Indonesia

SEB MERCHANT BANKING – COUNTRY RISK ANALYSIS August 31, 2018

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The recovery following the economic down turn in 2014-15 when Indonesia's commodity dependent economy was hit by the collapse in global raw material prices is now complete and the country has regained its pervious growth rate. the current year is seeing more of the same as economic expansion edges up to 5,1% with more in store going forward from ongoing structural reforms.

Summary and conclusion

Recovery completed: Spearheaded by exports and investments including in infrastructure, last year's activity quickened to 5% growth and is set for further gains in the current year. Since late 2017, economic expansion has accelerated on growing investment supported by new inflows of FDI which were attracted by ongoing reforms. Last year, that earned the country a significant jump up. Solid job creation continues to support household incomes and private consumption while improved confidence in the central bank keeps a lid on inflation despite global capital market volatility. A slight increase in the current account deficit to 1,9%/GDP in 2018 is almost fully covered by growing FDI inflows.

Steady fiscal and monetary policies: The fiscal balance for the current year was presented with a cut in the deficit to 2,1%/GDP. The government continues to rationalize expenditures with a shift to infrastructure, while budget revenues are likely to benefit from last year's tax amnesty which improved data collection and expanded the tax base. It has been well noted that even in a pre-election year, the government has persevered with prudent fiscal policies while the central bank's independence is no longer in dispute. It recently raised policy rates by 50bsp. in order to calm investor sentiment and has managed to keep the depreciation within 8% against the US dollar.

Structural policies gaining traction: The jump up by 23 scores on the World Bank's *Ease of doing business* indicator to rank 76, slightly ahead of China, is a tribute to the government's reform program. A one-stop shop has been set up for foreign investors in Jakarta and licencing requirements have been streamlined nationwide. The regulations on foreign borrowing activities of companies in force since 2015 seems to have had the intended effect and lessened concerns about domestic banks – otherwise well capitalized– being exposed to exchange rate vulnerability of their clients.

Upcoming elections: The outcome of presidential elections early next year is still in the balance. Last year saw simmering religious tensions surface in Jakarta's mayoral elections and the incumbent, president Jakobo, has now chosen a devoted Muslim as his running mate.

Ratings: Over the last year all major rating agencies have issued positive rating actions and raised the sovereign to one notch above investment grade. In our judgement an equivalent appraisal of the country should now also be in the offing provided coming elections confirm the polity's will to continue business friendly policies and barring a too negative influence of global exchange rate developments on the Rupiah.

Recent economic developments:

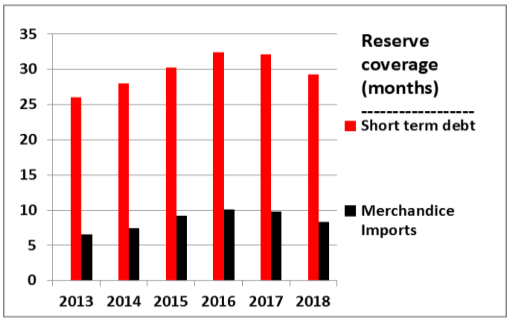
Activity quickens: Spearheaded by exports and investments including in infrastructure, last year activity quickened to 5% growth and further gains are expected for the current year. Since late 2017 economic expansion has been accelerating on growing investment activities supported by new inflows of FDI attracted by ongoing reforms (see below). Already in the first quarter of the current year investment demand rose 7,9% year-on-year (yoy) up from 7,3% annual expansion in the last quarter of the previous year. Household demand also held steady growing 5% yoy and recent improvements in retail and vehicle sales suggest continued growth supported by a strong labor market with unemployment declining to 5,3%.

Trailing exports: That said, however, the PMI for export sales has begun to weaken reflecting slowing global trade growth and concerns about a flagging Chinese economy. That is likely to hit mining and quarrying in particular and could offset the buoyant first quarter recovery of this sector to an annual growth rate of 5% coming after several weak years since global commodity prices collapsed in 2014/15. Most other sectors, by contrast, are set to power on including manufacturing, transport and other services to generate a slight acceleration of economic growth for the current year to 5,1%.

Price pressure under control despite strengthening labor market: Notwithstanding faster growth price pressure has continued to abate and could well fall within the midrange of the central bank's target band, i.e. 3,5% in terms of the overall consumer price index (CPI). Together with core inflation down at only 2,7% suggests a more flexible economy. The labor market has strengthened further as overall unemployment is set to drop to 5,3% for the current year. This improvement, though, could belie much hidden unemployment. 58% of the labor force is employed in the informal sector and one in three youths are unemployed or significantly underemployed. At only 55% female participation is also low.

Slight weakening of the external balances: Slower exports and buoyant imports are set to weaken the current account balance to 1,9%/GDP in 2018. While merchandise exports were still performing well in the first half of the year, indications are for softer development going into the second half on rising concerns about the global economy in general and China in particular. Strong prices for crude, coal and NLG have been offset by weaker prices for rubber and palm oil – among Indonesia's main export products dropping 22% from 2017 due to ample global supply. Then again, services exports will make a strong contribution to the external balance in the current year mainly due to growing tourism. On the other hand, imports is steaming ahead in particular of capital goods in line with rising domestic investment demand. In the first quarter of the year they were up by a whopping 27% in terms of value which may also indicate a certain contribution from higher prices including oil.

Capital inflows: Foreign direct investments (FDI) edged up to 1,7%/GDP in 2017 on buoyant manufacturing activities and are expected to continue growing in the current year. That will almost match the current account deficit. This reflects largely recent years' liberalization of Indonesia's investment regime and the effect of major infrastructure programs beginning to solve long-standing bottlenecks particularly in internal logistics. Net portfolio flows, in contrast, were mainly on the negative side in the first half of the year in sympathy with international developments and a rising dollar.



Reserves and debt: At the end, the central bank seems to have lost some reserves defending the exchange rate and for the whole year 2018 we expect the bank's reserve level to drop to $124bn, down from $132bn at the end of the last year, but still worth more than 7 months of import cover or twice as much as total outstanding short term debt. Indonesia's total foreign debt were rising rapidly until 2016, but has since stabilized at around a third of annual GDP. For most sectors external debt levels are no longer a cause for concern, with one exception – the residential construction sector. On average developers have more than two thirds of their debt in a foreign currency while they have nearly all their earnings in local currency. As per the central bank's regulations most of the debt is hedged against adverse foreign exchange rate movements and few loans fall due before 2020.

Economic and financial policies:

Steady fiscal and monetary policies: The 2018 government budget was presented with a 2.2%/GDP deficit, down from 2.5% in 2017, based on an estimated 7% rise in revenues. That will bring revenues as a share of GDP up to almost 13%, still low compared with peers, but a marked improvement from past performance. It has been noted that such a revenue increase would be the greatest since 2012. The recent tax amnesty has provided the tax authorities with new data on 40% of the nation's wealth which should much strengthen tax compliance. Limited access of tax officials to domestic and foreign bank data is also about to be fixed with the effect to further improve the tax base. So far in the current year the budget has performed above expectations with revenues up 22% in the January-April period thanks in part to growing value added and other taxes, although some of those gains are eaten up by higher subsidies for energy and fuel.

Commitment to infrastructure: On the expenditure side budget execution is less ambitious but the government is still believed to follow through on its commitment to raise capital investments in line with the ongoing budget shift to more focus on infrastructure. Half of the capital budget has been procured but not yet spent. To fund these additional outlays, the government has continued to rationalize the annual transfers from the central budget to regions.

Government debt low but vulnerable to investor sentiment: By the end of last year government debt stood at 32%/GDP slightly up from the year before, but much below the statutory limit of 60%, mainly due to increased bond issuances a part of which having presumably been saved. While the debt level is low compared to peers, its composition could be of some concern. 60% of it is held by non-residents, and 40% is denominated in a foreign currency leaving the government's debt service to some extent hostage to global investor sentiment and exchange rate volatility. Contingent liabilities related to explicit government guarantees for infrastructure projects amount to 2,4%/GDP, less than half the statutory limit of 6%, but it is noted that administrative pricing of certain fuel components – low octane gasoline and diesel – has the potential to hurt certain state-owned enterprises (SOE).

Monetary policies aimed at maintaining market confidence: The turmoil in global capital markets which started with the presentation of the expansive US government budget in late 2017 has challenged the Bank of Indonesia (BI) – central bank – in its exchange rate management. So far in the current year, the Rupiah has gradually weakened in particular against the US dollar. This was first met with interventions by selling dollars from reserves but then with a 50bsp (basis points) hike in its main policy rate. It is too early to say how this standoff with markets will end. So far the Rupiah has weakened by 8% against the dollar and more than 5% against the euro since the beginning of the current year, still better compared with many peers. Due to specifics of central bank regulations there are nevertheless concerns that it may break through the 15000IDR/USD bench mark (Box 1). As the regards other metrics, the BI should be in good shape as the currency depreciation is at this stage an unlikely threat to the inflation target of 3,5%±1pp (percentage point).

Banks are growing slowly but remain well capitalized with good earnings: The Indonesian banking system is overall profitable, well capitalized with a CAR (capital to asset ratio) at a high 23% and liquid except for smaller banks which reportedly could be vulnerable to liquidity chocks. The system is relatively small – total credit extension is less than 40%/GDP – and has for the last couple of years showed only modest growth. In 2017, the total loan portfolio could hardly catch up with nominal GDP. Because of the system’s s moderate size, the government should be in a relatively strong position to support it should that ever be called for. .

Bad debt: Early last year, the level of NPL (non-performing loans) peaked at 3,2% having climbed over several years. Already in the first quarter of the current year the level had declined further to 2,8%. The fly in the ointment, however, is that “Special mention loans”, including restructured loans, have remained high at an estimated 10% of all loans. These are dominated by so-called corporate legacy loans, i.e. loans that had been contracted at a rapid speed by the mining companies and others before they were hit by the commodity price collapse in 2014-15. Some of these debtors have foreign owners which are likely to guarantee for their subsidiaries if they want to continue local operations. That does not apply to the residential construction sector which – as mentioned above -- is burdened with foreign currency denominated loans – often from abroad – and has no natural hedge against adverse exchange rate movements. Corporate loans have grown to 70% of banks’ loan portfolio but signs are of more balanced growth in recent years.

Box 1. Hedging requirements.
Regulations adopted in 2015 required corporates to hedge liabilities denominated in foreign currencies and falling due within 3 months but also 25% of debt with 6 months’ maturity. At the time this was expected to bear on 70% of corporate foreign debt. However, companies were exempted from hedging exchange rate movements beyond 15000IDR/USD.

Structural issues:

Ease of doing business: The World Bank’s annual global survey *Ease of doing business* for 2018 had Indonesia up 37 places from 106th in 2016 to 72nd rank out of 190 countries, by many seen as a tribute to the country’s new reform drive under Pr. Jakobo, and the 16 reform packages announced under his administration since 2015. These are aiming at improving the investment environment and the coordination within the administration while harmonizing policies between the central and regional governments.to mend problems that had been confusing investors for many years. (For more specifics, conf. Box 2).

Weak governance standards: In other areas, by contrast, the image of Indonesia is marred by weak governance standards and prevalent corruption As a still relatively poor country -- income per capita at about $4000 – it also ranks lower than peers on UN Human development index. Notwithstanding progress it is lagging on key policy initiatives. Critics point out that it has failed to impose fully automatic formula based fuel and electricity pricing mechanisms resulting in slow adjustments of low octane gasoline and power. The recent freezing of electricity and diesel prices ahead of 2019 elections may even point to temporary reversal of previous reform measures. In contrast, policies should now rather focus on reducing state control and ease complex regulations. State owned enterprises (SOE) spread across 13 sectors and total assets amount to 51%/GDP. They are an instrument in the hands of the government and can represent entry barriers for private investments.

Box 2: Business friendly reforms:
Investors n can now
- Obtain all licenses at the national level in a one-stop shop in Jakarta
- Apply a standard formula for min wage calculation at lower administrative levels
- Comply with a *new negative investment list* that has been updated and streamlined for many sectors.

Politics

Jakarta gubernatorial election in April 2017 were accompanied by significant political and religious tensions where the incumbent -- a Christian -- lost and was subsequently sentenced to prison for blasphemy during an election rally. However, this represented a relatively rare incident of a religious confrontation directly impacting politics and most observers still believe that democratic processes remain intact. For upcoming general elections in 2019, the incumbent, Pr. Joko Widodo (*Jakobo*), has wisely chosen a devoted Muslim as running mate. External relations remain overall calm except for occasional skirmishes with China over fishing rights.in the South China Sea.

Outlook

Near terms outlook looks reasonably strong: Most observers see relatively favorable growth prospects for 2019. Activity will continue to quicken with GDP edging further up to 5,2% annual expansion riding on domestic demand including state sponsored infrastructure investments and private consumption. Other investments will benefit from rising FDI inflows including in export oriented industries that will uphold the current account balance in a gradually declining deficit. The government will also hold its line on the fiscal deficit while letting some overrun next year to push forward with its investment program, in order to solve logistical bottlenecks in the economy This should all lay the basis for gradually accelerating growth reaching closer to 6% going into the next decade.

Near term risk: Obvious near term risk to this scenario include an intensification of ongoing volatility in global financial markets out of concerns for US fiscal policies under the Trump administration with potentially serious implications for US monetary policies at a time when also other countries, in particular the EU, begin to rein in cheap money. In the case of Indonesia that might be exacerbated by the exposure of its corporate sector to forex dominated debt amounting to 45% of their total. The weakening of the Rupiah beyond 15000IDR/USD will leave many of them unhedged with repercussions on domestic banks to which they owe money albeit the latter concern is mitigated by abundant capital buffers and reserves of at least the larger of these banks. It is also noted that Indonesia's Financial Services authority recently conducted a stress test and announced that the financial system was well placed to withstand substantial pressure following a depreciation of the Rupiah to 20,000IDR/USD or higher NPLs and interest rates.

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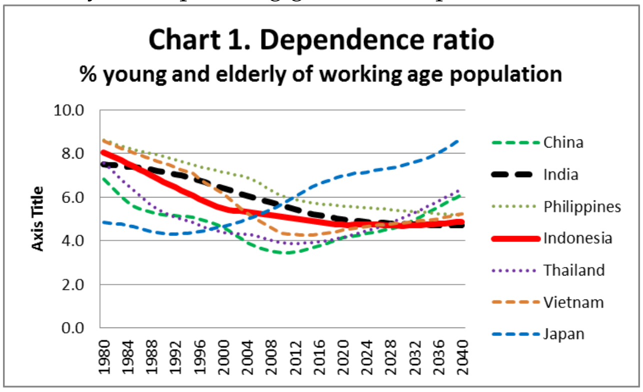
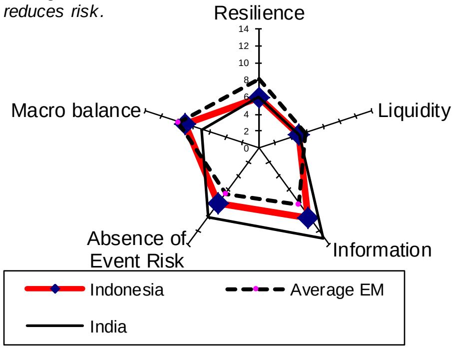
Event risks: On another note, next year's upcoming general and presidential elections also present an uncertainty should the incumbent not be re-elected. Concerns about more religious fundamentalism taking hold of politics will remain simmering, but likely no more than that. Most observers regard political event risk as relatively low in Indonesia. A new administration may be less focused on streamlining regulations and removing stumbling blocks for investors but it will take some time to offset the effects from the good work already in place. With continued fiscal stabilization even in a pre-election year and with little doubt remaining about the central bank's independence the base should be laid for continued pragmatic and business friendly policies.



A new India?: In the longer term Indonesia could represent a new large Asian market with stable politics and finances supporting a booming economy. Provided continued strong reform policies, a recent IMF report project growth accelerating to 6,5% a year. Like India, that could be .supported by favorable demographics now entering the stage in terms of a low dependency ratio where China was when growth took off in that country some two decades ago.

Key ratios	**2018**
Population (mill.)	267
GDP/capita ($)	4027
GDP (change)	5,1%
Inflation	3,4%
Curr.Acc. Balance/GDP	-1,9%
Reserves/imports (months)	8,7
Budget balance/GDP	-2,1%
Government debt/GDP	33%

How to read the chart?
Moving out from the center reduces risk.



External ratings:
Fitch: BBB
Moody's: Baa2
S&P: BBB-

Peers:

Philippines
India
Mexico

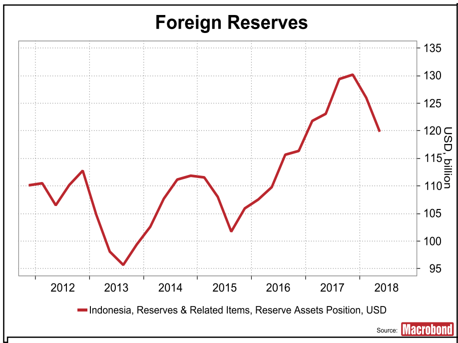
Graph: The pentagon shows the creditworthiness profile of Indonesia somewhat weaker than the Philippines on macro balance but stronger on resilience.

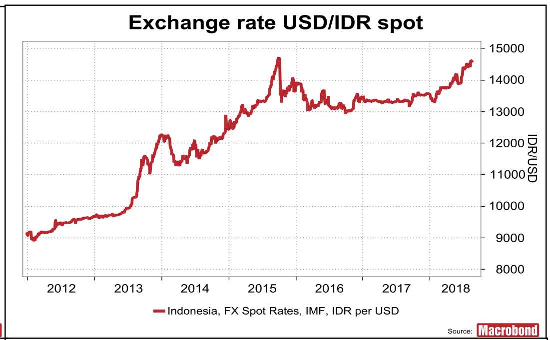
Key data:	2013	2014	2015	2016	2017	2018	2019	2020	2021
GDP (mill.US$)	918	892	861	933	1016	1076	1176	1276	1389
GDP/capita (US$)	3638	3491	3329	3568	3842	4027	4356	4683	5048
GDP (change)	5,6%	5,0%	4,9%	5,0%	5,1%	5,1%	5,1%	5,3%	5,3%
Investments/GDP	33%	32%	32%	32%	33%	33%	33%	34%	34%
Government Finances									
Budget balance/GDP	-2,2%	-2,2%	-2,6%	-2,5%	-2,6%	-2,1%	-2,4%	-2,2%	-1,9%
Govt debt/GDP	23%	26%	28%	31%	32%	33%	33%	34%	34%
Money & Prices									
CPI inflation (%)	6,4%	6,4%	6,4%	3,5%	3,8%	3,4%	4,0%	4,1%	3,8%
Money demand (%)	13,3%	11,6%	12,6%	7,8%	9,8%	8,6%	9,1%	9,0%	8,7%
Stock prices (%change)	252420	255518	258531	261461	264327				
Interest rates	5,9%	7,9%	7,5%	7,2%	6,3%	5,8%	6,5%	7,6%	8,1%
Exch. Rate ($)	10420	11850	13394	13304	13379	13757	13771	13891	13950
Structural									
Trade/GDP (%)	39%	39%	33%	29%	31%	33%	33%	32%	31%
Oil price (Brent)	$109	$99	$52	$44	$54	$71	$70	$67	$68
Balance of Payments (US$ bil)									
Export of goods	182 089	175 293	149 123	144 470	168 888	188 152	206 475	218 666	231 892
Imports of goods	176 256	168 311	135 076	129 152	149 995	170 756	183 186	195 417	205 043
Other:	-34 942	-34 492	-31 567	-32 270	-36 186	-37 403	-42 762	-44 375	-49 579
Current account ($ mill)	**-29 109**	**-27 510**	**-17 520**	**-16 952**	**-17 293**	**-20 007**	**-19 473**	**-21 126**	**-22 730**
(% of GDP)	-3,2%	-3,1%	-2,0%	-1,8%	-1,7%	-1,9%	-1,7%	-1,7%	-1,6%
FDI	12 170	14 734	10 704	16 136	20 151	22 194	23 871	25 660	27 505
Loan repayments	-33 741	-52 818	-45 162	-57 213	-63 942	-68 015	-68 642	-69 226	-69 699
Net other capital flows	37 895	64 670	59 784	62 060	80 022	80 731	75 799	79 243	80 692
Balance of payments	**-12 785**	**-924**	**7 806**	**4 031**	**18 938**	**14 904**	**11 556**	**14 551**	**15 769**
External debt and liquidity									
Reserves	96 144	105 162	103 950	109 193	122 888	124 097	134 444	138 648	150 213
Total debt	260 706	287 647	304 424	323 643	341 070	354 558	358 489	361 894	364 643
o/w short term debt	44 364	45 086	41 272	40 427	46 451	49 580	50 095	50 692	51 053

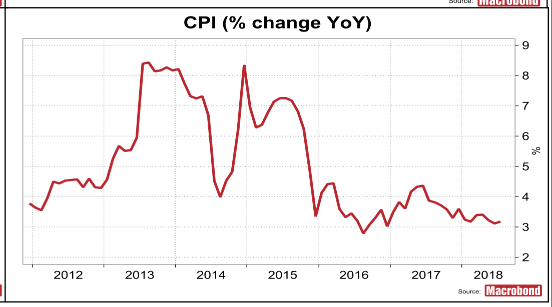
Source: OEF (Oxford Economic Forecasting) and SEB estimates.

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

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







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