Indonesia

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Growth should pick up to 5% in 2016 as recent reforms take root and government spending on infrastructure accelerates in the second half of the year. Strengthening political stability has bolstered investor sentiment against a background of decent financial and economic fundamentals. Barring a steep slowdown in China or a domestic backlash to reforms we see growth reaching 6% or more by 2020.

Summary and conclusion

Growth picks up: Last year, growth weakened following a sharp drop in main export prices and monetary policy tightening. That is now gradually turning around with activity expected to quicken to 5% in 2016 supported by a new push for government infrastructure with already 8 out of some 30 projects in the pipeline. At the same time household demand is about to recover from last year's elimination of longstanding fuel subsidies which increased price pressure and prompted tighter monetary policy. Since then inflation has receded to well within the 3-5% target. Combined with revamped reform policies and political stability these developments are lifting investor sentiment. That underpins a stable foreign reserve level at more than $100bn or seven months of import cover despite a somewhat higher current account deficit of 2,6%/GDP.

Prudent fiscal policies: In line with previous governments the present administration will continue observing the 3%/GDP limit to the budget deficit. That is despite the steep drop of revenues from the oil sector which has been only partially offset by reduced energy subsidies. In 2016, the deficit is set to come closer to this limit but for the good reason of ramped up public sector works. Government debt will, nevertheless, remain low at less than 30%/GDP, most of it at long maturity and evenhanded terms achieved through recent global bond issues.

A new push for infrastructure and reforms: After years of delay the new government since 2014 has launched a comprehensive reform package to fix weak infrastructure and multilayered bureaucracy which have earned the country poor scorings on the "ease of doing business" index. 35 new sectors of the economy will be opened for foreign investors and a "one-stop shop" offers the opportunity to obtain all investment permissions in one place in Jakarta. Previous infighting between reformers and protectionists appears to have subsided as the landslide victory for President Joko Widodo two years ago is beginning to bear fruit. The government has succeeded in expanding its coalition with the inclusion of two smaller parties and also gaining parliamentary support from the larger Golkar party. Underlying fissures with former president, Megawati, may not yet be over, though.

The medium term future of Indonesia has improved further over the recent year. Two rating agencies had already last year upgraded the sovereign to investment grade. That is also supportive of country risk despite oft-cited concerns about high foreign currencies leverage in particular among large commodity producing corporates. Barring major but not very likely external or internal shocks including a sharp slowdown in China, Indonesia should continue to prosper to the end of the decade as the government continues on a path of prudent and consistent policies and reforms.

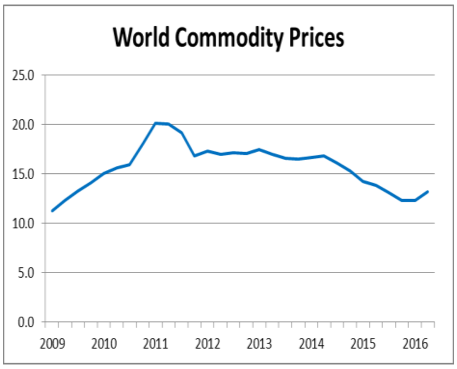
Recent economic developments:

Last year's slowing growth after a sharp drop in main export prices and monetary policy tightening is now gradually turning around with activity quickening to 5% in 2016 supported by a new push for government infrastructure. Also household demand is about to recover from last year's elimination of longstanding fuel subsidies which boosted price pressure and prompted tighter monetary policy. So far in the current year inflation has receded to well within the official 3-5% target. Revamped reform policies and political stability have lifted investor sentiment to underpin foreign reserves at more than $100bn -- seven months of import cover despite a slightly higher current account deficit.

Growth picks up: From last years' weaker but far from dismal results in view of the challenges, growth is set to improve slightly in the current year to around 5%, boosted by stronger implementation of the government's new and comprehensive infrastructure package to take place in the second half of this year. At the same time investor sentiment is improving as vital reforms, have passed Parliament while a steady macroeconomic framework holds sway. Also consumers, hard hit by the historic termination to fuel subsidies in 2015, are about to regain their foothold. Only the external sector could present a drag on the economy as imports outpace more sluggish exports.

Inflation subsides: Coming from a past of high and a persistently volatile history, consumer price inflation is about to fall well within the official target of 3,5%. From an average of well above 6% in 2015, the rate of inflation fell to 4% yoy (year-on-year) in the first quarter and is expected to end at 3,7% for the whole of the current year. That is due to the phasing out the influence of sharp fuel price increases in early 2015 after the government had ended subsidies but it also reflects the recent strengthening of the exchange rate.

Soft export demand: With 10% of the total, China is the second most important destination of Indonesian exports after Japan. Moreover, given its significance for East-Asian trade in general the further slowdown in China this year is taking its toll on Indonesian export performance. That is in particular relevant for commodities which make up around half of total exports. In addition, last year's ban on metal shipments and the channeling of palm oil to domestic use in transports also made an impact. But these negative export trends were offset by still stronger import compression resulting in a reduced current account deficit at only 2%/GDP. In the current year that is about to turn around as stronger domestic demand draws more imports while export revenues still languish under soft global energy and commodity prices. This will drive the current account deficit up to 2,6%/GDP, still below the 20012-2014 period though.



Capital inflows: Improved sentiment among global investors has created new interest for Indonesian assets. In the first six months of the current year private portfolio inflows mounted to more than $12bn. mainly into the stock market but also into government debt instruments including two new issues. That has helped Bank of Indonesia (BI) --the central bank – maintain reserves at a healthy level of more than $100bn enough to pay for 7 months of goods and services imports. This does not include $77bn. of contingency financing through the Chang Mai Initiative and bilateral swap arrangements. In return, about a third of reserves are linked to domestic banks deposits with BI and forward forex positions reducing the immediate liquidity of total reserves. Nevertheless, observers still note that Indonesia's external position is broadly consistent with medium term fundamentals.

Economic and financial policies:

In line with previous governments the present administration will continue observing the 3%/GDP limit to the budget deficit. That is despite the steep drop of revenues from the oil sector which has been only partially offset by reduced energy subsidies. In 2016, the deficit is set to come close to this limit but for the good reason of ramped up public sector works. Notwithstanding this, government debt will remain low at less than 30%/GDP, most of it at long maturity and fair terms.

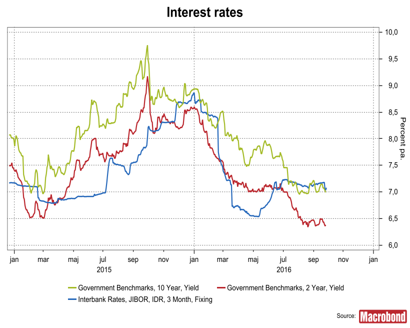
The budget for the current year is likely to end with a deficit of 2,8%/GDP worsening last year's result by 0,8 percentage points (PP) as reduced oil and gas prices are encroaching on government revenues. Already in 2015, that had cut revenues by 1,8%/GDP which was only partly offset by 1,2%/GDP lower government payments for energy subsidies. While subsidy rationalization continues, the main budget impact in the current year will be the estimated 0,7%/GDP increase in government supported infrastructure projects. That will bring the total government investment spending up to 3,3%/GDP still significantly below regional peers, though.

Box 1 Termination of fuel subsidies: These subsidies mainly on gasoline and other transport fuels had burdened the government for decades costing about 2%/GDP annually or more than 15% of total revenues. They were sharply reduced or cancelled all-together in late 2014 by the new government with effect from the following year. However, because of the same year's drop in prices of oil and gas, important revenue sources for the budget, the expected positive effect on the budget balance did not materialize.

The perennial fiscal problem of a very low tax take of only 13%/GDP, a reflection of that less than 10% of Indonesia's workers submit any income declaration, has prompted the government to issue a tax amnesty. International experience, however, provides little evidence that such measures have any lasting effect on tax compliance, if any at all. Last August, the first month of the amnesty ending next March, the government collected less than 1% of the target.

As in earlier years, the budget deficit for 2016 will predominantly be covered by issuance of government bonds and bills. Last December it issued a bond for $3,5bn targeting international investors and in March it repeated the success by another issue, a sukuk, for $2,5bn. as the EMBIG spread had dropped to 300bsp. That combines with other pre-financing to raise total government debt closer to 30%/GDP still well below peers in the same risk class. Moreover, low debt is underscored by the absence of any major contingent liabilities. Direct guarantees, mainly for SOEs, represent only 3%/GDP while the banking system is healthy enough to manage on its own without drawing on government resources in any significant way at least in a medium term scenario. Most of the government's own debt – about 85% of it – benefits from long maturity and fair market terms. A bunching of maturities last March had little impact on prices and were rolled over with apparent ease with help of the noted sukuk. Last April, foreigners held an estimated 40% of Indonesian sovereign debt.

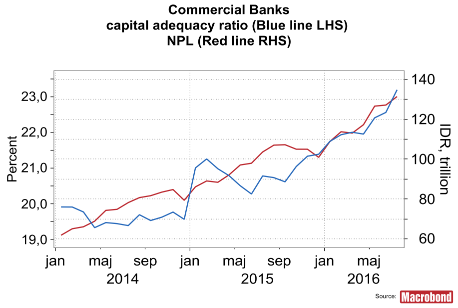
Monetary policy normalization: The turbulence in global markets around the first "taper tantrum" in 2014 hit the Indonesian market hard in part due to late response from the authorities. When this was followed by the inflation shock in 2015, BI reacted promptly by hiking rates with the aim to restore investor confidence in monetary policies and to anchor inflation expectations in general. In the event, the actual outcomes have vindicated this approach despite pain from high interest rates in an intermediate period for the economy. So far, since the beginning of the year consumer prices have been in steady decline hitting 3,5% yoy in last July. On that background the inflation target of 4%±1% should be well within reach and likely end at 3,7%, below last year's average of more than 6%. This has allowed the central bank to ease. So far this year it has lowered the policy rate by 100bsp and also cut reserve requirement for banks with NPL levels below 5%. More controversially, though, it has



reportedly also asked banks to lower lending rates to single digits by end 2016 excluding consumer loans.

Capital controls unlikely: It is noted that Indonesia have few effective capital controls left and that observers regard reintroduction of such as unlikely at least in a medium term scenario. During the severe financial turbulence in 2014 there was no hint the authorities were mulling capital controls in order to ease the pressure on reserves.

Sound banking system with pockets of concern: Observers are unison in commending the banking system as sound, profitable and with high capitalization at almost 19%. Even after rapid growth during the commodity boom up to 2014, the banking system is still moderate in size with total outstanding credits to the private sector at no more than 39% of GDP. Even though that rapid growth has now flattened, its legacy is seen in a rising trend of bad loans with non-performing loans (NPL) increasing to almost 3% with "special mention loans" adding another 2,5pp. That is up by a third from last year but still not yet alarming in view of also rising capital adequacy ratio. Vulnerability is manly found among small and medium sized banks in particular with large clients among commodity producers who contracted massive loans including in dollars when their global prices of their products were high. This has been a concern for a couple of year but recently subsiding as the central bank began to require such bank clients to hedge a part of their foreign currency liabilities. It also limited foreign borrowing only to investment grade firms.



FATF: Concerns about money laundering and associated mischiefs among banks were much reduced when FATF (the Financial Action Task Force) last year removed Indonesia from its monitoring list.

Corporate sector worries: Notwithstanding the concerns noted above, the corporate sector is still regarded as relatively strong at least when compared with other emerging market peers. The greatest remaining concern is its debt in foreign denominations. From 2010, during the boom years they doubled as a percentage of GDP to 20%. In early 2016, prevailing expectations were for roll-over risk to grow but so far such concerns have not materialized.

Reform policies

For many years Indonesia was infamous for an overall weak investment climate complicated by the needs for numerous permits from different levels of government and a dominating Negative Investment List (NIL). For this and other reasons infrastructure spending had become subdued falling to less than 4%/GDP about half the level of India. It has been calculated that poor infrastructure counts for some 20% higher logistics and transportation costs than in Thailand.

Since taking office in 2014, the new government has launched a comprehensive reform package to fix poor infrastructure and multilayered bureaucracy which has earned the country weak scorings on the "ease of doing business" index. Encouraged by stronger political backing President Joko Widodo has launched a comprehensive reform and infrastructure plan, parts of it already in the process of being implemented:

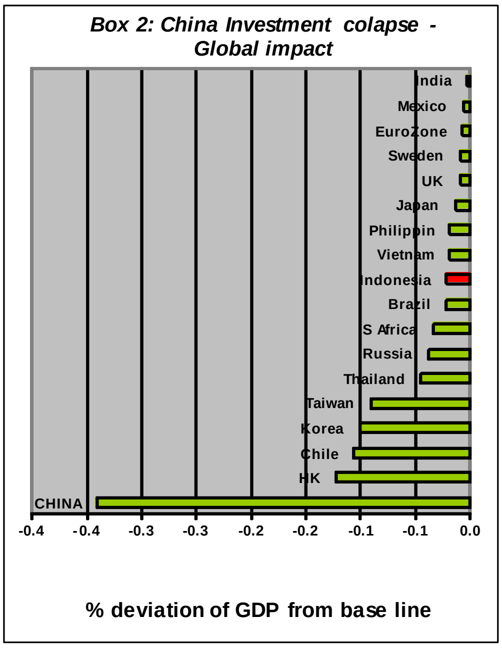
- Red tape: reduced import procedures and eased export licensing
- NIL reduced, opening for foreign investments in 35 new sectors
- Rigid labor market laws eliminated including the former requirement to hire 10 locals for each foreign employee.
- Termination of all electricity subsidies except for the poorest households
- Regulations for the new Land Acquisition Law mandating a time limit of maximum 2 years for public investment projects

- Reduced dwell time at ports from 6 to 4,7 days.
- Arranging a one-stop shop in Jakarta for processing all licensing requirements for new investments

Supported by the above changes the government hopes to realize an investment program worth almost 50%/GDP over the next 4-5 years of which 8 projects are in the pipeline. These are now being implemented on a PPP basis with 2/3 government financing with the objective to "crowd in" the private sector.

Political developments

The landslide victory for President Joko Widodo two years ago is beginning to bear fruit. The government has succeeded in expanding its coalition with the inclusion of two smaller parties and also gaining parliamentary support from the larger Golkar party although the underlying fissures with the still influential former president, Ms. Megawati, may not yet be over.



A gradual collapse in China's investment demand from 46% to 30% of GDP in 2017-20 would reduce annual growth in China by an average of 3,5 pp but have only moderate effect on most other countries except neighboring ones according to the econometric Global Oxford Model. Only Chile sticks out as the third most affected. This is due to its important copper export.

Total world growth will decline only by 0,6pp over the period and in a relatively smooth manner. This is in stark contrast to the Asian crisis which caused a deep but shortlived global recession. In contrast, a crisis in China would likely not develop as abruptly because the Chinese government will make sure that the many ongoing infrastructure projects do not remain unfinished. That is, unlike the Asian crisis. provided no domestic political consequences. Also in contrast to the Asian crisis, a crisis in China would be more of a financial and structural case which likely will take longer time to overcome.

One should not ignore that the model may understate other factors including financial contagion. This could make smothering problems to resurface, including in the Eurozone, with the result to augment the global impact. Still we believe that the direct effects shown by the model at least suggest the likely ranking of the countries most affected even though the total effect could be underestimated.

The president strengthens his power base: Mr. Joko Widodo was an outsider when he ran for President in the late 2014 elections. However, capitalizing on a landslide victory he has been able gradually to build a stronger power base beyond his original party ticket. That has resulted in the addition of two new parties joining the coalition government while the dominating Golkar party has promised legislative support. In total that means expanded support in Parliament to 69% of its members. Moreover, a reshuffle of the cabinet last June brought the well-respected World Bank official, Ms. Sri Mulyani, back into the government as finance minister. Observers saw that as a sign of the president's success in bolstering his position thereby boosting prospects for further reforms. In return he was seen compelled to also accept General Gunavan, a longtime confidante of former president, Ms. Megawati, who is often regarded as mill-stone on the president's neck despite being from the same party.

External security: Since last year, external security has been dominated by increasingly frequent frictions with China over fishing rights in Indonesia's territorial waters, which also China claims as its own.

Outlook

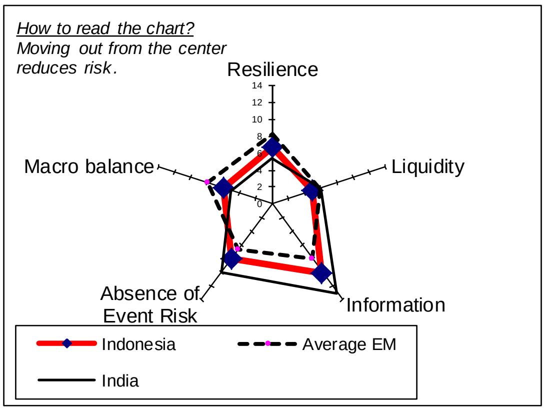
Short to medium term improving: Barring no major external or internal political or economic shocks, activity should quicken further in the 5-6% growth range and probably reach beyond 6% before the end of the decade. Next year, GDP should grow somewhat faster by 5,4% mainly on the back of domestic demand including for infrastructure but also a pick-up in private investments. The latter includes manufacturing and services following an easing of monetary conditions and administrative restrictions. Pharmaceuticals are an example of fast growing industries. Last year it expanded by 15%. In the same vein, new export activities combined with some recovery of commodity prices would help contain the current account deficit within the 2-3%/GDP range. Price pressure is now likely to stabilize within the authorities target range of 3-5% annual CPI growth.

As always, such a scenario comes with a warning of adverse developments. The whole region could buckle under a sharper than anticipated slowdown in China the longstanding growth engine in South-East Asia. (Conf Box 2.) Domestically, one cannot exclude protectionist forces once again pitting a fight against reforms seen as a threat to their vested interests including of the many state owned enterprises. Next scheduled general elections in 2018 could provide a battleground but so far protectionists appear to have the most headwind.

In the longer term, Indonesia should be able to take advantage of its great resource base and demographic dividend favored by a declining dependence ratio. By 2020, 70% of a projected population of 250 mn. people will be in working age. That should represent both great market opportunities and a solid base for new production activities combined with a continued prudent macroeconomic set-up.

However, Indonesia has a history of vulnerability, much of it by its own making under regimes of political suppression and economic imbalances. But memories of these and associated weaknesses are moving steadily into the distant past.

Key ratios	**2016**
Population (mill.)	261
GDP/capita ($)	3596
GDP (change)	5.0%
Inflation	3.7%
Curr.Acc. Balance/GDP	-2.6%
Reserves/imports (months)	9.5
Budget balance/GDP	-2.5%
Government debt/GDP	28%



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

Peers:
Philippines
India

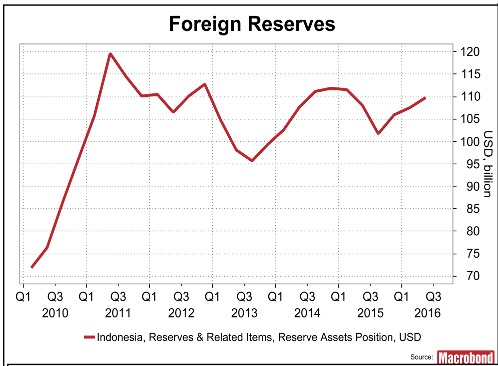
Graph: The pentagon shows the creditworthiness profile of Indonesia somewhat weaker than the Philippines on macro balance but stronger on resilience.

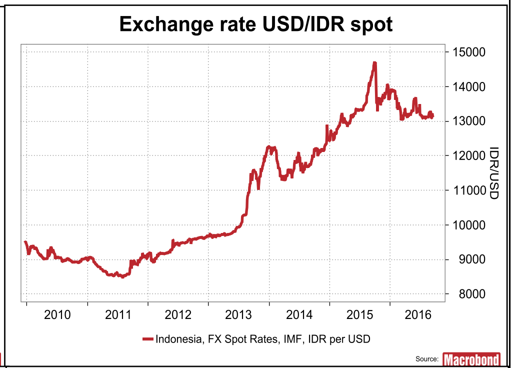
Key data:	2012	2013	2014	2015	2016	2017	2018	2019
GDP (mill.US$)	919	918	892	862	938	991	1067	1174
GDP/capita (US$)	3700	3649	3499	3340	3596	3757	3999	4358
GDP (change)	6.0%	5.6%	5.0%	4.8%	5.0%	5.2%	5.6%	5.7%
Investments/GDP	33%	33%	32%	32%	33%	33%	33%	33%
Government Finances								
Budget balance/GDP	-1.7%	-2.2%	-2.2%	-2.5%	-2.5%	-2.8%	-2.4%	-2.0%
Govt debt/GDP	23%	23%	26%	28%	28%	29%	31%	33%
Money & Prices								
CPI inflation (%)	4.0%	6.4%	6.4%	6.4%	3.7%	4.2%	4.3%	4.2%
Money demand (%)	18.2%	13.3%	11.7%	12.5%	8.6%	9.4%	9.0%	9.0%
Stock prices (%change)	248437	251676	254859	257940	260923	263839	266689	269473
Interest rates	4.7%	5.9%	7.9%	7.5%	7.3%	7.6%	7.9%	8.1%
Exch. Rate ($)	9373	10420	11850	13394	13348	13806	14068	14034
Structural								
Trade/GDP (%)	40%	39%	39%	33%	29%	29%	29%	29%
Oil price (Brent)	$112	$109	$99	$52	$44	$50	$52	$59
Balance of Payments (US$ bil)								
Export of goods	187 347	182 089	175 293	148 365	140 880	148 057	159 678	176 689
Imports of goods	178 667	176 256	168 311	135 076	132 089	135 993	144 337	160 662
Other:	-33 098	-34 942	-34 492	-30 942	-32 923	-35 616	-39 763	-43 285
Current account ($ mill)	**-24 418**	**-29 109**	**-27 510**	**-17 653**	**-24 132**	**-23 552**	**-24 422**	**-27 258**
(% of GDP)	-2.7%	-3.2%	-3.1%	-2.0%	-2.6%	-2.4%	-2.3%	-2.3%
FDI	13 716	12 170	14 734	9 943	18 664	24 045	26 348	28 168
Loan repayments	-29 527	-32 166	-37 582	-39 356	-41 284	-45 188	-46 721	-47 884
Net other capital flows	66 552	36 320	49 434	54 872	45 632	49 656	56 993	62 879
Balance of payments	**26 323**	**-12 785**	**-924**	**7 806**	**-1 120**	**4 960**	**12 198**	**15 905**
External debt and liquidity								
Reserves	106 086	96 144	105 162	103 950	104 042	108 910	116 240	124 815
Total debt	240 923	260 706	287 647	303 775	321 724	333 788	339 094	343 020
o/w short term debt	40 107	44 364	45 086	41 056	45 466	49 666	51 818	53 671

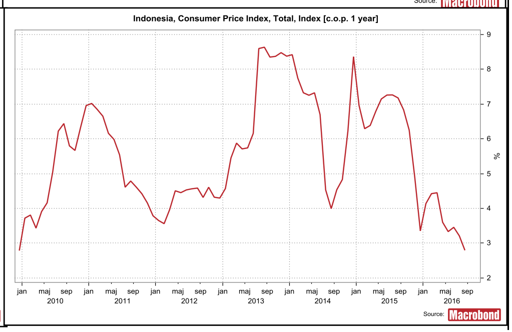
Source: OEF (Oxford Economic Forecasting) and SEB estimates.

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

Type of government: Parliamentary Democracy
Next elections 2019
Other:
Latest PC deal 2005
Latest IMF arrangements 2003 SBA







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