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Country Risk Assessment: Indonesia

MALAYSIAN RATING CORPORATION BERHAD
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OVERALL RISK ASSESSMENT

Indonesia's economic growth has been sustained by strong domestic demand that has allowed it to maintain its growth momentum over the years, even during the depths of the Great Recession. Stable political and economic policies have underpinned Indonesia's performance, particularly a credible commitment to fiscal prudence and a rules-based monetary policy framework. A youthful demographic profile, continued efforts at reform, and sustained investment in infrastructure and industry will likely see Indonesia continue on its growth trajectory over the medium term.

The banking system is well capitalised except for a few marginal banks, even as the Bank Indonesia (BI) begins the rollout for compliance with Basel III accords. Loan impairments have been generally declining, while return on assets (ROA) and net interest margins are relatively high. Liquidity has tightened over the past year, but remains sufficient for the proper functioning of financial intermediation. Loan growth appears excessive by developed country norms, but appears to be within the historical experience for Indonesia. Bank lending also goes mainly towards supporting investment and economic activities rather than consumption. Coupled with a relatively high rate of inflation, we do not think there is a build-up of excessive leverage in the economy.

The public sector has been improving its balance sheet over the past decade, a critical factor in stabilising the economy in the aftermath of the Asian Financial Crisis (AFC). The central government has run a small deficit of less than 2% since 2009, although it is has breached that level in 2012 and is likely to do so again in 2013. Nevertheless, the government debt-to-gross domestic product (GDP) ratio has continued to decline, as nominal GDP growth has been sustained at a high level over the same period. Indonesia has also been gradually phasing out energy and food subsidies to regularise government expenditure, efforts that will place public finance on an even better footing going forward. One point of vulnerability here is foreign ownership of government securities (the highest in the region) and the large portion of public debt denominated in foreign currency. Both factors are potential sources of instability, with ramifications for market interest rates and the rupiah (IDR).

The key concern for the Indonesian economy is its external exposure. The current account turned negative in 2012, and is likely to remain so in 2013, mainly due to lower average prices of oil and gas, which make up a third of Indonesia's exports. Indonesia also suffers from strong outflows of income, which has been boosted by the relatively poor performance of the IDR in 2013. Given that Indonesia was one of the favourite destinations for foreign direct and portfolio investments in 2009-2011, it has borne the brunt of investors rebalancing their portfolios with the unwinding of unconventional monetary stimulus in developed economies.

Notwithstanding the current account situation, the external debt position looks fairly comfortable, at around 28.7% of GDP at the end of 2012, of which more than 80% is long-term debt. Approximately half the external debt is owed by the public sector, of which 60% are long-term maturities. While total external debt has been growing at double digit rates in absolute terms since about 2009, the general trend of the external debt ratio to GDP has improved since the AFC, falling from above 85% of GDP at the turn of the century to less than 30% currently.

While we acknowledge that Indonesia's inflation risks are probably well contained and that its monetary policy framework ensures a credible, publicly announced, and legally binding commitment to keeping prices stable, the overall level of inflation has been persistently higher than its regional peers. This is despite the fact that the BI has been proactive in reacting to changes in inflationary expectations. Going forward however, we expect a gradual lowering of the inflation target to bring the inflation rate more in line with neighbouring countries.

A word of caution should also be said about political and institutional risk. Indonesia faces legislative and presidential elections in 2014, which will mark the first real transition in political power for a decade. Outgoing President Susilo Bambang Yudhoyono (SBY) is no longer eligible for re-election and his party is likely to lose the leadership role it currently enjoys. Indonesia's electoral system ensures that no single party is able to dominate the legislature, while complicating the candidacies for the Presidency. This achieves the goal of limiting the political ability to monopolise the Presidency, but leads to greater political uncertainty.

In addition, despite its popularity among foreign investors, Indonesia remains a difficult place to do business. Indonesia scores in the lower half of global rankings on many governance indicators (on some measures, much worse), and has a relatively poor record on corruption. While the reform process is ongoing, results have been slow in coming.

Table 1: Selected economic indicators - Indonesia

	2008	2009	2010	2011	2012
Real GDP growth (%)	6.0	4.6	6.2	6.5	6.2
Inflation rate (%)	9.8	4.9	5.1	5.4	4.3
Unemployment rate (%)	8.4	7.9	7.1	6.6	6.1
Fiscal balance (% GDP)	-1.3	-0.1	-1.6	-0.7	-1.1
Government debt (% GDP)	33.1	28.4	26.0	24.4	24.0
Current account (% GDP)	0.0	2.0	0.7	0.2	-2.8
International reserves (USD bn)	51.6	66.1	96.2	110.1	112.8
External debt (% GDP)	30.2	31.8	28.5	26.6	28.7

Source: CEIC, MARC Economic Research

COUNTRY PROFILE

Indonesia, an archipelago measuring 1.9 million sq km, is the world's 16th largest nation and South-East Asia's largest country. Situated between the Indian Ocean and the Pacific Ocean, Indonesia comprises 17,508 islands, with the largest being Sumatra, Jawa, Bali, Kalimantan, Sulawesi, the Nusa Tenggara islands, the Moluccas islands, and Irian Jaya. Spreading over such a wide expanse, the world's third most populous democracy has Malaysia, Papua New Guinea and Timor-Leste as neighbours, and is a rich mining field for natural resources such as petroleum, tin, natural gas, nickel, timber, bauxite, copper, coal, gold and silver. However, being also part of the "Pacific Ring of Fire," Indonesia has the largest number of active volcanoes in the world. As such, earthquakes and tsunamis are among the hazards faced by a country that is home to about 250 million people.

Modern Indonesia has a relatively young population, with a median age of about 28.9 years in 2012. About two-thirds of the population will be in the 15-64 years age group, and just under half live in urban communities. Jakarta, the capital of the nation, housed 9.6 million people in 2010, followed by Surabaya (2.8 million), Bandung (2.4 million), Bekasi (2.3 million), and Medan (2.1 million). The population is predominantly Muslim with Protestant, Roman Catholic and Hindu minorities. Bahasa Indonesia is the official language, while English, Dutch and local dialects are also widely spoken by the population whose literacy rate stands at an estimated 92.8% in 2011.

The Government and Legal System

Termed "Republik Indonesia" in the local long form, the country is a republic that has 30 provinces, two special regions, and one special capital city district. Having achieved independence from the Netherlands on 17 August 1945, Indonesia's constitution came into being in the same month but was abrogated by the Federal Constitution of 1949 and subsequently the Provisional Constitution of 1950. On 5 July 1959, the original constitution was restored and was subjected to a series of amendments that concluded in 2002.

Thanks to its colonial past, the nation's legal system has its roots in Roman-Dutch law but has received generous modifications in recognition of indigenous concepts and new criminal procedures as well as election codes. The current chief of state and head of government is President SBY with Vice President Boediono as his deputy. The power to elect Cabinet members is vested in the President, who, along with the Vice President, is elected for five-year terms (eligible for a second term) by direct electoral vote. The most recent election was held on 8 July 2009, and by virtue of the five-year term, the next election will be held in 2014.

The People's Consultative Assembly (called Majelis Permusyawaratan Rakyat) is the upper house of the legislative branch, comprising members of the House of Representatives (Dewan Perwakilan Rakyat) and the House of Regional Representatives (Dewan Perwakilan Daerah) who together have the power to inaugurate as well as impeach the president, and to amend the constitution. The former house formulates and passes legislation at the national level, while the latter has a mandated role that includes providing legislative input to the House of Representatives on issues that concern regions. This Assembly, however, does not formulate national policy.

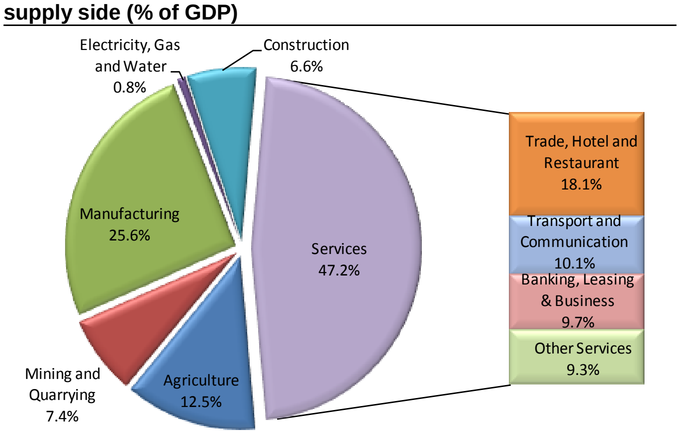
The judicial branch of the government consists of the Supreme Court (Mahkamah Agung), the Constitutional Court (Mahkamah Konstitusi), the Labour Court, as well as the Anti-Corruption Court. The Supreme Court is the final court of appeal but has no power to perform judicial reviews. Judges are appointed by the President from a list of candidates proposed by the legislature. Administrative and financial responsibilities for the lower courts were transferred to the Supreme Court in March 2004 from the Ministry of Justice and Human Rights. The Constitutional Court performs judicial reviews, reviews actions to remove presidents from office, and possesses jurisdiction over the results of general elections, while the Labour Court oversees cases pertaining to labour disputes. The Anti-Corruption Court was the result of the government's desire to improve transparency and accountability, and has jurisdiction over corruption cases brought forth by the Independent Corruption Eradication Commission.

Economic Background and Structure

Indonesia's economy features strong government influence, with over 160 state-owned enterprises in operation and the prices of many basic products including rice, electricity and fuel being regulated. By virtue of its large population, domestic demand has been one of the major driving forces of the archipelago's economic growth. Indonesia, like China and India, registered notably higher growth during the Great Recession than its Group of 20 counterparts due to the demand buffer afforded by its sizable population. Household expenditure makes up more than half of GDP, although the ratio has fallen over the past decade, declining from 61.7% in 2000 to 55.1% in 2012. Investment has contributed more greatly to GDP growth, comprising over a quarter of the economy in 2012, compared to under a fifth in 2000. On the supply side, services make up the bulk of the economy by contributing about half of GDP, while manufacturing forms another quarter and primary industries another 20%. Within the services sector, retail and wholesale trade, hotels and restaurants combine to form nearly 40% of the sector's contribution to GDP.

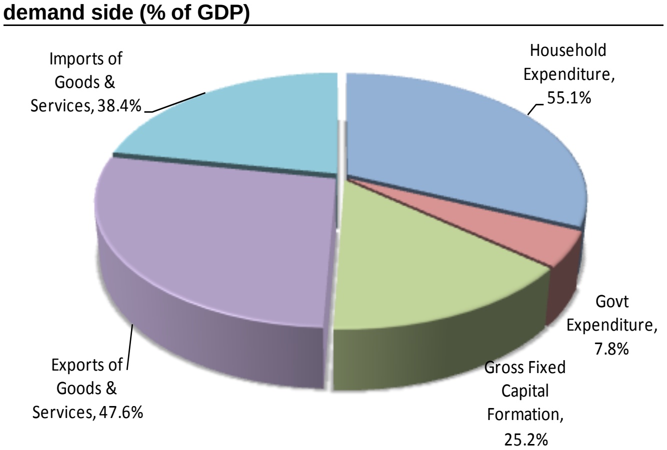
The economy, after facing immense turmoil from political and social unrest that beset the country in the aftermath of the AFC, was given a significant boost when President Yudhoyono took office in October 2004, when he implemented the "pro-growth, pro-poor, pro-employment" economic programme that is now continuing in his second term. Indeed, the State Ministry of National Development Planning had announced its Medium-Term Development Plan for 2010-2014 that targets an average economic growth of 6.3% to 6.8% for the period, hitting 7% or more by 2014; an unemployment rate of between 5% and 6% by the end of 2014, and a poverty rate of 8% to 10% by the end of the period. To achieve these, the government has repeatedly stated its intention to improve the private-sector investment climate via a reduction in general corruption and legal uncertainty.

Chart 1: Indonesia economic structure, 2000 prices (2012) – supply side (% of GDP)



Source: CEIC, MARC Economic Research

Chart 2: Indonesia economic structure, 2000 prices (2012) – demand side (% of GDP)



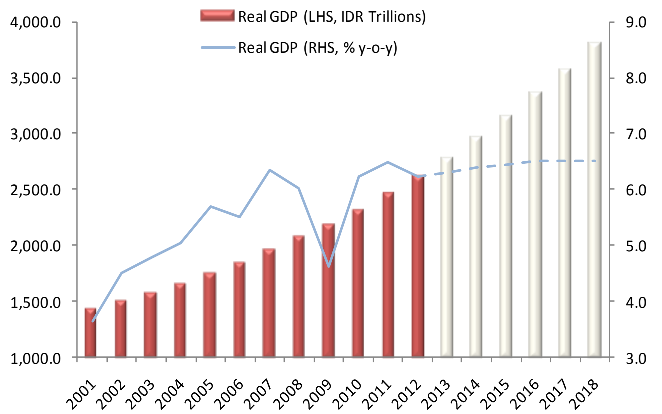
Source: CEIC, MARC Economic Research

ECONOMIC STRENGTH AND RISK

Being largely insulated from global trade, Indonesia has managed to maintain its growth momentum since the 4.6% growth registered in 2009. In recent years, Indonesia's real GDP growth has remained robust, expanding by more than 6.2% between 2010 and 2012. Growth has been broadly underpinned by sustained private consumption and investment, which together account for more than three-quarters of incremental growth in real GDP during that period. Trade value accounts for a sizable portion of GDP (2012: 86.0%), but the trade balance is relatively small and volatile, and prone to turning into deficits.

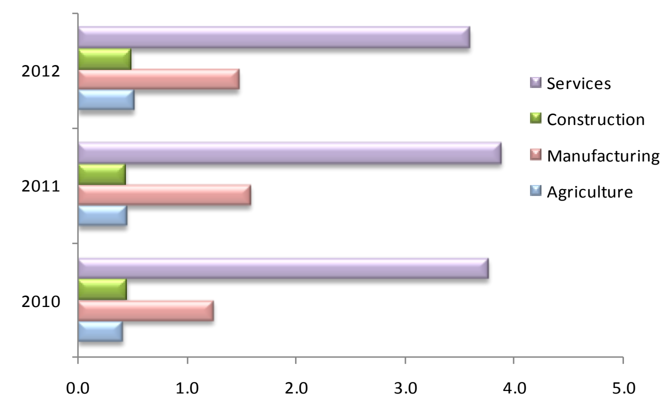
On the supply side, growth has been broadly based, led by manufacturing, retail trade and tourism-related industries. Services as a whole accounts for nearly 60% of incremental growth over the past three years, with another fifth contributed by manufacturing.

Chart 3: Real GDP and real GDP growth



Source: IMF WEO Database
Note: 2013-18 GDP figures are forecast figures

Chart 4: Contribution to growth 2010-2012 (percentage points)



Source: CEIC, MARC Economic Research

Prospects

The latest GDP data (3Q2013) indicates a moderate slowdown in growth that has been evident since the middle of 2012, falling below 6% in 2Q2013 for the first time since 3Q2010. Growth in 3Q2013 hit 5.6%, supported by sustained private and public consumption, offsetting a slower investment growth of 4.5%. Output expansion on the supply side was broad-based and continues to be underpinned by strong manufacturing, domestic trade and tourism growth.

Going forward, there is little reason to believe that growth will sustain a deeper setback. Indonesia's growth has been largely dependent on domestic consumption and investment, while the contribution of trade, although positive, has been at best a minor partner. With a stable macro-policy outlook and continued foreign direct investment (FDI) inflows, we think that Indonesia will be able to maintain decent output growth over the short to medium term. Looking further ahead, structural issues in the economy, such as widespread poverty, infrastructure requirements and the geographic isolation of many of the population outside the central islands of Java and Sumatera will need to be addressed.

Table 2: Gross domestic product (2000=100)

Growth (%y-o-y)	2008	2009	2010	2011	2012
GDP	6.0	4.6	6.2	6.5	6.2
Expenditure					
-Household expenditure	5.3	4.9	4.7	4.7	5.3
-Government expenditure	10.4	15.7	0.3	3.2	1.2
-Gross fixed capital formation	11.9	3.3	8.5	8.8	9.8
-Real exports	9.5	-9.7	15.3	13.6	2.0
-Real imports	10.0	-15.0	17.3	13.3	6.6
Production					
-Agriculture	4.8	4.0	3.0	3.4	4.0
-Mining & quarrying	0.7	4.5	3.9	1.4	1.5
-Manufacturing	3.7	2.2	4.7	6.1	5.7
-Electricity, Gas and Water	10.9	14.3	5.3	4.8	6.4
-Construction	7.6	7.1	7.0	6.6	7.5
-Services	8.7	5.8	8.4	8.5	7.7

Source: CEIC, MARC Economic Research

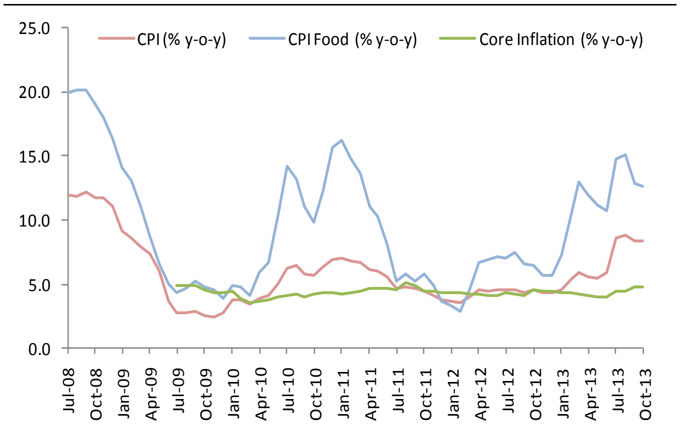
MONETARY MANAGEMENT

Inflationary Trends

Indonesia has generally suffered a higher rate of inflation than its regional peers, an outcome of both higher growth and a lower income level, which makes the country more vulnerable to food-price inflation. Indeed, food prices especially since 2008, have been the main driver of consumer price inflation. If not for considerable government intervention relating to certain consumer items, notably petrol, inflation would be even higher. Core inflation on the other hand, has been remarkably steady at a little over 4.0% since mid-2009.

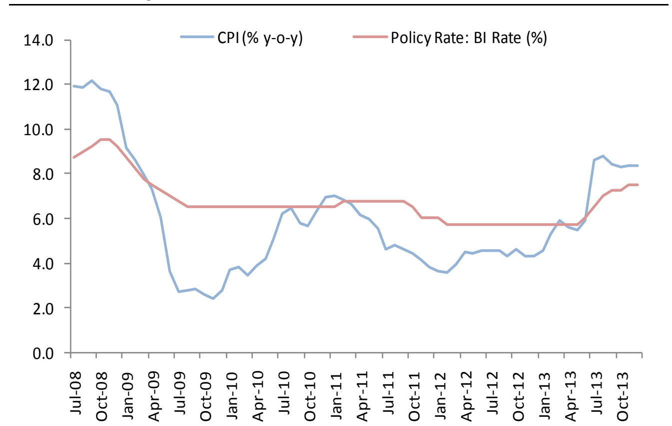
By 2013, inflation has begun to accelerate again, hitting a peak of 8.8% in August before moderating slightly to 8.4% in the two months through December. This acceleration was mainly due to a confluence of events, in particular the general investor retreat from emerging markets in the aftermath of rumours that the United States (US) Federal Reserve (Fed) would be withdrawing its monetary stimulus under quantitative easing, as well as Indonesia's policy response. The investor pullback hit the IDR badly, thus rapidly increasing import prices, while the government cut fuel subsidies to reassure investors who were nervous over Indonesia's fiscal and current account deficits. Meanwhile, price increases of administered goods accelerated from 2.7% in April 2013 to 16.7% in December, while prices of food showed double-digit growth beginning in February 2013.

Chart 5: CPI and core CPI



Source: CEIC, MARC Economic Research

Chart 6: Policy rate and CPI



Source: CEIC, MARC Economic Research

Interest Rate Management

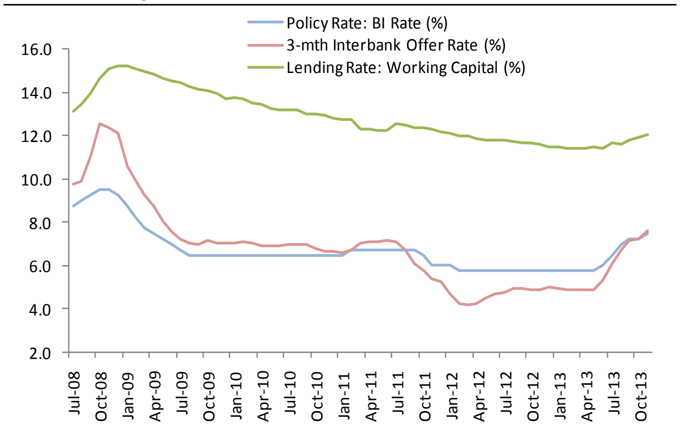
Monetary policy via the policy rate has been fairly responsive to movements in inflation, and generally erring towards maintaining a positive real interest rate. Bank credit activities appear to be on the frothy side by developed country standards, recording growth rates in excess of 20% for the last three years. Nevertheless, this appears to be the norm for Indonesia, and has not noticeably increased money supply growth excessively.

Moreover, it appears obvious that the economy has adjusted to an elevated rate of inflation, which would necessitate substantially tighter and potentially growth killing monetary policy to eradicate. Given that expectations appear to be well-anchored to a higher but steady inflation rate, the BI does not seem to feel the need for harsher intervention.

The BI last cut its policy rate in February 2012, from 6.00% to 5.75%, and has shifted to a tightening stance in the interim. The pick-up in inflation over the course of 2013 has prompted a swift policy response, in keeping with the BI's inflation target of 4.5%. The policy rate was raised by a cumulative 175 basis points to 7.50% in the five months through November 2013. At subsequent policy meetings, the rate has been kept on hold, as the BI assessed the economy's response to the interest rate hikes.

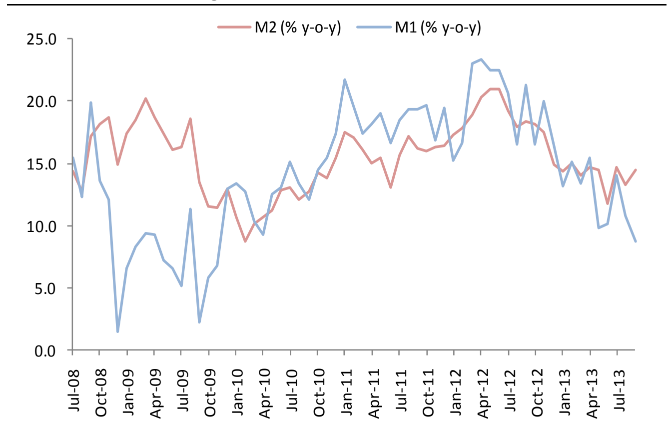
One consideration in assessing the effectiveness of Indonesia's monetary policy framework is the efficiency of the monetary transmission mechanism. With a policy interest rate as the primary intermediate tool, the key channel for policy action would be the impact of the policy rate on market interest rates. We estimate the interest rate pass-through to be on the order of 80% for short-term rates and falling below 40% for longer term bank lending rates. This is par for the course by developing country standards, but well below that for developed economies with mature financial markets and banking sectors. As a result, monetary policy in Indonesia and other developing economies needs to be much more aggressive and proactive than a developed economy facing similar macroeconomic circumstances. This puts the BI's rapid rate hikes last year in proper perspective.

Chart 7: Policy rate and market interest rates



Source: CEIC, MARC Economic Research

Chart 8: M1 and M2 growth



Source: CEIC, MARC Economic Research

Prospects

We believe inflation risks are probably well contained despite the recent acceleration in price increases, given the BI's policy response and the relatively tranquil reaction of foreign investors with respect to the Fed beginning to moderate its unconventional monetary easing. Nevertheless, Indonesia's relatively high rate of inflation, stable though it is, is a potential source of macro-risk and political and social instability, as inflation hits the poor the hardest. On balance, we think that the BI has been proactive in addressing the problem, although we would be more comfortable with a lower and more conventional inflation target (e.g. Thailand's 0.5%-3.0% core inflation target). However, bearing in mind the relatively weak pass-through from the policy rate to market interest rates, a policy objective to aggressively reduce inflationary expectations might be too damaging to the economy.

BANKING SYSTEM STABILITY

Indonesia has a highly diverse and fragmented banking system. There are over 120 commercial banks in operation, of which four are state-owned, and another 26 government regional banks. Commercial banks are further sub-divided into banks that are allowed to deal in foreign exchange and banks that are not. In addition, many foreign banks from both advanced and regional economies have representative offices in the country.

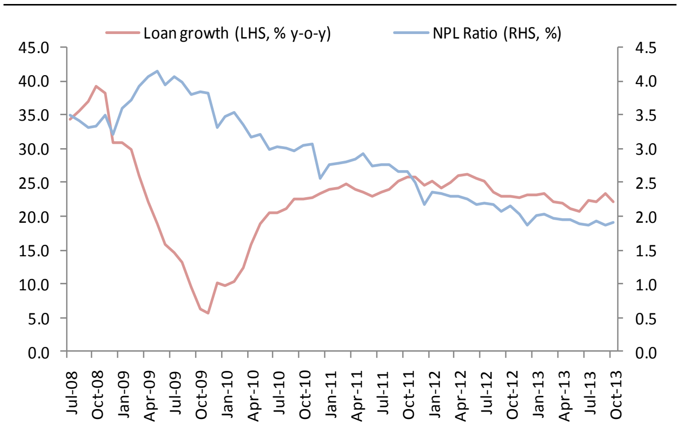
In general, the banking system appears to be robust, with high capital ratios and low loan impairments. The overall capital ratio for commercial banks has slowly risen from 17.2% at the end of 2010 to 17.4% at the end of 2012 (core capital ratio 15.6%). The non-performing loan ratio has been trending down since the middle of the last decade, peaking at 8.42% in July 2006 and has been falling steadily since, to 1.91% in October 2013. Even state-owned regional banks appear to be in good shape, with overall capital ratios circa 17.0% and core capital ratios at 16.0%.

Bank profitability is relatively high, with ROA averaging above 3.0% over the last four years, while net interest margins have exceeded 5% over the past year. Banking liquidity is currently adequate, with the loan to deposit (LD) ratio only exceeding 80% over the past year, peaking at 89.5% in October 2013, mainly due to slowing deposit growth.

Loan growth in the banking sector is very strong, and has been running in excess of 20% since June 2010. Ordinarily, this would cause some concerns regarding the build-up of excessive leverage in the economy. Nevertheless, strong credit growth is mitigated by Indonesia's higher than average inflation rate which reduces the real burden of debt, and positive real interest rates and high net interest margins which allow banks to build up risk-weighted capital. In addition, twice as much bank lending is directed towards industrial purposes compared to household consumption, reaching 71.4% of total loans as of November 2013. Less than 10% of total loans is for mortgages, compared to 21.5% for retail, wholesale trade, hotels and restaurants, and another 17.0% for manufacturing. The concentration of credit for industry suggests stronger expansion in industrial capacity, which in turn would support higher economic growth.

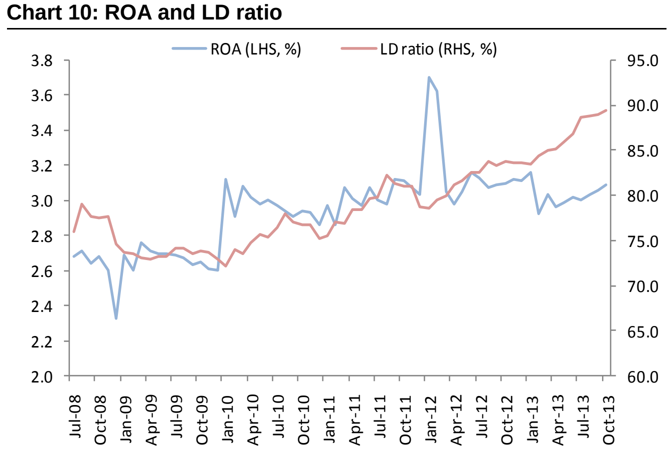
One other potential point of vulnerability is the foreign currency exposure of the banking system, which was a critical factor in Indonesia's downfall during the AFC. Speculative attacks on the IDR raised the domestic burden of foreign currency (FX) loans, even as domestic sources of repayment and collateral were constrained by the crisis. The resulting escalation in external leverage led to a massive pullback in corporate investment, which exacerbated the situation further. Even here though risk has been reduced over the past few years, with FX loans dropping from over a third of bank credit in 2002, to just 15.0% at the end of 2012. At the same time, we take comfort of the fact that the BI has accumulated a relatively strong international reserve position of USD95.7 billion as of September 2013, equivalent to 2.0 times of short-term external debt and over 6 months of imports.

Chart 9: Loan growth and NPL ratio



Source: CEIC, MARC Economic Research

Chart 10: ROA and LD ratio



Source: CEIC

Table 3: Banking statistics (Commercial Banks)

(end of period)	*2009*	*2010*	*2011*	*2012*	*Oct 2013*
Capital adequacy ratio (CAR)	*n/a*	*17.2*	*16.1*	*17.4*	*18.5*
Non-performing loans (NPL) ratio	*3.3*	*2.6*	*2.2*	*1.9*	*1.9*
Loans-to-deposit (LD) ratio	*72.9*	*75.2*	*78.8*	*83.6*	*89.5*
Net interest margin	*n/a*	*n/a*	*n/a*	*5.5*	*5.5*

Source: CEIC

Prospects

Capital ratios in the banking system appear more than adequate, even given the implementation of Basel III accords effective January 1, 2014. About a quarter of commercial banks (circa 30) may need to raise capital to meet the new requirements, but the majority of banks have capital bases that exceed the new capital ratios. The moderation in economic growth has not materially affected the banking system's prospects, with loan growth declining only slightly in 1H2013 and beginning to pick up again.

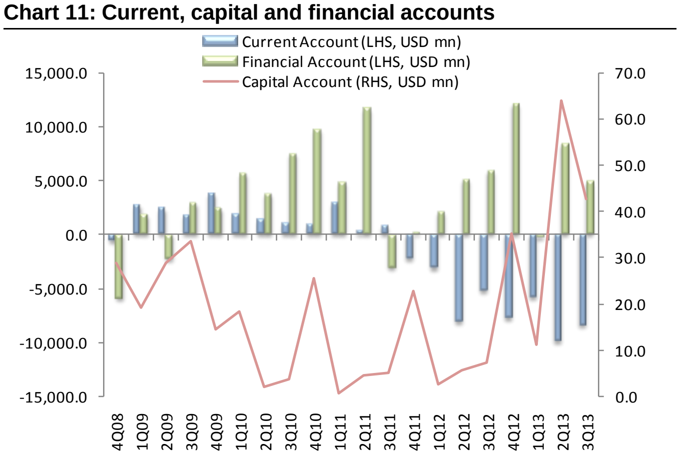
Sustained economic activity in key sectors, low exposure to household debt, high net interest margins, and reduced foreign exposure suggest Indonesia's banking sector is well placed to piggyback on Indonesia's economic development. Asset quality has continued to improve, while liquidity is getting tighter, but still within reasonable bounds. BI's assessment of credit risk suggests default probabilities are slightly elevated, but below the level of 2012. On the whole, we think Indonesia's banking system is relatively well placed, becoming better managed, and maintaining adequate capital buffers in the event of a downturn.

EXTERNAL EXPOSURE – BALANCE OF PAYMENTS, DEBT AND CURRENCY

Indonesia has generally maintained a small surplus in its current accounts, balanced by substantial inflows of foreign capital for both direct and portfolio investments. Inflows of capital have been attracted by both the country's growth potential as well as high nominal interest rates, and there has been considerable foreign investor interest in public debt securities, where foreign holdings as a portion of outstanding securities are now the highest in the region. Overall foreign ownership of both equities and debt exceeds that of domestic holdings. The Indonesia Stock Exchange (IDX) has also been one of the region's best performing, with the Composite Index rising more than three-fold between 2008 and 2012. In consequence, Indonesia's international reserves have more than doubled in the past five years, from USD50.6 billion in October 2008, to USD112.8 billion at the end of 2012 despite declining to USD95.7 billion by September 2013.

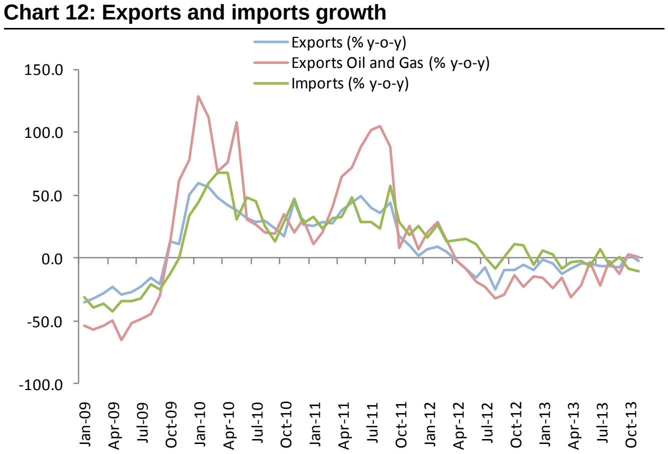
Continued strong investor interest in Indonesian securities has seen the IDX increasing by 17.4% from December 2012 to May 2013. The general pullback from emerging markets has tempered the increase in the IDX, however, such that all these gains and more have been lost – the IDX has been trading in the red since late-November.

Chart 11: Current, capital and financial accounts



Source: CEIC, MARC Economic Research

Chart 12: Exports and imports growth



Source: CEIC, MARC Economic Research

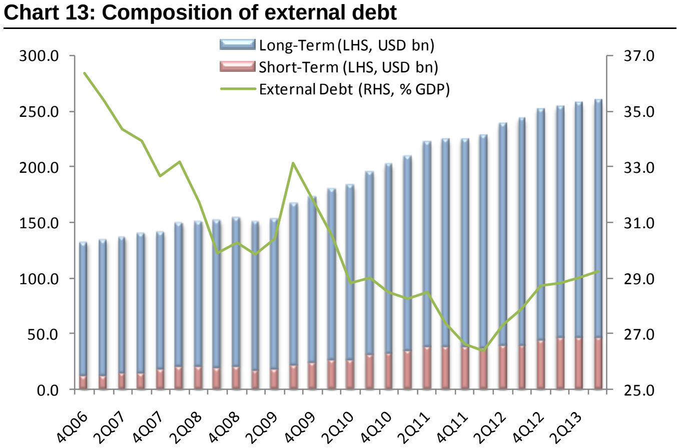
Delving deeper into external trade, oil and gas comprises the bulk of exports (approximately one-third) with non-oil manufacturing contributing another third. Just six countries account for nearly 60% of Indonesia's export market, which are Japan, China, Singapore, the US, South Korea and Malaysia in order of size. Half of Indonesia's imports however are of non-oil manufactures, with oil and gas imports forming another quarter. Sustained domestic demand however has turned the current account balance into an overall deficit for 2012 (-2.8% of GDP), and with accelerating inflation, the economy appears to be overheating slightly.

One consequence of the current account deficit and the selldown in foreign portfolio holdings has been pressure on the IDR, which has fallen 20.2% against the US dollar (based on monthly averages) as of December 2013 compared with the corresponding period in 2012. We think this pressure is only partly justified, as positive real interest rates, a current account deficit that has only emerged in the past year, a sound and consistent monetary policy, and the country's continued economic development suggests a more favourable valuation for the IDR. The BI has allowed the IDR to depreciate, refusing to be panicked into abandoning its inflation targeting monetary policy framework. We think this is the correct approach and will pay dividends over the long term. Nevertheless, we continue to see the market pressuring the IDR regardless over the near term, overshooting its fundamental value to the downside.

FDI has continued to climb based on the latest available data for 3Q2013, although portfolio investors have begun to reduce their weighting of Indonesia. The deterioration in the current account balance if prolongs is somewhat worrisome, as is the heightened sensitivity to foreign capital flows, but these are ameliorated by Indonesia's relatively substantial foreign reserves, which are sufficient to finance over 6 months of imports (based on 2012 data) and 2.5 times short-term external debt.

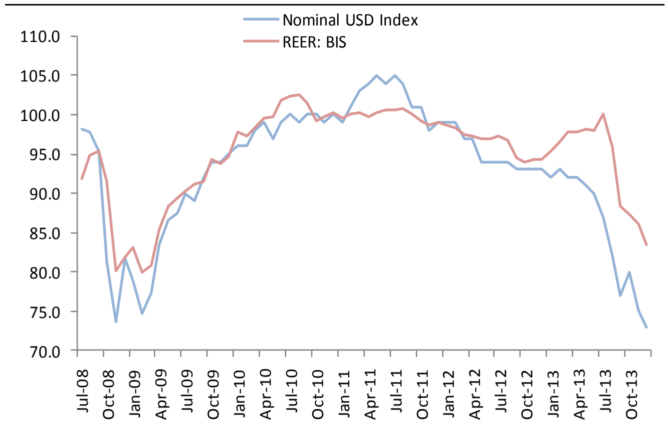
The external debt situation is also fairly comfortable, at around 28.7% of GDP at the end of 2012, of which more than 80% is long-term debt. Approximately half the external debt is owed by the public sector, of which 60% are long-term maturities. While total external debt has been growing at double digit rates in absolute terms since about 2009, the growth of the economy has more than compensated for this, to the point that as a percentage of GDP, the ratio has dropped from 87.1% in 2000, to 49.6% in 2005, to 28.7% in 2012.

Chart 13: Composition of external debt



Source: CEIC, MARC Economic Research

Chart 14: IDR/USD index and REER



Source: CEIC, MARC Economic Research

Prospects

Indonesia's export performance is highly correlated to global prices of oil and gas. Although there was a short fillip to prices in 3Q2013 as tensions rose with Iran, prices have begun to retreat again. Going forward, with the emerging economies continue to be threatened by the prospects of capital outflows and weaker China's economy - despite the strengthening of advanced economies - we believe the upside of oil prices is rather limited. As such, there's little prospect for improvement on the export side over the short term. Commodity prices are likely to remain relatively quiescent over the long haul, given the buildup in capacity after the mid-2000s boom in prices and moderating growth in many emerging markets, including crucially China.

As a result, Indonesia is likely to continue running a more or less balanced goods account which will tend to err on the negative side. Both the services and income components of the current account are strongly negative and will be so for the foreseeable future. The key issue for Indonesia is on the income side, where the deficit has nearly doubled since the Great Recession. Heavy inflows of unstable foreign portfolio capital have simultaneously increased the current account deficit (through income repatriation) while financing it through purchases of Indonesian securities. This is unsustainable, and will be a source of macro-destabilisation over the short to medium term.

Given Indonesia's relatively high level of international reserves and declining foreign debt-to-GDP ratio, the associated risks are somewhat ameliorated but are not entirely extinguished. We think this external imbalance forms the key macro risk for Indonesia.

Table 4: Balance of payments

USD millions	2008	2009	2010	2011	2012
Current Account	*125.6*	*10,628.5*	*5,144.3*	*1,685.1*	*-24,418.1*
-Goods	*22,915.8*	*30,931.7*	*30,627.4*	*34,782.6*	*8,618.2*
-Services	*-12,998.4*	*-9,740.6*	*-9,323.6*	*-10,632.2*	*-10,330.8*
-Income	*-15,155.4*	*-15,140.1*	*-20,789.9*	*-26,675.8*	*-26,799.8*
-Current transfer	*5,363.6*	*4,577.6*	*4,630.3*	*4,210.5*	*4,094.4*
Capital and Financial Account	*-1,831.8*	*4,852.3*	*26,620.4*	*13,567.0*	*25,161.3*
-Capital account	*294.5*	*95.8*	*49.8*	*32.9*	*50.6*
-Financial account	*-2,126.3*	*4,756.4*	*26,570.5*	*13,534.1*	*25,110.8*
FA: Direct investment	*3,418.7*	*2,628.2*	*11,106.3*	*11,528.4*	*13,981.9*
FA: Portfolio investment	*1,764.3*	*10,336.2*	*13,202.0*	*3,806.4*	*9,206.4*
FA: Other investment	*-7,309.2*	*-8,208.0*	*2,262.2*	*-1,800.6*	*1,922.4*
Net Errors and Omissions	*-238.3*	*-2,974.9*	*-1,479.6*	*-3,395.5*	*-528.1*
Overall Balance	*-1,944.6*	*12,505.9*	*30,285.1*	*11,856.6*	*215.1*
Overall Balance (%GDP)	*0.0*	*2.0*	*0.7*	*0.2*	*-2.8*

Source: CEIC, MARC Economic Research

FISCAL STABILITY

The government of Indonesia has been fairly fiscally conservative, having posted a budget deficit in excess of 2.0% of GDP in only three of the last twenty years. Consequently, debt levels are among the lowest in the region at circa 24% in 2012, despite beginning the turn of the century at 95.1% of GDP. This remarkable performance was achieved through conservative budget policies, which saw budget deficits average just over 1% over the past decade, and an inflation "tax", where inflation averaged over 7.0% during the same period. The high rate of inflation meant an effective doubling of the price level in just ten years, and reduced the real burden of debt not just for the government but also for all private sector debts as well.

Another feature of Indonesia's fiscal landscape is the dependence on oil and gas revenues, which averaged about a quarter of total government revenues in the past decade. As a counterbalance, subsidies for the consumption of oil & gas products took up an average of 19.9% of total central government expenditure. In terms of government involvement in the economy, both government revenue and expenditure averaged between 17%-18% of GDP over the past decade, which is somewhat lower than other countries at Indonesia's income level.

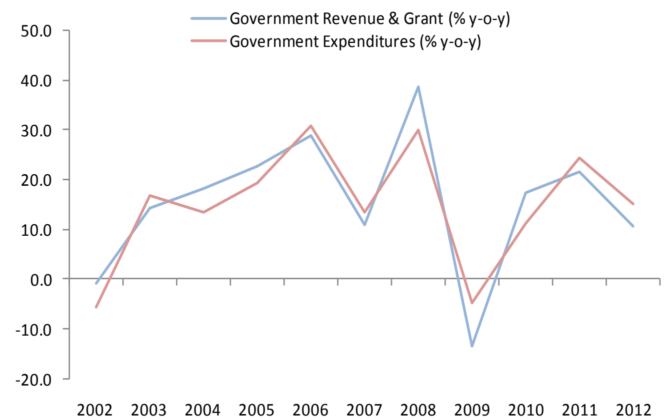
Two vital risk factors need to be taken into consideration when viewing fiscal policy risk in Indonesia. The first is the heavy reliance on external funding, where over 40% of the government's debt is either from external lenders, or are denominated in foreign currency. The second risk factor is the high portion of government debt held by foreigners (32.5% of tradable government securities at the end of 2013), whether foreign currency denominated or not. Both constitute potential flashpoints in the event of a loss of investor confidence.

Prospects

For 2013, the government initially penciled in a budget deficit of 1.65%, which at this stage is unlikely to be met. As of late November, the government anticipates the budget deficit to widen to 2.3% of GDP by the end of 2013. Lower commodity prices, especially for oil & gas, are hitting revenues while growing energy demand is increasing the cost of subsidies. Nevertheless, the expectations are that any enlargement of the budget deficit is unlikely to exceed 2.5%, and sustained high inflation would generally reduce the real impact of higher borrowing. Given the low debt level and ample international reserves, government securities are likely to continue to be targeted by foreign investors.

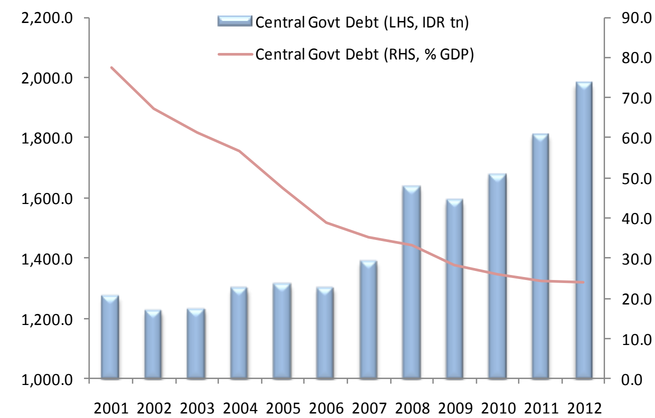
Going forward, government efforts to regularise subsidies are expected to continue, which should put the fiscal house in better order. The changeover in the government expected at the elections this year is not expected to substantially change the trend towards fiscal improvement, and while the relatively high government external debt exposure remains a worry, we foresee no near term threat to government finances. The overall debt burden is relatively low, and remains manageable even with further pressure on the IDR; while the banking system appears to be robust and thus should not need a fiscal backstop, as has been required in certain European economies.

Chart 15: Government revenue and expenditure growth



Source: CEIC, MARC Economic Research

Chart 16: Central government debt



Source: CEIC, MARC Economic Research

Table 5: Government Finance

IDR billions	*2008*	*2009*	*2010*	*2011*	*2012*
General Govt Revenue	*981,609*	*848,763*	*995,272*	*1,210,600*	*1,338,110*
General Govt Expenditure	*985,731*	*937,382*	*1,042,117*	*1,294,999*	*1,491,410*
General Govt Balance	*-4,121*	*-88,619*	*-46,846*	*-84,400*	*-153,301*
General Govt Balance (%GDP)	*-0.1*	*-1.6*	*-0.7*	*-1.1*	*-1.9*
Central Govt Revenue	*981,031*	*866,799*	*1,016,524*	*1,201,270*	*1,335,663*
Central Govt Expenditure	*980,511*	*954,001*	*1,056,592*	*1,289,607*	*1,481,674*
Central Govt Balance	*-1,748*	*-31,275*	*-88,575*	*-88,235*	*-189,397*
Central Govt Balance (%GDP)	*0.0*	*-0.6*	*-1.4*	*-1.2*	*-2.3*

Source: CEIC, MARC Economic Research

POLITICAL AND INSTITUTIONAL RISKS

In the post-1998 era, no political party in Indonesia has been able to garner a majority in the legislature, thus requiring coalitions, although the incumbent President is from the *Partai Demokrat* (PD), which forms the largest bloc in the Consultative Assembly. Both legislative and presidential elections are due in 2014, with the Senate and House elections to be held in April, and the Presidential election to be held in July (with any run-off to be held in September).

As President SBY has already served two terms of five years, he is no longer eligible for re-election. Another concern is that only political parties or political coalitions which have a minimum of 20% of seats in the lower house of the legislature or 25% of the popular vote are allowed to nominate presidential candidates, which adds further uncertainty to an already fluid situation. While a number of political parties have already declared their candidates, their candidature is contingent on gaining the requisite number of seats in the legislative elections. Indonesia thus faces a political transition over the coming year.

It appears clear however that PD is unlikely to retain either its leading role in the Assembly or in the Presidency, as it lacks strong leadership in the post-SBY era and has been hit by a series of corruption scandals. Recent opinion polls put current Jakarta Governor Joko Widodo of *Partai Demokrasi Indonesia Perjuangan* (PDIP) as the front-runner, although he has not been officially nominated. Another PDIP stalwart, Megawati Sukarnoputri, is also a potential candidate, bringing with her a long political lineage (she is the daughter of Indonesia's first President, Sukarno) and practical experience, having been previously elected as Vice President (1999-2001) and President (2001-2004). Two other potential nominees, based on popularity, are Prabowo Subianto of *Partai Gerakan Indonesia Raya* (Gerindra) and Jusuf Kalla of *Partai Golongan Karya* (or Golkar), although the former's party is of minor standing while the latter's party has already put their support behind Aburizal Bakrie.

Whichever party or President comes out on top, they will inherit an economy that by many accounts has come very far in the last 15 years, but faces considerable challenges to continue its development going forward. Along with potential macroeconomic risks as outlined previously, Indonesia faces a number of structural issues in the context of a fragmented political landscape. Chief among those is corruption, where Indonesia ranks 114th out of 177 countries in Transparency International's Corruption Perception Index 2013 (2012: 118th).

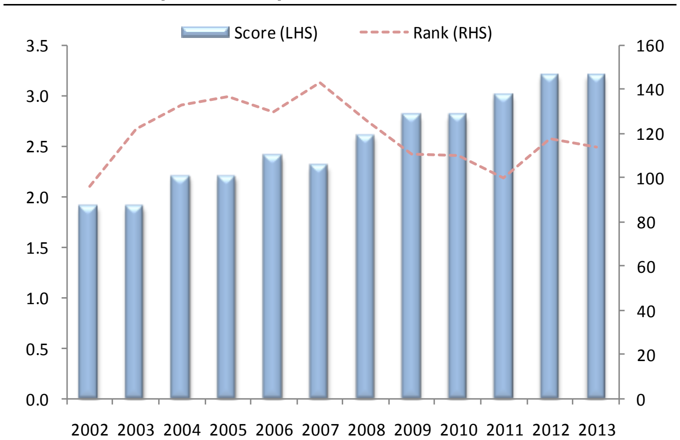
Indonesia also does somewhat poorly on the World Bank's World Governance Indicators, doing no better than middle of the road on most indicators, but falling to the bottom quintile on political stability and the bottom third in control of corruption measures. In terms of the World Bank's Ease of Doing Business report, Indonesia ranks 120th overall out of 189 countries (2013: 128th), doing relatively well on investor protection and trading, but doing much worse in terms of business startups, electricity supply, contract enforcement and resolving insolvency.

Prospects

Given Indonesia's history of one-man rule since Independence which only ended in 1998, a rough transition to a stable democracy would have been expected, especially in light of the continuing and ongoing evolution in governance arrangements. In that context, the past 15 years have been relatively peaceful, giving time for political and economic institutions to take root and build public trust. While Indonesian politics might appear disorderly to outsiders, the necessary checks and balances have been successfully inserted into the political process. While proportional representation and coalition governments have historically tended to lead to potentially extremist policies, Indonesia's practice has been fairly successful in fostering a climate conducive for economic growth and development, a necessity in maintaining the peace in a geographically segregated and densely populated country (in contrast with, for instance, the Philippines).

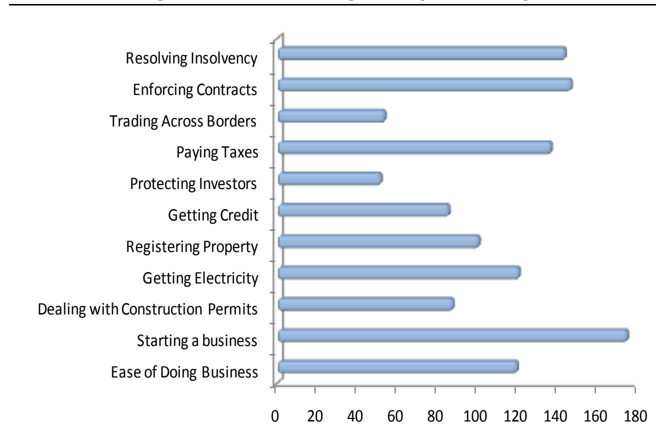
While the run-up to the next legislative and presidential elections appears to be chaotic, we do not think this presages any inclination to rock the boat in terms of economic policies or foreign investment. Instead, we believe there is a relative consensus on economic policies and trade relations among the major parties, while the permanent organs of government such as the BI are increasingly better and professionally run. In addition, the military and security forces have taken their forced exclusion from national politics and prominence with good grace. While democracy remains fragile, its roots in Indonesian soil are getting deeper and stronger. Structural problems however remain, and while we expect progress on this front, it is likely to be slow.

Chart 17: Corruption Perception Index rank and score



Source: Transparency International

Chart 18: Doing Business Ranking 2014 (Indonesia)



Source: World Bank

ANNEXURE

Vital statistics - Indonesia

	2007	2008	2009	2010	2011	2012	2013F
National accounts							
Growth (%)							
GDP	**6.3%**	**6.0%**	**4.6%**	**6.2%**	**6.5%**	**6.2%**	**5.4%**
Supply side							
Agriculture	3.5%	4.8%	4.0%	3.0%	3.4%	4.0%	n.a.
Mining & quarrying	1.9%	0.7%	4.5%	3.9%	1.4%	1.5%	n.a.
Manufacturing industries	4.7%	3.7%	2.2%	4.7%	6.1%	5.7%	n.a.
Electricity, gas & water	10.3%	10.9%	14.3%	5.3%	4.8%	6.4%	n.a.
Construction	8.5%	7.6%	7.1%	7.0%	6.6%	7.5%	n.a.
Services	9.0%	8.7%	5.8%	8.4%	8.5%	7.7%	n.a.
Demand side							
Total final consumption expenditure	4.9%	5.9%	6.2%	4.1%	4.5%	4.8%	n.a.
- Household expenditure	5.0%	5.3%	4.9%	4.7%	4.7%	5.3%	5.2%
- Government expenditure	3.9%	10.4%	15.7%	0.3%	3.2%	1.2%	n.a.
Gross fixed capital formation	9.3%	11.9%	3.3%	8.5%	8.8%	9.8%	5.0%
Exports	8.5%	9.5%	-9.7%	15.3%	13.6%	2.0%	n.a.
Imports	9.1%	10.0%	-15.0%	17.3%	13.3%	6.6%	n.a.
Public finance (% of GDP) - General government							
Government revenue & grant	**17.9%**	**19.8%**	**15.1%**	**15.4%**	**16.3%**	**16.2%**	**16.0%**
-Tax revenue	12.4%	13.3%	11.1%	11.2%	11.8%	11.9%	11.7%
-Non tax revenue	5.4%	6.5%	4.1%	4.2%	4.5%	4.3%	4.2%
Government expenditures	**19.2%**	**19.9%**	**16.7%**	**16.2%**	**17.4%**	**18.1%**	**18.4%**
Fiscal balance	**-1.3%**	**-0.1%**	**-1.6%**	**-0.7%**	**-1.1%**	**-1.9%**	**-2.5%**
Government debt	**35.2%**	**33.1%**	**28.4%**	**26.0%**	**24.4%**	**24.0%**	**26.2%**
Inflation rate							
Producer Price Index (PPI)	14.7%	27.0%	-1.8%	4.9%	7.4%	5.1%	n.a.
Consumer Price Index (CPI)	6.7%	9.8%	4.9%	5.1%	5.4%	4.3%	7.2%
Money, banking and policy rates							
M1 growth	19.3%	14.9%	13.0%	15.4%	16.4%	15.0%	n.a.
M2 growth	29.7%	1.5%	12.9%	17.4%	19.4%	16.4%	n.a.
Bank credit growth (commercial banks)	26.5%	30.5%	10.0%	22.8%	24.6%	23.1%	n.a.
Loan-to-deposit ratio (commercial banks)	66.3%	74.6%	72.9%	75.2%	78.8%	83.6%	n.a.
NPL Ratio (commercial banks)	4.1%	3.2%	3.3%	2.6%	2.2%	1.9%	n.a.
Policy Rate (Bank Indonesia Reference Rate)	8.00%	9.25%	6.50%	6.50%	6.00%	5.75%	7.50%
Balance of payments (% of GDP)							
Current account	2.4%	0.0%	2.0%	0.7%	0.2%	-2.8%	-3.5%
Capital & financial account	0.8%	-0.4%	0.9%	3.8%	1.6%	2.9%	n.a.
Overall balance	2.9%	-0.4%	2.3%	4.3%	1.4%	0.0%	n.a.
International reserves (USD bn)	56.9	51.6	66.1	96.2	110.1	112.8	88.7
Reserve-to-import (in months)	n.a.	5.6	5.2	5.9	6.2	6.4	4.9
External debt - USD bn	141.2	155.1	172.9	202.4	225.4	252.4	264.6
External debt - % of GDP	32.7%	30.2%	31.8%	28.5%	26.6%	28.7%	30.3%
Debt service ratio (% Exports of goods and services)	18.8%	14.1%	19.4%	17.4%	14.7%	17.1%	n.a.
Development indicators							
Population (in mn)	225.6	228.5	231.4	237.6	244.0	247.2	250.4
Population (growth)	1.3%	1.3%	1.2%	2.7%	2.7%	1.3%	1.3%
Human Development Index (HDI) - Medium human dev.	0.595	n.a.	n.a.	0.620	0.624	0.629	n.a.

Source: CEIC, IMF, UNDP, MARC Economic Research

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