Indonesia

SEB MERCHANT BANKING – COUNTRY RISK ANALYSIS September 14, 2015

Analyst: Rolf Danielsen. Tel : +46-8 7638392. E-mail : rolf.danielsen@seb.se

Hit by falling commodity prices, weak domestic demand and a slowing China the economic deceleration has continued. However, with political tensions receding and delayed government infrastructure spending set to recover, investor sentiment should improve before long despite simmering protectionist and nationalistic attitudes on the fringes.

Summary and conclusion

Growth decelerates. Against expectations, 2015 is set to turn out as another year of sub-par growth below 5% due to weak domestic demand suppressed by higher inflation. The latter was triggered by deep cuts in energy subsidies and a sharp depreciation of the rupiah. Adding to this are reduced exports reflecting the drop in external demand growth in particular from China. However, that is in part offset by an even sharper drop in imports sustaining the ongoing narrowing of the external current account deficit to 2,4% of GDP.

Reduced twin deficits. One of main investor concerns of recent years is gradually fading as not only the external but now also the internal imbalances have peaked and are set on a path toward prudent levels. The cut in fuel subsidies early in the current year was a major political achievement of the new president, Mr. Widodo, who took office after general elections in mid-2014. The savings, however, have been offset by unexpected revenue losses caused by weaker growth and oil exports. That left less for capital expenditure, including infrastructure, in order to keep the fiscal deficit on a declining path to 2%/GDP and the corresponding debt ratio at a low 27%.

Floating exchange rate: Monetary policies have solved the "impossible trinity" by accepting a more market based exchange rate in order to save reserves standing at a still strong 8 months of imports. This caused the rupiah to decline 15% against the USD over the last 12 months revoking some old fears about recent years' buoyant corporate foreign borrowing. Nevertheless, the IMF and rating agencies believe the problem is manageable not least thanks to the overall strength of the banking system.

Mixed reform record: Energy pricing reform apart, the new government has continued a mixed track record on other reforms. The government has slightly eased implementation of last year's ban on metal exports but mulled new restrictions on foreign investments in the financial sector and hiked import duties on a range of consumption items. In return it has announced cutting red-tape on business and introduced a "one-stop" investment licensing procedure.

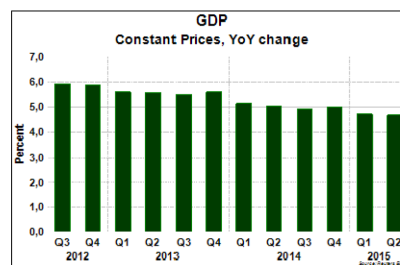
Outlook: Supported by improving fiscal metrics, two rating agencies upgraded the sovereign to investment grade already in 2013. As regards country risk, Indonesia is still a mixed bag of strengthening macro balances contrasting lack of reforms that could underpin more buoyant growth. While growth still continues at a decent level we emphasize the importance of sustainable macro policies for country risk. Downside risks, in particular a regional downturn led by China, is balanced by upside risk of more reforms.

Important: your attention is drawn to the statement on the back cover of this report which affects your rights.

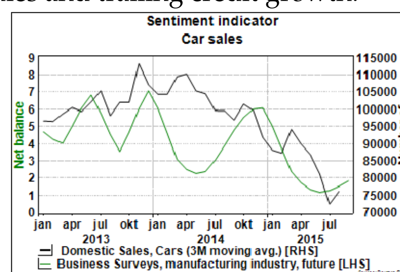
SEB

Recent economic developments

The soft patch in activity should be nearing its end and under any circumstances the country should be able to weather regional headwinds in terms of relatively sound external and internal balances.



Deceleration continues but is likely to bottom out before year-end. Since the commodity boom ended in 2012, the economy has slowed from more than 6% annual growth to 5% in 2014. Early expectations for the current year were for a small up-tick but as the print for the two first quarters both ended at 4.7% annualized, most observers have reduced their whole year estimates to well below 5%. -- In the first half of the year, investment growth shrank to less than 4% yoy, with the mining and energy sectors leading the way on account of weakening exports. In turn, falling export revenues sent knock on effects thru the rest of the economy. Households demand was also hit by sharp administered fuel price hikes in late 2014. The effect was seen in plunging car sales and trailing credit growth. This had a cooling effect on import demand which fell by more than 2% in real terms, twice as much as the drop of export volumes, averting an ever sharper cut in overall GDP growth.



Rising expectations for a year-end boost: High frequency indicators do not hold the promise of an immediate recovery because of soft credit demand, continued sluggish retail sales and above all the potential for further export market weakening. In return, government efforts to revitalize several infrastructure projects should begin to bear fruits and at least arrest the further slowing of activity. Still more likely is the case for a modest boost toward year-end with the effect to slightly lift whole year growth performance to 4.8%.

Headline inflation responds to price shocks. Late last year the new government hiked fuel prices by an average of 34% to rescue the budget from soaring subsidy outlays. In response, monthly inflation shot up to more than 8% yoy and has remained sticky so far into the current year at around 7% under subsequent pressure from the depreciating exchange rate. In contrast, underlying inflation has remained more subdued at around 5% as measured by core CPI and the likelihood is for headline inflation to eventually subside toward the end of the year provided this year's *el nino* does not cause problems for agriculture thereby increasing food prices.

Tight labor market continues: Despite cooling of activity, the labor market has remained tight as judged by the declining rate of unemployment and generous wage settlements at least in the Jakarta area. Care should be taken, however, when interpreting such numbers at least on a national scale due to the large informal sector in many parts of the country. On average it dominates two thirds of the labor market where only 35% of workers have employment contracts. The working age population is growing rapidly but lack of skilled personnel is an oft-cited bottleneck.

The current account deficit narrows: Since 2011, exports have nosedived as both volumes and in particular global commodity prices have softened significantly. Fuel and mining products make up more than a third of total exports, agricultural products represent about a quarter with manufacturing in the balance. In late 2014 export weakness intensified in part due to a newly imposed export ban on unprocessed mining products. The downward trend continued into the current year with total export value now seen falling another 10% mostly due to lower prices. With a 15% share of the total, China is Indonesia's largest export destination and the ongoing slowing of activity in that country has pulled down global commodity prices and to some extent also real demand. Japan is the second greatest export

markets for Indonesia and that country is also dependent on China for much of its exports and overall growth. Luckily then, at least in terms of the current account balance, also imports have been on a downward trend since 2012, and are estimated to drop more than exports, by about 13%. In 2015. As a result, the current account deficit should eventually shrink to an estimated $21 bn. -- 2,4% of GDP, a drop of $4bn. from 2014.

Deficit easily financed. .In January the government issued bonds worth $4bn. which were well received by international investors. That was before Rupiah's sharp drop in the Spring, but portfolio investors have not yet lost appetite for Indonesian exposure although interest has varied from month to month. Also long term investors have remained reasonably committed to Indonesia as measured by total FDI inflows. Last year they recorded an all-time high of almost $16bn. Even though FDI inflows disappointed in the first quarter, expectations are still for a recovery towards year-end provided invigorated implementation of delayed infrastructure programs. Scheduled loan repayments are estimated at $48bn. in 2015. They have so far been refinanced without major disturbances. In the first six months of the current year, the central bank covered $6bn. of the payment deficit with its own money -- international reserves, ostensibly to reduce volatility in an otherwise thin foreign exchange market.

External liabilities under control: As a result of a long history of annual current account deficits Indonesia's net international investment position (NIIP) was negative to the tune of 49% of GDP at the end of last year. Much of that reflects large FDI inflows over several decades. As regards outright debt the gross number stood at 35%/GDP of which short term debt accounted for a sixth. Debt owed by corporates made up some two thirds of total but that ratio has likely declined since then following strong central bank encouragement to reduce open currency exposures and set aside liquidity for shorter terms maturity. Halfway through the year about half of all targeted enterprises were compliant with the new guidelines according to a central bank survey. Banks themselves have since many years been subject to stricter regulations and are believed not to sit on major currency mismatches.

Robust reserves. Liquid reserves in the hands of the central bank stand at more than $100bn. -- equivalent to 8 months of imports. IMF reports that these reserves are 160% of the IMF's reserve metric for a floating currency. In addition, $76bn. of contingent financing is available[1], another reassurance that Indonesia should have ample buffers to meet foreign payment obligations in the case of unexpected shocks.[2]

Policies

Financial policies continue along an overall prudent path well aware of the dangers of losing market confidence in overstepping self-imposed chalk lines. The laggard is reform policies which once again derailed at the beginning of the year for reasons partly beyond the control of the new government.

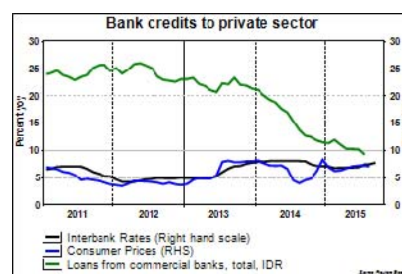
Fiscal policies under pressure: In early 2015, following sharply changed economic conditions during the last months of the preceding year; the new government presented a revised budget. It set high targets for revenues including a 30% rise in tax receipts. It incorporated newly adopted changes to subsidy policies aimed at saving the budget almost 2% of GDP, money to be allocated for an ambitious infrastructure program. The government still aimed at cutting the budget deficit to 1,9%/GDP well within the self-imposed limit of 3%. However, it soon turned out that the revenue expectations had been unrealistic -- both VAT and direct taxes failed to deliver in the face of the economic headwinds. On top of that, the further decline in the global oil price wiped out any budget savings as fiscal revenues from both crude oil and palm-oil exports decreased sharply. Also other government revenues disappointed. In January-May, VAT revenues had dropped by 5%, far below an over-ambitious growth target of 42%.

[1] Chiang Mai Multilateralization and bilateral swap arrangements
[2] IMF 2014 Article IV Country Report 15/74, Washington DC

New push for project implementation while fiscal prudence rules: In the event, the government chose to maintain fiscal prudence by slowing disbursements for investment projects. From a weak base of the previous year, the new budget had planned a doubling of the government's capital expenditures. to 2,6%/GDP in 2015. That has become an untenable position and already in May project payments were standing 18% lower than in the comparable period of the preceding year. Since then the government has announced a number of measures to increase tax collection including VAT on electricity use of households and a tax amnesty. This should facilitate budget execution through the rest of the year targeting 90% realization. The push has been supported by a revised land acquisition regulation of last March and changes to the government as of August with the inclusion of "technocrats" in key ministries. Although these measure are unlikely to have much impact before the end of the year, the World Bank's main baseline budget deficit for 2015 remains at 2,5%/GDP reflecting both improved budget execution but also weaker tax receipts.

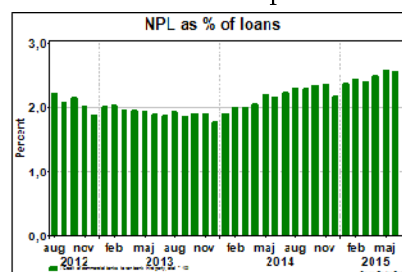
Financing challenges remain modest: Gross government financing needs for the current year could reach 5%/GDP but is unlikely to present much of a challenge. This estimate includes the budget deficit (2,5%/GDP) and capital injections for state owned enterprises (SOE) at about 0,5%/GDP with refinancing of maturating debt in the balance. The international bond issuance in January was placed easily and as the end of August the government had already reached 79% of the current year's issuance target. With partial support from the IMF the bank notes that the government could afford to raise the deficit to 3%/GDP – the maximum level allowed by law -- in order to accelerate government investment spending. This is in view of a solid track record and a government debt ratio at only 24%/GDP – of which 60% is on domestic hands and enjoys a favorable maturity profile. Curiously, it is also in contrast with the fact that since 2012 the primary deficit has remained in a small deficit of 0,6%/GDP.

Monetary policy attempts to regain independence: With the steep depreciation of the rupiah – at least against the dollar -- since the first quarter of the year, the monetary authorities have signalled that the central bank is no longer in the business of defending a peg or a target rate. That is despite some recent interventions as noted above but markets appear convinced that such were mainly to quell excessive volatility and not to lean against the trend. Late 2014, the central bank hiked policy rates slightly in face of escalating consumer price inflation following the sharp rise in administered fuel prices. A few months later it reversed that action again and since then one key policy rate -- at which the central bank accepts deposits from banks, has remained steady at 7,5%bsp. This is only slightly higher than the monthly rate of inflation and the central bank's consideration is likely to be that the high headline inflation is an aberration as compared with the lower core inflation.



Easing macro prudential measures: In return, the central bank has eased macro prudential measures including raising the loan-to-value ratio for mortgages with the objective to arrest further deceleration of credit growth which could hurt the economy. So far these measures have had limited effect. New credit extension up to July continued to slow below the 10% yoy mark.

Following a steep drop the exchange rate should be fairly valued by now. With the recent drop to 14000 IDR/USD observers believe the Indonesian rupiah should have reached the bottom and be fairly valued now. The real effective exchange rate (REER) is 10% down on its level five years back and also much lower – depreciated -- than the average of the other ASEAN currencies or China over the same period.



Banks are overall sound: The IMF commends the banking system for its capacity to withstand shocks. Capital buffers stand at almost 20% (of risk weighted assets) enabling banks to withstand an increase of NPL (non-performing loans) by 9 pp from its current low level of less than 3% of total loans -- reassuring in view of a recent up-tick in the level of NPL. Banks liquidity ratios are also strong but that often

reflects the fragmentation of the interbank market. In terms of loan concentration, big banks have the largest exposure but their clients are often better hedged against adverse currency movements. Banks' own currency exposure, is well hedged and regulated by the central bank which has set a limit on open currency position at 20% of equity. The whole banking system is quite small standing at only 40% of GDP in terms of private sector exposure. That combined with the sovereign's own robust financial position ensures a high likelihood of government support in case of systemic stress.

Box 1: Corporate sector vulnerabilities: In recent years, corporate debt has grown rapidly to 34% of GDP (2014 data) almost half of it as borrowing from abroad. Many borrowers are in the resources sector and struggling under soft global commodity prices. Scheduled amortization in 2015 has been estimated at $10bn. about 9% of total debt. So far there have been few (if any) headline grabbing payment events despite the large rupiah depreciation. That may be due to the fact that most of this debt has been incurred by companies with FDI related funding or with adequate cash inflows in foreign exchange. It is still to be noted, however, that as of last March according to estimates of Standard & Poors -- the credit rating agency, sectors at risk from a rupiah depreciation account for 25% of bank loans.

Reform policies – light in the tunnel? Last November, the new president started with a bang, hiking administered prices for gasoline and other fuels with the effect to reduce subsidies. That was a long overdue measure also because the policy had become increasingly outdated relative the supposed objective of serving the poor. As oil prices fell precipitously in the following months it became possible to introduce a new pricing scheme for energy in close relation to world market prices, thereby protecting the budget from the vagaries of global energy markets. But as explained above, the same event also put constrains on the budget execution and for several months an overambitious infrastructure program had to be cooled. In the meantime, last March a new land acquisition law made its way through the national assembly and last August, the President announced a revitalization of the reform and infrastructure programs announcing a 8% boost in the new budget for 2016.

That said, vested interests have not given up on advocating protectionist policies. The result is seen in new tariffs on imports of consumer items since last summer while new laws are being prepared to limit foreign ownership of financial institutions. Such actions have raised suspicion that it will take a long time to improve the business climate. In return, other investors point to the new push to streamline overlapping trade regulations, cutting red tape and to simplify the permission process for investments including a "one-stop" licensing procedure.

Political developments

Expectations were high when Joko Widodo, won the presidential race in July 2014 with 53% of the votes. Although being the former governor of Jakarta he was still regarded as an outsider. That invigorated hopes following the disappointment with the incumbent who had ruled two terms with few results to show for having been increasingly stymied by turf wars within the country's political elite. Such and other impediments to effective policy making have often been associated with the former president, Megawati Sukarnoputri, who continues as chairwoman of the leading coalition party, PDI-P. President Widodo's latest government reshuffle in last August has been hailed as a triumph for pragmatism as it included several "technocrats" taking charge of key ministries. But according to other observers the reshuffle may as well have raised Ms. Sukarnoputri's leverage on government policies.

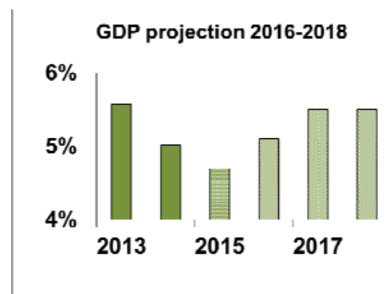
Nevertheless, it is still far too early to discount the future of the new president. The latest cabinet reshuffle also expanded the coalition to include a smaller party which tipped the parliamentary majority in favor of the government. That is likely to facilitate the passage of new reform initiatives. President Widodo faces his next race for office in 2019. He can constitutionally be reelected only once.

Outlook

The current year is unlikely to be much more inspiring than 2014. At 4,8%, growth will only rise slightly from last year and that factors in a revitalized government infrastructure and reform program in the second half of the year that again could be delayed into the next year. In 2016, by contrast, rising numbers of observers see growth accelerating to the 5-5,5% range closer in line with potential GDP growth according to Oxford Economics, a consultancy. That will reflect a broad based

recovery spearheaded by fixed investments including in government infrastructure projects supported by private consumption and trade as exporters should now have gained a competitive edge on competitors following the deep rupiah depreciation. Internal and external balances are also set to improve further with both the fiscal and the current account deficit within the 1-2%/GDP range, while inflation should subside to within the central bank's 3-5% target.

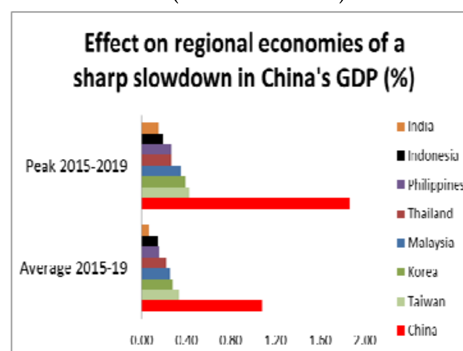
This scenario does not demand a vigorous implementation of the reform and infrastructure program in which case growth would likely speed up even more, provided that the program does not stall completely. Still at the beginning of his term, the President is likely to have some headroom to pursue his goals before election politics take over some 3-4 years from now.



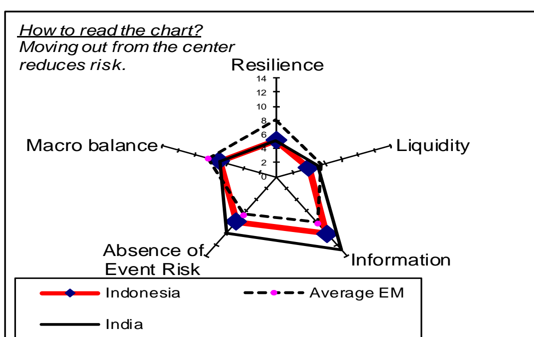
Domestic risks to this scenario include a reform impasse should vested interests turn against the president as an outsider to the established political elite or coopting him to lie low. The rating agency, Moody's: notes that "Indonesia's score on World Bank Governance Indicator underpins our assessment of low institutional strength". Since several years bureaucratic and political elites have mounted stiff resistance to any reform that could threaten status quo. In return it now seems clear that the lingering threat from the old dictator regime under Pres. Suharto has finally crumbled.

External risks are mainly the recently oft-cited threat in case China should experience a sharp slowdown. Our run on the global Oxford Model, however, places Indonesia among the least affected Asian countries despite the importance of the Chinese market for Indonesian exporters. The reason seems to be the relative resilience, predicted by the model, of global commodity prices which are more important to Indonesia than most other regional countries. (Chart below.[3])

Overall, Indonesia presents a mixed bag of opportunities and risks. In a credit perspective the paramount feature of its risk profile is a steady macro-economic development -- if not spectacular -- combined with a sound banking system and debt levels deemed manageable by most observers including the IMF. It is also noted that since the Asian crisis almost two decades ago the country never lost access to international capital markets.



Key ratios	2015
Population (mill.)	256
GDP/capita ($)	3458
GDP (change)	4.7%
Inflation	6.9%
Curr.Acc. Balance/GDP	-2.4%
Reserves/imports (months)	8.6
Budget balance/GDP	-1.9%
Government debt/GDP	24%



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

Peers:
Philippines
India

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

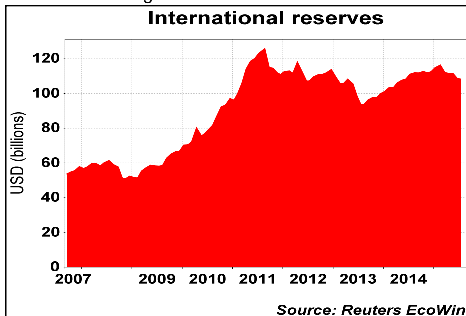
[3] The staples measure deviations (negative) of GDP from the base scenario as a result of reducing outstanding loan for investments in China (ILON!) by about 6%pa.

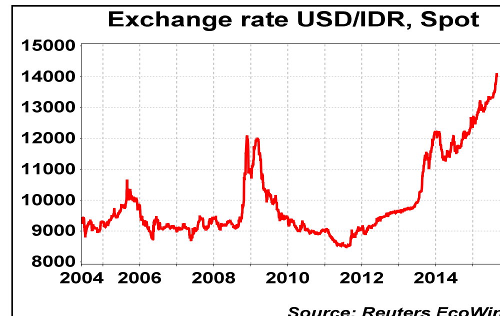
Key data:	2010	2011	2012	2013	2014	2015	2016
GDP (mill.US$)	756	894	919	916	890	886	1014
GDP/capita (US$)	3137	3661	3718	3662	3515	3458	3918
GDP (change)	6.4%	6.2%	6.0%	5.6%	5.0%	4.7%	5.1%
Investments/GDP	31%	32%	33%	33%	32%	32%	33%
Government Finances							
Budget balance/GDP	-0.6%	-1.1%	-1.7%	-2.2%	-2.2%	-1.9%	-1.7%
Govt debt/GDP	24%	23%	23%	23%	24%	24%	24%
Money & Prices							
CPI inflation (%)	5.1%	5.3%	4.0%	6.4%	6.4%	6.9%	4.6%
Money demand (%)	12.9%	15.5%	18.2%	13.3%	11.8%	10.7%	7.9%
Stock prices (%change	241065	244162	247215	250219	253171		
Interest rates	6.9%	6.5%	4.7%	5.9%	7.9%	7.2%	7.9%
Exch. Rate ($)	9082	8768	9373	10420	11850	13196	12750
Structural							
Trade/GDP (%)	36%	39%	40%	39%	39%	35%	33%
Oil price (Brent)	$80	$111	$112	$109	$99	$56	$59
Balance of Payments (US$ bil)							
Export of goods	149 967	191 109	187 347	182 089	175 293	157 577	174 234
Imports of goods	118 963	157 284	178 667	176 256	168 311	148 071	160 941
Other:	-25 858	-32 140	-33 098	-34 942	-32 385	-30 837	-32 664
Current account ($ mill	**5 146**	**1 685**	**-24 418**	**-29 109**	**-25 403**	**-21 331**	**-19 371**
(% of GDP)	0.7%	0.2%	-2.7%	-3.2%	-2.9%	-2.4%	-1.9%
FDI	11 107	11 528	13 716	12 170	15 502	15 235	16 800
Loan repayments	-23 975	-25 164	-29 508	-32 047	-38 870	-41 261	-45 173
Net other capital flows	29 589	41 117	37 367	39 044	57 789	48 358	53 630
Balance of payments	**21 867**	**29 166**	**-2 843**	**-9 942**	**9 018**	**1 002**	**5 887**
External debt and liquidity							
Reserves	79 763	108 929	106 086	96 144	105 162	106 164	112 051
Total debt	190 600	220 694	240 923	260 378	287 540	309 814	329 363
o/w short term debt	29 403	37 605	40 107	45 719	46 206	47 240	51 179

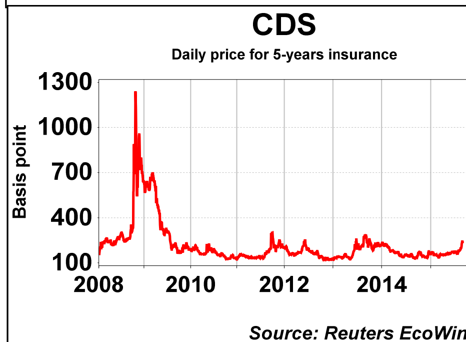
Source: OEF (Oxford Economic Forecasting) and SEB estimates.

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







Disclaimer

Confidentiality Notice

The information in this document has been compiled by SEB Merchant Banking, a division within Skandinaviska Enskilda Banken AB (publ) (“SEB”).

Opinions contained in this report represent the bank’s present opinion only and are subject to change without notice. All information contained in this report has been compiled in good faith from sources believed to be reliable. However, no representation or warranty, expressed or implied, is made with respect to the completeness or accuracy of its contents and the information is not to be relied upon as authoritative. Anyone considering taking actions based upon the content of this document is urged to base his or her investment decisions upon such investigations as he or she deems necessary. This document is being provided as information only, and no specific actions are being solicited as a result of it; to the extent permitted by law, no liability whatsoever is accepted for any direct or consequential loss arising from use of this document or its contents.

SEB is a public company incorporated in Stockholm, Sweden, with limited liability. It is a participant at major Nordic and other European Regulated Markets and Multilateral Trading Facilities (as well as some non-European equivalent markets) for trading in financial instruments, such as markets operated by NASDAQ OMX, NYSE Euronext, London Stock Exchange, Deutsche Börse, Swiss Exchanges, Turquoise and Chi-X. SEB is authorized and regulated by Finansinspektionen in Sweden; it is authorized and subject to limited regulation by the Financial Services Authority for the conduct of designated investment business in the UK, and is subject to the provisions of relevant regulators in all other jurisdictions where SEB conducts operations.

SEB Merchant Banking. All rights reserved.