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DIRECTORATE OF INTELLIGENCE

Intelligence Memorandum

Indonesia Under Subarto: Economic Progress And Problems

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ER IM 70-71
May 1970

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Directorate of Intelligence
May 1970

INTELLIGENCE MEMORANDUM

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Introduction

Indonesian President Suharto has devoted much of his time and energy in an effort to surmount the economic chaos inherited from President Sukarno. Progress has been noteworthy, considering the deteriorated state of the economy. Price stability has been restored and an improved investment climate has renewed interest in exploring Indonesia's mineral potential. But there are still serious obstacles to overcoming the country's present economic stagnation. This memorandum reviews Indonesia's economic progress under Suharto and evaluates the prospects for accelerated economic growth. It also assesses Indonesia's foreign aid needs during the early 1970s.

Economic Performance Under Suharto

1. When the Sukarno era came to an end in early 1966, the Indonesian economy was a shambles. Per capita agricultural production was lower than before World War II. Inflation was out of control, the rupiah was virtually worthless, and the foreign debt repayment schedule was clearly beyond Indonesia's capability. Almost all foreign-owned plants and plantations had earlier been taken over without compensation. Consequently, practically all new

Note: This memorandum was produced solely by CIA. It was prepared by the Office of Economic Research and was coordinated with the Office of Current Intelligence and the Office of National Estimates.

foreign private investment had come to a halt and foreign skilled manpower had departed the scene. Moreover, much of the country's infrastructure -- including transport facilities* -- was in serious disrepair after years of neglect.

2. Soon after assuming power in early 1966 the new leadership under then general and now President Suharto reversed Sukarno's policies and formulated a program aimed first at stabilizing and then rehabilitating the economy. The country's isolation from the West was ended, new laws were passed to insure favorable treatment for foreign investors, and numerous nationalized properties were returned to their former foreign owners. In 1966 the International Monetary Fund (IMF) was asked to help develop policies and marshal funds to bring the economy under control. As part of the stabilization process, inflation was to be stopped, government expenditures were to be brought into balance with revenues, and the balance-of-payments deficit was to be reduced to manageable proportions. To help achieve these objectives, a consortium of Western aid donors agreed to provide large doses of foreign aid. In addition, repayments on Indonesia's massive medium-term and long-term external debt to both Western and Communist creditors were postponed.

3. Since 1966, substantial progress has been made in stabilizing the economy. Spiraling inflation is now under control -- during 1969 prices rose by only about 10% compared with about 650% in 1966, 120% in 1967, and 85% in 1968. The improved monetary performance was largely a result of massive aid inflows -- more than $900 million during 1966-69 -- mainly in the form of consumer goods (see Table 1). Nearly 40% of the aid came from the United States and about one-fourth from Japan. Chiefly because of a better tax collection effort, budgetary performance has improved markedly. The budget was about balanced in 1968 in contrast to a deficit amounting to about four-fifths of total revenues in 1965.

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Table 1

Indonesia: Foreign Aid Commitments and Disbursements

Million US $

	Commitments				Disbursements			
	Jun-Dec 1966	1967	1968	1969	Jun-Dec 1966	1967	1968	1969
United States	45.8	57.5	131.5	221.8	37.7	50.1	113.2	145.0
Japan	40.0	60.0	110.0	120.0	40.0	50.0	61.1	62.7
Holland	17.3	33.3	26.2	44.1	--	25.0	17.1	34.8
West Germany	7.5	31.6	19.5	31.8	4.0	32.4	14.9	15.6
France	--	1.0	13.2	14.2	--	1.7	1.4	11.7
Other	17.0	15.3	62.3	130.8	3.0	84.6	57.4	45.6
Total	*127.6*	*198.7*	*362.7*	*562.7*	*84.7*	*243.8*	*265.1*	*315.4*

4. Although stabilization has been successful, little progress has been made in getting the economy moving. During 1966-69 the gross national product in real terms probably increased at only about the same rate as population -- 2.5% to 3% annually -- and per capita income is still less than $100.

5. The continuing slow pace of economic expansion largely reflects the inability to increase output in agriculture, which accounts for roughly 50% of the gross national product. The only significant gain was a 10% increase in 1968 in production of rice, the major food crop, and this primarily reflected increased acreage and favorable weather conditions. The rice crop rose only slightly in 1969, and output of other food crops was below 1966 levels, apparently because of reduced acreage. Output of export crops, especially rubber and copra, also has been largely stagnant. Manufacturing production has risen in recent years, but it still accounts for too small a share of the national product to have much effect on overall economic activity.

6. Although the Suharto government has had considerable success in attracting new foreign investors to develop the country's mineral and other resources, most of the new projects are still in the exploratory stage and so have not yet had any significant impact on the economy. About 180 foreign firms, excluding oil companies, have signed preliminary agreements which, if carried to fruition, would amount to a total investment of more than $1 billion. Over 80% of the intended investment is in mining and forestry operations. The problem is that extensive surveying and exploration remains to be done before large-scale operations are undertaken. In the case of crude petroleum, substantial benefits have begun to be obtained, partly because the industry was not nationalized by President Sukarno. Output reached 750,000 barrels per day in 1969 -- about 50% higher than in 1967 -- and investment in the industry is now amounting to about $100 million annually. Agreements with some 30 foreign companies to explore the country's oil resources have already been reached and expectations are high that important new oilfields will be found. Rising petroleum production, however, has had little impact on the economy. As elsewhere, oil exploration is essentially an enclave activity, and most equipment is

obtained from abroad. The rise in exchange earnings from oil exports has served to reduce somewhat Indonesia's foreign aid needs.

Prospects for Accelerated Growth

7. With stabilization goals mainly achieved, Djakarta expects during the next few years to shift its priority to promoting economic development. A five-year development program (1969-73),* begun in April 1969, sets goals that imply an overall economic growth rate of about 5% annually. The development program places chief emphasis on agriculture and calls for self-sufficiency in food production by the end of the five-year period.

Indonesia : Basic Economic Data
1969

Population	118 million
Population density of main islands (Persons per square mile)	
Java and Madura	1,500
Sulawesi	120
Sumatra and adjacent islands	105
Kalimantan (Borneo)	20
Other Islands	40
Per Capita Income	Less than $100
Exports	$975 million
Imports	$961 million
Foreign Aid	
Commitments	$563 million
Disbursements	$315 million

8. The obstacles to rapid agricultural expansion are many, however. More than two-thirds of the population live on Java and Madura where all cultivable land is tilled. It is almost impossible to increase the area devoted to rice there without other crops suffering. Although production on other islands could probably be increased, resettlement is expensive and efforts have thus far failed. Therefore, increased output will largely depend on increased yields which in turn necessitate application of modern techniques and inputs. Efforts are being made to use the new high-yielding variety of rice seeds, but these require a controlled water supply, and after years of neglect, most of the irrigation system is in serious

* *Fiscal years beginning in April.*

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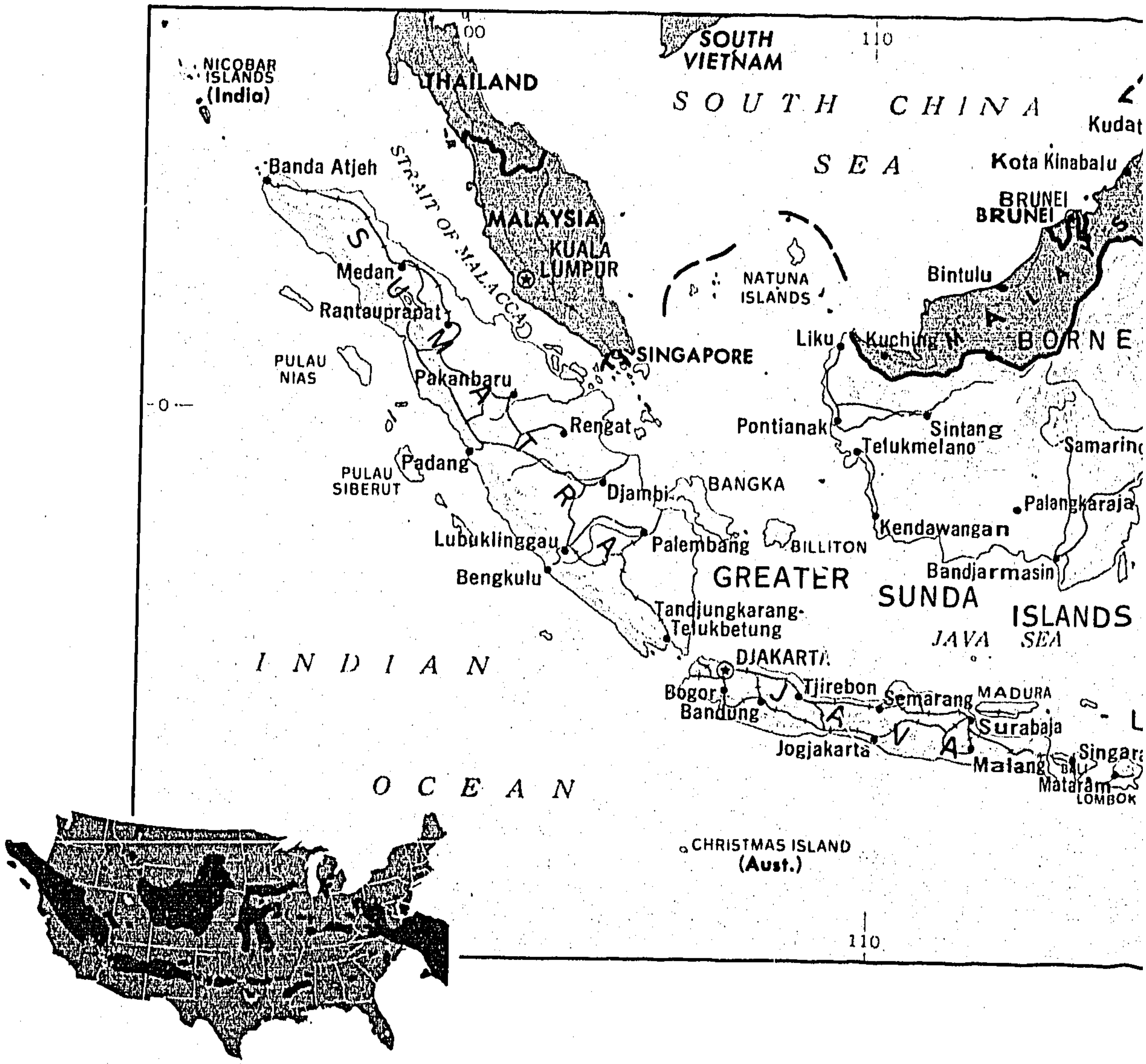

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NICOBAR ISLANDS (India)
THAILAND
SOUTH CHINA SEA
Kudat
Kota Kinabalu
BRUNEI
Banda Atjeh
STRAIT OF MALACCA
MALAYSIA
KUALA LUMPUR
NATUNA ISLANDS
Bintulu
SUMATRA
Medan
Rantauprapat
SINGAPORE
Liku
Kuching
BORNE
PULAU NIAS
Pakanbaru
Rengat
Pontianak
Sintang
Telukmelano
Samarin
PULAU SIBERUT
Padang
Djambi
BANGKA
Palangkaraja
Kendawangan
Lubuklinggau
Palembang
BILLITON
Bengkulu
GREATER SUNDA ISLANDS
Bandjarmasin
Tandjungkarang-Telukbetung
JAVA SEA
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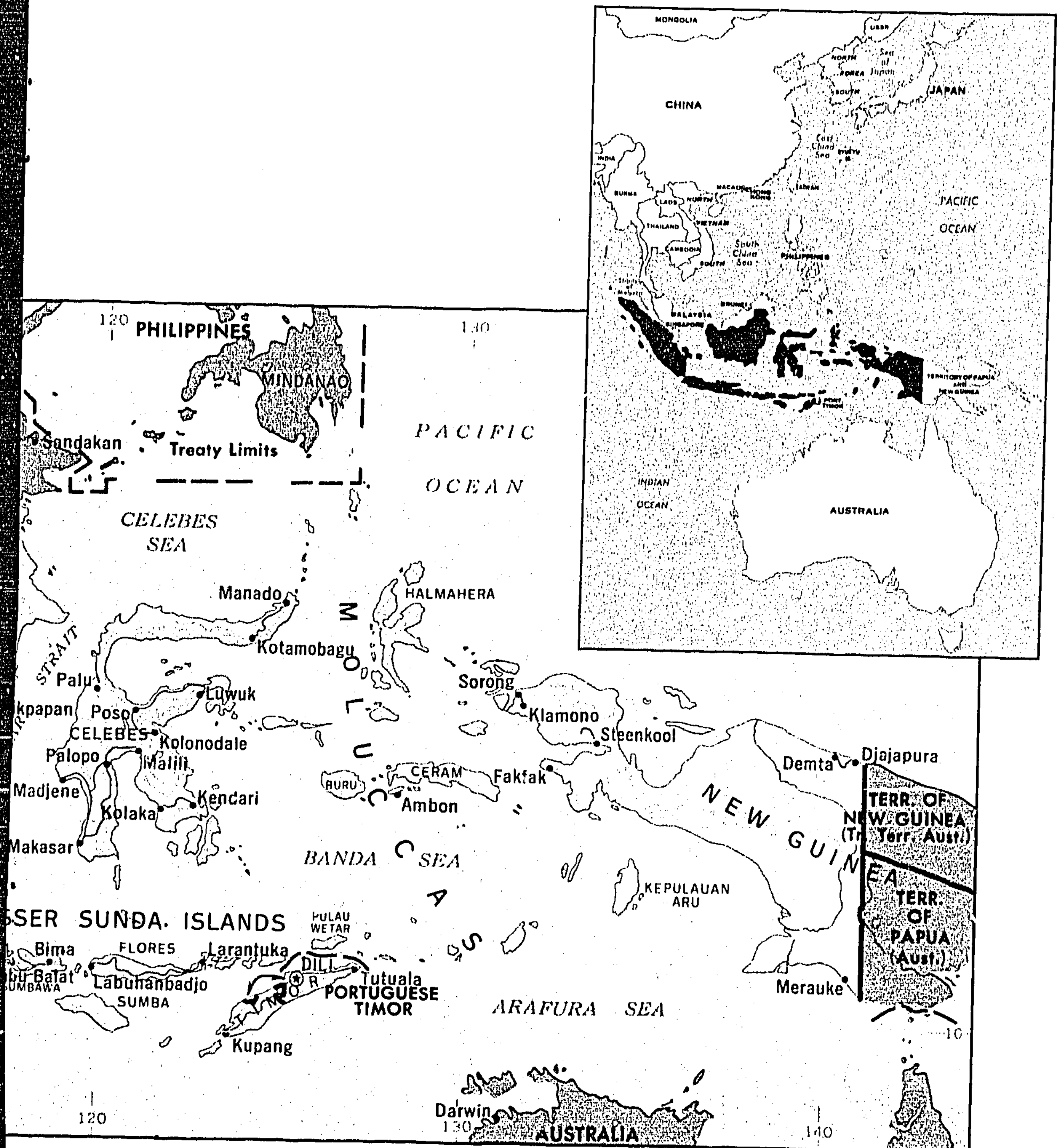

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Sorong
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Steenkool
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Djajapura
BURU
CERAM
Fakfak
Ambon
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TERR. OF PAPUA (Aust.)
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PORTUGUESE TIMOR
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disrepair. On Java and Madura, which account for more than half of total rice production, an estimated 60% to 70% of the irrigated land is served by systems requiring fundamental overhaul. Indonesia also greatly lacks the trained personnel and institutions to manage any major agricultural improvement program.

9. Production of export crops also suffers from past neglect and is unlikely to increase much over the next several years. After 1957, when the government began nationalizing foreign-owned plantations, investment in such industries as rubber, the leading agricultural export, was minimal. As a result, a substantial part of Indonesia's rubber trees are well beyond their prime productive age. Copra production suffers from the same problem. Most coconut palms were planted 60 to 80 years ago. Although some new trees have been planted in recent years, at least five years are required before coconut palms begin to bear, and five to seven years for rubber trees.

10. Conditions are also poor in the manufacturing sector. Most plants are still operating well below their former capacity because much equipment and machinery must be replaced. For example, an estimated 20% of the textile industry's machinery is inoperative. Shortages of imported spare parts as a result of bureaucratic red tape also hamper production. Meanwhile, new investment in manufacturing is very small. Past repression of the Chinese minority has discouraged this most likely source of capital from investing in manufacturing, and new foreign investment in this sector remains minimal. Extractive industries, especially oil and timber, will be the most rapidly growing areas and will provide most of the stimulus for growth in the years immediately ahead. Mineral output, which accounts for about 5% of GNP, is likely to double during the period through 1973, and this would increase the annual growth rate by about one-third above the present rate.

11. Given the formidable obstacles to increasing production, especially in the critical agricultural sector, Indonesia's rate of economic growth is likely to fall short of hoped-for goals. Nevertheless, because of increasing mineral output, we estimate that during the 1969-73 plan period the

economic growth will accelerate somewhat, reaching perhaps 4% annually by 1973. This will hardly change per capita incomes. Developments during this period, however, especially the attraction of private foreign investment, could lay the foundation for more rapid economic growth during the mid and late 1970s. The extensive oil exploration now under way, for example, could produce further sharp increases in production in the period beyond the early 1970s.

Indonesia's Foreign Exchange Requirements in the Coming Years

12. An annual increase of 3% to 4% in economic activity in the next few years will increase Indonesia's import requirements, but probably less rapidly than in the recent past. We estimate a 7% average annual growth of imports during 1970-73, while the 1969 increase was 15%. Imports of food, consumer products, and materials for consumer industries were raised rapidly in recent years to absorb purchasing power and thus stabilize prices. With inflation under control, imports will probably increase roughly in line with domestic demand -- perhaps 3% annually. Imports of capital goods will increase much faster than in recent years -- perhaps 15% annually -- as foreign investment increases.

13. Net service payments are also expected to rise substantially -- from $370 million in 1969 to about $550 million in 1973. Much of the increase will result from higher profit repatriation by foreign oil companies, which will grow along with Indonesia's foreign exchange earnings from oil. In addition, repayments on the foreign debt will amount to about $70 million in 1973. Only about $28 million annually for the next few years has to be paid on the massive Sukarno debt thanks to the general agreement recently reached with Indonesia's Western creditors calling for a long-term rescheduling of that debt.* Servicing debts incurred since mid-1966 will account for the balance.

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14. Indonesia will be unable to meet these rising foreign exchange needs from its own earnings. We estimate exports will grow fairly rapidly -- about 8% annually. More than half of the increase will likely result from higher exports of crude petroleum, which were valued at $360 million last year or about 35% of total foreign sales. Because of the large-scale investment now under way in developing petroleum resources, production is expected to rise sharply and exports will probably amount to about $580 million in 1973.

15. Exports other than oil will grow only modestly through at least 1973. In the 1967-69 period these exports -- mostly agricultural products -- rose by 8% annually, mainly because of higher prices and the shifting of previously smuggled goods into official channels. Now prices are expected to at least level off, and smuggling has probably been reduced about as far as possible. Moreover, the sharp rise in earnings from coffee exports during the past few years is not likely to be repeated, because Indonesia has already reached its quota under the International Coffee Agreement. Thus, we estimate that these traditional exports will probably grow by about 3% annually over the next several years in line with likely increases in output. New export commodities, such as timber and copper, however, will probably increase much faster and boost the growth of total non-oil exports to about 5% annually during the period 1969-73.

16. Under these conditions, exports would earn more than $1.3 billion in 1973, about $500 million to $600 million less than foreign exchange needs. Private capital inflows probably will provide some $200 million, double the 1969 amount, primarily because of investment by oil companies. Investment in developing copper and timber resources will increase, but most other spending by foreigners will consist of exploratory work involving relatively small sums. This leaves an annual foreign exchange gap of $300 million to $400 million during the 1970-73 period as indicated in Table 2. As in the past, the only means to close the foreign exchange gap will be through official foreign aid. Djakarta should have little difficulty in obtaining the required aid. Aid committed, but not yet delivered, already is sufficient to fill a large portion of Indonesia's

Table 2

Indonesia: Estimated Foreign Exchange Gap a/

Million US $

	Actual	Projection			
	1969	1970	1971	1972	1973
Foreign exchange needs	1,390	1,520	1,625	1,745	1,895
Imports	960	1,045	1,115	1,190	1,275
Services (net)	370	400	440	485	550
Debt servicing b/	60	75	70	70	70
Non-aid resources	1,075	1,180	1,275	1,375	1,540
Exports	975	1,060	1,135	1,200	1,340
Private capital	100	120	140	175	200
Foreign exchange gap	315	340	350	370	355

a. *All figures rounded to the nearest $5 million.*
b. *Including repayments on the Sukarno debt.*

basic foreign exchange gap through 1973, and additional aid pledges will surely be forthcoming.

17. Djakarta will probably seek substantially more than the $300 million to $400 million in annual aid during the next several years in the hope of speeding up the development process. The five-year plan, for example, calls for aid requirements increasing to about $700 million in 1973. It is unlikely that Indonesia can absorb the amounts desired, however, because of the inadequate administrative machinery and the lack of skilled manpower needed to implement aid programs. These problems account in part for the large backlog of economic assistance committed since 1965 but not yet disbursed -- about $400 million at the end of 1969.* Some additional

* *In addition, an estimated $540 million in new aid commitments were announced in April 1970. Further aid commitments are expected which would bring total new aid pledges to an estimated $600 million for the period January 1970 through March 1971.*

aid beyond $300 million to $400 million a year could probably be absorbed -- perhaps another $100 million annually. The increased aid receipts, however, will have little impact on increasing the rate of economic growth during the next several years. Much of the aid is necessary to improve infrastructure, especially transport, communication, and power facilities, but the benefits will be felt only gradually over the long run.

Conclusions

18. The Suharto government has made impressive progress since 1966 in stabilizing the Indonesian economy and overcoming the economic chaos inherited from the Sukarno period. Inflation has been brought under control, and the Suharto government has succeeded in attracting foreign investors. Nevertheless, the disarray inherited from the Sukarno era has made economic recovery a slow process.

19. During the early 1970s, Indonesia's economic growth rate most likely will range between 3% and 4%, which would barely exceed population growth. The 5% hoped for in the current development plan appears too optimistic. A basic reason for limited growth is the poor condition of the agricultural sector. The irrigation system is in serious disrepair, greatly limiting the usefulness of new seed varieties. Another major reason is the extreme scarcity of skilled manpower and the inadequacy of institutions to oversee development efforts.

20. To achieve even modest economic growth, Djakarta will need substantial amounts of foreign aid -- $300 million to $400 million annually -- to help finance imports. Given the large pipeline of already committed but undisbursed aid, the country should have little difficulty in meeting these requirements. Indonesia will almost certainly seek larger amounts of economic assistance but it is doubtful whether very much more could be effectively absorbed by the economy.

21. In the longer term -- beyond the early 1970s -- Indonesia's economic outlook is brighter. Barring major changes in Djakarta's economic and political policies, foreign investments in the

extractive industries are certain to increase. In time this would contribute substantially to foreign exchange earnings and make the country less dependent on foreign aid. The petroleum industry is already expanding rapidly, and if planned investments in copper, nickel, bauxite, and timber are undertaken, export earnings in the mid and late 1970s would rise rapidly. Any measurable improvement in the well-being of the population will still require rehabilitation and modernization of agriculture.