Fitch Ratings-Hong Kong-20 December 2017: Fitch Ratings has upgraded Indonesia's Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDR) to 'BBB', from 'BBB-'. The Outlook is Stable.

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

KEY RATING DRIVERS

The upgrade of Indonesia's IDRs reflects the following key rating drivers:-

Indonesia's resilience to external shocks has steadily strengthened in the past few years, as macroeconomic policies have consistently been geared towards maintaining stability. A more flexible exchange-rate policy since mid-2013 has helped foreign reserve buffers swell to USD126 billion as at November 2017, reaching seven months of current account payments, compared with the 'BBB' median of six months. Moreover, monetary policy has been sufficiently disciplined to limit bouts of volatile capital outflows during challenging periods. Macro-prudential measures have helped curb a sharp rise in corporate external debt, while financial deepening has coincided with improved market stability. The focus on macro stability is also evident in credible budget assumptions in the previous few years.

Indonesia's resilience has improved, but external challenges remain, including potential emerging market pressure in the context of the US Federal Reserve's policy normalisation. Indonesia's dependence on commodities remains relatively high and both its net and gross external debt (166% of current account receipts; 'BBB' median: 130%) remain elevated compared with 'BBB' peers. Domestically, the possibility that political noise becomes a distraction from economic policy-making in the run up to the 2018 local elections and 2019 presidential election represents a risk to the strong reform drive and could undermine domestic and foreign market sentiment, although such an outcome is not Fitch's base case.

The government's concerted structural reform drive is improving a still-challenging business environment. Implementation of measures to reduce business procedural and permit requirements have sharply improved Indonesia's position in the World Bank's Ease of Doing Business ranking to 72nd out of 190 countries; a rise of 37 places in two years. The reforms also seem to be contributing to stronger external finances, with foreign direct investment (FDI) picking up in recent quarters to such an extent that Fitch expects net FDI to cover the current account deficit over the next few years.

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

GDP growth remains strong against peers, as illustrated by average 5.1% growth over the previous five years ('BBB' median: 3.2%), although this is still short of the above 6% levels prior to the terms-of-trade shock in 2012. Fitch expects GDP growth to rise to 5.4% in 2018 and 5.5% in 2019, from 5.1% in 2017. Indonesia is benefiting from the global pick-up in trade and stabilising commodity prices. Investment is also set to gain further momentum on higher public infrastructure spending, lower borrowing costs and structural reform implementation.

A low general-government debt burden of 28.5% of GDP in 2017, as expected by Fitch, compares well with the 'BBB' median of 41.1%. The government is adhering to a self-imposed budget-deficit ceiling of 3% of GDP, which has helped maintain investor confidence in Indonesia during times of market turbulence. The government's 2018 deficit target of 2.2% of GDP exhibits a conservative approach, providing leeway for budgetary pressure in an election year. Fitch believes the deficit outturn is more likely to remain broadly stable at 2.7% of GDP, and stay within the 3% ceiling.

The government's revenue intake is very low; among Fitch-rated sovereigns, only four have lower government revenue as a percentage of GDP. This constrains direct-government financing of infrastructure projects and increases reliance on state-owned enterprises (SOE) to address the large infrastructure deficit. Hence, non-financial SOE debt of 4.5% of GDP as of July 2017 is likely to increase substantially in the coming few years, raising the state's contingent liabilities.

Fitch considers the sovereign's exposure to banking-sector risks as limited. Private credit represents only 37% of GDP and the banking sector's capital adequacy ratio remains strong, at 23.2% in October 2017. Banks' non-performing, special mention and restructured loan ratios stabilised in 2017. Risks that built up in the previous credit cycle led to deferral of private-sector capital expenditure and a rise in gross non-performing loans to 3.0% of total assets as of October 2017, from a low of 1.8% at end-2013.

Indonesia's economy continues to exhibit some structural weaknesses, notwithstanding recent improvements from reform
implementation, and is less developed on a number of metrics than that of many peers. Average per capita GDP is low at USD3,780, compared with the 'BBB' range median of USD11,173, and governance remains weak, compared with rating category peers, as illustrated by a low World Bank governance indicator score in the 45th percentile, albeit improving from 42nd a year ago ('BBB' median: 60th percentile).

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 did not adjust the output from the SRM to arrive at the final Long-Term Foreign-Currency IDR.

Fitch's sovereign rating committee decided to remove the -1 notch QO adjustment it had previously applied to Indonesia's SRM output in respect of External Finances. In Fitch's view, Indonesia's External Finances have become more resilient to potential external vulnerabilities as a result of the consistent focus of the government's policy framework on macroeconomic stability and the improvement in external buffers, including foreign-exchange reserves.

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 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:
- Further strengthening of external finances, for instance, by expansion of the manufacturing export base and lower commodity export dependence or a decline in external debt levels.
- Continued improvement of the business environment and governance standards.
- An improvement in the government revenue ratio from better tax compliance and a broader tax base.

The main factors that, individually or collectively, could trigger negative rating action are:
- A sharp and sustained external shock to foreign and/or domestic investor confidence, with the potential to cause external financing difficulties.
- Adverse political developments that lead to a removal of the budget deficit ceiling as a fiscal anchor, increasing the overall public debt burden.
- A weakening in macroeconomic prospects, for example, from a change in the authorities' focus on monetary stability or reversal of reforms to the business environment.

KEY ASSUMPTIONS
- The global economy performs broadly in line with Fitch's Global Economic Outlook (December 2017).

Full list of rating actions:

- Long-Term Foreign-Currency IDR upgraded to 'BBB' from 'BBB-'; Outlook Stable
- Long-Term Local-Currency IDR upgraded to 'BBB' from 'BBB-'; Outlook Stable
- Short-Term Foreign-Currency IDR upgraded to 'F2' from 'F3'
- Short-Term Local-Currency IDR upgraded to 'F2' from 'F3'
- Country Ceiling affirmed at 'BBB'
- Issue ratings on long-term senior unsecured foreign-currency bonds upgraded to 'BBB' from 'BBB-' Issue ratings on long-term senior unsecured local-currency bonds upgraded to 'BBB' from 'BBB-' Issue ratings on short-term senior unsecured local-currency bonds upgraded to 'F2' from 'F3'
- Issue ratings on Perusahaan Penerbit SBSN Indonesia III global certificates (sukuk) upgraded to 'BBB' from 'BBB-

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The following issuer(s) did not participate in the rating process, or provide additional information, beyond the issuer's available public disclosure: Perusahaan Penerbit SBSN Indonesia III

Applicable Criteria

Additional Disclosures
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