Rating Action: Moody's changes outlook on Indonesia's rating to positive from stable, affirms government bond rating at Baa3

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Singapore, February 08, 2017 -- Moody's Investors Service has today revised the outlook on Indonesia's government ratings to positive from stable.

Concurrently, Moody's has affirmed Indonesia's Baa3 issuer rating, Baa3 senior unsecured bond ratings, and (P)Baa3 senior unsecured MTN program rating.

The key drivers of the change in outlook are emerging signs of a reduction in structural constraints on Indonesia's rating, including its level of external vulnerability and the strength of its institutions:

1) Indonesia's vulnerability to external shocks is declining somewhat and is expected to continue to do so, as a result of measures fostering narrower current account deficits, higher foreign exchange reserves, and a slower rise in private sector external debt; and

2) Indonesia's lengthening track record of macroeconomic stability and fiscal discipline, together with its measured but ongoing progress on structural economic, fiscal and regulatory reforms, suggest that policy effectiveness is improving.

Moody's has affirmed the (P)Baa3 senior unsecured MTN programme rating and Baa3 senior unsecured ratings of the US dollar trust certificates issued by Perusahaan Penerbit SBSN Indonesia III, a special purpose vehicle established by the Government of Indonesia.

The payment obligations associated with these certificates are direct obligations of the government, and their ratings automatically reflect changes to Indonesia's sovereign ratings.

RATINGS RATIONALE

RATIONALE FOR THE POSITIVE OUTLOOK

Indonesia's credit profile exhibits two particular features which have until now constrained the rating to Baa3: its reliance on external capital and consequent exposure to an external shock which leads to that capital being withdrawn; and the relative weakness of its institutions and related policy effectiveness. Moody's decision to revise the rating outlook to positive from stable is based on its view that both constraints show signs of easing.

First, external vulnerabilities have eased and are likely to continue to do so. Partly as a result of government policies -- which we expect to remain in place -- the overall balance of payments has been restored to health despite the persistence of low commodity prices and sporadic episodes of volatility in capital flows. The current account deficit fell from over 3% of GDP in 2013 and 2014 to an estimated 1.8% in 2016 as the goods trade balance, inclusive of the cost of insurance and transportation, reverted to a surplus in 2015. We expect Indonesia's current account deficits to remain moderate over the coming years.

The reduction in Indonesia's external vulnerability is in part the result of a shift in monetary policy towards the preservation of macroeconomic stability and away from the prior focus on short-term growth, partly through the introduction of greater exchange rate flexibility. The revision of fuel subsidies, which eliminated price distortions that previously propped up demand for petroleum imports, also contributed to narrower current account deficits. Investment in domestic manufacturing sectors, such as automobile production, has also contributed to import substitution.

Bank Indonesia (the central bank) and the government have better coordinated the proper sequencing and implementation of measures that could affect price stability and the external accounts, including the revision of electricity tariffs and the indexation of wages.

Along with healthy foreign direct investment (FDI) inflows, these policies contributed to a build-up of gross international reserves to $116.4 billion as of end-2016—up from $105.9 billion a year ago— which provide a...
large buffer against volatility in capital flows. Reserve adequacy has been bolstered further by a tapering of private sector external debt, due in part to the imposition of tighter hedging requirements by Bank Indonesia since 2015.

Second, the abovementioned shift in the focus of macroeconomic and fiscal policy, along with ongoing structural reform efforts, suggests that Indonesia's institutional strength -- and specifically the effectiveness of its policy organs -- is improving.

A measured, forward-looking macro policy stance involving both monetary tightening and lower fiscal expenditure has supported a controlled adjustment to the terms of trade shock, in part by allowing space for policy accommodation as the shock was absorbed, thereby contributing to Indonesia's gradual economic recovery.

The acceleration in real GDP growth to 5.0% last year from 4.9% in 2015 coincided with continued price stability as core inflation (excluding food, fuel and other administered commodities) averaged 3.4% in 2016, as compared to an average of 4.5% in the preceding five-year period. We expect GDP growth to remain higher than in most other Baa-rated peers, while Bank Indonesia's emphasis on macroeconomic stability should keep inflation broadly stable and within the central bank's target range.

The government has demonstrated fiscal discipline against the backdrop of continued revenue pressure from lower oil and gas prices in recent years. Most recently, through the first six months of 2016, it recorded a historically wide fiscal deficit that tested its commitment to its full-year deficit cap of 3% of GDP; overall revenue had declined by around 5% year-on-year, while expenditure had risen 15.1% on account of improved disbursements due to administrative reforms.

In response, the government implemented a tax amnesty program that contributed an additional 0.9% of GDP in revenue, while curtailing spending, such that overall expenditure declined 5.7% year-on-year through the second half of the year. Overall, we estimate that the budget deficit was kept at 2.5% of GDP, thereby preserving some scope for fiscal support to the economy in the event of negative shocks.

Measured, but consistent, progress has been achieved in implementing structural economic, fiscal and regulatory reforms. The series of policy packages that the government has unveiled since September 2015 have focused on deregulation, infrastructure development, and the selective liberalization of sectors previously closed to foreign investment.

As a result, Indonesia's rankings in cross-country surveys, such as the World Bank's Doing Business report and the institutional sub-score in the World Economic Forum's Global Competitiveness Index, have improved. That said, evidence of the reforms spurring investment has been mixed: while net FDI inflows have picked up, the growth of realized investments monitored by the Investment Coordinating Board and gross fixed capital formation in the national accounts have seen only limited improvement. More tangible evidence of a strengthening in private investment, as the reform program unfolds, would both enhance potential growth and further support the view that government and policy effectiveness are improving.

RATIONALE AFFIRMING THE Baa3 RATING

Indonesia's Baa3 government rating incorporates credit strengths, such as the size of the country's economy and its robust growth performance relative to those of peers, low government indebtedness, and a stable -- if shallow -- banking system that poses limited contingent risks to the sovereign.

At the same time, the Baa3 rating reflects the constraints described above, including the vulnerability arising from the broad reliance on external sources of funding, as represented by the large proportion of foreign currency-denominated debt relative to total government debt, and the high proportion of non-resident investment in the local currency-denominated government debt market. This reliance on external capital partly reflects the shallow nature of the domestic financial system.

Moreover, despite the improvement in policy effectiveness implied by gains in macroeconomic and fiscal management, Indonesia continues to fare worse than comparably-rated peers in other important aspects of institutional strength, in particular, in the areas of rule of law and control of corruption.

Finally, Indonesia's sovereign credit profile is constrained by weak revenue performance—currently revenue as a share of GDP is the lowest among investment grade countries—which has had a negative impact on the government's capacity to support economic growth and has led to a deterioration in debt affordability in recent years.
Nevertheless, we expect the government to remain committed to keeping the deficit under the statutory ceiling of 3% of GDP and to be able to deliver on its commitment, thereby keeping the stock of government debt low as compared to that of peers.

COUNTRY CEILINGS

Moody’s has also raised Indonesia’s local currency bond and deposit ceilings to A1 from A3. The change reflects a revised view of the economy’s vulnerability to external shocks, as well as a repositioning for consistency with peers such as India. The Baa2/P-3 country ceiling for foreign currency (FC) debt and Baa3/P-3 country ceiling for FC bank deposits remain unchanged. These ceilings act as a cap on the ratings that can be assigned to the FC obligations of other entities domiciled in the country.

WHAT COULD CHANGE THE RATING -- UP

An upgrade would result from further progress in sustainably reducing external vulnerabilities, while at the same time demonstrating enhanced institutional strength. One positive indication of this development would be a reduction in the government’s reliance on external debt. Another would be further tangible evidence of enhanced government and policy effectiveness, not simply through the enactment of further reforms, but through the impact of those reforms on domestic and external investment and on competitiveness; and also through growth in the level, diversity and sustainability of government revenues.

WHAT COULD CHANGE THE RATING -- DOWN

A downgrade is unlikely, given the positive outlook. We could revise Indonesia’s rating outlook to stable if: 1) evidence built up that the nascent institutional strengthening is on hold, or reversing, particularly if associated with an unraveling of current macroeconomic and structural reform efforts; 2) we perceived that the government is unable to improve revenue performance, indicating limitations to policy effectiveness and posing continued constraints to economic growth; 3) we changed our expectations of the growth outlook to predict a material and durable weakening in economic performance relative to peers; and/or 4) a domestic or external shock increased the likelihood that fiscal, debt, or balance of payments metrics would weaken significantly from current levels.

GDP per capita (PPP basis, US$): 11,149 (2015 Actual) (also known as Per Capita Income)
Real GDP growth (% change): 4.9% (2015 Actual) (also known as GDP Growth)
Inflation Rate (CPI, % change Dec/Dec): 3.4% (2015 Actual)
Current Account Balance/GDP: -2.0% (2015 Actual) (also known as External Balance)
External debt/GDP: 36.1% (2015 Actual)
Level of economic development: High level of economic resilience
Default history: At least one default event (on bonds and/or loans) has been recorded since 1983.

On 06 February 2017, a rating committee was called to discuss the rating of the Government of Indonesia. The main points raised during the discussion were: the issuer's economic fundamentals, including its economic strength, have not materially changed. The issuer's institutional strength/ framework, have not materially changed. The issuer's governance and/or management, has not materially changed. The issuer's fiscal or financial strength, including its debt profile, has not materially changed. The systemic risk in which the issuer operates has not materially changed. The issuer has become less susceptible to event risks.

The principal methodology used in these ratings was Sovereign Bond Ratings published in December 2016. Please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

The weighting of all rating factors is described in the methodology used in this credit rating action, if applicable.

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