MOODY'S
INVESTORS SERVICE

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

10 Feb 2022

Singapore, February 10, 2022 -- 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 supported by continued economic resiliency and Moody's expectations that monetary and macroeconomic policy effectiveness will be maintained, containing risks as global interest rates rise. Following the hit to growth from the pandemic, Moody's expects economic activity to revert to its historical average in 2023, with growth sustaining at those rates thereafter. While factoring in some challenges to effective implementation, Moody's expects that recently passed structural reforms will support investment and export competitiveness, and limit any economic scarring.

The Baa2 rating also takes into consideration relatively weak fiscal strength. In particular, debt affordability is very weak, although the government has kept the debt-to-GDP ratio at levels well below those of similarly-rated peers. Recently approved revenue reforms and plans toward fiscal normalization will support a stabilization in the debt burden by 2023.

The stable outlook reflects balanced risks. Moody's expects reforms to be implemented at a gradual pace, with some delays or refinements likely to occur, overall maintaining growth and fiscal metrics at current levels. Materially more or less effective reforms than currently assumed would have implications for Indonesia's credit profile. Moody's baseline expectation is also for fiscal and monetary measures taken in response to the pandemic - in particular the central bank's financing of fiscal deficits - to be normalized or reversed by the end of this year, in line with government targets. An effective policy exit will inform overall policy credibility, with implications for foreign investor confidence, debt flows, the currency and inflation.

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 (PPSI III), at Baa2 and (P)Baa2 respectively. PPSI III 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.

Indonesia's long-term local-currency (LC) bond ceiling remains unchanged at A1 and its long-term foreign-currency (FC) bond ceiling remains unchanged at A3. The four-notch gap between the LC ceiling and issuer rating reflects a low likelihood of political event risk significantly disrupting the economy and modest external imbalances, balanced by a relatively large government footprint in the economy and some constraints on predictability and reliability of government policies. The two-notch gap between the LC and FC ceiling reflects low external indebtedness and that a debt moratorium remains unlikely.

RATINGS RATIONALE

RATIONALE FOR THE AFFIRMATION OF THE Baa2 RATING

ECONOMIC STRENGTH WILL REMAIN RESILIENT OVER THE NEAR-TERM

Moody's expects that GDP growth in Indonesia will return to a 5.0% average over the next two years, similar to pre-pandemic GDP rates. However, as with emerging markets globally, potential growth rates in Indonesia have steadily declined over the last decade, and now face additional pressures from economic scarring following the pandemic. The long-run effects on the labor market from lost years of schooling and job losses are not yet clear, although government efforts have aimed to mitigate these impacts. An improvement in investment activity, particularly for small and medium enterprises, will also depend on continued policy support from the government until ongoing efforts to encourage private sector participation bear fruit. However, fiscal constraints may limit the extent and form of policy support that can be provided over a longer-horizon.

Moody's expects that actual GDP growth will be slightly above potential in the next 2-3 years, particularly given that the economy will be in a recovery phase with output gaps still prevalent, and buoyed by low base effects. At these projected rates, growth will trend above the median for Baa-rated sovereigns, which is estimated at 3.7% year-on-year.

However, beyond this, the direction and pace of reform efforts, particularly to boost capital and labor productivity, will determine the extent of uplift to potential growth. Policy initiatives over the past two years are directed at improving the investment environment and boosting revenues. In 2020, the government passed the Omnibus Law on Job Creation, aimed at improving employment and investment through 51 new regulations, marking an important step in addressing issues around the business climate and overall competitiveness.

In addition, fiscal reforms aimed at improving the revenue base and improving spending efficiencies will create greater financing sources for investment and support headline growth. To this end, in late 2021, the government adopted a Tax Harmonization Law, which it expects will raise tax revenues by 0.7 to 1.2 percent of GDP per annum in 2022-2025. Towards the end of last year, a law on central-regional fiscal relations was passed that harmonizes spending between central and regional governments, strengthening the taxing power and improving the accountability of provinces. In the year ahead, the government intends to pass measures targeting fuel subsidies, as well as steps to reform the financial sector.

Moody's does not expect these reforms to generate immediate benefits, although they should support a preservation of growth and fiscal buffers over the longer run.

MONETARY AND FISCAL POLICY WILL NORMALISE, UNDERPINNING POLICY CREDIBILITY

Over the past two years, the government has extended both extraordinary fiscal and monetary support, with the central bank playing a pivotal role in deficit financing. Under the first joint decree between the Ministry of Finance and the central bank, Bank Indonesia (BI), signed in 2020, the latter can step in as a standby buyer in the primary market, should the need arise. In addition, under the third joint decree signed between the two parties in 2021, the MOF can issue through private placements to BI marketable and tradeable bonds up to IDR 224 trillion in 2022 (vs. IDR 215 trillion in 2021). BI is also responsible for the interest costs on allocations for vaccination as well as a portion of the interest costs on other healthcare expenses.

These arrangements are scheduled to expire in 2022, after which BI will cease its primary market activities and hold bonds purchased under these arrangements to maturity. Moody's baseline assumption is that such a normalization of fiscal and monetary policy support will occur by the end of this year without being replaced by similar other forms of extraordinary central bank monetary policy. While direct budget financing by the BI has contributed to a normalization of bond yields and allowed the government greater flexibility in spending policy response to the pandemic, a timely unwinding of this policy support will also be crucial to preserving policy credibility.

DEBT AFFORDABILITY REMAINS A FISCAL DRAG

Like most economies, fiscal stimulus was an important part of Indonesia's response to the pandemic. Announced stimulus stood at 4.5% of GDP in 2020, as a result of which the deficit widened to 6.1% of GDP in 2020 from 2.2% in 2019. An additional 4.5% of GDP worth of stimulus was announced in 2021, although strong commodity revenues helped the budget deficit moderate to 4.6% of GDP in 2021. The widening in the budget deficit was made possible by the passage of regulatory measures earlier in 2020 to relax the budget deficit ceiling of 3.0% of GDP, which had been strictly adhered to before the pandemic.

Moody's assumes that even with a slowdown in revenue growth relative to 2021 owing to a tempering in commodity prices, some unwinding in spending will drive a consolidation in the fiscal deficit to 3.8% of GDP in 2022. This will pave the way for the government to achieve its stipulated goal of reverting to the 3.0% deficit ceiling by 2023.

Taking this baseline assumption for deficit normalization, Moody's expect that debt levels will drift upward until 2023, peaking at 42.5% of GDP and then stabilize around that level thereafter. The increase in debt has not been as sizeable as compared with other emerging markets, and the debt burden will remain significantly below the Baa median of 64% of GDP.

While the debt-to-GDP ratio is relatively low, debt affordability acts as a significant drag on Indonesia's fiscal profile. The ratio of interest payments to revenues -- already weak pre-pandemic -- worsened to 19% in 2020, as revenues contracted. In 2021, an improvement in revenue growth coupled with lower interest costs resulted in a slight improvement in the ratio to 17%. However, factoring in rising interest rates globally and

domestically, Moody's expects this ratio will hover around 18% going forward. This is materially higher than the Baa median of around 8%. The share of foreign currency borrowing has moderated significantly over the last two years, but at around a third of total general government debt, continues to expose fiscal strength to shifts in external appetite and currency fluctuations.

RATIONALE FOR THE STABLE OUTLOOK

The stable outlook reflects the expectation that reform implementation should continue at a steady, albeit gradual pace. Upside and downside risks to reform implementation would not materially affect the rating, unless potential growth outturns were materially above peers. A key assumption behind the stable outlook is the restoration of pre-pandemic fiscal and monetary policies, particularly a cessation in the role of the central bank in financing fiscal spending, enabled by a recovery in growth and a consolidation in fiscal deficits. This predicates Moody's underlying assessment of Indonesia's monetary and fiscal policy effectiveness. A delayed or a disorderly exit would weigh on overall policy credibility.

ENVIRONMENTAL SOCIAL AND GOVERNANCE CONSIDERATIONS

Indonesia's ESG Credit Impact Score is moderately negative (CIS-3), reflecting high exposure to environmental risks and moderate exposure to social risks, contained by institutional and economic resilience.

Indonesia's overall Environmental issuer profile score is moderately negative (E-3 issuer profile score), driven primarily by physical climate stresses. Within physical climate risk, coastal flooding and rising sea levels are a particular consideration, with implications for agricultural production, infrastructure and property, and food security. At the same time, Indonesia is moderately exposed to carbon transition risk, with coal and palm oil among its major export products. Demand for arable land and intensive commercial logging have also led to soil erosion and deforestation.

Exposure to social risks is moderately negative (S-3 issuer profile score). Population growth and a declining dependency ratio are supportive of growth. However, wealth is concentrated and Indonesia's rankings on wealth and income inequality indices are weak. Spending on both health and education services are just below emerging market standards.

Governance is neutral-to-low, in line with other similarly-rated sovereigns and does not pose specific risks (G-2 issuer profile score). Our assessment of institutional framework includes issues related to rule of law and control of corruption. The government maintains a strong track record of effective fiscal and monetary policymaking.

GDP per capita (PPP basis, US$): 12,220 (2020 Actual) (also known as Per Capita Income)

Real GDP growth (% change): -2.1% (2020 Actual) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 1.7% (2020 Actual)

Gen. Gov. Financial Balance/GDP: -6.2% (2020 Actual) (also known as Fiscal Balance)

Current Account Balance/GDP: -0.4% (2020 Actual) (also known as External Balance)

External debt/GDP: 39.3% (2020 Actual)

Economic resiliency: baa1

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

On 08 February 2022, 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 materially decreased. 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 issuer's susceptibility to event risks has not materially changed.

FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATINGS

The stable outlook reflects balanced risks and takes into consideration a relatively slow pace of reform momentum.

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.

Downward pressure would likely arise from: 1) weaker policy effectiveness or signs of diminishing policy credibility, potentially reflected in prolonged delays or back-tracking on reforms that results in a persistent erosion in the revenue base and debt affordability, or which translate into a gradual loss of economic strength; 2) a meaningful deterioration in the external position were to occur, such as from prolonged currency depreciation or capital outflows, with ramifications for debt affordability and reserve adequacy; and 3) a prolonged, entrenched slowdown in growth has economy-wide impacts and fiscal repercussions, including difficulties reverting to a declining fiscal deficit trajectory following one-time stimulus packages.

The principal methodology used in these ratings was Sovereign Ratings Methodology published in November 2019 and available at https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1158631 . Alternatively, 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

For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions in the disclosure form. Moody's Rating Symbols and Definitions can be found at: https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_79004.

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