MOODY'S
INVESTORS SERVICE

Rating Action: Moody's affirms Indonesia's Baa2 rating, maintains stable outlook

10 Feb 2020

Singapore, February 10, 2020 -- Moody's Investors Service ("Moody's") has today affirmed the Government of Indonesia's ("Indonesia") local and foreign currency long-term issuer ratings at Baa2 and maintained the stable outlook. The local and foreign currency senior unsecured ratings and the MTN and shelf program ratings were also affirmed at Baa2 and (P)Baa2, respectively.

The affirmation of the rating is underpinned by a number of credit strengths - including Indonesia's robust and stable growth rates and a low government debt burden, preserved by consistent fiscal discipline and emphasis on macroeconomic stability - as well as persistent credit challenges. These comprise a very weak revenue base that constrains debt affordability, the government's reliance on external market funding that exposes its balance sheet and the economy to changes in foreign investor sentiment, and an economic structure that remains vulnerable to commodity cycles. Moody's expects that reforms aimed at reducing a number of structural economic and fiscal constraints will continue, albeit at a gradual pace, similar to the relatively slow progress achieved in the last few years.

The stable outlook reflects balanced risks at Baa2, mainly related to the pace and effectiveness of reforms. Significant delays or reversals in reforms would risk undermining Indonesia's growth potential and macroeconomic stability. Conversely, more effective reforms than Moody's currently expects would improve competitiveness, raise growth potential and strengthen Indonesia's external position.

Indonesia's A1 local currency bond and deposit ceilings remain unchanged. The A3 foreign currency bond ceiling and the Baa2 foreign currency deposit ceiling are also unchanged. The short-term foreign currency bond and deposit ceilings remain unchanged Prime-2. These ceilings act as a cap on the ratings that can be assigned to the obligations of other entities domiciled in the country.

Concurrently, Moody's has affirmed the backed senior unsecured ratings, and the backed senior unsecured MTN programme rating of the US dollar trust certificates issued by Perusahaan Penerbit SBSN Indonesia III, at Baa2 and (P)Baa2 respectively. This is a special purpose vehicle established by the Government of Indonesia. The associated payment obligations are direct obligations of the Government of Indonesia and rank pari passu with other senior unsecured debt of the government.

RATINGS RATIONALE

RATIONALE FOR THE AFFIRMATION OF THE Baa2 RATING

Robust and stable growth, as reforms continue albeit at a gradual pace

With a nominal GDP of just over $1.0 trillion and a population of more than 260 million, Indonesia is among the largest and most populous countries in Moody's rated universe. This, coupled with a robust pace of population growth, supports the economy's shock-absorption capacity. Through trade and capital flows shocks, GDP growth tends to fluctuate within a narrow range of around 4.9-5.2% year-on-year.

Growth slowed slightly to 5.0% in 2019, as the pace of investments moderated, and growth in exports (in nominal dollar terms) dipped into negative territory. Moody's forecasts GDP growth slightly below 5% this year as global growth remains tepid. However, even in a relatively slow-growth phase, Indonesia's economy continues to outpace most Baa-rated sovereigns and to allow increases in average incomes.

While robust by global standards, Indonesia's growth potential is hindered by various structural economic and regulatory bottlenecks, including infrastructure gaps, a burdensome and often opaque legal and regulatory system, and shallow domestic financial markets. Weaknesses in labor quality arising from health and education inadequacies, as well as skills mismatches offset some benefits from favorable demographics.Ongoing initiatives by the government seek to address these issues, at this stage, Moody's expects that the measures will only reduce structural constraints gradually. Meanwhile, total factor productivity growth will remain relatively weak and sensitivity to commodity price cycles relatively high.

While Moody's expects that ongoing reforms will address these challenges, the process is likely to be very gradual, in line with relatively slow progress in the last few years. Over recent years, reforms have primarily focused on building infrastructure, particularly transport connectivity, and deregulating policies to unlock investment. Now in its second term, the administration has expanded on these priorities to also include an emphasis on human capital development, by policies directed at addressing gaps in education and healthcare. Additionally, there is a renewed focus on improving the ease of doing business, both through planned changes to labor and tax regulations, and a streamlining of policies and procedures. Moody's expects that if implemented, the potential benefits from these reforms will materialize only gradually. Policymakers may face trade-offs between focusing on fiscal reform, particularly raising revenues; even while seeking to encourage investment.

Low debt burden, emphasis on macroeconomic stability balanced by weak revenue base and sizeable foreign currency debt exposure

Indonesia maintains a low government debt burden and moderate current account deficits underpinned by a prudent policy framework and an emphasis on maintaining macrostability. These credit strengths are balanced by a very narrow revenue base and a material proportion of foreign currency-denominated government borrowing that raises the sovereign's vulnerability to financing shocks.

Fiscal discipline is anchored by very strong adherence to a statutory deficit ceiling of 3% of GDP. Low deficits have kept the government's debt burden modest, at around 30% of GDP in 2019, well below the Baa-median of 47.3%. Moody's projects government debt to remain stable around 30% of GDP in the near to medium term.

On the external side, Moody's estimates that Indonesia's current account deficits stood at just under 3.0% in 2019. Although the deficit has widened from a low of 1.6% in 2017, it still remains modest in comparison with other Baa peers. Moreover, external buffers are sufficient to withstand some degree of shock. Pressure on the rupiah and turns in investor sentiment have eroded foreign reserves in the past, although following a prolonged episode of currency depreciation in 2018, levels have now recovered close to peak levels. Moody's External Vulnerability Index (EVI) -- which measures reserve adequacy against a sudden stop in capital -- has climbed over the past year, but at 51% in 2020 denotes strong reserve adequacy.

These fiscal and external features contrast with a number of persistent credit challenges that leave the sovereign vulnerable to financing shocks.

First, at 12% of GDP in 2019, government revenue is significantly below the median for Baa-peers at 27.6%, and the lowest of all investment-grade sovereigns. Weak revenue also weighs on debt affordability: interest payments stood at just over 14% of revenue in 2019, compared with a median of about 9% for Baa-rated sovereigns.

Moreover, slightly more than 40% of general government debt is in foreign currency, while 38% of local currency government securities are held by nonresident investors. Although foreign holdings of government debt have remained largely stable through the years, with about two-thirds of the government debt stock exposed to shifts in overseas investor appetite, the sovereign is vulnerable to a global or idiosyncratic financing shock.

RATIONALE FOR THE STABLE OUTLOOK

The stable outlook reflects balanced risks and takes into consideration a relatively slow pace of reform momentum. Upside risk relates to possibly stronger reform impetus than Moody's currently assumes that raises investment growth and boosts trade flows, as well as an increase in revenues. Conversely, downside risks relate to possible prolonged delays to reforms that directly or indirectly result in a persistent erosion in the revenue base and/or a marked slowdown in potential growth.

ENVIRONMENTAL, SOCIAL, GOVERNANCE CONSIDERATIONS

Environmental risks are a material consideration for Indonesia's credit profile. Coastal flooding and rising sea levels are a particular source of risk, with widespread implications, including for agricultural production, damage to infrastructure and property, and food security. Earlier this year, the government announced its plan to relocate the country's capital city to Kalimantan from Jakarta, in part because the latter is particularly vulnerable to rising sea levels and associated natural disasters. Separately, demand for arable land and intensive commercial logging have led to soil erosion and deforestation. In addition, given its geographical location, Indonesia is subject to considerable seismic activity that are manifested in natural disasters such as earthquakes, tsunamis and volcanos.

Social considerations are not material for Indonesia's credit profile. Demographics with population growth and a declining dependency ratio are supportive to growth. Conversely, Indonesia's education quality and spending are below global standards, which the government plans to address. Moreover, wealth is concentrated and Indonesia's rankings on wealth inequality indices are weak. This contrast between supportive and negative factors is captured in Moody's assessment of economic strength.

Governance considerations relevant to Indonesia's credit profile are captured in Moody's assessment of the strength of the sovereign's institutions and governance. Indicators such as the Worldwide Governance Indicators show that Indonesia's rule of law is relatively weak by global standards, although improving in recent years.

FACTORS THAT COULD LEAD TO AN UPGRADE

Over time, indications that fiscal policy measures can durably and significantly raise government revenue would put upward pressure on the rating. Higher revenue would enhance fiscal flexibility and provide more direct financial means for the government to address large social and physical infrastructure spending needs.

An upgrade would also likely result from indications that Indonesia's growth potential is strengthening, towards rates commensurate with the country's population growth and income levels, including through a deepening of financial markets and improved competitiveness.

FACTORS THAT COULD LEAD TO A DOWNGRADE

Downward pressure would likely arise if 1) evidence indicates that the gradual strengthening of Indonesia's policy framework and institutions stalls or reverses; 2) there were a meaningful deterioration in the external position such as from prolonged currency depreciation or capital outflows, which would also have ramifications for debt affordability.

GDP per capita (PPP basis, US$): 13,234 (2018 Actual) (also known as Per Capita Income)

Real GDP growth (% change): 5.2% (2018 Actual) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 3.1% (2018 Actual)

Gen. Gov. Financial Balance/GDP: -1.8% (2018 Actual) (also known as Fiscal Balance)

Current Account Balance/GDP: -2.9% (2018 Actual) (also known as External Balance)

External debt/GDP: 36.2% (2018 Actual)

Economic resiliency: baa1

Default history: No default events (on bonds or loans) have been recorded since 1983.

On 05 February 2020, a rating committee was called to discuss the rating of the Indonesia, Government of. The main points raised during the discussion were: The issuer's economic fundamentals, including its economic strength, have not materially changed. The issuer's institutions and governance strength, have not materially changed. The issuer's fiscal or financial strength, including its debt profile, has not materially changed.

The principal methodology used in these ratings was Sovereign Ratings Methodology published in November 2019. 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.

REGULATORY DISCLOSURES

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Regulatory disclosures contained in this press release apply to the credit rating and, if applicable, the related rating outlook or rating review.

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