2.9
Public long term	1.1	1.3	1.6	1.9
Official creditors	0.5	0.6	0.7	0.8
Financial institutions	0.4	0.5	0.6	0.7
Suppliers	0.2	0.3	0.4	0.5
Private long term	0.7	0.7	0.8	1.0
Interest	2.1	2.1	2.5	2.9
Public long term	0.6	0.6	0.7	0.8
Private long term	1.0	1.0	1.3	1.5
Short term	0.5	0.5	0.5	0.6

[a] Because of rounding, components may not add to the totals shown.
[b] Estimate.

the stabilizing of oil prices at $10 per barrel would create critical problems for Indonesian economic policy makers. We estimate that by 1987 the probability that Jakarta might seek to reschedule its external debt would exceed 35 percent. Although this value would not mean that rescheduling was imminent, it

Figure 4
Indonesia: External Debt and Debt Service Payment, 1979-85



[a] Including IMF loans.
[b] Including short-term trade financing and short-term borrowing by the central bank and commercial banks to finance international reserves.
[c] Estimate.

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would suggest that close and constant monitoring of Indonesian economic developments was warranted. Real economic growth would barely exceed 1 percent, while urban unemployment could become a social and political time bomb. If oil prices slipped below $10 per barrel, for example to $7 to $8 per barrel, and stayed at that level for six months or more, then foreign debt rescheduling, in our judgment, would be a distinct possibility.

Can Jakarta Steer Clear of Rescheduling?

If Jakarta's recent policymaking record is any guide, we believe the government is well equipped to deal with low oil prices, to shore up the country's flagging external accounts, to assuage the concerns of foreign bankers, and to meet heavy debt service obligations. Recent actions of the Soeharto government in our judgment indicate that it is prepared to make whatever decisions are necessary to maintain its international credit standing. In response to the softening of world oil markets in 1983-84, for example, Jakarta redefined its economic priorities and objectives:

- Policies to promote nonoil exports, such as currency devaluation, banking deregulation, new shipping and customs procedures, and simplified taxation.
- Rephasing large-scale capital- and import-intensive development projects.
- Implementing trade restrictions, particularly on consumer goods imports.

All signs from Jakarta suggest that more austerity is in store to deal with declining oil revenues. In anticipation of an additional 14-percent decline in oil and gas revenues for fiscal 1986, which begins 1 April, President Soeharto in January 1986 announced sharp cuts in the federal budget. At $19.4 billion, the new budget represents a 7-percent decrease over the previous fiscal year—the most austere budget since the early 1970s and one that includes a cut of 22 percent in development spending, the first such cut since 1969, according to the US Embassy.

From a strictly financial perspective, we believe Jakarta still has some breathing room under our $10 to $15 per barrel oil price scenarios, and, in the near term, we judge Indonesia's balance of payments will remain in fair shape. Although foreign exchange earnings will suffer as a result of declining domestic oil production and low international prices, we believe government austerity measures should keep import growth and current account deficits in check. Moreover, the country has ready access to foreign private credit, amounting to about $3 billion in unused credit commitments from commercial banks at the end of 1985. In addition, the government's financial stockpile is substantial with net external assets of the banking system totaling nearly $10 billion at the end of 1985. In our judgment, even if oil prices were to sink to $10 to $15 per barrel, the country's foreign debt would remain within serviceable limits, provided that Jakarta continues to pursue a prudent economic policy of budget cutbacks, rephasing large industrial projects, and adjusting the foreign exchange rate. Under these circumstances, and barring an unanticipated price collapse, we believe it unlikely that Indonesia would request rescheduling of its foreign debt during the next two to three years.

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Moving Into the Late 1980s

The Economic Policy Options

We believe Jakarta's policy options fall into two broad categories.[6] On the one hand, the government can continue to stress its high-technology import-substitution development strategy. Such a policy, however, risks continued slow growth, rising unemployment, and social unrest. If this policy is accompanied by increased deficit spending to create jobs, the result will be higher foreign borrowing, which would jeopardize Jakarta's standing with its foreign creditors and further reduce incentives to cut costs and improve efficiency.

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Jakarta's alternative is to bolster its labor-intensive export-promotion efforts. In the long run, we believe this would enable the government to ease the unemployment situation despite falling oil prices. This

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option, however, entails costs. It would reduce the government's ability to control the economy and threaten inefficient domestic firms with stiff new competition from both domestic and foreign investors. It might also fuel protectionist pressures in industrial country markets and pit Indonesian exporters against firms in the more advanced developing countries that have already gained access to these markets. [redacted]

The Threat to Stability

Whatever course Jakarta chooses, economic growth and political stability will continue to be hampered by soft world oil prices. This year the combination of weak export performance and budget austerity might produce a contraction of the economy to 4 to 5 percent [redacted] Beyond that, we calculate that, at best, economic growth will average no more than 3 to 4 percent for the remainder of the decade. This will coincide with a period when the labor force is growing by 3 to 4 percent per year (adding 2 million new workers to the labor force annually). The combination will result in sharp increases in an already severe unemployment-underemployment problem because the country needs to grow 5 to 6 percent annually to absorb these new workers, [redacted] Although the rising tide of unemployed does not directly pose a serious threat to the Soeharto government, we believe it could exacerbate existing ethnic tensions and threaten widespread social unrest. Indeed, anti-Chinese rioting in Central and East Java in the late 1970s and the Tanjung Priok riots in Jakarta in 1984 are vivid reminders of the social and economic pressures that underlie the normally placid veneer of Indonesian life. In the past, Jakarta reacted to rioting and public tensions by using oil revenues to remedy the symptoms, rather than the causes, of Indonesia's social ills. The regime must now come to grips with the shortcomings of an economic policy that has done little to lay the groundwork for sustained economic growth and relieve the plight of the country's poor. [redacted]

Despite the critical period Indonesia is entering, we believe the Soeharto government calculates that now is not the time for a major change in development policy. For one thing, the regime almost certainly is confident that its control of political institutions—including political parties, organized labor, and major religious groups—together with the reliability of the military and security forces, would allow it to cope with any outbreaks of domestic unrest. Consequently, we judge that the government is willing to ride out low oil prices and slower economic growth with financial austerity because it probably perceives the risk of widespread disturbances as low. The government has indicated during the past year that it will not tolerate dissent of any kind, according to the US Embassy [redacted]. Since mid-1985, Jakarta has tried and sentenced a leading dissident and a former Army general (among others) to 10 years in prison, has executed a Communist Party official who had been under sentence of death since the early 1970s, and has begun [redacted] in some cases restricting, militant speakers in the mosques. [redacted]

We believe the regime is also wary of a fundamental and possibly unsettling change in development strategy as it prepares for parliamentary elections in 1987 and a presidential election in 1988. The prospects for a shift in strategy after this period of intensified political activity also appear unlikely, in our judgment, as long as Soeharto retains the presidency, which he is certain to do in the election.[7] [redacted]

Even if basic reforms in economic policy were enacted, tangible results would take several years to materialize. Instead, we believe that Soeharto will intensify efforts to expand the country's nonoil export markets wherever possible even though, in our judgment, this is an option compromised by stiff competition from other exporters in Southeast Asia and by

[7] Soeharto's health is good and he gives no indication of stepping down. We expect him to seek and obtain another five-year term in 1988 through Parliament's pro forma reelection. [redacted]

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incipient trade protectionism in the industrial countries. Nevertheless, in the past year Indonesia has made direct overtures to expand economic relations with East European countries, reestablished direct trade ties to China after a 20-year freeze, [redacted]

Indicators To Watch

As dim as we judge the prospects for a dramatic shift in development policy, we cannot rule out the possibility entirely. We believe that the path the government probably would take in such a case would include measures to deregulate the economy on a broader scale than it has undertaken so far. We believe this would be a sign that Jakarta was beginning to think more seriously about how to adjust to lower oil prices, the rising foreign debt, and slower economic growth. Indications of such a shift would include:

- Efforts to encourage private domestic and foreign investment to make up for shortfalls in public investment funds. Nonoil exports, for example, have suffered from domestic protectionist measures—primarily nontariff barriers such as import licensing and quota restrictions—designed to increase local content in selected manufactures and protect uncompetitive upstream industries.

- Efforts to remove redtape, bureaucratic inefficiency, and corruption that have squeezed investment opportunities. Despite public pronouncements to the contrary, we anticipate little near-term improvement because of latent government misgivings about an independent private sector, ethnic resentment of local Chinese business activities, and nationalistic objections to foreign involvement in domestic economic activity.

- Efforts to encourage financial reform. Despite attempts at reform, Indonesia's financial markets remain poorly developed—concentrating on short-term deposits and lending, rather than the long-term financing required for major development projects, [redacted] Bond and stock markets, which could mobilize long-term financing for investment, have yet to take off. Moreover, Indonesia is vulnerable to capital flight and [redacted] must offer higher interest rates to keep deposits, thereby making bank credit expensive. [redacted]

Implications for the United States

Indonesia's uncertain economic prospects bear directly on bilateral economic relations with the United States in at least two important areas, international finance and foreign investment. US commercial banks would be directly effected in the unlikely event that Jakarta seeks to reschedule its foreign debt. At the end of 1985, these banks held roughly $3.3 billion of Indonesia's medium- and long-term foreign debt—equal to 25 percent of that country's foreign bank borrowings. [redacted]

US firms, we believe, are interested in playing a larger investment role in Indonesia if and when the government moves ahead to improve the investment climate, and, in particular, the prospects for investing in nonoil activities. Until now, US direct investment has been concentrated almost exclusively in developing the oil industry. Nevertheless, there are other industries that the Indonesians want to develop to diversify the economy. One faction in the government, for example, is pushing for a high-technology industrial development strategy that would encourage metal-working industries and the development of manufacturing capabilities in such industries as aircraft, ships, vehicles, and machinery. Part of the problem, however, is Jakarta's schizophrenic attitude toward foreign investment. Despite Jakarta's oft-repeated claims of openness to foreign investment, many Indonesians (including high-level government officials) remain opposed to foreign investment [redacted] Until its domestic policy dilemma is resolved, Indonesia, in our judgment, will remain overly dependent on foreign borrowings from US and other commercial creditors, although foreign investment could ease this dependence somewhat and reduce the possibility of a debt crisis later in the decade. [redacted]

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Appendix

Predicting the Probability of Debt Rescheduling

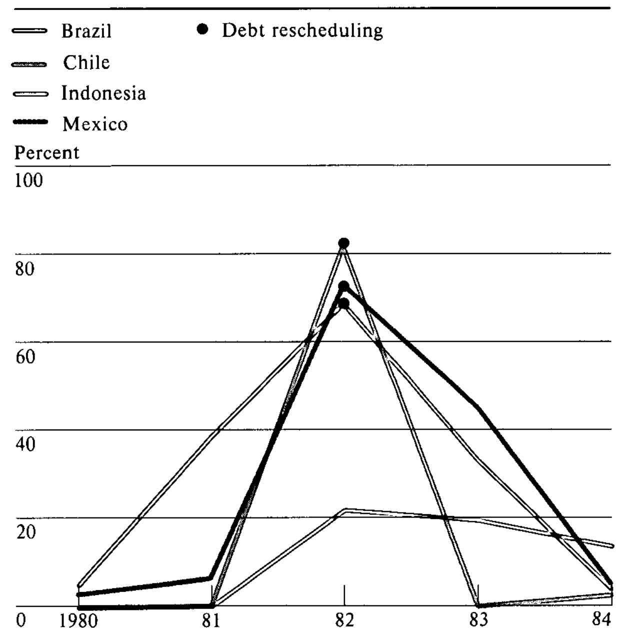
Balance-of-payments and debt analysts employ a variety of indicators to evaluate a country's overall repayment ability. Traditionally, such assessments involved two important technical steps: the selection of risk indicators and the choice of a formula to grade or rank economic strengths and weaknesses. Among the most frequently used indicators are the ratio of total debt service payments to exports of goods and services (the debt service ratio) and the ratio of international reserves to imports of goods and services (the liquidity ratio). Unfortunately, criticisms have been leveled at the arbitrary nature of the use of these indicators, particularly the presumption that any one indicator is capable of capturing the elements underlying potential balance-of-payments problems. 25X1

To deal with these criticisms, statistical techniques have been developed to make the process more objective. We believe one such technique, logit analysis, is particularly useful in objectively quantifying the likelihood that Indonesia will seek multilateral debt relief arising from declines in oil prices and export revenues. Logit analysis is an econometric technique that generates a function of economic and other variables believed to influence countries in their decisions to restructure their foreign debt. The advantage of logit analysis over nonstatistical methods, in our view, is that the sample data, rather than subjective judgment, determines the statistical weights (that is, the relative importance) that are attached to each indicator. 25X1

The model explicitly considers the demand for rescheduling by the borrower as well as the risks and financing constraints faced by the creditor. The explanatory variables found to be statistically significant include:

- The growth of real per capita income.
- The ratio of net official and net unofficial international reserves to imports of goods and services—the liquidity ratio.
- The ratio of total external debt less international reserves to exports of goods and services.
- A history of previous rescheduling episodes.

Figure 5
Logit Index of Debt Rescheduling



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- The ratio of amortization payments to total external debt.
- The ratio of trade surpluses of oil-exporting countries to global imports as a proxy for the supply of credit. 25X1

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We estimated values for these variables using data for 19 countries covering the period 1979-84; 12 rescheduling and 95 nonrescheduling cases. The appendix figure illustrates the output of the estimated model by portraying the probabilities of debt rescheduling for four countries during 1979-84. 25X1

Interpreting these values requires comparing them to some baseline value, because the higher the logit value the greater the likelihood that a rescheduling will occur. Many financial analysts use 50 percent as the baseline value, which suggests that estimates approaching this figure warrant serious concern. According to this baseline, the predicted probabilities provide a relatively favorable evaluation of Indonesia's financial health. 25X1

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