12063
Republic of Indonesia

Chief Analyst Atsushi Masuda
Analyst Shinichi Endo

Long-term Rating	BBB-
Outlook*	Positive
Short-term Rating	-

*Long-term Rating refers to Foreign Currency Long-term Issuer Rating in principle.

1. Outline

Indonesia is an archipelagic country with a large population and territory, abundant natural resource endowment and diverse ethnic groups. Its population counts 258 million (the fourth in the world) and its territorial coverage totals 1.91 million square meters, five times larger than Japan.

There are more than 300 ethnic groups in Indonesia, the largest being Javanese. Ethnic Chinese number 7 million, accounting for about 3% of the total population. As such, "Unity in Diversity (Bhinneka Turggal Ika)" has been the national principle since its independence. The constitution guarantees freedom of religion. Muslims account for 90% of its total population while others believe in Christianity, Hindu and Buddhism among others.

Indonesia's nominal GDP stood at USD932.7 billion and the per capita GDP at USD3,603 in 2016.

2. Political and social situation

Mr. Joko Widodo, former governor of the Jakarta special district, was elected president in the election in July 2014 and assumed the office in October that year. He is in his first term of presidency that continues until October 2019. Upon its inauguration, his administration had to rely on a minority ruling alliance, which posed concern over its ability to execute policy. However, President Joko initiated a process to buttress his ruling coalition by appointing Mr. Luhut Panjaitan as Chief of Staff in early 2015. After his first cabinet reshuffle in August 2015, the National Mandate Party (PAN) joined the ruling alliance in September 2015, followed by the Party of Functional Group (Golkar) in May 2016. This made the ruling alliance a majority, resolving the problem of a divided power between the president and parliament and solidifying his administration's political base. President Joko carried out his second cabinet reshuffle in June 2016, which featured the appointment of Ms. Sri Mulyani Indrawati, former managing director of the World Bank, as Minister of Finance. Having served in the same post under the Yudhoyono administration from 2005 and 2010, she was reputed for realizing remarkable fiscal reforms. The reinforcement of the political base and the appointment of the figures who are supportive to the reforms have contributed to enhancing the policy effectiveness of the Joko administration.

3. Economic fundamentals and recent developments

The Indonesian economy is primarily characterized by its high dependence on natural resources. That dependence, though declining recently, still needs to be lowered because the entire economy remains vulnerable to resource price fluctuations. The value-added shares in GDP of agriculture-forestry-fisheries and mining-quarry were high at 13.5% and 7.2%, respectively, in 2016. Their combined share, at 20.7%, exceeded 20.5% of the manufacturing sector. The primary sector accounted for 33.1% of the total employment, way higher than 13.1% of the manufacturing sector.

Among the supply-side challenges facing the Indonesian economy, an insufficient infrastructure stemming from an inadequate investment environment peculiar to an emerging country is frequently pointed out as a bottleneck to economic growth. Delayed development of infrastructure such as railways and roads is evident in the main cities including capital

Jakarta, where traffic jam is chronic and serious. Face with the situation, President Joko launched a series of economic policy packages in September 2015, when the Fed's first interest rate hike in 10 years was in sight. His administration enforced a total of 14 policy packages by the end of 2016. Those included a broad range of structural reforms such as ones aimed to improve the industrial competitiveness and social purchasing power, expand investments and exports, and enhance the efficiency of the transportation and tourism sectors. Thanks to these government efforts, Indonesia's ranking in the World Bank's ease of doing business survey jumped to 114th, 109th and 91st during the Joko administration from 120th level previously. Direct investment grew 12.4% year-on-year to 612.2 trillion rupiah in 2016, outperforming the government target by 3%. These indicate that the government efforts to improve the investment environment have begun to produce results.

Turning to the demand side, a buoyant private consumption may well be counted as a major driving force for the economy. The country's annual real GDP growth rates in the 10 years from 2006 to 2016 averaged 5.6%, of which 2.9ppt came from private consumption. Prominent in the background are a steady growth of the total population and the presence of an ample youth population. The total population grew a solid 1.51% per year during the same 10 years. Young people under 29 years of age accounted for 52.5% of the total population. A U.N. projection estimates the country's youth population ratio will still stay high at 47.1% in 2030.

The Indonesian economy, which had kept a moderate slowdown after peaking out in 2010, grew 5.02% in real GDP terms in 2016. The first growth higher than 5% in two years was led by a pickup of private consumption. Bank Indonesia's six rate cuts totaling 150 bps during the period from January to October 2016 greatly contributed to supporting the economic recovery.

4. External sector

Indonesia's balance of payments is characterized by a structure in which continuous current account deficits are financed by financial account surpluses. However, a stable financing of the current account deficits poses a major challenge since the financial account balance tends to fluctuate widely.

The current account has been in deficit since 2012. Mainly to blame for this was a shrinking trade surplus. Much of the contraction came from a decline in fossil fuel exports, which normally account for 20% of the total export value. Factors responsible for the reduced fuel exports included a growing energy demand at home, the economic slowdown in China, the main destination of the exports, and the fall of resource prices. Recently, however, the trade surplus has been widening thanks to the bottoming out of resource prices and the economic recovery in the foreign trade partners. The current account deficit-to-GDP ratio fell from 3.2% in 2013 to 3.1% in 2014, 2.0% in 2015 and 1.8% in 2016.

Notable in the financial account is the growing volatility of portfolio investments by non-residents. A massive capital outflow occurred as investors adopted a risk-off stance and U.S. interest rates went up after the U.S. presidential election in November 2016. According to an estimate by the Institute of International Finance (IIF), a net capital outflow totaled US$2.38 billion in November alone. This was the second-largest next to the US$4.01 billion registered during the tapering tantrum in 2013. Bank Indonesia countered the outflow in 2013 with a large-scale market intervention to defend the rupiah-dollar exchange rate. However, it failed to stem the expanding imbalances. The rupiah depreciated by 16.2% and the foreign reserves tumbled by US$9.47 billion during the period from May to September 2013. However, the situation was remarkably different with the capital outflow in November 2016. While Bank Indonesia kept its stance to care for exchange rate stability in line with the "Foreign Exchange Rate Stabilization Policy" announced in September 2015, it primarily relied on prudential regulations without resorting to any massive market intervention. The rupiah-dollar exchange rate has been staying stable since the end of 2016. The foreign reserves did decline by US$3.57 billion in November but resumed an uptrend from December onward. The reserves swelled to US$114.4 billion at the end of 2016, or equivalent to 8.6 months of imports and 2.7 times of short-term external debt.

Meanwhile, the external borrowing by Indonesia's private sector grew substantially during the period from 2010 to 2014 amid the large-scale monetary easing by advanced countries after the Lehman shock. As much as 90% of the private-sector external debt is denominated in the US dollar, with only 4% in the local currency. An insufficient hedging of exchange risks could inflate the sector's debt burden in rupiah terms should the currency depreciate markedly. In Indonesia, the private sector's external vulnerability through such exchange rate channel had been prominent since 2010.

Amid the growing speculation in the fall of 2015 that the Fed might go ahead with its first policy rate hike in 10 years, the market was increasingly wary about possible capital flight into the U.S. and depreciation of the rupiah's exchange rate. Bank Indonesia responded by beefing up its prudential regulations. It introduced in stages such measures as the hedge ratio regulation (from January 2015), the liquidity ratio regulation (ditto) and the rating requirements (January 2016) with the aim of curbing the external borrowing by non-financial corporations. The central bank also took successive measures to alleviate the external fragility through the exchange rate channel by introducing a mandatory settlement of commercial transactions in the rupiah in March 2015 and announcing an exchange rate stabilization policy in September 2015. Under these policy measures, the private sector's external debt decreased by 5.6% to US$158.7 billion at the end of 2016 for the first year-on-year contraction since 2005. Bank Indonesia's prudential regulations have begun to take effect.

The external debt-to-GDP ratio had kept rising to reach 36.1% in 2015 after hitting rock bottom at 25.2% in 2011. However, the ratio fell to 34.0% in 2016 as a result of the curb on the private sector's external borrowing, indicating that the surge of the external debt has now come to a halt. Nevertheless, not all the indicators related to external debt are improving. The external debt-to-exports (goods and services) ratio rose from 105.8% in 2011 to 188.0% in 2016. Given that the private-sector debt accounts for about a half of the country's total external debt, a continued curb on private external borrowing and a change in the export composition in favor of a shift to higher value-added manufacturing goods will hold the key to enhancing Indonesia's resilience to external shocks.

5. Fiscal policy

Indonesia's fiscal policy is defined by the rules set in the 2003 State Finances Law. The rules specifically set the caps on the fiscal deficit-to-GDP ratio and the public debt-to-GDP ratio at 3% and 60% respectively.

The fuel subsidy reform which the Joko administration implemented in 2015 is one of its policy measures that has produced the greatest effect. Before the reform, the retail fuel price was set below the international prices, with the balance footed by the government. This means that international prices higher than the levels assumed by the government inevitably leave a budget shortfall. For this reason, the actual subsidy outlays often exceeded the initial budget appropriations in the past. During the last 10 years, such shortfalls were particularly prominent in 2008, 2011 and 2012. Before the reform, the fuel subsidy had accounted for around 20% of the total budget outlay. The fuel subsidy, equivalent to 3% of the GDP, had been a strain on the government expenditures.

The 2015 reform allowed the retail fuel prices to move in tandem with the international market prices. The government's subsidy outlay drastically shrank, helped in part by the fall of global oil prices in the year. In 2016, the ratios of the fuel subsidy to the total government expenditure and GDP fell to 5.1% and 0.8% respectively, a substantial reduction from the pre-reform levels.

The fiscal leeway generated by the reform could be diverted to capital expenditure on public projects such as infrastructure development. The share of capital spending in the total government expenditure rose from the pre-reform levels of 8-9% to 11.1% in 2016.

The government also implemented a tax amnesty program as a temporary act valid from July 2016 to March 2017 with the aim of capturing tax-evaded assets and enhancing tax collection. The total value of such assets harbored in foreign countries, Singapore in particular, is estimated at around 4,000 trillion rupiah. Those who declare their assets or repatriate sale proceeds during the program period would be exempted from possible additional taxation or criminal charges. This program produced good results by bringing about 109.5 trillion rupiah in additional tax revenue at the end of 2016.

Minister of Finance Suri Mulyani, who was newly appointed in the cabinet reshuffle in July 2016, has been making efforts to secure the investor confidence by compiling a realistic and credible budget free of optimistic assumptions. Under her leadership, the budget deficit-to-GDP ratio was cut to 2.46% in 2016 from 2.59% in 2015 through spending cuts and enhanced efficiency. The 2017 budget envisages an increased public investment and a further cut of the deficit ratio to 2.41% through an additional curb on subsidy expenditures. The budget thereby pursues two targets of economic growth and fiscal consolidation. The public debt-to-GDP ratio was held to 27.9% in 2016. The ratio is projected to stay stable at mid-20% levels. Thus the government has been building up its track records of steady fiscal management.

However, the Joko administration is still faced with some challenges. The capital expenditure has been increasing but its level still remained lower at 1.7% of GDP in 2016. Acceleration of infrastructure development by the government is keenly needed in order to alleviate the infrastructure bottlenecks. His administration also has a host of challenges to address in the aspect of fiscal revenue. The government revenue-to-GDP ratio stood at 12.5% in 2016, which is lower than those of other sovereign peers rated in the BBB range by JCR, such as the Philippine (15.5%), Turkey (21.8%), and Brazil (36.0%). Indonesia's taxation base still needs to be broadened.

6. Financial sector

Indonesia's banking sector stays generally sound, with the capital adequacy ratio and the nonperforming loan ratio (at commercial banks) standing at 22.9% and 2.9%, respectively, at the end of 2016. The NPL ratio made a particularly remarkable improvement as compared to 7.6% at the end of 2005. The growth of credit supply to the private sector accelerated from 9.6% in 2015 to 11.0% in 2016.

Yet the banking sector still faces a number of challenges. The government has been looking to consolidate the banking sector through mergers since it introduced its "Banking Architecture (API)" in 2004. However, the consolidation has not progressed well as the number of banks only dropped to 116 by the end of 2016 from just over 130 at the start of the API. The lending rate charged by banks remains relatively high (only down from 12.66% in 2015 to 11.89% in 2016) despite a series of policy rate hikes by Bank Indonesia. The fall in the lending rate has been smaller than that of the deposit rate (from 8.34% in 2015 to 11.89% in 2016).

The banking sector also has a long-pending issue of being too small in comparison to the size of the country's economy. The ratio of money stock (M2) to GDP (an indicator of money stock held by the economic entities) stood at 39.9% at the end of 2016, which is much lower than those of the peers in the JCR BBB range such as India (81.5%), the Philippines (63.2%) and Turkey (54.0%). The delay in financial deepening has compelled the private sector to rely on foreign currency borrowing for funds to finance the investments required for economic growth. As seen above, the external borrowing by the private sector is restrained at the moment through Bank Indonesia's prudential regulations. With the country's financing requirements expected to expand to support its economic growth, a further financial deepening is crucially needed in the longer term.

7. Conclusion and Rating Outlook

The sovereign ratings for Indonesia mainly reflect Indonesia's solid economic growth underpinned by domestic consumption, restrained level of budget deficit and public debt, resilience to external shocks supported by the flexible exchange rate policy and accumulation of the foreign exchange reserves, and financial soundness of the banking sector. Meanwhile, the ratings are constrained by its still high dependence on raw commodities, volatile private capital inflows amid continued needs of current account deficits control, inadequate infrastructure and an investment environment which needs further improvements, and high dependence of private sector on external borrowing behind undersized financial system.

JCR changed the rating outlook from Stable to Positive in March 2017, based on the recent improvement on the investment climate promoted by a series of Economic Policy Packages and the containment of private external debt brought by Bank Indonesia's prudential regulations on external borrowing.

The Indonesian economy is bottoming out since resource prices have stopped falling. JCR holds that it is essential for the authorities to accelerate structural reforms to ensure long-term sustainable growth by capitalizing on that tail wind. Specifically, JCR will monitor future developments on the following points and have them reflected on its ratings, in the first place, acceleration of infrastructure development, secondly, promotion of foreign direct investment through improvement of the investment environment, and thirdly, further continued curtailment of private external borrowing.

As quantitative indices used to assess the progress, JR will particularly focus on (1) monthly implementation of government investment expenditures, (2) quarterly inflows of foreign direct investment, and (3) monthly outstanding balance of private-sector external debt.

12063 Republic of Indonesia

Main Economic Indicators

		FY2011	FY2012	FY2013	FY2014	FY2015
Real GDP growth	%	6.0	5.6	5.0	4.8	5.0
CPI inflation rate(period average)	%	4.3	6.4	6.4	6.4	3.5
Central government fiscal balance / GDP	%	-1.8	-2.2	-2.1	-2.6	-2.5
Central government primary balance / GDP	%	-0.6	-1.0	-0.9	-1.2	-0.9
Central government debt / GDP	%	23.0	24.9	24.7	27.4	27.9
Current account / GDP	%	-2.7	-3.2	-3.1	-2.1	-1.8
Trade balance / GDP	%	0.9	0.6	0.8	1.5	1.6
Financial account / GDP	%	-2.8	-2.4	-5.0	-2.0	-2.7
Foreign reserves	USD bn	112.8	99.4	111.9	105.9	114.4
In months of imports of goods and services	months	6.4	5.6	6.7	7.7	8.6
Rupiah per US dollar (period average)	IDR/USD	9,387	10,461	11,865	13,389	13,309
External debt / GDP	%	27.5	29.2	32.9	36.1	34.0
External debt / exports of goods and services	%	119.6	129.8	147.5	182.1	188.0
Foreign reserves / short term external debt	x	2.5	2.3	2.5	2.7	2.7
Debt service / exports of goods and services	%	17.7	19.9	23.8	32.6	33.5

(Source) Bank Indonesia, Ministry of Finance、Central Bureau of Statistics, and CEIC

Ratings

(millions of yen)

	Rating	Outlook*	Amount	Rate (%)	Issue Date	Maturity Date	Release
Series E (2015)	BBB-	-	22,500	1.08	2015.08.13	2018.08.13	2017.03.07
Series F (2015)	BBB-	-	22,500	1.38	2015.08.13	2020.08.13	2017.03.07
Foreign Currency Long-term Issuer Rating	BBB-	Positive	-	-	-	-	2017.03.07
Local Currency Long-term Issuer Rating	BBB	Positive	-	-	-	-	2017.03.07

History of Long-term Issuer Rating (Long-term Issuer Rating or its equivalent)

Date	Rating	Outlook*	Issuer Name
2002.10.25	B		Republic of Indonesia
2004.05.26	B+		Republic of Indonesia
2006.09.21	BB-	Stable	Republic of Indonesia
2007.09.06	BB	Positive	Republic of Indonesia
2009.02.05	BB	Stable	Republic of Indonesia
2009.07.07	BB+	Stable	Republic of Indonesia
2010.07.13	BBB-	Stable	Republic of Indonesia
2017.03.07	BBB-	Positive	Republic of Indonesia

*Outlook for long-term issuer rating, or direction in case of Credit Monitor

Japan Credit Rating Agency, Ltd.
Jiji Press Building, 5-15-8 Ginza, Chuo-ku, Tokyo 104-0061, Japan
Tel. +81 3 3544 7013, Fax. +81 3 3544 7026