Directorate of
Intelligence

~~Confidential~~

25X1

Indonesia: Groping for a New Industrialization Strategy

25X1

An Intelligence Assessment

~~Confidential~~

EA 85-10072
April 1985

Copy 357

Declassified in Part - Sanitized Copy Approved for Release 2011/11/17 : CIA-RDP86T00590R000200210001-0

Page Denied

Declassified in Part - Sanitized Copy Approved for Release 2011/11/17 : CIA-RDP86T00590R000200210001-0

Directorate of
Intelligence

Confidential

25X1

Indonesia: Groping for a New Industrialization Strategy

25X1

An Intelligence Assessment

This paper was prepared by
Office of East Asian Analysis. Comments and queries are welcome and may be directed to the Chief, Southeast Asia Division, OEA

25X1

25X1

Confidential
EA 85-10072
April 1985

25X1

Indonesia: Groping for a New Industrialization Strategy

25X1

Key Judgments

Information available as of 1 April 1985 was used in this report.

The sluggish performance of Indonesia's economy since the world oil glut emerged in 1982 is spurring President Soeharto and his chief economic policy makers to gradually shift the country's development away from dependence on oil to a more labor-intensive, export-oriented approach emphasizing light manufacturing. Although debate within the government about an appropriate industrialization strategy continues, we do not expect dramatic restructuring of the economy during the rest of this decade. Institutional inertia, competing domestic interest groups, and the modest economic growth we expect in the next few years will undercut incentives for radical policy shifts. Marginal improvements in bureaucratic efficiency and reductions in redtape, however, are likely and, we believe, will encourage increased private domestic and foreign investment.

Even if Soeharto undertakes far-reaching trade or investment reforms—an unlikely prospect in our view—their effect would be felt only gradually because potential investors would probably move slowly until they were sure of the government's commitment to reform. Thus, by the end of the decade, Indonesia's manufacturing output will probably remain oriented primarily to the domestic market, and the economy will continue to depend on oil exports for most of its foreign exchange earnings.

We believe Jakarta will continue to restrain spending until its financial position improves, and will not choose a clearcut growth strategy even then, but will try to balance the competing demands of a rapidly expanding labor force for jobs against the proponents of large industrial projects. The debate over growth strategy, however resolved, will have political overtones. Infighting among interest groups will intensify as the senior technocrats continue to hold the line on development spending while other factions—such as the Research and Technology Ministry and the backers of large industrial projects postponed in 1983—push for increased spending. A substantial increase in spending would require foreign borrowing and risk an external payments crisis because Indonesia's prospects for boosting foreign exchange earnings are being dimmed by the soft world oil market. On the other hand, continued austerity risks escalating domestic social and political discontent—a factor that Soeharto must consider with parliamentary and presidential elections approaching in 1987 and 1988.

25X1

EA 85-10072
April 1985

25X1

Indonesia: Groping for a New Industrialization Strategy

25X1

Pressures on the Traditional Development Strategy

Jakarta's development strategy has been a predominantly resource-based, government-controlled program financed by oil exports and emphasizing large projects that depend on imports. The financial motivation for such an approach is not hard to find. The oil and gas industry earns about 70 percent of Indonesia's foreign exchange and supplies over 50 percent of government revenues. Oil exports, benefiting from the oil price hikes of the early 1970s, rose from less than $1 billion to about $5 billion during 1971-75 and reached about $15 billion in 1981 following the second round of OPEC price hikes. On the expenditure side, public investment through the 1970s concentrated on infrastructure and human resource development, but much of the increase since 1979 has gone to heavy industrial sectors serving the domestic market such as petrochemicals, fertilizer, cement, paper, and steel. Although most use domestic natural resources, all depend heavily on imported capital equipment.

The sudden sharp turnaround in oil export earnings in 1982, however, slowed economic growth to −0.4 percent compared with 7.1 percent the year before and nearly brought Indonesia's industrialization program to a halt, forcing the government to reevaluate its policy options. Falling exports and rising imports caused the current account to deteriorate from a surplus of about $2 billion in fiscal year 1980 (1 April 1980–31 March 1981) to a deficit of $7.3 billion in 1982. Previously manageable foreign debt suddenly became worrisome for foreign lenders as falling oil export revenues pushed the country's debt service ratio from a favorable 10.6 percent in FY 1980 to 19.2 percent in FY 1982.

Jakarta adopted the following package of austerity and reform measures to avoid an untenable further deterioration in its current account and foreign debt position:

- Budget austerity, including cuts in subsidies.
- A 28-percent devaluation.
- Postponing or shelving major industrial projects to cut capital goods imports by some $10 billion over several years.
- Financial reforms, including deregulation of banking operations.
- Income tax reforms, particularly simplification of the tax system and broadening of the tax base.

Although the austerity program nearly halved the current account deficit in 1983 and 1984, helped restore the country's foreign exchange reserves to about $10 billion, and held inflation below 9 percent in 1984, efforts to spur growth through diversification of exports have had only limited success. The financial and tax reforms initially caused potential investors to postpone investment decisions until they can assess whether Jakarta is really committed to implementing basic reforms. Furthermore, Indonesia's 5-percent growth rate in 1984 was due largely to factors that will not be repeated. New production facilities boosted LNG (liquefied natural gas) output more than 30 percent and good weather helped produce another record rice crop.

Policy Options

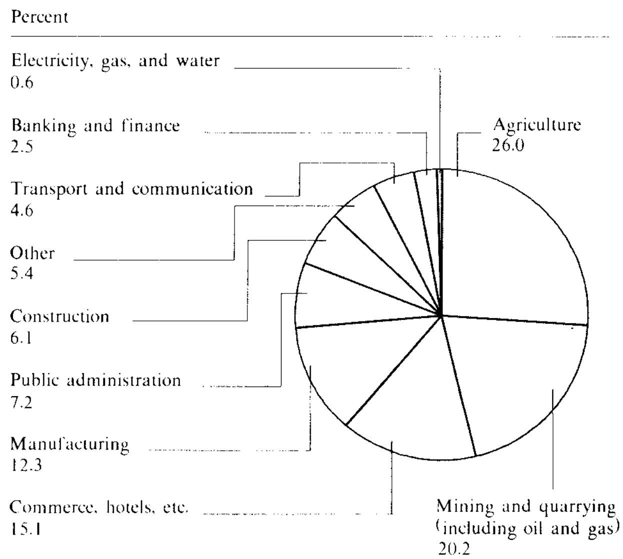
Each of the options under consideration by Jakarta's economic planners entails risks. Maintaining the current austerity program would protect Indonesia's financial standing with foreign bankers, but will slow the country's growth, intensify the unemployment problem, and weaken some of Soeharto's financial backers. Resumption of the traditional strategy of concentrating public investment in heavy industry and encouraging the private sector to develop consumer goods industries aimed at the domestic market would maintain the government's dominance of the economy, protect the financial interests of the elite, and utilize key natural resources. This approach, however, would require increased foreign borrowing, which would risk Jakarta's standing with foreign bankers and reduce incentives to cut costs and improve efficiency.

Alternatively, the Soeharto government has stated its intent to encourage increased privatization to make up for the shortfall in public investment funds and to emphasize an export-oriented, labor-intensive development strategy. Such a program holds the promise of increasing employment prospects and creating a more diversified economy able to cushion itself against downturns in individual commodity markets. This option, however, 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 would also run into protectionist barriers in industrial country markets and meet stiff competition from more advanced Third World countries that have already gained access to markets.

Failure to choose an appropriate growth strategy could be costly because population pressures are intensifying the demand for job-creating investment. Jakarta needs to create jobs for nearly 2 million new jobseekers annually and to alleviate unemployment and underemployment of the existing labor force. Modernization of agriculture—which employs about two-thirds of the labor force—while contributing to national self-sufficiency in rice production, has also reduced the demand for rural labor and accelerated the flow of landless laborers into the cities.

The manufacturing sector, which is primarily oriented to selling in the domestic market, is characterized by inefficiency and high costs, which hurt its competitiveness in world markets and limit its job-creating capacity. The combined effect of public and private investment from 1971 to 1978 tripled employment in manufacturing from 1.3 million to 4.5 million people, but industrial workers still accounted for only 10 percent of the labor force, and manufacturing currently accounts for only 12 percent of national output and an even smaller share of exports (see figure 1 and table 1). In industry, the bulk of public investment since 1979 has gone to heavy industries such as petrochemicals, fertilizer, and cement, which create fewer jobs and require greater investment per job than light industry. The private sector has been encouraged to invest in consumer goods manufacturing, but is still constrained by the growth of domestic demand.

Figure 1
Indonesia: 1983 Gross Domestic Product, by Industrial Origin



305277 4-85

25X1

Other mechanisms have absorbed only limited amounts of surplus labor. The 1982-83 economic slowdown has forced increasing reliance on the informal economy for jobs as street vendors, hawkers, pedicab drivers, and suppliers of other personal services—outlets that up to now have not offered a satisfactory long-term solution to the unemployment problem. Indonesia's transmigration program, which calls for resettling 750,000 families to the outer islands during 1984-88, offers only partial relief because of the magnitude of Java's population growth. Indonesia thus remains highly dependent on the export of oil, natural gas, and primary products. And the end of the oil boom has presented Jakarta with two key tasks it has long expected, but is still not fully prepared to undertake:

- To reduce dependence on oil by diversifying nonoil exports.
- To carry out a development program that emphasizes manufacturing industries that employ relatively large amounts of labor.

Table 1
Indonesia: Exports by Commodity Group, 1983

Percent

Commodity Group	Share
Agriculture	16.4
Timber	2.9
Rubber	4.9
Coffee	2.5
Palm oil	0.4
Other	5.7
Minerals and metals	4.0
Tin	1.5
Nickel	0.8
Aluminum	0.8
Copper	0.4
Other	0.5
Manufactures	6.4
Plywood	2.9
Other	3.5
Oil and gas	73.2
Oil	61.1
Gas	12.1

25X1

Conventional approaches to promote exports of manufactured products to supplement traditional commodity exports, however, have met tough obstacles. Rising foreign sales of textiles and plywood, for example, leveled off in 1984 as foreign demand sagged. Soaring apparel exports to the United States have resulted in quota limitations under the Multifiber Agreement, and Japanese tariffs have hurt sales of Indonesian plywood.

Nonconventional approaches have fared no better. Jakarta has expanded trade ties with the USSR and Eastern Europe, has begun to prepare openly for the resumption of direct trade with China, and has adopted such troublesome expedients as countertrade.[1] In our view, these measures are unlikely to produce dramatic results because Indonesia can purchase higher quality, lower priced imports from its major trading partners—Japan, the United States, and Western Europe—and find more lucrative markets for its exports.

Debate Within the Government

Implementing a coherent policy program to cope with financial and population pressures is complicated by the fact that different factions within the government have conflicting agendas. The original group of Western-trained economists, known as the technocrats or the Berkeley Mafia, are Soeharto's leading economic advisers and head the key economic and financial ministries (see table 2). Many have been associated with Soeharto since he came to power in the 1960s and remain responsible for devising the government's development strategy and implementing overall financial and economic policies. A younger faction of engineering-oriented specialists exhibits less concern than the older technocrats for balancing competing demands for resources within overall financial constraints and tends to push for a high-technology strategy—this would encourage metalworking industries and the development of manufacturing capabilities in such industries as aircraft, ships, vehicles, and machinery. A third faction includes the ministries representing heavy industries and their backers in the military and the bureaucracy. They exert influence in favor of both state-owned industries such as petrochemicals, cement, paper, and fertilizers and the privately owned consumer-goods manufacturing sector.

The original technocrats have sought to promote job creation in Indonesia's rural areas through government-sponsored construction programs and transmigration. They have repeatedly asserted the need to encourage the development of efficient, labor-intensive firms able to compete with foreign firms in domestic markets and abroad. Nonetheless, they have accepted a statist approach to development and have authored the government's series of five-year development plans. They have not been able to open the

[1] Countertrade is a barter-type mechanism recently adopted by Indonesia and other Third World countries to compensate for foreign exchange shortfalls resulting from the world oil slump and the Third World debt crisis

25X1

Soeharto, the Chief Executive

President Soeharto, in power for nearly two decades, is the final arbiter of all major decisions in Indonesia. His longstanding goals have been to bequeath the nation a legacy of political stability, economic growth, and an equitable distribution of income. Strongly aided by the OPEC oil price windfalls of the 1970s, Soeharto's government has made remarkable gains under the guidance of his team of Western-trained economic technocrats. [redacted] 25X1

Although the sluggish world economy and soft oil market have prevented Soeharto from restoring vigorous growth following the 1982 slump, he demonstrated his willingness to take tough political steps by introducing a package of stiff austerity and reform measures in 1983, which have succeeded in averting a financial crisis. He has continued to respond vigorously to the country's economic problems by replacing managers of key government agencies with more competent people. [redacted] 25X1

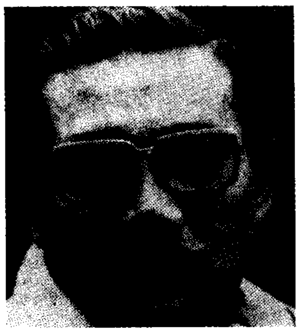
Despite his demonstrated willingness to make major personnel shakeups, we believe Soeharto is unlikely to permit existing manufacturing firms to be bankrupted by more efficient new competition. He seems quite willing to tolerate continuing factional struggles within the bureaucracy as long as they do not get out of hand. Thus, he probably will continue to encourage Habibie to pursue a high-technology approach to development—in Indonesia's context, a strategy emphasizing the absorption of metalworking capabilities and the manufacture of aircraft, ships, vehicles, and machinery. At the same time, Soeharto will continue to give Wardhana the authority to approve or deny requests involving significant foreign exchange expenditures. [redacted] 25X1

economy to greater competition because such a move poses major financial risks for many existing firms backed by high-level officials in the military and the bureaucracy. The current concern with averting a financial crisis and adjusting to the reality of lower oil income, however, has strengthened the resolve of the technocrats to impose restraints on public investment and to seek a greater role for competitive private investment.

Opposed to the technocrats are groups that have invested in production facilities to serve the domestic market. [redacted] Military officers are also among those backing Jakarta's statist approach to development of heavy industry. This group includes active and retired officers whose careers have been devoted to industrial management—an option that arose originally during the struggle for independence because the military was the only national institution that had prepared Indonesians for leadership positions. Protectionist barriers have enabled them to prosper despite inefficiency and corruption, and they will continue to oppose moves to open the economy to freer competition.

The freewheeling Minister of Research and Technology, B. J. Habibie, more interested in developing technological capabilities than in living within current financial constraints, is pushing the high-technology 25X1

Ali Wardhana, the Finance Czar



Ali Wardhana, one of the original Berkeley Mafia, served 15 years as Minister of Finance before succeeding his mentor, Widjojo Nitisastro, as Coordinating Minister for Economics, Finance, and Industry in 1983. Wardhana and his fellow technocrats were the architects of the market-oriented development strategy followed by Soeharto since he came to power in the mid-1960s. As Minister of Finance, Wardhana oversaw the preparations for the tax law revisions introduced by Soeharto in 1983 and was a key designer of Soeharto's financial austerity and reform program. Soeharto has entrusted Wardhana with the responsibility for avoiding excessive foreign debt, and he is determined to avoid the pitfalls of the major LDC debtor countries. Under Presidential Directive No. 8 of 1984, for example, Wardhana must grant prior approval before export credit negotiations can begin for any significant industrial project. 25X1

Wardhana earned a reputation for his ability to say no during his tenure as Finance Minister. Armed with the authority granted by Soeharto, Wardhana has been able to resist pressures from many fronts to restore canceled projects. Wardhana and his colleagues in the financial and economic ministries remain closely attuned to the need for external financial balance and maintain a united front against groups that would undercut Soeharto's austerity program. 25X1

strategy. He views the absorption of technology as the key element of economic development and is determined to push Indonesia into the front ranks of the Third World in at least some areas of metalworking and machinery manufacturing.

Wrestling With the Tradeoffs

Each of Jakarta's factions is counting on increased investment in manufacturing to diversify the economy, but the government needs to continue restraining public spending for at least the next several years because it has no alternative revenue source comparable to oil exports. Even with solid gains in nonoil exports, soft oil prices will be the chief determinant of Indonesia's foreign exchange receipts for the foreseeable future. Continuing softness in oil prices thus is forcing Jakarta to choose between cuts in investment spending to maintain financial balance and foreign borrowing to spur economic growth. Jakarta cut imports by $3 billion in 1984 by postponing, cutting back, or canceling major industrial projects. The rephasing program is expected to reduce planned expenditures by as much as $10 billion over the next few years. We believe any further drop in oil prices would trigger additional cuts in imports of machinery, equipment, and semiprocessed materials, which account for more than 85 percent of total imports. Although such reductions in capital goods imports help relieve balance-of-payments strains and avoid excessive foreign borrowing, they also tend to slow job creation and economic growth.

The rephasing program, by stretching out investment in electric power and transportation systems, is slowing the growth of labor-intensive industry in the countryside because manufacturing facilities cannot operate effectively without such infrastructure. Even though the government is continuing a $1.5 billion investment program in the nation's road network and is planning to spend hundreds of millions on port improvements, railroads, and shipbuilding in the current five-year plan, the program is lagging earlier

B. J. Habibie, the Champion of High Technology

A key policymaker with close ties to President Soeharto, Habibie exerts major influence on economic policy making through his personal participation in such bodies as the Pertamina Board of Commissioners and the role of BPPT (Department of Research and Technology) in decisions involving technology. Habibie exercises influence on both civilian and military programs, and he or one of his representatives plays a decisive role in establishing technological standards throughout Indonesian industry. He carefully cultivates ties with advanced industrial countries through frequent travel abroad and includes on his personal staff several foreign advisers, including an American. 25X1

Habibie has no peers in the Indonesian hierarchy who match his understanding of advanced technology, and few can match his energy level in carrying out his functions. Both his close personal ties to Soeharto and his unchallenged technological capability have helped him to gain favored access to funding without the constraints imposed on other ministries. 25X1

Habibie almost singlehandedly has created an aircraft manufacturing industry in Indonesia by expanding a small government firm, P. T. Nurtanio, from an airline service operation employing about 600 workers in 1976 to a full-fledged airframe producer employing over 12,000 people in less than eight years. The showcase firm, however, has had problems in building a small passenger aircraft under license from a Spanish firm. The company probably will succeed in correcting technical deficiencies and will sell at least some aircraft abroad in the near future, but not before tarnishing Habibie's reputation. 25X1

More recently, he initiated a program to scrap older ships in order to improve the efficiency of Indonesia's merchant fleet. Replacements are to be built in Indonesian shipyards by P. T. Pal, the national shipbuilding company, even though steamship company officials have complained that work at Indonesian yards costs substantially more than in South Korean, Taiwanese, or other foreign shipyards. Despite the high cost, Habibie sees this program as a means of spurring technological advance. 25X1

plans. And, because of insufficient job opportunities, landless peasants continue to migrate to the cities, intensifying social strains in urban areas.

Although powerful groups within the military and the bureaucracy are exerting influence for the resumption of major projects and their associated imports, the technocrats are holding the line; Presidential Instruction No. 8 of 1984 gives Economics Minister Wardhana authority to approve or deny applications for new foreign credits. We believe any sharp recovery in foreign exchange earnings will intensify pressure on the government to resume its earlier investment program quickly. For their part, the technocrats are concerned that any such resumption would risk balance-of-payments problems and hurt the country's good international credit rating, especially if the recovery were only temporary. Thus, for the time

Table 2
Indonesia: Key Economic Policy Makers

The Players	Title/Institution	Remarks
The Technocrats		
Ali Wardhana	Coordinating Minister for Economics, Finance, and Industry	Favor a market-oriented development strategy, favoring foreign investment, free convertibility of currency, flexible exchange rate, prudent external debt management, and use of fiscal and monetary policy to maintain price stability.
J. B. Sumarlin	Chairman of the Central Planning Commission (Bappenas)	
Radius Prawiro	Minister of Finance	
Rachmat Saleh	Minister of Trade	
Arifin Siregar	Governor of Bank of Indonesia	
Subroto	Minister of Mines and Energy	
The Engineers		
B. J. Habibie	Minister of State for Research and Technology	Favor high-technology industries.
Hartarto	Minister of Industry	
The Palace Insiders		
Sudharmono	Minister of State and State Secretary	Maintain close ties to the Soeharto family; include high-level military and bureaucratic elite; maintain control over key heavy industrial sectors.
Ginanjar Kartasasmita	Chairman, Capital Investment Coordinating Board	
Bustanil Arifin	Chairman, State Logistics Board and Minister of Cooperatives	
Admiral Sudomo	Minister of Manpower	

25X1

being, Jakarta is restraining public investment but, we believe, will increase spending as soon as financial conditions permit.

Tinkering With the Existing Strategy

We have no evidence that the debate within the government on moving ahead with a new industrial strategy will be resolved in favor of sharp policy shifts soon. More than likely, in our view, Soeharto will not opt for a clear-cut strategy, but will follow a cautious, middle ground approach shifting between the demand for labor-intensive investment and the development of heavy industry. Jakarta is taking some initiatives to improve the economy's performance. For now, these moves are aimed primarily at improving management and introducing some financial and regulatory reforms. The key will be whether the tax and financial reforms are decisively implemented and produce visible benefits, thus paving the way for a new industrial policy.

Banking reforms adopted in 1983 were aimed at encouraging the private sector to take up some of the slack caused by shortfalls in government funding. By freeing interest rates on deposits and eliminating many of the investment regulations originally designed to protect ethnic Indonesian entrepreneurs, the government sought to mobilize domestic savings and encourage private investment. Government officials realized the move probably would benefit the ethnic Chinese business community, but President Soeharto apparently was willing to risk the political consequences to protect the country's financial position. Thus far, although the effect on investment is inconclusive, the effect on savings apparently has been favorable. Furthermore, there has been no major political criticism of the move, and the government has not had to reverse itself.

Jakarta introduced a new value-added tax on 1 April and is trying to broaden the income tax base. With less than 750,000 registered taxpayers in a nation of about 170 million people, Indonesia's income tax base is among the lowest in Asia. As one of the major income tax revisions introduced last year, Jakarta offered a pardon for new taxpayers to register by December 1984 and has now extended the amnesty to June 1985. Given the past performance of Indonesia's cumbersome bureaucracy and the lack of trained personnel to administer the income and value-added tax programs, we believe the government is likely to achieve only marginal improvements in tax equity and efficiency and modest gains in tax revenues—and this only if Soeharto persists in using the authority of his office to implement the new tax structure.

Soeharto is pushing for better economic management by replacing top managers of important government entities with more competent leadership. Dissatisfaction with Pertamina's financial performance, for example, led to the dismissal of Pertamina President Sumbono and the ouster of Director General of Oil and Gas Wijarso last year. Foreign oil company officials thus far have found the new leadership more competent and cooperative. In late 1984, rumors began circulating widely in Jakarta that a shakeup in BKPM (the Capital Investment Coordinating Board) was impending, spurred largely by the country's dismal investment performance. And, early this year, Soeharto replaced the top management of BKPM. The new investment chief is a protege of State Secretary Sudharmono, Soeharto's top aide in charge of the civil bureaucracy, and he has a reputation for management skill as well as powerful political clout. The move might improve BKPM's management, but we believe it will do little to increase investment in the near term because of factors beyond Jakarta's control. More recently, Soeharto fired the Director General for Customs and Excise, who headed one of the traditionally most corrupt organizations in the Indonesian bureaucracy. According to the US Embassy, Soeharto acted because Customs Service corruption threatened to undermine plans to promote domestic products, nonoil exports, and private investment.

Whether the changes in management reflect a long-term commitment to encouraging efficient private investment remains to be seen. Part of the problem is Jakarta's reluctance to assure improved financial incentives for foreign investment or to relax its regulatory controls—moves that would signal a welcome to foreign investors. Despite the government's oft repeated claims of openness to foreign investment, many Indonesians—including high-level officials—remain opposed to foreign investment [redacted] 25X1 [redacted] Foreign investors pulled back sharply in 1984 25X1 because of uncertainty about the implementation of new tax laws and signs of growing nationalism evident, for example, in the Manpower Ministry's tightened restrictions on employment of expatriates. The soft world oil market and a wave of domestic political unrest reflecting Muslim discontent later in 1984 created additional disincentives.

Despite the recent changes, Jakarta's complex investment approval process and manpower policies still discourage new foreign investors. Manpower Minister Sudomo, a former intelligence chief and longtime associate of President Soeharto, alarmed potential investors in 1984 with a series of well-publicized investigations of expatriate employees. In our view, Sudomo tightened restrictions on expatriates at least in part to spur the transfer of jobs to indigenous Indonesians. The dismal investment figures for the first half of 1984, however, led President Soeharto to halt Sudomo's actions and to return control over expatriate work permits to BKPM, according to US Embassy reporting. He also ordered the elimination of duplicate licensing requirements and unnecessary regulations—moves that probably will not be fully implemented, even though such action would be very attractive to foreign investors.

Looking to the Late 1980s

More of the Same. We believe Indonesia will adhere to the senior technocrats' conservative approach to financial management over the next several years to avoid a debt crisis—a choice that will protect the balance of payments but constrain investment in industry. Memories of the economic chaos of the late Sukarno years and the aftermath of the 1975 Pertamina debacle still inhibit Soeharto and his top economic advisers from excessive foreign borrowing. Jakarta's hopes for a rise in foreign exchange earnings, however, are being dampened by the soft world oil market, which has seen a steady erosion of OPEC's pricing power over the past three years and promises continuing austerity for the next few years.

The Indonesians are counting on growth in industrial country demand for nonoil exports and gradual recovery in domestic demand to achieve 4- to 5-percent annual growth rates in the next few years. As long as the economy achieves such growth—a target we consider likely—we believe Soeharto will opt for policies aimed at improving efficiency and employing more labor and will avoid radical departures from the existing growth strategy. As he approaches a period of heightened political tension before parliamentary elections in 1987, we believe he will seek to avoid unsettling important groups among his supporters or giving political ammunition to opposition elements by initiating a risky or potentially painful new growth strategy.

At least for the next few years, Jakarta will continue to press for better access to markets in industrial countries, especially the United States and Japan, for such labor-intensive products as textiles, plywood, and other light manufactures. Pressures to boost foreign exchange earnings will spur continuing efforts to reduce bureaucratic inefficiency and corruption. Even if the technocrats were to eliminate internal barriers to an export promotion strategy—redtape, inefficiency, corruption, and high costs—exports in the 1980s offer less promising growth prospects than during the past few decades. Market opportunities for Indonesian-manufactured exports will be constrained both by protectionism in developed-country markets and by competition from other Third World countries that have already gained access to the most lucrative markets. Accordingly, Indonesia's manufactured exports in 1990 will probably continue to consist mainly of traditional goods such as textiles, wood products, processed food products, and other light manufactures.

Would Soeharto Surprise Everyone? Although we believe the probability is low, we cannot rule out a move by Soeharto to follow up the recent financial and tax changes with a far-reaching trade reform program in the next few years, particularly if the economy is hit by a severe global downturn or a slumping oil market. A major trade reform designed to restructure the manufacturing sector by eliminating protective tariffs or the maze of investment regulations that now insulate domestic firms from competition would risk financial damage for many of Soeharto's supporters, including high-level government officials and his own family members. Moreover, the initial impact almost certainly would intensify unemployment, and the long-term growth in jobs for Indonesians would occur only gradually. During the 1983 oil market slump, however, Soeharto placed national interests before parochial interests when he postponed or canceled major industrial projects and, in our view, would take equally drastic actions if the country's economic situation deteriorated sufficiently.

Political Costs of Slower Growth

The Soeharto government, in our view, is keenly aware of the political risks [2] of failing to generate enough jobs, but is more likely to resort to authoritarianism to contain any dissent than to introduce radical reforms. Although we believe the austerity program represents a necessary step to avoid a foreign debt crisis, we remain skeptical that Jakarta will be able or willing to reorient its development strategy sufficiently to ease the expected worsening in the country's unemployment problem later in the 1980s. Given the expected shortfall in investment funds over the next several years and the steadily rising demand for jobs,

25X1

Emerging Trends and Information Gaps

If Jakarta were to aggressively pursue deregulation and privatization, two key elements about which we know little could significantly influence Indonesia's long-term growth prospects:
- *The growth of the informal or underground economy.*
- *The emergence of small-scale unregulated entrepreneurial activity.*

Indonesia's informal economy traditionally has been perceived as a labor-absorption mechanism—providing jobs such as street vendors and pedicab drivers—with little or no data available on its output or growth. We do not know whether it has expanded from processing activities such as food preparation for sidewalk stalls into operations such as bicycle or auto repair, manufacturing of simple textiles or building materials, or similar small-scale operations. Furthermore, we do not know what the prospects are for moving beyond simple subsistence to more dynamic entrepreneurial growth or the government's likely reaction to such a development. As it is, the government is suspicious of the private sector and, according to the US Embassy, is unwilling to dismantle the excessive regulations that stifle private investment and efficiency.

Nonetheless, financial and tax reforms enacted in 1983 could be the first steps in a textbook case of deregulation and encouragement of small-scale entrepreneurial growth. Not surprisingly, the initial financial and political costs of the reforms have been high—the pullback in investment in 1984 and the risk of alienating important segments of Indonesian society if the Chinese business community appears to be the greatest gainer from the financial reforms. 25X1

25X1

If the government continues to eliminate unproductive regulations, however, Indonesia could see the emergence of dynamic new industries headed by entrepreneurs responding to market incentives. The emergence of the informal economy or a successfully deregulated private sector characterized by small-scale entrepreneurs would signal a dramatic shift toward a free market economy and a promising start on a new growth path. Information on these and other emerging developments, however, is badly lacking, and reporting on newly emerging trends is likely to become as important as reporting on the oil industry and agricultural performance is now for assessing Indonesia's long-term growth prospects. 25X1

25X1

the government will be hard pressed to alleviate social discontent arising from growing unemployment and underemployment.

We do not know how the growing number of unemployed will respond to their predicament, but we believe the government's first response to unrest stemming from economic hardship—or any other reason—will be stern. Soeharto has never hesitated to crack down on opposition elements when riots or demonstrations have occurred in the past, and he shows no sign of changing his approach. This suggests that political initiatives—probably growing authoritarianism—will precede any radical shift in Indonesia's economic policy.

25X1