L.5.2 RFD 278

Board of Governors of the Federal Reserve System

Division of International Finance

REVIEW OF FOREIGN DEVELOPMENTS

November 13, 1956

Unsuccessful Stabilization Attempt in Indonesia 11 pages

Yves Maroni

NOT FOR PUBLICATION

November 13, 1956

Unsuccessful Stabilization Attempt in Indonesia

Yves Maroni

The first significant attempt to bring about internal financial stability in Indonesia since the start of World War II was made in September 1955 and can now be said to have failed. Foreign exchange taxes were raised, some cutting of public expenditures was initiated and an effort was made to substitute non-inflationary financing for borrowing from the Central Bank in covering the remaining deficit. While the initial results were favorable, measures subsequently adopted ran counter to the main purposes of the program. Credit policy was loosened and the effort to cut public expenditures was thwarted by an increase in civil service salaries and the rebuilding of depleted Government rice stocks. The budget deficit remains as large as ever and, in recent months, much of this deficit has again been financed by the Central Bank. Bank credit is expanding rapidly and reliance on import and exchange restrictions and on a complex system of multiple exchange rates to maintain external balance has not diminished.

This failure can perhaps be ascribed in large measure to the magnitude of the dislocations wrought by 15 years of inflation and the resulting difficulty of changing overnight patterns of behavior firmly embedded in many sectors of the society. Indonesian society was apparently not prepared to accept the readjustments needed to restore internal financial stability. The developments of the last twelve months suggest that success requires a much more sustained effort than was evidently brought to bear in this case.

This paper will discuss the stabilization program in the light of an analysis of the inflationary forces at work, particularly as they have affected the country since 1950.

The inflationary forces

Indonesia has been subjected to inflationary pressures almost continuously since the beginning of the second world war. War dislocations and destructions and postwar revolution disrupted production and trade and created exceptional demands on the Treasury which added to the liquidity of the economy while the supply of goods and services remained severely limited. Although a currency reform in 1950 restored the relationship between money supply and prices to something like what it had been before the war, inflationary forces continued to operate in the economy. Since 1950, money supply has approximately tripled and so have the available indices of food prices and the index of the cost of living in Djakarta.

Budget deficits

Large and persistent budgetary deficits, heavily financed by Central Bank advances, have been the principal cause of inflationary pressure since 1950. Deficits have been incurred every year except in 1951. Total expenditures have increased rapidly because of heavy and rising outlays for defense and home affairs associated with the drive to establish law and order in the far flung islands, a steady expansion of Government activities to promote economic development, and large and growing personnel costs resulting from the excessive number of public employees and the successive pay increases granted them in recognition of the rising cost of living. While revenues have also increased, they have failed to catch up with the advancing level of expenditures except in 1951. In that year, a very large increase in receipts from customs duties and foreign exchange taxes, as a result of the Korean boom in raw material prices, brought about an unplanned surplus which disappeared when the boom collapsed.

Central Bank advances to the Government have been the principal source of financing for these deficits. With the exception of 1951, when the budget surplus made it possible to reduce them by 1.4 billion rupiahs, they rose steadily from 1,352 million at the end of 1949 to 9,834 million rupiahs at the end of June 1955. In fact, they would have risen about 2.4 billion more, had it not been for the "profit" on revaluation of gold and foreign exchange holdings following the 1952 devaluation of the rupiah. This "profit" was credited to the Government and used to reduce the advances previously received from the Central Bank.

Central Bank advances and the revaluation profit together financed nearly eighty per cent of the total deficit incurred from the beginning of 1950 to mid 1955. The balance was raised mostly through forced loans consisting of the following: (a) an issue of long term bonds given to the public at the time of the 1950 currency reform in exchange for half of the currency being turned in and half of their deposit balances; (b) the accumulation of arrears on the open account agreement with Japan in 1951 and 1952 (the amount being consolidated in August 1952); and (c) the requirement introduced in August 1952 that importers make advance payments on their purchases of foreign exchange, the amounts so collected being credited to the Government subject to refund upon arrival of the imports and actual purchase of the foreign exchange. Recurring amounts were obtained from importers' prepayments by progressively raising the percentage to be prepaid and by moving the date on which prepayment was due to an increasingly early stage in the process of securing the desired foreign exchange.[1]

The balance of payments

Since 1950, the balance of payments has also been an intermittent source of inflationary pressure. The Korean war boom in raw material prices brought about surpluses on current account in 1950 and 1951; Indonesia's gold and foreign exchange reserves rose by $310 million in these two years. The budgetary surplus of 1951 offset only partially the inflationary impact of the balance of payments surplus incurred in that year.

With the end of the Korean raw material boom, export earnings declined sharply in 1952 and continued at a reduced level in 1953 and the first half of 1954. Import demand remained high, however, as a result of the high incomes of the previous boom years and was prevented from declining by the reappearance of large budgetary deficits. A large balance of payments deficit ensued; the gold and foreign exchange holdings declined by $354 million between the end of 1951 and June 30, 1954.

While the balance of payments deficit drained off some of the new money being created by the budgetary deficits, the loss of international reserves could not be allowed to continue indefinitely. Consequently, the authorities undertook to bring it to an end by tightening import and exchange restrictions and by modifying several times the system of multiple exchange rates, particularly import rates. These measures, the first of which were adopted in August 1952, resulted in slowing down the drain on reserves, but they also reduced the supply of goods available in the country and forced the domestic economy to bear an increased share of the inflationary pressures associated with the chronic budgetary deficits.

In the second half of 1954, raw material prices, and particularly the price of rubber, turned upward; as a result, the Indonesian balance of payments began to show a surplus. Gold and foreign exchange holdings rose by $91 million in the last half of the year and by another $59 million in 1955, in spite of a substantial relaxation of import restrictions in September 1955. In this period, the balance of payments was adding to the inflationary pressures generated by the budget deficits.

1/ The percentage, initially set at 40 per cent, was raised to 75 per cent in April 1953, reduced on certain imports to 50 per cent in October 1953, but raised again to 75 and 100 per cent in July 1954. The due date was originally the date on which the license to purchase foreign exchange was granted. As part of the stabilization program here under discussion, it was moved in September 1955 to the date on which the application for an import license was filed.

Bank credit

Inflationary pressure has also been generated by an expansion of bank credit to the private sector,[1] particularly in 1950 and 1951 and to some extent since October 1954. The amount of such credit outstanding, which represented only about 20 per cent of bank deposits at the end of 1949, doubled in 1950 and then tripled in 1951. The defacto devaluation of the rupiah in March 1950 and the almost simultaneous currency reform brought about a recovery in economic activity which called for increased credit. The currency reform also reduced the extent to which enterprises could use idle balances for self financing and as a result further increased the demand for credit. An even more powerful stimulus came from the inflated demand for imports associated with high incomes due to the raw material export boom of late 1950 and 1951. Rising costs of production also necessitated increased credit to carry on productive activity. Finally, inventory accumulation became rather widespread in 1951, particularly in the sugar industry, further adding to the demand for credit.

The banking system had ample liquid reserves to meet these demands, since sixty per cent of bank funds at the end of 1949 were held on deposit at the Central Bank and in the form of short term Treasury bills. Moreover, these reserves were bolstered by the 1950 budget deficit and the 1950-51 balance of payments surplus. Nevertheless, by the end of 1951, bank credit to the private sector nearly equaled bank deposits.

The collapse of raw material prices, in late 1951 and particularly in 1952, induced increased caution on the part of the banks. At the same time, costs of production became more stable and the attractiveness of inventory accumulation largely disappeared. The reappearance of a heavy budgetary deficit, financed primarily by borrowing from the Central Bank, brought about new additions to money supply which the balance of payments deficit absorbed only partially. The resulting increase in liquidity enabled the public to finance its needs for funds without further increasing its demand for bank credit in 1952. As a result, bank credit did not rise significantly after the third quarter of 1951.

Relative stability of bank credit continued for the ensuing three years, partly as a result of the progressive tightening of import and exchange restrictions, a corollary of which was a lower demand for credit to finance imports. These restrictions were supplemented in April 1953 by a Central Bank request to the commercial banks not to increase their advances to importers beyond the level of March 31, 1953.

1/ Excluding bank credit to semigovernment institutions, which fluctuated irregularly and somewhat independently of credit to purely private enterprises and individuals.

This request was made as the prepayment requirement imposed on importers was being raised from 40 to 75 per cent of the rupiah equivalent of the foreign exchange applied for. Its purpose was to make sure that the rise in the prepayment requirement would not be circumvented through bank borrowing. As it turned out, bank credit to importers, which had shown some tendency to rise through the first quarter of 1953, thereafter declined steadily for 18 months.

Bank credit expansion was resumed in the fourth quarter of 1954 when import restrictions were somewhat relaxed and credit extended to importers turned upward. This rise gathered momentum in 1955, partly as a result of the opening in January and February 1955 of two new banks which were not subjected to any credit ceiling until September 1955. Moreover, ceilings on credit to importers were abolished in October 1955, as a part of a policy of further relaxing restrictions on imports.

The 1955 rise in prices of some export products, especially rubber, led to some increase in demand for credit by certain exporters, while other exporters required increased credit to carry larger inventories of such products as tea, coffee, and copra the prices of which fell. Increased credit was also required by industry in connection with the establishment of several new plants and the expanded activities of plants already in existence and by plantations, sugar mills, and coconut oil processing plants which experienced wage increases and transport difficulties. As a result of all of these factors, bank credit outstanding rose 55 per cent from September 1954 to September 1955.

The stabilization program

A new cabinet came into power in August 1955 with a mandate to lead the country through its first general elections and until the newly elected parliament would meet in March 1956. In spite of the caretaker status thus conferred upon it, this cabinet in September adopted vigorous measures to restore financial stability. The stabilization program was designed (a) to reduce the budget deficit, which was identified as the principal source of continuing additions to liquidity, (b) to eliminate the need for inflationary financing of the remaining deficit, and (c) to increase the supply of goods, which had been held down by severe import and exchange restrictions only slightly relaxed a year earlier.

To reduce the budget deficit, sharp increases in foreign exchange taxes were made and some pruning of expenditures was undertaken. To eliminate the need for inflationary financing, importers' prepayments were raised and an earlier due date was adopted.[1/] To ensure effective sterilization of the funds thus collected from importers, the banks were required to transfer them immediately to the Bank Indonesia instead of being allowed to hold them as had been the case previously, and the Bank Indonesia was instructed to apply them in reduction of its outstanding advances to the Government. To increase the supply of goods, import restrictions were relaxed and the credit ceilings were abolished.

These measures came at a time when the liquidity of the public was impaired by a partial failure of the previous rice crop and open market sales of rice from Government stocks to avert famine. The rice sales brought total cash collections of the Government in the third quarter above total cash outlays. Cash outlays simultaneously fell off somewhat due to a temporary saturation of the administrative machinery which slowed down the process of paying Government bills. It is true that, in this period, bank credit and the reserves of gold and foreign exchange were increasing, but this did not fully offset the contraction generated by Government operations and by a rise in non-monetary liabilities of banks. As a result, money supply had temporarily, and perhaps fortuitously, turned mildly downward when the new measures took effect.

Under these conditions, importers found it difficult to pass the increases in foreign exchange taxes on to the public, or to raise the stiffer prepayments by calling on wholesalers, retailers, or the public to back up their purchase orders with higher downpayments. The additional taxes had to be absorbed largely by importers whose profit margins had been inflated under earlier conditions of ample liquidity and severe import restrictions. The obligation to pay higher taxes and above all the increase and acceleration of the prepayments produced a major credit squeeze. To raise the necessary funds, importers, and the wholesalers financing them, began selling accumulated inventories which they had held for speculative purposes. Inventory liquidation soon spread in the knowledge that the relaxation of import restrictions ensured an increased supply of imported goods in the near future. Prices of such goods fell by 27 per cent in the three months ended November 30, 1955. Since the new foreign exchange taxes bore more heavily on luxury goods than on essential commodities, a shift in the pattern of imports away from luxury goods and toward more essential goods followed.

1/ The prepayment required had been 75 per cent of the foreign exchange applied for in the case of some imports and 100 per cent in the case of the rest, and the due date was the date on which the license to purchase the desired exchange was granted. The prepayment was raised to a uniform level of 100 per cent for all imports, plus all foreign exchange taxes which would be payable on the imports involved, including, for foreign importing firms only, a sum of at least 5 million rupiahs which such firms were required to maintain on deposit at all times. The due date became the date of filing the application for the import license.

In the fourth quarter of 1955, importers' prepayments yielded the Government more than 2 billion rupiahs. Much of this appears to have come from idle balances, inventory liquidation, and the continuing expansion of bank credit. In October and November, when the prepayments yielded about 1.5 billion rupiahs, money supply fell by 525 million rupiahs while bank credit to the private sector (including semi-government institutions) rose by 360 million. Foreign assets increased by 330 million, and non monetary liabilities of banks declined by 140 million. As shown in table I below, it appears that the Government was running a cash deficit of about 150 million rupiahs in October and November. Complete data on

Table I

Monetary Contraction in Indonesia
in October and November 1955
(In million rupiahs)

Decline in money supply		525
Known factors accounting for expansion		
Increase in bank credit to private sector	360	
Increase in foreign assets	330	
Decrease in non-monetary liabilities of banks	140	
		830
Net contraction originating in Government sector (derived)		1,355
Increase in importers' deposits for prepayments (approx.)		1,500
Apparent Government cash deficit (residual)		145
financed by=Increase in circulation of Government currency	50	
Estimated excess of prepayments received (1500) over reduction of Govt. debt to central bank (1420)	80	
Increase in Government cash balances (derived)	15	
		145

Government financial operations are not available for periods less than a full quarter. However, it is known that the Government reduced its indebtedness to the Central Bank by 1,420 million rupiahs between September 30 and November 30. Thus, about 80 million rupiahs of the funds raised from importers under the prepayment requirement was available to finance the cash deficit. Another 50 million rupiahs was derived from an increase in the Government currency issue and the balance presumably came from drawing down of cash balances.

Failure of the program

The success of the stabilization program was short lived. Even as it was having its most notable results, the authorities weakened it by adopting further measures which ran counter to its avowed purposes. Credit policy was loosened and the budgetary position was allowed to deteriorate.

The loosening of credit policy apparently resulted from inability to withstand the pressures generated by the readjustments which the program induced. The squeeze on importers produced increased demands for bank credit and, together with the regulation requiring banks to transfer the prepayments to the Bank Indonesia, brought about a rapid decline in bank liquidity. The banks reacted by attempting to tighten credit extended to industry and agriculture so as to maintain import financing. In October, they raised their margin requirement on import letters of credit to 60 per cent. In the belief that lack of credit was threatening the internal supply of goods, the Bank Indonesia abolished the ceilings which had limited credit to importers and undertook to provide credit to the banks.

It gave those banks whose balances with it were entirely depleted the opportunity to borrow from it against promissory notes up to 40 per cent of the amounts deposited by them with the Foreign Exchange Fund on account of import financing, provided the borrowed funds would be used to finance the importers' prepayments. The small "national" banks received special rediscounting privileges against paper resulting from the activities of "national" importers. In addition, the Bank Indonesia undertook to grant rediscount facilities to banks against export paper and against paper originating in activities involving a saving in foreign exchange expenditure.

Available statistics do not reveal to what extent these facilities were used. However, bank credit increased by nearly 30 per cent between September 1955 and the end of June 1956, when it stood at a level approximately twice that of 21 months earlier.

Not only did credit policy thus create a loophole in the stabilization program, but in addition the budgetary position soon began to deteriorate. As early as December 1955, the efforts to cut expenditures were thwarted by salary increases granted to civil servants and by some rebuilding of Government rice stocks. Later, Government collections from foreign exchange taxes declined as the pattern of imports shifted away from the more heavily taxed luxury goods and toward the less heavily taxed essential goods. Net collections from importers' prepayments dwindled as it became necessary to make heavy payments from the accumulated funds with the arrival of the imported goods.

No plan existed to tap permanent non-inflationary sources of revenue to replace these temporary resources, representing in effect a forced loan from the importing community. Instead, in April 1956, the Government lowered the prepayment requirement on imports of industrial raw materials,[1] and the prepayment account became a net drain on the budget. This drain continued into the third quarter of 1956 as stiffer screening of import license applications resulted in increased rejections and hence speedier refunds. It reached a peak when the import license office closed down during August while administrative procedures were being overhauled. The budget deficit rose in 1956 and inflationary methods of financing were again used. Central Bank advances to the Government increased by 460 million rupiahs in the second quarter and by another 1.3 billion in the third quarter of 1956.

The collapse of the price of rubber in the early part of 1956 brought about a reversal of the balance of payments; the gold and foreign exchange holdings fell by $138 million in the first seven months of the year. While this drain on reserves served to offset the expansionary impact on the money supply of the rise in bank credit and the reappearance of the budget deficit, it could not be allowed to continue indefinitely. The Government undertook to stop it first by stiffening the screening of import license applications. Then, in August and September, the Government twice altered the already complex system of multiple exchange rates, in effect carrying out a partial devaluation and a proliferation of rates. To tide over the situation until these changes began to make themselves felt, Indonesia drew $55 million from the International Monetary Fund on August 2, after repaying an earlier drawing of $15 million in June.

Two politically inspired developments also contributed to reduce the external deficit of Indonesia. One was the repudiation by the Indonesian Government of the debts to the Netherlands which it had assumed upon acquiring undisputed sovereignty over the country in 1949, thereby saving about 100 million rupiahs (about $9 million) annually on the servicing of these debts. The other was the unilateral reduction by two thirds of the pension payments to former Netherlands Indies civil servants, which the Government brought about by repudiating the guarantee of the guilder value of these pension payments and adjusting them to the official rate in effect since the formal devaluation of the rupiah in 1952.

The minimum statutory reserve requirement against the Central Bank's demand liabilities had to be suspended in July 1956. However, from the end of August to mid-October, reserves rose by about $22 million and the suspension has now been revoked.

1/ On imports of raw materials, the prepayment required at the time of applying for an import license was made equal to the amount of foreign exchange taxes payable or (where no such taxes were applicable) to 50 per cent of the c. and f. value. The balance of the prepayment was made payable at the time the foreign exchange license was granted. Since November 16, 1955, the prepayment required of "national" importers for imports of raw materials had been only half of the full requirement.

The new exchange system, which embodies higher foreign exchange taxes on many goods, will affect the budgetary position in two ways. On the one hand the higher taxes should yield increased revenue, but on the other the lower imports resulting from these taxes and from the administratively imposed restrictions will cause current refunds of importers' prepayments upon delivery of the goods to exceed new collections for a time. It is too early to assess the net result of these opposing changes on the budget.

Conclusion

The Indonesian financial position continues to be precarious. The budget deficit has not been eliminated in spite of the stabilization program of September 1955 and inflationary financing was again used in the second and third quarters of 1956. There appears to be little hope of abandoning its use in the near future. Bank credit, which had been relatively stable for the three years ending in September 1954, has been expanding at an excessive rate in the last two years. The balance of payments was again in deficit in the first eight months of 1956 and the loose budget and credit policies have made it necessary once more, in attempting to stop the drain on reserves, to rely on variations in the intensity of import and exchange restrictions and in the complexity of the system of multiple exchange rates.

Balancing the budget would seem to require heroic measures. The size of the civil service is excessive and needs to be reduced. However, this may be politically impossible so long as equally attractive alternative opportunities for employment are not available. Political instability in the country adds to the problem since it requires that heavy expenditures on defense, home affairs, and justice be made every year. The establishment of internal security and of the rule of law throughout the islands would permit large reductions in expenditures which are not now possible, and would open the way for a large increase in productive activity.

Bringing the expansion of bank credit down to a rate consistent with the growth of the economy appears to call for good judgment, the willingness to act, and the ability to withstand the pressures which adoption of such a policy is sure to generate. The Bank Indonesia has all of the powers needed to implement this policy. Its basic statute which took effect in 1953 enables it to influence domestic credit through its discount policy and open market operations. An ordnance of January 15, 1955, gives it the power (a) to fix minimum reserve requirements for commercial banks and to specify the form in which these reserves shall be held, (b) to impose credit ceilings either on specified types of operations or on an overall basis, (c) to prohibit certain types of credit operations, (d) to fix minimum and/or maximum interest rates chargeable by banks, (e) to license banks and prescribe the conditions under which they may operate, (f) to require the submission of such data as it may need, and (g) conduct examinations of books and records of banks.

It is true that discount policy may be ineffective insofar as most large banks are branches of foreign banks and have ready access to foreign money markets,[1] and that open market operations are presently impossible in the undeveloped Indonesian money market. However, judicious imposition of minimum reserve requirements, or preferably of credit ceilings, would greatly influence the amount and type of credit outstanding. While it would not be easy to estimate the legitimate needs of the economy for additional credit at any particular time, given the uncertainties of Indonesian economic life and the unreliability of statistics, this would not be impossible and the result might be better than the unregulated expansion of credit of the last two years.

There is no simple solution to the balance of payments problem. The 1956 deficit is largely due to the decline in world prices for rubber, Indonesia's principal export. However, it would be neither as large nor as intolerable from the standpoint of the level of reserves, were it not for the fact that the demand for imports is inflated as a result of the loose budget and credit policies and the shortages built up by tight import and exchange restrictions in effect between August 1952 and September 1955.

While it is important to devise ways and means of minimizing the impact on the Indonesian economy of fluctuations in world prices for raw materials which Indonesia exports, it is even more urgent to strengthen the external position of the country by eliminating the inflationary pressures originating from within. This might be the first step toward adopting a policy of deliberately countering the pressures generated by the fluctuations of the balance of payments through fiscal adjustments and measures to influence credit. Such a policy need not be spelled out here. While it would require difficult adjustments in the economy, it offers the best hope for Indonesia until the country's great economic potential can be developed and its dependence on a few raw material exports can be reduced through diversification.

1/ The Bank Indonesia rates of interest on discounts and advances vary from 3 to 6 1/2 per cent, depending on the collateral. The foreign banks are Dutch, British, and Chinese. The Netherlands Bank rate is currently 3 3/4 per cent, while the Bank of England rate is 5 1/2 per cent.