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Country Development Strategy Statement

FY 1984

The Macroeconomic Framework in the Early 80's

Indonesia

January 1982

Agency for International Development
Washington, D.C. 20523

BEST AVAILABLE

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UNITED STATES OF AMERICA
AGENCY FOR INTERNATIONAL DEVELOPMENT
AMERICAN EMBASSY
JAKARTA, INDONESIA

January 26, 1982

To My AID Associates:

Enclosed is a paper entitled "The Macroeconomic Framework of Indonesia's Development in the Early 1980s."

During a recent TDY in Washington I was advised that the Indonesian Mission would defer a major CDSS (for the FY 1985 cycle) until late in 1982 but in the interim would submit to Washington an update of economic conditions in the country.

The attached document assesses Indonesia's economy during the past year, and identifies changes and trends in the country's financial position, some of which are rather troubling. Perhaps of most significance, during the last eight months the current account balance turned negative and a $3.5 billion deficit is now projected by the Ministry of Finance for FY 81/82. Although Indonesia continues to manages resources well, for example the recent domestic fuel price increase and associated sharp increase in the education budget, it will probably be many years before the Government's development efforts can rely on a domestic non-oil tax-base, or the country's energy needs can rest on alternative energy sources. In view of a decline in non-oil export earnings and little immediate prospect for improvement, it seems likely that Indonesia will face a bumpy road as it strives to sustain its develop efforts.

A second paper requested by Washington focuses on the private sector. It will be forwarded to AID/W in the next few weeks. This paper will be exploratory: it will reflect the U.S. Mission's views of the Indonesian private sector, present and potential U.S. private sector contributions to development, and the range of proposals and issues that will need to be reviewed in the coming year. We are looking forward to AID/W comments on this paper as we attempt to define an appropriate role for AID in support of the private sector.

During the next several months selected components of the USAID program will be reviewed by the Mission with the help of consultants as a basis for planning our future program. In addition to looking at regular program work, we hope to consider possible ways in which the Mission can contribute more effectively to strengthening analyses of selected policy issues of interest to the GOI, issues that would draw on and also strengthen the Mission's work and experience. We anticipate that the FY 84 ABS will reflect some of our thinking on program priorities, and that the CDSS will spell out our directions in detail.

At present, most of the Mission's work continues to focus on program implementation. The Government's present reserve levels, its ability to borrow, and continued donor support promise a high level of development investment at least for the moment. But the macroeconomic policy environment, mentioned above, the absence of an adequate number of tested program concepts, and a weakly developed cadre of manager and technicians (public and private), are likely to limit the rate of investment in the future and the rate of Plan achievement.

To increase our impact, we will be exploring ways in coming months to improve our focus, increase contact with policy-makers in the Government, and strengthen relations with the private sector.

In the last year or two of high reserve levels there has been much discussion of the opportunities for commercial ties and of the packaging of aid to serve these commercial interests. But unlike other donor programs, some of which have been tailored to exploit Indonesian resources and other commercial possibilities for the benefit of the donor country, the AID program has tried to remain focused on the basic causes of the country's poverty during this short period of financial affluence. We are striving to sustain our support for several of the Government's programs designed to develop the rural economy despite a more restrictive AID budget. To support the Government's efforts, and particularly the development role of the private sector and to create jobs, the Mission is designing the Central Java Enterprise Development Project and is completing its U.S. Private Sector Development Exploratory Project Paper.

I look forward to discussing some of these and other program related issues in Bangkok.

William P. Fuller

Director

The Macroeconomic Framework of Indonesian's

Development in the Early 1980s

The Macroeconomic Framework of Indonesia's Development in the Early 1980s

Introduction

Indonesia's macroeconomic circumstances have changed in important ways in the last twelve months as has the mission's perspective on the economy. A balance of payments deficit has recurred and consequently budget prospects are far less optimistic than they were even eight months ago. These factors, the new U.S. Administration's emphasis on the role the market needs to play in the development process, and tighter U.S. resource levels, will affect the mission's strategies and priorities. These priorities will be reflected in the FY 84 ABS and more fully in a revised CDSS to be submitted this time next year.

A second paper, on the U.S. and Indonesian private sectors, accompanies this update of macroeconomic conditions. This accompanying paper is an analysis of the private Indonesian economy and of possible ways in which U.S. private sector activities can contribute to Indonesian development. The paper is exploratory; it reflects the U.S. Mission's views on present U.S. private sector contributions and on the range of proposals and issues that will be reviewed in the coming year.

1. Overview of the Indonesian Economy

A. The Government's Development Achievements

The Indonesian government's development achievements of the 1970s were sustained and expanded in the first two years of the 1980s.

- Rice production continued to break past records; for each of the last three years harvests have increased by over 7% per year, well above the long term trend of 4% sustained in the 1970s. Output is expected to reach 22.2 million metric tons (mmt) for 1981, an increase of 10% over the 20.2 mmt of 1980. The immediate public food problems are quality control of grain stock and maintaining floor prices for farmers. In late 1981 President Suharto gave his first public support to the government's long recommended strategy of food crop diversification. (The idea that "rice" is not the whole food story is examined in the previous CDSS. As explained there, only 30 to 40% of the Indonesian population is said to have an adequate daily consumption level of calories and protein.)

- The national family planning program continues to show progress according to data from the 1980 Census. The present national rate of population increase is around 1.9 to 2.0%, down from 2.7% in 1970. For East Java, the country's most populous and densely settled province, the net population growth rate may have slowed to as little as 0.8% per year. This low rate is in part explained by a contraceptive use rate of 62% of all eligible couples.

- Primary school construction, staffing, and attendance continue to improve. By 1981, 81% of all girls in the primary education age group were enrolled in school, a level almost as high as that for boys. The recently announced FY 82/83 budget provides a sharply higher level of resources for primary education. Even accounting for a dropout rate as high as fifty percent by the end of the sixth year, present school attendance levels will soon come to represent a massive demand for further schooling.

- Price stability continues to be the government's principal macro-management objective, as evidenced by a further decline in the inflation rate from 17.1% in 1980 to 7.3% in CY 1981. The money supply grew by about 24% in 1981 as compared with 35% in 1980.

- A final government achievement was the introduction of three large domestic fuel price increases in as many years.

The government acted firmly to prevent the mounting cost of this subsidy from diverting resources from development. (The importance of these continued subsidy reductions for job creation is dicussed in a following section.)

This record of sustained development achievement in recent years must be viewed against a backdrop of a weakening in the economy's overall financial prospects. The balance of payments outlook has deteriorated sharply in the last eight months. The current account surplus has dropped rapidly from $2.3 billion in FY 80/81 to a deficit estimated to be between $3 and 4 billion in FY 81/82. The reasons for this change, discussed below, center on a flattening of oil earnings, a sharp decline in non-oil exports, and the continued growth of imports and invisibles. Because of this rapid change in the oil picture and because of the country's poverty described in a later section and in the last year's CDSS, it would be unrealistic to call Indonesia a typical OPEC country.

Because of these oil-related factors and despite record rice harvests, the 1980 GNP of $65.8 billion (up 9.6% over 1979 in real terms) is expected to grow at a lower rate (6% in 1981) to $69.7 billion, or to about $465 per capita (as calculated on a dollar GNP of $60 million in 1980, a 1981 population of 150.3 million, and a late 1981 exchange rate of Rp.640 to $1, up from Rp.625) at the same time income distribution is unlikely to become more equitable; at present the poorest 40% of the population enjoys only 14% of the income.

In retrospect, the economy held up well during a period when the world economy grew by only 2% (1980-1981). Total world oil production including that of the OPEC countries has fallen steadily since 1979. The prospect for 1982 is for a continuation of this decline, a part of which Indonesia may have to share.

B. Recent Changes in the Balance of Payments

The World Bank projections of just a year ago indicated that the FY 1980/81 (the Indonesian fiscal year runs from April 1 to March 30) current account surplus would be $2.20 billion (up from $1.99 billion the year before), and that it would decline to $1.5 billion in FY 81/82, to $0.7 to 0.8 billion in FY 82/83, and would turn negative only in FY 83/84 at -$0.5 billion. These end of 1980 projections were sharply higher than those projected by the Bank the year before. Just as upswings were inaccurately forecast by the government and others, so too were the early signs of a sharp downturn not generally known until July or August of 1981. First estimates of a deficit of $800 million for FY 81/82 have given way to estimates between $3 and 4 billion. (See Annex A for the Ministry of Finance's Balance of Payments. The Bank estimates are not strictly comparable with those from the Ministry of Finance. The Bank estimates are used here to emphasis the magnitude and rapidity of recent changes.)

In March of 1981 total reserves reached $11.5 billion but declined to $10.9 billion in October; these levels still represent nearly a year's non-oil imports. Whether the government will need to draw further on these reserves depends on trade prospects in the near future.

- Foreign Trade

Oil export earnings have been level during 1981 because of the world recession, the resulting slump in oil demand, and the elimination of oil price premiums. Total oil production grew from 573 million barrels in 1980/81 to only 576 million barrels in 1981/82. Oil prices have risen six times in real terms in the last ten years, but have now levelled off at around $35 per barrel and may soon fall in real terms. Earnings are expected to remain flat and possibly decline as domestic oil consumption continues to expand. The rate of expansion, however, which had been estimated to be 10 to 12% per year prior to the recent price jump, is now estimated to be around 9% in FY 82/83.

Although present oil export earnings have remained flat this year, non-oil exports fell sharply. They are a third below 1979 levels.

Raw log export earnings, until recently the country's chief non-oil export earner, declined 48% between FY 80/81 and FY 81/82 because of a government provision designed to encourage the export of plywood and timber products. Although sawn wood exports show a slight drop during this period, plywood exports jumped 136%, but from a very small base. This increase suggests greater domestic participation in this industry and also an expansion of employment, two of the government's intended goals of this change in regulation.

To encourage small domestic shrimp producers and exporters, larger firms with mechanized trawlers were banned by government decision in 1980. As a consequence, shrimp exports have also fallen at least in the short term. Palm oil export earnings were also off, by 51%; rubber, by 25%; coffee, by 43%; and agricultural exports overall, by 28.9% in current prices between FY 80/81 and FY 81/82. Although one of the government's new export policies appears to be winning export earnings for plywood (at the expense of log exports), the broader effect of the world commodity price slump is clear. Total exports including oil and gas in constant prices are expected to fall again this year, possibly by 5%.

Continuing business uncertainty, heavy regulation, and the world recession are adversely affecting the export of manufactured goods from the country's small industrial sector. The small volume of manufactured exports is expected to be off 10.8% in FY 81/82. The 1978 rupiah devaluation is paying off within some parts of the economy, but, unlike the one in 1966, the 1978 devaluation was not "clean" in the sense that the barnacles of protective regulations were not removed. Continued heavy regulation by the Ministries of Trade and Industry has meant that the economy is unresponsive to growth in international demand (when it recovers) and, so too, to the growth of production and employment opportunities that a clean devaluation could bring. Counter-arguments point out that this unresponsiveness is a small price to pay for consumer (and cartel) protection (in the case of palm oil), expanded opportunities for pribumi (indigenous Indonesian) businesses (plywood and shrimp), and trade barriers and quotas constructed by rich nations (possibly in the case of garments in the future). Because the government is anxious to expand its manufacturing base, still the smallest in S.E. Asia at 9% of GDP, these issues may receive attention following the elections.

All non-oil imports, except rice and wheat, have continued to increase by about 23% in FY 81/82, thereby contributing to the current account deficit and also to the decline in the rate of inflation. Intermediate and capital goods for the country's investment programs grew by 77.6%; oil imports (crude and products) grew by 30.1%. Imports in constant prices grew by 14.8% this year and will probably be difficult to curtail because only 10 to 15% are consumer goods. Despite these short-term trade difficulties and a sharp decline in terms of trade for non-oil exports in the last three years, overall trade terms during the 1970s, and as projected by the World Bank for the 80s, are highly favorable for both oil and non-oil exports. These terms, should the Bank's projections prove correct, bode well for the country's trade balance and for its labor-intensive export industries.

In light of the present and unexpected current account deficit, current investment plans will depend on some increased borrowing (for which the government's credit rating is excellent), a drawdown of reserves, greater dependence on concessional assistance and packaged loans, and possibly some curtailment of ambitions. But having been twice wrong in projecting resource levels, for the beginning of the Third Plan and now for its last two years, 1981/82 and 1982/83, forecasters should examine their assumptions carefully in making further predictions.

Although the government has managed its second oil boom well by most macro indicators in spite of adverse international market conditions, the medium to longer term outlook is very uncertain. The country cannot rely on oil and gas, at least not to the extent that it has recently. Alternative energy sources will take years to develop as will domestic sources of revenue. What appears more certain is that the government through its subsidy reductions is striving to use resources well.

- Uses of Foreign Exchange Reserves

One of the most frequently asked questions in 1979 and 1980 was "How should Indonesia spend its new found income?" Some people questioned the question by stressing the necessity of monetary management and pointed to the lack of managerial and physical capacity to absorb additional investments. No big budgetary initiatives stand out during this period. (Off-the-balance-sheet investments are discussed later.)

The World Bank and the Ford Foundation recommended privately in 1979 that the new reserves be used for an expansion of foreign training for public administrators and technicians. It is noteworthy in retrospect that several ministries appear to have done just that but without fanfare. This was an important constraint-reducing decision which may reflect the government's perception that government training has a high payoff.

- Foreign Investment

Foreign investment approvals have been on the increase again: the total investment level was $900 million in 1980 and $1.2 billion in new investments during 1981, up from $644 million in 1977. The Investment Coordinating Board chairman predicts that a level of $2 billion in new investments will be approved during 1982. The Board will issue a revised priority list in April, 1982, effective through the end of the Third Plan (FY 1983/84), which will reflect an emphasis on automotive, heavy equipment, and other industrial sectors. The agricultural and agrobusiness sectors are less likely to attract foreign investment because regulations are even more onerous here than in manufacturing. In fact, regulations in all sectors tend to discourage labor-intensive practices and export industries even though both are avowed policies of the government.

Actual foreign investments have tended to be well below approved levels. Net foreign investment as recorded in the Balance of Payments was only $317 million for FY 79/80 and $140 million for FY 80/81; in FY 81/82 the level is estimated to increase to $178 million. As liberalization of the government's investment regulations cannot be expected until after the 1983 elections, if then, there is little likelihood that these low actual levels will increase rapidly to reflect present approved levels.

It is evident from this review of the economy that maintaining domestic growth depends as much on the international market as it does on the domestic one. Recent rumors of a devaluation and the government's announced counter-purchase trade policy linking export promotion with country specific trade surpluses with Indonesia may cause further hesitation in investment circles. Added to these prospects is the concern that semi-skilled and skilled labor costs in urban centers are well above rates in the unorganized commercial sector. A recent World Bank study (refered to later) makes a related point: that wage rates and associated costs are not the foreign-investment inducement that has often been claimed. These factors, which are elaborated on in the accompanying private sector paper, conspire to slow the growth of the private sector, foreign investment, and of labor-using industries.

2. The Government's FY 1982/83 Budget

Recent swings in the government's domestic budget have followed those in the oil-financed foreign exchange budget. Oil revenues have traditionally financed about 60 to 70% of the total budget. The FY 81/82 budget was 54% higher than the FY 80/81 budget, up from $14.4 billion to $22.2 billion. On the other hand the FY 82/83 budget of $24.4 billion shows little growth in real terms, with a nominal change of about 12.3%. (Throughout this paper the present rupiah dollar rate of Rp.640 is used for FY 82/83, up from 625 in late 1981.)

A. Routine and Development Expenditures

The total FY 82/83 budget is estimated to be Rp.15.6 trillion ($24.4 billion) and is financed by domestic revenues of Rp.9.4 trillion from oil, Rp.4.3 trillion from non-oil sources, and foreign aid of Rp.1.85 trillion ($2.9 billion).

Routine expenditures of Rp.7 trillion, down 6.7% in comparison with the FY 81/82 level, reflect no change in government salaries, small changes in allowances, some shift of routine expenditures to the development budget, and a sharp reduction of the fuel subsidy. This long standing subsidy has declined because of the elimination of the wheat subsidy, the anticipated need for rice imports, and the establishment of a sugar price level in 1980 well above the world market price. Power and transportation rates are also expected to increase shortly.

Development expenditures of Rp.8.6 trillion, up 34.5% overall from Rp.6.4 trillion in FY 81/82 indicate greater emphasis on education (up 66% to $2.0 billion), on agriculture and irrigation (up 27.4% to $1.9 billion), and on communications and tourism (up 23.5% to $1.56 billion). This is the first time that Agriculture has not had first priority. The share of foreign project assistance in the development budget has declined from 24.4% in FY 81/82 to 21.2% in FY 82/83.

The government's annual development plans give a misleading impression that the bulk of public investment is for rural programs. When account is taken of large-scale public enterprise investments, as fully described in the FY 82/83 budget statement, the priority accorded to industrial development stands out clearly. It is estimated that 56% of public investment is made through direct budget programs and 44% by state enterprises, virtually all of which are for industry and infrastructure. In each of the last two years, total investments for industry and mining have doubled. For the last two years of the Third Plan, FY 82/83 and FY 83/84, $8.3 billion and $10.0 billion are required respectively for capital-intensive industry, mining, power, and supporting infrastructure.

Without questioning this public priority here (as Indonesia's manufacturing base is so small) it should be noted that there is no clear employment strategy entailed in this program, nor is its competitiveness vis-a-vis other Asian countries certain. Furthermore, the role of the private sector and the necessity of private sector credit appear to be treated as afterthoughts. Another point of concern is that the World Bank, in drafting its most recent economic report, provides an analysis of the sources of financing for this industrial program. Both the Bank and Japan give this industrial priority their tacit support.

There are, however, wide discrepencies between planned and actual expenditures over the years, and it is therefore difficult to determine actual investment priorities. We are not certain whether this year's tight budget will adversely affect the already large program disbursements for rural programs if "hard" programs take precedence.

Because FY 82/83 is the next to the last year of the Third Plan, key ministries have started sectoral preparations for intragovernmental discussions about the Fourth. In the ABS we intend to say more on the government's plan preparations.

B. The Distortions Caused by Resource Subsidies

Large domestic price increases for oil products in April of 1979, in May of 1980, and again in January of 1982 (of over 60%) have kept pace with the rising international price of oil and gas. The budget subsidy for retail oil sales, 90% of which is for kerosene and diesel, was 11.1% of the total FY 1980/81 budget, 10.8% of the FY 81/82 budget, and is projected to be 9.3% of the FY 82/83 budget. The recent flattening in international oil prices lessens the rate of increase in the opportunity cost of oil consumed domestically, but its subsidy burden is still large and is now projected to grow by 7 to 8% a year. The government's determination to reduce this burden is clear; a very large 60 to 66% increase in the price for oil products was announced this January, the beginning of an election year. If this increase had not occurred, the budget subsidy would have been $2.4 billion, not the currently projected $1.4 billion for FY 82/83.

Until recently the case for subsidies has rested on equity considerations; the rural poor were assumed to use a great deal of kerosene for cooking. Two recent studies indicate, however, that the poorest 40% of population enjoys less than 20% of the kerosene subsidy (and uses this fuel primarily for lighting) and an even smaller percentage of the food subsidy. To fulfill its own commitment to education, and to answer critics, the government has allocated the revenues earned from the recent fuel price increase to an expanded education program.

The economic subsidy for domestic fuel consumption, in contrast to the financial subsidy which appears in the budget, is now around $2 to 2.5 billion a year and causes a still higher social cost by encouraging some disguise of the country's labor-intensive manufacturing and trade opportunities. This social cost occurs because oil earnings allow large energy price subsidies which act to encourage a somewhat more energy-consuming capital-intensive portfolio of investment projects than would otherwise be possible. The government clearly recognizes these penalties and will continue to raise fuel prices. The present current account deficit heightens the premium of taking such a step.

Subsidy reductions will remain an important means of taxation for some time to come, but direct tax revenues must be increased as well. The private savings rate rose from 11.7% of private income in 1972 to 20.9% in 1980. Government savings have come almost entirely from oil, and therefore do not represent a sacrifice by consumers. If public savings are to grow to the extent required by the public investment program as estimated by the World Bank, then net domestic taxes (taxes minus subsidies) will have to increase from 4.4% of GNP in FY 80/81, to 10% in FY 85/86, and to 18.1% in FY 90/91, thereby squeezing private income considerably. Given administrative problems, low interest rates, and the poorly developed financial markets, it is unlikely that the public will contribute significantly to public investments during this decade, except by subsidy reductions.

3. The Plight of the Underemployed on Java

Characterizing poverty is a continuing challenge; no one index or study begins to capture the nature or dynamics of how the poor half of the Indonesia population lives. Two recent contradictory studies on wages highlight the employment problem facing the country in the 1980s. (Other poverty analyses and indicators are available in the FY 83 CDSS.)

A. Whither Rural and Urban Wages?

The recent World Bank study Wages and Employment in Indonesia, September 30, 1981, provides useful, up-to-date analyses of wages levels, unemployment, and the labor structure - analyses made all the more interesting by conclusions which run contrary to the generally optimistic 1979 Bank report on employment and income. This study also helps to balance the admittedly upbeat view of the economy presented at the beginning of this paper.

The recent World Bank study estimates that employment grew by 3.3% per year during the 1970s, down from the 4.6% estimated in an earlier Bank report, and that there will be 2.0 million new entrants to the labor force each year during the 1980s. Not only have job-creating policies and programs not performed up to expectation but the size of the problem has been underestimated in the past. Urban unemployment for males is as high as 18 to 25%.

As part of its analysis the Report explains that institutional factors explain why Javanese rice laborers earn a return well above the wage in other, non-rice, rural jobs. The prevailing wage in non-rice activities is often as low as 30% of that in rice because productivity is so very low in the innumerable trades and services. With the breakdown in traditional rice harvest practices, more people will be forced to seek lower paying jobs in non-rice agriculture and in rural services. In a similar way, many urban jobs in the modern, organized sector pay higher wages than is reflected by the numbers of skilled and unskilled people looking for work.

The total labor force is projected to grow at 3% per year until 1990. Then, as now, no increase in real wages is expected in traditional occupations, urban or rural.

The authors of the Report conclude by noting that they do not see the constellation of manufacturing and trade policies developing in Indonesia which have developed in East Asian countries and which are needed to cause real wages to be bid up. The policy conclusion of this is that employment must become a separate policy objective; sufficient numbers of jobs will not multiply from a growth-only industrial strategy.

Quite another picture is described by William Collier, Soentoro and their associates at the Agro-Economic Survey in Bogor in their "Labor Absorption in Javanese Rice Cultivation", June 1981. From their studies of East Java they see increases in job opportunities on and off farm, higher incomes, and increases in real wages. While labor use per crop has continued a long term decline, contrary to Geertz's labor-absorption involution thesis, double and triple cropping have created more employment per hectare per year. Real wage increases since 1976 come from this multi-cropping of rice and from the many new factories producing plastics, noodles, sandals, soap, and bicycles in and around Surabaya. Collier and his associates describe breakdowns in traditional rural institutions such as land ownership and harvest practices, but also observe offsetting benefits for the rural poor, at least in East Java. (According to the 1980 Census, the percentage of all rural households which own less than 0.5 hectares increased from 45.7% in 1973 to 63.1% in 1980.) Landless laborers and their children are able to achieve higher incomes since 1976 because of their job opportunities as agricultural and non-farm laborers.

How to assess these assessments? The Bank study does not include the influence of the country's second oil boom, a short boom era which we believe Collier's work sees in isolation. In light of the FY 82/83 budget and the drastic reduction in real expenditures it may represent in coming years, Collier's optimism for real wages may prove to be short-lived. From other work bv the Agro-Economic Survey we know that land sales and landlessness are increasing. These may prove to be the more enduring phenomenon. Even with greater cropping intensity, on-farm work for women has declined sharply during the last fifty years. Poor land owners may be financing short term improvements in their consumption levels with land sales. Collier summarizes by saying that all of the positive job-creating factors are "still very fragile and could be easily reversed."

In conclusion, the Bank's wage study makes a telling point on the importance of manufacturing. "In Indonesia the ratio of the increment in employment in the tertiary (service) sector to that in manufacturing has been 8:1, while in the three "successful" rice economies of Japan, Taiwan and South Korea it has been between 1:1 and 2:1" (p. ix). Even if the multiplier effect of the oil boom is strong, as Collier suggests, what happens when the boom subsides? Rural marketing and services are a residual sector, not one which promises growth of employment opportunity in the absence of dynamic, sustained expansions in manufacturing and international trade. The Bank study concludes that a much greater effort has to be made in giving a labor-intensive orientation to the growth process. The attention given to labor-intensive choices within projects and firms, as limited as that attention has been, far surpasses the attention paid to the employment potential of Indonesia's several growth sectors.

Another Bank study, Selected Issues of Industrial Development and Trade Strategy, in six volumes, provides a lengthy analysis of the country's industrial policy and regulatory environment, both of which act to slow investment and skew decisions towards capital-sand energy-intensive technologies and products. The invasion of plastic household products into rural Indonesia is one such manifestation of these biases, causing a curtailment in the traditional manufacture of tin, leather, textile, and pottery products. The adverse employment impact of these new rural goods has to be weighed against the opportunities created in new industries. In the following private sector paper we draw heavily on the Bank's six volume study of industry to address this and other issues.

B. Characterizing the Indonesian Economy

The altered balance of payments picture of the last few months, coupled with long-overdue attention to domestic and international market conditions, is forcing reconsideration of the earlier view of the buoyancy of the economy in the 1980s. The AID view of Indonesia has been caught up in the successes of the government's several public development programs with which AID has been associated but which have acted to divert our attention from the broader economy.

The development challenges of the 1980s increasingly entail the whole economy, the private business environment, investment, and domestic and international trade. Here, the country's commercial interests or sectors are diverse and competing.

The sectors of oil, gas, and state enterprise are generally speaking very capital intensive, reflecting the government's emphasis on building the country's small industrial base to expand value-added exports and to supply domestic consumer goods. More than half of the nation's capital is in state hands and a large share of basic commodity trade as well. It is this modern sector which controls the scale and direction of the country's investment plans and which promises so little growth in job opportunies.

The Chinese business elite has great influence with the government and controls much manufacturing and commerce outside the state preserves, despite an almost complete block on the direct access of Chinese businessmen to the large majority of the nation's finance capital under government control. The size of the public sector investment program may be explained in part by a desire to keep basic industries public and out of the hands of the private sector Chinese.

Within the government, ministries responsible for planning, finance, banking, and increasingly, energy, science, and technology, favor energy efficient uses of the country's non-renewable resources and increased attention to public and private sector activities that create employment.

Added to these ministerial interests is the government's increased attention to equity (pemerataan - the root of which means "to level"). This concern for equity is being reinforced by an increased sense of nationalism. The sense of pemerataan, a key word since the inception of the Third Plan in 1978, is also heightened by the national elections.

In sum, the macroeconomic signals, the full set of prices and regulations, including the governmental hierarchical decision process itself, are at best ambiguous and at worst are in sharp conflict with the types of policies and the unity of effort needed to employ the labor force, a population expanding by two million new entrants each year.

Over the longer term, however, the subtle dynamics of change will probably alter the economic structure. On the heels of a seed revolution is an information revolution brought about by radio, television, cassettes, and video. The present investment in primary education will cause a blue jean clad demand for more and better education. Policy changes (which outsiders may feel should be made by decree) will more forcefully and enduringly take place as ministries become more development-minded and as national and international channels of communication develop. Public and private forces are slowly directing the economy's price and regulatory structure to favor more economic sectors. Impatience with the pace of this change should not obscure the fact of its existence.

4. Program Directions of Other Donors

Concessional assistance pledges in support of Indonesia's development plans are traditionally made at the annual meetings of the long standing Inter-Governmental Group on Indonesia (IGGI). Annual IGGI commitments have grown over the years from $560 million in FY 1970 to an estimated $1.8 billion in FY 81/82 pledged at the May 1981 meeting in The Hague (IGGI-24). (Data on donor pledges for FY 79/80, FY 80/81 and FY 81/82 and a few estimates for FY 82/83 are included in Annex B.) In addition to these pledges, a number of donors provide substantial concessional "aid" as part of financial packages for major projects of commercial interest to themselves. Some of this assistance is included in the IGGI pledge.

Since FY 74, the U.S. share of the total annual IGGI pledge has declined from about 30% to about 6% including food aid and to 4% without it in FY 81/82. In contrast to this trend, the Australians, Canadians, French, Germans, Dutch and the Japanese have increased their concessional assistance in recent years, increases motivated in part by the desire for access to raw materials and markets.

Because the Japanese have the largest bilateral program in Indonesia, its program is important. Until recently, food self-sufficiency and a reduction of the population growth rate were announced Japanese goals. Yet because of absorptive capacity problems with Japanese aid and competition from other donor programs, the Japanese have opened their assistance to a wider range of Indonesian requests. In addition to its aid interests, some 210 Japanese companies have invested in joint ventures for the domestic manufacture and sale of consumer goods. (The U.S. has 73 joint ventures in Indonesia and, unlike the Japanese, none are in rural areas. The accompanying paper elaborates on U.S. joint ventures.

We may also see greater World Bank interest in human resource development because there is within the Bank a growing awareness of this constraint to development in general and to project implementation specifically. The Bank may commit $150 to 200 million of its present $800 million annual commitment to education, and it is showing additional interest in transportation, health, coal and possibly geothermal energy, and in industrial policy.

Aside from issues of development assistance, the Indonesian government is increasingly aware that its international economic relationships should include attention to technological transfer, foreign investment, and access to foreign markets for raw materials and manufactured goods. Both the government and its principal donors are showing a diversification and sophistication in their bilateral and multilateral relations.

In conclusion, overall ODA assistance levels have been steady in nominal terms. In FY 78/79 bilateral assistance was $833 million, in FY 79/80 and FY 80/81 it decreased slightly to $733 million and $737 million respectively, and in FY 81/82 it declined to $681 million. During this period, U.S. assistance dropped from $206 million to $93 million. Because of increased multilateral support during this period, total IGGI - ODA assistance has increased slightly in nominal terms.

On a final note, the long established IMF office in Jakarta is to be closed this year following the representative's departure. It is expected that government and donor officials will be the poorer for this loss of expert analysis and advice.

5. The Direction of AID Assistance to Indonesia

A. Foreign Assistance in Perspective

The role of foreign assistance in what outsiders recently called an oil-rich OPEC country was spelled out in the FY 83 CDSS. Early optimism about foreign exchange reserves has now dampened. In searching for resources to finance development and an efficient energy strategy, Indonesia faces a long bumpy road. The donors now have a better understanding of the fundamentally underdeveloped character of Indonesian institutions.

But unlike other donor programs, some of which have been tailored to exploit Indonesia resources and other commercial possibilities for the benefit of the donor, the AID program has remained focused on the basic causes of the country's poverty and continues to support several of the government's programs designed to develop the rural economy for the benefit of the population.

It is AID's view that the government will continue to need assistance to design and test institutions to expand capacity in the public and private sectors for many years to come. AID's programs provide important opportunities to discuss some of the policy aspects of the government's Third

Plan rural programs, opportunities which we will explore in the months ahead.

B. A More Influential Role for the AID Program

The government's own resource levels, its ability to borrow, and continued donor support promise a high level of development investment. The absence of adequate numbers of tested program concepts and a weakly developed cadre of managers and technicians, however, limit the rate at which financial resources can be utilized and therefore the rate at which Plan goals can be achieved.

AID's program goal is a significant expansion of the institutional capacity of the government and the private community to use more of their own resources and those of development banks, U.S. companies, and other donors. The government strives to use its own resources well and welcomes the direction and discipline inherent in assistance programs such as our own. Because we believe the government will increasingly rationalize its macroeconomic environment to support broad-based growth and employment, project assistance will be increasingly influential.

In the early 1980s we plan to increase the impact of our present portfolio and broaden its influence by strengthening contacts with the private sector and by raising with ministry officials selected program and macroeconomic policy issues which bear on equitable growth.

Over the years the AID staff has evolved good working relationships with Indonesian staff in several development ministries and agencies. These relationships have enabled the AID staff to work closely with their governmental counterparts in identifying specific problems and designing and managing projects. These relationships and the results which flow from them are dependent on the availability of experienced AID technical and managerial personnel. The Indonesian government also has become aware of the value of the interaction between the AID staff and government managers at both the central and provincial levels. It is on this base of experience and staff capability that the mission plans to expand its policy discussions with the government in the years ahead.

Annex A

Balance of Payments
FY 79/80 - FY 81/82
in $ Millions

		Actuals 1979/80	Actuals 1980/81	Estimate 1981/82
I.	Current Account			
	1. Exports	17,820	22,470	23,716
	Oil and LNG (gross)	11,649	16,883	19,516
	Non-oil	6,171	5,587	4,200
	2. Imports	-12,631	-17,259	-21,661
	Oil + related services	-3,534	-5,255	-6,840
	Non-oil imports, c + f	-9,097	-12,004	-14,821
	3. Services	-3,612	-4,863	-5,624
	Oil	-1,675	-2,539	-2,912
	Non-oil and freight	-1,937	-2,324	-2,712
	4. Current Account Balance	1,577	348	-3,569
	Oil	6,440	9,089	9,764
	Non-oil	-4,863	-8,741	-13,333
II.	SDR	65	62	-
III.	Official Capital	2,452	2,710	3,046
	1. Program aid	196	162	-28
	2. Project aid	2,256	2,548	3,018
IV.	Other Capital	-1,358	-361	793
V.	Debt	-722	-617	-856
VI.	Overall Balance I through V	2,014	2,142	-586
VII.	Errors and Omissions	-324	594	-511
VIII.	Monetary Balance (- = increase)	-1,690	-2,736	1,097
	Net Official Reserves	4,860	7,596	6,499

Source: Ministry of Finance

Annex B

IGGI Member ODA Loan and Grant Pledges,
in $ Millions

	1978/79	1979/80	1980/81	1981/82
A. Bilateral Donors				
Australia	40.0	40.0	36.0	40.0
Belgium	17.0	15.0	12.0	16.0
Canada*	13.0	12.0	24.0	25.0
Denmark	0	8.2	8.0	8.0
France	41.8	46.2	65.2	70.0
Germany	150.0	73.0	68.0	68.3
Italy	0	0	5.0	5.0
Japan	272.0	235.0	280.0	262.9
New Zealand	5.0	4.2	4.2	5.7
Netherlands	75.0	75.0	80.0	62.1
Switzerland	0	2.0	4.0	3.2
United Kingdom*	13.0	22.0	22.0	22.0
United States	206.4	200.4	128.9	93.0
Sub-Total	833.2	733.0	737.3	681.2
B. Multilateral Donors				
ADB	204.0	235.4	250.0	300.0
IBRD	650.0	726.0	800.0	750.0
IDA	0	89.0	0	0
UN Family	15.0	48.0	55.0	55.0
EEC	0	0	10.0	10.0
Sub-Total	869.0	1,098.4	1,115.0	1,115.0
TOTAL	1,702.2	1,831.4	1,852.3	1,796.2

*Disbursement estimate. Canada's commitments are expected to be higher.

Annex C

U.S. Bilateral Development Assistance Levels,
in $ Millions

	FY 79	FY 80	FY 81	FY 82	Proposed FY 83
Loans	70.6	54.6	33.4	45.2	53.2
Grants	20.6	28.1	33.2	22.1	15.1
Sub-Total	91.2	82.7	66.6	67.3	68.3
Title I	104.3	101.0	50.0	17.5	20.0
Title II*	10.9	16.7	12.3	8.2	9.0
Sub-Total	115.2	117.7	62.3	25.7	29.0
TOTAL	206.4	200.4	128.9	93.0	97.3

*includes shipping costs