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INDONESIA HEADING INTO THE CRUNCH

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This update will be distributed in conjunction with last February's paper, which remains a fully valid description of Indonesia's dilemma and prospects. The principal political developments since last winter are positive, but do not decisively resolve Indonesia's financial problems. This update will describe those developments, but concentrate on deepening the previous analysis of the Indonesian situation, which is now a race between extraordinary political virtuosity and inexorable oil-price decline.

Recent developments

Aside from minor personnel shifts, the principal political developments of 1985 are:

1. Widespread acknowledgment of the serious and prolonged nature of the oil price decline, and accurate diagnosis of the nation's options.

2. The taking of initial major steps to facilitate non-oil exports.

3. Military reform on a large scale.

4. Efforts to reform the governing political party, Golkar.

5. Virtual disappearance of the wave of bombings and other disturbances that occurred from September 1984 through January 1985, and simultaneously the ongoing trials of major figures involved with the Tanjung Priok (Jakarta port) riot of late 1985.

1. Consciousness of the oil problem. Acknowledgment of trends which will produce a major crisis is extraordinarily painful for any major institution, even when outsiders see such trends as a foregone conclusion. Banks have difficulty with such acknowledgments, and third world governments have far greater difficulties. Even in 1985, Mexico lost huge oil revenues through resolute unwillingness to face trends in international oil markets; such an attitude is normal. Such acknowledgment is particularly painful in Indonesia, which is less developed economically than most OPEC countries and which knows that such an acknowledgment means drastic changes in a development strategy closely identified with national pride and sovereignty and a statist economic management policy that is regarded as vital to safeguarding pribumi interests vis a vis the Chinese.

What is different in Indonesia is that, prior to a crisis, most of the elite has squarely and openly faced the problem. The president has made speeches about it. The nation's leading economists have petitioned the president for liberalization of trade in response to the problem. And major actions have begun.

2. Early actions to promote non-oil exports. Two and three years ago, Indonesia was successful in avoiding the fate of its fellow OPEC high absorber nations (Mexico, Venezuela, Nigeria) by having the

political will to take more decisive defensive actions than they did: $21 billion of major projects were cut back, the real living standards of civil servants were sent into decline, and fertilizer, rice, and gasoline subsidies were decreased.

During 1985 Indonesian officials took harder looks at their future options than their counterparts elsewhere and began a series of offensive measures. The government, along with many foreign experts, identified the most serious problems as barriers to trade. (Indonesian transportation costs are widely believed to be the highest in the world.) Suharto effectively dismissed his own customs service and turned over its most vital roles to the Swiss Societe General de Surveillance. He abolished protection of the domestic shipping companies. He gave foreign companies access to the government's programs for special treatment of export industries. With World Bank support, he committed to a massive program for the modernization of the ports of Palembang, Panjang, Tanjung Priok, Teluk Bayur, and Pontianak. He reopened trade with China after a 20 year interlude.

As always with Indonesian (and most others') policy changes in such sensitive areas, the results are qualified by reactions to the changes. The customs and shipping reforms have been partially qualified by some new kinds of protectionism. Giving incentives to foreign export industries will have virtually no effect because, under pressure from the U.S. and GATT, the underlying programs are scheduled for abolition in 1986. Port modernization is vitally important, but will take considerable time to implement.

Having made these qualifications, the reforms are nonetheless important financially and extremely important as indicators of the intentions and will of the political elite. These reforms, however limited, are consequential, are offensive rather than just defensive, and demonstrate a will to absorb political pain in the interest of sound economic management that has few peers.

The customs reform had its greatest impact on the port of Tanjung Priok, the site of the 1984 riots in which a couple hundred people were killed. The political risk of such a reform at this time needs no elaboration. Liberalization of shipping at this time is about as easy as a Reagan move to liberalize the U.S. textile industry. Granting foreigners equal access to export industry incentives is a potent political symbol which will upset nationalistic feelings. Opening trade relations with China is personally painful to Suharto, who came to power in conjunction with the assassination of all his closest colleagues by communist coup makers whom Suharto believes to have been guided by Beijing. And the opening comes just a few months after a rash of anti-Chinese bombings and fires has underlined the sensitivity of the Chinese issue.

3. Military reform. Most militaries which have ruled for long periods of time become fatter and lazier with each passing year, especially if they face no early prospect of combat. The Indonesian military, on the other hand, has undergone almost continuous upgrading and reform. In the last decade, the size of the Indonesian

army has been reduced by about 100,000 men, the number of generals has declined from 500 to about 200, and the official military budget now consumes only about 2.3% of GNP. (The U.S. spends 6% of GNP; it is rare for a country to spend less than 4%. Indonesian military units supplement their budgets by engaging in business.) General Jusuf had a reform drive in the late 1970s. In 1983, President Suharto replaced the top 60 generals to make way for a fresher generation. In 1985, General Murdani has simplified the organization of the army, reduced the roles of the navy and air force, promoted efficiency and professionalism, and, as an old intelligence man, redesigned the whole appartus to be receptive and responsive to local-level intelligence.

These reforms head in exactly the opposite direction of Philippine trends; the Indonesian reforms tend to create a more professional, more durable, more effective institution. The emphasis on intelligence is vitally important; in a guerrilla war, the only kind the Indonesian army is likely ever to fight, intelligence is all.

4. Golkar reform. Soedarmono has launched a campaign to make the governing party a more professional organization, with more schooling for senior officials and a formal cadre system. Whether this will be as consequential as the military reforms remains to be seen.

5. As reported in February, the period September 1984 to January 1985 had seen one of Indonesia's periodic outbreaks of violence. The Tanjung Priok riot was a major event, and the subsequent fires, bombings, and assassinations (the latter not as widely publicized) bespoke considerable tension. Subsequently, the government put on trial a number of leading dissidents, including a well-known Muslim preacher and a former secretary general of ASEAN, whose trials are still controversial.

In the meantime, the rash of violent incidents has completely ceased. The following is a complete list of notable violent incidents in recent months:

May: 3 communists, imprisoned since 1968, are executed.

July: Several violent clahes in Timor kill 30-35 soldiers.

July: Fire destroys government radio station.

This underlines once again the fact that Indonesia goes through cycles of violence and calm, and that one must not overinterpret either the violence or the calm.

When one analyzes these recent political developments, the trend is decisively positive. Suharto continues to build a nation, just as decisively as Marcos continues to tear one down. The politics of the economy introduces more sweeping and more successful reforms in any year than Reagan attempts in two presidential terms.

The Underlying Situation

These reforms, however, are not necessarily going fast enough to overcome in the next 18 months the consequences of declining oil prices. And the government has not announced an overall program adequate to generate compensating non-oil exports. Maybe Suharto will surprise the world time after with decisions like the customs reform, and maybe the decisions will prove sufficient. But Javanese politicians like to keep people guessing, so we will not know until it happens. For bankers, this is disquieting.

The fundamental situation therefore remains the one analyzed in the February report, with unpredictably auspicious political developments balanced by the expected bad news on the oil price.

Not knowing Suharto's agenda, one can only watch the fundamentals. Many of those fundamentals have been spelled out -- in the February report and above. The nation has extraordinary natural resources, an extraordinarily forward-looking government, and a broad base of international support. It is also extraordinarily primitive in many ways (estimates of rural per capita income run as low as $75 per year), dependent on oil income, and ridden with political interference in the economy. (Indonesia probably has as much graft as the Philippines and more monopolies; the difference is that Indonesia is improving rapidly from a low base, whereas the Philippines is declining rapidly from a formerly high base.)

On balance, Indonesia is fairly well equipped to weather a storm. In a country with such poverty, the key to social stability is an adequate supply of cheap rice. Suharto has emphasized plentiful, cheap rice above all else, and the Bulog granaries have an embarassment of rice. Suharto can squeeze and squeeze in other areas so long as he maintains such a rice policy, and he seems to be in a position to do so.

Furthermore, Indonesia's basic economic policies have created a strong agricultural base. By keeping inflation moderate, by retaining near-market interest rates, by limiting taxation of exports, and by protecting the agricultural sector only modestly against foreigners, the Suharto regime has fostered agricultural growth a typically rapid for low and middle income countries. Agricultural exports have been quietly growing about 10-11% per year and could grow a great deal faster, even in difficult times.

Industry and industrial employment, on the other hand, are the regime's critical weaknesses. Many reform proposals are about, but the regime's concentration on petroleum and heavy industry, and its protectionism and red tape, have discouraged light industry and failed to provide the nearly two million jobs needed each year to employ the growing workforce. The financial books will not balance without fundamental reforms in this area; none have been announced, and when announced they will take time to produce results.

Conclusion

Indonesia is headed, once again, into a squeeze. When an irresistible force, like declining oil prices, meets an immovable object, like Suharto's brilliant management, the short-term results are unpredictable. Indonesia may need a rescheduling; it may not. In today's world, that is an unsettling uncertainty and requires conservative management.

The longer-term results are more predictable. Countries governed like Indonesia are the kinds one wants to be associated with over the longer term. Ultimately, that determination to reform and develop, even at the cost of considerable political pain, is the vital quality. If Indonesia gets into difficulty, its chances of coming out of the difficulty stronger than ever are excellent.

There is a small but significant risk (perhaps 10%) that a period of financial difficulty could coincide with a period of decline in Suharto's health and in his regime's flexibility. That could turn a cash flow problem into something more closely resembling an insolvency problem. This kind of coincidence has happened often enough that one cannot ignore it, and Suharto is not a young man. But on the fundamentals of sound management, Indonesia remains light years ahead of Mexico, Nigeria and the Philippines, and its chances of insolvency are correspondingly reduced.

This calls for tactical caution to minimize risk in the portfolio until the trend of events becomes clearer. But it also calls for determined efforts to protect and consolidate a position from which strategic expansion will be possible later.