FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Indonesia at 'BBB'; Outlook Stable

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

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 compared with 'BBB' category peers, such as governance indicators and GDP per capita.

Fitch forecasts Indonesia's GDP growth to recover gradually to 5.3% in 2021 and 6.0% in 2022, from a contraction of 2.1% in 2020 induced by the Covid-19 pandemic. The recovery is being supported by government stimulus spending and net exports, including from improved commodity prices. We expect growth momentum to be further supported in the near term by fiscal relief measures and infrastructure spending. Growth, nonetheless, remains subject to significant downside risk from weak domestic demand, including consumption of services, as Covid-19 infections continue to spread. The authorities started their vaccination program in January and aim to reach herd immunity by 1Q22, an optimistic target in Fitch's view. Over the medium term, we expect growth to receive a boost from implementation of the Omnibus Law on Job Creation, which aims to alleviate several long-standing barriers to investment.

Government spending remains focused on alleviating the impact of the health crisis, with 4.2% of GDP allocated in 2021 for health and relief measures to support households and businesses, after 3.8% of GDP was disbursed in 2020. Infrastructure development remains a key medium-term priority for the government, but its investment capacity may be constrained by rising interest payments (18% of revenue in 2020), constitutionally mandated spending on health and education, and the possible need for further capital support to state-owned enterprises. A newly established "sovereign wealth fund", the Indonesia Investment Authority, is intended to help finance infrastructure development over the next few years from a combination of government and private-sector funds, including through disinvestment of government assets, such as toll roads.

We expect the fiscal deficit to narrow only marginally to 5.6% in 2021 from 6.1% in 2020, broadly in line with the government's target. Fiscal consolidation should speed up from 2022, once the impact of the pandemic abates, given broad support across the political spectrum for prudent fiscal policies and Indonesia's track record of low debt accumulation compared with its peers. The government aims to adhere to its temporarily suspended 3% deficit ceiling again by 2023. In our view, consolidation is likely to come from the phasing out of relief policies and spending rationalisation, rather than from revenue measures. We expect the revenue ratio to pick up gradually to 12.3% of GDP in 2021 and 12.8% in 2022 as the economy recovers, from 12.1% in 2020, the lowest in the 'BBB' category.

The impact of the pandemic on Indonesia's fiscal metrics has been less severe than for most of its peers. The 3.9pp widening in the fiscal deficit in 2020 was smaller than the 5.5pp median rise for 'BBB' peers and we expect government debt to peak at around 42% of GDP in 2022, well below the 'BBB' median of 57%.

Nonetheless, the authorities face financing challenges, which are being alleviated by having the central bank purchase government bonds in the primary market. The challenges are exacerbated, in Fitch's view, by Indonesia's low revenue ratio and strong dependence on foreign financing of the debt. Around 39% of government debt is denominated in foreign-currency, while non-residents held 25% of local-currency government debt in January, albeit down from 39% in December 2019. Investor inflows into local-currency government debt have remained muted since the large outflows of around USD9 billion in March 2020.

Monetary financing of the deficit has helped to reduce the government's interest costs, freeing up resources for relief measures, but has also raised questions about Indonesia's policy approach over the medium term. Repeated central bank financing would raise the potential for government interference in monetary policymaking, risk fiscal dominance, and could undermine investor confidence, which would weaken the credit profile.

Bank Indonesia (BI) has announced that in 2021, it will only stand by to purchase bonds in the primary market as the buyer of last-resort and will not repeat its more elaborate "burden sharing" arrangement of 2020. BI has so far this year taken up 0.4% of GDP in primary market purchases and plans to adhere to a maximum share per auction of 25% for conventional domestic bonds and 30% for shariah bonds. Parliament dropped a draft law late last year to expand BI's mandate to monetise debt. In Fitch's view, passage of such a law would negatively affect Indonesia's credit profile.

BI has also responded to the pandemic by cutting its policy rates by 150bp in total since early 2020, easing macroprudential policies and providing ample liquidity to the banking system. We expect BI to keep its policy rates unchanged through 2021, as an improved current account position, including from the rise in commodity prices, should help offset pressures from rising US yields in the near term. We expect BI to start a tightening cycle in 2022, when inflation picks up with a rise in economic activity.

BI's foreign-exchange buffers strengthened to USD138.8 billion by end-February 2021 from USD121.0 billion at end-March 2020, and covered 8.2 months of current account payments at end-2020 ('BBB' median: 5.0 months), after the current account deficit narrowed to 0.4% of GDP from 2.7% in 2019. However, we expect the deficit to widen to 1.9% in 2021, as growth accelerates and imports rise.

In Fitch's view, Indonesia remains more vulnerable than many of its peers to shifts in investor confidence towards emerging markets, for instance from a further rise in global bond yields. The country remains more dependent on commodity exports and portfolio flows, while external debt ratios are higher than peer medians and external liquidity, measured by the ratio of the country's liquid external assets to its liquid external liabilities, is weaker.

The Indonesian economy is less developed on a number of structural metrics than many of its peers. Indonesia's relatively low basic human development is indicated by its ranking on the United Nations Human Development Index (43rd percentile versus the 'BBB' median of 68th percentile), while average per capita GDP also remains low, at USD3,884, compared with the median of USD10,471 for peers in the 'BBB' rating range. These structural metrics could improve over time with successful reform implementation.

ESG - Governance: Indonesia has an ESG Relevance Score (RS) of 5 for both Political Stability and Rights and for the Rule of Law, Institutional and Regulatory Quality and Control of Corruption, as is the case for all sovereigns. Theses scores reflect the high weight that the World Bank Governance Indicators (WBGI) have in our proprietary Sovereign Rating Model. Indonesia has a medium WBGI ranking at the 46th percentile ('BBB' peer median: 59th), reflecting a recent track 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

The main factors that could, individually or collectively, lead to positive rating action/upgrade are:

- External Finances: 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.

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

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

The main factors that could, individually or collectively, lead to negative rating action/downgrade:

- Fiscal 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.

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 to arrive at the final LT FC IDR by applying its QO, relative to SRM data and output, as follows:

- Macroeconomic: +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].

KEY ASSUMPTIONS

The world economy performs broadly in line with Fitch's latest Global Economic Outlook, published in March 2021.

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 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 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 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.

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	LT	BBB	Affirmed	BBB

VIEW ADDITIONAL RATING DETAILS

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Additional information is available on www.fitchratings.com

APPLICABLE CRITERIA

Country Ceilings Criteria (pub. 01 Jul 2020)

Sovereign Rating Criteria (pub. 26 Oct 2020) (including rating assumption sensitivity)

Sukuk Rating Criteria (pub. 15 Feb 2021)

APPLICABLE MODELS

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

Country Ceiling Model, v1.7.1 (1)

Debt Dynamics Model, v1.2.1 (1)

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

Sovereign Rating Model, v3.12.1 (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