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forced upon. At the same time, such straight across-the-board payments to industrialists could generate new wage demands from the employees, thus annihilating the Government assistance.

A third proposal, the one put forward by Dr David Horowitz, the Bank of Israel Governor, is generally supporting the three-year program of Mr Sapir, but proposes instead of blocking taxes, an overall 15% reduction of all wages and benefits.

The discussion is still going on and a final decision is not expected very soon. And not only because of divergences between Messrs Sapir and Zadok, but as well because one of the coalition-partners, the extreme left wing Mapam party, strongly opposes the plan of Mr Sapir. Meanwhile, nobody seems to bother with the real disease of Israel's economy, preferring

to look instead after different treatments for symptoms. The deep-rooted disease of the economy however is a structural one. First of all due to the fact that the great majority of local industrial plants are far too small—rather workshops—and thus unable to take advantage of large scale production economies. Secondly, because Israel economic institutions are much too rigid and overextended for the industrial base carrying them.

The belief of those realistic onlookers at the state and needs of Israel's economy is that the sooner these facts will be recognised and dealt with, by the Government and the other responsible economic factors, the easier it will be to find a way out of the present tight economic situation, worsened by the threat of growing unemployment and bankruptcy.

## Indonesian Economic Problems in 1966

Professor Dr H. W. Arndt, Canberra, and Professor Dr J. Panglaykim, Djakarta \*

The last months showed signs of awakening in Indonesia, awakening to the country's economic condition, and perhaps the beginning of a new era—although as yet action has largely been confined to the political sphere.

Beginning with two Statements in April by Sultan Hamengkubuwono IX, Deputy Premier in charge of Economic Affairs and one of the triumvirs of the new leadership (the other two being Lieutenant-General Suharto and Mr Adam Malik), a picture of economic breakdown has been revealed to the Indonesian people and to the world which can have few parallels in a great nation in modern times except in the immediate aftermath of war or revolution.

It remains true that this breakdown does not greatly impinge on the majority of the people who live in the villages of Java and the Outer Islands. Nor is there as yet evidence of catastrophic or even serious food shortage. Average standards of food consumption, and of living generally, are still, as far as it is possible to judge, substantially higher than, for example, in India. But economic breakdown in every other form is apparent in varying degrees.

The country is in default on a foreign debt officially estimated at \$ 2,400 million. Current foreign exchange earnings in 1966 are unlikely to cover much more than one-half of foreign exchange requirements for imports and (unrevised) debt service. Tax collection has been falling ever further behind almost uncontrolled government expenditure. In consequence, inflation, as reflected both in rising money supply and rising prices, is continuing at a rate which is probably still rising. Shortage of imported raw materials and other factors have reduced industrial production to

below 20% of capacity. While rice production is seemingly well maintained, production of estate and other rural products, with few exceptions, continues to decline. Shipping, rail and road transport and all other public services are suffering from years of running-down of equipment and are operating with difficulty and intermittently. The whole elaborate system of government controls of the economy is rendered practically inoperative by evasion and corruption. The relevant laws and regulations are neither respected nor enforced.

All these features of the economic situation have been increasingly in evidence, and obvious to observers on the spot, for the past two years and more. It is only in the last few months that they have been officially acknowledged and squarely faced by the country's leaders.

### Failure of "Emergency Measures"

It is now clear that the first series of economic measures taken by the old leadership in the wake of the abortive coup in late November and December 1965 was not as constructive as appeared at the time. While principles proclaimed were sound enough, the actions taken were partly—as in the case of the decision to make all foreign trade a government monopoly—merely further steps on the doctrinaire road followed in the preceding two years and partly emergency measures hastily conceived under extreme political pressures. The latter was true especially of the decisions to grant a large New Year bonus to government employees and of the December "currency reform" which was its direct outcome. It became apparent to the Central Bank that the amount of currency required for the bonus (75,000 rupiahs to each of about 4 million employees or 300,000 million rupiahs), on top of rapidly rising routine expenditure and considerable withdrawals of cash from the banks, was altogether beyond the capacity of the government printing press. Hence the decision to in-

\* A detailed version of this report written in June this year in Djakarta and equipped with a great number of tables and sources has been published as "Survey of Recent Developments" in the "Bulletin of Indonesian Economic Studies"; Research School of Pacific Studies, Australian National University, Canberra, No. 4, June 1966. In its July-issue INTERECONOMICS has already published an interview on "Topical Problems of German-Indonesian Trade".

roduce the new rupiah (equal to 1,000 old rupiahs) which made it possible to put into circulation large stocks of Rp 50 and 100 notes printed in 1960 that had been overtaken by the inflation and never used. Unaccompanied by any other stabilisation measures, it was an act of desperation, not a currency reform. The other major decision, to raise the price of petrol and public utility charges to levels which would cover costs, though sound enough in principle, appears to have been disastrous in its timing—certainly for its authors. The 250-fold increase in the price of petrol was interpreted by the public as signalling final abandonment by the old leadership of efforts to hold the line against inflation. Together with the increases in public utility charges, it played an important part in arousing the students to political action which in March reached its climax in the overthrow of the old regime.

The months that have passed since then have been dominated by a continuing half-hidden struggle—"play" might be the better word if the stakes were not so high—for political power. At the end of June the feeling in Djakarta was that there was still much "unfinished political business", too much for decisive economic action. It seemed doubtful whether the new Triumvirate as yet commended sufficient political power to take any, let alone all, of the highly unpalatable decisions that would be needed to tackle the economic situation. Confining action to areas in which it could count on a national consensus, such as the ending of "confrontation" against Malaysia and the "rescheduling" of foreign debt, it was seeking to consolidate its political position.

#### **"Rescheduling" of Foreign Debts**

A Sultan's Statement on April 12th<sup>1</sup> contained the following candid passage:

"Any person who entertains the idea that Indonesian society is experiencing a favourable economic situation is guilty of lack of intensive study. For years to come Indonesia's economy is saddled with foreign debts totalling \$ 2,400 million. This year we have to begin to pay our long-term debts. If we fulfil all our obligations, we have no foreign exchange left to spend for our routine needs. This is the reason why for years we have been importing our daily necessities through short-term loans (better known as deferred payments) on conditions detrimental to us."

In December 1965 Indonesia ceased to be able to meet its foreign exchange commitments. For some time the Central Bank was unable to honour even cash letters of credit and had to suspend payment on a volume of foreign trade credit which, together with other short-term credit still outstanding at the end of the year, was estimated at \$ 177 million.

In April the Government for the first time compiled an account of Indonesia's total foreign debt and of repayments due over the years 1966-74. It showed that of the total medium and long-term debt of \$ 2,175 million, more than 60% was due to countries of the Communist bloc, mainly to the Soviet Union, and mostly on account of military aid. Among the other creditors, Japan was only slightly behind the USA, and much the largest if short-term debt is included.

<sup>1</sup> All extracts from this Statement are quoted, with slight emendations, from the version printed in the English edition of *Business News* of 15th April 1966.

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With total foreign exchange earnings (including oil revenue) for 1966 estimated at only \$ 430 million, it was obvious that Indonesia could not honour its commitments to repay \$ 530 million in that year. By April, the need to seek a moratorium from Indonesia's creditors was publicly acknowledged, and efforts began to secure a "rescheduling" of its commitments. The high priority given by the new leaders to ending "confrontation" against Malaysia was generally interpreted as not unconnected with the need to give proof to the world of Indonesia's intention to concentrate its efforts on the country's economic problems and thus to justify a sympathetic attitude among creditors and potential lenders.

Intensive diplomatic activity persuaded an initially reluctant Indonesia to accept a consortium of all the creditor countries as the best instrument for negotiating an equitable rescheduling of Indonesia's existing commitments and exploring the possibilities of equally urgently needed new credits. It was also no accident that among the first of the international institutions Indonesia proposed to rejoin was the International Monetary Fund. An IMF mission arrived in Djakarta late in June, with an assessment of Indonesia's foreign exchange position as its first task.

#### **Balance of Payments**

The Sultan's Statement pointed out that Indonesia's export income had dwindled from \$ 750 million in 1961 to \$ 450 million in 1965 and proclaimed the

Government's intention to "give priority to every project which yields foreign exchange without bringing losses in other fields". This is indeed one economic field in which the new leadership has taken legislative action. A new regulation announced on 20th May, 1966, widened the free market for foreign exchange by increasing the Export Bonus, i.e. the proportion of their foreign exchange earnings which private exporters may legally sell to importers.

At the time of writing it was impossible to obtain a clear picture on the trend of exports. But there seemed some ground for optimism that, if current rates were maintained for the rest of the year, exports in 1966 would reach the current official target figure of \$ 300 million and might even approach \$ 400 million.

On the import policy, the Sultan's Statement was not very specific. The Government merely foreshadowed "an austerity programme, a programme of retrenchment covering all facets". It is true that no official figures for Indonesian imports are available, but one can say that the minimum import requirements (for goods and services) for 1966 will be at \$ 560 million. Only for a revival of industrial activity priority imports of \$ 420 million will be necessary. Whether they will in fact become available to the industries concerned depends not only on the total amount of foreign exchange available, but also on the ability of the Government to enforce a priority programme.

Summing up, it is apparent that export earnings in 1966 of at best \$ 450 million will be insufficient to finance these minimum requirements, new foreign credits amounting to at least \$ 200 million in 1966 will have to be sought. Some new emergency credits have already been secured. And the negotiations for a consortium of creditor countries clearly envisage that this consortium will agree not merely to "reschedule" present debt service obligations but to grant new credits.

It is generally recognised that new foreign credits, while necessary, are not the answer to Indonesia's balance of payments problems. How can some sort of equilibrium be restored? What can be done to ensure that, gradually, the country comes to live within its means?

At the moment the Government seems determined to continue the system of direct control of imports by priority categories. Unofficially there has been some discussion on the possibility of moving towards a free exchange rate, which would make it possible to abandon controls which have proved virtually unenforceable. But this measure can be effective only if domestic inflation is reasonably under control.

### **Inflation**

The Sultan in April gave an unvarnished picture of the degree and pace of inflation:

"In 1965 prices in general rose by more than 500 %; in fact the price of rice soared by more than 900 %. Unless swift and correct steps are taken, it may skyrocket by more than 1,000 % in 1966. In the 1950s the State budget sustained deficits of 10 to 30 % of receipt and in the 1960s it soared to more than 100 %. In 1965 it even reached 300 %. The most serious of all took place in January, February and March 1966. Within the first quarter of this year it amounted to almost the whole government expenditure in 1965."

Since then the inflation has continued to accelerate and there seems little confidence in official circles that anything much can or will be done to slow it down in the near future. Optimists speak in terms of a plan to bring inflation to a halt over the next two to three years.

During 1965 the money supply increased almost five-fold. Of the total increase of about Rp (new) 2,300 million, not much more than one-half was accounted for by the budget deficit. The rest resulted from credit expansion, mainly through government banks, to state enterprises and the private sector, and for various extra-budgetary projects; but even these funds originated very largely in expansion of the note issue by the Central Bank.

For 1966 the latest estimates suggest a budget deficit of about Rp (new) 12,000 million, the difference between expected expenditure of Rp 21,000 million and expected revenue of Rp 9,000 million. If this amount is added to the money supply outstanding at the end of 1965, one reaches the estimate of Rp 15,100 million for the end of 1966. But this makes no allowance for additional expansion of money supply through bank credit and extra-budgetary channels which accounted for nearly half the total in 1965.

One effect of inflation is to raise, in step with prices, the working capital requirements (in money terms) of all enterprises. Private firms have no hope of covering more than a small part of the continuously growing financial requirements from their own funds and from what they can obtain in the unorganised money market; and interest rates in the unorganised market, linked as they are to the expected rate of growth of prices and at present of the order of 10-15 % a month, have become prohibitive for any business activity, such as exporting at anything like the official exchange rate or manufacturing for sale at anything like controlled prices, which cannot take advantage of the capital gains (in money terms) to be made from buying now and selling later at free rupiah prices. If expansion of exports and manufacturing is not to be impeded by shortage of funds, therefore, finance will in practice have to be provided by the banking system; and virtually all such finance is in present circumstances, directly or indirectly, central bank finance. The same applies in any case to the credit requirements of the central government (e.g. Rp 2,500 million for rice purchase) and of the state enterprises. No estimates of likely credit expansion for all these purposes in 1966 are available. But it is bound to add considerably to the inflationary pressures generated by the budget deficit.

Money supply doubled in the first quarter of 1966. If it continued to rise at this rate through 1966 it would reach a total of Rp (16 x 3 =) 48,000 million. Clearly, a very strenuous effort will be needed to keep the rate of inflation within the given limits.

The social effects of the inflation cannot be documented by statistics since we are without any data on wage earning and other money incomes. A high civil servant with a salary of 200,000 old rupiahs a month would have needed about Rp 750,000 for household expenses at the end of December. By May 1966, the same household costs had risen to Rp 2,500,000. His salary probably remained virtually un-

changed. Most government employees' money wages and salaries now contribute an almost negligible addition to their ration of rice and clothing; they make ends meet, if they can, by finding outside jobs. The rural population was not affected so much.

#### **Stabilisation Strategy**

Meanwhile much thought is being given by the new Government's economic advisers (among whom the economists of the University of Indonesia are coming into prominence) to a possible strategy for bringing inflation under control, if not this year, then in 1967 and 1968. Logically enough, this thought follows two main lines: reducing demand pressures by increasing government revenues and cutting back government expenditure; and increasing the flow of goods and services by reviving domestic production aided and supplemented by foreign credits.

At present 65% of tax revenue comes from indirect taxes, mainly on imports, so that total tax revenue is heavily dependent on the country's capacity to import. Plans are in hand, through reform of tax administration, to collect arrears of tax amounting to Rp 2,000-3,000 million and to ensure more effective collection of tax currently falling due. In the belief that the rural sector has substantial unused taxable capacity, a proposal is under consideration to extend the existing, but little more than nominal, land tax both by raising the rate of tax and by ensuring effective

collection from the villages through the regional authorities to the centre. The administrative and political obstacles in the way of all such plans to tax more, and more effectively, are, needless to say, formidable.

Even more formidable, and in a sense fundamental, are the difficulties of bringing about substantial cuts in government spending. For one thing, the Triumvirs have here to contend, not merely with opposition from private vested interests, but from that of powerful groups within the state apparatus, frequently led by potential rivals for political power. One need only mention the political issues raised by any proposals to follow up the eventual ending of "confrontation" by a substantial cut in military expenditures. Similar issues are raised by any attempts to eliminate or reduce government spending functions or agencies which are sources of power and privilege, even livelihood, of politicians and high officials.

More fundamental is the problem of alternative employment for those who would lose their jobs with retrenchment in civil and military expenditure. It is estimated that at least 30% of employees of government departments and agencies, even of such institutions as the Central Bank, could be dispensed with without reducing (indeed possibly increasing) their performance. In effect, government employment, both civil and military, at present constitutes a vast system of unemployment relief.

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### Economic Rehabilitation

On the new Government's approach to the problem of reviving productive activity and developing the country's productive capacity the Sultan's Statement of April 12, which was mainly concerned with "the most pressing needs which may materialise in 6 to 12 months" had relatively little to say:

"In the agricultural sector, food yield and farmers' income must be improved appreciably. To this end, irrigation, fertilisers, pesticides and implements to boost output are essential. Credits and better transport too will help their income... Rehabilitation of highways, maintenance and expansion of the network of roads in economically important areas are a necessary condition for our economic recovery and stability. To bring efficiency and effectiveness into maritime transport we need port facilities, particularly dock facilities to render fast service to ocean-going vessels demanding services and repair... This subject will be given special attention."

It is recognised that increased production depends in the first instance on imports of materials, spare parts and equipment: raw materials for the textile and other manufacturing industries, fertiliser and pesticides for agriculture, and spare parts and equipment in every sector of the economy. Hence the urgency of minimum foreign credits this year and every possible stimulus to export earnings in this and later years. Since much of the necessary replacement investment is of the "sparkplug" type—scores of diesel locomotives, generators, trucks, looms, dredges

and other machines needing only small but essential parts to be made serviceable again—much of such import expenditure, if efficiently applied, could have spectacular effects on output.

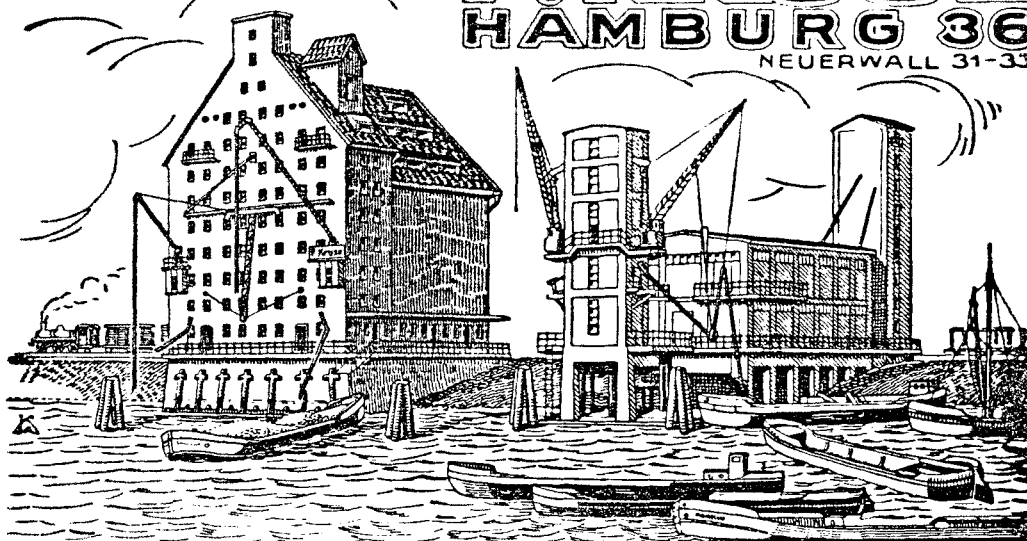
But the proviso is important. To quote the Sultan's Statement once more:

"What are the prerequisites ... to economic rehabilitation? Every official, whether in the government or the private sector ... should render the greatest contribution within his ability in the interest of the State and nation, not merely act for personal gain... The Government deliberately restricts its programme within the limit of its capacity and the prevailing atmosphere in the conviction that it will not reach its goal without public support and aid... The public should exercise social control to see that no abuses are committed. If they are committed, the guilty party needs to be warned. If it ignores the reminder, the public ought to report it to the authorities."

The old regime has left behind a legacy of moral disorder—of graft and corruption, of breakdown of law enforcement and decline in respect for the law—which can have few precedents in modern history. To repair this damage may be even harder than the damage to the nation's material capital. Yet unless some minimum standards of government and administration are restored, and some social cohesion and sense of common purpose created among the people, it is difficult to see how all the foreign aid can put Indonesia back on the road of economic recovery and development.

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