MOODY'S
RATINGS

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

16 Apr 2024

Singapore, April 16, 2024 -- Moody's Ratings 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, the foreign currency senior unsecured 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, backed by structural factors such as abundant natural resources and strong demographics, supporting stable and robust GDP growth. It is also underpinned by prudent fiscal and monetary policies that have focused on discipline and ensuring macroeconomic stability.

While this approach has allowed debt burdens to remain stable, and at low levels in relation to the size of the economy, the Baa2 rating also takes into consideration relatively weak fiscal strength. In particular, debt affordability is very weak due to a low revenue base, although the government has kept the debt-to-GDP ratio at levels well below those of similarly-rated peers. Moody's Ratings baseline assumption is that fiscal discipline will continue, supporting a stabilization in the debt burden around current levels.

As a palm oil and coal exporter, Indonesia is also moderately exposed to carbon transition risks, which has a bearing on the impact of its economic development aspirations and strategy.

The stable outlook reflects balanced risks. Upside risks relate to ongoing efforts to expand the size and competitiveness of the manufacturing sector which could lead to a material and durable step-up in GDP growth that would drive a faster move to higher income levels than currently assumed by Moody's Ratings. Moreover, while the rating incorporates no change in the broad direction of reforms, there may be potential policy shifts following the political transition posing both upside and downside risks to Indonesia's credit profile.

Concurrently, Moody's Ratings has affirmed the backed senior unsecured ratings, and the backed senior unsecured MTN program 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 AFFIRMATION OF THE RATING

GROWTH PROSPECTS REMAIN FAVORABLE, FURTHER UPWARD MOMENTUM WILL HINGE ON A WELL-EXECUTED MEDIUM TERM GROWTH STRATEGY

Following a strong bounceback, Moody's Ratings expects growth to remain at its pre-pandemic average of around 5.0% over 2024-2025, as solid domestic demand offsets a relatively weak external environment. At these projected rates, growth will trend above the median for Baa-rated sovereigns, which is estimated at 3.0% 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.

A key policy focus area has been to expand the industry sector so as to increase the value-add of key commodities through down streaming activities. This has been most successfully carried out in the nickel industry, where trade and investment realization have materially increased. The government has plans to extend this policy to other raw materials such as such as copper, bauxite, tin and agricultural commodities, and identifies benefits related to regional development, foreign direct investment, job creation, and export growth. However, gains from job creation and regional development may be diluted when considering tradeoffs from trade and market distortions, environmental and social costs, and potential foregone fiscal revenues.

The government's medium-term development plan, encapsulated in its "Vision 2045 Strategy" rests on improving the business climate with the goal of boosting the share of manufacturing and diversifying the economy. Successful achievement of the strategy would be reflected in real growth rising to cross 6% on a sustained basis. This will entail making a break in the current track record of slowing productivity growth. Potential growth rates in Indonesia have steadily moderated over the last decade, implying that output gaps have closed. The moderation in growth potential is primarily driven by a stagnation in productivity growth, which averaged -0.3% in the 10 years preceding the pandemic, contracted by 2% during 2020-22 and only recovered to a marginal positive growth in 2023.

Moody's Ratings assessment of Indonesia's economic strength takes into consideration the large size of the economy, favorable demographics, and a strong and stable growth performance; but also adjusts for weak labor market flexibility and product market diversification. Suboptimal global competitiveness has resulted in weak ties with global production networks. Restrictive trade policies and some degree of resource nationalism is reflected in weak participation in global value chains. According to the OECD, just 5% of Indonesia's firms use inputs of foreign origin, compared to a 43% average in the East Asia/Pacific region.

MONETARY AND FISCAL POLICY SUPPORT INSTITUTIONAL CREDIBILITY, ALTHOUGH LOW REVENUES DRAG FISCAL POLICY EFFECTIVENESS

Over recent years, the central bank has continued to expand its toolkit to deftly manage liquidity and currency movements. Bank Indonesia's mandate includes maintaining price and financial market stability in order to support sustainable economic growth. BI adopts multiple policy tools—including foreign exchange and macroprudential measures—to achieve these objectives, in addition to safeguarding and developing the payment and financial system.

Extraordinary measures taken during the pandemic, such as the central bank's direct financing of the government's budget were reversed in accordance with communicated deadlines, thus preserving policy credibility. Post-pandemic, the central bank also reversed interest rate cuts implemented over 2020-22, and was particularly vigilant around inflation control, tightening the policy rate seven times since August 2022 for a cumulative 250bps.

BI has also been proactive in managing rupiah stability, adopting a 'triple intervention strategy' that involves active intervention in the spot and forward FX markets, as well as the bond markets. More recently, it has also introduced a new short-term rupiah-denominated debt instrument aimed at attracting liquidity (i.e. portfolio inflows) back into short-term securities.

Fiscal policy is underpinned by a long track record of adhering to expenditure targets. These targets are embodied primarily in a 3% ceiling on the fiscal deficit, that has not been breached since it was instituted in 2002, barring the pandemic years. While in recent years, the deficit has primarily been contained due to strong revenue growth on the back of commodity price increases, rather than expenditure consolidation, the revenue base is very low and weighs on debt affordability. Meanwhile, spending on interest payments and subsidies is material, accounting for 14% and 9% of central government expenditures, limiting the space for productive spending.

Looking ahead, key changes to fiscal policy will arise from the final form that the free meal program for students proposed by incoming president during his campaign, will take. In its original form, the program is estimated to cost upwards of IDR 400 trillion, or around 2% of GDP, which would result in the fiscal deficit materially widening to cross the 3% of GDP ceiling, and also result in a reversion in the debt consolidation that has been underway since 2022. However, our baseline assumption is that implementation will be more gradual and targeted.

EXTERNAL VULNERABILITIES HAVE STABILIZED AT THE MARGIN, ON THE BACK OF AN EXPANDED POLICY TOOLKIT

Although Indonesia continues to remain exposed to external vulnerabilities arising from the structure of its financing requirements, such that around 28% of total debt is foreign currency denominated and subject to fluctuations in the trade account, arising mainly due to a high share of commodities in total exports; a gradual build up in external buffers and an expanding policy toolkit have mitigated the effects of this exposure on foreign currency fluctuations.

Trade surpluses have steadily improved over the past five years, to $46.3 billion in 2023 from a trough of $5.8 billion in 2013, although terms of trade have remained largely stable. As a share of GDP, trade surpluses have climbed from under 1% in 2013 to 3.4% in 2023. An important driver, as described above, has been the significant rise in the share of value-added commodity exports through the downstreaming process, which has added a dimension of vertical diversification within commodity exports and reduced sensitivity to prices.

Stronger trade surpluses have also supported a shift to current account surpluses, although more recently, the current account has shifted back to a deficit position. These trends have supported a gradual accretion to foreign exchange reserves, which have risen to around $130 billion currently, or around 7 months of imports.

This improvement in foreign reserve buffer has supported a reduction in currency volatility. Where previously Indonesia was subject to significant swings in debt portfolio flows, this had also coincided with marked currency depreciation. While Indonesia continues to be subject to capital flow volatility, currency impacts are smaller. Moreover, the domestic debt market has deepened as reflected in a marked narrowing in the share of foreign currency-denominated debt to total debt since 2020.

RATIONALE FOR THE STABLE OUTLOOK

The stable outlook incorporates fluctuations in growth arising from challenges to the implementation of reforms on the one hand; and from incremental improvements in competitiveness and the investment environment that Moody's Ratings currently assumes will occur, on the other.

Over recent years, the government has taken a host of reforms to address gaps to meeting Indonesia's growth potential. These measures include easing barriers to foreign investment, improving the investment climate, building infrastructure, financial market deepening, expanding and strengthening the monetary policy framework, and maintaining fiscal discipline. While this has secured Indonesia's medium-term growth trajectory at a healthy 5% rate, moving to a higher growth trajectory will entail a larger gamut of reforms coming to fruition.

The stable outlook also captures the risks associated with policy effectiveness. As in any large democracy, there are political challenges to the reform process. As a new administration assumes duties in October this year, we may see further uncertainty particularly around the pace of reform implementation, with implications for fiscal outcomes and for overall investment. In particular the implementation of the free meal program proposed by president-elect Prabowo can have a wide range of implications depending on the form it is ultimately implemented in.

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 E-4 overall Environmental issuer profile score is driven by physical climate stresses. Coastal flooding and rising sea levels are a particular source of risk, with widespread implications, including for agricultural production, infrastructure and property, and food security. Given its geographical location, Indonesia is also subject to considerable seismic activity that manifests in natural disasters such as earthquakes, tsunamis and volcanoes. Waste and pollution are also a source of environmental risk. Demand for arable land and intensive commercial logging have led to soil erosion and deforestation. As a palm-oil exporter, Indonesia is also modestly exposed to carbon transition risk.

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 in line with other similarly-rated sovereigns and does not pose specific risks (G-2 issuer profile). 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$): 14,687 (2022) (also known as Per Capita Income)

Real GDP growth (% change): 5.3% (2022) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 5.5% (2022)

Gen. Gov. Financial Balance/GDP: -2.4% (2022) (also known as Fiscal Balance)

Current Account Balance/GDP: 1% (2022) (also known as External Balance)

External debt/GDP: 30.1% (2022)

Economic resiliency: baa1

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

On 09 April 2024, 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 issuer's susceptibility to event risks has not materially changed.

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

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 was sustainably strengthening toward 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 from 1) weaker policy effectiveness or signs of diminishing policy credibility, potentially reflected in a marked shift to an expansionary fiscal policy without accompanying revenue reform, or a backtracking on expenditure reforms ; 2) a significant deterioration in the external position, 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 that had economy-wide impacts and fiscal repercussions.

The principal methodology used in these ratings was Sovereigns published in November 2022 and available at https://ratings.moodys.com/rmc-documents/395819 . Alternatively, please see the Rating Methodologies page on https://ratings.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 on https://ratings.moodys.com/rating-definitions .

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