DEPARTMENT OF THE TREASURY

WASHINGTON. D.C. 20220

ASSISTANT SECRETARY

1 - Executive Director
2 - Permanent Office Copy

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Dear Mr. Fried:

On November 15, the World Bank Board of Executive Directors will be considering a proposed $65 million loan to Indonesia (see Annex A for a summary of the loan and project). Since 23 percent of this loan ($15 million) will be used for the expansion of the oil palm planting program of a Government-owned estate group, we have reviewed and analyzed this loan very extensively.

The reasons why this loan has received such extensive review and examination are obvious. Sec. 901 of PL 95-118, which became effective October 3, 1977, requires the United States to:

> "oppose any loan or other financial assistance for establishing or expanding production for export of palm oil, sugar, or citrus crops if such loan or assistance will cause injury to United States producers of the same, similar, or competing agricultural commodity."

Additionally, President Carter has instructed you to oppose and vote against any loans for the production of palm oil, sugar, or citrus crops "where such production is for export and could injure producers in the United States".

<u>Project Description</u>

The project is intended to assist 5,750 settler families in increasing their present per capita income of $50 to approximately $80 in the third year of the project, and to approximately $160 by 1990. The project is also expected to create about 11,500 permanent jobs among the rural target population at the rate of two jobs on each smallholding at a cost of about $2,450 per job compared with $5,800 in small industry and $15,500 in large industry. In addition, 4,000 casual laborers would be employed in rubber development for four to six months each year.

In an attempt to diversify the economy, approximately $15 million of the total $65 million will be used to develop 5,000 ha. for oil palm plantings in the next five years and to add some processing facilities when the planting program is completed. In all, this loan will increase Indonesia's production of palm oil by 19,000 tons, or by approximately 4.2 percent of current (1976) production.

Will the Palm Oil Be Exported?

Indonesia presently exports about 85 percent of its palm oil output with local consumption mainly in the form of soap, detergents and edible fats products. Since the early sixties, palm oil production in Indonesia has grown at an average rate of 7.7 percent a year and the combined output of palm oil and palm kernel oil is estimated to reach 1.2 million tons by 1990. This increase is based on a projected area increase of about 4.5 percent a year over the next 13 years.

Although the oil palm is the most efficient producer of vegetable oil, the majority of Indonesians prefer an unrefined cooking oil made from coconuts which has a characteristic flavor and odor. Yet, while Indonesia's population has grown rapidly, coconut production has expanded quite slowly because of the increasing proportion of over-aged coconut trees and the long gestation period of the government's current replanting program will not be felt until the late 1980's and consequently coconut oil production in Indonesia is projected to increase at an average annual rate of 3.7 percent -- from 530,000 tons in 1976 to about 880,000 tons in 1990.

During the same period, the demand for vegetable oils in Indonesia is expected to grow at an average annual rate of 5.6 percent from 710,000 tons in 1976 to 1.6 million tons in 1990. This increase will result from Indonesia's overall increase in population and an expected increase in per capita consumption of 5kgs in 1976 to 9kgs in 1990 primarily as a result of the modest growth in per capita incomes.

An analysis of this supply and demand outlook for vegetable oils in Indonesia has led World Bank economists to conclude that palm oil will over time replace a large share of coconut oil for domestic consumption since it is significantly cheaper. By 1990, the gap between estimated consumption requirements for all vegetable oils and the available supply of coconut oil will be 720,000 tons. This very large internal residual demand will have to be met by palm oil.

To put it in other terms, Indonesia's domestic consumption of palm oil, which now amounts to only 11 percent of production, will account for about 60 percent of production by 1990. Since the oil palm planting being financed by this loan will be in South Sumatra, which is the nearest area of oil palm production to the main consumption centers in Java, the likelihood is strong that most if not all of the production involved in the loan will be for domestic consumption rather than export.

Will the Production Cause Injury to U.S. Producers of a Competing Commodity (Soybean Oil)?

Nevertheless, if we accept the unrealistic assumption that the palm oil from this project will be exported and that it will be exported in whole or in part to the United States, then will there be injury? The test of injury is a somewhat difficult one to administer but the Trade Act of 1974 (PL 93-816) provides some criteria for measuring serious injury. These include, first, a significant idling of productive facilities in the industry, the inability of a significant number of firms to operate at a reasonable level of profit, and significant unemployment or underemployment within the industry. Secondly, the measures include a decline in sales, a higher and growing inventory and a downward trend in production, profits, wages, or employment (or increasing underemployment) in the domestic industry concerned, and finally an increase in imports (either actual or relative to domestic production) and a decline in the proportion of the domestic market supplied by domestic producers also are measures.

Because the impact would be primarily on individual farmers, the appropriate tests appear to be the impact on domestic U.S. prices of soybean oil and the level of palm oil imports. Palm oil is not a perfect substitute for soybean oil because of some undesirable characteristics and will be substituted only if the price drops more in proportion than does the price for soybean oil. Palm oil is a close substitute for about two-thirds of the market for soybean oil in the United States.

Using projected future price trends, the models designed by both USDA and IBRD project lower prices in the future for palm oil. The USDA model, assuming a continuation of current per capita income growth rates and trade policies, projects a price in 1985 (1975 prices) 17 percent below the 1975 level (an unusually high year); the World Bank's projections show a price of about 9 percent below that level.

Soybean oil prices are projected by USDA (1975 prices) to decline 10 percent by 1985 and they are projected by the IBRD to fall 15 percent in the same period. Taking the very worst projection of the two -- the 7 percent greater decline in palm oil than in soybean oil -- the difference would not result in significant substitutions of palm oil for soybean oil.

The decline in prices is projected on the basis of worldwide increases in supply relative to demand and the fact that the increases in demand are not expected to keep pace with the increases in income. Moreover, these projections include planned future increases in production to the extent known by the Treasury Department based upon information collected from all international institutions.

In 1976, Indonesia was the second largest producer of palm oil producing 450,000 m.t.; this amount represents 1.4 percent of world vegetable oil production of 30,151,000 m.t. In the same year, Indonesia exported 400,000 m.t. or about 20 percent of the international traded palm oil (2,005,000 m.t.) and 2.6 percent of total world exports of vegetable oils (615,295,000 m.t.). Approximately 89 percent (400,000 m.t.) of Indonesia's production in 1976 was exported.

In 1976, imports of palm oil into the United States were approximately 352,000 m.t. compared with 436,000 m.t. in 1975. Estimates for 1977 indicate the figure to be around 300,000 m.t. Imports in 1974 were only 187,000 m.t. Malaysia has been the major supplier over the past 2 years contributing 325,000 m.t. in 1976 and 368,000 m.t. in 1975. In contrast, Indonesia has contributed only 13,530 m.t. in 1976 (4 percent) and 30,158 m.t. (7 percent) in 1975 to U.S. imports. Thus, Indonesia has not been a significant supplier to the United States.

Using the above information, two different cases can be constructed to estimate whether U.S. farmers may suffer any injury in the future from the additional production of 19,000 tons of palm oil in the early 1980's that this loan will make possible.

<u>Case I</u>

Market impact estimates done by Treasury's Commodity Division indicate that imports of 45,000 tons would make approximately a $0.01/lb. change in the market price for palm oil all other things being equal, that is, the demand for palm oil is estimated to be highly price inelastic. Currently, palm oil is selling for approximately $0.20/lb. and soybean oil for $0.19/lb. Therefore, even if all other projections were wrong and the entire 19,000 tons from this project were exported to the United States, an outcome highly unlikely on the basis of past trends and future internal requirements in Indonesia, the price for palm oil would decline from $0.20 to $0.196/lb. or four-tenths of a cent. Soybean oil prices could drop by $0.003/lb. to $0.187/lb.

Case II

In constrast, if a less extreme but still unlikely case is assumed, i.e., if the Indonesians were to export 80 percent of the project's output (15,200 m.t.) and 10 percent of it were to come to the United States, U.S. imports as a result of this project would total 1,520 m.t., an insignificant amount -- half of one percent of estimated 1977 imports -- that is not likely to effect U.S. prices in any measurable way.

Moreover, there is the question of third markets. Most of Indonesia's exports are now directed toward other world markets where its palm oil competes with U.S. exports of soybean oil. Although the addition to Indonesia's exports from this project are small (14,000 m.t.) in comparison to total supply, there would be some additional competition as a result of this project.

Third market consumption of fats and oils totaled 41 million m.t. in 1976 increasing at a rate of 1.2 million m.t./year. Since the output of this project is already included in USDA and IBRD's projections, there is no additional impact on prices but, if it were not the impact would be minimal. On the basis of an additional 14,000 total availability of vegetable oil supplied would increase only .03 percent. Additional supplies of this amount would not be expected to cause more than a .1 to .2 percent decline in prices for palm oil and other closely competing products such as animal fats and soybean oil (price elasticity is assumed to be -.2).

Effect on U.S. World Market Share

The economic calculations cited above show that injury would be insignificant even on the basis of worst case and completely unrealistic assumptions.

In fact the appraisal report suggests that little if any of the palm oil production resulting from this loan will be exported and that in any event, Indonesia's total exports of palm oil over the next ten to fifteen years will not keep pace with the increase in world exports of vegetable oils.

The vegetable oil supply and demand balance in Indonesia indicates that while Indonesia's palm oil production over the next 13 years will grow by 700,000 tons, its exports are likely to grow by only 100,000 tons, or by approximately 1 1/2 percent a year. This means not only a drastic decline in Indonesia's share of world palm oil exports, but more significant for U.S. soybean prospects, a decline in Indonesia's market share of total vegetable oil exports. By 1990, Indonesia's share is likely to be only 2 percent of total world exports of fats and oils.

<u>Conclusion Concerning Injury</u>

On the basis of this analysis and all the available information, we find it unlikely that this project will cause injury to United States producers of any similar or competing agricultural commodity. This conclusion is also supported by the Department of Agriculture and the other agencies represented on the National Advisory Council on International Monetary and Financial Policies.

<u>Other Legislative Tests</u>

Since it is unlikely that this project will finance palm oil for export, and it is the conclusion that this project will not cause injury to the United States producers, other legislative criteria must be examined to determine the United States vote on this loan.

Sec. 901 of PL 95-118 also states that it is the policy of the United States in connection with its voice and vote in the international financial institutions:

> "to combat hunger and malnutrition and to encourage economic development in the developing countries, with emphasis on assistance to those countries that are determined to improve their own agricultural production, by seeking to channel assistance for agriculturally related development to projects that would aid in fulfilling domestic food and nutrition needs and in alleviating hunger and malnutrition in the recipient country".

A review of this project shows that it meets these standards of United States policy and it strongly complements the efforts of the Indonesian Government to alleviate hunger and malnutrition by raising the income of 5,750 rural farm families from a 1976 per capita level of $50 to a projected level of $160 by 1990.

Although this analysis has concentrated on that minor portion of the project which deals with the production of palm oil, the major project components cannot be ignored. They include the construction of 5,750 settler houses including the provision of water supply and sanitation facilities and the equipping and staffing of community and health facilities, including family planning services, in 35 villages. A village office, primary school, health post, mosque, community center and project office will be constructed by local laborers for each village.

A low-cost feeder road system including all-weather access roads, village roads and farm roads and tracks will also be constructed and within the settlement areas. Additionally, seeds and fertilizer distribution for food crops for 10,500 ha., including 700 ha. of house gardens and the establishment and staffing of agricultural credit, extension and cooperative services are also provided in the project. The farmers' participation of his smallholding will also be enlisted and protected by his receiving (within six months) certificates of conditional ownership of his full 5 ha. Certificates of full ownership of 5 ha. will be granted at the end of three years if the settler has rendered satisfactory performance in developing the rubber area.

In conclusion, the Indonesia Nucleus Estates and Smallholders I Project, which will be before the Board of Executive Directors on November 15 appears to be an excellent project of the sort which continues to justify strong United States support for the World Bank. I, therefore, can see no reason for the United States to oppose the project.

Sincerely,

C. Fred Bergsten

The Honorable
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Attachment