INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

INTERNATIONAL DEVELOPMENT ASSOCIATION

ECONOMIC DEVELOPMENT OF INDONESIA

(in six volumes)

VOLUME I

MAIN REPORT

February 12, 1968

Asia Department

CURRENCY EQUIVALENTS

Currency Unit - Rupiah

Floating Rate (November 1967)

(1) B.E. Market Rate

U.S.$ 1.00	=	Rp. 150
1 Rupiah	=	U.S.$ 0.007
1 Million Rupiahs	=	U.S.$ 6,667

(2) Curb Rate

U.S.$ 1.00	=	Rp. 170
1 Rupiah	=	U.S.$ 0.006
1 Million Rupiahs	=	U.S.$ 5,882

This report was prepared by a mission that visited Indonesia from October 17 to November 15, 1967. The members of the mission were:

O. J. McDiarmid	Chief of Mission
B. K. Abadian	Chief Economist
Jack Beach	Power
N. D. Ganjei	Fiscal (I.M.F.)
D. Juel	Planning
G. W. Naylor	Industry (Consultant)
G. J. Novak	National Accounts
J. Parmar	Industry
R. E. Rowe	Agriculture
M. Schrenk	Industry
H. van Helden	Transportation
E. Levy (part time)	Statistics
Mrs. N. S. Gatbonton (part time)	External Debt
Miss G. M. Prefontaine	Secretary

Messrs. R. Hablutzel and W. Ladejinsky also contributed to this report.

Since the mission's visit substantial changes have occurred in the effective exchange rate structure and prices have risen at a more rapid rate than during the previous months of 1967. These developments may require reconsideration of the magnitudes in the 1968 budget. However they have not altered the basic conclusions of the mission in respect of the performance and prospects of the economy.

CONTENTS

BASIC DATA

	Total	Cultivated as % of Total
Area: (in square miles)	735,381	7.5 Of which 0.6 Estate farming 6.7 Smallholder farming

	Total	Density per sq.mile
Population: (1967)	112.3 million	153

Rate of Growth (1961-1967) = 2.4% per annum.

Density of main islands (1967):

Java and Madura	1,425
Sulawesi	113
Sumatra	100
Kalimantan	23
Other Islands	38

Political Status: Member of the United Nations, Association of Southeast Asian Nations

Gross National Product (1967): Rp. 950 billion

Real Rate of Growth (1961-1967) = 1.6-2.4% per annum

Per Capita NNP (1967) = $80 1/

Gross Domestic Product at Factor Cost (1966, at 1960 prices): Rp. 495 billion
of which, in percent,

Agriculture, fishing, forestry	48
Mining and quarrying	3
Public administration	5
Manufacturing and trade	27
Other economic sectors	17

Percent of Gross Domestic Product at Market Prices	1967
Gross investment	9.5
Gross savings	4.6
Balance of payments current account deficit	4.9
Investment income payments	n.a.
Government taxation receipts (1967)	6.2
Government current revenue (1967)	6.5

1/ This is based on official estimates.

Resource Gap as % of Investment (1967)	52.0
1963/1967	42.0

Money and Credit

Conversion (February 1, 1968)		D.P.	B.E. Market Rate	B.E. Credit Rate
1 rupiah	=	$0.0036	$0.0038	$0.0042
1 dollar	=	Rp. 280	Rp. 266	Rp. 240

	September 1967 (Rp. million)	% Change p.a. (1964-66)
Total money supply	40.2	458
Time and savings deposits	0.1	n.a.
Commercial bank credit to private sector	18.3	265
Rate of change in prices (percent)	121.7	453 1/

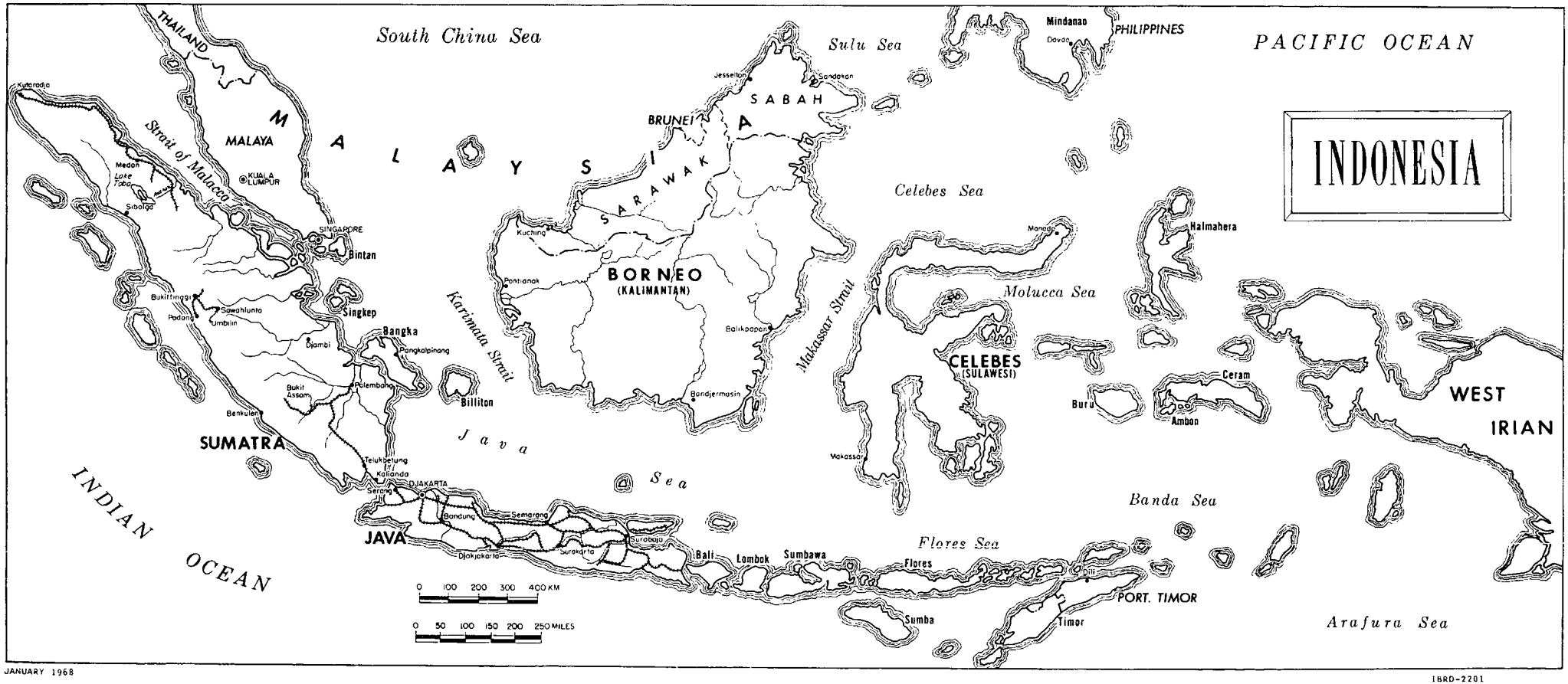
1/ Average annual rate of change.

Public Sector Operations (Rp. million)	1964	1967
Government revenue receipts	246.3	60,747.0
Government expenditures		103,700.0
Of which:		
(a) Development	n.a.	17,300.0
(b) Non-development	n.a.	72,000.0
(c) Special Accounts	n.a.	14,400.0
Revenue surplus/deficit	(-)350.0	18,373.0
External assistance to public sector	1.2	24,580.0
Of which:		
PL 480)	1.2	4,800.0
Other)		19,780.0

External Public Debt	As of October 31, 1967
Total external public debt	$ 2.3 billion
Of which undisbursed	$ 0.3 billion
Total debt service in 1967 after rescheduling	$68.1 million
Of which Payments for nationalized properties	$25.1 million
Debt service ratio in the 1970's	29 to 45 percent

Balance of Payments ($ million)	1966	1967 Proj.	% Change
Total exports merchandise (oil net) f.o.b.	554	590	6.5
Total imports f.o.b.	528	720	36.4
Invisibles (net)	165	182	10.3
Current account balance	(-) 139	(-) 312	124.5

	1967
Commodity concentration of exports - Rubber and oil (net)	45%
Gross gold, dollar and sterling reserves	negative



JANUARY 1968

IBRD-2201

SUMMARY AND CONCLUSIONS

i. This Economic Report on Indonesia is the first since April 1956. The last report covered the immediate post-independence period (1950-1954).

ii. The Suharto Administration assumed responsibility for the affairs of Indonesia in July 1966 following the abortive coup of September 30, 1965 and its aftermath. Comprehensive changes in the direction of economic policy were promulgated in July and October 1966 with a view to re-establishing market forces in the economy and strengthening its economic links with the non-Communist world. Steps to contain the inflation which had been rampant for many years, the partial elimination of subsidies for the numerous public sector enterprises, a new foreign investment law, and the use of a system of floating exchange rates, were the principal measures taken. These efforts have been accepted by Indonesia's principal creditors as the bases for a comprehensive rescheduling of her intolerable burden of short and medium-term foreign debt and for the resumption of substantial foreign aid from the Western countries and Japan.

iii. The Indonesian authorities have not yet produced a medium or long-term development plan since the Administration and its economic advisors have naturally been preoccupied with short-range problems. Nor does this report offer such a plan, though the mission has attempted, particularly in the sector annexes, to make some suggestions for actions which seem to us to be a necessary prelude to the production and execution of a successful plan. In addition, the report presents an analysis of the main developments in the economy since the last economic report with particular emphasis on what has happened in 1966 and 1967. It also appraises Indonesia's request for project aid for 1968 which was submitted to the meeting of the Inter-governmental Group on Indonesia held in Amsterdam, November 20-22, 1967.

Features of the Economy

iv. Indonesia is a prime example of a dual economy. The Dutch invested heavily in plantations, subsidiary industries, infra-structure, and commerce during the colonial period but smallholder and subsistence agriculture is still predominant. Manufacturing, both modern and traditional, is not well established. Almost the entire modern portions of the industrial and agricultural sectors are now under state control. This was inevitable following the nationalization of Dutch enterprises in the late 1950's. Other foreign properties were taken over in the 1960's but have now largely been returned.

v. Due to the vastness of the land and sea area covered by the Indonesian archipelago (about the same as continental U.S.A.), as well as the partial breakdown of the transport and communication systems because of neglect, the economy is split into various markets with large variances between the prices of similar goods within fairly short distances. Improved

transportation and communication is, therefore, one of the key development requirements. The natural resource base is more notable for its diversity than for its proven magnitude, particularly in view of the large population. Over 60 percent of the area is forested. There are rich but comparatively unexploited fish and timber resources and substantial but largely unexplored potential in the mining sector. With the present level of 27 million tons of petroleum output, Indonesia is the principal oil producer east of the Persian Gulf. This may expand rapidly in a few years if the new off-shore explorations are successful. She is also a major world producer of tin. There may be large deposits of bauxite, nickel and copper that have attracted keen outside interest in recent months.

vi. Java, with 9 percent of the area, has 65 percent of the population but most of the non-agricultural resources are on the other islands. Sumatra, three times larger than Java, has only 16 percent of the population but is the principal source of the country's exports. Legally, Indonesia is a unitary state but the diversity of economic resources and the distances between major population centers make central-regional relations very important.

Inflation and Stagnation

vii. Indonesia has endured serious inflationary pressures throughout her history as an independent state. In the period 1955-1958, inflation was accompanied by moderate economic growth, whereas after 1959 stagnation or slow growth prevailed. Principally because of the subservience of economic ends to political objectives and slogans and to military adventures, little or no net investment or savings occurred in this period. The inflation attained its peak in 1966 with 635 percent rise in prices in a single year. A striking feature was the lack of growth in the manufacturing sector which is normally the most dynamic part of a developing economy, particularly in one that has stringent import restrictions as in Indonesia prior to 1966. The stagnation in the manufacturing sector was because of the failure to replace Dutch and other expatriate investment, combined with the loss of entrepreneurship and technical and administrative skills when the Dutch nationals left in the later 'fifties. Even in agriculture the modern estate sector continued to lose ground and peasant agriculture improved its relative position. It was not surprising that export earnings declined greatly, aggravated by a fall in international prices of some of Indonesia's primary exports, notably rubber which produces 40 percent of total non-oil earnings. The decline in export earnings reduced the availability of raw materials and spare parts, resulting in idle capacity in manufacturing industry and lack of maintenance throughout the economy. These factors exacerbated inflationary pressures caused primarily by deficit spending and an extensive array of subsidies and handouts to state enterprises.

viii. A generation-long inflation at the rate experienced in Indonesia left its mark on income distribution and on the role of money and banking in the economy. As to the former, the salary and wage-earners in the urban areas were particularly hard hit. The rural population that produces and consumes most of its own real income was less adversely affected. As the rapid rise

of prices grew into hyper-inflation, money partially lost its role as a medium of exchange or store of value. The major part of the wage payments by government and enterprises is now made in kind. Low or negative interest rates on bank deposits and rapid decline in the purchasing power of monetary savings eroded the incentives and capacity to save. Savings deposits became insignificant and the banking system is now largely a purveyor of new credit rather than mobilizer of financial resources.

Stabilization Policy

ix. With the change of government in 1966, stabilization efforts were given the first priority. There was to be a two-pronged attack on the problem. Tightened credit, a balanced budget and return to a real rate of interest constituted the first prong and the rescheduling of debt, commodity aid and a fluctuating exchange rate, the second. There has been some backsliding from the first set of measures as the inevitable conflict between growth and stabilization emerged in a situation of transition. The second set have been adhered to with greater fidelity.

x. As most (67 percent) of the inflationary pressure was generated by the deficit in the government budget in 1964-1966, the preparation of the budget for 1967 offered the first opportunity to apply the stabilization policies. The budget was balanced with an increase over 1966 expenditure of roughly 170 percent which implied little or no increase in real terms. In the event, however, in place of fiscal balance, deficit financing of about Rp. 18 billion (about 18 percent of gross expenditures) has occurred. However, only about a third of the shortfall is a budget deficit and the balance arises from the prefinancing of rice imports and domestic rice procurement, a part of the stabilization program. Furthermore, an appreciable part of the budget deficit is accounted for by rise in development portion of the budget. Thus the 1967 fiscal performance is quite encouraging. There has in fact been about an 80 percent rise in domestic revenues in real terms as compared with 1966.

xi. In 1967 the rise in prices was around 6.5 percent per month compared with 18 percent per month in 1966. Contrary to experience in recent years, prices rose somewhat less than money supply, indicating a reduction in the velocity of circulation and perhaps a little greater willingness to hold cash balances. Application of tighter monetary policy no doubt was a factor in slowing down the pace of hyper-inflation. Three broad categories of credit were delineated by the state banks (who hold about 90 percent of total bank assets), with interest rates ranging from 6-9 percent per month instead of the previous 9 percent or so per annum. The rigor of the tight money policy of October 1966 was softened somewhat early in 1967 because of the fear of slowdown in economic activity and concern about the absorption of foreign aid. Prepayment of import taxes was waived and advance deposit against imports from aid sources was reduced from 100 percent to 50 percent. In April 1967 interest rates were lowered by 2 percentage points and by mid-1967, the monthly

rate of interest on the three categories were lowered to 3, 4 and 5 percent respectively. To promote the utilization of aid, advance deposit requirements for aid imports was further reduced. Recently this facility has, however, been withdrawn. Despite stabilization measures and their impact noted above, inflation is continuing on a scale that would be considered alarming were it not for the fact that it represents a vast improvement over the recent past.

xii. Decontrol Measures. Since the new regime was determined to give the market a chance to work, a general policy of decontrol was announced in July and October 1966. Price controls, formerly quite general, are now limited to petroleum products, electric power, urban transport and drinking water. On the external side, import controls were removed and replaced by a fluctuating exchange rate system based on the supply (including foreign aid) and demand for foreign exchange. In July 1967, further measures reduced the multiplicity of effective exchange rates and lowered the fiscal burden on the export sector. Effective import duties were increased substantially. The inadequacy of government revenues from other sources has limited freedom of action on the exchange rate front. The stated objective is a unitary fluctuating rate but it is doubtful if this can be accomplished pending the overhaul of the rest of the revenue system. While the entire structure of rates has depreciated continuously, the spreads between the rates set in the market and those at which aid funds and official exchange earnings are sold have been narrowed recently.

xiii. Other Measures. The new foreign investment law was approved in December 1966, granting liberal incentives and assurances to new foreign investors, a right-about-face from previous policies. A compensation agreement had already been reached for nationalized Dutch enterprises. Other foreign-owned industrial and trading properties that were nationalized in 1965 or brought under state supervision were to be returned to their owners. This has now been largely accomplished. Foreign investors have responded to this law and the reform attitude of the new Government and a number of substantial investments have now been sanctioned or are in various stages of consideration. Most of these are in extractive industries such as mining, forestry and oil production. Government now has in draft a domestic investment law to give incentives to domestic capital comparable to those it has already given to foreign investors.

xiv. Under the previous administrations, state enterprises were favored in respect of foreign exchange allocations and subsidized credit. State enterprises are now treated generally like private concerns and rely on their own resources for expansion or rehabilitation. While this policy has not been fully implemented and considerable control is still exercised by government departments over key decisions of state enterprises, and some credit advantages seem still to accrue to them, major subsidies have been eliminated.

Performance of the Economy

xv. Indonesia lacks the statistical equipment to provide useful macro-economic measures of economic performance. The publication of official statistics was stopped or at least suppressed in the closing years of the Sukarno regime. The mission has attempted to make its own computations of national product and investment but only very rough estimates were possible. A very preliminary estimate for 1965 national income indicates a small real increase as compared with 1964. Agricultural output may have grown at 2-4 percent annually during recent years. In 1966 there appreas to have been some increase in national income mainly due to a better than average increase in agricultural production. Very preliminary indications are that foodgrain production was lower in 1967 than in 1966. The growth of manufacturing industry is uncertain. While imports of needed materials and equipment can be secured by any importer with the necessary rupiahs, the less expansionary credit policy, unemployment and the administrative control over the budget are all likely to have had some dampening effects.

xvi. No estimates of investment are available but there is abundant evidence that it has been very low. Evidences of disinvestment in infrastructure, estates and industries are widespread and most new investment projects have either been stopped or are moving ahead slowly. Voluntary domestic savings have also been very meager. As for the Government, though development expenditure has risen from 7.8 percent of central government expenditures in 1966 to an estimated 17 percent in 1967, this and part of routine expenditures have been financed by a combination of foreign loans and central bank credits; public savings have probably been negative up to 1968.

xvii. The previous Administration regarded foreign and domestic credits rather than taxes as the preferred methods of financing public expenditures, and domestic revenues fell to less than 3 percent of national income in 1966. The objective of the present Administration is about 10 percent. In 1967 something around 6-7 percent was probably attained. Tax reform is of highest priority and has not yet been systematically tackled. The I.M.F. is providing expert assistance in this field.

xviii. Total exports (including oil on a gross basis) which were between $850 and $950 million a year in the period prior to 1958 tapered off to $616 million in 1963. Since then, oil exports have risen slowly. A significant part of the decline in exports was due to deterioration in the terms of trade which fell from 100 in 1960 to 61.5 in 1966. This implies that the earning power of Indonesia's exports today would be higher by more than $300 million if there had been no change in world market prices since 1960. The substantial rise in exports in 1966 is heartening but it may be in part statistical because of improvement in reporting. Indonesia's exports for 1967 are estimated at $774 million, showing an increase of 8.4 percent over the preceding year. If the oil sector is treated on a net basis, the rise in export in 1967 would be around 6.5 percent.

Policy Measures

xix. Measures taken in July and November 1967 to remove some of the burden of the stabilization program from exports and foreign aid were certainly in the right direction. Most important was the reduction of export taxes. However, export taxes will have to be reduced further if Indonesia's export potential is to be realized. It seems also essential that the Government should move gradually to a longer-term policy designed to encourage more import substitution.

xx. At present, the primary task of the Government is to raise the level of revenues. A pragmatic approach is to focus on improving tax administration and enforcement machinery. The provincial and local authorities do not seem to have utilized adequately the potential revenue which could be derived from taxes such as those on real estate and by development and improvement levies that fall within their tax jurisdictions. Prices of many public enterprises, especially in the fields of transport, water, electricity and petroleum, remained almost unchanged for a number of years until a five-fold increase in utility rates was made in February 1967. Another and more selective increase seems in order. The disposal of many of the smaller state-owned industrial and commercial units to the private sector should be feasible and would make a modest contribution to government revenues. There is also urgent need for further tax adjustments. Increases in the tax burden should fall on consumption or property rather than on the production and export sectors. Many items of consumption are under-taxed. The mission also seriously questions actions similar to the ones that eliminated the already low (10 percent) tax on domestic textile products or reduced the rates on tobacco products. In fact, many items that enjoy a wide market such as soft drinks could bear higher taxes.

xxi. In the field of monetary policy, it would seem desirable to narrow the gap between subsidized (partly at the expense of the holders of bank deposits) rates of interest charged by the state banks and market rates. Greater emphasis on market forces in the banking field should be supplemented by the provision of adequate working capital. The establishment of specialized agricultural and industrial credit institutions is needed. Further, the Central Bank (Bank Negara Unit I) does not seem to have as much independence vis-a-vis the Government as would be desirable.

Outlook for 1968

xxii. The 1968 budget is in balance at Rp. 143 billion, and it does not show much increase in real terms over 1967. On the revenue side, the mission feels that the 1968 budget forecast reflects considerable optimism since, apart from the 1967 experience which may contain non-recurrent elements, revenues have failed to keep pace with the rate of inflation. However, the Government has worked out a quarterly review procedure with a view to keeping routine budget expenditure in line with available financial resources. Unless this is done rigorously, it appears likely that deficit financing will continue to cause inflationary pressure. There is also a danger that sizeable

under-estimation may occur on the expenditure side. The Government intends to raise salaries and wages substantially. However, the budget situation in 1968 is likely to be improved by the recent decision to keep the AID-B.E. rate and the valuation rate for custom duty in line with the B.E.-market rate.

xxiii. The most significant change in the 1968 budget is the distinction between the financing of routine as against development expenditures. All the former are to be financed from domestic revenues, leaving the counterpart of aid entirely available for the development budget. In 1968, about 32 percent of total public expenditures are earmarked for the development budget as compared with 22.5 percent in 1967.

xxiv. Gross exports are expected to rise by 11 percent. This favorable prospect is largely due to the oil sector which is expected to show a rise of 24 percent. Exports from the non-oil sector are expected to increase only about 5 percent in 1968 compared to 6 percent in 1967.

Sector Programs

xxv. Systematic sector programs should be developed, both in terms of investment and economic policies, before the Five-Year Plan which the Government hopes to launch in 1969 is undertaken. The planning mechanism and approach is discussed in Annex 5. Up to now, only a skeleton organization has been set up though strong leadership has been assigned and foreign advice has been requested. Food production, particularly on Java, should be given top priority. The Bimas scheme for increasing rice production deserves more support. The mission has included in this report a number of suggestions as to sector policies and programs. In agriculture we concentrated more on the estate sector, since the Asian Development Bank is making a study of ways to increase food production. Agriculture and industry should expand in a complementary fashion through emphasis on greater production of agricultural inputs, particularly fertilizer, which Indonesia, by virtue of her petrochemical raw materials, is equipped to undertake.

xxvi. In industry, in addition to the need for technical and managerial assistance mentioned below, the mission was convinced that a number of problems need to be tackled. For example, domestic industry needs a more rational set of customs duties and internal taxes. Both inter-island transport rates and the rate structure for electric power appear to penalize domestic industry. As might be expected at this stage of Indonesia's stabilization program, there is a general lack of working capital. More attention needs to be paid to ways of meeting the minimum working capital requirements of Indonesian industry on other than the present rather hand-to-mouth basis. Also the revaluation of assets for tax purposes is an obvious requisite following the long bout of inflation.

xxvii. In transportation the mission is assisting the Government in preparing an application to the UNDP for a transportation survey with emphasis on roads and on the unification of previous studies of other sectors into an overall transportation plan. Telecommunications is another field requiring

study and a member of the Bank staff has visited Indonesia to map out such an undertaking. A study of part of the country to assess its power needs is also recommended in this report.

xxviii. Technical Assistance. In connection with our examination of the undertakings that make up the $75 million 1968 project aid program and also of a large number of "retarded" projects that have been held up for a variety of reasons (financial, technical and managerial), the mission was impressed with the high priority that should be given to advisory services, particularly to state enterprises in the field of management. The Indonesian Government reacted favorably and quickly to the mission's suggestion on this subject and the necessary machinery has been set up to decide where such assistance is most needed and to see that it is properly used by the agencies concerned. Other subjects in this general area which we investigated included budgetary and planning procedures and coordination, the improvement of statistical services and the providing of necessary advice and assistance to the National Planning Council on the whole range of technical assistance activities and related problems. The Indonesian Government is very anxious to have the assistance of the Bank, particularly in an advisory role on procurement as well as project preparation problems. The mission assisted the Government in preparing a request to the Bank for an advisor on technical assistance, who has now been appointed.

Creditworthiness, Terms of Aid and External Capital Requirements

xxix. The traditional exports of Indonesia, excluding oil and tin, are not likely to rise by more than 2-3 percent a year. Given the necessary investment recommended by the mission, tin exports can be doubled in ten years. The prospect for increased exports of oil, forestry products, minerals and fish is good. On this basis, exports are likely to increase by 5 to as much as 9 percent a year depending on the success, or lack of it, in the explorations for natural resources now in progress or contemplated, and the continuing interest of foreign investors.

xxx. However, even assuming the attainment of the highest conceivable rate of export growth, Indonesia's foreign debt service burden will remain excessive through the 1970's unless very significant additional rescheduling of debt service payments will have been effected. Her creditors have been generous in rescheduling payments due in 1967 and 1968 and, in principle, agreeing to consider the same for obligations due in 1969 and 1970. However, under these arrangements the rescheduled payments fall due on a rapidly increasing scale beginning in 1971. When these are added to payments originally called for after 1971 on the present indebtedness of about $2.3 billion, and when provision is made for new borrowings, total debt service will be in the range of about 30 to 40 percent of foreign exchange earnings by 1978 even with a 9 percent annual increase in exports. This is assuming that future borrowings will be serviced on DAC terms, which approximately conform to those being offered to Indonesia by the Intergovernmental Group on Indonesia. Thus, only the softest terms available should apply to any lending operations which the Bank Group may contemplate in Indonesia.

xxxi. In 1968, if Indonesia receives the $325 million of project and commodity aid that was deemed necessary by the Amsterdam meeting of the Inter-governmental Group to carry out the intentions of the Government in respect of stabilization and rehabilitation, her gross capital inflow (including the rescheduled debt service that would have been due in that year in the absence of rescheduling) will total about $708 million. Taking into account service payments on rescheduled debt due in 1972 and 1973 plus service payments on new debt, the mission has estimated that Indonesia will require an average gross capital inflow for the period 1969 to 1973 in the range of $500 to $750 million a year, depending on the growth rate which the donors wish to support by such assistance. This would provide Indonesia with a net capital inflow of $274 to $505 million a year. The former might permit an annual growth rate of around 4 percent and the latter about 5 percent. This is assuming that the 1969 and 1970 service payments on old debt will in fact be rescheduled.

CHAPTER 1

ECONOMIC AND POLITICAL BACKGROUND

The Country and People

1. The Japanese occupation of Indonesia during World War II was followed by the Declaration of Independence and the adoption of a Constitution in 1945, the culmination of the revolutionary movement that started in the 1920's. Following a protracted period of military engagements with the Netherlands' forces, negotiations resulted in the international recognition of the new Republic of Indonesia on December 31, 1949.

2. The country embraces a number of widely separated regions which were not closely united by economic, cultural or administrative ties during the colonial period. Therefore, a major task of the last seventeen years has been to achieve political and economic unification. These regions differ widely in their degrees of political and cultural advancement, resources, economic development and income, population density and the extent of their economic relations with the outside world. While the recognized islands of this, the world's largest archipelago, number about 3,000, the heartland of the country consists of the islands of Java and Sumatra, with Kalimantan (South Borneo) and Sulawesi (The Celebes) being of secondary but growing importance. The economic and socio-political development of the smaller islands and territories, such as Timor and Western New Guinea (West Irian) is just beginning.[1/]

3. Though in form the Administration is mainly centralized in Djakarta, with the provincial and other authorities largely appointed by the Central Government, the distances between the principal population centers (Indonesia encompasses a land and sea area about equal to the size of the United States; its land area is about a sixth as large) and the diversity of their economic interest make central-regional relations very important. This is particularly significant as between Java and Sumatra. Though Java produces some export crops and manufactured goods for the other islands, its economy is basically inward-oriented, with principal emphasis on food production and import substitution. It normally runs a heavy trade deficit with the outside world. Sumatra, on the other hand, is the principal producer of rubber, petroleum and palm oil, which earn the bulk of Indonesia's foreign exchange. Thus some degree of economic autonomy for Sumatra and other islands, including the right of disposal over a portion of their foreign exchange earnings, has long been an important political issue and helped to spark the abortive Sumatra and Sulawesi rebellion of 1958. The superior political power of Java has aroused opposition from the Outer Islands, where per capita productivity and external viability is generally greater. The Provinces in the outlying islands have been given more autonomy than those on Java and they also tend to have closer relations with foreign countries and are, therefore, rather less nationalistic.

1/ The final disposition of West Irian is to be settled by a plebiscite under U.N. auspices in 1969.

4. In addition to natural barriers and lack of communications, man-made obstacles to economic intercourse in the form of levies (both legal and illicit) on the inter-island and coastal flow of commerce are important. One of General Suharto's economist-advisers has summed it up with the remark that Indonesia lacks a common market. Currently, rice prices may vary from Rp. 10 per kilogram to Rp. 45 per kilogram within short distances separating surplus and deficit areas. Cement costs twice as much to move from the government plant at Gresik near Surabaja down the coast to Djakarta than from Yokohama to Djakarta. Certainly, improved physical transport facilities would help, but they will not suffice unless the barriers and charges imposed by provincial authorities and the armed forces, usually without coordination and sometimes without authority, are reduced or eliminated. Nevertheless, better transportation is one of Indonesia's key economic development requirements.

5. As in respect of other aspects of the economy, there are few reliable statistics on Indonesia's population and labor force. In 1966 the population was estimated at 110 million and the labor force at about 40 percent of that number. In 1830 population was estimated at only 8 million, indicating an annual growth over the decades of about 2.6 percent. This is also the average of the various growth rates estimated for recent years. Sixty-eight percent of the labor force is engaged in agriculture and the supply of skilled labor is quite small, although the training of Indonesians to make good industrial workers is not difficult. More attention is now being given to technical education. Literacy rates are relatively high as compared with other countries in South Asia, being about 43 percent for persons 15 years of age and over. This, however, is based on a sample taken on the island of Java and lower literacy rates no doubt prevail on other islands. Educational facilities have been improved substantially since Independence. Half the children of elementary school age are now in school and some 800,000 students are in institutions of higher learning of various degrees of proficiency.

6. About 95 percent of Indonesians are Moslems and predominantly Malay in origin. However, their Islamic culture is greatly influenced by earlier Hindu-Buddhistic traditions. They have strong linguistic and other cultural ties to the Malay Peninsula, though as elsewhere in Southeast Asia, communication between neighbors (except for smuggling) is not very extensive, perhaps largely because they lived for a long time under colonial administrations which did not encourage economic intercourse. The largest minority group, the Chinese, number about 3 million (roughly 3 percent of the population) but they play a more important role than their numbers indicate as traders, small manufacturers and money-lenders.

7. Until the Dutch were obliged to give up their holdings and leave Indonesia in the later 1950's, the modern capitalistic sector was primarily Dutch-owned. British, Americans, and other foreign groups have played a comparatively minor role except in petroleum and, to some extent, rubber. However, corporations from these and a few other non-Dutch countries, particularly the British, invested in plantations.

8. While most foreigners' conception of Indonesia is that of a very densely populated but rich country, neither of these generalizations is quite true if the total area is considered. With the present population roughly estimated at 112 million and the land area of about 735,000 square miles, the population density is about 153 persons per square mile for the country as a whole, whereas Java and the small neighboring island of Madura have 65 percent of the population but only 7 percent of the area with a population density of over 1,400 per square mile. This compares with about 100 persons per square mile for Sulawesi and Sumatra, 20 for Kalimantan and about 40 for the other islands. Efforts of the Government to relieve population pressures on Java by assisting movement (called transmigration) to other islands, principally Sumatra, have not been very successful though efforts continue. Sumatra is about 3½ times as large as Java; it embraces 25 percent of the area of the country and only about 16 percent of its population.

9. Indonesia's natural resource base is more notable for its diversity than for its proven magnitude, particularly in terms of resources per capita. Since it lies athwart the equator and has a stable tropical monsoon climate with evenly distributed rainfall, much the same type of crops can be grown in most parts of the country, although soil conditions, and therefore yields, vary substantially. A considerable portion of the soil is quite poor, apart from the volcanic areas of Sumatra and Java, and probably will not be capable of supporting a large agriculture-based population in the foreseeable future. The arable land constitutes only about 12 percent of the land area or 0.8 acres per capita, which is about average for Far Eastern countries. In Java, some 70 percent of the total area is under cultivation as compared with 4-5 percent in the outer islands.

10. About 60 percent of the land area is forested, although up to now the forests have been fairly unproductive. However, they are the subject of intense interest by foreign investors now that Indonesia has embarked on a policy of encouraging private foreign investment.

11. In respect of mineral resources, Indonesia is the most important Asiatic petroleum producer east of the Persian Gulf. Even without anything like full exploitation, its annual output is now (1968) about 29 million metric tons, putting it in a class with the lesser Middle East-North African producers. The major oil reserves are in Sumatra with lesser deposits in Kalimantan. Other mineral deposits are also diverse. Tin, bauxite, copper, manganese, some gold and silver, and low quality coal are significant in terms of current output. Deposits of these minerals are largely in Sumatra and adjacent smaller islands. Nickel and iron deposits are also believed to be substantial and, together with copper in West Irian, are attracting considerable outside interest.

12. Indonesia is a prime example of a dual economy, with well-defined modern and traditional sectors. This is primarily because of the substantial Dutch colonial-period investment in plantations, subsidiary industries and commerce. Peasant and smallholder agriculture was left comparatively undisturbed by the structural changes associated with modernization. However, the dualism is not along geographical or wholly along sectoral lines. Except in the case of petroleum and other mineral products, none of the main export products falls entirely in the modern sector. Although the Javan agricultural community consists mostly of smallholdings producing rice and corn, it also has rubber, tea and sugar estates. Estate agriculture in Sumatra, however, is more important than in Java and it is on that island that rubber, palm oil, copra and tea, grow in largest quantity. However, even in rubber, which is now Indonesia's largest export, the quantity produced by small landowners or cultivators is over twice the estate production. Of course, the modern sector is much more capital intensive and labor-productive than the traditional part of the economy.

13. Manufacturing, both modern and traditional, is not very well established. Most industrial establishments originally grew up in response to the demands of the estates for manufactured equipment and repairs. An exception is the textile industry where some complementarity has been developed between the modern and traditional sectors, the former producing piece goods and the latter, converting it into the well-known batik (printed) products.

14. Manufacturing and mining produce about 12 and 3 percent respectively of Indonesia's national product, as compared with about 50 percent for the agricultural sector.

Politics and Administration

15. From 1945 to 1950 the independent portion of the country was under the Constitution of 1945 which concentrated legislative and executive power in the revolutionary leadership. The guiding economic philosophy stressed a cooperative rather than a socialistic form of society though it was strongly anti-capitalistic since that term was associated with colonialism and monopoly.1/ When the Republic of Indonesia was established in 1950 a new provisional Constitution was adopted, giving the President only limited powers mainly ceremonial functions, and vesting legislative authority in a parliament with the Cabinet responsible to it. However, up to 1956 the parliament was appointed rather than elected, and the Executive continued to play the dominant role. Fifteen coalition cabinets held office between 1950 and 1955 and a stable party structure was slow to emerge. In 1955 two elections were held, one for members of a

1/ The five guiding principles (Pantjasila) were religion, humanitarianism, nationalism, democracy and social justice. These have remained as the avowed objectives of all subsequent administrations including the present one.

Constituent Assembly to draft a permanent constitution and one for the People's Representative Council or Assembly, which was to serve as a parliament until the constitution was ready. Eighty-seven percent of the electorate participated in electing the Council. Up to now no other general elections have been held in Indonesia. Four major parties -- the Nationalists (PNI) founded by the revolutionaries in the 1930's, two Moslem parties (the Masjumi and the Nahdatul Ulama) and the Communist party (PKI), were supported by the electorate in that order and together received 80 percent of the popular vote in these elections. Some 30 other small political parties and organizations were represented in parliament. However, the Constituent Assembly could not agree on a Constitution and was dissolved by President Sukarno in 1959.

16. The political life of Indonesia was quite unstable from 1957 on. Demands for regional autonomy, other divisive internal forces, conflicting economic ideologies and a program of nationalization involving the elimination of the Dutch and to some extent the resident Chinese from the economic life of the nation, were disturbing factors. Martial Law was imposed in 1957, and in 1958 a major rebellion against the Government broke out in Sumatra, which was not finally extinguished until 1961. These events led the President and other Indonesian leaders to conclude that the country was not ready for parliamentary democracy. In 1959 the advent of the new Nasakom ideology (an unlikely combination of nationalism, religion and Communism) led to further concentration of power in the hands of the President. At this time, the provisional Constitution of 1950 was abandoned and the more authoritarian Constitution of 1945 was decreed as the country's permanent charter. President Sukarno assumed the role of Head of Government (dispensing with a Prime Minister) in addition to his position as Head of State (President). In 1960 he had himself made President for life. Tighter controls over the economy, censorship of the press, control of political parties (the Masjumi Party was outlawed for alleged participation in the 1958 rebellion and other parties were limited to ten in number) were part of the Guided Democracy theme of the President. The effectiveness of the remaining legal political parties was greatly impaired. Measures were taken to discourage political dissent and acceptance of the State ideology was required for appointment to important offices. Political activity became increasingly concentrated in mass organizations under the direction of the Executive.

17. The takeover of the Dutch properties[1/] in 1958 and 1959 inevitably resulted in a substantial degree of de facto socialism. In May 1959 a major step was taken in the direction of the removal of non-Indonesians from the distribution business. In order to assure essential supplies

---

1/ The West Irian dispute was the ostensible motivation for the seizure of the Dutch properties.

under the rather chaotic conditions, a monopoly of the import of nine so-called essential items (including foods, fuel and clothing) was placed in the hands of government trading companies which had been nationalized at the time of the takeover from the Dutch. Thus the Government largely abandoned its gradualist approach to socialization. Almost the entire modern part of the Indonesian economy came under state control.

18. The elected parliamentary body set up in 1956 was dissolved in 1960 and replaced by an assembly of 283, all appointed by the President. This in turn became a part of the larger body called the Provisional People's Consultative Assembly (MPRS), which included delegates from the regions and from functional groups. This body still exists. It is responsible for determining the main lines of State policy but was completely under the control of the President up until the establishment of the present government in 1966. Since then, the legislative branch has played an increasingly important role. The Cabinet numbers 23 at present but in the past has been much larger.

19. The recent political history starts with the abortive coup of October 1, 1965, when the Army Commander-in-Chief and five Generals were assassinated by a combination of dissident military factions and youth groups under strong Communist influence. The liquidation of the cadres of the Communist Party (PKI) followed the immediate defeat of the coup by the army. Large-scale massacres occurred particularly in Central and Eastern Java and on Bali. The Communist Party was banned in March 1966 and President Sukarno gave General Suharto comprehensive emergency powers. There have been two governments since the effective removal of Sukarno from power. The first was set up on March 12, 1966, and the second was installed on July 26 of the same year. In both governments, the key figures have been General Suharto, Sultan of Djogjakarta and Adam Malik. Sultan of Djogjakarta and Malik have been in charge of economic and financial and political affairs respectively. For a time Suharto, Sultan of Djogjakarta, Malik and two other ministers constituted the Presidium (an inner Cabinet) which initiated major decisions and regulations. This has now been dissolved, and all ministers report directly to acting President Suharto.

20. Several of the 23 principal Ministries are headed by high officials of the Armed Forces and most other ministries and agencies have military personnel in high level positions.

21. There are 25 provinces in Indonesia, of which all but three have military persons as governors. The provinces have considerable but ill-defined autonomy but the governors and other higher provincial and local officials are appointed by the Central Government. The government has indicated that it intends to strengthen the provincial authorities but how this can be done without sacrificing efficiency in the use of financial resources still remains to be worked out. Provincial and local financial relationships with the Central Government are discussed in Chapter 3 and Appendix 2.

22. While Indonesia has a number of able and dedicated public officials, they are spread very thinly over too many ministries and agencies. Over-staffing at the lower echelons is as prevalent in Indonesia as in many other developing countries with redundant urban populations. It is more serious here because of the very low level of public revenues. About 60 percent of public expenditure is for personnel. Consolidation of ministries and agencies, which is needed to increase efficiency, would make it possible to reduce the number of employees. However, the stagnation that has long prevailed in the economy has precluded discharged government workers from finding other jobs. The purge of Communists and others from public service following the abortive 1965 coup was not done in a selective manner calculated to improve the efficiency of the public service.

23. Indonesia has had no effective planning organization or repository of economic information. Of particular interest to economic affairs generally is the group of leading economists from the University of Indonesia, who have been seconded as advisers to the Government. They are now undertaking the reorganization and strengthening of the National Development Planning Agency (Bappenas).

Principal Economic Changes Through 1965

24. The first decade and a half following Independence can be divided roughly into three periods, namely, the breaking-in period from 1950 to 1954, the comparatively productive interval of 1955-1958, and the troubled seven years of "Guided" democracy and economy from 1959 through 1965. The principal economic developments during the first of these periods was the subject of the previous Bank economic report written twelve years ago (AS-47a, April 27, 1956). In the second period, inflationary pressures, exchange depreciation and balance of payments difficulties continued, but there was considerable economic development, particularly in import-substitution type industries. The last period was a time of slow or stagnant economic growth, little or no net investment or savings and mounting inflationary pressures which reached epidemic proportions by the end of the period. In the 1950's, the export sector was replaced by the domestic sector as the more dynamic element in the economy.

25. The last report observed that in 1954 national income was probably only a little higher than it had been prior to World War II and in per capita terms was certainly lower.[1/] Economic growth during the previous five years probably ranged from 1½ - 2 percent per annum. Using the best estimates then available and the current official exchange rate, per capita income was calculated at $90, though the mission felt that this estimate was definitely too high in view of the over-valuation of the rupiah. $80 per capita is generally cited in other sources for the early 1950's.

1/ According to the National Planning Bureau, per capita income was restored to the pre-War level in 1955, though it is doubtful whether this was actually achieved.

26. The 1955 mission felt that, although the progress of the economy was discouraging, the distribution of income was probably somewhat more equitable than before the War in view of the improved position of peasant agriculture. Smallholder rubber and sugar production came to exceed that of the plantations. The production of all estate crops, except rubber, remained well below pre-War levels. The relative expansion of the non-estate sector was attributed to the better terms of trade for rice and other food as compared with export crops. At that time, there was considerable encroachment on the foreign-owned estates by squatters. The report attributed the slow economic progress of the country to: (1) low gross savings and investment; (2) bad distribution of population (there were plans, still unrealized today, to resettle 400,000 Javan families mainly in Sumatra between 1955 and 1957); (3) inadequate infra-structure; (4) low levels of skills and administrative capacity; and (5) difficulty of administration in a widely scattered economy. These disabilities still obtain. The report concluded that the order of priorities for public investment were power, transport and communications, irrigation and agriculture (now we might rank transport first). The report estimated that about $1.3 billion was invested by foreigners in Indonesia, of which about $1 billion was Dutch investment. The end of the Korean War boom had a particularly severe impact on Indonesia because of her internal financial instability and unrealistic exchange rates. From 1957 to 1962, Indonesia's export earnings declined 27 percent, of which about 15 percent was due to a decline in prices and 12 percent to a reduction of the quantity of exports. Indonesia, like other raw material supplying countries, suffered severely from the worsening in the terms of trade but she could not compensate for this by increasing output. The decline of the estates, the interference with export trade by its transfer from private to public hands and the lack of materials and equipment for export industries all played a significant part. In the case of sugar, for example, in the late 1920's, production was 3 million tons and exports 2.5 million tons. It then ranked first among Indonesia's exports.[1/] In the early 1950's only about half this amount was being exported and even this was to virtually disappear in the next few years. Petroleum was the only major export that showed appreciable growth in the 1950's.

27. Any accurate measurement of Indonesia's economic progress during the latter 1950's is impossible, owing to lack of data and the effect of inflation on the year-to-year comparability of all financial magnitudes. Some estimates by the National Planning Bureau indicate that the net domestic product at factor cost in constant 1955 prices grew from Rp. 109.1 billion in 1953 to Rp. 134.5 billion in 1957, an increase of 4.3 percent a year.

1/ In 1928 sugar was 23.8 percent, rubber 17.2 percent and oil 9.1 percent of total exports.

28. 1958 was a turning point for the worse in Indonesian economic affairs primarily due to the final expulsion of the Dutch over the West Irian controversy and the outbreak of rebellion in Sumatra. All observers agree that there was a considerable decline in the real domestic product in 1958 and continued stagnation in 1959. From 1958 through 1964 we have annual estimates of the national product by the Central Statistical Office. These indicate that net domestic product increased by 9.3 percent or only 1.5 percent a year over this 6-year period. In 1958, 1962 and 1963, economic growth appears to have been negative. These growth estimates by sectors are as follows:

Table 1

Growth by Industry Groups
(In Percent)

	Official Estimate		Mission's Estimate	
	1958-1964	Annual Average	1958-1964	Annual Average
Agriculture, Forestry	10.0	1.6)	12.5	2.0
Fisheries	38.2	5.6)		
Mining and Quarrying	43.3	6.1	52.7	7.3
Manufacturing	-1.2	--	-1.1	--
Construction	13.2	2.1	6.1	1.0
Transport and Communications	21.6	3.3	20.7	3.2
Other	6.8	1.1	23.8	3.6
Total:	9.3	1.5	15.1	2.4

This would mean that per capita real product declined somewhat from 1958 to 1964 as compared with the increase of up to 2.5 percent a year prior to 1958. The mission's estimates, shown in Table 1, do not differ greatly from the official figures.

29. A striking feature was the lack of growth in the manufacturing sector which is normally the most dynamic part of a developing economy, particularly in one which has stringent import restrictions as in Indonesia up to 1966. The decline in the industrial sector was because of the failure of the Government to replace Dutch and other expatriate investment, combined with the lack of entrepreneurship and technical and administrative skills. Even in agriculture the modern estate sector continued to lose ground and peasant agriculture continued to improve its relative position. The shift towards the subsistence sector was also associated with the declining competitive position of Indonesian exports in the world market. In the mining sector, gains in petroleum and bauxite were more than offset by losses in tin, coal and other mineral products. From 1958 on, the decline in the contribution of services to the domestic product resulted from the withdrawal of the Dutch from trade and banking and discrimination against other non-Indonesian citizens, notably the Chinese.

30. Most estimates of investment for this period are very low.[1/] The 1955 mission estimated investment at only 6-7 percent of national income and our own calculations for the period 1963-1966 would indicate about the same. Indications are that the investment that did take place was the result of the Government's attempt to provide more adequate opportunities for Indonesian entrepreneurs and to replace foreigners. The share of investment in government expenditures is estimated (by Paauw) at 20 percent in 1954 but only about 9 percent in 1958. The rebellion in 1958 in Sumatra reduced investment at provincial and local levels and the withdrawal of the Dutch caused a sharp shrinkage of private sector investment.

31. Despite inflationary pressures, consumption absorbed an increasing portion of domestic production and imports during most of the 1950's and consumption per capita was probably increasing in absolute terms up to 1958. However, starting with that year, there was no longer the case. As explained below, the burden of this fell primarily on the urban population; indications are that those engaged in subsistence agriculture were able to maintain their previous levels of consumption.

32. Although the Indonesian Government produced a five-year development plan in 1956, an 8-year plan in 1961, and a 3-year plan in 1965, there was never any sustained effort at economic development. Several false starts were made, notably under the short-lived Djuanda regime in 1963. Instead, political and military objectives held the center of the stage. The "confrontation" with Malaysia in 1963 resulted in a sharp increase in military demands on the economy.

33. The exclusion of first the Dutch in the later 1950's and subsequently other foreigners from the economic life of the nation produced a vacuum which the Government has not yet been able to fill itself or induce the generally impecunious indigenous private sector to occupy. Through a combination of ideology and necessity the Government found itself involved in more and more diversified activities, from running estates and heavy industry to foreign and retail trading. The steadily mounting inflationary pressures induced the Government to undertake to supply essential goods to the people in an effort to safeguard their well being, even though this meant conducting trade in fields where the Administration had no competence.

34. The measures that were taken to Indonesianize the main economic activities and to establish the basis for a "guided economy" greatly retarded the smooth operation of the economy. Shortages and strains developed particularly in distribution. In 1957, when the Dutch properties were seized, the Netherlands managerial personnel were withdrawn from inter-island merchant shipping and the Government was not able to build a national

---

1/ However, Douglas Paauw (Indonesia - Survey of World Cultures - Chapter 5; Yale University Press, 1963) says that pricing of imported capital goods at the official exchange rate resulted in a downward bias to estimates of investment as a portion of national income.

fleet to fill the void created by the ouster of the Dutch. Part of the shipping capacity was also diverted to military operations in connection with the rebellion of 1958, the West Irian dispute and the Malaysia confrontation. In May 1959 the Government issued a directive aiming at the removal of all the alien traders -- mainly Chinese and Indians -- from rural areas. The void was to be filled by an Indonesian cooperative network but this failed to materialize.

35. The decline in export earnings reduced the availability of raw materials and spare parts. The manufacturing sector, therefore, developed considerable idle capacity and also was badly maintained. These factors exacerbated inflationary pressures caused by deficit spending. Credit institutions were also disrupted. Dutch banks that had extensive credit relation with Dutch-owned enterprises in Indonesia were taken over in December 1957. There was a run on these banks as they ceased business relations with their former clients.

The Inflation

36. Indonesia has suffered from serious inflationary pressures throughout her history. Between 1951 and 1957 the cost of living in Djakarta increased 100 percent or by 8 to 12 percent annually. The inflation was mainly fed by government deficits. About 20 percent of public expenditures were financed with Central Bank credit. However, from 1955 to 1957 there was considerable investment in productive facilities, and though money supply increased rapidly, the ratio of monetary expansion to price increases was less than in later years. After 1957, however, money supply and prices rose at about the same rate (in 1958 to 1961 money supply increased 241 percent and the cost of living rose 196 percent).

37. A generation-long inflation at the rate experienced in Indonesia has naturally left its mark on the income distribution of the country. No comprehensive data are available but it is clear that the less advanced (largely subsistence) sector may have benefited to some extent from inflation. Table 2 provides some evidence of this. It shows that, while the ratio between the general cost-of-living index and food prices (an indication of the real income of the smallholder rural sector) was fairly stable from 1958 to 1965, the real wage of industrial workers in Djakarta declined about 60 per cent during this period.

Table 2

Food and Real Wages 1/

(General Cost-of-Living Index = 100)

	Industrial Real Wages	Food 2/
1958	100	105
1959	71	98
1960	61	95
1961	71	104
1962	35	106
1963	36	104
1964	41	105
1965	--	104

1/ Base of the Index: for food 1953 = 100.
2/ Food prices divided by cost-of-living index.

38. The rural population that produces and consumes most of its own income and makes minimum use of money has been less adversely affected by inflation and the relative change in the price of food items. Price control and, later, payment in kind, were resorted to as a way to minimize the depressive impact of inflation on living standards of the most vocal segment of the population. These controls which could be administered more readily in the more advanced sector of the economy adversely affected the incentives to invest and the capacity to save. Moreover, most investments were diverted for speculative reasons to the building of stocks and other short-term profitable channels.

39. A combination of factors such as rapid rate of urbanization and population pressure, the slow rate of economic growth as well as hyperinflation exerted great pressure on the urban living standards and unleashed political unrest, spearheaded by student movement in the fairly vocal social environment of urban Indonesia.

CHAPTER 2

THE ECONOMIC REFORM PROGRAM

Policy Framework

40. The economic policies and programs of the present government were enunciated in July and October 1966. First priority was given to financial stabilization, and to measures to reestablish an internal market economy and to link it with the outside world - a tie largely severed by the policies of the previous regime.

41. In the four years, up to the end of 1966, consumer prices had risen 160 times, and the money supply 100 times. Inflation reached a crescendo in 1966 with a 714 percent monetary expansion and a roughly commensurate increase in prices. This situation contributed to the political events of 1966, and for the Suharto Government there was no alternative to halting or at least dampening inflationary pressures before turning to more attractive rehabilitation, structural, and development programs.

42. During the period of hyper-inflation, bank credit for the productive sector of the economy accounted for roughly 25 percent of the increase in money supply and government deficits for 75 percent. This understates the role of the public sector in the inflation, since a large amount of bank credit also went to government enterprises. Therefore, it was clear that an attack on weakness in public finance lay at the heart of the stabilization problem. However, the Government's stabilization program was basically two-pronged. A balanced budget and tightened credit with a real rate of interest on loans from state banks was the first prong. Rescheduling of foreign debts, foreign commodity aid and a floating exchange rate system made up the second.

43. Except in magnitude and duration, Indonesian inflation had followed the usual pattern. As it generated momentum, money was, in large part, displaced by payments in kind, particularly in rice and other consumer necessities. Money wages and salaries paid to workers, including the military and civilian employees of the Government,became very nominal in real terms. The importance of rice as a medium of wage payments and as an index of inflation resulted in official pressure to keep the price of rice below the international level and this in turn tended to discourage production, thus further aggravating the supply situation. Since the velocity of circulation had risen sharply, the money supply in terms of real value declined. Many point to this fact as an evidence of lack of liquidity and to the need for more credit expansion. This underlines the tendency for inflationary forces to perpetuate themselves.

44. On July 5, 1966, the People's Consultative Assembly (MPRS) took a decision [1] to reform basic financial and development policy including the redefinition of the roles of the public and private sectors. This was followed on October 5, by a series of decisions aimed principally at intensifying the stabilization effort. The July decision contemplated a sequence of programs that would lead to (1) recovery; (2) rehabilitation; and (3) stabilization over the following two or three years. However, it is not apparent that this phasing had much effect on policy. More important was the more specific list of priorities set out in the decision namely to (a) control inflation; (b) increase food production; (c) rehabilitate infra-structure; (d) promote exports; and (e) improve supplies of clothing and shelter.

Initiation of the Stabilization Program

45. The preparation of the budget for 1967 offered the first opportunity to apply stabilization policies. Estimates for that year indicated a budget balanced at Rp. 81.3 billion. Tax and other domestic revenues were estimated at about Rp. 52 billion and the counterpart of foreign aid at Rp. 29.5 billion. On the expenditure side the routine expenditures were estimated at Rp. 65.9 billion and development expenditures at Rp. 15.4 billion. Thus no deficit financing was contemplated though only about half of the counterpart of foreign aid could be earmarked for development.

46. As expenditures and receipts have evolved over the year, it appears that the overall fiscal performance of the Government has been fairly good despite the fact that it now appears certain that fiscal operations resulted in monetary expansion of considerable proportions for the year as a whole. (See Chapter 3).

47. There has been an overage of expenditures due to nonbudgeted outlays mainly for rice (rice is furnished government employees in kind and rice prices have risen) and fertilizer and to a considerable increase in development expenditures over the amount provided for in the budget.

48. However, tax revenues (mainly from oil and import duties) were about Rp. 9 billion above original estimates.

49. The other facet of the Government's financial policy adopted in October 1966 was to increase interest rates on loans from government banks (75-80 percent of the total). In October, interest rates were raised from a range starting at about 9 percent per annum to 6 to 9.5 percent per month. In response to alleged credit needs and demands, these rates were subsequently progressively reduced to 3 - 5 percent per month. Thus concern about cost-push inflation and fear of business recession led to a partial reversal of the tight money policy. For the time being at least this range no longer represents positive rates of interest in view of the continuing inflation. Market rates of interest range between 10 and 20 percent a month. Such rates are charged by the private banks for credit to which the Government does not attach high priority (such as for imports). Credit extended by

[1] MPRS decision number XXIII.

the State Banks was to be directed mainly towards the financing of exports and domestic production though in practice it has not been provided on a very selective basis.

50. Although any statistical measurement of the decline in business activity because of the tight money policy is lacking, there are general complaints of lack of inventory financing. This was eased somewhat when interest rates were adjusted downward by State Banks to the range of 3 to 5 percent a month. Now lack of creditworthiness of the borrower rather than the cost of credit seems to be the principal problem. The higher cost of credit was also partially offset by the removal of quantitative restrictions on imports and, later, additional tariff protection extended to local industry. In other sectors of the economy the rice situation was reasonably satisfactory in the first quarter of 1967, although lack of credit for the purchase of imports may have reduced production in the latter months of 1967. Mining is not making much progress because of the lack of equipment and spare parts, as well as managerial problems. With the freeing of the foreign exchange system, foreign competition became a problem for the spinning branch of the textile industry and some other products such as sugar and vegetable oils. Some observers felt that the business recession was becoming somewhat more serious as 1967 advanced, despite the lower interest rates and protective surcharges on tariffs. Unemployment has become a more serious problem as government jobs are curtailed, and private investment did not expand to keep pace with the expansion of the labor force.

51. Despite stabilization measures and their impact noted above inflation is continuing on a scale that would be considered alarming were it not for the fact that it represents a vast improvement over the recent past.

52. During the first 10 months of 1967, money supply rose about 95 percent (as compared with the 65 percent originally contemplated for the year as a whole), and during the same period the consumer price index for Djakarta rose by 78 percent. For the year as a whole monetary expansion will probably be about 150% and the price hike 100%. Private credit expansion was more important than the budget deficit as a factor in monetary expansion in recent months. This is in line with government policy.

53. In September 1967, the price index in Djakarta rose by 10.4 percent and in October by 9 percent. Factors that have seriously impeded any progress towards stabilization in recent months have been an acute rice shortage (partly due to unseasonable dry weather and partly due to administrative failures in connection with the rice promotion program), and shortages in some other consumer goods, notably kerosene which seems to have been caused by a temporary breakdown of the transportation system.

Steps to Decontrol the Economy

54. Since the new regime was concerned to pave the way for the recovery of investment and production and to encourage private foreign investment in the economy, to these ends a general policy of decontrol was adopted. A new foreign investment law was approved as early as December 1966, which granted

liberal incentives and assurances to new foreign investment, a right-about-face from previous policies. In respect to other foreign interests, most non-Dutch foreign-owned industrial and trading properties that were nationalized in 1965 or at least brought under state supervision were to be returned to their owners (a compensation agreement had already been reached for nationalized Dutch properties). This has now been accomplished with the exception of some estates. The recognition of the acute scarcity of domestic savings and managerial capacity encouraged this attitude of hospitality to foreign investment. Foreign investors (notably Americans who were able to obtain foreign investment guarantees from the U. S. Government) have responded to this law and the reform attitude of the new Government and a number of substantial investments have now been sanctioned or are in various stages of consideration by Indonesian authorities. Most of these are in extractive industries such as mining, forestry and oil production. The Government would like to encourage some foreign participation in existing or proposed state-owned enterprises but this program has not yet yielded substantial results. It now has in draft a domestic investment law to give incentives to domestic capital comparable to those it has already given to foreign investors.

55. In view of the importance of government-owned industrial and commercial enterprises in Indonesia, the new regime turned its attention to them in October 1966.

56. Under the previous administrations state enterprises were favored in respect of foreign exchange allocations, subsidized credit and exchange allocations, among other advantages. The present Government decreed that state enterprises should be treated generally like private concerns and rely on their own resources for expansion or rehabilitation and no longer receive special advantages. While this policy has not been fully implemented and considerable control is still exercised by government departments over key decisions of state enterprises, and some credit advantages seem still to accrue to them, major subsidies have been eliminated.

57. Other action was taken to move from a controlled to a freer economy. Price controls, formerly quite general, are now limited to petroleum products, electric power, urban transport and drinking water. As part of the stabilization program, and after a long period when they were held at very low levels, rates of public utilities were increased fivefold early in 1967. They still lag well behind the inflation.

58. On the external side, import controls were removed and replaced by a fluctuating exchange rate system based on the supply (including foreign aid) and demand for foreign exchange. This system is described in Chapter 4. Recent measures (of July 28, 1967) reduced the multiplicity of rates and lowered the fiscal burden on the export sector. Import duties also have been increased substantially, both by imposing surcharges and by increasing value for duty. The inadequacy

of government revenues from other sources has limited freedom of action on the exchange rate front. The stated objective is a unitary fluctuating rate but it is doubtful if this can be accomplished pending the overhaul of the rest of the revenue system.

General Performance of the Economy

59. The last year for which useable estimates of national income are available is 1964. The Central Bureau of Statistics has estimated real economic growth at 4.8 percent for that year.

60. The mission's estimates for 1965 however indicate a rise in real national income of 4.2 percent (Appendix Vol. VI, Table 7). Output in the manufacturing sector is estimated to have fallen by about 25 percent according to the official statistics, but this appears to be in error.

61. Agricultural output is generally considered to have been growing fairly steadily at 2 - 4 percent a year during recent years. However, in 1967 little if any growth occurred.

62. In 1966 there appears to have been some increase in national income which, if true, must be attributed mainly to a better than average increase in agricultural production and to a nearly doubling of real current budgetary expenditures measured in real terms. Very preliminary indications are that foodgrain production was lower in 1967 than in 1966. It is difficult to say about manufacturing because, while imports of needed materials and equipment can be secured by anyone with the necessary rupiahs, the less expansionary credit policy, unemployment, and the administrative controls over the budget are all likely to have some dampening effect. All the establishments visited by the mission emphasized the disabilities under which they were operating, particularly the shortage of working capital. Production in mining, particularly tin[1] and coal, is hardly likely to recover. (Management and other problems have brought the production of tin concentrates down to only one-third of the 1954 peak year.) About the same is true of coal with output now about a third of the peak post-War level. Prospects for petroleum output in 1967, on the other hand, are particularly favorable. Investment by the foreign companies (Caltex and Stanvac) had been held up by the unfavorable exchange rate (Rp. 10 to $1) in 1966 applicable to their purchase of local currency and sales of products to the Government. This was increased to Rp. 85 to $1 in the first quarter of 1967 and indications are that the oil companies are reacting favorably.

1/ There has been, however, increase in tin production in 1967.

63. No official estimates of investment are available but there is abundant evidence that it has been very low. 1/ Evidences of disinvestment in infrastructure, estates and industries are widespread and most new investment projects have either not been completed or are of low priority or both. The 1967 budget contains no new projects and, for the most part, expenditure on existing projects is only sufficient to prevent their physical deterioration.

External Economic Position

64. Indonesia had a deficit on current account of $139 million in 1966 which was reduced to $41 million by net capital inflow. Estimates are that her current account deficit will be about $312 million in 1967 but this depends a great deal upon the speed with which foreign aid is disbursed. Exports in 1967 are expected to be about $590 million or about 6.5 percent higher than in 1966. Growth in exports has been seriously impaired by the decline in the price of rubber which constitutes about 40 percent of Indonesian non-oil exports.

65. Actual Indonesian exports are considerably higher than recorded exports. Smuggling has been publicly estimated at $100 million or more annually and has by all accounts increased dramatically since the ending of confrontation with Malaysia and Singapore. Still greater increases in the incentives for legal exports appear to be the only means of curtailing smuggling. However, a considerable portion of the proceeds of smuggling is returned as lower priority imports.

66. The combination of the stabilization measures taken since October 3, 1966, and the progressive improvement in the effective export rates appears to have improved the competitive position of Indonesian exports. This is beginning to be demonstrated in improved export trends this year.

67. From the standpoint of foreign debt and foreign exchange reserves, Indonesia, of course, is in a very serious plight indeed.

1/ The mission has made a very tentative estimate of overall investment from 1963 to 1966, based on the import of capital goods and materials for the production of capital goods (Appendix Table 7).

In Pakistan such imports constituted, in the Second Plan, over 70 percent of the investment of the monetized sector. Considering that Indonesia, like Pakistan, does not have a broad-based capital goods producing industrial sector, a similar ratio for Indonesia has been used. As for investment in the non-monetized sector, it is assumed that annually 5 percent of the value added of the agricultural sector is invested. On this basis, the rate of gross investment in 1963-1966 varied between 5 to 7 percent of the net national product. This is about the same as rough estimates made during the mid-1950's.

68. Her medium and long-term foreign debt is $2.3 billion, 42 percent of which is owed to Communist countries. While the magnitude of this debt is not overwhelming for a country of Indonesia's potential, the terms on which it was incurred, including the speed of amortization, makes it very onerous indeed.

69. Thus, debt rescheduling was given high priority by the new Administration. Debt service obligations to Western countries falling due in 1967 (about $250 million) and arrears up to June 30, 1966, were rescheduled over a period of 8 years starting in 1971. Preliminary agreement has been reached on rescheduling of obligations to the U.S.S.R. (which has 30 percent of Indonesia's foreign debt). Another successful meeting to consider the rescheduling of Indonesia's foreign debt obligations to Western countries in 1968 and tentatively the two subsequent years was held in October 1967. The net foreign exchange reserves of Indonesia were negative by $77 million as of March 1967. She has not possessed any net reserves since 1962.

Recent Reform Measures

69a. On January 29, 1968, some important policy measures were announced by the Government. These include:

(1) Continuation and improvement of quarterly budgetary review and spending authorization so as to finance the routine expenditure exclusively from domestic revenue and the development program from the proceeds of foreign aid (including PL 480). To implement the program, a Special Account is to be established with the Central Bank. Proceeds of all non-project aid (including PL 480) will be credited to this account and all development outlays from the budget and credit for production purposes (e.g., for the purchase of fertilizer and pesticide and for the financing of essential production such as textile and estate agriculture) will be debited to this account.

(2) Net reliance of Government on the Central Bank also is to be limited every quarter. The objective of the credit policy is to slow down the rate of rise in prices to less than one-half of the rate in 1967 (price rise in 1967 was 112 percent).

(3) Imports are re-grouped. The B.E. imports[1] are divided into three categories: (a) very essential, (b) essential, and (c) less essential. Aid proceeds can be used for the purchase of groups (a) and (b) only. Some less essential items from the former B.E. list are transferred to the D.P. list, and most of the licensable items (over 30 items) are included in the D.P. list.[2]

(4) In setting AID-B.E. rate, Government will follow as closely as possible the B.E. market rate (within 15 percent of the market rate), and

(5) Short-term foreign credit of up to one year (including B.E. tanpa cover) is to be limited to a maximum of $75.0 million.

1/ B.E., D.P., AID-B.E. are described in paragraphs 115-118.
2/ A larger prohibited list is introduced comprising sedan cars, with value in excess of $2,000 (f.o.b.), large size T.V. sets, radios (console) and batik cloths.

CHAPTER 3

FISCAL AND MONETARY PERFORMANCE AND PROSPECTS

The Fiscal System

70. Indonesia has provincial and local governments but its Constitution bestows the main economic and political power on the Central Government with the provincial and local administrations having limited and rather vaguely defined responsiblity for certain matters. Under present administrative arrangements, the effective tax power is almost all vested in the Central Government. The expenditure function, on the other hand, is much more diffused, with the result that there are substantial downstream flows of funds from the center to the provinces and to their subdivisions. Part of these flows is a consequence of the legislative earmarking of certain taxes for provincial and local use, and part a consequence of subventions provided in the budget on a year-to-year basis. Now (1967), about 30 percent of all revenue of the Center is transferred to lower levels of government. The revenues which they collect on their own amount to only 2 percent of total public revenues in Indonesia, whereas they spend 27 percent of it.

71. There have been continuing efforts by provincial authorities to secure a larger portion of taxes levied by the Central Government, and new draft legislation is now under consideration that envisages increased allocations to the provincial and local authorities. The most important feature of this is the provision under which 30 percent of the domestic revenues of the Central Government are to be passed on to cover the routine expenditures at the lower levels. This excludes the share they are now obtaining of export taxes and the entire proceeds of the land tax which are already earmarked for development expenditures by the provincial and local governments. On the other hand, the counterpart of foreign aid and the Central Government's share of export taxes will not be shared but retained at the Center.

72. Until 1966, the Central Government budget was not a very effective device for the allocation and control of public expenditures. For one thing, responsibility for the preparation of the budget and for its execution was in part vested in different authorities. One ministry prepared the routine and development budget and another executed its credit and foreign exchange aspects. Control over disbursement was largely nonexistent. The reorganization of the budget operation in 1966 made the Budget Division of the Ministry of Finance responsible for both preparation and implementation, although the mechanics of disbursement for military and development expenditures and service payments on the public debt is still the responsibility of the Central Bank rather than the Treasury. However, these outlays are effected according to quarterly allocations of the Ministry of Finance.

73. The budget is divided into two main parts, namely "routine" expenditure and development expenditure, although the distinction between them is not very well defined and development expenditure is not necessarily synonymous with public investment or even capital formation. Generally speaking, it encompasses construction and rehabilitation outlays. An important task still to be accomplished is to coordinate the work of the National Development Planning Agency (Bappenas) with the preparation of the development budget by the Ministry of Finance. The 1968 budget reflects this coordination only to a relatively minor extent mainly because Bappenas hardly existed as an effective planning office prior to July 1967. Another important administrative step to be taken is the coordination of provincial and local budgets, particularly their development aspects with the activities of the Central Government. Under present administrative arrangements, only the Ministry of Home Affairs, which has to approve the provincial budget, seems to be familiar with their contents and even this Ministry's control appears to be very limited.[1] One control the Center does have is over borrowing by provincial governments, since neither they nor local governments may borrow without the prior approval of the next higher authority in the administrative hierarchy.

General Revenue Structure

74. The tax structure of the Central Government is described in Appendix 2. It includes the usual types of taxes levied on income, wealth and property, production and consumption. Personal incomes and commercial profits are subject to the income tax and company tax, the net wealth tax covers personal and real property holdings, traditional taxes are levied on agricultural land (IPEDA) and urban real estate (IREDA). There is also a tax on property transfers. In addition to the import tariffs, excises and sales taxes fall on consumption. Up to July 1967, exports were taxed in an implicit manner through the multiple exchange rate system. This has now been simplified somewhat and the designation changed to explicit export taxes.

75. The tax structure of the local authorities including provinces, districts and sub-districts is complex. The tax jurisdiction of these authorities covers a variety of taxes, fees and duties such as taxes on real estate, market places, restaurants and hotels, advertisements, household movables, and also motor vehicles, entertainment and business license fees. As noted above, the provinces (sometimes called regions) receive a share of the export taxes, and the regencies (districts) receive all of the proceeds from the land tax though both are administered by the Central Government. West Irian and Jogjakarta have pre-empted the revenue from the central government income tax and some other regions levy surcharges on the central government taxes. The local authorities have not exercised their taxing power fully and revenue from the locally administered taxes has become almost insignificant in comparison with funds received from the Center.

1/ An exception may be the use by the provincial governments of their share of export taxes. The Ministries of Home Affairs and Finance do attempt to see that these funds are used for development purposes.

76. The present tax legislation in Indonesia has explicitly or implicitly provided certain flexibility in the administration of a number of taxes by allowing wide discretionary power to the Ministry of Finance and other taxing authorities. For example, while the income tax code determines the applicable rates, the Ministry of Finance is left free to adjust the income brackets subject to these rates. The tariff has established the basic rates but the Ministry is empowered to impose surcharges (which are now in excess of 100 percent for some items) and a host of other levies. The same position holds with respect to the other taxes such as excise and sales taxes. Under the changing conditions in Indonesia this is probably desirable since the Government is in a position to respond to the inflation by adjusting the specific rates and the tax coverage. However, this administrative flexibility was not used by previous administrations to keep revenues in step with inflation. Even in the case of ad valorem taxes, the valuations on which they were based tended to be petrified for long periods, thus undermining revenues.

Fiscal Performance, 1960-1965

77. As in respect of other features of Indonesia's economic performance, fiscal affairs took a pronounced turn for the worse about 1960. In retrospect, the five years, 1955-1960, look reasonably good. Whereas prices increased by about 25 percent per year, central government revenue went up by 26.1 percent a year. During this period, government revenue, as a proportion of national income, increased from 12 to 13 percent. In contrast, from 1960 through 1965, the price hike ran at an annual rate of 225 percent compared with a 79 percent yearly increase in revenue. Consequently (according to the very rough national accounts estimates available), central government revenue dwindled by 1965 to the totally inadequate level of about 3.1 percent of national income. There are indications that the financial operations of the provincial governments and local authorities also contracted considerably, leading to their greater dependence on the Central Government and the banking system.

78. During the early 'sixties, the loss of revenue (in real terms) from indirect taxes was greater than that of direct taxes which were generally more responsive to changes in prices. The share of direct taxes increased from 17 percent of total revenue in 1960 to 33 percent in 1965. Of course, under inflationary conditions the inducement to defer all tax payments is great. This factor, coupled with increasing collusion between the tax payer and tax collector, undermined tax administration. Income and corporation taxes are not levied on the basis of books of account and all tax assessment has perforce been arbitrary. Further, the levy on salary and wages is complicated by the fact that a significant part of payments are in kind. This practice has greatly increased the administrative work needed for determining the tax obligation of individual assessees.

79. Another very important factor in fiscal deterioration after 1959 was the change in the tax base resulting from the nationalization of foreign properties. The foreign trade sector, in which the Dutch and other

foreigners were predominant, traditionally produced a large share of the revenue. This sector practically disappeared after 1957 and the state enterprises that succeeded to the ownership of most of the modern sector of the economy have produced little revenue. Their administration was generally poor, resulting in a rise in operating costs, and this, coupled with price controls on their end-products, reduced their earnings to near zero except for the oil companies. With a thriving black market in controlled goods, a sizeable part of their products were diverted to these channels which deprived them and the Government of revenues.

80. Of overriding importance in this whole situation was political instability and the attitude of government leadership which came to regard bank credit and foreign loans rather than taxes as the proper techniques for financing public expenditures.

81. Side-by-side with decrease in revenues (in real terms), there occurred a substantial real decline in government expenditure. The decline was naturally much less steep, hence huge deficit financing. During 1960-1965, whereas the annual rate of increase in prices was 225 percent, government expenditure increased by 112 percent per year. The central government expenditure in 1965 was 8 percent of national income compared to 14 percent in 1960. Defense expenditures, of course, reflected the events of the period, particularly the West Irian and Malaysian confrontations. As a portion of total expenditures, defense increased from 24 percent in 1955 to about 40 percent in 1960 and reached a high water mark of over 58 percent in 1966. It has since declined. Outlays for economic services, especially for financing of state enterprises, increased from 23.2 percent of the total expenditure in 1960 to 41.7 percent in 1965. But at the same time, the relative size of social services, e.g., education and health, declined from 8.7 percent to 4.3 percent and similarly the relative cost of general administration was reduced from 16.1 percent to 4.5 percent.

82. Compared with 1965, government receipts in 1966 rose more than 13 times. Since prices rose about 7 times, some improvement occurred in the mobilization of revenues in real terms. However, expenditures increased nearly 12 times in 1966 and total deficit financing amounted to over Rp. 12 billion (Appendix Table 9). This was 8.6 times the 1965 level and 6½ times the total money supply at the beginning of the year. Thus the new Administration assumed power under very trying financial circumstances.

Recent Fiscal Performance

83. In accordance with the policy declarations of July and October 1966, the 1967 budget was balanced at Rp. 81.3 billion, an increase over 1966 expenditure of roughly 170 percent which, however, implied little or no increase in real terms. Rp. 29.5 billion was to be financed with the counterpart of foreign aid so that domestic resources were estimated at about Rp. 50 billion. However, included in the estimate of foreign aid counterpart was Rp. 9.2 billion of aid that was to offset an equivalent amount of foreign debt

payments coming due in 1967. Since, instead of being refinanced, these debt service payments were rescheduled, this amount should be deducted from both the revenue and expenditure side of the budget.

84. Domestic revenues for 1967 are now estimated at about Rp. 61 billion or roughly Rp. 8 billion above budget estimates (Appendix Table 20). Two-thirds of the increase is accounted for by direct taxes. While the counterpart of foreign aid fell short of budget estimates by about Rp. 4 billion, there has been net increase in aid receipt by Rp. 4 billion over the original budget estimates. Total revenues including the counterpart of foreign aid are now estimated at about Rp. 85 billion (Rp. 61 billion of domestic revenues plus about Rp. 24 billion of aid counterpart) or nearly Rp. 4 billion above budget estimates.

85. On the other hand, cash expenditures for 1967 are estimated at about Rp. 104 billion, or Rp. 23 billion more than provided in the budget. Thus, in place of fiscal balance, deficit financing in the neighborhood of Rp. 18 billion was required. However, Rp. 14 billion of this arises from the prefinancing of rice imports and domestic rice procurement.1/ Aside from the settlement of these special accounts (in part a non-recurrent operation), government expenditures in 1967 are now estimated at about Rp. 89 billion or Rp. 8 billion above the budget estimates. Around Rp. 4 billion of this was taken care of by the increase in revenues. About Rp. 2 billion out of the roughly Rp. 8 billion increase in budgetary expenditures has been in the development portion of the budget and the real increase in domestic revenues as compared with 1966 may be about 80 percent. Thus, on balance, the fiscal 1967 performance is quite encouraging.

86. A major impediment to improved fiscal performance in Indonesia is the very large expenditure for government personnel, including the cost of payments in kind (mainly rice). Personnel expenditures appear to be about 60 percent of total outlays of the Central Government. Personnel expenditures in 1967 are likely to be about 22 percent larger than contemplated in the budget, apparently owing chiefly to the increase in the price of rice. Even so, it appears that the real income of government employees may have fallen in 1967 and the Government is under considerable pressure to increase real wages and salaries in 1968.

87. In 1968, as in 1967, a balanced budget has been prepared. The level is about Rp. 143 billion. This is about 68 percent higher than

---

1/ The Government has decided to liquidate extra budgetary or special accounts of the government sector before the end of the 1967 fiscal year, in order to achieve a sound basis for the 1968 budget. Formerly, such expenditures were carried over to be liquidated in the following year. These special accounts include funds for the prefinancing of rice imports and government guarantees for the prefinancing of fertilizer imports and some commitments in connection with PL 480 transactions. Of course, to the extent that these accounts increased, the money supply expanded.

1967.[1] In real terms, and assuming the 1968 budget is adhered to, this does not appear to be a substantial increase, particularly since it contemplates an increase in domestic revenues of only about 77 percent, which is unlikely to exceed by more than about 20 percent the increase in the price level as between the two years.

88. On the revenue side, the Administration is counting more on improved collections of direct taxes than on indirect taxes in 1968 and, of course, this is a particularly difficult area in a developing country. If this is accomplished, it would mean a reversal of trends in 1966 and 1967 when the share of direct taxes fell. Self-assessment and withholding procedures adopted in August 1967 are expected to improve the yield of income and company taxes in 1968, together with a sharp improvement in the oil revenues. If the tax objectives are realized, tax revenue in 1968 would represent around 8 percent of the 1968 national income compared with 6.2 percent for 1967, though such an improvement is modest and should be possible if the administrative machinery can be improved substantially. However, on the basis of its examination of estimates for individual taxes, the mission feels that there may be a shortfall of 15 percent or so below the revenue estimates (see Appendix 2).

89. There is also a danger that sizeable under-estimation may occur on the expenditure side. It is expected that payment for salary and wages will increase by 40 percent in 1968 and, although there is some planned rise in expenditure on goods, these allocations are not likely to be sufficient if the rate of rise in prices is substantially higher than 50 percent. However, the Government has worked out a quarterly review procedure with a view to keeping routine budget expenditures in line with available financial resources. Unless this safeguard is effective and extra budgetary expenditures are eliminated, it appears likely that deficit financing will continue to cause inflationary pressures in 1968, although probably at a considerably reduced magnitude as compared with 1967.[2]

90. Public Savings. The public accounts of Indonesia are not adequate for an accurate calculation of public savings. This is primarily because the amount in the development budget of the Central Government probably considerably overstates gross public investment, first since it is a composite of capital and maintenance expenditures, second because no record is available of the reinvestment (if any) of the gross earnings of public enterprises, and third, there is no assurance that the development funds earmarked for investment by lower levels of government (the land tax and the provincial share of export taxes) are actually all used for investment purposes. However, there is a strong presumption that even gross public savings have been negative for many years. The large excess of routine expenditures over domestic revenue

1/ This is after adjustment for the settlement of special accounts with the Central Bank that is being made at the end of 1967 and which should be a non-recurrent expenditure item.

2/ However, the judgment in this and the preceding paragraphs were made prior to the recent revisions in the AID-B.E. and revaluation rates (see paragraph 132 below) which will result in a substantial increase in revenues in 1968 both from counterpart funds and custom duties. It appears, on balance, that the prospects for a balanced budget in 1968 have been improved by these measures.

in the central budget of Rp. 14 billion in 1966 and probably Rp. 19 billion in 1967 were much larger than the transfers from the Center to the provinces and local governments for development purposes. Thus, though development expenditure has been rising from 7.8 percent of central government expenditures in 1966 to an estimated 17 percent in 1967, this and part of routine expenditures have been financed by a combination of foreign and central bank credits.

91. However, this rather dismal picture bids fair to take on a somewhat brighter hue in 1968. The most significant change in the 1968 budget is the distinction which is made between the financing of routine as against development expenditures. All of the former are to be financed from domestic revenues, leaving the counterpart of foreign aid entirely available for the development budget. (In 1967, about 14 percent of aid counterpart was used to finance routine expenditures). There is no evidence that the Government has padded its development budget in order to bring about this result. In 1968, about 32 percent of total public expenditures are earmarked for the development budget, as compared with 22.5 percent in 1967. Furthermore, this understates the emphasis the Government wishes to place on rehabilitation and development in 1968 as compared with 1967, since it is requesting $75 million of foreign aid for public sector projects (including rehabilitation) which is not included in the budget. Nor does the budget include $44 million of drawings on pre-June 1966 credits which are anticipated in 1968. Of the total disposable resources of the Government (domestic revenues less debt service plus foreign aid), about 40 percent would go for development and rehabilitation if present plans are carried out. This compares with about 30 percent in 1967. Its budgetary policies, as well as its foreign aid request, which is discussed below thus reflects the Government's intention to make 1968 the first year under the new regime in which rehabilitation and a start towards economic development is given emphasis along with financial stabilization. Nevertheless, it is apparent that preponderant emphasis on the latter is still justified and should control internal financial policy as well as the composition of foreign aid.

92. Therefore, the central budget is intended to be neutral as far as public savings are concerned in 1968. At the same time, Rp. 12.8 billion of taxes collected by the Center will be transferred to the provinces and should be spent for development. This is roughly 11.5 percent of domestic public revenues and 1.0 percent of national income. Thus if the discipline of the 1968 budget is adhered to a modest rate of public saving (apart from the terra incognita of public enterprises) will be initiated.

Fiscal Issues and Policy Considerations

93. At the present time the primary task of the Government is to raise the level of revenues. A pragmatic approach to this immediate problem is to concentrate on the improvement of tax administration and enforcement machinery and to make such changes in rates as seem immediately practicable in order to bring the current level of taxation up to that which prevailed in 1960 (10 percent of national income). Government authorities rightfully regard

consideration of basic reforms in tax policy as rather academic at this stage. In the future, there will be a need for the preparation of long-term revenue projections in connection with the forthcoming Five-Year Economic Plan and new revenue measures will then have to be studied.

94. Center-Regional Fiscal Relations. The increasing responsibility of the Central Government for securing revenue and allocating funds to regional and local authorities has created problems and difficulties. In 1967 provincial and local authorities financed less than 8 percent of their total expenditure from self-imposed taxes. The same pattern is maintained in the 1968 budget estimates. These authorities do not seem to have utilized adequately the potential revenue which could be derived from taxes such as those on real estate and by development and improvement levies, which fall within their tax jurisdictions. Almost all the development expenditure of these authorities (i.e., Rp. 8.9 billion in 1967 and Rp. 12.8 billion in the 1968 estimates) is financed from the Center through assignment of (a) 10 percent of the export proceeds; (b) all of the land tax revenue; and (c) development subventions. Also, close to 82 percent of their current expenditure (i.e., Rp.8.5 billion in 1967 and Rp. 17 billion in the 1968 estimates) is financed by the Central Government. Still, legislation is proposed to allocate to them even more centrally collected revenues.

95. No doubt, the heavy and probably increasing reliance on the Central Government has reduced the incentives of the local authorities to improve their tax administrations. Similarly, the local authorities lack any direct participation in central government tax operations. For example, the land tax, where local participation would be useful, is collected by the Center and transferred to the districts (regencies). The absence of visible links between the revenue performance and financing of expenditure at the local level has reduced tax consciousness on the part of both local authorities and the citizenry.

96. The strong inflationary forces in recent years have, undoubtedly, affected the taxable capacity of the country, and, moreover, caused important changes in the distribution of the tax burden among the different sectors and classes of taxpayers. The group which may have incurred comparatively less losses could be the food producing agriculturalists, whose terms of trade may have improved over the years. (Estate agriculture is fairly heavily taxed by export levies). If this is a reasonable assumption and if it is borne out by further studies, an increase in the land tax may be in order and a corresponding reduction of subsidies to local levels of government. In any event, assessments need to be kept up-to-date. Another potential source of tax revenue is urban real estate where the fixed rupiah assessment basis has not been changed for many years. Also, this tax is based only on land (not buildings) and is negligible in yield. A recent enquiry has revealed that the annual property taxes on highly desirable residences and business premises in Djakarta are as low as Rp. 650-Rp.800 ($4-$5) and Rp. 1,500-Rp. 2,500 ($10-$16) respectively.

97. State Enterprises. The financial contribution of the state enterprises to the Central Government has been negligible, although the funds allocated for the financing of these enterprises have constituted a substantial part of expenditure of the Central Government for economic activities in recent years. The state enterprises are treated similarly to private enterprises with respect to taxation. Furthermore, 55 percent of their net profits after tax must be transferred to the Central Government for the development fund. The income tax revenue from this source has been very low and collections were mostly attributable to the change of the effective basis for tax assessment from net profits to gross profits, to cash flows or other arbitrary bases determined ad hoc by the tax authorities. Industries in the public sectors are presently operating at a fraction of their capacities, and owing to their weak competitive position vis-a-vis imports they are applying increasing pressure for further reduction of their direct and indirect tax burden and asking for an increase of tariff protection. The Government is at present considering a new policy on state enterprises. It has already undertaken to invite foreign participation in them but this is not likely to solve the problem. The problems of state enterprises are discussed further in Chapter 6.

98. In reference to many public undertakings, especially in the fields of transport, water, electricity and petroleum, their profits -- and thus the extent of their financial contribution to government revenue -- depend on the prices set for their goods and services which remained almost unchanged for a number of years until a fivefold increase in utility rates was made in February 1967. Another and more selective increase seems to be in order. The losses sustained by these enterprises not only eliminated their revenue contribution to the Government but also prevented the necessary repair and maintenance which has now led to heavy demands for subsidies and for rehabilitation funds. The disposal of many of the smaller units, particularly at the provincial and local level, to the private sector should be feasible and would make at least a modest contribution to government revenues.

99. Adjustment of Present Tax Rates. Despite the important steps taken in 1967, there is still a need to see that any increases in the tax burden falls on consumption or income and property rather than on the production and export sectors. Many items of consumption are under-taxed. An important case in point is the domestic distribution of oil products. In an oil producing country the prices of these products should not be excessive but at present they are a third to a half of prices in the United States. This not only deprives the Government of revenue but leads to excessive consumption and thus reduces oil exports. To remedy this, subsidies for kerosene and fuel oil should be abolished, government use of oil products without charge should be eliminated and the domestic sale prices of oil products substantially scaled up. Without these measures, it is hard to see how even the 1968 budget estimate of Rp. 6 billion of oil profits can be realized.

100. There has been a significant downward revision in the sales taxes in 1967 on lower priced items. Broader interpretation of the term "luxury" item would result in more revenue. This falls within the discretionary power of the Minister of Finance. The proposed extension of the tax to imports is

welcome as it will put domestic industry on a par with imports as well as producing more revenue. However, the mission seriously questions the action taken in November of eliminating the already low (10 percent) tax on domestic textile products. In fact other items which enjoy a wide market such as soft drinks should bear an excise.

Money and Credit

101. Money Supply. Through 1966 the deficit in the government budget was the principal cause of inflation. This is indicated by the fact that during 1964-1966 the money supply increased by Rp. 20.8 billion and net claims on the Government (exclusive of credit to government enterprises which, for this analysis are included in the private sector) by Rp. 14 billion (Appendix Table 9). Thus 67 percent of monetary expansion was caused by fiscal operations. By contrast, in the first three-quarters of 1967, 62 percent of the increase in money supply originated in credit to the private sector and state enterprises. This reflects the policy of limiting public expenditures but not putting such a tight rein on productive and trade credit, providing it is extended on a selective basis favoring production and exports.

102. Up until October 3, 1966, the most notable effort to halt the inflation was taken in May 1963, during a brief period under Dr. Djuanda. The measures then adopted included exchange reform, steps to balance the budget, imposition of tighter credit restraints, and the removal of price and other administrative controls.1/ The similarity to recent measures is obvious. With the opening of the Malaysia campaign, renewed inflation eliminated the prospect of achieving a balanced budget and financial stability.

103. The evolution of monetary expansion over recent years is shown in Appendix Table 8 . That the stabilization attempt of 1963 was truly abortive is clear from the 155 percent monetary expansion of the following year, though even this was mild compared to the 280 percent of 1965 and the 715 percent of 1966. Over this period, public sector financing accounted for 65 percent and the private sector (including state enterprises) for about 30 percent of the increase. These relationships were fairly constant from year to year. The hyperinflation of early 1966 slackened substantially in percentage and real terms towards the end of the year as the stabilization program took hold.

1/ Before the introduction of new measures, the system of exchange rates was very complex. The reform reduced the number of selling rates to three. Price controls were also eased. The size of the budget deficit was to be reduced through tax measures, and government expenditure also reduced. The rates of public utilities were raised several-fold. More foreign aid was expected to promote stability. Credit measures included the raising of the interest rate and making credit available only to those with adequate collateral and plans for repayment.

104. In the first nine months of 1967 money supply increased by Rp. 19.1 billion or 91 percent. The budget deficit contributed 37 percent of the monetary expansion. The lower rate of increase of money supply in 1967 was accompanied by a monthly rise in prices in the first nine months of the present year of around 6 percent compared with 22 percent for the comparable period of 1966. Thus contrary to experience in previous years prices rose somewhat less than money supply, indicating a reduction in the velocity of circulation and perhaps a little greater willingness to hold cash balances.[1/] The increase in the income velocity of money during the hyperinflation period and its apparent small decline in 1967 is shown in Table 3 . After July 1967 the price situation worsened mainly because the price of rice in Djakarta in October was 120 percent higher than in June following delays in imports and concern about the new crop. The Central Bank had to provide a sizeable amount of credit for pre-financing the purchase of rice from abroad.

105. The difficulty of attaining monetary stability is emphasized by recent developments. The relaxation of the initial very tight money policy of October 1966 because of its feared impact on production and utilization of aid, has resulted in very substantial further expansion. Factors that might normally neutralize some of this expansion such as an increase in time deposits or a drawdown of foreign exchange reserves are not operative since the long and severe inflation has eliminated savings deposits as part of the people's liquid assets and, of course, foreign exchange reserves have long been nonexistent or negative.

106. Bank credit extended in 1967 was primarily for production and exports (Appendix Table 13). Selective credit control policy is not new[2/]

1/ In 1965 and 1966 the increase in prices was considerably above that of money supply. In such a bout of inflation, persons are naturally averse to holding cash (they have a low liquidity preference in real terms). This preference for holding goods is reflected in a rise in the income velocity of money. On the other hand, money also lost part of its function as a medium of exchange. The volume of transactions effected against cash declined and payment in kind has become a significant feature of the economic system.

2/ From early 1965 monetary policy required that credits should be granted by state banks on the basis of the expected results of the program rather than the adequacy of collateral. A 60:40 ratio was to be maintained between advances to state enterprises, including cooperative bodies, and to the private sector; credit for production was to constitute 80 percent of the total credit. It was slightly modified in January 1966, when state banks were instructed to provide 85 percent of their credits for production and exports and private banks were to pre-empt 50 percent of their advances for these purposes. The Central Bank was to supplement the resources of commercial banks for financing essential consumer goods, exports and infra-structure only. In May 1966 new instructions were issued which barred the government banks from extending long-term credit for investment purposes or giving overdraft facilities.

but with the advent of a "tight money policy", under the Presidium Instruction of October 3, 1966, the policy was extended further. Ninety, instead of the previous 85 percent, of all new credits were to be used for production or export purposes and no import credit was to be provided without the express consent of the Presidium. However, the principal changes in credit policy at that time were aimed at reducing the overall rate of monetary expansion. One-third of the 30 percent reserve requirements against current deposits was to be held as current account balances with the Central Bank.[1/] 100 percent advance deposit for imports and prepayment of 50 percent of import levies were also required. Most important, the interest rate structure was revised upward. Three broad categories of credit were delineated for state banks with interest rates ranging from 6 to 9 percent[2/] per month instead of the previous 9 percent or so per annum. The interest rate charged by the Central Bank on its own advances is one-half of the rate for each of the three categories.

107. The rigor of the tight money policy of October was softened somewhat early in 1967 because of fear of a slow down in economic activity and that economic aid would not be absorbed with sufficient speed to meet budget requirements. The prepayment of 50 percent of import taxes was waived and the advance deposits against imports from aid sources was reduced to 50 percent. In April all interest rates were lowered by two percentage points and by mid-1967 the rate of interest on the three credit categories were lowered to 3, 4 and 5 percent respectively.

108. To promote the utilization of aid, in July 1967 advance deposit requirements for aid imports were further reduced. Only 25 percent of the import value was to be collected for non-consumer aid imports at the time of purchase of AID-B.E. certificates and 10 percent on the arrival of documents. Payment requirement for consumer goods 50 percent at the time of the purchase

---

1/ Since October 1966, the Central Bank (B.N.I. Unit I) has been fairly restrictive in its lending policy towards other banks. This has helped to reduce excess liquidity. However, primary bank reserves were still 50 percent above legal requirements in June 1967 as compared with 101 percent in December 1965 and 48 percent at the end of 1966.

2/ Extension of credit (a) to food producers was to be made at 6 percent interest rate per month; (b) to exporters, producers of exports and other basic commodities, and transportation was fixed at 7½ percent per month; and (c) to the distributors of essential consumer goods and for other purposes at 9 percent per month. In February 1967 some revisions were made of items included in the three credit categories. The first category now comprises the production of nine basic commodities (i.e. rice, salted fish, cooking oil, sugar, salt, kerosene, soap, coarse textile and coarse batik); agriculture, export and transportation sectors; the distribution of spare parts; chemical industry, maritime industry, food and housing industry, handicrafts, paper industry, mining and other products.

of AID-B.E. and 10 percent upon arrival of documents. The balance was covered by import credit for the maximum period of three months, at the rate of 3 percent per month. Thus credit was furnished by the state banks for aid imports and fertilizer at concessionary rates, whereas other imports were financed by the private banks at free market rates. These facilities for aid imports were withdrawn recently and 100 percent deposit is now required. Bank credit can, however, be obtained for imports of essential goods. The Central Bank also has extended credit to Pertani (a state enterprise) for the purchase of fertilizer at one percent per month.

109. In view of the importance of financial stabilization, a review of the credit control mechanism is particularly important in Indonesia. The Central Bank (Bank Negara Unit I) does not seem to have as much independence vis-a-vis the Government as might be desirable. At the apex of the Indonesian banking structure is the Monetary Board.1/ The Minister of Finance is the Chairman of the Board. Its Charter stipulates that the decisions of the Board are to be made by majority vote and the Government has a majority on the Board. In case of disagreement, a dissident member has the right to appeal to

---

1/ This Board was established under the Bank of Indonesia Act of 1953. The predecessor of the Bank of Indonesia was the Java Bank established in 1827. Immediately after its establishment, the Java Bank secured a monopoly of note issue from the Netherlands Indies Government. In 1891 the Bank got the right to trade in foreign bills of exchange and developed its commercial business activities. Apart from operating as a bank of issue, Java Bank did not perform any other major central banking functions. As for the present structure of the Indonesian banking system, there is as yet no foreign bank in Indonesia and after 1965 the banking system became predominantly state-owned (about 90 percent of the asset structure). The main business of the larger credit institutions is foreign exchange banking (they are called "foreign exchange" banks). This is explained by the fact that the Dutch were primarily interested in the development of agricultural and mineral resources for export. Therefore, during the colonial period the banks directed their operations mainly to financing the credit requirement of export-oriented estate and mining enterprises, and handling foreign trade operations. Of course, they also did a domestic business. Smallholders had to depend on the unorganized money market consisting of individual money-lenders of Chinese, Arab and Indonesian origin who have extensive connections with Singapore and Hong Kong and draw on the funds made available to them from these foreign sources. In 1965 Bank Negara Indonesia was formed by merging four of the five state commercial banks and a state savings bank. Subsequently, a good deal of autonomy was restored to them and B.N.I. now has five units, one of which specializes in short-term agricultural credit. Unit I exercises central banking functions through its central office and commercial functions through its banking department. Private commercial banks comprise some 80 units, but their collective assets are only about 10 percent of total bank assets. The total assets of the Central Bank (B.N.I. Unit I) accounts for over 90 percent of the consolidated assets of B.N.I. and other foreign exchange banks. Further, the total advances of B.N.I. Unit I to foreign exchange banks is (June 1967) almost equal to the total assets of these banks. Thus the banking system has become primarily the purveyor of funds rather than the mobilizer of resources.

Table 3

Liquidity Position, 1964-1967

(In Billions of Rupiahs)

	1964	1965	1966	1967 (Estimate)1/
Gross Domestic Product	7.5	33.0	360.8	950.0
Average Price Index (September 1966 = 100)	1.86	6.67	76.5	207.8
Money Supply	0.45	1.35	11.18	33.4
Real Value of Money Supply2/	0.24	0.20	0.15	0.16
Income Velocity of Money3/	16.7	24.4	32.3	28.4

1/ The estimate refers to the last 2-3 months of 1967.
2/ Money supply divided by price index.
3/ Gross Domestic Product divided by money supply.

the Cabinet. If the Governor of the Central Bank disagrees with the position of the Board and is not supported by the Cabinet, he is entitled to publish his views. However, the Cabinet can veto such publication on grounds that it would harm the national interest. As for the relation of the bank with the Treasury, the Act stipulates that "The Bank shall, whenever the Minister of Finance deems it necessary to temporarily strengthen the Treasury funds, be bound to advance to the Republic of Indonesia monies in current account against sufficient pledge of treasury bonds..." and that such advances should "...not be allowed to exceed 30 percent of the revenues of the Treasury in the budgetary year preceding the one in which the Government asks for the advances." Subsequently, this percentage was raised to 50 percent and higher so that it is not a deterrent to deficit financing.[1/]

110. In respect of its powers to curtail bank credit other than advances to the Treasury, the Central Bank has rather broad authority for quantitative and qualitative controls, the determination of interest rates charged by state banks and establishment of liquidity requirements.

111. The rather comprehensive powers of the Central Bank over the supply of bank credit, together with the fact that about 90 percent of the assets of the banking system are in state-owned institutions, should enable the Government to exercise effective control over the quantity and use of bank credit. However, most of the money supply consists of currency since the habit of deposit banking has not established itself in Indonesia. Furthermore, the organized money market is not the only source or even the major source of finance to the private sector. Therefore, while monetary policy may be fairly effective in limiting the expansion of total credit, qualitative controls such as the authorities have attempted recently are likely to be of limited effectiveness.

112. Conclusions. Even with the plethora of money in Indonesia, the value of the money supply in real terms is, of course, much below (one-half to one-third, depending on how one measures the inflation) of what it was ten years ago. Many argue that this lack of liquidity in real terms needs to be rectified by a more liberal credit policy. Three to five percent a month for state bank loans looks high to them, though again in real terms it is negative. Depositors are receiving a still more negative rate of around 2 percent a month. Market interest rates which reflect both the inflation and the shortage of savings are said to be 10 to 20 percent a month. The ultimate solution is obviously financial stabilization of the economy, but in the meantime, it would seem desirable to narrow the gap between the subsidized (partly at the expense of the holders of bank deposits) rates of interest charged by the state banks and market rates; particularly since the rationing of credit by the state

1/ The Bank of Indonesia Act also requires that the note issue, together with the demand liabilities of the Central Bank, be covered at least 20 percent by "gold, gold coin or bullion, or by the reserves consisting of foreign currency which are generally convertible; or by the right to draw on the International Monetary Fund and (strangely) the World Bank..." In 1958, however, the Government tied the foreign exchange reserve requirement to the level of imports and it has not been an effective constraint on monetary expansion.

banks does not seem to be very effective in placing funds in the hands of those needing working capital for productive purposes. Greater emphasis on market forces in the banking field should be supplemented with the provision of adequate working capital for public and private enterprises. The establishment of specialized agricultural and industrial credit banks is needed.

113. At the present time, the demands of the Government on the Central Bank are being reduced by fiscal policy. However, as longer-run strategy, the Bank should have more independence from the Ministry of Finance.

CHAPTER 4

EXTERNAL TRADE AND FINANCE

The Mechanism

114. The inflation that would have made any fixed exchange rate obsolete almost immediately and its basic philosophy of placing major reliance on market forces have impelled the present Administration to devise a flexible exchange rate system, and to substantially eliminate quantitative import restrictions except through the medium of state trading.[1] At the same time, the need to discriminate price-wise against less essential imports, to absorb tied (and to some extent commodity restricted) foreign aid funds, and to encourage the repatriation of capital (including the proceeds of smuggling), have resulted in the continuation of a multiple-rate system although a unitary rate remains the objective. Effective exchange rates at February 1, 1968 level are summarized in Table 4.

115. The movements in the five principal rates since the inception of the stabilization program are shown in Table 5. The B.E., D.P., and the Curb rates are determined by the supply and demand for foreign exchange in the categories of transactions to which they apply, but the B.N.I. (Bank Negara Indonesia) and the AID - B.E. rates are set from time to time by the Central Bank.[2] The idea is that these latter two rates will generally follow movements in the B.E.-market rate.

116. The B.E.-market rate, which is thus by far the most important, is determined by the supply of foreign exchange from the proceeds of all recorded non-oil exports less export taxes accruing to the Central Government on such exports, and by the demand for private imports of commodities in the "B.E. List" which are not financed with foreign aid or the Foreign Exchange Fund.[3]

1/ A May 1966 decree which made B.E. deposits in the foreign exchange banks freely negotiable was the principal change marking the transition from the earlier system, that used both import restrictions and fixed exchange rates, although a limited foreign exchange auction system had existed before that time.

2/ Until recently the AID-B.E. rate was set by a Cabinet sub-committee.

3/ The import policy reform of January 27, 1968 divides imports into three categories. The first category makes up the B.E. List. B.E. goods are classified into three groups. Group A comprises very essential goods needed for stabilization and rehabilitation purposes (e.g., foodstuff, fertilizer, pesticide, textile, medical products and news print). Group B consists of essential goods for industrial use (e.g., spare parts and ancillary equipment particularly for food and textile industries) and some essential consumer and capital goods. Group C comprises some less essential items including those that can be made locally. Aid funds can be used for the import of groups A and B only. The second category which is made up of less essential items and which may be paid for only with D.P. and privately-owned exchange held abroad constitute the D.P. List. Most of the licensable items are now merged with this list and others are transferred to the B.E. List. The third category covers a few (4) prohibited imports.

The B.E. List proper includes the country's essential import items. The name, B.E. (Bonus Export) rate, originated at the time when the exporter was allowed to retain for sale in a free market only a small percentage of the proceeds of each export transaction (27 percent prior to October 1966), the sale of which gave him his "bonus" while the balance had to be surrendered at a fixed (over-valued) rate. It is something of a misnomer today because the exchange rate system works out so that about four - fifths of total sales proceeds from recorded merchandise exports are "retained" for sale in the market or used by the exporter for imports. The other fifth is now an export tax.

117. The B.N.I.-B.E. rate applies to sales of exchange from the Foreign Exchange Fund. This Fund is fed mainly from the oil revenues and the Central Government's share of the export tax (15 percent on major Category A exports).[1/] The reason why the term "B.E." is attached to the "B.N.I." and "AID" rates is because import items purchased at these rates also have to be on the B.E. List.[2/] All "permissible" imports and invisibles (other than government invisibles and those connected with trade) are eligible for payment at the D.P. (Devisa Pelengkap) rate. Transactions in foreign exchange sold at any of the first five rates in Table 5 have to be handled through the foreign exchange banks. Curb market funds are handled outside the Indonesian banking system. The curb is a tolerated (and quite flourishing) market and funds flowing into it are used for a variety of purposes.

118. Up until the middle of 1967 the spread between the three B.E. rates was narrowing, but from then until November 1967, the Government showed reluctance to raise the AID - B.E. rate (and a lesser reluctance to raise the B.N.I. rate) as the B.E.-market rate depreciated. In part, this reluctance was based on concern about cost-push inflation and in part because of the comparatively slow movement of important blocks of foreign aid funds. However, in November 1967, the AID - B.E. rate was raised to 140 and recently to 240. However, the B.E. market rate has now depreciated much further and the spread in the rate situation seems to have widened again.[3/]

119. As Table 4 indicates, because of the tax collected in foreign exchange from exporters, effective export rates for legitimate trade are lower than the B.E.-market rate. These export taxes amount in all to 25 percent of the B.E. rate for major and 10 percent for all other exports.

1/ The 10 percent portion of the export tax goes to the provinces (called A.D.O.) as foreign exchange. It may be spent by them directly or sold in the B.E. market.

2/ Except for government imports.

3/ Latest reports indicate the B.E.-market rate is now (February 1, 1968) about 266.

Table 4

Effective Exchange Rates (Based on Rates Prevailing as of February 1, 1968[1])

(Rupiahs per U.S. Dollar)

Realized by Sellers of Exchange		Cost to Buyers of Exchange	
Rate	Applied to	Rate	Applied to
85	All foreign exchange receipts of oil companies.	85	All foreign exchange payments of oil companies.
199.5	Retained exchange earnings from major exports (75 percent of the B.E.-market rate).[2]		
239.4	Retained exchange earnings from all other exports (90 percent of B.E.-market rate).		
266	Purchase of exchange by Central Bank (B.N.I.-B.E. rate).	266	(B.E.-market rate). Items on the B.E. List, invisibles connected with trade and certain other eligible expenditures. Sales of foreign exchange from the Foreign Exchange Fund - used for government imports on the B.E. List and invisibles.
240	Purchases of expired B.E. certificates by the Central Bank and repurchase of AID - B.E.	240	All aid imports which must be on the B.E. List (Groups A and B).
280	Repatriated exchange and some invisible receipts (D.P. rate).	280	Imports on D.P. List (not eligible for B.E. exchange) and non-trade private invisibles.

1/ Excluding bank charges, the spread between buying and selling rates and all import taxes and tariffs, etc. Assumes no over-pricing.

2/ Coffee, copra, diamonds, palm oil, palm seeds, pepper, rubber, tin and tobacco.

Table 5

Changes in Exchange Rates

(In Rupiahs per U. S. Dollar)

	B.E. Market Rate	B.N.I.-B.E. Rate	AID B.E. Rate	D.P. Market Rate	Curb Market Rate
1966					
October 3	120	-	-	135	143
November 25	93.5	85	-	104	127
December 28	85	85	-	105	120
1967					
March 30	97	89.5	90	114	120
April 26	111	90	90	120	131
May 31	138	138	n.a.	148	150
June 15	137	135.5	132	148	152
July 27	137	135.5	132	154	163
August 11	142	135.5	131	156	167.5
August 25	150	135.5	131	168	170
September 5	145	139	131	163	167
September 29	148	145.5	131	165	171
October 12	150	146	131	166	174
October 26	152	146	131	166	170
November 7	153	146	131	168	174
November 14	157	146	131	173	176
December 28	225		131	250	
February 1	266		240	280	

120. Prior to July 28, 1967, when a major reform was made, the situation was much more complicated and the average export rate was a somewhat lower percentage of the B.E.-market rate than at present. Taking into account both the change in the B.E.-market rate and in the system, it appears that for major exports the effective rate has depreciated from about Rp. 92 to the dollar to about Rp. 118 to the dollar as between July 27 and November 14, 1967.1/

1/ Before the July 28 regulations, Indonesia had a mixing system for exports, the blend depending on which of three categories of items the export fell. There was also an "over-pricing" arrangement under which, if an exporter could sell his product for more than the officially set f.o.b. price, he could sell the difference in the D.P. market. The official or so-called check prices were kept below international prices deliberately to give the exporter a better effective rate. Exporters of major items (rubber, copra, pepper, tea, tin and tobacco) could retain 50 percent of their export proceeds (calculated at the check price) for sale in the B. E. market and were required to surrender the other 50 percent at the "transaction" rate of Rp. 10 to the dollar. Secondary export items (such as coca, hides, livestock and oil seeds) could retain 75 percent and other exporters 90 percent. Assuming a B.E.-market rate of 137 (July 27, 1967) and an over-price rate of 30 percent, the effective export rates would have been 92 for the first category, 117 for the second category and 131 for the third. After July 28, 1967, the number of categories of exports were reduced to two. The first (Category A) includes nine major exports (coffee, copra, diamonds, palm oil, palm seeds, pepper, rubber, tin and tobacco) and Category B all other exports. Over-pricing was abolished in principle but not in all cases in fact. The use of the Rp. 10 to the dollar rate was abolished and the surrender requirement converted into a tax.

Another important change made as part of the July 28 regulations was to add capital goods to the list eligible for financing with B. E. exchange.

121. In general the foreign trade system can now be described as fairly flexible in respect of exchange rates, liberal with regard to the degree of government control, and relatively non-discriminatory as between importers. However, there does not seem to be any justification for allowing any sizeable spread to develop between the B.E.-market and the B.N.I. rates.[1] Such a spread gives an advantage to government imports. Now that the complex overpricing system has been abolished, the justification for the retention of the D.P. market is that it provides an incentive for capital repatriation including the proceeds of illegal exports.

122. Government Trading. This plays an important but diminishing role in Indonesian economic affairs. Not only government imports, but a considerable part of imports for the private sector, are conducted by State Trading Corporations. From 1959 when they were established as a result of the takeover of Dutch trading companies up to July 1967, these corporations had a monopoly of trade in nine commodities designated "essential goods" (rice, textiles, salt, kerosene, fish, sugar, coconut oil, soap and batik) and of all imports by public sector industrial enterprises. Other commodities such as fertilizer are handled by government agencies in whole or in part.

123. In October 1966 the law (No. 19 of 1960), which gave the State companies their monopoly position, was suspended and their reduced functions are now being studied.[2] The volume of their business is reduced substantially.

Foreign Trade Administration and Policies

124. In addition to recent changes in the exchange rate system described above, a number of other steps have been taken mainly in July and November 1967 to (a) simplify administrative procedures, (b) check the inflow of certain types of imports by imposing higher tariffs or surcharges, (c) compensate for the loss of revenue because of more favorable effective export exchange rates by shifting more of the fiscal burden to the import sector, and (d) accelerate the utilization of aid funds by selective relaxation of domestic credit.

1/ Since January 8, 1968 the Central Bank has been intervening in the market thus making the two rates almost identical.

2/ Prior to these recent changes they handled about 50 percent of Indonesia's imports and 10 - 12 percent of exports. Domestic trade accounted for 40 - 50 percent of their turnover. Major goods imported by them were capital goods for the public sector, raw materials, and consumer goods such as paper, wheat flour, and tires. Major goods traded domestically were cement, cotton yarn, and all "essential goods". Their exports were mainly rubber, copra, pepper, cinnamon, and tobacco. Their exports of estate produce were reduced since the establishment of independent Estate Companies, bringing down their share in total exports to 5 percent since 1964.

125. As to administrative procedures, a simplification was effected by eliminating the requirement of submitting export licenses and declarations of contract to the Government, and of foreign exchange contracts to the banks. Exports still require an export permit, and on the principal export items this must be accompanied by a statement by the exporter of the f.o.b. invoice price which enables the Government to exercise some control over capital flight. Licenses are also still required for payment of invisibles to be effected through the Foreign Exchange Fund. Importers buying B.E. and D.P. funds are required to specify the items to be imported therewith. Also, exporters as well as importers are now allowed to arrange for the handling of their products at ports without the intermediary of transportation, forwarding, and wharfage companies. Two government shipping agencies, Bipalindo and Bapeluma, were dissolved.

126. On the import side, the most important measure taken in July was the increase in the valuation rate for tariff duties from Rp. 90 to Rp. 130 per dollar, which implies an increase by nearly one-half in customs charges. More recently the revaluation rate was raised further to Rp. 240. The greatest impact of this is doubtless on imported consumer goods, and this was expected to improve the competitive position of domestic consumer goods industries. At the same time, the possibility of effecting imports without letter of credit (under the tanpa cover regulation) was restricted to non-consumer goods, with a likely effect in the same direction.[1] At the same time the validity of import orders under tanpa cover, previously unlimited, was limited to one month. New commitments under these credits have been suspended since July 29, 1967 but was resumed, in October, for rice imports. Outstanding commitments are to be reduced and subsequently limited to a net maximum outstanding amount of $30 million consisting of rice imports only. Large amounts of 180-day credits were raised abroad under this arrangement in the first half of 1967 and thus heavy short-term obligations incurred. The principal reason for the popularity of this type of financing was the favorable rates of interest available abroad as compared with the lack of import financing facilities and the higher rates of interest in Indonesia.

127. Import Levies. Indonesia, of course, relies mainly on floating exchange rates and foreign aid rather than administrative means to maintain equilibrium in its balance of payments. Therefore, the blend of imports depends on the composition of domestic demand. The structure of domestic prices of imports reflects international prices plus import taxes and, to a small extent, differential exchange rates. The customs tariff is summarized in Appendix Table 32. The range of basic duties is up to 100 percent. Essential consumer goods and raw materials carry only nominal rates. Also, the exchange rate used for valuing imports for duty has been lower than the B.E.-market rate. As noted above, it was raised from Rp. 90 to Rp. 130 to the dollar

1/ On August 29, 1966, a regulation was issued providing for an import payments method under which imports could be effected against B.E. exchange to be acquired later. These are unguaranteed credits, but traders were required to register their commitments at foreign exchange banks. No rules were established for the terms and repayment period for such credits.

in July and more recently to Rp. 240. Periodical revision of the rate seems entirely justified and necessary for fiscal reasons as well as to provide more protection to the few domestic industries during this difficult period.

128. Indonesia's import tax system is quite complex and is badly in need of simplification and rationalization. Looking only at the tariff, items carrying duties of 50-100 percent represent only 10-15 percent of imports. However, there is now a surcharge of 100 percent on the tariff for these items, increasing the range of duty plus surcharge to 100-200 percent. A surcharge of 50 percent applies to goods with basic customs rates of 10 to 40 percent and manufactured goods in the 50 percent bracket, thus increasing the range of duty plus surcharge to 15 to 75 percent. These surcharges were applied in July 1967. In addition, in November 1967, for goods imported with D.P. or free exchange on goods subject to duties up to 50 percent, the surcharge was increased by half (except for nonmanufactured goods in the 50 percent tariff bracket) and for other dutiable imports by 100 percent. To complete the story, there are two other extra-duty charges on imports. The 50-100 percent bracket carry on "excess profit" tax of Rp. 25 per dollar and all dutiable goods a similar "excess profit" tax of Rp. 20 per dollar.[1] These are, of course, equivalent to duties. Obviously, this is an unnecessarily complex structure. Calculated on the basis of the B.E.-market rate, total import taxes ranged up to about 190 percent (see Appendix Table 32) following the July 28 amendments.

129. Prior to the July 1967 regulations the collection of customs duties was about 15 percent of the total value of imports. Dutiable goods were charged an average of 20 percent. The hikes in rates and in valuation for duty should now have considerably more than doubled the effective average rates of duty. Therefore, the general level of effective duties have now been raised substantially[2] though there is considerable room for adjusting rates on different items and establishing a proper relation between rates on imported materials, components and finished goods so as to achieve the desired level of net protection where appropriate. This subject is examined further in the industry annex of this report.

130. Some time ago, the application of the sales tax to imported goods was suspended though it continued to apply to similar goods if produced in Indonesia. However, the Government now proposes to apply the tax to imports starting in 1968.

131. Credit Arrangements for Imports. As a general policy, no import credit was available from the state banks (at the 3-5 percent a month range of interest rates) so that importers had to secure their financing from other

---

1/ In addition, there appears to be an additional 10 percent of duty levied on the 50-100 percent brackets.

2/ Based on an exchange rate of Rp. 150 to the dollar, the projection of import duties in the 1968 budget would be about 27 percent of total expected imports for that year.

sources at 10 percent a month or higher. However, under the July 28 regulations, instead of a 100 percent deposit requirement on the opening of letters of credit, for aid financed goods only the deposit requirement was 25 percent for Category I (mainly non-consumer goods) and 50 percent for Category II (mainly consumer goods). Upon the arrival of documents, an additional 10 percent deposit was required for both categories, and the remainder was payable within 3 months. This means that import credit (against documents) was available to the extent of 65 percent for Category I and 40 percent for Category II.[1/] It was expected that these credit facilities under aid should somewhat reduce demand for short-term commercial credit from abroad under the tanpa cover facility during the remainder of 1967.

Recent Developments

131a. After the Bank mission had completed its work in Indonesia a number of adverse developments of a short-term nature occurred which have given rise to some concern regarding the stabilization program and induced the Government to announce a number of new measures in the fields of import policy, exchange rates and fiscal and monetary measures. These developments cannot be covered fully in this report. It would appear that the principal factors involved were (a) the partial failure of the dry season rice crop in late 1967 and the repetition of delay in harvesting the wet season crop in 1968 (in general, food production probably declined in 1967); (b) delays and difficulties in procuring rice from abroad; (c) uncertainties about availability of foreign aid, and (d) the larger than anticipated monetary expansion in 1967. Despite the last element it does not appear that the acceleration of the price hikes in food and foreign exchange (rice rose in Djakarta from Rp. 45 to Rp. 75 a kilo and the B.E. import rate reached Rp. 300 = $1) were primarily inflationary in origin. Speculation against the rupiah in the foreign exchange market and the hoarding of imported and domestic commodities accentuated the effects of the more basic factors mentioned above.

1/ This was changed recently. The requirement now is 100 percent down payment which may be partly covered with bank credit for Groups A and B imports.

132. The Government has announced its intention to attempt to allow fluctuations in the B.E.-market rate and the price of rice only within certain ranges and has been intervening in the foreign exchange market to this end. As a result there has been some appreciation in the B.E. rate to about 266:1 (February 1, 1968). The Government has also adjusted the B.E. aid rate and the rate at which goods are valued for duty purposes to 240:1 and intends to limit the spread between such rates and the B.E.-market rate. Imports have been reclassified into three categories (see p. 36). Import duties are to be raised on less essential items and reduced on some more essential items. Importers are required to pay in full for their foreign exchange when purchased but bank credit may be obtained for imports of A and B groups.

133. Appraisal of Policies. The measures that were taken in July and November 1967 were certainly in the right direction. Most important was the reduction of the export tax (implicit before July 28 and explicit thereafter) from an average of around 30 percent of export proceeds to about 22 percent.1/ The greatest boost was given to tea, sisal and sugar, but rubber, copra, coffee, tobacco, pepper, palm oil and tin must also have obtained a considerable net advantage. It was quite apparent that fiscal charges on exports had become too burdensome, and the prospect for exports had deteriorated as a consequence, while the overall fiscal contribution of imports was too low. As soon as alternative sources of revenue can be developed a further reduction in export is needed if Indonesia's export potential is to be realized.

134. No consistent import policy was pursued by the government in recent years. However, for much of the time, liberal imports of consumer goods were permitted for social reasons and to combat the run-away increase in the cost of living, generated by huge fiscal deficits. Since the removal of quantitative restrictions in May 1966, and since the regulation was issued permitting B.E. imports without letters of credit and foreign exchange cover, consumer goods imports surged in 1966 by a third to over $300 million. One consequence was a drop in production of domestic consumer goods industries, which were unable to compete with cheap imports.

1/ After taking account of the elimination of the over-price system.

135. Steps were taken during 1967 to reverse this trend. They included the setting up of new investment priorities favoring "exchange saving" units, selective reduction of interest rates on state bank loans for production, the increase in customs surcharges noted above, the imposition of an "excess profit tax" on six import items, the change in the exchange rate basis for levying ad valorem import duties from Rp. 90 to Rp. 130/dollar, and the limitation of imports financed with short-term credits obtained abroad to non-consumer items. Although these steps were in the right direction, they were not very discriminating or based on a well-considered development strategy but rather were motivated by overall fiscal, and, to a lesser extent, balance of payments consideration.[1] Also, the credit relaxation for aid-financed imports introduced in July 1967 affects all B.E. items whether or not they compete with domestic production. It is difficult to criticize the current import policy on the grounds that it may be too liberal, because there are few alternative choices in view of the present condition of the economy, with the high rate of inflation and the general limitations of the administrative machinery. It seems, nevertheless, that the Government could move gradually to a longer-term policy designed to encourage more economical import substitution. Most obviously, imports of textile goods could be reduced from the 1967 level which is estimated to exceed $150 million, and there is little disagreement that more should be spent on fertilizer so that rice imports could be reduced.

Balance of Payments, 1958 to 1966

136. With the exception of one year (1959), Indonesia had substantial recorded deficits on current account throughout this period aggregating $1.79 billion overall or an average of nearly $200 million a year. Since there was undoubtedly a considerable unrecorded capital flight, the actual net inflow of resources was probably much less. The trends of the major elements are shown in Table 6.

137. Exports. Total exports (including oil on a gross basis) were between $850 and $950 million a year in the period prior to 1958. They tapered off to $616 million in 1963 and have since risen slowly. The substantial rise in 1966 is heartening but it may be in part statistical because of improvement in reporting. Also over 40 percent of it was because exports was largely offset by the increase in the outflow of investment income to the foreign oil companies. Exports (with oil figured on a gross basis) probably account for roughly about 13 percent of GDP.

138. Exports of crude oil and petroleum products have been a fairly constant magnitude throughout the past decade, so that non-oil export proceeds, broadly speaking, have been responsible for the $200 million drop from the pre-1958 amount to the level of the last four or five years. Among

1/ The increase in taxation of imports was designed to offset the loss of revenue resulting from the reduction of export taxes also effected in July 1967.

non-oil exports rubber accounted for the largest single reduction from a pre-1958 value of about $350 million to a current level of about $220 million. Aggregate earnings from all other exports have declined less, from an earlier total value in the neighborhood of $300 million to an average of $230 million in the last three years.

Table 6

Principal Exports Other than Oil

1962 and 1966

(In Millions of Dollars)

	Rubber	Tin	Copra	Coffee	Tea	Tobacco	Others
1962	299	37	15	13	20	16	54
1966	190	36	15	33	14	24	68

139. The volume of Indonesia's principal exports over a series of years up to 1965 is shown in Appendix Table 43. The recent picture is one of general stagnation, with the exception of substantial increases in copra, coffee, tea and tobacco. In the case of tin, the decline in volume was partly offset by a considerable increase in price from the pre-1957 trend price of less than $1.00 per pound to an average of $1.70 in 1965 and 1966. However, rubber, which today accounts for 40-50 percent of non-oil export earnings, has had a long-term price decline due to competition with synthetic. It fell from a high of 38 cents per pound in 1960 to a current price of about 20 cents per pound, while the volume of Indonesia's exports remained stationary throughout the last decade at a level slightly below what it was at the time of the Korean boom. The principal reason for this has been the gradual deterioration of the plantations, large as well as small, owing to inadequate replanting of rubber trees.

140. In Appendix 1, where we examine the prospects for Indonesia's exports in future (to the extent that this is possible under present very unsettled conditions), we discuss in more detail the factors that have affected Indonesia's major export crops. In general, it can be said that while Indonesia has a broad range of natural resources for export, this potential at present is far from being fully realized, because (1) physical facilities have been neglected, mismanaged and allowed to sink into a state of disrepair over several years, and (2)the whole commercial establishment, ever since the nationalization of the trading, shipping and forwarding companies, has operated under a system providing negative incentives. The improvement since October 1966 when all state enterprises were divested of many of their privileges, has not yet been followed up with the creation of positive incentives

for the reorganization of the trading enterprises along business lines. It should not be too difficult, however, to find a solution to the problem of commercial management within a reasonably short time. Still, there are only a few items where such a solution would by itself lead to an immediate acceleration of export earnings, even if combined with a further reduction of export taxes. Possibly, such an effect could be expected for copra, tea and tobacco. In most other cases it is in the field of production that serious and long-lasting bottlenecks are inhibiting rapid recovery from the depressed level of production. Rubber and tin are cases in point.

141. Imports. Indonesia's merchandise imports in recent years have been in the order of $600 million. This is not a high level, probably about 10 percent of GDP. Of course, imports were constrained by tight import controls up to May 1966. The spurt in 1961 was partially compensated by increased foreign aid and by the sharp reduction (in fact, exhaustion) of reserves. The inadequacy of the flow of imports was, of course, a factor in the inflationary pressures that mounted steadily.

142. The relationship between imports of consumer goods, raw materials and spares, and capital goods, has been fairly constant in the long terms. It was nearly the same in 1966 as it was in 1938.

Table 7

Structure of Imports in Percentages, 1938 - 1966

	1938	1966
Consumer goods	43.3	44.2
Materials and spares	32.2	26.7
Capital goods	24.5	29.1

143. 1966 was a rather abnormal year inasmuch as a large backlog of demand for non-food consumer imports that had arisen in 1965, the year of political crisis, was filled, in part with a Japanese "stop gap" credit. On the other hand, raw materials such as cotton yarn, paper, chemicals and construction material were imported in unusually small quantities.

Imports by the three major categories in recent years were as follows:

Table 8
Summary of Imports by Commodity Groups
(In Millions of Dollars)

	1963	1964	1965	1966
1. Consumption goods	154.6	298.9	230.7	304.7
2. Basic and auxiliary materials	208.1	174.0	266.7	183.9
3. Capital goods	140.0	229.1	220.8	200.0
Total:	502.7	702.0	718.2	688.6

Source: Appendix Table 40.

144. About half the import of consumer goods has been rice which is the largest single import item. An average of $100 million was spent on rice in the last four years. It is followed by textiles in the form of yarn and fabrics which together accounted for an average of $70 million a year. The major part of this is yarn and cambrics which in the above classification are treated as raw materials.

145. A more detailed breakdown of imports is shown in Appendix Tables 39 & 41. The so-called "capital goods" category is probably overstated in Table 8 since it includes passenger cars and a large amount of unspecified goods, a considerable part of which is probably not productive equipment. Construction materials, however, are not included as capital goods. Considering the very low level of gross investment in Indonesia during these years (probably 5-7 percent of GDP), it is rather surprising that the portion of imports falling in the capital goods category was so large. Of course, nearly all capital goods used in the economy have to be imported and, as elsewhere, foreign sources of finance favor such goods. In future, capital goods imports will have to increase sharply as Indonesia moves into the rehabilitation and development phases of her program.

146. Terms of Trade. An attempt has been made in Appendix Table 51 to calculate terms of trade indices from 1960 to 1966 on the basis of partial price data. Another series based on Indonesian import and export statistics starting in 1963 gives different results but with dubious import prices, so that the first series appears more reliable. The decline of export prices by almost 30 percent since 1960, of course, reflects the rubber situation. Rubber prices have fallen about 50 percent in the last ten years.

147. The deterioration in the terms of trade from 100 in 1960 to 61.5 in 1966 would mean that the earning power of Indonesia's exports today would be higher by more than $300 million a year if there had been no change in world market prices since 1960.

Balance of Payments - 1967 and 1968

148. The most striking development in the balance of payments estimates now available for 1967 is the increase of over 124 percent as compared with 1966 in the current account deficit. This was made possible by the fresh foreign aid made available by the governments organized in the Inter-governmental Group for Indonesia by The Netherlands. In 1967 net capital inflow is expected to increase to $325 million, the highest since 1961 and three times that of 1966. $77 million of this is expected to be repatriated funds which will be sold in the D.P. exchange market. D.P. and "free" imports (imports financed outside banking channels) are expected to total $103 million. This part of the exchange market was fed, prior to July 28, 1967, in part with export "over-pricing" in addition to repatriation of capital including the proceeds of smuggling. It is gratifying that these resources are being returned to Indonesia albeit in the form of lower priority imports. Of course,

Table 9

Summary of Balance of Payments

(In Millions of Dollars)

	(1) 1966 Actual	(2) 1967 Revised Estimate	(3) Increase Percent	(4) 1968 Projection	(5) Increase Percent
Export Income	554	590	6.5	652	10.5
Non-oil exports	(499)	(530)	6.2	(556)	4.9
Oil (net)	(55)	(60)	9.1	(96)	60.0
Imports (Excluding Oil Sector)	528	720	36.4	815	13.2
Trade Balance	26	-130		-163	
Net Services (Excluding Oil Sector)	-165	-182		-200	
Current Account (Deficit -)	-139	-312	124.4	-363	16.3
Gross Capital Inflow	169	372	120.1	448	20.4
Official	(119)	(267)1/		(369)2/	
Other	(50)	(105)		(79)	
Debt Service	-62	-47		-84	
Net Capital Inflow	107	325	203.7	364	12.0
Reserves (- increase)	41	-5		-1	
Subtotal	148	320		363	
Errors and Omissions	-9	-8		--	
	139	312		363	

1/ Includes $58 million of disbursements from credits obtained prior to June 30, 1966.

2/ Includes $44 million of disbursements from credits obtained prior to June 30, 1966. While Indonesia is requesting $325 million of new official aid in 1968 as compared with $209 million estimated for 1967 (an increase of $116 million), the current account deficit is calculated to increase by only $51 million, and net capital inflow by only $39 million. Debt service will increase by $37 million, repatriation of capital and receipt of short-term credits are expected to be $52 million less than in 1967. On the other hand, direct investment is to increase by $26 million.

Table 10

Summary Balance of Payments 1955 - 1966

(In Millions of U.S. Dollars)

	1955	1956	1957	1958	1959	1960	1961	1962	1963	1964	1965	1966
Exports f.o.b.	881	843	848	647	817	881	766	711	616	632	634	714
Of which foreign-owned oil companies	(106)	(195)	(250)	(248)	(259)	(280)	(239)	(241)	(204)	(206)	(210)	(244)
Imports f.o.b.	499	744	652	487	582	749	1056	737	562	590	610	596
	382	99	196	160	235	132	-290	-26	54	42	24	118
Services, net	-285	-263	-281	-225	-210	-216	-236	-222	-282	-272	-272	-257
Of which investment income of foreign oil companies	(-40)	(-47)	(-75)	(-67)	(-71)	(-65)	(-74)	(-86)	(-71)	(-53)	(-66)	(-92)
Current balance	97	-164	-85	-65	25	-84	-526	-248	-228	-230	-248	-139
Official capital net	-10	34	54	78	147	184	364	97	112	103	30	75
Other capital, net	2	-2	-2	-6	-8	-2	-7	25	11	25	18	23
Monetary movement, net	-89	132	33	-7	-164	-98	169	-176	-127	92	200	41

Source: I.M.F.

had it not been for the elimination of over-pricing under the July 28 regulations the amount of D.P. and free imports might have been higher and the more essential B.E. imports lower. On the other hand, importers complained that the elimination of over-pricing discouraged exports even though the reduction of export taxes more than compensated.

149. Another important element in capital inflow in 1967 is an expected drawing of $56 million against project credits extended and contracts entered into prior to June 30, 1966 (the cut-off date for the debt rescheduling exercise described below). These credits are summarized in Appendix Table 3 . Some of the principal projects involved are discussed in Annex 2.

150. According to latest estimates (submitted to the Amsterdam aid meeting of November 20-22, 1967), Indonesia's exports for 1967 will total $774 million as compared with $714 million in 1966, an increase of 8.4 percent. These figures include the value of oil exports on a gross basis. If one deducts from the value of oil exports the foreign exchange cost of oil production for export and for the cost of oil products distributed in Indonesia (thus treating oil income on a net basis), Indonesia's foreign exchange earnings are expected to increase from $554 million in 1966 to $590 million in 1967 or by 6.5 percent. Since net oil income is only expected to increase from $55 million in 1966 to $60 million in 1967, non-oil exports would amount to $499 million and $530 million respectively in these two years, an increase in non-oil exports of 6.2 percent.

151. About $265 million of exports were realized in the first half of the year and the same would have to be achieved in the second half to meet this target. The quantity and price assumptions involved are discussed in paragraph 156. Seasonal factors as well as the new exchange measures introduced in July should enable the 1967 target to be achieved, barring a further decline in export prices, notably rubber.

152. External Assistance, 1967. In support of Indonesia's efforts to stabilize and rehabilitate her economy, the Inter-governmental Group met at Amsterdam in February and later in Scheveningen to consider Indonesia's economic situation and requirements for financial assistance during 1967.

153. Official credits authorized during 1966 had amounted to $127.6 million, of which $86.3 million were disbursed, and $41.3 million remained available for utilization during 1967. The foreign exchange gap for 1967 was estimated to be $200 million so that new commitments available for utilization in 1967 would need to be made in the order of $158 million. The Scheveningen meeting was successful in offering pledges of assistance adding up to the desired amount. All of these funds are available for B.E. imports.

Table 11

External Assistance Offered for 1967

(In Millions of U.S. Dollars)

	Unutilized Balance from 1966	New Offer	Total
West Germany	4.0	25.0	29.0
India	8.0	-	8.0
The Netherlands	18.3	15.0	33.3
United States	8.0	57.0	65.0
United Kingdom	-	1.4	1.4
Japan	-	60.0	60.0
Others	3.0	-	3.0
Total:	41.3	158.4	199.7

154. If the export target is met and all the foreign aid now available is used, Indonesia's imports will probably increase by 36.4 percent in 1967. However, the $209 million of the aid furnished by the Inter-governmental Group for use through the B.E. mechanism will not all be sold in time to produce 1967 imports.

1968 Balance of Payments

155. The 1968 balance of payments projection prepared by the Indonesian Government was the principal documentation considered at the Amsterdam meeting. According to this estimate, total exports (with oil on a gross basis) are expected to increase to $859 million in 1968 or by 11 percent as compared with the 8.4 percent increase registered in 1967. This more favorable showing, however, is largely due to the oil sector. Gross oil exports are projected to increase by 24 percent and net income from oil by 60 percent to a total of $96 million in 1968. This striking increase is almost entirely attributable to the expected expansion of Caltex production for which improved production and transport facilities are being provided. It will probably be 2 or 3 years before the new off-shore fields now being explored yield a return. (See Annex 2 for an analysis of the oil industry).

156. Exports from the non-oil sector are expected to increase only about 5 percent in 1968 as compared with over 6 percent in 1967. While the price of rubber (which makes up 40 percent of Indonesia's non-oil exports) is not expected to decline further in 1968, the disabilities under which the smallholder rubber producers operate will probably prevent any substantial increase in volume or in earnings. In respect of Indonesia's other major exports, such as palm oil, copra, coffee, paper and tin, little change in prices is anticipated, with the exception of some increase in coffee and pepper.

A combination of run-down plantations at home and higher tariff barriers abroad plus the technical and managerial problems of the tin industry combine to produce a rather gloomy prospect for Indonesia's non-oil exports in the short run. It may even be that the 5 percent increase contemplated for 1968 will be difficult to achieve.

157. Aid Program for 1968. The Government requested from the participating countries at the Amsterdam Conference of November 20-22, 1967, $325 million of disbursements in 1968 from new foreign aid commitments. $250 million of this is for "program aid", that is, foreign exchange to be sold through the B.E. mechanism to public and private importers and $75 million is earmarked for projects (new and continuing), rehabilitation and balancing undertakings, miscellaneous equipment and spare parts. The approach of the Amsterdam meeting was, of necessity, considerably different from that of the normal consortia or consultative groups chaired by the I.B.R.D. The main focus was on a balance of payments gap, which emerges not as a result of an investment program but rather to meet the requirements of the economy for consumption and intermediate goods and to offset domestic inflationary pressures. The I.M.F. reviewed the need for $250 million of program aid and the Bank for $75 million of "project aid". One of the major tasks of this mission was to review proposals for the utilization of this component of the aid program. Our findings on this subject are in Chapter 5 and Annex 2.

158. The meeting took note of estimate of $325 million required to carry out the intentions of the Government in 1968 in respect of stabilization, rehabilitation and development.

159. 1968 Imports. This level of aid would permit a further increase to $815 million (from $720 million in 1967) or 13.2 percent in Indonesia's non-oil imports in 1968. Despite the increase projected in foreign aid for 1968, there may be some question as to the adequacy of import availabilities for that year. For the first time, the balance of payments forecast in 1968 provides a breakdown of imports as between project and non-project aid. Project imports (under the impetus of the $75 million program) are to increase from $57 million in 1967 to $119 million in 1968, accounting for 62 percent of the total increase in imports in that year. This leaves room only for an increase of non-project imports of 5.4 percent ($36 million) which is more than accounted for by the proposed increase in rice imports of $40 million (from 400,000 tons in 1967 to 600,000 tons in 1968). Thus there seems to be an important question as to whether the 1968 non-project imports now anticipated will be adequate to sustain a much higher level of economic activity than the rather depressed situation which is now prevalent. However, these balance of payments figures are on a disbursement, rather than an arrivals basis and a substantial amount of imports financed with 1967 aid will actually reach Indonesia in 1968 (perhaps $50 million). Also, some of the "project" imports to be financed with aid funds in 1968 are similar to goods categorized as non-project imports in 1967. Nevertheless, in view of the vital part which non-project imports have to play in the further stabilization of the economy, the emphasis placed on securing $250 million for program aid at the Amsterdam meeting was fully justified.

160. In 1968 the gross capital inflow is estimated at $448 million, if Indonesia's aid request is fully met (Table 9). It is to be noted that the increase in gross capital inflow in 1968 of $76 million as compared with 1967 is greater by $25 million than the increase of $51 million in the current account deficit as between these two years. This is because of the increase in 1968 of debt service on medium and long-term debt incurred after June 30, 1966. While the increase in official loans and grants as between 1967 and 1968 is $116 million, this is only calculated to produce an increase in gross capital inflow of $76 million and in net of $51 million. As noted, the difference between the last two figures is explained by an increase in debt service. The $50 million difference between official aid and gross capital inflow is explained by a lower estimate (by $27 million) for the "repatriation" of capital and by a $14 million reduction in drawings on credits incurred prior to June 30, 1966.

161. In the absence of debt rescheduling, Indonesia's total debt service payments in 1967 would have been about $350 million or over $300 million in excess of payments actually made. If we add this latter amount to Indonesia's gross capital inflow shown in the balance of payments, the total is about $670 million, which should be regarded as gross capital inflow for purposes of international comparisons. For 1968 this might reach $708 million if the full amount of aid requested for that year is actually received.

Foreign Debt Arrangements.

162. By the end of 1965 Indonesia was in arrears with respect to part of her debt service payments, and a payments crisis emerged in 1966 when a deficit on current account of $248 million combined with debt maturities falling due (including arrears) in the amount of about $530 million. Western creditor countries and Japan, at the request of the Indonesian Government, met and agreed to a rescheduling of unpaid obligations falling due before December 31, 1967. Bilateral rescheduling negotiations were held with the U.S.S.R. and other Eastern European creditors and these led to somewhat similar arrangements.

163. The rescheduling agreed to in principle at the Tokyo and Paris meetings in September and December 1966 by France, Germany, Italy, Japan, The Netherlands, the United Kingdom and the United States provided for 100 percent relief from principal and interest payments on credits of more than 180 days, related to contracts effective prior to July 1, 1966. The new schedule of payments is to start January 1, 1971, after a 4-year grace period, and the rescheduled or refinanced amount is to be repaid over a period of eight years on an ascending scale starting at 5 percent in 1971 and reaching 20 percent in 1978. Interest rates applicable to the rescheduled amounts and other matters were negotiated in agreements concluded subsequently on a bilateral basis with the creditor countries. An agreement was also reached with the U.S.S.R. which provided for payment of rescheduled amounts between 1969 and 1978.

164. A further meeting was held in Paris in October 1967 between the above-mentioned participating countries and Indonesia to consider debt service falling due in 1968, 1969 and 1970. The representatives of the participating governments agreed to recommend to their governments that they negotiate formal agreements to reschedule or refinance amounts of debt service falling due in 1968 for contracts which had entered into force prior to July 1, 1966, on the same basis as had been agreed for the 1967 debt service. They also agreed to recommend to their governments that "they consider favorably the possibility of additional relief from servicing of debt" falling due in 1969 and 1970 on terms "not less favorable" than those for 1967 and 1968.1/ Assuming that the service payments due to the participating countries are rescheduled or refinanced in accordance with these understandings and that (in accordance with the December 1966 agreement with the participating countries) agreement is reached to reschedule service payments due the U.S.S.R. and other non-participating countries under similar arrangements, the debt service payments of Indonesia will be as indicated in Appendix Table 2 .

165. Indonesia's longer run debt service and creditworthiness prospects are discussed in Chapter 7.

1/ The Paris meeting in 1967 also reaffirmed that, in respect of the interest rate on the rescheduled payments, interest during the respective grace periods (moratorium interest) should not exceed 4 percent per annum; that this interest should not be payable during the grace periods, and when paid, should not be compounded.

CHAPTER 5

POPULATION, SHORT-TERM PLANNING AND DEVELOPMENT

Population

166. By number of inhabitants, Indonesia is the sixth largest country in the world. The population increased from 76 million in 1950 to 112 million in 1967, and on certain assumptions it is expected to reach about 124 million in 1971. This implies a steady rise in the annual rate of increase from an average of 2.1 percent in the 1950's to 2.4 percent in 1965 and further to an estimated 2.6 percent in 1971. It is possible that these figures underestimate the actual increase.

167. In 1967 the estimated population density per square mile on the main islands was as follows:

Kalimantan	23
Sumatra and Surrounding Islands	100
Sulawesi	113
Java and Madura	1,425
Other Islands	38
All Indonesia	153

168. This illustrates the fact that both numbers and their location are involved, with Java the main problem. The rate of population increase does not vary much between these geographical areas, though it is slightly less in Java than in the other main islands. Further details on the population development are given in Appendix Table 4.

169. The rapid increase in population is creating serious economic and social problems in Indonesia, as explained in other sections of this report. Speaking generally, population pressure is creating increasing underemployment in the rural districts as well as a sizeable population movement from the countryside to the towns, where unemployment is increasing.

170. Clearly, Indonesia needs active programs to reduce the birth rate and to influence in some degree the future location of the population. In both respects some first steps have already been taken.

171. The Indonesian Planned Parenthood Association (IPPA) was established by a group of private citizens in 1957 and has continued its operations ever since. The Sukarno regime was not in favor of family planning, but the present government has repeatedly emphasized the need for reducing the birth rate. Thus, in 1967 the Acting President, General Suharto, stated that family planning is a matter of life and death. At the First Family Planning Conference which met in Djakarta in February 1967 all religious groups

favored family planning. According to many sources, most younger Indonesians now want smaller families.

172. Present conditions, therefore, should be conducive to family planning which is in fact spreading. Actual operations are run by the Indonesian Planned Parenthood Association utilizing local government clinics. The Association is teaching and training personnel, supplying information material and serving the clients free of charge; these pay for the commodities they need. The Association has covered its expenses by funds it has received from the City of Djakarta and several foreign sources such as the International Planned Parenthood Federation and the Population Council (New York). The U.S. A.I.D. has taken an interest in Indonesian population problems, so far in an advisory capacity, but it may decide to provide commodity aid. The Ford Foundation has a resident adviser on family planning in Djakarta and, in January 1967, also announced a grant to the Association.

173. The Indonesian Planned Parenthood Association in November 1967 had seventeen branch offices, mostly on Java, and utilized about seventy facilities (clinics), of which about thirty were in Djakarta where a pilot project has been started. The Association hopes to increase its number of facilities to about 150 by the end of 1968.

174. Beside Djakarta, it is worthwhile to mention Central Java, where efforts are made to instruct midwives on family planning. According to the Health Service of the province, up to November 1967 about 300 midwives from central hospitals had received such instructions, and it was planned to shortly increase this number to 800.

175. According to information received from the Ministry of Health, local governments are running about 5,000 clinics, each with midwives. These clinics form the basis on which comprehensive planning can be built. It is hoped that over the course of five to ten years every one of them should be able to actively advise on family planning.

176. So far there has been no appropriation in the Central Government's budget for family planning. The mission understands that the Government may provide for an appropriation in 1969, which would make family planning an official program. The mission strongly supports such a step.

177. As the activities of the Indonesian Planned Parenthood Association evidently is hampered by limited financial resources, it is recommended that the Government endeavor to provide some funds also for 1968. Furthermore, Indonesia should be able to obtain technical assistance for family planning on a larger scale than up to now.

178. The overpopulation of Java caused the Government to engage in transmigration efforts as early as 1950. The civilian transmigration scheme is now administered by the newly created Ministry of Veteran

Affairs and Transmigration. In addition, the Army, the Navy, the Air Force and the Police have their own schemes, but the civilian scheme is more important than all the others combined. Furthermore, there is some unofficial (private) inter-insular migration, mostly from Java to Sumatra. Figures for this migration are not available. The following descriptions deal with the official civilian scheme.

179. Farm families from densely populated areas are resettled in other islands, mostly in Sumatra, Kalimantan and Sulawesi. The Government organizes and finances the transmigration, which at present costs about Rp. 50,000 per family. Administrative expenses and all other general costs are included in this amount, which is not reclaimed by the Government.

180. Good and experienced farmers can take part in the scheme. They must be married and not older than 45 years. Physical examination is required, and specified training is recommended. On the average, two hectares of land is allotted to each family. The farmer also receives food for 8-12 months, clothes for the family, housing, cooking utensils, farm tools and seeds, medicines and other health facilities. Necessary infra-structure is provided. The settlers are not able to earn much money the first year, but their earnings generally increase during the second year, and after that they are expected to make a profit.

181. Under the scheme, about 96,000 families were resettled during the period 1951-1966. This amounts to about 480,000 persons. Obviously this has had little effect on Java's population. The transmigration has varied considerably from year to year, reaching a record of more than 13,000 families in 1965. Political developments caused transmigration to decline to near zero in 1966. Some recovery took place in 1967 when about 2,000 families took part in the scheme. The Central Government has increased its appropriation for 1968. Furthermore, the provincial governments have now declared their willingness to cover 50 percent of the expenses. On these terms, transmigration could increase, but better management of the resettlement areas is badly needed. The Government hopes that the official efforts, by setting good examples, will gradually stimulate private inter-island migration.

182. The mission welcomes the steps taken by the central and provincial governments to stimulate transmigration in 1968. Even then transmigration will not be on a scale that could ease the population pressure in Java. Therefore, the steps already taken to increase transmigration in 1968 should be followed up by further steps in subsequent years. It should be realized, however, that it is a long-term task to develop policies which can effectively influence the future location of the population (cf. the remarks on regional planning in Annex 5.) The limitation of numbers rather than their relocation must be the answer to Java's population problem.

Economic Planning

183. Background. Indonesia is just starting to establish the bases for useful economic planning. Its immediate problems are to break away from a condition of virtual stagnation which has persisted for a long period, and at the same time complete the stabilization of the economy.

184. Attempts at planning began in 1952 with the establishment of the State Planning Bureau, which employed a team of foreign experts and formulated a five-year plan for the period 1956-1960. The Bureau lasted till 1958. In 1959 a National Planning Council was established with 73 members (later increased to 81). The Chairman of the Council was ex officio a member of the Cabinet. The Council prepared an eight-year plan for the period 1961-1968. This was a voluminous publication embedded in 17 volumes. Both the five and eight-year plans proved to be abortive. The latter was converted into a three-year plan which also has now been abandoned.

185. Since the new regime took power in 1966, a number of steps have been taken to improve economic policy-making and prepare for planning. These steps include a start toward reorganization of the National Development Planning Agency under the leadership of a cabinet member.

186. Annex 5 of this report will describe the Government's present planning and economic policy-making machinery. On the basis of these facts, the Mission will give views and suggestions that may be of assistance to the Government in respect of the serious planning effort on which it is now embarking.

187. Strategy for 1968. In the past year the activities of those now responsible for planning were concentrated on day-to-day problems and on 1968. As for the latter, a simple approach was chosen. The 1968 budget includes a development budget which has been particularly coordinated with a program of foreign rehabilitation and project aid for 1968. This program is outlined in the next section and further elaborated in the sector annexes.

188. Five-Year Plan for 1969-1973. More elaborate planning is being introduced for the following years. By Presidential Instruction of June 8, 1967, the National Development Planning Agency was assigned the task of drafting a Five-Year Plan covering the calendar years 1969-1973, in cooperation with the ministries and institutes concerned.

189. The Instruction outlines the broad objectives of the proposed 1969-1973 plan. These are to increase national income per capita, to enlarge foreign exchange earnings, to increase employment opportunities, and to improve the distribution of income. Other objectives are to achieve progress in building up the people's spirit and talents.

190. Priority is to be given to quick return projects that will help to accomplish these objectives. Measures to improve management and to utilize the labor force more effectively are also given high priority.

191. Despite the broad socialist objectives of the regime, private economic activities are to be strongly promoted. The Government is to guide and coordinate all economic activities within the framework of planned development. Government projects, however, are to be limited to projects that encourage such activities (presumably infra-structure) and projects that cannot be executed by private enterprises.

192. Agriculture, including forestry and fisheries, will obtain first priority. Special attention will be given to small and medium-sized industries, especially those supporting the development of the agriculture sector. In mining, priority is to be given to undertakings that increase exports or produce goods necessary for the improvement of infra-structure. Transportation and communications are to be developed in step with production in other sectors. Transmigration (from dense to less densely populated areas) will be carried out.

193. In educational planning, first priority is to be given to vocational education. Within the spiritual field, measures to maintain the order of community life, to secure economic, political and social security, and to eliminate remnants of feudalism and colonialism will receive priority.

194. Monetary stability is emphasized as an absolute condition for success, and investment will be financed by utilizing non-inflationary sources. The country will make use of international cooperation and foreign aid as far as this is in harmony with the development policy and not in contradiction with the foreign policy.

195. The 1969-1973 Plan is to be an overall plan covering not only the public sector, but also defining economic policies by which development will be influenced in the private sector. The Plan will be composed of objectives, certain quantitative targets, general policies (including policies regarding finance, credits and capital imports), specific policy measures, and a public investment program. Major private projects, both Indonesian and foreign, assured as well as possible, will be taken into account. The Plan will include programs for all important sectors.

196. Obviously, these objectives are extremely general and lack quantification. This is partly because the National Development Planning Agency has, so far, been occupied with urgent short-term problems and lacks adequate staff. However, some medium-term macro-economic analysis has been carried out, and the various ministries have been instructed to draft five-year sector programs. Such a draft plan has been prepared for agriculture.

197. It is hoped that a first draft of the whole Five-Year Plan will be completed in August 1968. This will leave 3 - 4 months for the Government to consider the Plan and for necessary revisions to be made. All things considered,this is a very tight time schedule.

198. Annual Plans. The Agency realizes that the Five-Year Plan proper has to be a framework without too many details. Yet the Five-Year Plan will include a detailed annual plan for 1969, a less detailed plan for 1970 and an even less detailed plan for 1971. During 1969 the Government will prepare a revised and detailed plan for 1970, on the basis of new experience and information. In the same way, throughout the whole five-year period, the Five-Year Plan will be followed up with revised and detailed annual plans.

199. In 1969 and 1970 emphasis will continue, as in 1968, on rehabilitation rather than new projects. Gradually the latter are to absorb an increasing share of gross investment resources.

200. Regional Planning. The Presidential Instruction does not define the regional aspects to be taken into account when formulating the new Five-Year Plan. Clearly, at the present stage of economic and administrative development, the Central Government has only limited possibilities to conduct an active regional policy. The Government, therefore, is likely to apply a simple method which consists of influencing only the regional distribution of major projects; the plan may be expected to show where a number of such projects can be located.

201. The provinces are in varying degrees engaged in planning activities. Djakarta, which is a separate planning region and as such is in the same position as the provinces, has developed a plan for the period 1965-1985. The preparation of the plan took many years and was done with UN technical assistance. The twenty-year period has been subdivided into five-year periods, with details being gradually filled in on a continuing basis. According to the planners, the most urgent tasks for Djakarta are to improve the water situation, the electricity supply and the transport services. The predominant long-term task is to plan for an expected increase in population from about 4 million now to about 8 million in 1985.

202. Conclusion. The Presidential Instruction of June 8, 1967 regarding the 1969-1973 Plan forms a basis on which it should be possible to prepare a realistic plan. Likewise, the intention of the National Development Planning Agency to supplement the Five-Year Plan with annual plans is essential. Emphasis on annual (and sectoral) plans is all the more necessary in Indonesia because of the serious current difficulties and the failure of previous medium term planning.

203. Certainly, during the course of the planning process, the steps so far taken will have to be followed up by many others. The Mission's views on the steps required in formulating annual and medium term plans are in Annex 5.

The 1968 Rehabilitation Program

204. The terms of reference of the Mission included the evaluation of the request that the Indonesian Government made to the Inter-governmental Group in November, 1967, for disbursements of $75 million for project and rehabilitation undertakings in 1968. The Government's plans are to initiate in that year the rehabilitation phase of its economic recovery program by repairing and rehabilitating some vital public sector facilities and making a start on a limited number of new public investment projects. The Mission is in agreement with the Government that the preponderant emphasis in the 1968 foreign aid program should, as in 1967, be on imports that will contribute directly to the success of the stabilization effort by providing budget support and meeting essential current import requirements. However, assistance that will provide better production and distribution facilities is also needed. The two objectives (and categories of aid) are complementary.

205. The undertakings recommended by the mission and agreed to by the Government are listed in Appendix Table 54 and summarized below:

Table 12

(In Thousand Dollars)

	Total Foreign Exchange Cost	First Year Disbursements
Agriculture	20,425	10,843
Power	43,070	14,200
Industry and Mining	81,653	17,103
Transportation and Communications	41,700	37,700
TOTAL:	186,848	79,846

206. It is not intended that this part of the aid program should meet all of Indonesia's requirements for imports of capital equipment and materials to be used in the public sector rehabilitation and development program in 1968. In addition, some $44 million of disbursements are expected to be made against credits that were extended for public sector projects prior to June 30, 1966 and which are still available (see Appendix Table 3 for the list of credits). There is also some $16 million of foreign exchange expenditures contemplated directly from the 1968 Development Budget. If $75 million is actually disbursed in 1968 from the new aid program (which seems optimistic in view of the considerable preparatory work still to be done and the time required to make commitments), then the total foreign exchange expenditures from public sector undertakings in 1968 would be $135 million.

207. It is not possible to say with any precision what impact this program will have on gross domestic investment and economic growth. This is partly because we have no reliable base in the form of previous national accounts data from which to measure its incremental effect, and partly because of the physical nature of the aid goods. If the Mission's recommendations are reflected in actual commitments, about half of the amount involved in the $75 million program would be used for projects including relatively small amounts for rounding out or balancing investments already made. The rest is largely for the rehabilitation of presently installed facilities and for spare parts. Since it is difficult to draw a precise line between deferred repair and rehabilitation, the Mission cannot say precisely how much of this money will be used for gross capital investment in the usual sense of the term but certainly the major portion of it would be so used.

208. Though this money is destined for the public sector including, of course, public sector industries, it is not intended to cover all the requirements of the public sector for capital goods imports. It is hoped that Indonesia will be able to spend part of her own foreign exchange and of the $250 million of program assistance on the importation of capital goods for the public and private sectors.

209. However, one may legitimately speculate about the possible level of investment that Indonesia may achieve in 1968 with the help of this aid. Our very tentative estimate is that in 1966, a bad year for investment, gross fixed capital formation was in the neighborhood of 6 percent of national income and over the last three years it may have averaged around 7 percent. This is based not on direct estimates of gross investment, but rather on the relation between imports of capital goods and the amount of investment that has occurred in countries with economies similar to that of Indonesia.

210. The increase in capital goods envisaged by this program would be to increase the gross investments as compared with 1966 by roughly 2 percent of national income or to, say, 8 percent. This is obviously still very low, particularly given the backlog of rehabilitation needed to produce a growth in the economy much in excess of that of population. Based on experience in other countries, about double this rate of investment will be required to produce a reasonable rate of economic growth.

211. The details of the proposed uses of the $75 million is discussed in the sector annexes of this report. There can be no disagreement on the great importance of transport and communications which was assigned nearly half the recommended amount on a disbursement basis. The Mission would have liked to have seen more go to agriculture but here the problem of lack of project preparation is an impediment. Tin received top consideration in the industry list because of its run down condition and its importance for exports. The list leans heavily in the direction of quick disbursements and projects with expected favorable capital/output ratios, although we felt that we could not neglect entirely longer-term undertakings which should be started now but which will not result in increased production for three or four years.

212. As to the conditions that should accompany the provision of this aid, the Mission was impressed with the great importance of improved management in nearly all the agencies and organizations for which it is being requested. Detailed recommendations on this subject are made in the sector annexes. The Government reacted positively and at high levels to our suggestions. The necessary mechinery has been set up to decide on the disposition of technical and managerial assistance and to see that it is properly used by the agencies needing it. The implementation of these suggestions will, of course, depend on the willingness of donor countries to provide a considerable amount of managerial and other technical assistance in addition to other forms of aid.

213. In selecting specific projects and other undertakings for this expenditure, the most important factors that we considered were (a) the absorptive and administrative capacity of the agencies to utilize the funds effectively; (b) the bottlenecks in the economy that could be removed, or at least partially removed with this aid; and (c) stimulation to other parts of the economy from the investments proposed.

214. It was necessary to check on the availability of rupiah financing to install the proposed inflow of capital goods and repair and rehabilitation commodities. As noted above, the foreign financed items to be used by the public sector in 1968 may total about $135 million. However, a portion of this will be utilized by state enterprises that should not need to draw on the budget for rupiah financing. This element has been estimated at about $20 million, leaving a balance of about $115 million of imports that will require some rupiah expenditure from the budget for their utilization. In rupiah terms at present exchange rates, this is about Rp. 21 billion.1/ Since the development budget after deducting the Rp. 2 billion portion of that budget that is to be spent on imports amounts to about Rp. 30 billion, the ratio of rupiah to foreign exchange would be in the order of 3:2, an adequate coverage.

215. Whenever possible we checked rupiah requirements against budget allocations and found the latter adequate. However, the implementation of the program will definitely require some adjustment of budget allocations within and possibly among ministries. This, we are assured, will be done as the program moves forward and that the Government will give top priority to its rupiah requirements. The budgetary procedures of the Government provide sufficient flexibility to make any necessary adjustments even after the budget has been approved by Parliament.

216. It needs to be stressed, of course, that this entire exercise is based on the assumption that the overall rupiah resources to carry out the Rp. 32.7 billion Central Government development budget will be forthcoming. This will depend on the availability of the $250 million program aid as well as the capability and determination of the Government to finance its routine expenditures from its own resources.

1/ At the current B.E.-market rate of 185:1.

217. A most important question is whether at this stage of Indonesia's stabilization and recovery program this type of foreign aid for specific objects of expenditure is appropriate or whether continuing to channel all aid through the B.E. market would not better serve the objectives of growth as well as stabilization. Of course, in a perfect world where the allocation of total resources is made in accordance with a plan calculated to optimize economic growth, it does not matter too much in what form foreign aid is provided or under what administrative arrangements. It is also true that Indonesia by its removal of controls and adoption of the B. E. system has allowed market forces considerable latitude in optimizing the use of foreign aid. However, Indonesia, for good and sufficient reasons, has not yet produced a plan or a set of economic policies that would assure us that the allocation of rupiah resources alone will take care adequately of the investment and rehabilitation needs of the economy as far as the public sector is concerned. The Mission noted that, by and large, the recommendations of last year's Bank report that made certain recommendations in respect of the use of imported goods had very little impact on the actual distribution of such goods. Also, the discipline and technical and managerial assistance that should accompany the use of foreign aid earmarked for specific purposes is needed. In fact, the mission concluded that the administrative improvements that should accompany the provisions of this foreign aid may well be more important than the aid itself.

CHAPTER 6

THE SECTORS

218. This chapter will summarize the current situation and prospects in agriculture, industry and infra-structure and our principal recommendations pertaining to those sectors. The mission was not able to study education, health and other social services.

Agriculture

219. The agricultural sector accounts for around 50 percent of the national product and provides a livelihood for well over 70 percent of the population. Exports of agricultural origin produce practically all the country's foreign exchange earnings with the exception of about 15 percent from the oil sector and 7 percent or so from tin, bauxite and minor mineral exports. Export taxes on agricultural products produce nearly 20 percent of government revenues apart from foreign aid.

220. The sector is divided into two well demarcated parts, smallholder operations and estates. Less than 10 percent of the cultivated area is in estates. Estates are almost entirely devoted to the production of export crops but smallholder production is both for export and domestic consumption with food dominating the domestically oriented part of the industry. Except for relatively small amounts of rubber, vegetable oils and hard fibers, agriculture contributes relatively little to the needs of domestic industry for raw materials, although the processing of export crops, in particular smallholder rubber, is a significant part of the manufacturing sector. Since the nationalization of Dutch and other foreign-owned properties, the estates have been in the public sector with the exception of two large rubber estates recently returned to their American owners. Negotiations are still going on regarding the return of the British and some other former foreign-owned estates, but it seems likely that the bulk of the estates will remain in the public sector for some time to come. However, it is the policy of the present government to treat the public sector estates as commercial enterprises and to give their managements a substantial degree of autonomy.

221. Smallholders, apart from producing export crops, notably rubber, are chiefly engaged in providing food for domestic use with rice the predominant crop. Since rice has long been regarded as the staple of life in Indonesia (the most essential of the nine basic commodities) policy towards the rice producer has been somewhat ambivalent during the inflation. Production, particularly on over-populated Java, has been encouraged by special schemes to provide some farmers with a subsidized package of inputs at the same time as the price of the rice procured by the Government for its personnel and for injection into the market for price control purposes has been kept below international levels. Thus, both export crops, through export taxes or unrealistic exchange rates, and the food sector have been required to contribute to reducing government deficits even though Indonesia has had a rice deficit for the last thirty years and her main agricultural exports have been anything but buoyant.

222. Indications are that in recent years food production has been keeping abreast of population growth or possibly a little better. In the early part of the 1960's, imports of rice averaged about a million tons but in 1965 and 1966 average imports were only about a fifth of this amount. However, rice stocks were apparently drawn down and a crisis occurred in the latter part of 1967 with the threat of partial crop failure because of dry weather and administrative snags in imports. Imports in 1967 are estimated at about 400,000 tons and, because of the crisis and price hikes of this year, the Government is planning to increase imports to 600,000 tons in 1968. Since average production has been estimated at over 9 million tons for 1965 and 1966, imports were clearly a marginal factor in the overall rice supply situation in those years. However, imports of rice are very important as a stabilizing element in the cost-of-living indexes, since only a fraction of the rice produced (20 - 30 percent) reaches the urban centers.

223. The food situation, together with the principal measures being taken to augment food production in Java and the land ownership and tenancy arrangements under which these measures operate, are discussed in Annex 1. The mission did not have the opportunity to examine in depth the food situation on the Outer Islands where the potential for increasing production may be better than on Java. On that island improvements must be made at the intensive rather than the extensive margin as can be done on the Outer Islands. The Asian Development Bank is making an investigation of possibilities of increasing food production throughout the country. In general, the mission was favorably impressed with the measures being taken (particularly the Bimas scheme) as well as the intelligence and technical competence of the farmers in Java. At the same time, the institutional arrangements involving cooperatives, credit and extension seem to be quite weak and in need of a great deal of attention if a stable rate of increase in output is to be achieved. Of course, as in other sectors of the economy, the effort to achieve a higher level of production while putting an end to the long bout of inflation is confronting authorities with difficult choices. The worsening rice situation in late 1967 appears to have been partly the result of a conflict between an orthodox credit policy and action required to stimulate production.

224. The mission also reviewed the landholding problems of Java. The family planning and transmigration programs hopefully may eventually curb the increasing population pressure on that island but these will accomplish their objectives very slowly at best. This means that landholdings must remain very small and increased productivity per unit of land is imperative.

225. The land reform legislation of 1957 and 1960 was well intentioned but faulty in substance and execution. Its principal defect was the relatively high maximum holding (5 hectares) that owners could retain which resulted in very little land to distribute to the landless. Also the inflation made the pricing of redistributed land unrealistic and thus gave a strong incentive for owners to circumvent the program. At present land reform seems to be a dead issue.

226. The mission believes that action in this field is imperative not only for social and related reasons but to increase productivity and make it possible for the cultivators to use fertilizer and other inputs. In addition to need for land reform, tenancy conditions are poor. At present many tenants are more akin to farm laborers than independent farmers. They should receive a larger share of the product and the Government should use its power to make rental contracts more equitable and in written form.

227. A prerequisite of successful programs to increase food production on Java is the maintenance and improvement of the island's irrigation system, one of the largest and best developed in the world. Nearly 2.0 million hectares are technically irrigated at present, but since 1940 many irrigation structures have fallen into disrepair. Further, due to land hunger, a progressive and illegal deforestation of river catchment areas is continuing. Crop destruction and partial failure due to flooding and poor water distribution are becoming increasingly serious. Lack of finance is the basis of these problems and until farmers pay realistic water charges, and sufficient funds are made available for erosion control, it will be impossible to correct the situation. Of course, the ability of farmers to pay for irrigation maintenance is linked to producer prices, and as stated earlier, government policies presently depress these below international levels.

228. The mission believes that a detailed review of the irrigation situation is essential, both to establish the capital cost of a comprehensive program of remedial works and the recurrent costs of annual maintenance. In the absence of such a review it is difficult to justify expenditures on new irrigation schemes.

229. Smallholder originating exports account for about 40 percent of all exports and in 1966 were valued at some U.S. $220 million equivalent. The major commodities are rubber, coffee, copra and pepper. Since 1960 the volume of smallholder exports of rubber and coffee has increased, but that of copra has steadily declined. In the case of rubber, the major export, there are reasons to believe that smallholder production may decline in the future. Indications are that most smallholders probably receive little more than one-third of the export value of their produce. With the prospect of continuing low world rubber prices and increases in the cost of living, it is not improbable that rubber smallholders will turn to more remunerative activities, in particular food production mostly for their own subsistence. A serious consideration for the long run is that smallholders are unlikely to engage in either the new or replanting of rubber under such circumstances, and 80 percent of smallholders' rubber now requires replanting.

230. In the mission's view it is dangerous to judge the strength of the smallholder rubber industry on the increases of production in recent years. Probably these have stemmed largely from extensive plantings, made during the rubber boom in the late 1940's and early 1950's, reaching their peak production. Since that time replanting and new planting has been insignificant. The mission appreciates that improvement of the smallholder rubber industry would involve major changes in processing and marketing arrangements and the provision of an adequate infra-structure in producing areas. Even without Government

financial assistance for replanting this program would be expensive. Under the present tight fiscal situation it cannot be tackled on a nation-wide scale, but there is an immediate need to identify the problems and to initiate improvement programs in selected areas.

231. Unlike rubber the steady increases in smallholder coffee production and exports are the result of favorable price relationships and marketing arrangements, and will continue. Performance in this area should point the way to tackling the rubber problem.

232. Revitalizing copra exports appears to be at least partially a question of improving the producers' share of export receipts, but since the bulk of the crop is produced on the eastern islands, of equal importance would be the improvement of shipping facilities.

233. The mission is concerned that there is no field agency with specific responsibility for assisting cash crop smallholders. The Ministry of Estates is responsible for the sector but does not provide an extension service. Since most smallholders grow both cash and food crops, the mission believes that the Ministry of Agriculture, now responsible for the latter alone, should be staffed and equipped to service all non-estate agriculture.

234. Government-owned estates now account for about 60 percent of estate production. The balance is divided between foreign-owned estates managed by the Government and private estates which are largely Indonesian owned. Estate production and exports, which in 1966 were valued at about U.S. $177 million equivalent, are stagnating due to the generally poor financial situation of the industry which has been brought about through heavy export taxes and unrealistic exchange rates. In the case of two crops, oil palms and tea, production could be economically and significantly increased within two to three years by correcting nutrient dificiencies which have developed as a result of sub-optimum fertilizer use in recent years. Such programs would require the provision of foreign exchange and authority for the estates to import their fertilizer requirements directly. In the case of rubber estates the problem is more complex and average yields are so low that probably two-thirds are not financially viable. Even if it proves possible to maintain these in operation, under present policies production increases cannot be anticipated until after 1970 when the benefits of replanting programs, which commenced on a satisfactory scale only in 1963, begin to be felt. Probably there would be economic advantages in maximizing latex production by slaughter tapping appreciable areas of estate rubber with a view to replanting with an alternative crop; oil palms would be suitable in many cases, or alternatively, by using the area for other non-estate agricultural development.

235. The mission believes that production by the estate sector will continue to stagnate, if not decline, without a large injection of new capital, changes in export taxes, and improvements in management and research. The estate sector has such potential that in the mission's view the Government should seek external assistance, in particular from the commercial sector,

to review the management arrangements for the government-owned estates and to help in preparing development programs for individual enterprises. In some cases, for example tea processing and marketing, specific management and technical assistance probably would be required.

236. The problems of research to support both estate and smallholder non-food crop production also require immediate attention. At present research is inadequate, but even so, duplication of effort occurs.

237. While forest exploitation is being intensified by the operations of a few foreign companies, the resource is so large and the demand of domestic and foreign markets so favorable that a greater effort should be made both to increase timber production, and to establish forest product processing industries. Heavy investment is required for these purposes, and the great part of this as well as operating expertise must be sought from abroad.

238. The mission believes that the Government's capacity to attract required investment, and to evaluate proposals made by foreign commercial operators is restricted by its lack of experience in modern timber extraction, processing and marketing techniques. Consideration should be given to obtaining the services of a qualified consulting firm to assist in these directions.

239. Marine fishing is another area where production is significantly lower than the capacity of the resource, and where it could be increased to supply both domestic and foreign markets. Increased supplies to the domestic market, chronically short of animal protein, could be achieved by the adoption of improved fishing vessels, gear and methods proven in other countries. A problem, however, is the marketing, processing and distribution of the increased catch since present arrangements are barely satisfactory for the existing level of production.

240. The mission believes that high priority should be given to the improvement of the fish marketing and distribution system as the precursor of a program to increase catching capacity.

241. At the present time, Indonesia possesses insufficient technical experience to engage in the export of marine commodities on a commercial scale. Surveys indicate, however, that tuna and shrimp resources are such as to be attractive to foreign companies. Every effort should be made to attract foreign participation, at least until such time as local entrepreneurship can be developed.

Industry

242. In the field of industry, in addition to the need for capital and technical and managerial assistance, the mission was convinced that a number of problems need to be tackled. For example, domestic industry needs a more rational set of customs duties and internal taxes. Both inter-island transport rates and the rate structure for electric power appear to penalize domestic industry. As might be expected at this stage of Indonesia's stabilization program, there is a general lack of working capital. More attention needs to be paid to ways of meeting the minimum working capital requirements of Indonesian industry on other than the present rather hand-to-mouth basis. Also the revaluation of assets for tax purposes is an obvious requisite following the long bout of inflation. These problems together with an investment program for this sector are discussed in Annex 2.

243. Industrial development in Indonesia is at an early stage as evidenced by its still modest contribution to the national product. Appendix Table 5 shows that value added by industry during the first half of the 'sixties was stable in absolute terms as well as in proportion to the Net National Product, of which it represented about 12 percent. It declined after 1964 to about 11 percent mainly because of a sharp reduction in output of small-scale establishments. The main reason for this was probably the lack of spare parts and raw materials, but the civil disorders also resulted in a decline of production in many factories, as in the case of the sugar mills. In 1967 there was a further decline in in some lines of manufacturing production caused in part by the fiscal and monetary retrenchment and in part by liberalization of consumer goods imports.

244. Industry is operating at a low rate of capacity, and labour supply is in excess of needs. The mission was told that in the public sector there were only a few enterprises which operated at more than 40 percent of their real capacity (in basic industries officials believed that operations were generally at about 20 percent of the initial capacity). In this situation it is difficult to evaluate the general efficiency of factory establishments, the competence of management, and the productivity of workers. The mission visited a number of mills where the technical efficiency was moderately good and financial results under the difficult circumstances of 1967 could be considered satisfactory. However, striking differences can be observed in this respect between different establishments. Some of these differences can be explained by the age of the installed equipment. Modern factories with up-to-date machinery exist side by side with mills where the equipment has not been replaced since the last century. However, the fact that a very large part of factory-scale industry is in the public sector has also much to do with inefficiency in those industries where public policies failed to create adequate incentives.

245. Important Retarding Factors. Lack of an adequate infrastructure has limited the size of the market for domestic industrial establishments. The lack of adequate roads, ports and shipping capacity is the cause of extremely high transport costs even between different points inside Java, and this is responsible for the fact that imported goods have a significant competitive advantage in certain regions vis-a-vis goods produced inside the country but in other regions. This makes it necessary, for example, for the principal cement factory at Gresik in East Java to apply differential prices for cement consumed in East Java and for cement "exported" to Djakarta. Also it makes domestic fertilizer expensive at destination.

246. A second inhibiting factor has been connected with the scope of the State Enterprises. The State Enterprises Law (No. 19 of 1960) established the principle of separating production from trading and transport. This has prevented the creation of any working or financing links between industry and commerce, which has been a most fruitful relationship at the early stage of industrialization in most countries. As the pricing of finished goods was subject to ministerial directives, and the cost of imported materials depended on other government policies, the whole price system within which industries became accustomed to operate was a matter of inter-ministerial coordination and therefore a matter of personal influence and politics. At present, with the Government's policy of placing government enterprises on the same footing as private enterprise within a price and import system left largely to the operation of market forces, and with the same degree of restrictive credit policy applied to all enterprises, public sector industry is faced with major readjustments which have not really had any effects yet on their structure or on their management. Such a state would normally result in bankruptcies, mergers, rationalization moves, and streamlining of the work force, but none of these is legally possible, and therefore the structure remains for the time being unchanged as far as the public sector is concerned.

247. Present Industrial Structure. Indonesia has both a traditional textile industry based on a large handloom capacity and the typical local craft of batik making, and a modern cotton spinning and weaving industry. The country does not produce any raw cotton. Since the end of World War II, mechanized spinning as well as weaving has been developed, but the industry is still in a state of imbalance with a highly inadequate spinning capacity. Thus, a good portion of the industry has been based on imported yarn. Since this is the most important import substitution industry, it is discussed at length in Annex 2.

248. The engineering industry was started before the turn of the century, basically to serve the large rubber, copra and palm-oil estates and the sugar industry, which at that time was a principal exporter. Several large workshops, previously Dutch-owned but now in the Government sector have developed into sizeable plants, producing sugar crushing equipment, boilers, rubber rollers, storage equipment, water gates, scrapers, moulds, rolling stock for plantation railways, miscellaneous machine parts and construction steel. The equipment of these shops is mostly very old, and the layout less than optimum. In recent years they attempted to develop new production lines for items such as road rollers, diesel engines, pumps and hand tractors as well as other types of

agricultural machinery, but some of these projects are still in the planning stage and others on a pilot basis. Small and medium-size shops in the metal-working field exist in the private sector in most major cities, with an estimated total capacity of 55,000 tons per annum. Besides, the State Railways have their own workshops at Djakarta and Madiun and there exists a well-equipped army industrial plant at Bandung, a Navy engineering establishment at Surabaja, and a maintenance shop for the Air Force at Bandung. The total capacity of these workshops is estimated around 100,000 tons per annum. Their present output is believed to be about 30 percent of that.

249. The low rate of capacity utilization in metal-working industries is caused by several factors. For one thing, the change in the exchange rate for imports has greatly increased their costs. Second, the austerity program has reduced demand; and third, their equipment is obsolete and efficiency leaves much room for improvement.

250. There are about 55 sugar mills (1966 campaign); all except three were formerly Dutch-owned but are now in government hands, and some of them are fairly modern and efficient. Production has declined from a level of about 840,000 tons in 1965 for the whole of Indonesia to about 650,000 tons this year. This is attributed to the disruptive effect of the 1965/66 political events and the figure of 750 to 800,000 tons is projected for 1968. This is still less than in 1939 when Indonesia produced 1.6 million tons of sugar and export was in excess of a million tons.

251. An interesting feature of the sugar industry is that the mills grow the cane themselves on land leased from farmers at a rent determined by mutual agreement each year, subject to approval by the Regency Administrator. This rent is mainly influenced by the price of rice. The industry is discussed in Annex I, Appendix 6.

252. Molasses from the sugar mills are all exported at present, mostly to the United Kingdom, in the volume of about 250,000 tons per year.

253. The chemical and allied industries are of more recent origin, with 13 State Enterprises operating many more plants, many of which are, however, inefficiently small by international standards. There are 4 paper and newsprint factories with capacities ranging between 10 and 25 tons per day, which compares with an optimum size, under modern conditions, of 100 tons per day.

254. The cement factory at Gresik is modern and efficient and has an annual capacity of 375,000 tons. Another at Padang has 120,000 tons capacity but is about 40 years old. Various factors, including the lack of foreign exchange allocation for their import requirements during recent years, and the recent depression in construction activity have been responsible for their low utilization of capacity.

255. One of the few examples of full capacity operation in industry, known to the mission[1/], is the urea plant at Palembang with a rated capacity of 100,000 tons and a level of output in 1966 of 95,000 tons. Other factories in the chemical sector which are described as moderately efficient are the oxygen, nitrogen, ammonia and carbon dioxide factories. The glass industry is reported to operate at very low capacity. The largest glass factory is a state-owned plant at Surabaja with a capacity of 14,000 t/p.a., mostly pressure bottles. Output in 1966 was 3,000 tons. A few small private glass factories exist with a capacity of 1,000 - 2,000 tons. Serious managerial and labor problems appear to exist in the salt industry. Large scale new investment projects have been initiated in the chemical sector, but their economic and financial feasibility appears not to have been thoroughly examined before they were started, and their execution has been suspended. They are analyzed in Annex 2.

256. Indonesia also has a few industries serving the transportation sector, such as nine private car assembly plants (capacity: 10,000 cars p.a.) and two tire factories, one of which is owned by Goodyear at Bogor (capacity 300,000 motor tires) and the other state-owned, P.N. Intirub (capacity 160,000). A new tire factory is under construction at Palembang with a planned capacity of 180,000 motor tires p.a.

257. As in heavy industry, the present rate of capacity utilization in the light industry appears to be generally very low.

258. The principal goods produced are leathergoods, cigarettes, beer, soft drinks, ceramics, agricultural and household implements, batteries, paint, paper ink, asbestos, hardboard, bricks, timber, rope, umbrellas, matting, tubing, edible oils, spirits, ice and shoes. In many of these enterprises, the real production capacity is listed as a fraction of their initial capacity. No data are available on their current volume of production.

259. In the private sector there are about 250 medium size establishments and roughly 50,000 small-scale industries producing batteries, radios, T.V. sets (assembly), sewing machines, food and confectioneries, soft drinks, cigarettes, matches, paint, soap, plastics, paper, rattan, leathergoods, rubber-goods, ceramics, pharmaceuticals, etc.

260. The policy issues that need to be resolved and the institutional reforms required for this sector are discussed in Annex 2. Here a brief comment may be made on the more general aspects of the key issues of protection, revaluation of assets, and the exchange rate.

1/ Others were the G.K.B.I. (cooperative cambric mill) at Jogjakarta in process of expansion under a $2.5 million private Japanese credit; and the P.N. Karunggoni II (sugar bags) at Surabaja.

261. Clearly it is not sufficient to say that because an Indonesian firm cannot compete with imports under present conditions, more protection (in the form of tariffs, surcharges or import exchange rate depreciation) is indicated. That is, should emphasis be placed on (a) export industries, (b) industries to service export industries; (c) the further processing of export products; or (d) import substitution directed towards the domestic market. Only in the case of the (d) category and to a limited extent the (b) category is the protection solution relevant. The basic arguments for protection are: (1) the need to eventually improve the balance of payments, (2) the employment problem and (3) the infant industry argument. In respect of (1), it may be assumed that Indonesia must reduce its import dependency (ratio between consumer goods imports and GNP), if its balance of payments is to become viable. This is because Indonesia cannot continue to count on the present large inflow of commodity aid and the present low level of debt service payments that have temporarily resulted from the rescheduling exercise. Therefore, increase in domestic production of consumer goods is desirable and necessary.

262. The employment argument is also quite persuasive. At present, industry (as well as the government budget) is carrying a heavy burden of excess employees, which in a normal market economy they would not have to sustain. In other words, the market price of labor is much above the opportunity cost. The choice therefore is between putting a still heavier burden on the budget or denying consumers the benefit of very cheap imports. Given this choice, the mission would opt for the latter. In addition to these arguments, the infant industry case for protection has some, (though one suspects in view of market limitations, less) relevance. There are undoubtedly some external economies (power, transportation, training of management, and the labor force) which could be generated by a larger industrial component in the economy.

263. The Government has increased effective rates of duty on imports by the blanket and across-the-board application of surcharges. However, this has been revenue-motivated. Concern about cost-push inflation is indicated by the fact that only half as much surcharge has been applied to the lower brackets in the tariff structure as to the higher. This has obviously failed to meet the protection objectives. A revamping of the tariff structure on the basis of well-considered industrial policy is badly needed.

264. On the question of revaluation of assets, the case for such action up to now has not been primarily economic (if we assume pricing and costing is now done on a rational basis) but rather that it would provide a better basis on which to evaluate the relative profitability of different industries and, therefore, a better basis for future investment decisions. The revaluation of assets alone will not, of course, protect against erosion of capital, nor under present circumstances reduce the tax burden of most establishments. The method of revaluation seems to present a very difficult problem in view of the age of many industrial assets, the wrong decisions that were made in installing them, and the lack of any return under present circumstances. Replacement value on some sort of ad hoc basis seems to be the only approach to this problem and, of course, will not yield theoretically perfect results.

265. It is important that regulations be revised to allow for a continuous revaluation of assets, according to an index reflecting the inflation. Brazil is an example of a country which permits this type of revaluation. Revaluation of assets will now become important because tax collection is expected to be improved and therefore the impact of the additional tax burden caused by the artificially low depreciation could become significant and be a deterrent to investment, and also efforts are being made to attract foreign investment by giving tax exemptions for the initial five years of operation. Since new companies generally require 3 - 4 years of operation to reach full profits, this exemption is not as valuable as it may appear, and could be substantially more than offset by the subsequent higher tax burden through artifically low depreciation allowances unless provision is made for revaluation of assets. Furthermore, when companies assume liabilities denominated in stable currencies they must be allowed to write up the liabilities according to the increased rupiahs necessary to discharge them. The companies must be allowed to write up the fixed assets at least correspondingly so that this "loss" is taken over the life of the assets, instead of against income in the year in which the "loss" through the depreciating local currency was incurred.

266. While it is difficult to contend that the exchange rate mechanism over-values the rupiah in the sense of producing a disequilibrium in the balance of payments (given the present level of foreign aid), the lag in the B.E.-aid and B.N.I.-B.E. rates behind movements in the B.E. market rate does tend to keep the latter from depreciating as rapidly as it otherwise would and should. A recommendation that the aid-B.E. rate should be depreciated more rapidly, of course, runs into the problem of absorption of aid for stabilization. There has been a considerable lag in the utilization of some (U.S.) foreign aid this year, even with the spread that has existed between the B.E. market and the aid-B.E. rates. We have here an obvious conflict between the stabilization objective and the need for increasing domestic output. This also is a problem in connection with rice production. The only real solution is to stabilize by fiscal and monetary policy rather than by imposing the major burden of stabilization on the balance of payments and domestic production.

Transportation

This sector is considered in detail in Annex 3.

267. The nature of the transportation needs of Indonesia is clear from the fact that the country consists of several thousand islands. Ports and shipping are of prime importance. All foreign trade is ocean borne, and interinsular shipping is the country's trunk line, connecting the intra-island land transport systems. The great distances involved make domestic air transport also of more than average importance. All railway, air and a large portion of sea transport is owned and operated by the State. Urban bus transport is also partially owned by the Central Government. Trucks are the principal medium in the private sector.

268. Transport facilities are in difficulties both physically and financially. Because of budget paring, the dissipation of the purchasing power of allocated funds by inflation, and mistakes in planning and priorities, maintenance has been neglected over many years. The rate of disinvestment both in the infra-structure and carrier fleets has probably been greater than in any other sector of the economy.

269. In the longer run Indonesia must plan on larger investments in this field. However, because of the decline or stagnation of trade in recent years, the physical capacity of the transport system is, with some exceptions, not a bottleneck at present. In any case, it is not the most immediate problem. The high unit cost of transportation and the better utilization of equipment on hand are the more important and pressing problems. With improved efficiency, the interinsular shipping fleet, the ports and the railways (with the exception of some need for more motive power for the last) could all handle more if traffic should increase. The most urgent need, therefore, is for improved management organization and labor policy. The mission was happy to find that the Government recognizes this need, and is taking action to obtain expert managerial assistance from abroad.

270. The above does not mean that some sizeable investments in the transport sector are not immediately required. Furthermore, rehabilitation of the transport sector will take considerable time, and action must start now to avoid bottlenecks emerging when economic activities increase.

271. With respect to its rates and tariff policy, the Government is faced with a dilemma. On the one hand, stimulating exports in the face of falling export prices and better distribution of food and other commodities to avoid cost-push inflation seems to call for lower real costs of transport. On the other hand, the urgent need to balance the budget while rehabilitating facilities calls for all transport modes to more than cover their operating costs. The dilapidated physical condition of the transport system, and under-utilization thereof because of the reduced economic activities accentuate the problem. Maximum efforts must be made to make the best and most efficient use of the existing infra-structure and carrier fleet, giving priority to those investments which will have an immediate cost-reducing effect.

272. The above is generally reflected in both the Government's development budget and its request for U.S.$ 75.0 million of foreign "project" aid for 1968. Of the Rp. 45.0 billion Development Budget, Rp. 8.0 billion is allocated for the transport sector (roads, railways, maritime affairs and airfields). This does not include transport projects in the provinces, the amount of which could not be determined, but which probably are a sizeable portion of provincial development expenditures. In addition, state enterprises operating in the transport sector (shipping companies, airlines, state harbor enterprises and some road transport companies) are expected to obtain a share from a Rp. 7.0 billion lump sum allocated in the Development Budget for self-liquidating development projects. Of the request for U.S.$ 75.0 million foreign project aid, nearly 43 percent is for the transport sector.

273. All things considered, including particularly the need for a quick impact, the mission agreed with the priority given by the Government to the transport sector in the 1968 aid program. It has the following specific observations:

(a) The cost estimates are rough, and in many cases based on previous purchases for similar items with a suppliers' credit probably at high prices. We could not check the estimates in detail.

(b) In recommending the program the mission assumed that the strengthening of management and in some cases specialized technical assistance as recommended in Annex 3, will materialize before orders are placed, so as to ensure that the most suitable types of equipment or materials are purchased, and that they will be used efficiently.

(c) A considerable part of the actual expenditures for the transportation part of the $75 million may be disbursed only in 1969, but the mission could not estimate how much the carry-over will be. This will depend on when orders can be placed, which in turn depends upon when the envisaged managerial and other technical assistance will be in the field. Most deliveries may be made within a year after ordering, with the exception of dredging by contract which may extend over several years.

274. In view of the economic planning program and needs of the country, the mission considered the desirability of recommending a comprehensive study of the country's transport system, but has come to the conclusion that such a study is neither really needed or would be of enduring value at present. The main reasons for this view are: (a) present and past traffic statistics are too distorted and incomplete to provide a starting point for a traffic forecast and, in any event, future transportation needs will depend largely on developments in the productive sectors of the economy. Until more thought is given to longer-range economic policies, these will be too uncertain to provide a reasonably reliable basis for traffic forecasts; (b) present costs, both as to transport and construction, are too distorted to form a basis for cost calculations needed for the preparation of a sound investment program;

and (c) most important, there are already many reports, analyzing problems and shortcomings in various parts of the transport field. If these reports were put together by competent experts and supplemented by a road study (see below), an adequate basis would be available for short and even medium-term planning. In general, the problems are well known. What is needed now are not more reports, but longer-term help of experienced "do-ers" to assist in implementing recommendations. Technical assistance on the managerial level is likely to produce greater immediate benefits than an overall transport survey. An exception to this is the road sector, which has not been studied and for which a UNDP allocation may be requested.

275. A major problem affecting the transport sector as a whole is heavy overstaffing, and the lack of adequate performance by and discipline of labor and higher level staff. Overstaffing leads to inefficiency, not only because of the direct cost of overstaffing as such, but also because some workers wait in hopes that the other man will do the work; 30 percent overstaffing may well cause a reduction of 50 percent or more in the output per man. This problem cannot be solved by foreign funds and technical assistance; it has to be faced and solved by the Government itself. The mission fully recognizes the social and political problems involved, but believes it would be better to send superfluous and incompetent or unwilling staff home, continuing, if need be, part of their pay for some time. Without such drastic measures, management will not be able to put the house in order.

276. Roads and Road Transport. It is in this sector that the Government faces its largest problem, both of a short and long-term character. Only 5 percent of the 80,000 km. in the roads system is classified as in good condition, 11 percent is fair, and 84 percent is bad or very bad. But in addition to this, the design standards are still largely pre-1940; only 3 percent is designed for axle loads of 5 tons, about 20 percent for 2.75 to 3.5 tons, and the remainder for only 1.5 to 2 tons. Rehabilitation and upgrading of such a dilapidated and outdated road network will take many years and large funds. The price of gasoline amounts to only about U.S.$ 0.12 equivalent per U.S. gallon, which is likely to be lower than anywhere else in the world. It should be possible to increase motor fuel prices or taxes to cover a large share of the cost of road rehabilitation and upgrading.

277. About half of the road vehicle fleet is more than 10 years old, and some 25 percent or more is estimated to be inoperative. This, together with poor road conditions which cause high maintenance and replacement cost of vehicles, leads to high road transport cost. Needless to say, the replacement of the overage vehicle fleet will put a heavy burden on the country's balance of payments during the next three to five years.

278. Maritime. Ports and shipping, particularly interinsular shipping, are vital parts of the transport system. But, although their physical condition is poor, much more could be handled with improved organization and management, requiring only modest funds for some additional port equipment (most cargo can be handled manually), and spares for the inter-island fleet.

279. The major problems causing delays in shipping are: (a) the backlog in maintenance dredging in ports and their access channels; (b) inadequate and inoperative navigational aids; and (c) the need for better shore-to-ship radio communications. Removing the deficiencies in these three sectors requires considerable funds, and time for preparatory work, particularly with respect to dredging. The dredging fleet is in poor condition, because of lack of proper repair facilities, spare parts for engines, and above all, lack of funds. Part of the fleet should possibly more economically be scrapped, and the remainder needs a thorough overhaul which can possibly best be done in foreign shipyards.

280. Estimates of dredging volumes vary, and it is obvious that a sounding program for the ports and their access channels is needed before a reliable dredging program for the next three to five years can be prepared. Also, a hydraulic survey may be useful, to study the possibility of reducing siltation by changes in layout of port basins and access channels, or construction of current deflecting structures.

281. Ocean shipping is not faced with great problems since the ocean fleet can be maintained in foreign shipyards where materials and spares are available. As to interinsular shipping, about 30 percent of the fleet of the government-owned company (Pelni), is inoperative, as is about 20 percent of the privately owned fleet. But because of reduced freight volumes, there is surplus capacity under present circumstances. If the operative part of the fleet could be operated efficiently, it might be possible to handle nearly double the present volumes at greatly reduced cost to the shippers.

282. Until 1967 Pelni was subsidized by the Government, but now has to cover its costs from revenue. Because of the inefficiency of the operations, this has of course led to high shipping rates. It should not be overlooked, however, that the inefficiency of interinsular shipping results to a considerable extent from the deficiencies mentioned in paragraph 279 , which are outside the control of the shipping companies. Since the high shipping rates have an adverse effect on the productive sectors of the economy, a phasing out rather than a sudden cutting off of subsidies might have been advisable.

283. Railways. The railways play a relatively modest role in the transport system. On Java 4,600 kms. of line serve the island. On Sumatra there are four isolated systems with a total length of only 2,000 kms., and there are no railways on the other islands. The railways are important for passenger transport; the number of passenger kms. is about eight times that of goods-ton kms. About two-thirds of the locomotives and rolling stock are more than 40 years old, and part of it needs to be scrapped. Track and bridges are in unsatisfactory or poor condition. But the mission considers the conditions of the railways to be still somewhat better than the other transport media. Since the various parts of the system are located in the more densely populated areas where demand for transport is largest, and because of only limited road transport competition, the railways have

suffered less heavily financially, and have managed to keep themselves going, largely meeting traffic demands. The 1968 operating budget shows no cash deficit, though no allowance was made for depreciation and interest charges. Considering the unfavorable physical condition of the lines and heavy overstaffing, it would appear that with improved efficiency and some rehabilitation the railways might be able to pay their way in the future, provided of course that rate adjustments follow closely any further inflation. Present rates and tariffs would appear to be quite reasonable. If the railways were provided enough working capital to buy the necessary stock of materials and spares for the most urgently needed rehabilitation, it should be possible to gradually improve them without very large outside investments. Longer-term financing would seem to be justified for gradual dieselization of motive power since this usually pays off rather quickly. This would be a much better investment than the upgrading of the Atjeh Railway on Sumatra, for which the first U.S.$ 6 million equivalent of a U.S.$ 100 to $150 million project is included in the 1968 Development Budget.

284. Aviation. The government-owned airline, Garuda, operates its international lines to Tokyo and Amsterdam at a loss and the domestic trunk system at a profit. There is also one government-owned and one private feeder company. In a vast archipelago, the Government has to see to it that the aviation needs are well provided for by either operating its own airline, as it is now doing, or by making satisfactory arrangements with private companies. As to international air transport, the situation is quite different, since many foreign airlines are quite capable and willing to provide this service.

285. The domestic aircraft fleet is largely old and inefficient, and should gradually be replaced by modern craft more suitable for the needs and prevailing conditions. Because of the favorable load factors for domestic aviation, which make it possible to operate at a profit, it may well be possible to find private foreign financing for the fleet renewal, part of which is included in the list for the U.S.$ 75 million of foreign project aid.

Electric Power

286. The process of nationalization of all private electricity supply companies throughout Indonesia was completed in 1957. Perusahaan Listrik Negara (PLN), a State Electricity Enterprise, was created in 1958 to administer all public owned electricity companies, which it effects through fifteen regional bodies each responsible for administering the supply of power in its particular geographical area. The activities of PLN and other similar state enterprises are coordinated and supervised by the Directorate General of Power and Industry. The Directorate is also responsible for the execution of major projects in the field of electric power which are carried out by special organizations created for the purpose.

287. At the beginning of 1967 the installed generating capacity throughout Indonesia totaled 585,811 kw comprising 282,599 kw hydro, 125,194 kw steam and 178,018 kw diesel. The available firm capacity is about 335,000 kw. Energy generated by public utility stations in 1966 was about 1,561 million kwh of which 1,196 million kwh were sold to the public. Units used in auxiliaries, lost in transmission and transformation and otherwise unaccounted for represented 23 percent of units generated. This is a high figure but understandable in view of PLN's scattered generating facilities and dilapidated distribution systems. The figures of capacity and energy generation do not take into account the output from a considerable number of captive plants. No reliable statistics of the capacity of these plants are available but it is estimated to amount to about 200,000 kw.

288. Three important generating stations have been commissioned since 1962; 50,000 kw thermal stations at Tandjung Priok (Djakarta) and Tandjung Perak (Surabaja) and the 100,000 kw Djatiluhur hydroelectric station in East-West Java. In addition, generating capacity now under construction and which should be commissioned in 1968 includes one further unit of 25,000 kw capacity at Djatiluhur and gas turbine units each of 14,000 kw capacity, at Medan and Palembang (Sumatra) and Semarang (Central Java). Projects under construction or planned for completion during the next six years will have a total installed capacity of about 540,000 kw.

289. Of the total sales in 1966 of 1,196 million kwh, Java accounted for 979 million kwh or 82 percent and Sumatra 145 million kwh or about 12 percent. Sales throughout the rest of Indonesia were about 72 million kwh or about 6 perecnt. On an all-Indonesia basis 20 percent of PLN's sales have been to industry and this figure has remained fairly constant over the last five years. The percentage varies from region to region being as high as 41 percent for Region XIV (Padang) and as low as 2 percent for Region XIII (Banda Atjeh) in 1966, but these extremes are not representative on account of the very small base on which they have been calculated. More meaningful would be the percentage of industrial sales in East-West Java, West-West Java, Central Java and East Java which, in 1966, were 20, 24, 13 and 24 percent respectively. These figures would be higher if industrial consumption from captive plants were to be taken into account. Reliable figures for such consumption are not available.

290. The annual growth rates over the last five years have been about 8 percent for the combined West Java system and 5 percent for East Java. Adequate generating capacity is available at this time in both systems but the transmission and distribution networks are unable to meet potential demand. In both systems, however, the work of strengthening and rehabilitating the networks is in progress. As this work progresses a significant increase in growth rate could occur. Even so, generating capacity presently available should be sufficient to meet expected demand until about 1971 when the 70,000 kw Karang Kates hydroelectric project is expected to be commissioned in East Java and the third and fourth units, possibly 75,000 kw each, at Tandjung Priok thermal station, Djakarta should be in operation. Generating capacity in Central Java is completely inadequate but some improvement may be expected in the near future with the installation of a 14,000 gas turbine unit at Semarang, due for completion early in 1968 and the addition of about 15,000 kw of diesel plant included in the 1968 Crash Electrification Program.

291. In Sumatra about 43 percent of sales occur in the Palembang area where energy sales of 62 million kwh in 1966 showed no appreciable increase over that for 1965 and only about an 8.5 percent increase over 1964. Energy sales in the Medan area, which accounts for about 33 percent of the total, were 47 million in 1966, an increase of about 5 percent over 1965 but 14 percent lower than sales for 1964. Undoubtedly the main reason for these poor performances is the lack of generating capacity, or more properly stated, PLN's inability to use existing generating capacity because plant is out of service due to breakdown or lack of spare parts. Some relief for these two areas can be expected by the end of the first quarter of 1968 when gas turbine units of 14,000 kw capacity, now under construction in the cities of Palembang and Medan should be in commission.

292. Indonesia has expressed interest in a general power survey and in possible Bank help in organizing such a survey. The mission believes that a limited power survey covering the islands of Java and Sumatra is all that is needed at this time and that this should form part of an overall survey which would include a critical review of the PLN organization, particularly in the fields of technical and commercial operation, planning, and project construction. A review of existing tariffs is also very necessary, particularly industrial tariffs, as the present structure is not attractive to industry and encourages the setting up of private generating plants.

293. The mission reviewed the 1968 Crash Electrification Program presented by the Directorate General of Power and Electricity and recommended an allocation of $14.2 million for the power sector from the $75 million of project aid requested by the Government of Indonesia. Of this amount $11.5 million would be used for the rehabilitation and reinforcement of diesel electrification systems, including the purchase of new diesel units and spare parts, $1.0 million for initial work in connection with the proposed expansion of the Tandjung Priok steam power station and $1.7 million for the Karang Kates (East Java) and Riam Kanan (Kalimantan) hydroelectric projects.

CHAPTER 7

THE DEVELOPMENT PROBLEM

294. At this midway point in Indonesia's stabilization and recovery program, long-range forecasts are almost certain to be misleadingly wrong and even medium-term predictions may contain a substantial margin of error. This applies both to the internal and external sides of the economy. The degree of tolerance of the Indonesian people towards the austerity measures required for financial stabilization and to make a start towards economic growth, as well as the Government's will and capacity to enforce such measures, are important question marks on the internal side. Tax evasion, illegal levies by individuals in commanding positions, understandable but improvident concern about consumers' welfare, illustrate some of the problems and attitudes to be surmounted to accomplish the sustained effort which the situation requires. On the external front, uncertainties regarding the outcome in terms of increased exports of the new foreign investments now being considered, and the speculative nature of export price forecasts, are the principal factors that would make an attempt to forecast the balance of payments over an extended period hazardous, if not counter-productive. The future action of foreign creditors and aid suppliers in respect of Indonesia's heavy medium-term obligations and capital requirements are other factors obscuring our view of the future evolution of Indonesia's balance of payments. In Appendix 1, we have attempted to illustrate (together with the possible variances) the export outlook up to 1975.

295. It was mainly because of the considerations referred to above, in addition to the overriding importance of the short-term needs of the country for stabilization and rehabilitation as a prelude to longer-range development planning, that led this mission to adopt a limited time horizon in preparing this report. At the same time, we have made it clear that the measures taken since October 1966 are more reassuring and, therefore, expectations can be brighter than on previous occasions when attempts (such as 1960 and 1963) were made to end inflation, correct exchange rate aberrations, and reduce the subservience of economic to political ends. However, many difficult political decisions and administrative actions are still required to produce a reasonable level of savings, investment and economic growth.

296. In this situation, rather than to attempt to say specifically where we think the economy is heading at the end of ten years, it seems more profitable to indicate what may be required to produce a rate of growth at least above that of the population during the next few years. The physical investments and administrative actions that we suggest are spelled out in the previous chapters and the sector annexes. Here, we will examine the overall savings and investment requirements, the amount of foreign capital needed, and the terms on which it should be provided if Indonesia's difficult foreign debt problem is not to be accentuated beyond endurance.

297. As we have emphasized previously, the Indonesian problem is particularly difficult because hyper-inflation was not accompanied by any appreciable growth in per capita terms. Thus the problem is somewhat akin to that confronting Japan and Germany during the first few years after World War II without the technological and other obvious advantages of those countries. While the priority that should be given to stabilization is clear, it is also evident that the revival of production is nearly as essential to the achievement of stability as the latter is to sustained economic growth. This revival cannot be accomplished if financial restrictions are applied indiscriminately and in a way that prevents a fuller utilization of existing productive capacity and produces too much more unemployment.

298. On the crucial matter of savings, interest rate policy should be such as to produce incentives to savers even when all reasonable expectations are that prices will continue to rise, albeit at a slower rate. Viewed in this light, the 3-5 percent per month range of interest rates charged by the state banks appears low, particularly in view of the fact that price hikes in 1967 considerably exceeded expectations. Concern about cost-push inflation should not prevent the adoption of such a policy. Investors should be required to pay the rate that savers require, though the ends towards which credit expansion is directed seems to require even greater attention than it is now getting. As long as Government adheres to such a policy, it can expand the frontier of its investment program to the extent that savings and the rate of monetization of the economy permits.

Overall Capital Requirements

299. Any estimate of future savings and investment obviously has to be very conjectural. The following are very rough orders of magnitude. We have calculated that to achieve alternative rates of growth of 4 and 5 percent (of national income) would require in the period 1969-1973 an investment of around $5.0-$7.2 billion equivalent.1/ On the basis of these two alternative growth assumptions and the prospect of domestic savings, we then examine the extent of the resource gap and the reqirement for gross capital inflows.

300. In the period 1964-1966 Indonesia's domestic savings probably averaged around 4-5 percent of national income. In 1968-1973, even if 20 percent of the increment in the national income is saved, domestic savings would be only around $3.5-$4.5 billion, under the two growth assumptions mentioned above.2/ Thus the internal resources gap that might be generated by these rates of growth would be $1.5 and $2.8 billion respectively.

301. On the assumption that all of Indonesia's external debt incurred prior to June 30, 1966, will be rescheduled and that service on such debt will not be resumed until 1971 (see paragraph 196 above), foreign debt service during this five-year period would be in the order of $1 to $1.1 billion

1/ Assuming a low capital/output ratio of 2:1 and 2.5:1 because of the large rehabilitation and repair element in investment and the excess capacity available. Average gestation period assumed is two years.

2/ Pakistan's marginal savings rate is generally estimated at 21-23 percent.

(depending on the growth assumptions and thus the amount of gross capital inflow). The debt service ratios under certain assumptions regarding terms of new credits and export growth rates are calculated in Appendix Table 3 and summarized in paragraph 312 below.

302. Thus the gross capital inflow that Indonesia may require from 1969 to 1973 to achieve the two modest growth rates postulated above would be $2.5 or $3.8 billion, or say, $500 or $750 million a year. 1/ Although these sums appear large in relation to the foreign aid requested by Indonesia for 1968 ($325 million), they are in the same order of magnitude as the capital inflow plus the postponement of debt service (due to the rescheduling exercise) projected for 1968 (paragraph 161). Also, it is hoped that within a few years a significant portion of Indonesia's capital requirements may be met from private foreign investment.

303. However, this should engender no complacency about the Indonesian situation for a variety of reasons, not least of which is rapidly mounting debt service during the 1970's. For example, barring any further debt adjustments after 1971, by 1978 debt service might already exceed $500 million with a gross capital inflow of the same amount.

Balance of Payments Prospects

304. In Appendix 1 we have estimated that, assuming substantial private foreign investment in the export sectors of the economy, exports may grow by as much as 7-8 percent a year. It is conceivable that this might be increased to about 9 percent if some improvement takes place in Indonesia's terms of trade. A pessimistic alternative might be about 5 percent based only on traditional exports (no success with the new mining and oil ventures) plus some increase in oil revenues from the present fields during the next five years. The possible range of export earnings under these two assumptions would be $3.6 to $4.2 billion from 1969 through 1973. Adding to these figures the $1.5 to $2.8 billion of net capital inflow posited above (to give growth rates of 4 and 5 percent respectively), we have a range of foreign exchange availabilities (after debt service) of about $5.1 to $7 billion, depending on foreign aid availability and export performance. 2/

305. On the import side, one may distinguish between capital and other imported commodities. In 1967 Indonesia imported about $900 million of goods and services (excluding imports of the oil sector which are netted out before export earnings are calculated). About one-sixth, or $150 million, consisted of capital goods and raw materials for producing such goods.

1/ The following table (in billions of dollars) summarizes the calculations for 1969-1973:

	4-percent growth	5-percent growth
Investment	5.0	7.2
Savings	3.5	4.5
Resources Gap	1.5	2.7
Debt Service	1.0	1.1
Gross Capital Requirements	2.5	3.8

2/ All service on new borrowings is calculated on the basis of DAC terms (3 percent, 7 years of grace, 25 years of repayment).

306. As nearly as the mission can judge, investment in 1967 was in the range of $600 to $700 million equivalent. Thus, capital goods imports would seem to have been 25 percent or less of domestic investment. In future, it may be higher since investment in the subsistence portion of the economy which probably made up an unusually large percentage of investment in 1967 would not be expected to have a substantial import component. Therefore, an import component of, say, 40 percent might be a more realistic guide to the future. Applying this to the $5 billion and $7.2 billion of investment postulated in paragraph 299 above, we have requirements for capital goods imports of $2 billion or $2.9 billion over the five-year period. Subtracting these amounts from the foreign exchange availabilities in paragraph 304, we have two sets of availabilities for financing the import of consumer goods and services. With a 4 percent growth rate and a corresponding capital inflow of $500 million a year, the residual after $2 billion of capital goods imports would be $3.1 billion or $3.7 billion, depending on export growth. Alternatively, with a 5 percent rate of growth in national income and corresponding capital inflow of $750 million a year, $3.4 billion or $4.1 billion would be available for consumer items and services.

307. In 1967 and 1968 the Government has estimated imports and services for the "non-project" sector of the economy at $742 million and $784 million respectively. Some of these imports are presumably materials to produce capital goods but the amount is not known. Perhaps a figure of about $750 million could be used as Indonesia's consumer goods and services import requirements in 1968. This would be $3.75 billion over five years. However, import demand will rise with economic growth. As a first assumption, if this demand increases in direct proportion to the two rates of growth posited above, it would total $4.2 or $4.4 billion. If, as we would expect, some net import substitution occurs over this period so that the ratio of consumer imports to national income might be reduced, a little lower level of such imports could be tolerated, perhaps about $4 billion over the five years. However, unless exports achieve their full potential of 9 percent a year growth, the mission feels that with $500 million a year, gross capital inflow will hardly be sufficient to finance necessary consumer import demand during this period, together with the amounts of domestic investment indicated above.

Investment Resources of the Public Sector

308. Owing to inflationary pressure, current public outlay has declined in real terms in the past several years. For rehabilitating the administrative machinery and providing for salary increases of personnel, it seems likely that the rate of current outlay (routine budget) may rise by about 8-9 percent (in real terms) a year. Further, a rate of growth of internal revenue (excluding the oil income) in excess of 20-22 percent (in real terms) a year would not be realistic. In fact, such a rate which would be about five times the postulated rate of growth of the national income can be considered optimistic in the light of Indonesia's past experience. This would increase government revenues to around 12 percent of national income

by 1973. Should domestic revenue and current outlays follow the pattern delineated above, public savings for the period 1969-1973, net of debt repayment, would be in the vicinity of $215-$260 million.[1/]

309. The amount of public investment expenditure that could be financed with this level of net public savings plus $500 to $750 million of foreign assistance will depend, of course, on the composition of foreign aid (program or project) and the division of project aid between the public and private sectors (including in the latter productive enterprises now in the public sector). If Indonesia continues to receive about $200 million of program assistance, as in 1967, and we assume that about one-third of project aid is earmarked for the public sector, then a public investment program of between $420 and $520 million a year could be financed without inflationary consequences. This compares with about $400 million in 1968.[2/]

310. Private Savings. Of $3.5-$4.5 billion of domestic savings estimated as a possibility above, after deducting the share of public savings there remains $2.3-$3.1 billion to be provided by the domestic private sector (including public enterprises). By 1973 such a rate of private domestic savings would be about 6-7 percent of national income, still a very modest target. Public enterprises should be able to make a modest contribution. Of overriding importance is the success of Government in channelling domestic private capital (national as well as foreign) to priority sectors. As domestic foreign capital[3/] is likely to be backed up by significant entrepreneurial skill, Indonesia's success in her development efforts may well rest on the extent that domestic capital, including that of non-citizens, would feel assured of government encouragement. Hence the importance of the proposed legislation on the Investment of Domestic Capital.

1/

	Millions of Dollars	
	Four-Percent Growth Alternative	Five-Percent Growth Alternative
1. Revenues	5,160	5,480
2. Non-development Outlay:	4,946	5,218
(a) Current Outlay	3,950	4,110
(b) Debt Repayment	996	1,108
3. Public Savings (net of debt repayment)	214	262

2/ I.e. $200 million of commodity assistance, 36 percent of $50 million of PL 480 assistance ($18 million which is the 1968 budget assumption), $75 million of project assistance, $44 million utilization of the old pipeline of project aid and $64 million (converted at the rate of Rp. 200 = $1.00) development outlay by the regions from the proceeds of A.D.O. and the land tax.

3/ Owned by resident non-citizens.

311. Foreign Debt Service. Under the assumptions regarding new capital inflow suggested above, in the period 1971-1975 Indonesia's average annual repayment obligations would be around $303-$336 million. In 1976-1980 this would increase to around $437-$549 million (Appendix Table 2).

312. Even if Indonesia achieves 9 percent annual rate of growth in her exchange earnings, her debt service ratio in the period 1972-1975 would be in the range of 30-33 percent. By 1981 the range would be slightly lowered to 24-33 percent of the exchange earnings. The debt ratio will be much more unfavorable if the growth in exchange earnings is only 5 percent a year. Under this assumption, during 1972-1975 the debt ratio would have a range of 38-42 percent. By 1981 it would become worse or 41-56 percent. Thus, if the exchange earnings remain sluggish, even though the economy grows at 5 percent a year and foreign aid is in the vicinity of $750 million a year, the debt ratio would exceed 50 percent of exchange earnings.

313. In view of Indonesia's foreign debt prospects and gross capital requirements, it is obvious that only the softest terms of lending possible are essential for the foreseeable future.

APPENDIX 1

EXPORT PROSPECTS

1. In 1967 some progress has been made in reducing the fiscal burden of the export sector. As soon as alternative sources of revenue can be developed, a further reduction in export taxes is needed particularly because of the fall in rubber prices and the need for greater savings to rehabilitate the estate sector and the tin industry. There is, however, no short-cut solution to Indonesia's major economic problems. Buoyancy in the export sector can be secured only by vigorous implementation of long-term development programs. Production and transportation snags hamper major traditional exports and they will probably remain unresponsive to short-term incentives though they may decline if such incentives are negative and lead to a withdrawal of marginal resources from export in the form of domestic production.

2. Another prerequisite to a substantial expansion of Indonesia's exports is foreign investment. With sizeable foreign capital participation in forestry, petroleum, fishery, and mining sectors, Indonesia may be able to achieve a much higher level of export earnings within the next five years. The interest of foreign capital in these fields is the most optimistic aspect of Indonesia's export outlook.

I.- Non-petroleum Exports

3. Of Indonesia's non-oil exports around 75 percent originates from Group A (major) Commodities which pay a 25 percent export tax and 25 percent from Group B (minor) Commodities which pay 10 percent. Both groups are largely agricultural and mining items or processed products. Export of manufactures and semi-manufactures accounted for about 45 - 60 percent of the Group B in 1966 but have declined sharply in 1967.

Group A Exports

4. Rubber: Second to Malaysia, Indonesia is the second largest producer of natural rubber, producing about 650 - 700 thousand tons or 30 percent of total world output. Of this, one-third comes from plantations and two-thirds from a large number of smallholders. In 1960 Indonesia received an average price of 65 cents a kilo whereas she is receiving an average of 30 cents in 1967. Volume of exports has been on the whole steady (see Appendix Table 44). On the domestic front there are serious problems that face the industry.

5. Smallholder Rubber: The area under smallholder rubber is estimated by the authorities at about 1.5 million hectares, but probably this is an underestimate. Of this about 80 percent comprises trees which should be replanted. A program of replanting could increase

A program of replanting could increase production but initial benefits would not be attained for seven years. Presently, the Government has no program of replanting the area extensively. It would appear that production, in future, will depend on whether rubber prices will be sufficiently attractive for smallholders to maintain the level of production of the recent years. The rice-rubber price ratio, an interplay of the declining international price of rubber and the rising domestic price of rice, has recently been such as to make the tapping of unproductive trees less attractive. In other words, if the price of rubber is low enough and rice high enough, it is said people will stop tapping the low-yielding rubber trees and spend their time on rice growing for subsistence. Since rubber is a cash crop and unemployment and underemployment fairly rampant, tapping continues but on a smaller scale. The critical point in the rice-rubber price ratio was passed in 1967 so smallholder rubber production is falling. The stiuation could change quite quickly if either rice prices fell or the rubber price rose. In the longer-run, however, substantial investment by the private sector is needed in the smallholder rubber business. Better marketing organization is also essential. At present there is no plan for providing the finance to improve the quality of rubber. The prospect of increase in the international rubber prices is also not very promising. Under the above circumstances, the mission can see no prospect of an increase of exports from smallholder rubber.

6. Rubber Plantations. Most of the plantations were formerly Dutch-owned and at the time of seizure of Dutch property in 1958 were well maintained. The same is not true of plantations formerly owned by other nationalities which, for a considerable period, had not replanted due to prevailing political uncertainties. Initially, after nationalization, the Government did little on the estates to replace aging trees but between 1963 and 1966 approximately 22 percent (an average of 5.5 percent a year) of the area was replanted with high-yielding varieties. Still, taking all estates combined, 47 percent of the trees are older than 25 years. Up to 1970 rubber production from the estates is expected to remain at an annual level of 220-230 thousand tons. Owing to replanting, production after 1970 could grow at the rate of about 6 percent a year.

7. Price Prospects. Rubber prices (except for a brief period in June 1967 during the Middle East war) has continued to decline in the past year. The decline in Singapore price was over 20 percent by October 1967 compared to December 1966. World consumption of rubber has increased at an annual rate of about 14 to 15 percent for synthetics and 2 percent for natural rubber. On the supply side, synthetic rubber production has kept pace with rise in demand and as its price is competitive, it is now catering to around 60 percent of the world demand.

With cheaper synthetics and scope for more substitution, the price of natural rubber is forced downwards. The vigorous expansion of free world synthetic rubber is still on. Meanwhile, expansion of natural rubber due to maturing of high yielding trees planted in the second half of the fifties, outside Indonesia, has augmented availabilities. These factors, coupled with increasing possibility for substitution among major types of rubber and a declining trend in average production costs, especially of natural rubber, tend to suggest continuation of low prices, with a further decline of modest proportions not unlikely.

8. With the shortage of funds and lack of incentives for the replanting of smallholder rubber in Indonesia, the gain expected after 1970 in the export of Indonesian estate rubber (i.e. about 2 percent overall increase) is likely to be offset by somewhat lower prices and reduction in smallholder production. This does not mean that there is no way of increasing the profit of Indonesia's rubber industry. Lower production cost resulting from planting of high-yielding trees, from the use of fertilizer, from proper upkeep of trees and improved processing of latex should help the industry to recover.

9. Tin: World consumption of tin (excluding the U.S.S.R.) increased in the past decade by about 2 percent a year. Tin production which was in excess of demand declined over the same period, particularly after 1956. After 1958 production was less than consumption and the gap was bridged by release from the U.S. stocks. With control over the supply (under International Tin Agreement) prices picked up in the sixties with the peak occurring in 1965. Since then prices have eased, but are still 30-40 percent higher than the 1960 level. With higher prices there has been a resurgence of production outside Indonesia. There is every indication that capacity of tin mines in Bolivia will increase in the near future. Indonesia would also be able to increase her supply to at least 25,000 tons per year sometime in the early seventies if the necessary foreign financing is made available to rehabilitate the industry. This is twice the level of her present output which would still be below her production of 33,000 tons in 1955. Despite the rise in production the gap between world demand and supply may not be fully bridged. The Communist countries also have not been able to reduce their net import requirements. Tin prices, therefore, are not likely to diverge substantially from the prevailing international prices.

10. Since the nationalization of Indonesia's mines, tin mining has been in the hands of three state enterprises. The reason for the drastic decline in the output of tin from 33,000 tons in 1955 to 13,000 tons in 1966 is due to several factors. The ore content has declined sharply[1] and lower grade ores are not as profitable to exploit.

1/ The content of tin has declined from 9.73 kg/m^3 to 0.44 kg/m^3 in the last twenty years and the decline is continuing as the richer areas are worked out. At the current tin price of $3,000 per ton it is profitable to work areas containing as low as 0.15 kg of tin per cubic meter.

With lower ore content, despite higher prices, the exchange rate has been a discouraging factor. Public management of mines has also been deficient. It appears that for any increase in Indonesia's output, considerable investment will be needed to replace obsolete equipment and provide spare parts. The mission has recommended such a program to foreign lenders. If this program is financed we expect output to double in ten years.

11. Copra: During 1950-63 world production of fats and oils increased by 3.5 percent a year. The greatest increase occurred in the developed countries, most striking being the production of soybean oil, sunflower seed, rapeseed oils, tallow and lard. Major developments that would influence the fats and oils situation are: (a) increase in the rate of production of vegetable oils; (b) decline in the rate of growth of demand for fats and oils (especially vegetable oils) in particular in Western Europe which is a principal buyer; and (c) the increase in consumption in the developing countries. The implementation of the EEC fats and oils policy in 1967 discriminates against non-associated countries, and may result in a change in the trade pattern. These factors would be remedied if part of the increase in output is absorbed by the developing countries. In the developing countries groundnuts and fish oil production have shown notable increases. Coconut oil and palm oil, the two other oils mainly grown in the developing countries, have increased at a much slower pace. Palm oil and coconut oil do not reach full production capacity until about eight to ten years after planting. Since most of the expansion plans have been initiated in recent periods, the increase in supply is expected around 1975 and after.

12. Indonesia has provided around 14 percent of total world exports of copra. The prices of the product have been falling which is likely to continue at an annual average rate of about 1-2 percent. In view of lack of any sizeable expansion program in the past and substantial time lag between planting and maturing of trees, Indonesia cannot expect much increase in her exchange earnings from this source.

13. Palm Oil: World total production of palm oil is around 1.2 - 1.3 million tons, excluding subsistence production in areas of wild palms. Little more than half of the production is commercial. This has tended to decline reflecting the rapid growth of consumption in producing areas. Palm kernel oil production is estimated at 0.4 million tons and together with palm oil represents about 5 percent of world total supplies of fats and oils. This is a much smaller proportion than in the early fifties. Output of palm oil increased only 1.2 percent annually between 1950 and 1963 and of palm kernel oil by 0.6 percent compared with approximately 3.5 percent for fats and oils as a whole. Palm oil prices have shown a moderately rising trend relative to price of fats and oils as a whole. The strength of palm oil prices has arisen mainly from the lag in supplies rather than from an upsurge in demand. The improved quality of palm oil widened its range of uses in the importing countries. With secular downward drift in the price of vegetable oils and rising trend in palm oil prices, the competitive position of palm oil in food uses is affected. Fish oil and tallow have also been increasingly used for soap preparation, substituting for

palm oil. Various countries have plans for the expansion of their palm oil output. The general trend is for the expansion to be chieved through plantings of high yielding varieties, usually with the maximum recovery of oil being insured by the establishment of fully integrated modern mills. Existing information indicates that, should the planned expansion materialize, total world production would be around 2 million tons by 1980, an annual increase of about 3.0 percent. Despite these factors, there is no reason for any sizeable fall in prices; the expected decline in the price is around 1 percent per year.

14. Indonesia accounts for roughly over 15 percent of commercial production of world palm oil and palm kernel oils. Since the war, production has been declining, but given the requisite input of capital and pursuit of export promotion policy, there is no reason why Indonesia cannot increase her output and export volume of palm oil and palm kernel by at least 6 percent per year.

15. Coffee: Although Indonesia's production of coffee in immediate post-war years represented only about a quarter of its pre-war coffee production, it rose continuously in the 'fifties at the rate of about 10 percent per year. The rise has continued into the 'sixties, although in some years (e.g. 1964) there have been declines due to poor weather conditions. Production can be expected to increase under existing favorable price arrangements for smallholders.

16. Under the International Coffee Agreement, Indonesia's present quota is 1.17 million bags, representing 2.52 percent of the total world quota. New proposed quotas would reduce Indonesia's share to 2.47 percent of the total world quota. If world consumption of coffee rises by about 2.5 percent annually, Indonesia's export volume should benefit roughly to the same extent. Due to International Coffee Agreement, coffee prices in the 'sixties have stabilized. Indonesia's exchange earnings from coffee should, therefore, rise at around the rate of growth of the volume of world consumption.

17. Tobacco: Political events in Rhodesia and drought in India reduced tobacco plantings considerably. Due to the decline of supply since 1965, the prices have firmed up. It appears that prices would decline during 1970-1975 to the average of 1961-1963 level, that is around 10-15 percent lower than the prevailing prices. During 1955-1963 world export of tobacco increased by about 3-4 percent per year and those originating from the developing countries by 6-7 percent per year. Indonesia has not, however, shared in this rising export trade. Her share in the trade is limited to 1-2 percent of total volume of tobacco exports and largely comprises cigar filler and wrapper leaf. The market for these commodities is restricted and probably Indonesia will not achieve more than about 2 percent of growth in her export earnings from tobacco.

18. Pepper: Export of Indonesia's pepper has fluctuated greately in the past and the range of annual price fluctuation has been considerable. A 2-3 percent annual rise in her export earnings from this source appears reasonable.

19. To summarize, Indonesia's Group A exports is not likely to increase in the foreseeable future by more than 2-3 percent per year. This is set out in the following table:

	Proportion of Group A Exports (In Percent)	Expected Annual Rate of Growth (In Percent)
1. Rubber	50	1
2. Tin	10	7
3. Palm oil and kernel	10	6
4. Tobacco	11	2
5. Coffee	8	3
6. Copra	8	2
7. Pepper	3	3
	100	2.51

20. The realization of 2-3 percent growth rate is, however, predicated on factors such as additional investment outlay, greater incentives and credit facilities, etc. without which even this modest growth rate cannot be achieved.

Group B Exports

21. The main items of Indonesia's Group B exports are summarized below (amounts in millions of dollars):

Export of	1966 Amount	1966 Composition (In Percent)	1967 Amount	1967 Composition (In Percent)
1. Agricultural Products				
a. Estate	23.4	20.5	30.3	34.0
b. Smallholders	25.5	22.3	25.0	28.0
2. Cattle Products	4.8	4.2	4.0	4.5
3. Forest Products	6.5	5.7	9.1	10.2
4. Mining Products	2.8	2.5	5.8	6.5
5. Manufacturing and Semi-manufacturing	51.2	44.8	15.0	16.8
Total	114.2	100.0	89.2	100.1

22. Agricultural Exports: In Group B agricultural exports predominate. Tea export, a major item in this group, has been stagnant, and due to a wide range of problems, is not likely to rise markedly in future.

23. Indonesia has immense fishery potential. With thousands of islands and many hundred thousand miles of shorelines, most of the people live in close proximity to the sea. The surrounding waters are rich in shrimp, tuna, shellfish, etc. Despite the bounty, fishing is not a flourishing industry. Of the estimated 110,000 small vessels owned exclusively by single operators less than one percent is motorized. Sizeable investment is required for modernizing this fleet and establishing processing and refrigeration units, etc. Already there are five1/ foreign companies that have commenced operations in Indonesia. It is expected by the Indonesians that as a result of such investments, fish exports would add to their foreign exchange earnings around $25 million a year.

24. Cattle Products: Indonesia is very poor in cattle wealth and her present export of these products is limited. There is not much prospect of appreciable expansion of this sector for the export market.

25. Forest Products: The present export of forest products is very limited. Indonesia, however, is endowed with very rich forest resources and alternative sources of supply (such as the Philippines) may be running short of accessible timber. About two-thirds of Indonesia is forest-clad and less than one-tenth of the forest area is explored. Kalimantan, West Irian, Sumatra and Sulawesi are the principal forest areas, accounting for 1.2 million square kilometers of forest land. Present production is very limited, but conditions are conducive for rapid expansion and foreign interest is keen. There are two Japanese companies that have started operation and companies from several other countries are showing interest in this field. The present expectation is that the export of forest products will become a principal item in the next decade.

26. Mining Products: Apart from tin and oil there are three minerals that have attracted considerable interest from foreign investors. These are bauxite, copper and nickel. Indonesia probably has substantial reserves of high grade bauxite ore. The Government is currently negotiating with Alcoa for the establishment of an integrated aluminum plant to use Hydro-power from the Asahan power project in North Sumatra.

27. Large deposits of lower grade nickel are found in Sulawesi, Weigo and West Irian. A refining plant is being erected in central Sulawesi. The Freeport Sulphur Company of the U.S. has received authorization to explore for copper in West Irian. These mining ventures have considerable potential but the outcome is, of course, unpredictable.

1/ Two of these are Japanese with total approved capital of $3.0 million. They are: Toyo Menka Kaisha (in Kalimantan) and Arafura Pearl Co. (in the sea surrounding Ambon Islands). There is also Fincon from Philippines (south of Java) with an approved capital of $1.0 million and the Gulf Fisheries Company of the U.S.A. (east of Kalimantan) with an approved capital of $1.0 million.

28. Manufactures and Semi-manufactures: Sizeable amounts of manufactures and semi-manufactures were exported in 1966. These exports declined drastically in 1967 but have great scope for rapid expansion through processing and use of the existing raw material, minerals and other export products.

29. To summarize, the possibility for increasing Group B exports, given the necessary domestic and foreign investment, is very significant. The following table reflects the uncertainties in the situation.

Export of:	1967	1975
1. Agricultural Products	55	100-120
2. Cattle Products	4	6
3. Forest Products	9	18-25
4. Minerals (other than tin and oil)	6	10- 20
5. Manufactures and Semi-manufactures	15	50- 75
Total	89	184-239

The overall rate of growth of the group (by most optimistic standards) works out at around 20 percent a year.

II. Petroleum Exports

30. Stanvac and Caltex: Increase in total production of oil from "contract of work" agreements (see Annex 2), the operating cost and Indonesia's share in the oil profit is presented below (in millions of dollars):

Year	Exports	Cost	Net Profit	Indonesia's Share	Net Expenditures of Domestic Oil Companies	Net Oil Revenues
1968	233	26	205	123	27	96
1969	295	30	265	159	33	126
1970	351	30	321	193	39	154
1975	395	30	365	219	45	174

The bulk of the increase in exports is expected to occur before 1971 (see Annex 2).

31. Other Oil Companies: Indonesia's share in the production of other foreign oil companies will be 39 percent of their production (see Annex 2). If we make the extremely speculative assumption that the total production of this group would be $250 million by 1975, Indonesia's share would be around $98 million from this source.

32. Overall Export Prospects: With the assumption that there would be appreciable foreign capital participation, vigorous development effort in the priority sectors, and good luck, Indonesia might be able to achieve an overall rate of growth in her exchange earnings of around 9 percent per year. This is summarized below (in millions of dollars):

Year	Group A Exports	Group B Exports	Indonesia's Net Exchange Earnings from the Export of Petroleum Products	Total
1967	393	89	98	580
1975	497	246	272	1,015
Annual Rate of Growth (Percent)	3	13.6	13.6	7.3

APPENDIX 2

REVENUE SYSTEM

This section does not duplicate some description of the tax system in Chapters 3 and 4.

Central Revenues

1. Direct Taxes. The yield of direct taxes has not been responsive to rising prices and money incomes. They constitute, in 1967, about 26 percent of the domestic revenue. It is expected that in 1968 the proportion may be around 32 percent. Improved administration is mainly responsible for the increase. Direct taxes are the income tax, the corporation tax, the land tax and some other small levies.

2. Income, Corporation and Dividend Taxes.[1] The total revenue from the personal income and corporation taxes in the revised budget for 1967 (excluding corporation tax on the oil companies) accounts for over 11 percent of domestic revenues. In 1968, as the result of the new measures introduced in assessment procedures and collection efficiency, this proportion is expected to rise to over 13 percent.

3. The Income Tax Law makes a distinction between income from employment and other income. Income tax rates are progressive, ranging from 21 to 50 percent for different slabs of income over 12,600 rupiahs. The maximum rate is 50 percent of taxable employment income and 60 percent of other taxable income amounting to 240,000 rupiahs and above. The exemption limit can be altered by the Minister of Finance.[2]

4. Short-run capital gains of up to one year from sale or exchange of assets are subject to income tax.

5. Dividends are treated separately and are subject to a flat 20 percent tax. The tax is withheld at source and the yield of this tax has been very small.

6. The corporation tax rates rise from 20 percent to 60 percent on profits ranging from 10,000 rupiahs or less to 1.0 million rupiahs and more. Shifts between brackets can be effected by the Ministry of Finance. Losses are deductible from the profits of the following two years. Capital gains from the sale of company's equipment is taxed at the flat rate of 10 percent if the equipment has been in company's possession for at least four years. If not, the gains are treated as part of the corporation income.

1/ The present income tax law dates back to 1944. Corporation tax goes back to 1925. The dividend tax was enacted in 1959.

2/ For June-December 1967 the exemption limit is set as Rp. 12,600 for married or single persons, Rp. 7,200 for each legal wife and Rp. 3,600 for each dependent, with the proviso that the maximum number of dependents, for the purpose of calculating the exemption limit, shall not exceed 10 persons. Under inflationary pressure, these exemption limits are periodically revised upwards.

7. An act of 1964 provides tax incentives with respect to investment in major sectors of the economy. Profits and incomes obtained as a result of new activities by domestic capital in these priority sectors are exempt from corporation and income tax for three years from the start of production,but not for more than five years from the date of obtaining the permit for undertaking the project. These enterprises can depreciate their capital investment in four years.

8. According to a draft legislative proposal on the investment of domestic capital, domestic capital used for the rehabilitation, renewal, extension and new development in agriculture, plantations, fishery, mining, industry, transportation, rural housing, tourism, infrastructure and other productive fields (to be specified by the Minister of Finance) are to be given the following concessions:

(a) The origin of the capital would not be questioned if invested within five years after the enactment of the law and the capital would be exempt from the property tax and the stamp duty;

(b) The capital would also be exempt from corporation income and dividend tax for a period of two years from the start or production. One additional year is added to the exemption period for meeting each of the following conditions:

(i) if, as the result of the investment, there occurs appreciable increase in earnings or savings of foreign exchange;
(ii) if the investment is made outside Java;
(iii) if the investment is in infrastructure; and
(iv) if the investment is large.

The decision rests with the Minister of Finance.

(c) Import of capital goods can be exempted from the import tax;

(d) Special relief from the corporation tax also can be granted to activities that have priorities and reinvested profits in sectors that have priority do not have to pay the corporation tax if such investments are made not later than five years after the promulgation of this law.

9. Under another statute that has attracted a great deal of attention abroad 1/ foreign enterprises are granted a maximum of a five-year tax holiday from the corporation tax beginning with the start of production. This concession is extended to the reinvestment of the net profits of such undertakings. During this period the dividend tax is suspended. Also corporation tax rates applicable to these companies are reduced by 50 percent on all the brackets for a period of five years after the end of the tax holiday period. These companies enjoy the benefit of accelerated depreciation and can deduct their losses during the period of exemption from their future taxable profits. On the basis of reciprocity, foreign shipping and air transport companies are exempt from the corporation tax.

10. Henceforth a withholding procedure will be applied to the income, the corporation and the property taxes.

11. A large amount of discretion rests with the tax administration. For example, in lieu of a normal net income tax the basis of assessment of the income and the corporation tax may be the gross turnover of an enterprise or some other base to be determined by the Director General of Taxes. The maximum rate of income and corporation tax levied on such turnover is 20 percent. The withholding procedure is grafted on the system by having the wholesaler retain the tax payable by the retailer. Proceeds of sales or purchases have become the base of income and corporation taxes. Thus, these direct taxes have assumed features of gross income (indirect) taxation.

12. Corporation tax on foreign oil companies: Based on the Tokyo Agreement of June 1, 1963, the net operating income of foreign companies (Stanvac and Caltex) that have the formal status of contractors for the state-owned oil companies (Permina and Pertamin) are divided in the ratio of 60-40 between government and foreign companies but in all events government gets a minimum of 20 percent of gross value of crude oil produced in any one year. The taxes which are paid in foreign exchange by the foreign companies are channeled through the State Enterprises (Pertamin and Permina) and do not all reach the Treasury as noted below.

13. Under a production-sharing scheme to be applied to new off-shore areas, the tax system has been replaced and the foreign companies who have received concessions take a flat 40 percent of any oil production that flows from the contract area to meet all their costs. The balance of 60 percent of output is split in the ratio of 65:35 between Indonesia and the foreign company concerned. The contracting company thus pays all the exploration, development and operating expenses and bears the risk and Indonesia gets 39 percent (65% of 60%) of the total value of production.

14. The 1967 revised estimate for oil revenue is around Rp. 7.3 billion. Until recently the revenue from this source was pre-empted for subsidizing domestic sale of kerosene and gasoline and other operations

---

1/ Investment of Foreign Capital Act, dated January 10, 1967.

of state oil companies and little reached the Treasury. For 1968 budget, the official estimate places the oil revenue at Rp. 16.4 billion. This estimate assumes that the state companies will be in a position to pay in full for the oil products they receive for domestic distribution. Recent experience shows that this payment has been of the order of 75 percent of the delivery made to them. Further, oil income has to be treated net of debt repayment and other deficits of domestic oil companies as these expenditures are not included in the government budget. On these reckonings, oil revenue in 1968 would total Rp. 8.5 billion. This assumes that the exchange rate for pricing products into the domestic market will be 130:1 instead of the present 85:1, and that the foreign exchange earnings of the sector will be converted at 150:1. The subsidy involved in the difference between 130:1 and a realistic exchange rate is deducted by the domestic oil companies before turning the oil revenues over to the Treasury. The foreign exchange income for balance of payments purposes in 1968 would be $96.5 million as shown in Table 2 of the oil section in Annex 2.

15. Property Tax: The Indonesian tax system includes a tax on net wealth covering real property, financial assets, equity in business and personal property such as automobiles and house furnishings. The rate is 0.5 percent of the market value and deduction is allowed for the cash value of all debts payable by the taxpayer. The yield from this tax has been negligible; in 1967 collections on this account may not have exceeded Rp. 35 million but it is estimated that in 1968 the revenue may reach Rp. 500 million. The experience of Indonesia in administering the wealth tax has not been satisfactory. Payment is based on self-assessment. The unsettled ownership rights and land tenure system have made the valuation of real property and land on the basis of the present cadasters very difficult.

16. Tax on Income from Land (The Land Tax): There is a 5 percent tax on the net income from land. In 1967, the tax is expected to yield roughly 0.3 percent of the value added from agriculture. For arriving at the net income, the yield of the land -- actual as well as imputed -- is valued at market prices 1/ and deductions are allowed for inputs. The assessment is made on the basis of cadastral surveys conducted under the old colonial administration which is supplemented from time to time by surveys in the principal agricultural areas of Java, Madura and Bali. Sumatra, Northern Sulawesi and Kalimantan are areas that have still to be surveyed. The tax is assessed by the Center and a team composed of village chief (Lorah), representatives of the subdistrict and central office collect the tax. Ten percent of the proceeds are set aside for meeting the cost of collection. Tax rebate is also allowed in lean years. The tax on plantations and smallholders is at the rate of 500-800 rupiahs per hectare of land in use; 200-300 rupiahs per hectare of land under new trees and 100-125 rupiahs per hectare of wasteland.

1/ Rice was valued at 100-175 rupiahs per quintal in 1966, and Rp.400-600 per quintal in 1967. In 1968 the valuation price is to be Rp.600 per quintal.

17. The rental value of urban land is also subject to the tax 1/. Assessment is made according to the area of land classified with respect to its location and use. The tax is administered by the central government in cooperation with the local governments. This tax has not been fully enforced. As in the case of rural land tax (IPEDA), low assessment has brought down the effective tax rate. According to recent inquiries in the District of Djakarta, a high-priced house on the average pays not more than Rp.800 annually and the tax on business premises in active commercial areas does not exceed, on the average, Rp. 2,500. In 1967 and 1968 the yield of all these taxes are estimated at Rp. 2.0 billion and Rp. 4.0 billion respectively:

	1967	1968
	(In billions of Rupiahs)	
1. Plantation	0.20	0.50
2. Urban Land Tax	0.30	0.75
3. Rural Land Tax	1.50	2.75
Total	2.00	4.00

The proceeds of rural and urban land taxes are used by the regencies for development purposes. The land tax, essentially an income tax, is, however, devoid of exemption limits or progressive features. Without more up-to-date surveys, greater enforcement power and periodical revision of prices, it is hard to see how the 1968 budget targets can be realized and the tax be made responsive to changes in income and prices.

18. Indirect Taxes: Indirect taxes constitute about 70 percent of current public revenues. This is made up of export taxes 30 percent, import taxes 34.6 percent, excises 15.8 percent and sales taxes 10.1 percent.

19. Tax on Export Proceeds: The proceeds from the export tax (formerly profit on surrendered exchange at an over-valued rate) accounted for over 23 percent of the total tax revenue in 1967. Together with import duties they yielded over 50 percent of the total tax revenue in 1967. In 1968 the estimated revenue from the above two sources combined with the anticipated collections on account of sales tax on imports will represent 45 percent of the total. Accordingly, about one-half of the tax revenue in Indonesia is derived from taxation of international trade.

20. Import Taxes: Import duties are estimated to provide about one-quarter of domestic revenues in 1967 and 1968.2/ The tax is ad valorem

---

1/ This is IREDA the urban equivalent of IPEDA (the land tax).

2/ According to Presidium Instructions dated May 2, 1967, capital goods for government projects are exempted from import taxes. The law on the Investment of Foreign Capital dated January 10, 1967, exempts the foreign enterprises from import duties "on the fixed equipment needed for the enterprise." Under the proposed legislation for domestic capital investment, similar provisions are included.

(c.i.f. price) and the rate at which the dollar is converted to rupiahs has been raised in April from Rp. 75 to Rp. 90 and in July to Rp.130. In addition to basic duties, a number of surcharges are levied on imports. These are summarized in Table 32 of the Statistical Appendix. The cumulative effect of the import tax varies greatly from category to category. The average rate in 1967 is expected to be around 25 percent of the value of imports. To discourage non-B.E. imports, since November 1967 such imports are charged additional taxes. Although no definite judgment can be made as to the degree of protection that these rates provide,the retail price of imported commodities in Djakarta suggests a rather low effective tariff.

21. Excise Duties: Main excises are those on tobacco and sugar. The yield from duties on beer and alcohol is very low and that on petroleum products is uncertain. In 1966 the tax has been changed from specific to an ad valorem base. The price on which the tax impinges is periodically reviewed. The prices diverge considerably from the actual retail prices and thus the tax retains specific features. The following table summarises the main features of the tax.

	Excise Tax Rate (In Percent)	Expected Revenue (In millions of Rupiahs)	
		1967	1968
1. Tobacco 1/			
a. Cigarettes manufactured by machines and cut tobacco	50	7,560	9,923
b. Cigarettes manufactured other than by machines	35		
c. Other tobacco products	25		
2. Sugar 2/	10	600	900
3. Petroleum products	10	...	...
4. Beer	50	75	90
5. Distilled alcohol	70	52	24

1/ The rate before August was 60 percent, 40 percent and 30 percent of the retail price for three respective groups.
2/ The tax is levied on sugar factories. Small manufacturers are exempt. The tax is on the cost price which is about one-half of the retail price.

The tax rate on tobacco has been reduced successively, the latest change was effected in August 1967.

22. Domestic Oil Profits: The difference between the sale proceeds and the cost of operation of domestic oil companies if any would accrue to Government1/. The selling price is determined by Government. However, the sales price of gasoline, fuel oil and industrial diesel oil is below the cost price involving the Government in an estimated subsidy of about Rp. 950 million in 1967 (see Table 31 of the Statistical Appendix). Furthermore, cost of oil for military and some civilian uses is not fully recovered.2/ In 1967 total cost of operation of oil companies at the prevailing exchange conversion rate (i.e., Rp.85 per dollar for the domestic oil companies) is estimated at Rp. 7.2 billion. At Rp. 130 conversion rate, the cost of operation would be Rp. 11.0 billion and the requirement of the army, including some civilian uses, Rp. 4.0 billion. For realizing the proposed Rp. 6.0 billion of oil profits in the 1968 budget, total sales will have to be about Rp.21.0 billion involving almost tripling of the average sales prices.

23. Sales and Turnover Tax: The tax is levied on the value of goods delivered by manufacturers and also on services. Major exemptions include food items, some raw materials, imports and exports. Sales tax on imports, abolished since 1960, is now to be reimposed. The tax rate is progressive (a) 5 to 10 percent on essential items; (b) 20 percent on less essential items; and (c) 50 percent on luxury goods. The Minister of Finance has the power to decide about the list of goods that are subject to the tax schedule. In April 1967 the sales tax on essential and semi-essential goods was reduced from 20 percent to 10 percent. There were further modifications in July 1967. Recently the sales tax on domestic textiles was abolished. As a result of these changes the proceeds from the tax are expected to be about one-third lower than the original 1967 budget estimates.3/

24. Nontax Revenues: Receipts of the Central Government from domestic sources, other than taxes, provided about one-fourth of budget receipts in the early 'sixties. But their importance has declined in recent years. In 1967 the contribution from these sources accounted for only one percent of the total budget receipts and this item is not significant in the 1968 budget estimates.

1/ Based on decision of the Presidium in February 1967.

2/ In the first seven months of 1967 the army received an advance of Rp. 928 million for its use of oil, reducing the share of the Center in oil profits from Rp. 1,752 million to Rp.824 million

3/ In addition to these, there are three other relatively unimportant taxes in force in Indonesia, namely, stamp taxes, taxes on transfer of title of automobiles and other levies on luxury goods. The Minister of Finance is authorized to adjust the rates.

25. The contribution of government enterprises also has been nil or very small. The receipts recorded from the nontax revenues include collections of fees and dues charged by the different departments mostly on account of the services rendered. On the basis of the past administrative practices in Indonesia, one may conclude that the main reason for decline of revenue from this source has been the slow response of the departments in adjusting their charges to the rising prices during the recent inflationary period. Owing to the multiplicity of these levies and of the departments administering them, it is not possible to obtain a clear picture of the extent of current underassessment. But, in comparison with the other countries in similar stage of development, a strong case can be made for increasing revenue from these sources.

26. Provincial and local governments are estimated to get 27 percent of total domestic revenue. Of this, 29-38 percent are from the export tax (ADO); 11-13 percent from the proceeds of the land tax; 43-50 percent from the central government revenues and less than 8 percent from regional revenues. Export tax and land tax are earmarked for the development programs.

27. The central assistance under a 1956 act was to be based on factors such as size, population, economic potentiality, level of literacy, length of roads and irrigation networks of the respective regions, etc. It is not clear how, in practice, these criteria are applied. An analysis of the central aid classified by broad regions in 1967 shows that Java gets, on a per capita basis, 44.5 rupiahs, Sumatra 83.7 rupiahs, Sulawesi and Kalimantan around 71-72 rupiahs and other islands 17.9 rupiahs. Considering the fact that on per capita basis most of the export tax (ADO) accrues to the "Outer Islands" particularly the West Irian province (see Appendix Table 30) at the expense of Java. Also there have been regulations relating to the size of the Central Government assistance by tying it to certain proportions of various tax receipts.1/

28. Under the 1956 Act2/ real estate, road and slaughter taxes are reserved for the provinces whereas the regencies have in addition the copra tax and the development tax. In 1965, additional tax powers3/ were vested in local authorities. Local assemblies also have the power to authorize the regional governments to impose additional levies. These taxes become effective after the approval of the Ministry of Interior or other high regional authorities. At present local authorities levy a wide variety of taxes that yield very meager returns.

1/ See, for example, Regulation No.12, 1958

2/ Law No.32 of 1956, Article 3

3/ Law No.18 and No.19