Fitch Affirms Indonesia at 'BBB'; Outlook Stable

Fitch Ratings - Hong Kong - 24 January 2020:

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

Key Rating Drivers

Indonesia's rating balances a favourable medium-term growth outlook and a small government debt burden compared with 'BBB' category peers against challenges that include a strong dependence on external financing, low government revenue, and lagging structural indicators such as governance indicators and GDP per capita.

Indonesia's GDP growth is likely to remain resilient in the next few years, underpinned by a renewed public infrastructure push and reform agenda during the second five-year term of President Joko Widodo (popularly known as Jokowi), which commenced in October last year. Fitch forecasts growth to marginally accelerate to 5.1% in 2020 and 5.3% in 2021 from 5.0% in 2019, significantly higher than the 'BBB' category median of 2.8% for 2019. Domestic demand in 2020 is likely to be supported by some monetary policy easing, while the contribution to growth of net exports may continue to be negatively affected by a weakened terms-of-trade.

The government's plans for infrastructure development over the next five years are ambitious and include construction of a proposed new capital in East Kalimantan. Infrastructure development was already a key policy aim during President Jokowi's first term, when progress was made on a number of projects, including an underground metro system in Jakarta. The government estimates that the total cost of developing the new capital city over a number of years would amount to USD31 billion (2.8% of 2019 GDP), of which it expects a large part to be financed by the private sector, although such interest remains to be seen. Costs related to the development of the new capital and the relocation have not been factored into our projections yet, given the uncertainty that still surrounds the total costs and timing of the project.

The government's structural reform efforts have the potential to lift economic growth and foreign direct investment over the medium term, depending on details and implementation. Parliament is scheduled to discuss two "Omnibus Laws" in the next few months, which are likely to contain a number of long-awaited amendments to regulations related to taxation and the business environment. The "Omnibus Law on Job Creation", which is still being prepared by the government, reportedly will aim to simplify the regulatory framework, ease land acquisition, reduce the number of items on the negative investment list, and ensure greater labour market flexibility. The latter would be significant, given Indonesia's high severance pay requirements. Whether far-reaching reforms will be passed in Parliament remains uncertain, however, given their contentious nature in the political debate.

Fitch expects the general government deficit to remain stable in 2020 at 2.2% of GDP, higher than the 1.8% budget target, as we expect revenue to underperform. We estimate general government revenue of 14.0% of GDP in 2019 and 14.2% of GDP in both 2020 and 2021, the lowest in the 'BBB' rating category. The government is working to improve tax compliance, including through improved IT systems to ensure optimal use of available data, which should over time improve the revenue ratio. The most prominent change in the "Omnibus Law on Taxation", however, is a gradual reduction in corporate tax rates between 2021 and 2023 from 25% to 20%, which is likely to offset some of the revenue gains from other measures in the short run before any potential medium-term gains materialise through higher investment.

Indonesia's government debt is low at a Fitch-estimated 30.1% of GDP in 2019. However, the debt burden is higher than peers' when measured as a ratio against low general government revenue, at 215.3%. We expect the debt/GDP ratio to rise only marginally in the next few years, assuming the government continues to adhere to a self-imposed deficit ceiling of 3% of GDP. Last December, the government reportedly discussed amending the deficit rule to allow some flexibility in a given year, by adopting a five-year average for the deficit, but decided to maintain the existing framework for the time being.

State-owned enterprises (SOEs) have been leveraging up their balance sheets considerably since mid-2017 as a result of their important role in the government's infrastructure development. The gross combined debt of SOEs increased by 1.5pp of GDP in the 24 months through September 2019 to 5.9% of GDP. This trend is likely to continue in the next few years, given the government's ambitious infrastructure programme, and could test the ability of the government's risk-monitoring framework to contain vulnerabilities.

Inflationary pressures are likely to remain muted in the current growth environment. We forecast headline inflation to average 3.2% in 2020 and 3.3% in 2021, compared with 3.0% in 2019. Inflation has been under control in recent years, staying within Bank Indonesia's (BI) target range of 1pp above or below 3.5%. Low inflation and the recent strengthening of the rupiah exchange rate should provide BI room to cut its policy rate by at least another 25bp this year after the total reduction of 100bp in 2019, which was delivered in combination with macro-prudential easing.

Favourable market conditions have facilitated a further build-up of foreign-currency reserves to USD129 billion in December 2019, covering 6.2 months of current account payments, similar to the current 'BBB' median of 6.1 months. However, external liquidity, as measured by the ratio of the country's liquid external assets to its liquid external liabilities, is weaker than that of 'BBB' peers. Indonesia

should continue to benefit from favourable global risk appetite in our baseline scenario, but the country's dependence on foreign portfolio financing and on commodity exports leave it vulnerable to a possible turn in market sentiment.

We expect the current account deficit to remain at 2.7% of GDP in 2019 and 2020, and to slightly fall to 2.6% in 2021, with net FDI inflows covering 1.6% of GDP, or more than half of the gap, leaving the remainder to be financed by portfolio inflows. Strong structural reform implementation and foreign companies' perception of an improved level-playing field could help accelerate FDI inflows and strengthen Indonesia's external finances.

Fitch considers the sovereign's exposure to banking-sector risks as limited. Private credit represents only 36.0% of GDP and the banking sector's capital-adequacy ratio remains strong, at 23.7% in November 2019. Foreign-currency loan exposure for Indonesian banks is equivalent to around 15% of total loans, although direct foreign-currency assets and liabilities are generally well-matched or hedged, and some liabilities relate to funding from banks' foreign parents.

The Indonesian economy continues to exhibit some structural weaknesses relative to peers, despite improvements in the business environment resulting from the reform agenda, and is less developed on a number of metrics than many of its peers. Average per capita GDP remains low at USD4,151 compared with the current 'BBB' range median of USD12,152, while governance continues to be weak, as illustrated by a low score for the World Bank governance indicator (47th percentile versus the current BBB median of 56th percentile).

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 (LT FC) IDR scale. Fitch's sovereign rating committee did not adjust the output from the SRM to arrive at the final LT FC IDR.

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 LT FC 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.

RATING SENSITIVITIES

The main factors that, individually or collectively, could trigger positive rating action are:

- Reduction in external vulnerabilities, for instance, through a sustained increase in foreign-exchange reserves, reduced dependence on portfolio flows or lower exposure to commodity price volatility.

- An improvement in the government revenue ratio, for example, from better tax compliance or a broader tax base, which would strengthen public finance flexibility.

- Continued improvement of structural indicators, such as governance standards, closer in line with those of 'BBB' category peers.

The main factors that, individually or collectively, could trigger negative rating action are:

- A sustained decline in foreign-exchange reserve buffers, resulting from a sharp external shock to investor confidence.

- A rapid increase in the overall public debt burden, for example resulting from budget deficits well exceeding the current 3% ceiling or accumulation of the debt of publicly owned entities.

- A weakening of the policy framework that could undermine macroeconomic stability.

Key Assumptions

The world economy performs broadly in line with Fitch's latest Global Economic Outlook, published in December 2019.

ESG Considerations

Indonesia has an ESG Relevance Score of '5' for Political Stability and Rights, as World Bank Governance indicators 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.

Indonesia has an ESG Relevance Score of '5' for Rule of Law, Institutional and Regulatory Quality, and Control of Corruption as World Bank Governance Indicators have the highest weight in the SRM and are therefore highly relevant to the rating and a key rating driver.

Indonesia has an ESG Relevance Score of '4' for Human Rights and Political Freedoms, as World Bank Governance indicators have the highest weight in the SRM and are relevant to the rating and a rating driver.

Indonesia has an ESG Relevance Score of '4' for Creditor Rights, as willingness and ability to service debt are relevant to the rating and a rating driver, as for all sovereigns.

RATING ACTIONS

ENTITY/DEBT	RATING		PRIOR
Indonesia	LT IDR BBB ⭘ Affirmed		BBB ⭘
	ST IDR F2 Affirmed		F2
	LC LT IDR BBB ⭘ Affirmed		BBB ⭘
	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

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Applicable Criteria

Sovereign Rating Criteria (pub. 26 May 2019)
Country Ceilings Criteria (pub. 05 Jul 2019)
Sukuk Rating Criteria (pub. 22 Jul 2019)

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Dodd-Frank Rating Information Disclosure Form
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