FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Indonesia at 'BBB'; Outlook Stable

Mon 22 Nov, 2021 - 6:09 AM ET

Fitch Ratings - Hong Kong - 22 Nov 2021: Fitch Ratings has affirmed Indonesia's Long-Term Foreign-Currency Issuer Default Rating (IDR) at 'BBB' with a Stable Outlook.

A full list of rating actions is at the end of this rating action commentary.

KEY RATING DRIVERS

Indonesia's rating balances a favourable medium-term growth outlook and a still low, but rising, government debt/GDP ratio against a high dependence on external financing, low government revenue and lagging structural features such as governance indicators and GDP per capita compared with 'BBB' category peers.

Economic activity in Indonesia is recovering gradually after a strong Covid-19 surge from June through August that constrained domestic demand. Fitch expects real GDP to grow by 3.2% in 2021, although there is upside potential to our forecast from a swift recovery in mobility in 4Q21 and continued high prices of Indonesia's export commodities. Indonesia's vaccination drive has accelerated in recent months, but still lags behind many of its peers, with close to 50% of the population inoculated with a first dose and just over 30% fully vaccinated as of mid-November. We forecast growth to accelerate to 6.8% in 2022, with the main risks relating to the evolution of the pandemic. Thereafter, we expect growth to remain at around 6% over the next few years, as the negative output gap from the pandemic closes gradually. Growth should also receive a boost from the implementation of the Omnibus Law on Job Creation, passed about a year ago, which aims to alleviate long-standing barriers to investment.

The severe Covid-19 surge earlier this year has put further pressure on fiscal metrics, as it prolonged the need for relief spending, weakened the balance sheets of state-owned enterprises, and lowered the government's revenue intake. Parliament has nevertheless passed new revenue-enhancing measures in a tax reform law in October, which includes a rise in the VAT rate by 1pp to 11% from April 2022, a voluntary disclosure programme, and implementation of a carbon tax. The government expects implementation of the tax reform law to yield an additional 0.8% of GDP in tax revenue in 2022, mostly from the VAT rate hike. Long-standing challenges to raising the revenue ratio more significantly remain in our view, including to expand the tax base and improve compliance. Nevertheless, the reform should help the government to meet its ambitious deficit target of below 3% of GDP in 2023, when the budget ceiling will be reinstated.

Fitch forecasts the fiscal deficit to decline to 4.5% in 2022 from 5.4% in 2021. These are slightly narrower than the targets presented in the government's 2022 budget of 4.9% and 5.8%, respectively, which exclude the positive impact of the tax reform. There is a risk of higher relief spending, depending on the evolution of the pandemic, although other government expenditures are likely to fall short of spending targets. By mid-November, the government had spent only just over 65% of the budgeted 4.5% of GDP in 2021 for its Covid-19-related measures. The National Economic Recovery Programme entails a broad range of measures to support households and companies affected by the pandemic, including food assistance, cash transfers, discounted electricity prices, temporary tax relief and tax incentives, wage subsidies, and support for SMEs through a credit restructuring scheme and working capital credit.

The pandemic has caused a significant rise in Indonesia's general government debt, in line with its rating peers. We forecast debt to rise to 43.1% of GDP by end-2021, from a pre-pandemic level of 30.6% in 2019, still well below the 'BBB' category median (60.3%). We expect the debt ratio to peak at 45.1% of GDP in 2022 before declining gradually, facilitated by the resumption of strong GDP growth and tighter fiscal policy. However, the government debt-to-revenue ratio will rise to 341% by end-2021, well above the peer median of 253%.

Low revenue and high non-resident holdings of local-currency debt exacerbate the challenges of financing the higher deficits in our view, which the authorities have sought to ease through direct central bank financing. The Ministry of Finance and Bank Indonesia (BI) announced an extension of their "burden-sharing arrangement" and financing arrangements through 2022 in August, which they had previously committed would not be extended beyond 2021. Monetary financing arrangements include a private placement with BI amounting to 1.3% of GDP in 2021 and 1.2% in 2022 and purchases in the primary market if deemed necessary, while the central bank financed around 3% of GDP in 2020.

These financing arrangements are helping to keep government interest costs down and free up resources for relief measures, but they run the risk of government interference in monetary policymaking. The authorities have emphasised that the independence of the central bank is not in doubt and the policy for this and next year has been instituted at the central bank's initiative. Market participants have so far reacted positively to the extension of the arrangements, with bond yields and the exchange rate remaining broadly stable. However, prolonged monetary financing could eventually undermine investor confidence and weigh on Indonesia's credit profile, especially if emerging markets come under pressure as global liquidity conditions tighten.

BI's foreign-exchange reserves strengthened to USD145.5 billion by end-October 2021 from USD121.0 billion at end-March 2020, and will cover 7.0 months of current account payments at end-2021, according to Fitch forecasts (BBB median: 7.7 months). Foreign direct investment has also recovered in 2021, with investments in several sectors, including electric-vehicle production. Higher FDI inflows and swap lines with other central banks, strengthen Indonesia's external resilience. Nevertheless, we believe Indonesia remains more vulnerable than many of its peers to shifts in investor sentiment towards emerging markets, given the high dependence on portfolio inflows and commodity exports, and external debt ratios that are above peer medians.

Continued weak price pressure from the negative output gap and limited pass-through of higher international oil prices to retail fuel prices should keep inflation within BI's target range of 2%-4% in the near term. We expect the central bank to discount the price increase from the VAT rise, estimated by the authorities at 50bp, but to nonetheless hike its policy rate by 50bp to 4.0% at end-2022 in light of its mandate to focus on both internal and external price stability, and to mitigate or pre-empt any market pressure from the US Fed's tightening policies.

The low revenue intake and rising interest payments of 16.5% of revenue in 2021 may reduce the state's capacity to invest in infrastructure, which remains a key medium-term priority for the government. The authorities are also constrained by constitutionally mandated spending on health and education, and the possible need for further capital support to state-owned enterprises. The Indonesia Investment Authority, established February 2021, is intended to help finance infrastructure development over the next few years from a combination of public and foreign official and private funds, including through disinvestment of government assets, such as toll roads. This may help to finance more infrastructure development over time, which would support medium-term growth.

The Indonesian economy is less developed on a number of structural metrics than many of its peers. Indonesia's average per capita GDP of USD4,175, for example, is significantly lower than the 'BBB' category median of USD11,428.

ESG - Governance: Indonesia has an ESG Relevance Score of '5' for Political Stability and Rights and '5[+]' for the Rule of Law, Institutional and Regulatory Quality and Control of Corruption. These scores reflect the high weight that the World Bank Governance Indicators have in our proprietary Sovereign Rating Model. Indonesia has a medium World Bank Governance Indicator ranking at the 47th percentile (BBB peer median: 59th), reflecting a recent record of peaceful political transitions, a moderate level of rights for participation in the political process, moderate institutional capacity, established rule of law and a high level of corruption.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to negative rating action/downgrade:

- Public Finances: A continued increase in the overall public debt burden over the next few years to levels well beyond our current forecasts, for example, resulting from failure to reduce the fiscal deficit to pre-crisis levels or further accumulation of debt by publicly owned entities.

- Macroeconomic: A weakening of the policy framework that could undermine macroeconomic stability, for instance, resulting from continued monetary financing of the deficit in the next few years.

- External Finances: A sustained decline in foreign-exchange reserve buffers, resulting, for example, from outflows stemming from a deterioration in investor confidence or large foreign-exchange interventions.

Factors that could, individually or collectively, lead to positive rating action/upgrade:

- External Finances: A material reduction in external vulnerabilities, for instance, through a sustained increase in foreign-exchange reserves, reduced dependence on portfolio flows or lower exposure to commodity price volatility.

- Public Finances: A marked improvement in the government revenue ratio in the next few years closer to the level of 'BBB' category peers, including from better tax compliance or a broader tax base, which would strengthen public finance flexibility.

- Structural: Significant improvement of structural indicators, such as governance standards, closer to those of 'BBB' category peers.

SOVEREIGN RATING MODEL (SRM) AND QUALITATIVE OVERLAY (QO)

Fitch's proprietary SRM assigns Indonesia a score equivalent to a rating of 'BBB-' on the Long-Term Foreign-Currency (LT FC) IDR scale.

Fitch's sovereign rating committee adjusted the output from the SRM score to arrive at the final LT FC IDR by applying its QO, relative to SRM data and output, as follows:

- Macro: +1 notch adjustment to offset the deterioration in the SRM output driven by the pandemic shock, in particular from the growth volatility variable. Fitch believes that Indonesia has the capacity to absorb the shock without lasting effects on medium-term macroeconomic stability.

Fitch's SRM is the agency's proprietary multiple regression rating model that employs 18 variables based on three-year centred averages, including one year of forecasts, to produce a score equivalent to a LT FC IDR. Fitch's QO is a forward-looking qualitative framework designed to allow for adjustment to the SRM output to assign the final rating, reflecting factors within our criteria that are not fully quantifiable and/or not fully reflected in the SRM.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Indonesia has an ESG Relevance Score of '5' for Political Stability and Rights as World Bank Governance Indicators have the highest weight in Fitch's SRM and are therefore highly relevant to the rating and a key rating driver with a high weight. Indonesia's percentile rank below 50 for the Governance Indicator has a negative impact on the credit profile.

Indonesia has an ESG Relevance Score of '5[+]' for Rule of Law, Institutional & Regulatory Quality and Control of Corruption as World Bank Governance Indicators have the highest weight in Fitch's SRM and are therefore highly relevant to the rating and are a key rating driver with a high weight. Indonesia's percentile rank above 50 for the Governance Indicator has a positive impact on the credit profile.

Indonesia has an ESG Relevance Score of '4[+]' for Human Rights and Political Freedoms as the Voice and Accountability pillar of the World Bank Governance Indicators is relevant to the rating and a rating driver. Indonesia's percentile rank above 50 for the Governance Indicator has a positive impact on the credit profile.

Indonesia has an ESG Relevance Score of '4' for Creditor Rights as willingness to service and repay debt is relevant to the rating and is a rating driver for Indonesia, as for all sovereigns. Indonesia had a fairly recent restructuring of public debt in 2005, which has a negative impact on the credit profile.

Except for the matters discussed above, the highest level of ESG credit relevance, if present, is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or to the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING ACTIONS

ENTITY / DEBT ⬍	RATING ⬍	PRIOR ⬍

Indonesia	LT IDR	BBB Rating Outlook Stable	Affirmed	BBB Rating Outlook Stable
	ST IDR	F2	Affirmed	F2
	LC LT IDR	BBB Rating Outlook Stable	Affirmed	BBB Rating Outlook Stable
	LC ST IDR	F2	Affirmed	F2
	Country Ceiling	BBB	Affirmed	BBB
senior unsecured	LT	BBB	Affirmed	BBB
Perusahaan Penerbit SBSN Indonesia III				
senior unsecured	LT	BBB	Affirmed	BBB

VIEW ADDITIONAL RATING DETAILS

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PARTICIPATION STATUS

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APPLICABLE CRITERIA

Country Ceilings Criteria (pub. 01 Jul 2020)

Sukuk Rating Criteria (pub. 15 Feb 2021)

Sovereign Rating Criteria (pub. 26 Apr 2021) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Country Ceiling Model, v1.7.2 (1)

Debt Dynamics Model, v1.3.1 (1)

Macro-Prudential Indicator Model, v1.5.0 (1)

Sovereign Rating Model, v3.12.2 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Indonesia	EU Endorsed, UK Endorsed
Perusahaan Penerbit SBSN Indonesia III	EU Endorsed, UK Endorsed

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Sovereigns Asia-Pacific Indonesia