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Recent Financial Developments in Indonesia 10 pages

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Indonesia, with an area about one-fifth and a population about one-half that of the United States, is rich in natural resources - including minerals, water power sites, fertile land, and forests - but poor in both political and economic organization. Since attaining independence in 1949, the country's policies have been anticolonial with socialist overtones. An ambivalent attitude toward foreign investment in Indonesia has also prevailed. In addition, per capita income is low, not much in excess of $100 per year according to the latest available estimates (for 1955).

The country has been experiencing severe financial strain for some time. A chronically unbalanced government budget, financed mainly by the expansion of central bank credit, has produced mounting inflationary pressure for several years. Political instability, evident in frequent cabinet changes and in growing conflict between the Central Government and the regional authorities, has held back production, disrupted trade, and retarded development planning. Failure of export earnings to grow since 1955 and overimporting, especially in 1956, have drained foreign exchange reserves and necessitated a suspension of central bank legal reserve requirements since January 1957.

Foreign exchange rates, a complex system based on varying retention quotas for exports and surcharges for imports, grew progressively unrealistic during the first half of this year as internal prices rose. Foreign exchange controls were being circumvented on an increasingly broad scale, particularly in the islands outside Java where dissident military forces have been consolidating local rule virtually independent of the Central Government.

In this situation, some radical measures to reverse the balance of payments deficit seemed necessary. The step taken was a partial devaluation and exchange simplification. The purpose of this paper is to review recent financial developments within Indonesia, particularly since the devaluation, and to inquire whether or not real progress is now being made toward the goal of financial stability.

## The June devaluation

On June 20, 1957, Indonesia took an important step toward simplifying its complex multiple foreign exchange rate structure to bring the rates more in line with prevailing prices. The basic feature of the new system is to issue certificates, expressed in local currency, to all exporters for 100 per cent of the foreign exchange surrendered at the official rate. The rate remains at Rp 11.4 = $1 U.S. These certificates are freely saleable within 42 days (formerly 60 days) and are required for all imports and for invisible payments. Import licenses are also still required but have been issued fairly liberally since the new system went into effect. Prior to the exchange reform, issue of import licenses had been virtually suspended since the end of April.

All merchandise exports and invisible receipts are subject to a uniform surcharge or tax of 20 per cent ad valorem. Inflow of capital is exempt from this duty. Thus there are now two buying rates for Indonesian currency as opposed to nine buying rates before the exchange reform. At current selling prices for certificates less the tax, exporters now realize approximately double the official rate. On the import side, there are now six different rates based on surcharges of from 0 to 175 per cent. Prior to the exchange adjustment on June 20, there were 18 selling rates based on surcharges running up to 400 per cent.

Since the exchange reform, the certificate rate has fluctuated between 205 and 260 per cent of the official rate. At an average of 230 per cent of the official rate, the certificate system yields effective rates for the rupiah ranging from about 21 to $1 to about 72 to $1 for those imports bearing the highest surcharge. Prevailing rates are slightly lower than this, i.e., more rupiah per dollar, since certificates are currently bringing about 250 per cent of face value.

The certificate system is not a new development in Indonesia but an outgrowth of the previous system of export incentives. Negotiable certificates were first introduced in 1947 and have been in use in one form or another during much of the last ten years. In the ten months prior to June 1957, i.e., under the then-existing export incentive scheme, certificates ranging in amount from 2 to 20 per cent of the exchange surrendered were given to exporters of designated commodities. These were saleable in the open market. The June devaluation merely increased the amount of export incentive and applied it uniformly to all commodities. At the same time, importers' prepayments were sharply cut.

Immediate results of devaluation

The exchange reform has provided a temporary stimulus to exports which had become quite unprofitable under the old system. Rubber and oil exports in particular had been falling off and rubber shipments had been evading the exchange regulations in large volume.

The exchange reform was put into effect during a period of extreme balance of payments crisis and with the advice of experts from the International Monetary Fund. Whether the new system will be effective in providing reasonably stable and realistic rates in the future depends to a substantial extent on whether the Indonesian Government can control the inflationary pressure that has been building up for several years. An incidental feature of the exchange reform is that the government revenue yield from the new exchange system is somewhat smaller than under the old restrictions; therefore new revenue sources will have to be developed if the budget deficit is not to be increased.

The immediate results of the devaluation policy have been generally but not remarkably favorable. Exports increased substantially in July but fell off again in August and still further in September. July applications for export licenses were virtually double those for June. The July increase represented mainly shipment of stocks previously held back. By September, however, applications for export licenses were back nearly to the average of the first 6 months of 1957 (before the devaluation) and more than 20 per cent below the average for 1956. Since all exports require licenses, applications for these licenses are a comprehensive series.

Foreign exchange reserves have stopped declining since June and have increased moderately. However, they are still only about 15 per cent of central bank liabilities as opposed to the 20 per cent legally required before suspension of the statute.

Sharp criticism has been levelled at the certificate system because of its impact on the cost of imports. When the system was adopted the Government intended to try it for six months before making modifications. Some changes may be announced in 1958 if the criticism persists until then.

Evidences of currency overvaluation before June

The Indonesian rupiah has been overvalued for some time. At the end of 1952, the free market rate in Djakarta was about 22 to $1 or nearly double the official rate. Since that time, the rupiah has weakened steadily, although not spectacularly. At the end of 1954, it was quoted around 35 to the $1 and at the end of 1956 at about 31 to the $1. The slight improvement over the two years 1955 and 1956 does not represent any real improvement in Indonesia's financial position but merely a tightening of regulations governing currency and capital movements. In 1957, the rupiah has declined further in free markets as the country's exchange crisis developed. In June, the rate in Djakarta was about Rp 42 = $1 while in Hong Kong it was slightly lower, about Rp 45 = $1 U.S.

Although comprehensive price indices for Indonesia are lacking, the limited information on price movements that is available shows some conflicting trends. Food prices rose rapidly from 1954 through the first quarter of 1956 and thereafter first dropped about 18 per cent, due to a good harvest and substantial receipts of aid grain from abroad, and thereafter held reasonably steady for the balance of the year. In the first half of 1957, food prices rose slowly but did not reach the March 1956 high. In contrast, prices of export products rose rapidly in 1955 but in 1956 declined slightly, although a sudden spurt in the final quarter of the year brought the year end level above the average for 1955. Import prices have followed the same general trend, rising rapidly in 1955 and showing some weakness in 1956 until the final quarter. In this quarter, prices of imported foodstuffs rose more rapidly than did prices of non-edible imports. The value of the import price index, however, is questionable since it is unweighted and reflects official rather than actual selling prices in many instances.

In 1957, the price trend of imports has been steadily upward but export product prices have fallen off somewhat. Indonesia's terms of trade worsened considerably up to the exchange reform of June 20.

The quantity of exports in 1956 rose nearly 7 per cent above 1955 but because of lower prices export trade earnings fell nearly 5 per cent in the aggregate. In the first half of 1957, the same pattern of slightly larger volume but lower earnings persisted. Oil exports especially decreased in 1957. There were widespread reports throughout the first half of 1957 that rubber and other products were being stock-piled rather than exported at the unprofitable official rate. A growing amount of rubber was also smuggled with no surrender of the exchange proceeds. Partly to cope with this smuggling, the Government in 1956, permitted a limited volume of barter trade with Singapore. Most of the imports under this program consisted of consumer goods not obtainable under the import licensing system.

A major difficulty in the political struggles between Java and the outer islands at present involves the export and import regulations. The outer area feels that it generates more of aggregate export trade than it has returned to it in the way of imports or development expenditures. Most of this smuggling of export crops has been from the outer islands. Import prices are reported to be much lower there than in the areas of Java where the Government import restrictions have been more effective.

Budget trends

In common with most Asian countries, Indonesia uses a double budget in which current and capital expenditures are kept separate. One problem in recent years has been delay in formulating the budget estimates. Usually they have not been final until well into the fiscal year to which they apply. The budget for 1956 was not in final shape until August of that year while the estimates for 1957 were not submitted to Parliament until August 1957.

There have also been marked differences between budget estimates and actual results. For example, the 1956 deficit, originally estimated at Rp 1.8 billion, actually worked out to be Rp 2.2 billion.

In 1955, the Government had a deficit of 1.7 billion rupiah. This was more than wholly offset by importers' prepayments which amounted to 2.1 billion rupiah during the year. Thus on balance government financial operations did not expand the money supply in 1955. There was, however, an expansion of Rp 1.1 billion or approximately 10 per cent due to private credit expansion and a foreign exchange surplus.

In 1956, the budget deficit was not offset by advance deposits of importers. On the contrary, there was a small decline in these prepayments. Again there was private credit expansion to add to the money supply but offsetting this was a Rp 1.8 billion excess of foreign payments over receipts. Money supply again expanded Rp 1.1 billion or about 9 per cent.

At the end of 1956, Indonesia had a total public debt of just over 19 billion rupiah of which slightly less than 5 billion was external. By mid-1957, this debt had risen to nearly Rp 21.5 billion with virtually all the increase being internal. More than two-thirds of the internal debt is short-term, consisting in the main of central bank advances. The total debt to importers on account of prepayments was just over 3 billion rupiah at the end of 1956. By mid-1957, this obligation had been approximately halved.

The financial position in 1957 is difficult, not only because of the upward trend of government expenditure but also because of the necessity for returning still more of importers' prepayments under the new exchange system. The new system provides for prepayments of only 10 per cent (originally 20 per cent) at the time of applying for import licenses. Central bank credit is being substituted for these prepayments with results that are bound to be inflationary.

Money supply in the first half of 1957 expanded Rp 1.7 billion or 13 per cent in sharp contrast to 1956 when a slight contraction occurred during the corresponding period. With the foreign exchange deficit necessarily curtailed by dwindling reserves, the inflationary impact of the budget deficit is magnified.

The revenue system of Indonesia has little built in flexibility as approximately two-thirds of all taxes are indirect. The major fiscal problem is under taxation of land and agricultural income on which no appreciable progress has been made for a number of years. The only new revenue measure so far enacted to close the budgetary gap has been a head tax on foreign residents in Indonesia. This was aimed largely at forcing Chinese, long resident in the island, to take local citizenship. The tax, effective January 1, 1957, calls for annual payments ranging from Rp 375 for a child to Rp 1500 for the head of a family. Indonesian officials estimated 1 1/2 million foreigners would be affected and the revenue would be Rp 900 million per year. However, other sources doubt the foreign population is this large and point out that many families will be unable to pay these high levies. The revenue actually gained will probably be only a fraction of Rp 900 million.

Defense and security expenditures have been the major factor of increase in budget outlays during recent years. In 1955, these expenditures were put initially at 5.5 billion but actually amounted to 7.2 billion. In 1956, the initial estimate was 8.2 billion but the actual ran somewhat in excess of 8.3 billion. Armed insurrection is fairly widespread in Indonesia and communist agents are active. Thus substantial security outlays are inevitable.

So-called economic expenditures which include the bulk of development plan outlays also rose rapidly in 1956 and accounted for the largest part of the difference between preliminary and actual budget results. These expenditures are scheduled to rise farther in 1957.

The present Government, which assumed office in March 1957, has yet to make real progress toward reducing the budget deficit and lessening the reliance of the Government on central bank credit. On the contrary, the deficit and the need to return importers' prepayments compelled the Government to borrow Rp 6.5 billion from the Bank Indonesia during the first ten months of this year. Thus a larger than normal expansion in money supply is in prospect this year despite the fact that bank credit has been more effectively restrained than last year. Aggregate bank credit to the private sector has actually fallen somewhat in 1957 but this is a result of the return of importers prepayments which were made possible in the first instance by bank credit. For purposes other than import trade, credit has continued to expand. For example, non-trade debt to reporting private banks rose nearly 15 per cent in the first quarter of 1957.

Bank credit expansion

The inflationary impact of budget deficits in Indonesia has been augmented in recent years by expansion of bank credit for both government and private enterprises. In 1955, the increase in advances and bills discounted by the three government banks and the eleven commercial banks dealing in foreign exchange was more than Rp 1 billion. In 1956, the advance was somewhat smaller but was still nearly Rp 700 million. In addition, banks not dealing in foreign exchange expanded loans more than Rp 300 million. In the first half of 1957, aggregate bank credit extended to the private sector decreased somewhat but the decrease was wholly in loans to importers. Nontrade credit continued to rise.

A major factor in the bank credit expansion has been loans to importers to finance the heavy advance deposits and import surcharges. In 1956, these loans to importers increased more than Rp 400 million despite the fact that advance deposits in the aggregate were being reduced.

The central bank in Indonesia does a large commercial banking business which makes it difficult to exercise effective restraint on the other commercial banks. However, the central bank has attempted to restrain credit both to those importers who are its own customers and to other banks who have borrowed from the central bank in order to extend credit to importers. In 1955, the Bank Indonesia provided importers with up to 75 per cent of required prepayments and up to 50 per cent of prepayments plus import surcharges. Early in 1956, these credits were reduced in two stages down to 45 per cent of prepayments or 30 per cent of prepayments plus surcharges. Late in 1956, the central bank stopped lending altogether to foreign exchange banks for financing importers. Despite these restrictions total credits extended to importers by the foreign exchange banks increased by about Rp 200 million during 1956.

In May 1957, the Bank Indonesia imposed for the first time minimum reserve requirements on commercial banks. The required cash reserve is 30 per cent of demand and time liabilities. In addition, banks are required to hold treasury bills equal to 10 per cent of their total cash balances (i.e., vault cash plus balances with the Bank Indonesia). Only private banks with loans outstanding of more than 75 million rupiahs are affected. Government banks and small private banks are exempt from meeting these requirements. While these reserve requirements are clearly a step in the right direction they were not immediately effective in restraining credit expansion because bank liquidity was already fairly high (about 35 per cent on the average) and was being rapidly increased by the return of importers' prepayments and the consequent retirement of bank loans made to finance these prepayments.

So far in 1957, bank credit has not been the active force on the side of monetary expansion that it was in the two previous years. However, the extent to which banks are financing the purchase of foreign exchange certificates for importers is not yet clear. Moreover, there has been a continued increase in industrial loans by banks during 1957.

## Trends in international trade and payments

The background of Indonesia's foreign exchange crisis may be seen both in the progressive loss in foreign exchange earnings and in the rising tide of imports. In 1955, a small surplus on international account was realized. In 1956, however, export shipments were off slightly more than 5 per cent in value despite the fact that the physical quantity of goods exported increased nearly 7 per cent. The principal loss in value of exports was in rubber, which normally accounts for about 40 per cent of foreign exchange earnings, and in which 1956 shipments dropped more than 10 per cent in volume and more than 17 per cent in value compared to 1955. Shipments of tea, spices, tobacco, and sugar also declined in 1956 and these declines were not wholly offset by moderate increases in shipments of petroleum products, tin, and coffee.

On a payments rather than shipment basis, export earnings in 1956 also declined about 5 per cent while payments for imports increased virtually 50 per cent. On a tonnage basis, imports increased about 40 per cent over 1955, while prices also rose. Rice imports were 5 times the volume of 1955. Consumer goods imports rose faster in 1956 than did imports of either capital goods or raw materials. It was primarily merchandise trade responding to strong demand originating in internal inflation, rather than invisibles that accounted for the worsening of the Indonesian balance of payments last year. Invisible payments decreased slightly in 1956 because of restrictions on transfers of earning.

It should be noted that the trade and balance of payments figures include only legal shipments where foreign exchange proceeds are surrendered in accordance with the exchange control regulations. Since an increasing proportion of Indonesia's foreign trade has been moving through illegal channels, this may help to account for the poor record of foreign exchange earnings. It also results in an understatement of imports.

In the first half of 1957, export earnings fell off very rapidly. Applications for export licenses, which are the only reasonably up-to-date measure of export performance, were 25 per cent below the corresponding figure for the first half of 1956.

Export shipments did not decline this rapidly but may well have slumped further in the third quarter. Oil shipments were down sharply in the first half of 1957 compared to the like period of 1956 as were sugar shipments; but rubber shipments did not decline and both coffee and tea shipments increased slightly.

As already noted, applications for export licenses increased substantially but temporarily following the exchange reform. The latest available figure for September is about 20 per cent below the average for 1956. Thus it would appear that when due allowance is made for the lag between export licensing and shipment, 1957 foreign exchange earnings for Indonesia may be anywhere from 15 to 20 per cent below those of last year. Unless these earnings recover to at least the 1956 level there is little prospect that foreign exchange reserves can be rebuilt very rapidly, despite the very sharp restriction in imports since June. Import license applications have dropped to less than 40 per cent of the 1956 average since the exchange reform.

The geographic pattern of Indonesia's exports is interesting; showing in 1956 about 38 per cent of total shipments to other Asian countries and an almost identical percentage to Europe. Shipments to the American area, including Canada, amount to only 16 per cent of the total. In the Asian area, Singapore is Indonesia's best customer but most of the tin and rubber that goes to Singapore is re-exported after further processing. The Netherlands is the best customer in Europe.

On the import side, the principal development in 1956 was a rapid increase in purchases from Japan and other countries of Asia at the expense of a relatively smaller dependence on European countries as sources of supply. The increase in purchases from Japan is striking because payment had to be made currently. In past trade with Japan, Indonesia has accumulated an open account debt of nearly $170 million.

Recently Indonesia has expressed renewed interest in making its trade debt to Japan a part of the eventual reparations settlement with that country.

## Japanese reparations

Indonesia's financial position will be improved if it can make a reasonable reparation settlement with Japan and begin receiving aid from this source. The reparations negotiations have dragged on inconclusively for years but in recent weeks both sides have shown a renewed interest in coming to terms. The latest Indonesian position has been that the country should receive at least $400 million from Japan in reparations over a ten year period. The Japanese, on the other hand, have insisted that any sum in excess of $200 million would require them to reopen their settlement with Burma and to increase their reparations deliveries to that country. The chief possibility for a settlement would appear to lie in some compromise that would make Indonesia's trade debt to Japan a part of the reparations figure.

Japan is anxious to use the leverage it would obtain through a reparations settlement to increase its trade with Indonesia. The Indonesians, on the other hand, want to obtain as large a settlement as possible and have so far been willing to delay negotiations in hope of arriving at a better result. The foreign exchange crisis has undoubtedly increased pressure for a reparations agreement.

## Outlook for the near future

The June devaluation does not appear to have taken Indonesia very far along the road to eventual financial stability. The foreign exchange drain has been stopped temporarily and this is a necessary first step, but the devaluation has not given either sustained or sufficient stimulus to export trade to keep this from lagging badly compared to last year. An increasing proportion of total exports are still being diverted through illegal channels and the Government is at the moment without power to control this situation. On the contrary, the settlements it has made with local Army commanders in the outer islands will merely encourage other groups to bargain for greater independence from Central Government direction.

Stopping the foreign exchange drain has of course intensified the tendency for budget deficits to expand the money supply and to raise prices. The sharp cutback in importers' prepayments has brought an end to the expansion of bank credit, but at the same time has made the financing of the budget deficit more inflationary. No real progress has been made toward cutting current costs of government nor expanding the revenue base. The tax on foreigners is more a political than a fiscal measure.

What is lacking in Indonesia is a strong Central Government with the ability to convince people that it has a consistent policy to deal with the country's financial problems and to promote economic growth. The present cabinet, like its predecessor administrations, is not yet supplying this sort of leadership and may be displaced soon. Until a strong economic program is formulated there is little prospect for other than temporary improvement in Indonesia's financial position. Moreover, such a program cannot succeed until political stability, internal security, and the unity of the nation are restored.

The picture is not all dark. A national economic conference is now in process. Leaders of both the central and provincial administrations are coming together in a sincere effort to reunify the nation by compromising differences. From this conference may come the basis for a more conservative and constructive financial policy in the future.