FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Indonesia at 'BBB'; Outlook Stable

Fri 01 Sep, 2023 - 3:46 AM ET

Fitch Ratings - Hong Kong - 01 Sep 2023: Fitch Ratings has affirmed Indonesia's Long-Term Foreign-Currency Issuer Default Rating (IDR) at 'BBB' with a Stable Outlook.

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

KEY RATING DRIVERS

Credit Fundamentals: Indonesia's rating balances a favourable medium-term growth outlook and low government debt/GDP ratio against weak government revenue and lagging structural features, such as governance indicators, compared with 'BBB' category peers. Several external finance metrics, such as its current account, are stronger than pre-pandemic levels, but should normalise to some extent in the next few years, on the assumption that commodity prices will fall further.

Solid Growth Outlook: Domestic consumption is holding up well, supporting our forecast of 5.0% real GDP growth for 2023, even though net exports have started to contribute slightly negatively to growth and downside risks are strengthening with the weakening of China's economic rebound. Growth has stabilised at around the pre-pandemic level with outturns of just over 5% for the past seven quarters. We forecast that growth will continue to hover at around this level, at 5.2% in 2024 and 5.0% in 2025.

Economic activity should receive a boost over the medium term from the implementation of reforms from the past few years and continued infrastructure development, including the construction of the new capital, Nusantara, in East Kalimantan. Quarterly growth data suggest that investment has not yet been affected much by uncertainty related to the general elections scheduled in February 2024. Parties' election spending may also support growth in the next six months.

Inflation Under Control: Tight monetary policy and coordination to contain rising local food prices have brought inflation back to the mid-point of the 2023 target range (3.0%

+/- 1%), at 3.3% in August 2023, from a peak of 6.0% in September 2022. Dry weather from El Nino is a key risk to our forecasts of 2.7% in 2023 and 3.0% in 2024, as it could affect harvests and prices of food and beverages, which form 25% of the CPI basket. The target will be lowered in 2024 to 2.5% +/- 1%, but we expect Bank Indonesia (BI) to start cutting rates early next year, in the absence of severe depreciation pressure on the rupiah.

Fiscal Policy to Remain Prudent: The general government deficit has already returned to pre-pandemic levels in 2022, at 2.4% of GDP, and we expect it to remain broadly stable at that level over the next few years. The upcoming elections could change Indonesia's fiscal policy stance, but this is not our baseline scenario, given the broad political support for the deficit ceiling of 3% of GDP. We expect general government debt to gradually fall to 38.0% of GDP by 2025, from 38.9% in 2023, still well above the 2019 level of 30.6%.

Revenue Ratio to Fall: We expect the modest uptick in the 2022 general government revenue ratio, to 15.1% of GDP, to reverse to 14.3% in 2023, well below the 'BBB' category median of 22.1%. The government has taken some steps to enhance revenue such as raising the VAT rate by 1pp in 2022, which should generate additional revenue of 0.3% to 0.4% of GDP this year, but we expect falling commodity prices to have a larger negative impact. The interest/revenue ratio, which we project at 13.9% in 2023, is significantly higher than the 'BBB' category median of 8.5% this year.

Current Account Turns into Deficit: The current account balance turned negative in 2Q23 at -0.6% of GDP after seven quarters of surplus, as exports of mining and manufacturing products fell. We expect the deficit to widen gradually to 0.9% in 2024 and 1.5% in 2025, from 0.3% in 2023, as commodity prices decline. However, we view a return to pre-pandemic levels and strong dependence on portfolio flows to finance the deficit as less likely over the next few years. We expect the basic balance surplus (current account + net FDI) of 1.0% of GDP in 2023 to worsen gradually and return to a small deficit in 2025.

Potentially Stronger External Finances: We expect FDI to pick up gradually, including in the electric-vehicle sector, as downstreaming activities gather pace, increasing manufacturing exports and adding more value to Indonesia's commodity exports. This could reduce balance-of-payment vulnerabilities over the medium term if these developments structurally lead to higher manufacturing exports and FDI inflows, and lower current account deficits. Indonesia could also stand to gain from multinationals' China+1 strategies, amid competition from other countries to benefit from shifting supply chains.

Reserve Buffers Used: Foreign-exchange reserves fell by USD7.5 billion between March and July to USD137.7 billion at end-July 2023, as BI has been intervening to address market volatility and the government reduced issuances in foreign currency. The reserves are equivalent to 5.7 months of current-account payments, above the 4.2-month 'BBB' median, and external debt ratios are improving. However, external liquidity is weaker - as measured by the ratio of liquid external assets to liquid external liabilities - and the country remains more dependent on commodity exports than many peers.

Less Dependence on Foreign Financing: 28% of government debt is denominated in foreign currency, down from 38% in 2019 and 44% a decade ago, in part because local-currency government debt jumped due to the pandemic. This reduces the government's exposure to foreign-exchange fluctuations. Foreign investors in government bonds have increased their combined holdings by around USD5 billion year-to-date, after a net outflow of USD16.5 billion over the past three years.

The share of non-resident holdings of local-currency government debt has fallen to 16% of total debt, from 39% in 2019, and is likely to remain closer to the lower level over the next few years due to larger government debt and bond yields remaining high globally. Local banks have increased their holdings by around 10pp to 31% over the same period.

ESG - Governance: Indonesia has an ESG Relevance Score (RS) of '5' and '5[+]' respectively for Political Stability and Rights and for the Rule of Law, Institutional and Regulatory Quality and Control of Corruption. These scores reflect the high weight that the World Bank Governance Indicators (WBGIs) have in our proprietary Sovereign Rating Model.

Indonesia has a medium WBGI ranking at the 49th percentile, reflecting a recent record of peaceful political transitions, a moderate level of rights for participation in the political process, moderate institutional capacity, established rule of law and a high level of corruption.

RATING SENSITIVITIES

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade

- External Finances: A sustained decline in foreign-exchange reserve buffers, resulting, for example, from outflows stemming from a deterioration in investor confidence or large foreign-exchange interventions.

- Public Finances: A material increase in the overall public debt burden closer to the level of 'BBB' category peers; for example, resulting from rising fiscal deficits or accumulation of debt by publicly owned entities.

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

- Public Finances: A marked improvement in the government revenue ratio in the next few years closer to the level of 'BBB' category peers, including from better tax compliance or a broader tax base, which would strengthen public finance flexibility.

- External Finances: A material reduction in external vulnerabilities, for instance, through a sustained increase in foreign-exchange reserves, a further decline in the dependence on portfolio flows or lower exposure to commodity price volatility.

- Structural: Significant improvement in structural indicators, such as governance standards, closer to those of 'BBB' category peers.

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.

The rating committee decided to remove the +1 notch adjustment used to offset the deterioration in the SRM output driven by the pandemic shock, in particular from the growth volatility variable. The SRM score has returned to its pre-pandemic level, as Indonesia has absorbed the shock without lasting effects on medium-term macroeconomic stability.

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.

COUNTRY CEILING

The Country Ceiling for Indonesia is 'BBB', in line with the Long-Term Foreign-Currency IDR. This reflects the absence of material constraints and incentives, relative to the IDR, against capital or exchange controls being imposed that would prevent or significantly impede the private sector from converting local currency into foreign currency and transferring the proceeds to non-resident creditors to service debt payments.

Fitch's Country Ceiling Model produced a starting point uplift of 0 notch above the IDR. Fitch's rating committee did not apply a qualitative adjustment to the model result.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Indonesia has an ESG Relevance Score of '5' for Political Stability and Rights as WBGIs have the highest weight in Fitch's SRM and are therefore highly relevant to the rating and a key rating driver with a high weight. As Indonesia has a percentile rank below 50 for the respective Governance Indicator, this has a negative impact on the credit profile.

Indonesia has an ESG Relevance Score of '5[+]' for Rule of Law, Institutional & Regulatory Quality and Control of Corruption as WBGIs have the highest weight in Fitch's SRM and are therefore highly relevant to the rating and are a key rating driver with a high weight. As Indonesia has a percentile rank above 50 for the respective Governance Indicators, this has a positive impact on the credit profile.

Indonesia has an ESG Relevance Score of '4[+]'for Human Rights and Political Freedoms as the Voice and Accountability pillar of the WBGIs is relevant to the rating and a rating driver. As Indonesia has a percentile rank above 50 for the respective Governance Indicator, this has a positive impact on the credit profile.

Indonesia has an ESG Relevance Score of '4' for Creditor Rights as willingness to service and repay debt is relevant to the rating and is a rating driver for Indonesia, as for all sovereigns. As Indonesia has a fairly recent restructuring of public debt in 2005, this has a negative impact on the credit profile.

The highest level of ESG credit relevance is a score of '3', unless otherwise disclosed in this section. A score of '3' means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. Fitch's ESG Relevance Scores are not inputs in the rating process; they are an observation on the relevance and materiality of ESG factors in the rating decision. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/topics/esg/products#esg-relevance-scores

RATING ACTIONS

ENTITY / DEBT	RATING	PRIOR
Indonesia	LT IDR BBB Rating Outlook Stable Affirmed	BBB Rating Outlook Stable
	ST IDR F2 Affirmed	F2
	LC LT IDR BBB Rating Outlook Stable Affirmed	BBB Rating Outlook Stable
	LC ST IDR F2 Affirmed	F2
	Country Ceiling BBB Affirmed	BBB
senior unsecured	LT BBB Affirmed	BBB
Perusahaan Penerbit SBSN Indonesia III		

senior unsecured	LT	BBB	Affirmed	BBB

VIEW ADDITIONAL RATING DETAILS

FITCH RATINGS ANALYSTS

Thomas Rookmaaker
Senior Director
Primary Rating Analyst
+852 2263 9891
thomas.rookmaaker@fitchratings.com
Fitch (Hong Kong) Limited
19/F Man Yee Building 60-68 Des Voeux Road Central Hong Kong

George Xu
Director
Secondary Rating Analyst
+852 2263 9629
george.xu@fitchratings.com

James McCormack
Managing Director - Head of Sovereigns
Committee Chairperson
+852 2263 9625
james.mccormack@fitchratings.com

MEDIA CONTACTS

Leslie Tan
Singapore
+65 6796 7234
leslie.tan@thefitchgroup.com

Additional information is available on www.fitchratings.com

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APPLICABLE CRITERIA

Sukuk Rating Criteria (pub. 13 Jun 2022)

Sovereign Rating Criteria (pub. 06 Apr 2023) (including rating assumption sensitivity)

Country Ceiling Criteria (pub. 24 Jul 2023)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Country Ceiling Model, v2.0.0 (1)

Debt Dynamics Model, v1.3.2 (1)

Macro-Prudential Indicator Model, v1.5.0 (1)

Sovereign Rating Model, v3.14.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Indonesia	EU Endorsed, UK Endorsed
Perusahaan Penerbit SBSN Indonesia III	EU Endorsed, UK Endorsed

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