

RATING PERSPECTIVE

Indonesia: Improving fiscal position prompted upgrades

On September 21, 2006, JCR has upgraded the long-term senior debts ratings of Indonesia to BB-/BB (foreign currency and domestic currency) from B+/B+. Outlooks on the ratings remain stable. The upgrade reflects Indonesia's improved resilience to external shocks due to steadily declining levels of external and government debts on the backdrop of stabilized macro-economy and improved fiscal structures of government. Although the still high level of external debts and relatively heavy debt service burden renders the country susceptible to fluctuation of the exchange rate induced by private capital flows, levels of the debts are likely to stay on a gradual decreasing path supported by prudent macro-economic management. The stable outlooks on the ratings balance prospect of continued decrease in levels of both external and government debts, against remaining vulnerability associated with still high level of debts and heavy debt service burden. If the government will succeed to improve the mid-to-long term growth prospects by reinvigorating both foreign direct and private domestic investment through various reforms, the ratings could be further upgraded.

1. Decreasing debt level and improving fiscal structures

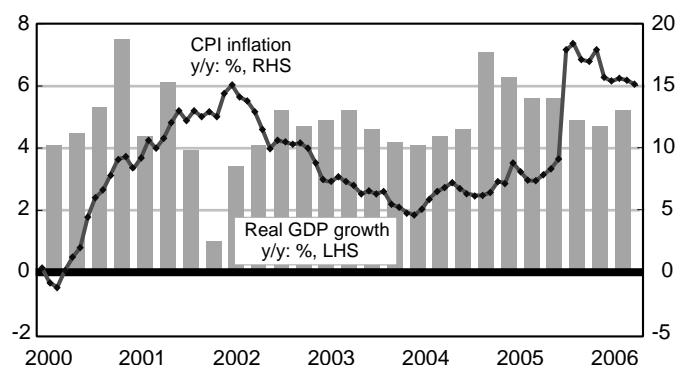
Amid robust economic growth, relative stability of exchange rate and persistent central government primary surpluses, level of general government debts has been decreasing, and gross debts (including IMF loans) at end-June were 44% of GDP, much lower than 103% at end-2000. Fiscal position of the government, which once deteriorated markedly due in part to heavy interest burden of rupiah denominated bonds issued from 1999 by the government to recapitalize devastated banks, are stabilizing. With steady economic recovery and replacement of a part of variable interest rate bonds with

fixed ones, outstanding of the former bonds relative to GDP decreased to 6% at end-August 2006 from 19% at end-1999, making the fiscal position more resilient to domestic interest hikes. In addition, substantial reduction in fuel subsidies, carried out in 2005 despite its political sensitivity, rendered the fiscal position much less affected by international oil price hikes.

2. Gross financing needs will be large with relatively heavy debt redemptions

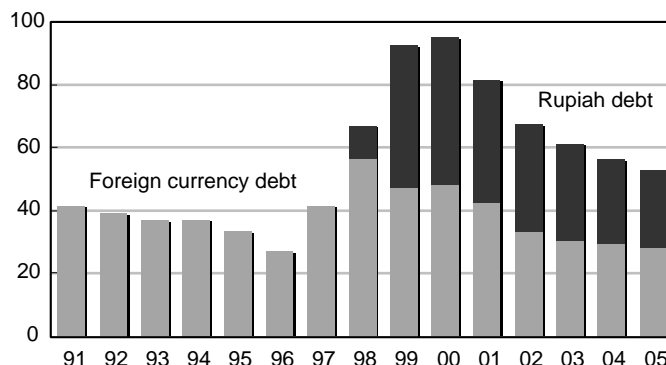
While the fiscal deficit remains small, amounting to 0.5% of GDP in 2005 and expected to be within 1.2% in coming years, gross financing needs (i.e. fiscal deficits plus gross debt amortization) will be large with relatively heavy debt redemptions, making its estimated ratio to GDP around 3.5% in 2006 and 2007. As the remaining assets in the Asset Management Company (PPA) and state assets with near term prospects for privatizations are limited, the government has to increasingly rely on bond financing in coming years. In views of facilitating smooth and stable bond issuance, it is important to develop deep and liquid secondary markets of rupiah denominated government bonds. Some market turbulences induced by huge and abrupt redemptions of mutual funds investing in government bonds have been seen in the past years. JCR thinks it desirable to prevent recurrence of such incidents by putting an appropriate regulatory system in place. On the other hand, JCR acknowledges commendable achievements in domestic debt management, which effectively lengthened maturity profile while containing the portions of variable interest rate bonds.

Chart 1. Robust economic growth



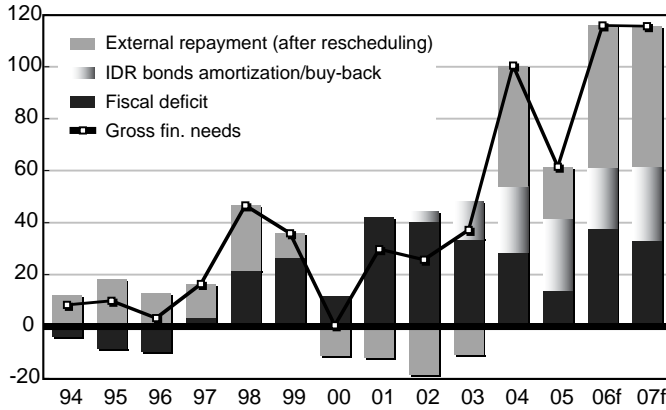
Source: BPS

Chart 2. Steadily decreasing debt level



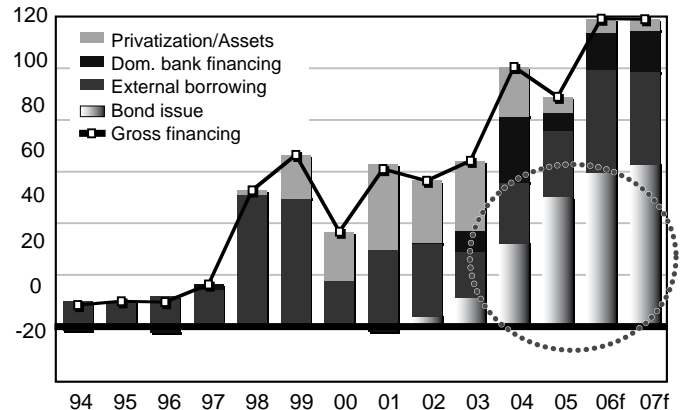
Sources: BI and MoF. gross gov't debt (including IMF loan) to GDP: %

Chart 3. With no Paris Club rescheduling, larger financing needs



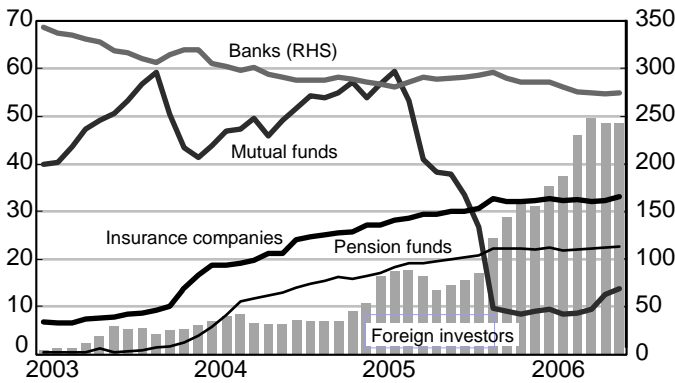
Source: MoF. gross gov't financing needs (IDR tn)

Chart 4. Depending more on IDR bond issue



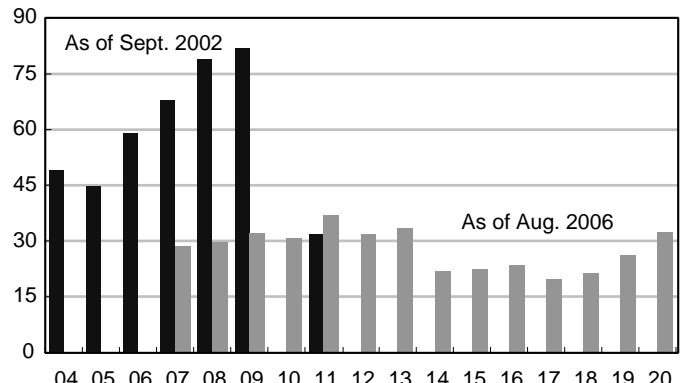
Source: MoF. gross gov't financing (IDR tn)

Chart 5. Foreign investors absorbed selling by mutual funds



Source: MoF. main holders of IDR gov't bonds (IDR tn)

Chart 6. Effective domestic debt management



Source: MoF. maturity profile of IDR gov't bonds (IDR tn)

3. Contingent liabilities becoming moderate with stabilizing banking sector

The contingent risk stemming from banking sector is becoming moderate as banks' financial standing is improving amid steady economic growth. Although a substantial increase in non-performing loans at big state-owned commercial banks has been seen, these are isolated incidents at these weakly governed banks with insufficient risk management, and thus not indicate any system-wide deterioration of banking assets, in JCR's view. JCR thinks that the authority has been taking steps in the right direction aiming at expediting clean-up of these banks' balance sheets, by tightening asset classification guideline and introducing measures to facilitate restructurings of loans held by state owned banks. With regard to liabilities associated with sub-national governments, lack of information regarding fiscal and debts positions, and financial performance of entities owned by them make it difficult for the central government to monitor and control the direct and contingent liabilities of consolidated

Table 1. Growing NPLs: problems at state banks, not entire banking system

	2003		2004		2005	
	H1	H2	H1	H2	H1	H2
Loan to deposit ratio	51.3	53.7	57.9	61.8	65.7	64.7
ROA	2.2	2.5	2.7	3.5	2.9	2.6
Net interest margin	0.4	0.3	0.5	0.6	0.5	0.5
Gross NPL ratio	8.0	8.2	7.6	5.8	<u>7.9</u>	<u>8.3</u>
Net NPL ratio	1.2	3.0	2.1	1.7	<u>3.7</u>	<u>4.8</u>
Capital adequacy ratio	23.0	19.4	20.9	19.4	19.5	19.5
Liquidity ratio	16.6	15.1	14.8	14.9	15.3	15.8

Source: BI. major financial indicator of banking sector

general government. For effective debt management, the government needs to establish data collection systems, with technical assistance from multinational institutions.

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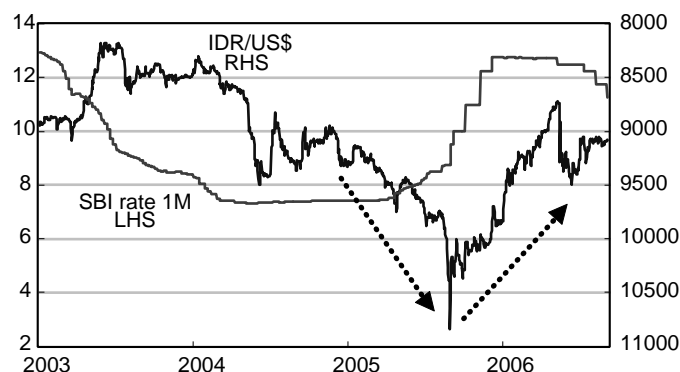
4. Heavy external debt services burden and still high debt level

Although still high, level of external debts has been steadily decreasing in past years. Debts net of liquid assets (i.e. international reserves and external assets of deposit money banks) were US\$78.0 billion at end-June, 2006, amounting to 79% of annual export of goods and services in 2005, far lower than 207% at end-1998. Nevertheless, Indonesia remains vulnerable to fluctuation of the exchange rate associated with capital flows because of high level of external debts and relatively heavy debt service burden. As debt services relief provided by Paris Club creditors following tragic tsunami in December 2004 expires, external debt service burden increases from 2006. Gross external debt service (including interest) of public and private sector in 2006 and 2007 will be more than US\$20 billion, exceeding 20% of goods and services export in 2005, although it is expected to decline slowly through 2009 thereafter.

5. Thin forex markets and susceptibility to capital flows

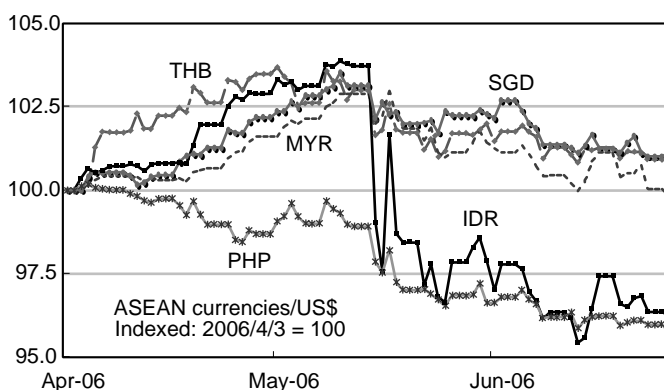
In the late August of 2005, rupiah exchange rate depreciated sharply, driven by sudden and large private capital outflow, partly induced by loss of investors' confidence in face of an inadequate coordination of macro-economic policies such as failure to respond promptly to surging inflationary pressures. In May 2006, rupiah exchange rate depreciated much more sharply than its counterparts of neighboring countries amid world-wide capital outflow from emerging markets countries. Due in part to remaining restrictions on short term foreign exchange swap transactions, foreign exchange markets are thin and susceptible to private capital flows induced by shifts in investors' sentiment, easily translating into higher level of external debt and its service burden. Right after market turbulence in August 2005, fuel subsidies were substantially reduced in view of improving fiscal structure, and the central bank implemented successive rounds of monetary tightening. In addition, highly respected technocrats assumed important posts of economic coordinating minister and finance minister in limited-scale cabinet reshuffle in December 2005. These events, being perceived as signs of government's firm commitment to prudential macro-economic management, brought about a dramatic reversal of investors' sentiment, which led to substantial portfolio capital inflow. In order to avoid a recurrence of balance-of-payment pressures possibly emanating from outflow of these capitals, effective macro-economic policy coordination is required. Amid easing inflationary pressures, the central bank started gradual monetary easing from May 2006, effectively disseminating their policy intentions to financial markets and discreetly controlling the pace of easing while paying close attentions to global capital markets conditions. To date, they have succeeded to avoid inviting any slight balance-of-payment pressures by monetary easing while many other central banks are keeping tightened monetary conditions.

Chart 7. "Mini-crisis" and recovery thereafter



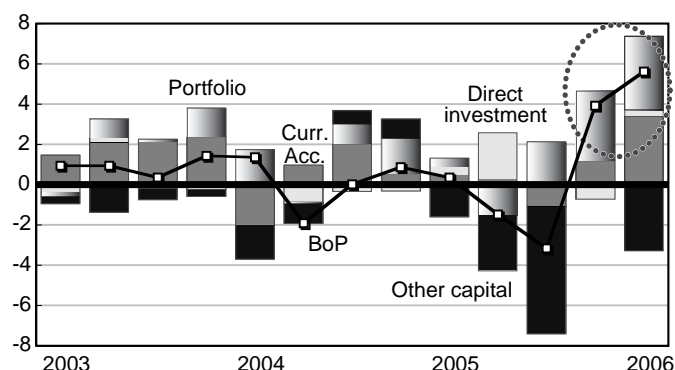
Sources : BI and Bloomberg

Chart 8. Most affected currency in ASEAN during May 2006



Source: Bloomberg. from Apr. 3 to Jun. 23, 2006

Chart 9. Substantial portfolio capital inflow



Source: BI. quarterly balance of payments (US\$ bn)

6. Stable outlooks on the ratings

The stable outlooks on the ratings balance prospect of continued decrease in levels of both external and government debts, against remaining vulnerability associated with still high level of debts and heavy debt service burden. Although relatively robust, economic growth in recent years has failed to create sufficient employment to fully absorb growing entrants to labor force, leading to surging unemployment rate. While the government made various efforts to improve economic structure, reduce corruption, and improve investment climate, the outcome of these efforts to date is mixed. Labor market reform and electricity price hike, for example, have been met with strong oppositions and forced to be postponed. If the government succeeds to improve the mid-to-long term growth prospects by reinvigorating both foreign direct and private domestic investment through various reforms, the ratings could be further upgraded. On the other hand, ratings will be under downward pressure if many of the reform measures aiming at enhancing economic structure stall at oppositions from various parties including vested interests, or if policy coordination failures among various parts of the government surfaces again like in 2005 and obstructs prompt and appropriate response to emerging adverse macroeconomic developments.



Table 2. Main Economic Indicators

		1998	1999	2000	2001	2002	2003	2004	2005	2006 f
Real GDP Growth y/y	(%)	-13.1	0.8	4.9	3.8	4.3	4.5	5.1	5.6	5.2
Unemployment Rate	(%)	5.5	6.4	6.1	8.1	9.1	9.6	9.9	10.3	10.8
CPI Inflation y/y	(%)	58.4	20.5	3.7	11.5	11.9	6.8	6.1	10.5	13.5
Lending Rate	(%)	32.2	27.7	18.5	18.6	19.0	17.0	14.3	16.0	15.5
Central Gov't Fiscal Balance/GDP	(%)	-2.1	-2.3	-1.2	-2.8	-2.4	-1.9	-1.4	-0.5	-1.2
Gross General Gov't Debts/GDP	(%)	74.6	99.2	102.7	86.0	71.6	64.9	59.5	52.0	43.0
Exports of Goods & Services	(US\$ bn)	54.8	55.8	70.6	62.9	65.8	69.4	88.4	100.1	108.0
Imports of Goods & Services	(US\$ bn)	44.0	43.0	56.0	50.5	52.7	56.9	79.1	91.8	104.5
Current Account Balance/GDP	(%)	4.3	4.1	4.8	4.2	3.8	3.4	0.7	0.3	0.7
International Reserves (excluding gold)	(US\$ bn)	22.7	26.4	28.5	27.2	31.0	35.0	35.0	33.0	34.0
Import Cover	(month)	6.2	7.4	6.1	6.5	7.1	7.4	5.3	4.3	3.9
Gross External Debts/GDP	(%)	158.5	108.0	87.5	81.7	64.9	57.4	54.6	46.4	42.0
Net External Debts/GDP	(%)	118.7	76.4	63.3	58.2	44.2	38.4	37.7	30.2	27.0
Int'l Reserves/S-T External Debts	(X)	0.0	1.4	1.3	1.3	1.4	1.6	1.7	1.4	1.5
Gross External Debts/Exports	(%)	275.7	270.8	204.5	213.3	200.8	197.3	159.1	133.3	120.0
Net External Debts/Exports	(%)	206.6	191.6	148.0	151.9	136.8	131.9	109.7	86.7	77.0
Debt Service Ratio	(%)	31.7	30.0	22.5	23.6	24.7	25.5	22.1	26.0	29.0
Exchange Rate (period average)	(US\$1=)	10,014	7,855	8,422	10,261	9,311	8,577	8,939	9,710	9,500

Sources: ADB, BI, BPS, IMF, MoF and World Bank