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February 6, 1985

COUNTRY RISK UPDATE
INDONESIA

As was the case with our last review in July 1984, the conflicting trends at work in the international oil markets are still bedeviling assessments of Indonesian country risk. Market psychology has shifted back and forth from optimism that prices had stabilized to pessimism that they would fall to still lower, uncharted territory. The current majority view is undoubtedly pessimistic, however, and it is now evidently shared by the OPEC oil ministers themselves, who just last week agreed on an average cut in official prices of $1 per barrel.

Economic developments in Indonesia, meanwhile, have become somewhat clearer. The recovery of business activity from the 1982-83 recession is continuing, though at a less vigorous pace than had been first thought. On the one hand, recent estimates of the 1984 grain harvest still indicate another excellent year, with growth in agricultural output on the order of 5 percent or so. Then, too, the economy is benefiting from a substantial increase in non-oil exports. At the same time, inflationary pressures are proving to be weaker than anticipated. Despite the shock of the 1983 devaluation, consumer prices rose by just 8.8 percent during the year, and at an even slower rate in recent months. Trends elsewhere in the economy are less favorable, however. Private sector investment shows little sign of recovery, while public sector outlays are still declining. And sales of manufactured products geared to the domestic market are moving sluggishly. On balance, it appears that GDP is growing at an annual rate of little more than 4-1/2 percent, only slightly faster than in 1983.

Explanations for the evident weakness of the economy are not hard to find. One is the recent decline in oil production. From just over 1.5 mbd in the first half of 1984, output has fallen to about 1.35 mbd currently. For the year as a whole, production probably amounted to 533 million barrels, an increase of only 5 percent, and there is little reason as yet to expect a quick rebound.

But the main reason is probably the government's financial policies, which remain fairly cautious. The fears expressed earlier in the year that the authorities would relax their austerity program too soon -- and perhaps revive some of the projects shelved in 1983 -- have given way to anxieties that they may be being too tight-fisted. This reflects the fact that public sector outlays were unexpectedly (and unaccountably) less than budgeted in the first half of the 1984-85 financial year, with a consequent buildup of government cash balances held by the domestic banking system. (The 1984 budget deficit is still estimated at over 5 percent of GDP, though, which is high compared with earlier years.) Last August's foreign exchange scare, soaring short-term interest rates, and the resulting brush with a liquidity crisis only added to this concern.

Finally, the unsettled political situation last fall -- following a riot in a Jakarta suburb and three separate bomb blasts in the capital business district -- may also have adversely affected confidence.

The substantial improvement in the 1984 balance of payments reflected these trends. As already noted, non-oil exports did well, rising about 19 percent in value terms; the rupiah's depreciation, together with economic expansion in the OECD countries, evidently produced substantial gains in volume for the second year in a row. Exports of oil and natural gas rose by 8 percent, mainly because of sharply higher LNG shipments. Merchandise imports, on the other hand, dropped by nearly 11 percent, with the petroleum sector, capital equipment and other product categories showing similar declines.

Sharply higher interest payments offset some of the gain in the trade balance, but, even so, the deficit on the current account was cut in half to an estimated $3.1 billion, or 3.8 percent of GDP. The capital account produced a corresponding improvement, with gross foreign assets rising by about $600 million and a slowdown in the growth of the external debt. Net debt was little changed at 120 percent of export earnings, while the growth of western bank exposure fell to about 11 percent, compared with 15 percent a year earlier.

Prospects for the 1985-87 period appear to be less favorable at this juncture, though. At best, real GDP may only grow at a 3-1/2 to 4 percent annual rate during the period assuming continued restraint in government outlays. The growth of export volume is likely to tail off because of sluggish demand in the oil sector and the waning effects of the rupiah's depreciation. The recent weakness of non-oil commodity prices and slower economic growth among the industrial countries are other negative influences. The timing and extent of a recovery in imports is also unclear, though the boost that the January 1985 budget is likely to give to domestic consumption (from the 20 percent hike in civil servants' salaries) could well lead to a rising trend from the second half of the year.

The price of oil remains the key, however, in view of the country's dependence on oil and gas revenues for 70 percent of merchandise exports and 60 percent of government revenues. In our revised base forecast (see table 1), we now assume that energy prices fall further this year -- in Indonesia's case a total cut in the average export price of $3 per barrel, to $26.50, or a decline of about 10 percent. On this assumption, the current account deficit widens by about $2 billion annually to the equivalent of $5.5 billion (5.8 percent of GDP) by 1987, as the recovery of exports stalls and imports revive. Net debt jumps substantially at the same time to the equivalent of 170 percent of export earnings, though there would be little change in the rate of growth (13 percent) of western bank exposure. Nonetheless, in the absence of further adjustments in government policy (see below), the implication is one of worsening creditworthiness.

In view of the prevailing market pessimism, our alternate (40 percent subjective probability) scenario considers the repercussions of a more drastic price decline -- on the order of $7 per barrel or 24 percent. This entails a fall in the terms of trade of roughly 12 percent over the next three years, with the value of exports in 1987 still 15 percent below the record level achieved in 1981. Compared with the base case, the adverse impact on the current account would amount to about $2 billion annually and result in deficit of 8 percent of GDP (see Table 2). Indonesia's net debt burden would soar to 220 percent of export earnings at the same time, with bank lending increasing at an annual rate of 23 percent. In this case, the probability is high that a restructuring of maturities would occur by the end of the forecast period.

These results highlight the policy dilemma Indonesia now faces. For while its economic adjustment efforts may well have been more rigorous than those of other highly populated OPEC countries, they are nonetheless inadeqate should oil prices fall further, as seems probable. This will be a bitter pill to swallow for a government which in the last two years has shelved investment projects costing $21 billion, devalued its currency, drastically reduced domestic oil product subsidies, liberalized the local financial system, and introduced far-reaching reforms of the tax system. If economic stagnation and a heavy debt burden are to be avoided, however, even more radical measures will be required.

Apart from further cuts in public spending, the only plausible option would be a major overhall of the trade regime -- one that promotes export-led recovery from a revitalized manufacturing sector. This is something that has been mooted many times in the past, but which has always floundered in the face of the conventional Indonesian political wisdom because of its heavy cost to existing business interests in both the public and private sectors. And even if such a policy was implemented, there is still the risk that the Suharto government would not act with sufficient speed or conviction. Accordingly, our view is that BTCo must continue to manage its exposure conservatively in the year ahead. The implications for medium-term business -- including merchant banking transactions vulnerable to abrupt shifts in market perceptions of Indonesian credit risk -- should receive particular attention.

David T. Beers

Notes

1. Excluding gold valuation changes.
2. Valued at year-end prices per ounce in 1978-84 and $325 in 1985, $350 in 1986, and $375 in 1987.
3. Imports of goods and services.
4. Including estimated short-term and private sector debt, and debt to the IMF.
5. Net is the difference between lines 42 and 29.
6. Amortization of medium-term debt.
7. Including interest on short-term debt and debt to the IMF.
8. Debt service as a percent of exports of goods and services.
9. Sum of lines 30, 43 and 48, minus 11.

INDONESIA (Scenario A)	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987
INTERNATIONAL LIQUIDITY ($MM)										
29. Gross Foreign Assets	3774	6303	11168	11308	8339	9430	9859	9784	9386	9464
30. - Annual Change /1	464	2466	4842	599	-3153	1346	634	-125	-475	0
31. - Central Bank Reserves	2677	4205	6804	6249	4563	4882	5559	5509	5086	5164
32. - Gold /2	51	143	1412	1235	1419	1164	959	1009	1086	1164
33. - Foreign Exchange	2626	4062	5392	5014	3144	3718	4600	4500	4000	4000
34. - Reserves, % of Imports /3	21.0	28.8	35.0	24.3	17.1	18.5	22.4	22.1	18.9	17.3
35. - Claims on Western Banks	3023	5162	7953	7557	6166		NA			
36. IMF Drawings (MM SDR)	0	0	0	0	0	425	420			
37. - % of Quota	0	0	0	0	0	42	42			
38. Net Foreign Assets of										
39. Commercial Banks	387	1411	3746	4383	2810	3575	3350			
40. - Assets	1097	2098	4364	5059	3776	4548	4300	4275	4300	4300
41. - Liabilities	-710	-687	-618	-676	-966	-973	-950			
EXTERNAL INDEBTEDNESS ($MM)										
42. Total Debt /4	14307	15969	19536	22237	26334	33264	36608	40238	44283	50218
43. - Short-term Debt	1379	1678	2108	2507	3239	3698	3400	3500	3750	4125
44. - Debt to Western Banks	5819	5806	6274	7226	9948	11422	12700	14100	15980	18350
45. - % Due Within One Year	34.0	39.1	41.0	41.0	38.6	37.6	NA			
46. Net Debt/Exports Ratio /5	0.9	0.6	0.4	0.4	0.8	1.2	1.2	1.4	1.6	1.7
47. Debt Service	2931	3332	3264	3640	3934	4425	5240	5905	6875	7850
48. - Principal /6	2048	1979	1653	1701	1939	1900	2290	2580	3025	3500
49. - Interest /7	883	1353	1611	1939	1995	2525	2950	3325	3850	4350
50. Debt Service Ratio (%) /8	25.9	21.4	14.7	14.6	18.5	22.2	24.2	27.7	30.7	32.7
51. Gross Financial Requirement /9	5438	5545	7511	7042	9500	12820	9384	10010	11120	13860
52. - % of Imports	42.6	38.0	38.7	27.4	35.5	48.7	37.8	40.1	41.4	46.4
MEMO ITEMS										
53. Population (MM)	145	148	151	154	157	159	163	166	169	173
54. Oil & LNG Exports (% of total)	71.4	72.0	81.4	80.5	80.5	69.3	71.3			
55. F/x Rate, Rupiah per US$	442	623	626	632	661	909	1026	1165	1250	1300

INDONESIA (Scenario A)	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987
DOMESTIC ECONOMY										
1. Gross Domestic Product ($MM)	51456	51400	72587	85518	90159	78322	79940	81272	87804	98341
2. - Real Growth (% change)	7.7	6.3	9.9	7.9	2.2	4.2	4.7	4.0	3.5	4.0
3. Per Capita Income ($)	355	347	481	556	575	491	491	490	518	569
4. Gross Fixed Investment (% GDP)	20.5	20.9	20.9	22.4	22.6	24.1	NA			
5. - Real Growth (% change)	15.0	4.4	-100.0	ERR	6.5	11.4	NA			
6. Government Deficit (% GDP)	4.6	4.3	3.3	3.2	3.3	5.5	5.3	5.3		
7. Domestic Credit (% change)	38.2	4.4	-2.9	35.5	50.1	18.7	NA			
8. Money Supply (M2, % change)	24.1	34.9	52.4	25.8	20.6	20.9	25.5	19.5	21.4	15.7
9. Consumer Prices (% change)	8.1	22.0	18.5	12.2	9.5	11.8	8.8	9.5	11.0	11.0
10. Unemployment (% of labor force)	NA	NA	NA	NA	NA	NA	NA			
BALANCE OF PAYMENTS ($MM)										
11. Current Account Balance	-1414	980	2865	-566	-5324	-6338	-3060	-3555	-4320	-5735
12. - (% GDP)	-2.7	1.9	3.9	-0.7	-5.9	-8.1	-3.8	-4.4	-4.9	-5.8
13. - Merchandise Trade (net)	2649	5909	9171	6806	1893	963	4860	4645	4620	4390
14. Exports	11035	15154	21795	23348	19747	18689	20700	20295	21305	22875
15. (% change)	2.5	37.3	43.8	7.1	-15.4	-5.4	10.8	-2.0	5.0	7.4
16. Imports	-8386	-9245	-12624	-16542	-17854	-17726	-15840	-15650	-16685	-18485
17. (% change)	12.1	10.2	36.5	31.0	7.9	-0.7	-10.6	-1.2	6.6	10.8
18. - Services (net)	-4077	-4959	-6361	-7622	-7351	-7405	-8020	-8300	-9090	-10275
19. Receipts	291	398	446	1530	1527	1217	980	1000	1075	1100
20. (% change)	75.3	36.8	12.1	243.0	-0.2	-20.3	-19.5	2.0	7.5	2.3
21. Payments	-4368	-5357	-6807	-9152	-8878	-8622	-9000	-9300	-10165	-11375
22. (% change)	23.9	22.6	27.1	34.4	-3.0	-2.9	4.4	3.3	9.3	11.9
23. - Transfers	14	30	55	250	134	104	100	100	150	150
24. Long-term Capital (net)	1596	1320	2156	2151	5096	5323				
25. - Direct Investment (net)	279	226	183	133	225	292	350	300	300	300
26. Short-term Capital	-12	-856	-2593	-1959	-1625	1193				
27. - Errors & Omissions	-133	-402	-1773	-1669	-2151	462	0	-500	-500	-500
28. Total Balance	170	1444	2428	-374	-1853	178				

INDONESIA (Scenario B)		1984	1985	1986	1987

BALANCE OF PAYMENTS ($MM)

		1984	1985	1986	1987
11.	Current Account Balance	-3060	-4900	-6245	-7725
12.	- (% GDP)	-3.8	-6.0	-7.1	-7.9
13.	- Merchandise Trade (net)	4860	3150	2640	2350
14.	Exports	20700	18325	18645	20075
15.	(% change)	10.8	-11.5	1.7	7.7
16.	Imports	-15840	-15175	-16005	-17725
17.	(% change)	-10.6	-4.2	5.5	10.7
18.	- Services (net)	-8020	-8150	-9035	-10225
19.	Receipts	980	1000	1075	1100
20.	(% change)	-19.5	2.0	7.5	2.3
21.	Payments	-9000	-9150	-10110	-11325
22.	(% change)	4.4	1.7	10.5	12.0
23.	- Transfers	100	100	150	150
24.	Long-term Capital (net)				
25.	- Direct Investment (net)	350	300	300	300
26.	Short-term Capital				
27.	- Errors & Omissions	0	-500	-500	-500
28.	Total Balance				

INTERNATIONAL LIQUIDITY ($MM)

		1984	1985	1986	1987
29.	Gross Foreign Assets	9859	9784	9386	9464
30.	- Annual Change	634	-125	-475	0
31.	- Central Bank Reserves	5559	5509	5086	5164
32.	- Gold	959	1009	1086	1164
33.	- Foreign Exchange	4600	4500	4000	4000
34.	- Reserves, % of Imports	22.4	22.6	19.5	17.8
35.	- Claims on Western Banks	NA			
36.	IMF Drawings (MM SDR)	420			
37.	- % of Quota	42			
38.	Net Foreign Assets of				
39.	Commercial Banks	3350			
40.	- Assets	4300	4275	4300	4300
41.	- Liabilities	-950			

EXTERNAL INDEBTEDNESS ($MM)

		1984	1985	1986	1987
42.	Total Debt	36608	41583	47553	55478
43.	- Short-term Debt	3400	3500	3750	4125
44.	- Debt to Western Banks	12700	15445	19250	23610
45.	- % Due Within One Year	NA			
46.	Net Debt/Exports Ratio	1.2	1.6	1.9	2.2
47.	Debt Service	5240	5965	7055	8090
48.	- Principal	2290	2580	3025	3500
49.	- Interest	2950	3385	4030	4590
50.	Debt Service Ratio (%)	24.2	30.9	35.8	38.2
51.	Gross Financial Requirement	9384	11355	13045	15850
52.	- % of Imports	37.8	46.7	50.0	54.6