Indonesia

SEB MERCHANT BANKING – COUNTRY RISK ANALYSIS Oct 11, 2013

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Since more than a year, Indonesia's rising star has begun to wear off its shine in line with weaker exports and falling commodity prices. New turmoil in international financial markets has also hit the country and refocused investors' attention to potential erosion of economic fundamentals.

Summary and conclusion

Growth weakens but still remains solid. Since late 2011, softer global prices of commodities, which account for 2/3 of Indonesia's exports, has put a damper on investment demand while rising headline inflation has undermined the purchasing power of households with the effect to hold back consumption. As a result, growth is seen dropping to below 6%, some half a percentage point lower than in 2012. In line with slowing exports, this year's current account deficit could rise further to 3,2% of GDP, up from 2,7% in 2012. That has sounded alarm bells among investors as it adds to concerns over widening of the fiscal deficit to 2,4% of GDP and growing political risk.

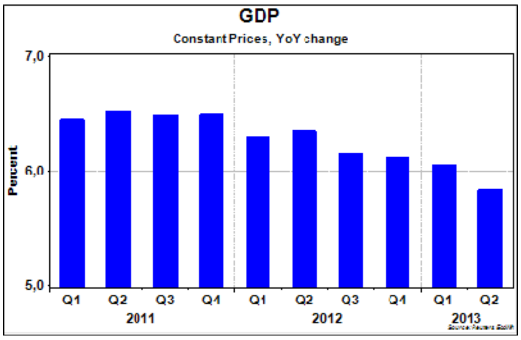
Global financial turmoil hits the rupiah. The weakening of the rupiah began in early 2013 as foreign investors reversed previous purchases of domestic securities while domestic investors moved deposits and other liquid holdings abroad. This intensified in May as fears spread that the US would end super-lax monetary policies – "tapering". In line with its policy to maintain order in the foreign exchange market, the central bank sold dollars from reserves. Eventually, higher interest rates combined with delay to "tapering" calmed markets and stopped the run on the rupiah but the episode revealed the fragility of investor confidence. The chief economist of one leading domestic bank stated: "The imbalances that occur in our external sector will … if not addressed properly, destabilize our economy in the future…". Also, the steep rise in prices after the government reduced gasoline subsidies in last June, portend the risk to further undermine market sentiment.

Long term prospects still remain strong: favorable demographics and natural resources paint an attractive picture of Indonesia's prospects provided the country can implement supportive structural reforms within a stable political climate conducive to business. Next year's elections will provide a litmus test to the latter.

The upshot: So far the recent financial markets turmoil has not impacted Indonesia's external ratings as long term fundamentals remains strong. That could change should the authorities foot-drag on reforms and not succeed in calming market jitters soon.

Recent economic developments

Momentum weakens: The deceleration of quarterly growth that started in late 2011 continued into the current year. Observers, including the World Bank have downgraded their estimates to only 5.6%, half of one percentage point (pp) down on the previous year, and 0.2 pp below estimates only three months back. Taking into account the potential for further global financial turmoil in the fourth quarter of 2013, for example triggered by political and monetary events in the US, we shave off another 0.1 pp from Indonesia's growth performance for 2013



Sentiment holds back domestic demand. The decline in global non-energy commodity prices has damped investor interest in developing new mines and other extractive and raw material industries. This has been accompanied by falls in the stock market to undermine sentiment further. Only housing and commercial real estate are still experiencing a boom. At the same time, higher consumer prices have reduced the purchasing power of many households. In contrast, government consumption appears to have kept up quite well along with a small lift in trade balance as measured in real terms. On the supply side, "mining and quarrying" suffered most in the first half of the current year with oil and gas output dropping almost 6% (yoy). Manufacturing, by contrast, appears to have held a steady pace along with the rest of the economy managing to rise 5,7%.

Inflation picks up: According to the monthly survey of Bank Indonesia (BI) – central bank -- inflation expectations have picked up following actual consumer price inflation. Volatile food prices caused the index of annual consumer price inflation (CPI) to jump to 6% from 4% at the end of last year. Core inflation, by contrast, has so far remained steady at around 4% pa. despite steep hikes of minimum wages, jumping by an average of 18% -- affecting a third of the formal sector workforce -- with extreme hikes in Jakarta of more than 40%. In return, prices rose sharply after the government in last June implemented a long awaited price-reform for energy with the effect that pump-prices of gasoline and diesel rose by IDR1000 and 2000 respectively. Headline inflation shot up to 8.6% in July and 8.8% (yoy) in August reflecting also the 20% depreciation of the rupiah against the dollar since the beginning of the year, with a coincidental jump in inflation expectations.

Rising current account deficit. Due to adverse terms of trade effects, the trade balance in nominal terms failed to reflect the limited recovery that took place in real terms as noted above. So far in 2013, the import bill has outpaced export revenues leaving the trade balance in a widening deficit. For instance, coal which accounts for 14% of total exports, suffered significantly after China imposed restrictions of lowquality coal which makes up one fifth of Indonesia's total coal exports. Net export of services, has also under-performed in the current year compared with the same period of 2012, adding to the trade shortfall and raising the current account deficit by about 1 pp to 3,5% of GDP in the first six months of the year. That represented a doubling from the first to the second quarter of the year and sounded the alarm-bells among many investors.

Volatile capital flows take center-stage. In the years after the global financial crisis, Indonesia had almost become an "investor darling", triggering massive inflows of foreign direct investments (FDI) and portfolio investments. In 2012, FDI inflows had more than doubled over the past three years to IDR222 trillion, equivalent to about a quarter of GDP. These types of inflows continued for a total of more than $8bn. during the first 4-5 months of the current year, but were almost offset by outflows of deposits and other liquid assets mainly from domestic banks. Some observers point out that banks and other investors may have been motivated to such transfers of funds by the prior preferential treatment accorded by BI to many state-owned enterprises with regard to allocations of foreign reserves.

"tapering": However, as the global financial turmoil intensified following the remarks of the US Fed Chairman in May, previous portfolio inflows now turned to outflows. That was so in part because investors feared this would cause new financing problems for emerging markets, in particular for those who had run into current account deficits. The central bank attempted to shore up investor confidence by raising the policy interest rates two times in June and July by a total of 75 basis points (bsp) but was still left with no alternative than to support the rupiah by selling foreign exchange from reserves. As CPI inflation shot up after the fuel price hikes in June, interest rates turned sharply negative and the pressure on the rupiah intensified further. By late July reserves had fallen to $92bn. -- about $17bn below the end of 2012 level. In the end, two more interest rate hikes and the subsequent announcement from the US Fed that "tapering" would be delayed, calmed markets and helped stabilize the exchange rate.

External debt position still remains favorable. At less than 30% of GDP, Indonesia's external debt position is still quite favorable to peers. Less than a third of it, about $60bn., is on short terms (remaining maturity) and is fully covered by foreign exchange with BI. A point to make, however, is that half of the short term debt is owed by the private sector, in large part by banks, and that the dominating part of it is denominated in US dollars. The rupiah has already depreciated significantly against the US dollar which now makes it more expensive in local currency terms for debtors to service and repay dollar denominated debt.

Financial policies:

"Lagging behind the curve" is probably the way many investors and observers will judge the authorities' response to recent adverse developments.

Fiscal policies weaken in 2013: The original budget reading for 2013 expanded on the previous budget in line with the nominal increase of GDP, but let the fiscal deficit relative to GDP at about the same level, 1,8%. But by May it was already clear that weak revenue growth, in particular tax collection, combined with stronger budget execution on the expenditure side was about to produce a higher budget deficit. While the government has been eager to present the subsequent subsidy reduction for fuels as a reform measure, it also served to reign in an undesired budget development. In the event, the budget deficit will now rise to at least 2,4% of GDP, about the same as without the subsidy reduction. That is because savings for the current year will be eaten up by promised income compensation for poor households. For 2014, by contrast, this compensation is supposed to end with the effect (all else equal) to reduce the deficit by 0,8% of GDP to 1,5%.

Government faces rising funding costs. To fund the deficit, the government has continued to rely mainly on the domestic capital market. For several years this exhibited a downward trend in the yield, but that has turned around markedly. So far in the current year the yield obtained in auctions has increased to 8%, up from 5,3% in 2012. Moreover, total incoming bids in government bond auctions have dropped to a coverage ratio of only two, down from three in 2012. That situation will hopefully prove to be temporary. The government debt is still modest at less than 25% of GDP and projected to continue falling further in coming years. That said, the medium term maturity profile, could prove the more challenging the longer global financial turmoil prevails. In 2014, IDR170tn. ($15 bn.) matures, half of which owed foreign investors.

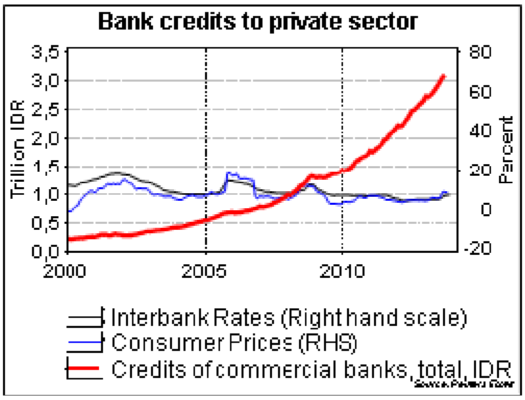
New policy package:
In last August the government presented a new policy package focused on economic stabilization and structural forms based on four pillars: 1) Support to FDI by reducing impediments -- “debottlenecking” and licensing requirements. 2) rationalizing the negative investment list. 3) tax breaks for exporters and labor intensive sectors. 4) removing import restrictions on beef and other food stuff.

Monetary policies in headwinds. With a floating currency, the BI should be able to target the rate of inflation but its actions have left the impression that it is more concerned with the domestic level of activity and short term movements in the exchange rate. Like many other emerging markets central banks, BI has experienced conflicts with potentially inconsistent policy targets in a world where excess liquidity in developed countries is seeking higher returns than in home markets. For example, as inflation edged up in 2013, BI may have been too late in raising interest rates, perhaps fearing that higher rates would attract unwanted portfolio inflows and motivate banks to lend when the authorities aim was rather to cool credit expansion. That was following years of rampant credit growth at 20-25% pa. with a rising share of it in foreign currencies.

Banks are solid but BI warns about the housing market. The stability of the financial system is also within BI remits and the central bank recently noted that the rapid development of certain types of mortgage loans could have undesired consequences for banks’ balance sheets and financial system stability. However, as mortgage lending is still low and the total banking system is under-developed, representing only a third of

Sensitivity analysis by one of the major banks shows that 1 pp hike in BI’s policy rate would produce a 1-1,3 pp decrease of annual credit expansion. However, the caveat could be that such correlations are not be relied upon under the extraordinary financial conditions experienced worldwide in recent years.

GDP, systemic risks from this source is moderate. Such risk is also mitigated by strong capitalization with the risk weighted capital ratio standing at more than 18% for the entire system while strong profitability is reflected in a high interest margin of more than 5%. The level of non-performing loans (NPL) is less than 2% of total lending, although an uptrend in "special mentioned" loans, not included in NPL, could become a concern. To cool the property market, where prices continued high particularly in the greater Jakarta region with 25% higher prices in last June than one year earlier, the government recently restricted loan-to-value ratios for banks' mortgage lending with emphasis on the second and third mortgages per individual. However, that will have effect for only 30,000 households.



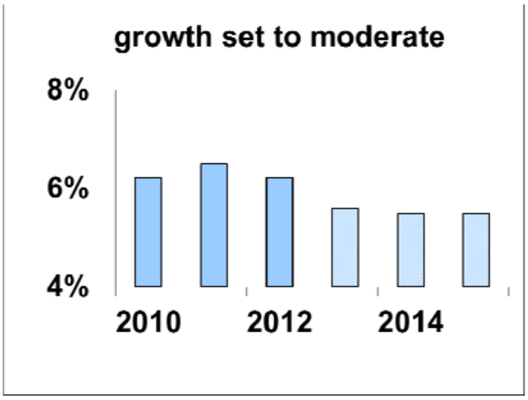
Politics

General elections are scheduled for 2014 and most interest is focused on the presidential elections where the incumbent, President Yodhoyono, is barred from running for office a third time. In an environment of weak party affiliations, individuals matter as much as parties and this could open for an outsider to enter the stage. A name often mentioned in that context is Joko Widowo, the governor of Jakarta and an unusual reform-friendly politician. Otherwise, the presidential office and the 560 seats in Parliament are likely to be filled with old faces with track records of diluting or delaying three quarters of all reform bills presented to them.

Most parties are stymied by corruption scandals or paralyzed by infighting often in the context of family feuds. Barring a new-comer, expectations for the next Parliament are not high. Some 60 families have reportedly managed to place their family members in top positions on party lists to support their election prospects. Clans have risen to prominence in party politics, not least on the local level. There they can control both the executive and legislative branches of government to gain privileges in business relations. That is often to the dismay of foreign investors as reflected in Indonesia's poor scorings in surveys such as the World Bank's "ease of doing business": 128th worst among 180 countries, or International Transparency's corruption index: 118th worst of 175 countries.

Outlook:

Many observers still regard the weaker economic performance in 2013 as no more than a soft patch on Indonesia's otherwise spectacular performance since 2010. As such they pencil in more than 6% growth in 2014 and beyond. That is based on continued strong FDI inflows and a quick return to calm in financial markets allowing the central bank to reverse recent rate hikes without

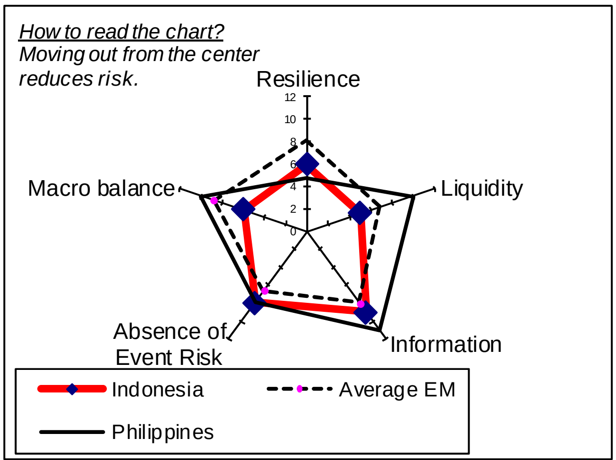


causing damage to inflation expectations. Resumption of steady growth in China and other major trading partners of Indonesia is also a pillar of support for this scenario.

In return, the chief economist of one leading domestic bank states: “The imbalances that occur in our external sector will … if not addressed properly, destabilize our economy in the future…”. In about the same vein, others see downside risks not only from the outside world, but also from internal forces, including a political system that appears to become increasingly rent-seeking and often inward looking. For instance, control of food imports is an area where vested interest have been pitched against national interests including for the stabilization of consumer prices. In addition, should the authorities not be able to stage a timely and pre-emptive performance against speculators including in the foreign exchange markets next time around, it may take a long time to rebuild lost confidence. As a result of these and other caveats we project growth moderating toward the 5% range, which is not necessarily a credit weakness. History shows that excessive buoyancy, not moderation, is the main threat to stability and downside risks.

In the longer term, Indonesia should enjoy favorable conditions in terms of demography and declining dependency ratio despite weak human development factors. Following the example of China, openness to the outside world is paramount to tap this potential. That is provided the country can implement supportive structural reforms within a stable political climate conducive to business. Next year’s elections will provide a litmus test to the latter.

Key ratios	**2013**
Population (mill.)	240
GDP/capita ($)	3701
GDP (change)	5.6%
Inflation	7.0%
Curr.Acc. Balance/GDP	-3.7%
Reserves/imports (months)	6.7
Budget balance/GDP	-2.4%
Government debt/GDP	21%



External ratings:
Fitch: BBB-
Moody's: Baa3
S&P: BB+

Peers:
Thailand
Philippines
India

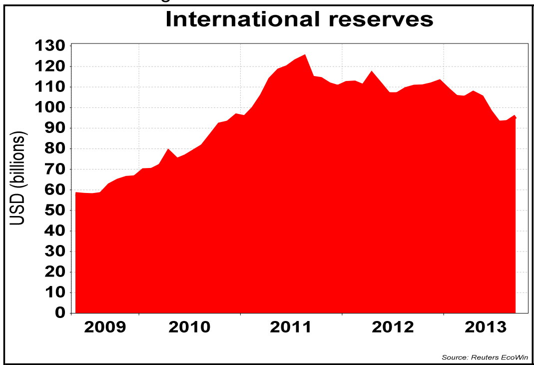
Graph: The pentagon shows the creditworthiness profile of Indonesia somewhat weaker than the Philippines on macro balance but stronger on resilience.

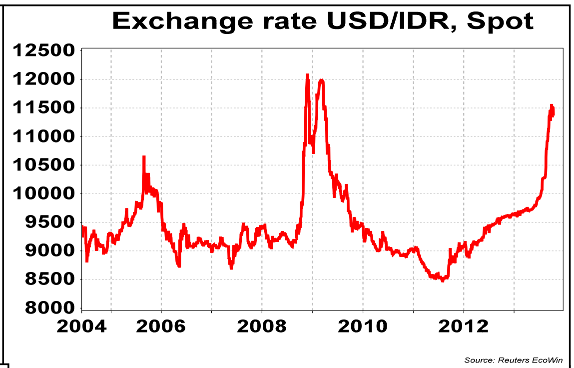
Key data:	2008	2009	2010	2011	2012	2013	2014	2015
GDP (mill.US$)	512	543	710	845	876	888	988	1109
GDP/capita (US$)	2248	2356	3050	3591	3688	3701	4079	4536
GDP (change)	6.0%	4.6%	6.2%	6.5%	6.2%	5.6%	5.5%	5.5%
Investments/GDP	24%	23%	24%	24%	25%	25%	26%	26%
Government Finances								
Budget balance/GDP	0.0%	-1.6%	-0.6%	-1.2%	-1.8%	-2.4%	-2.1%	-1.7%
Govt debt/GDP	27%	27%	25%	23%	22%	21%	20%	18%
Money & Prices								
CPI inflation (%)	9.8%	4.8%	5.1%	5.4%	4.3%	7.0%	6.7%	5.0%
Money demand (%)	16.4%	15.9%	12.2%	16.0%	18.5%	12.0%	8.8%	9.0%
Stock prices (%change	227672	230290	232827	235285	237677			
Interest rates	9.7%	8.2%	6.9%	6.5%	4.7%	5.8%	7.3%	7.8%
Exch. Rate ($)	9710	10427	9085	8789	9403	10336	10445	10338
Structural								
Trade/GDP (%)	50%	38%	40%	43%	42%	41%	42%	42%
Oil price (Brent)	$97	$62	$80	$111	$112	$108	$103	$105
Balance of Payments (US$ bil)								
Export of goods	139 606	119 646	158 074	200 788	188 496	184 069	210 780	241 012
Imports of goods	116 690	88 714	127 447	166 005	179 878	181 092	199 766	228 283
Other:	-22 790	-20 303	-25 483	-33 098	-33 049	-35 745	-39 484	-42 045
Current account ($ mill	**126**	**10 629**	**5 144**	**1 685**	**-24 431**	**-32 768**	**-28 470**	**-29 316**
(% of GDP)	0.0%	2.0%	0.7%	0.2%	-2.8%	-3.7%	-2.9%	-2.6%
FDI	3 419	2 628	11 106	10 437	14 309	15 452	17 825	19 971
Loan repayments	-16 704	-20 432	-23 975	-25 115	-31 067	-33 183	-33 036	-33 194
Net other capital flows	18 373	9 337	29 066	43 848	39 385	45 158	53 578	51 937
Balance of payments	**5 214**	**2 162**	**21 342**	**30 855**	**-1 804**	**-5 341**	**9 896**	**9 399**
External debt and liquidity								
Reserves	54 289	56 451	77 793	108 648	106 844	101 503	111 399	120 798
Total debt	148 541	161 392	190 600	220 694	240 923	254 014	251 441	252 114
o/w short term debt	19 801	22 714	29 673	36 251	38 288	38 595	38 905	39 217

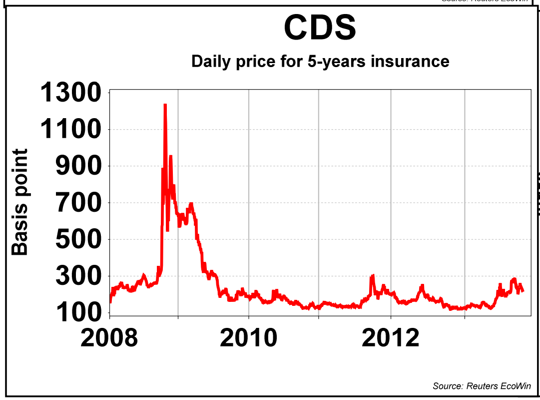
Source: OEF (Oxford Economic Forecasting) and SEB estimates.

Rating history					
Fitch (eoy)	BB-	BB	BB+	BBB-	BBB-
Moody's	Ba3	Ba2	Ba2	Ba1	Baa3

Type of government: Parliamentary Democracy
Next elections 2014
Other:
Latest PC deal 2005
Latest IMF arrangement 2003 SBA







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