FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Indonesia at 'BBB'; Outlook Stable

Mon 10 Aug, 2020 - 3:29 AM ET

Fitch Ratings - Hong Kong - 10 Aug 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 low government debt/GDP ratio against a high dependence on external financing, low government revenue, and lagging structural features compared with 'BBB' category peers, such as governance indicators and GDP per capita.

Fitch forecasts economic activity in Indonesia will contract by 2% in 2020, largely attributable to the impact of the coronavirus. The contraction is exacerbated by the effects of social-distancing measures on consumption and investment, a temporary deterioration in Indonesia's terms of trade and the sudden stop in foreign tourism inflows. The strong, broad-based impact of the pandemic on economic activity was illustrated by the 5.3% yoy contraction in 2Q20, which we had largely anticipated in our projections. Fitch forecasts a rebound to 6.6% growth in 2021, partly driven by a low-base effect, and expects growth momentum to continue at 5.5% in 2022, supported in part by the government's renewed focus on infrastructure development. Our forecasts are subject to considerable risks, in particular due to a continued spread of COVID-19 within Indonesia.

The government has responded swiftly to the crisis with a broad range of relief measures to support households and companies, including small and medium-sized enterprises. Total COVID-19-related government support amounted to IDR695 trillion, or 4.4% of GDP, and included direct cash transfers, provision of basic foods, guarantees and tax incentives.

The authorities have also taken some exceptional, temporary measures, which include a three-year suspension of a self-imposed deficit ceiling of 3% of GDP and direct central bank financing of the deficit. In Fitch's view, prudent fiscal policy in past years has provided headroom for the relief measures. Fiscal deficits were well below the ceiling over the past decade, illustrating support for prudent fiscal policy across the political spectrum. Hence, we believe the government is likely to resume adhering to the 3%-of-GDP deficit ceiling by 2023, in line with its stated intention.

Higher government spending and lower revenue due to the slowdown should cause the fiscal deficit to rise to around 6.0% in 2020 from 2.2% in 2019. We expect the deficit to narrow to 5.0% in 2021 and 3.5% in 2022, as most of the pandemic-related expenditure should be temporary. We forecast general government debt to rise to 36.7% of GDP in 2020 from 30.6% of GDP in 2019, and to peak at 39.1% of GDP in 2022. Both the debt burden and its increase this year (6% of GDP) are still significantly smaller than the 'BBB' category median of 51.7% (9.5% of GDP higher than in 2019).

The government debt burden, when measured as a ratio against general government revenue, is however higher than that of peers, at 307.7% in 2020 (BBB median: 138.3%), according to Fitch estimates. 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 lowest among 'BBB' category peers at 11.9% in 2020. However, a gradual reduction in corporate tax rates between 2021 and 2023, from 25% to 20%, 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.

The low revenue base exacerbates the challenges of financing the large pandemic-related expenditure. The authorities have responded to the higher spending needs by implementing a "burden sharing" scheme in which Bank Indonesia (BI) will purchase government bonds in the primary market and bear part of the interest costs of additional debt issuance. The scheme will help reduce the government's direct interest costs, and in our view is unlikely to generate inflationary pressures in this year's environment of demand compression. However, the scheme raises questions about Indonesia's policy approach over the medium term. In particular, if central bank financing were to be sought repeatedly, beyond 2020, it would raise the potential for government interference in monetary policymaking, and could undermine investor confidence. This may be mitigated by Indonesia's generally disciplined monetary policy stance of the past few years, which reinforces our belief the scheme will be one-off, driven by the unusual circumstances of the pandemic, as the authorities have asserted.

Indonesia's dependence on foreign portfolio financing and commodity exports leaves it vulnerable to renewed bouts of external risk aversion and other shocks. External liquidity, measured by the ratio of the country's liquid external assets to its liquid external liabilities, is also weaker than that of 'BBB' peers. Sharp portfolio outflows and central bank intervention caused a drop in foreign-exchange reserves by USD10.7 billion to USD121.0 billion at end-March 2020. Stabilisation of the global financial environment and issuance of foreign-currency government bonds since then have facilitated BI rebuilding its reserves to USD135.1 billion by end-July, covering 7.1 months of current account payments, well above the 'BBB' median of 4.9 months. We forecast these reserve buffers will be supported by a narrowing of the current account deficit to 1.8% of GDP in 2020 from 2.7% in 2019, in light of the compression in domestic demand and a recovery in Indonesia's terms of trade since April.

BI has provided liquidity to the banking system in response to the pandemic and cut its policy rate by a total of 100bp since February 2020 to 4.0%. We expect BI to keep the rate unchanged, provided the economy does not deteriorate further, given its apparent desire to prevent volatility of the rupiah. Fitch considers the sovereign's exposure to banking-sector risks limited. Private credit represents only 36.4% of GDP and the banking sector's capital-adequacy ratio remained strong at 22.1% in May 2020.

The government is continuing to press ahead with its structural reform efforts, although in recent months the policy focus has been on the immediate crisis at hand. Parliament's discussion of the "Omnibus Laws on Job Creation" is likely to be completed in the next few months. Fitch understands the draft law contains a number of long-awaited amendments to regulations related to the business environment and reportedly aims to simplify the regulatory framework, ease land acquisition, reduce the number of items on the negative investment list, and ensure greater labour market flexibility. In Fitch's view, the reforms have the potential to lift economic growth and foreign direct investment over the medium term, depending on the details and implementation. Meanwhile, Indonesia's ranking for Ease of Doing Business has significantly improved in recent years, but at the 60th percentile, it is still below the 'BBB' median of the 71st percentile.

Social-distancing measures appear to have slightly delayed, but not fully derailed, the government's ambitious plans for infrastructure development over the next few years, which include construction of a proposed new capital in East Kalimantan. Infrastructure development was already a key policy aim during the first term of President Joko Widodo, also known as Jokowi, when progress was made on a number of projects, including an underground metro system in Jakarta. State-owned enterprises (SOE) play an important role in these plans and have been raising the leverage on their balance sheets considerably since mid-2017. The gross combined debt of SOEs increased to 7.3% of GDP in March 2020 from 4.7% two years earlier. This trend is likely to continue in the next few years and could test the ability of the government's risk-monitoring framework to contain vulnerabilities.

The Indonesian economy is less developed on a number of structural metrics than many of its peers. Indonesia's relatively low basic human development is indicated by its ranking on the United Nations Human Development Index (41st percentile versus the BBB median of 67th percentile), while average per capita GDP also remains low, at USD4,000, compared with the 'BBB' range median of USD9,878.

ESG - Governance: Indonesia has an ESG Relevance Score of 5 for both Political Stability and Rights and the Rule of Law, Institutional and Regulatory Quality and Control of Corruption, as is the case for all sovereigns. These scores reflect the high weight that the World Bank Governance Indicators have in our proprietary Sovereign Rating Model. Indonesia has a medium ranking at the 47th percentile (BBB peer median: 58th) in the World Bank Governance Indicators, 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.

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 adjusted the output from the SRM to arrive at the final LT FC IDR by applying its QO, relative to rated peers, as follows:

- Macroeconomic: We have introduced a +1 notch adjustment to offset the deterioration in the SRM output driven by the pandemic shock, in particular from the growth volatility variable. Fitch believes that Indonesia has the capacity to absorb 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 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

Factors that could, individually or collectively, lead to positive rating action/upgrade are:

- External Finances: 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.

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

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

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 a deterioration in investor confidence.

- Fiscal Finances: A continued increase in the overall public debt burden over the next few years to levels beyond our forecasts, for example, resulting from failure to reduce the fiscal deficit back to pre-crisis levels or accumulation in the debt of publicly owned entities.

- Macroeconomic: A weakening of the policy framework that could undermine macroeconomic stability, for instance, resulting from continued monetary financing of the deficit in the next few years.

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].

KEY ASSUMPTIONS

The world economy performs broadly in line with Fitch's latest Global Economic Outlook, published in June 2020.

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 World Bank Governance Indicators have the highest weight in Fitch's SRM and are 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 & Regulatory Quality and Control of Corruption as World Bank Governance Indicators 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.

Indonesia has an ESG Relevance Score of 4 for Human Rights and Political Freedoms as social stability and voice and accountability are reflected in the World Bank Governance Indicators that have the highest weight in the SRM. They are relevant to the rating and a rating driver.

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.

Except for the matters discussed above, the highest level of ESG credit relevance, if present, is a score of 3. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity(ies), either due to their nature or to the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

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	LT	BBB	Affirmed	BBB

VIEW ADDITIONAL RATING DETAILS

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Additional information is available on www.fitchratings.com

APPLICABLE CRITERIA

Sukuk Rating Criteria (pub. 22 Jul 2019)

Sovereign Rating Criteria (pub. 27 Apr 2020) (including rating assumption sensitivity)

Country Ceilings Criteria (pub. 01 Jul 2020)

APPLICABLE MODELS

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

Country Ceiling Model, v1.7.1 (1)

Debt Dynamics Model, v1.2.0 (1)

Macro-Prudential Indicator Model, v1.4.0 (1)

Sovereign Rating Model, v3.12.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Indonesia	EU Endorsed
Perusahaan Penerbit SBSN Indonesia III	EU Endorsed

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Sovereigns Asia-Pacific Indonesia