Fitch Ratings

Fitch Revises Indonesia's Outlook to Positive; Affirms at 'BBB-'

Fitch Ratings-Hong Kong-21 December 2016: Fitch Ratings' Outlook on Indonesia’s Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDRs) has been revised to Positive, with both ratings affirmed at ‘BBB-’. The issue ratings on Indonesia’s senior unsecured foreign- and local-currency bonds and foreign-currency sukuks - issued through Perusahaan Penerbit SBSN Indonesia II and III - have also been affirmed at 'BBB-'. The Country Ceiling has been affirmed at 'BBB' and the Short-Term Foreign- and Local-Currency IDRs at 'F3'. The senior unsecured short-term issues have also been affirmed at 'F3'.

KEY RATING DRIVERS

Indonesia's ratings balance a low government debt burden, favourable growth outlook and limited sovereign exposure to banking-sector risks with a weak external position compared with 'BBB' category peers that makes the country relatively vulnerable to shifts in market sentiment and a weak - but improving - business environment.

The revision of the Outlook on the Long-Term IDRs to Positive reflects the following key rating drivers:

A strong structural reform drive since September 2015 is gradually improving the difficult business environment, and is likely to support the growth outlook in the medium term. Eye-catching reforms include a reduction in the number and duration of bureaucratic procedures - illustrated by a strong improvement in Indonesia's rank for the World Bank Ease of Doing Business indicator to 91 from 106 - and a more standardised approach to minimum wage setting. The impact of the reform programme on investment and real GDP growth will depend on the implementation and to what extent the government continues to create a more welcoming climate for investors. Continued macro-policy settings supporting stability combined with a persistent reform drive have the potential to structurally reduce vulnerabilities in Indonesia's external finances.

Indonesia's 'BBB-' IDRs also reflect the following key rating drivers:

GDP growth has come down in recent years, but is still solid compared with peers, illustrated by average growth of 5.3% over the last five years ('BBB' median: 3.2%). We forecast GDP growth to accelerate gradually in the next two years, driven by the positive impact of the speeded-up structural reform effort, some stepped-up infrastructure spending, and monetary policy easing over 2016. Fitch forecasts GDP growth at 5.1% in 2016, 5.4% in 2017 and 5.7% in 2018.

The low general-government debt burden of 27.8% of GDP in 2016 compares well with the 'BBB'-median of 40.6%. Fitch does not expect the government debt to rise significantly as the government is adhering to a self-imposed budget-deficit ceiling of 3% of GDP, which has helped to hold up investor confidence in Indonesia in times of market turbulence. The government revenue intake is very low, constraining direct government financing of infrastructure projects and increasing the reliance on state-owned enterprises to address the infrastructure deficit. However, a tax amnesty bolstered government revenue by IDR97trn (0.8% of GDP) in the first phase of the programme concluded at end-September 2016, and may help raise revenue more permanently.

Fitch considers the sovereign's exposure to banking sector risks as limited. Private credit represents only 36% of GDP and the banking system's health is relatively strong, although risks built up in the previous credit cycle imply a more challenging operating environment. This has led to deferral of private-sector capital expenditure and has increased gross non-performing loans to 3.2% of total assets in October 2016, from a low of 1.8% at end-2013. However, the banking sector's capital adequacy is strong, at 22.9% in October 2016.

Foreign reserves stood at USD111.5bn in November 2016, equal to 7.0 months of current-account payments and higher than the 'BBB'-median of 6.5 months. However, Indonesia remains relatively vulnerable to shifts in market sentiment, as it is largely dependent on commodities for its exports and portfolio inflows to finance its persistent current-account deficit - which Fitch expects to slightly rise to 2.3% of GDP in 2017 from 1.9% in 2016. Gross external debt is stabilising relative to GDP, as an acceleration of corporate external debt has been reined in by BI's external borrowing requirements implemented in 2015, even though external government debt on commercial terms is growing.

The Indonesian economy continues to exhibit some structural weaknesses, notwithstanding the improvements noted above,
and is less developed on a number of metrics than many of its peers. Average per capita GDP remains low at USD3,576 compared with the 'BBB' range median of USD9,188, while governance continues to be weak, as illustrated by a low score for the World Bank governance indicator (41st percentile versus the 'BBB' median of 58th percentile) and Transparency International's corruption index (88th of 168).

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 IDR scale. Fitch's sovereign rating committee adjusted the output from the SRM to arrive at the final Long-Term Foreign-Currency IDR by applying its QO, relative to rated peers, as follows:

- External Finances: -1 notch, to reflect Indonesia's vulnerability to changes in market sentiment and portfolio shifts, as a large part of government debt is held abroad or financed in foreign currency, and its relatively high net external debt.

Fitch's SRM is the agency's proprietary multiple regression rating model. It employs 18 variables based on three-year centred averages, including one year of forecasts, to produce a score equivalent to a Long-Term Foreign-Currency 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.

RATING SENSITIVITIES
The main factors that, individually or collectively, could trigger positive rating action are:

- A strengthening of the external balances, making Indonesia less vulnerable to sudden changes in foreign-investor sentiment, for instance through lower commodity export dependence or structurally higher foreign direct investment inflows.
- Continued improvement of the business environment and governance standards.
- Maintenance of sustainable GDP growth at a higher level than rating peers.

The rating Outlooks are Positive. Hence, Fitch does not anticipate a high probability of negative action over the forecast period. However, the main factors that could see the ratings revert to Stable Outlook are:

- A sharp and sustained external shock to foreign and/or domestic investors' confidence with the potential to cause external financing difficulties.
- A rise in the public debt burden, for example caused by breaching the budget-deficit ceiling.

KEY ASSUMPTIONS
- The global economy performs broadly in line with Fitch's Global Economic Outlook (November 2016)

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Applicable Criteria
Sovereign Rating Criteria (pub. 18 Jul 2016) (https://www.fitchratings.com/site/re/885219)
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