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Indonesia: Country Risk Insights

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In a nutshell

- Despite growth having slackened to its slowest pace in five years, resource-rich Indonesia's economic potential remains an attractive draw for emerging market investors. In 2014, gross domestic product (GDP) growth moderated to 5.0% from the 5.8% average growth pace achieved during the 2010-2014 period. The government has revised downwards its growth target for 2015 to a still optimistic 5.2% from 5.8% previously. However, Indonesia continues to hold enormous promise. It is the largest economy in Southeast Asia. Its population is relatively young, the third youngest in East Asia, and around 10 years younger than in most major advanced countries. Indonesia's rising working-age population and low dependency ratio have helped power GDP growth. Apart from China and India, the growth of the consuming class in Indonesia is already stronger than in any economy of the world. Continued structural reform efforts by the new government under the reformist new president, Joko Widodo (popularly known as "Jokowi"), are expected to keep Indonesia on a positive and respectable growth trajectory over the medium term.

- On top of that, Indonesia's public debt remains manageable and sustainable at 26.1% of GDP (end-2014), much lower than the median of other emerging market economies. Contingent liabilities also appear manageable and unlikely to pose a threat to public debt sustainability. At end-2013, the debt of non-financial state-owned enterprises was moderately low at 5% of GDP. According to stress test results, the general government debt-to-GDP ratio will likely remain modest under shocks from contingent liabilities, sharp exchange rate movements, slower economic growth, and higher interest rates. However, Indonesia's fiscal deficits remain persistent (2014: 2.3% of GDP), with budgetary pressures coming from energy subsidies and weak revenue collections. Over the 2011-2014 period, for example, energy subsidies averaged 3.5% of GDP a year. Subsidy rationalisation has started. To relieve fiscal pressures further, Indonesia needs to improve its tax take, i.e. total tax receipts. If not, there could be heightened fiscal risks going forward because of expected increases in public spending on health and pensions over the medium to long term.

- While Indonesia's banking system remains stable, it is expected to face tougher times ahead. Thanks to financial sector reforms, gone are the days of capital deficiency, weak compliance and governance. The banking sector, now stronger with larger domestic-deposit bases, meets Basel III's capital ratio standards. As at end-June 2014, the sector's regulatory capital to risk-weighted assets stood at 18.9%, while regulatory Tier-1 capital to risk-weighted assets stood at 17.7%. It remains profitable and appears generally robust with low loan impairments at the aggregate level. The latest data show overall non-performing loans (NPLs) to total gross loans standing at 2.5% in April 2015. However, aggregate asset quality going forward is expected to drop on account of slowing economic growth and recent market volatilities that have caused the rupiah to fall significantly. Commodity exporters who took on debt in anticipation of continued high demand for their products and high prices have been hit by lethargic demand and a swift decline of prices.

- Indonesia's external weaknesses continue to be a major risk concern. Its current account (CA) balance remains in deficit territory, though there have been improvements. Over the 2Q2014-1Q2015 period, the deficit narrowed from -3.9% to -1.8% of GDP. At the same time, Indonesia managed to chalk up six consecutive quarters of balance of payments (BoP) surpluses. While these indicate falling annual external financing requirements, it remains dependent on external financing. The problem is, Indonesia has always been vulnerable to international capital volatility, and its external vulnerability has been accentuated by rising international financial market uncertainty. Its external sustainability is sensitive to both CA and exchange rate shocks, and the falling rupiah is a major concern. Also of concern is Indonesia's gross external debt. While still at a moderate level (end-June 2015: 34.4% of GDP), it is nearly three times the size of the country's official reserves. Indonesia's official reserve assets at end-2014 were, according to the International Monetary Fund (IMF), sufficient to deal with most shocks. By end-August 2015, it had fallen 5.9% to USD105.3 billion, and any further falls should increase concerns further.

- Weak institutions and a poor business environment are also risk concerns that continue to plague the Indonesian economy. It was ranked 107th out of 175 countries in Transparency International's Corruption Perception Index 2014. It also did poorly in the World Bank's World Governance Indicators (2014 update), with percentile rankings in all six indicators below 50. And as expected, it is ranked very low at number 114 in the World Bank's Ease of Doing Business 2015 report. President Jokowi has been vocal about wanting to return Indonesia to 7% growth. Making this difficult to achieve is the resistance he faces in his reform efforts. This is because not only does he head a minority coalition in the national parliament, he is also an outsider to the political establishment. For Indonesia to reach its economic potential, it is probably not too much to say that the success of governance reforms may turn out to be the deciding factor.

Table 1: Selected economic indicators

	2010	2011	2012	2013	2014
Real GDP growth (%)	6.4	6.2	6.0	5.6	5.0
Inflation rate (%)	5.1	5.4	4.0	6.4	6.4
Unemployment rate (%)	7.1	7.4	6.1	6.2	5.7
Fiscal balance (% GDP)	-0.7	-1.1	-1.9	-2.3	-2.3
Government debt (% GDP)	26.1	24.4	24.0	26.1	26.1
Current account (% GDP)	0.7	0.2	-2.8	-3.3	-3.0
Gross international reserves (USD bn)	96.2	110.1	112.8	99.4	111.9
Total gross external debt (% GDP)	26.8	25.2	27.5	29.1	33.0

Source: CEIC, IMF, Statistics Indonesia, MARC Economic Research

Key Strengths

Large economy with a growing and increasingly affluent middle class

The Indonesian economy has slackened to its slowest growth pace in five years. In 2014, growth moderated to 5.0% from 5.6% previously. Over the 2010-2014 period, GDP growth had averaged 5.8%. The economy slowed further in both the first and second quarters of 2015, growing 4.72% and 4.67% year-on-year (y-o-y), respectively, compared to 5.0% in the last quarter of 2014. Meanwhile, inflation remains on the high side when compared to its regional neighbours. In 2014, it averaged 6.4%. For the last month of 2014, however, inflation had spiked upwards to 8.4% y-o-y from November's 6.2%, thanks to the more than 30% average increase in subsidised gasoline and diesel prices. Meanwhile, the latest data showed consumer price index (CPI) inflation at 6.83% in September 2015.

The Indonesian government's growth target for 2015 has been revised downwards to a still optimistic 5.2% from 5.8% previously. The growth target for 2016 has also been revised downwards to an also still optimistic 5.5% from 5.8%-6.2% previously. The government expects inflation to likely average around 6.5% in 2015, with the end-2015 inflation rate at below 5.0%, just within Bank Indonesia's inflation target of 4% with a ±1% deviation. Risks to the inflation outlook are expected to come from increases in oil prices, demand-side pressures, which are likely to be limited given Indonesia's current slower pace of growth, as well as depreciation of the Indonesian rupiah. El Nino is another concern, as Indonesia has a large agriculture, forestry and fisheries sector.

As a commodities-driven economy, Indonesia's ongoing slowdown is due to the global economy's sluggish recovery, as well as the swift decline of prices for commodities from crude oil to coal. A large part of the blame can also be placed on the government as it has been slow to spend its budget and pump prime the economy. However, it should be noted that Indonesia's growth has also been weighed down by the lagging effects of monetary and regulatory policies enforced in 2013 and 2014, moves the regulators cannot be faulted for. The policies included increases in the policy interest rate, which rose by a cumulative 175 basis points (bps), and limiting loan-to-value ratios for mortgage and auto financing. In February 2015, Bank Indonesia did ease its policy rate by 25 bps to 7.5%. Going forward, there may be limited elbow room for further monetary policy easing to support economic growth in view of persistent pressures on the CA balance and rupiah. Volatile markets resulting from China's recent devaluation of the yuan have certainly not helped.

Notwithstanding the ongoing slowdown, the Indonesian economy is expected to remain resilient as the government struggles to find new sources of growth following the fading of the global commodities boom. Now the fourth largest economy in East Asia after China, Japan and South Korea, it has the world's fourth largest population (around 250 million) and a growing middle class. Its population is relatively young, the third youngest in East Asia, and around 10 years younger than in most major advanced countries. Indonesia's rising working-age population and low dependency ratio have helped power GDP growth. The resilience of Indonesia's domestic demand to external influences has set it apart from its peers in the Association of Southeast Asian Nations (ASEAN) region. Over a 10-year period, the correlation between domestic final demand and exports was considerably lower in Indonesia than in Malaysia, Thailand and the Philippines.

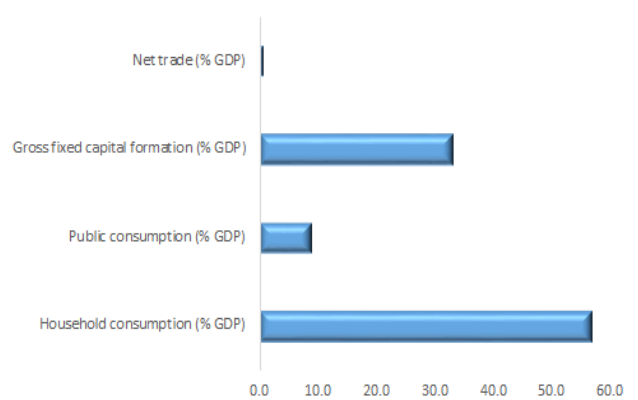
There is little reason to believe that Indonesia's growth will sustain a deeper setback in the medium term. Based on a number of powerful positive trends, Indonesia's economy holds enormous promise. Apart from China and India, the growth of the consuming class in Indonesia is already stronger than in any other economy. Continued structural reform efforts by the new government and sustained investment in infrastructure and industry will likely help keep Indonesia on a positive and respectable growth trajectory over the medium term. Together with China and India, it has the potential to drive the Asian economy through the 21st century.

However, pressing governance issues continue to hamper Indonesia's economic growth and development. It is critical that Indonesia addresses its governance issues like weak implementation capacity and poor inter-agency coordination if it wants to take advantage of its demographic dividend.

Over the short term, delays in budget execution will have to be tackled to prevent economic growth from slowing down further. According to Bank Indonesia, Indonesia's weaker 2Q2015 growth was due to the government being "*less inclined to consume and invest due to slower-than-expected absorption of government spending, including infrastructure project realisation, congruous with the reorganisation at several government ministries/agencies*."

To re-accelerate economic growth over the long and medium term, a concerted policy push is vitally important. Indonesia's current estimated potential output growth has fallen to about 5.5% per year compared to 6.0% or above per year in the past decade.[1] It needs to resist the urge to raise protectionist measures to boost local manufacturing as the economy struggles because what it needs most are reforms that help lower firms' costs and improve productivity. Improvements in the educational system will certainly help as only 25% of students who enter school come out of the system meeting minimum international standards in literacy and numeracy.

Chart 1: GDP - % share of demand side components (2014)



Source: CEIC, MARC Economic Research

Chart 2: Central bank policy rate and CPI (2012 = 100)

Source: CEIC, MARC Economic Research

Public debt remains manageable and sustainable

Indonesia's persistent fiscal deficits have been trending upwards. In 2014, it rose to 2.3% of GDP from the recent low of 0.7% in 2010. The 2015 fiscal deficit is projected at 2.2% while the fiscal deficit target for fiscal year 2016 is 2.1%.

Budgetary pressures in recent years have come mainly from energy subsidies and weak revenue collections. Indonesia's fiscal consolidation efforts are important because energy subsidies account for a sizable portion of government spending. Over the 2011-14 period, energy subsidies averaged 3.5% of GDP a year, thus contributing largely to the government's fiscal deficits.

However, if oil prices drop lower, or if low prices persist, savings from fuel subsidies rationalisation may turn out to be insignificant. Tax revenue collection has been affected by low oil prices. For example, in the first four months of 2015, it reached just 24% of the full-year target, and was 1.3% lower than the same period last year. The government, feeling that it would not be able to meet its earlier fiscal deficit target of 1.9% of GDP for whole year 2015, has revised it downward to a deficit of 2.2%.

Going forward, fiscal pressures will likely continue because the revenue declines reflect both the declining trend in oil production and continued structural weaknesses in tax revenues. Indonesia's tax take (2011: 12.6% of GDP) is low when compared to its regional peers. With public spending on health and pensions expected to increase over the medium and long run, Indonesia's tax take will have to rise if it is to avert heightened fiscal risks going forward. Many Indonesian companies in the coal, palm oil, cocoa and other

[1] World Bank: *High Expectations*, Indonesia Economic Quarterly, March 2015, page iv.

commodities sectors, for example, avoid corporate taxes by using transfer pricing. But times are bad with the global commodities boom having faded, and as such, attempts to increase the tax take will likely be difficult.

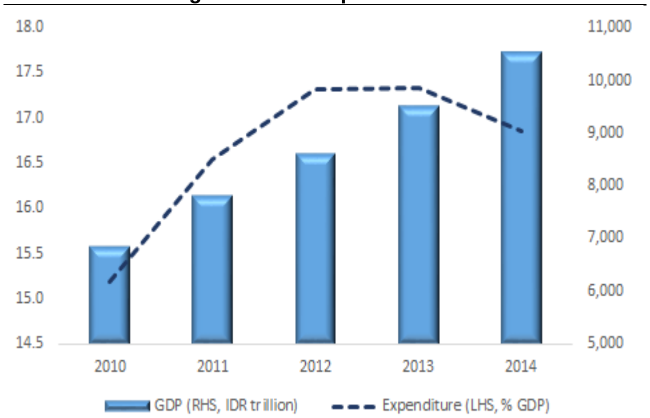
Notwithstanding persistent fiscal deficits, Indonesia's general government debt, which is at a manageable 26.1% of GDP as at end-2014 (2000: 95%), is much lower than the median of other emerging market economies. Since the late 1990s, public debt as a share of GDP has fallen by around three-quarters. In addition, the average maturity of public debt is at 10 years, with an average interest rate well below the GDP growth rate.

There are, however, concerns about exchange rate risk. As at end-2014, slightly over 44% of central government gross debt was exposed to exchange rate risk. Government funding needs have become increasingly reliant on foreign investors. As at end-2013, non-resident investors held around 59% of total government debt, among the highest in major emerging market economies.

Meanwhile, Indonesia's contingent liabilities appear manageable and unlikely to pose an immediate threat in terms of debt sustainability. As at end-2013, the debt of non-financial state-owned enterprises was moderately low at 5% of GDP. However, their debt has nearly doubled since end-2009 and bears watching.

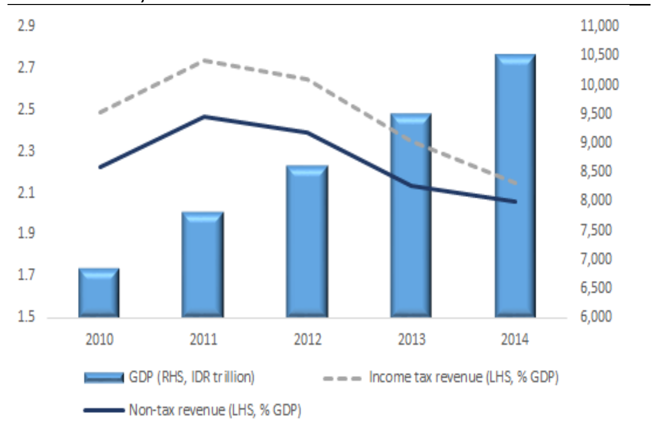
In conclusion, Indonesia's public debt remains sustainable and is robust against macroeconomic shocks. According to the results of standard stress tests carried out by the IMF, the general government debt-to-GDP ratio will likely remain modest under shocks from contingent liabilities, sharp exchange rate movements, slower economic growth, and higher interest rates.

Chart 3: GDP and government expenditure



Source: CEIC, MARC Economic Research

Chart 4: GDP, tax and non-tax revenue



Source: CEIC, MARC Economic Research

Major Challenges

Tougher times ahead for the banking system

Prior to the Asian Financial Crisis (AFC), the Indonesian banking sector suffered from structural weaknesses that included capital deficiency, high NPLs, weak compliance and governance. The situation has improved since. The sector, for example, meets Basel III's capital ratio standards. As at end-June 2014, regulatory capital to risk-weighted assets stood at 18.9%, with regulatory Tier-1 capital to risk-weighted assets also at a commendable 17.7%.

Loan impairments at the aggregate level remain low currently, with the latest data showing overall NPLs to total gross loans standing at 2.5% in April 2015. Though higher than at end-2013 (1.8%) due to slower economic growth, it is still significantly lower than the previous decade's peak of 8.4% (July 2006). However, there are pockets of vulnerabilities. Sectors with high NPLs include construction (5.5%), wholesale & retail trade (3.6%), and transportation, warehousing and communications (3.5%). The construction sector in particular has been affected by the government's slow disbursement of the infrastructure budget. As expected, bank profitability has declined slightly. In April 2015, return on assets (ROA) stood at 2.5%, compared to 3.1% at end-2013.

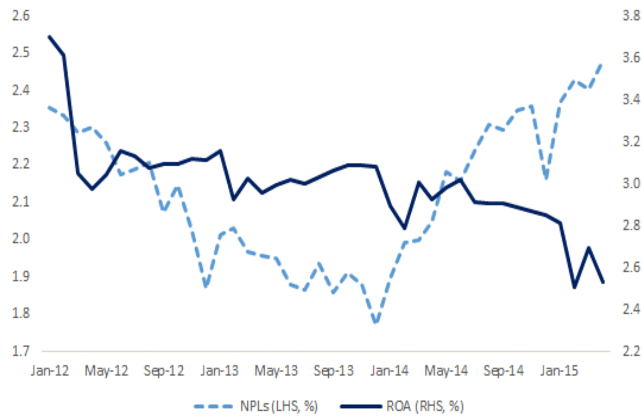
There will be speed bumps ahead for the banking sector with asset quality expected to drop on account of slowing economic growth and recent market volatilities that have caused the rupiah to fall significantly. Commodity exporters who took on debt in anticipation of continued high demand for their products and high prices have been hit by lethargic demand and a swift decline of prices, as well as recent market volatilities that resulted in the rupiah becoming one of the region's worst currency performers. The banking sector itself has a relatively low share of foreign currency-denominated external debt and is thus unlikely to be significantly affected by the weak rupiah. As of June 2015, its USD31.8 billion foreign debt represented 10.4% of total external debt. The external debt of the non-financial corporate sector, on the other hand, is about four times larger at USD125.8 billion, representing 41.4% of total external debt. With private sector external debt now higher than government debt, just like during the AFC, this needs to be watched closely.

Over the past five years, the rise in corporate foreign debt in Indonesia has been the fastest in the region. The significant fall of the rupiah means that companies with foreign currency-denominated external debt now face higher debt servicing costs. The situation has been made worse by falling earnings and slumping asset prices. With many Indonesian firms generating most of their revenue in the domestic market, the currency mismatches will likely lead to rising NPLs in the domestic banking sector going forward, even though domestic loans growth has been on a moderating trend. According to stress test results of the Financial Services Authority of Indonesia (Indonesian: Otoritas Jasa Keuangan or OJK), one to five of the smallest banks will likely see their capital deteriorate if the rupiah continues to fall to 15,000 rupiah per dollar.[2]

Despite the rapid rise of corporate foreign debt leading to rising risks in the banking sector, the sector is in a much stronger position compared to pre-AFC days. Thanks to financial sector reforms post-AFC, gone are the days of capital deficiency, weak compliance and governance. The banking system is now stronger with larger domestic deposit bases. On top of that, Indonesia's holdings of foreign exchange reserves are larger. Given the banking sector's current high capital levels and profitability, especially in the case of the larger banks, we do not expect the sector's financial fundamentals to be significantly dented by falling asset quality.

[2] On September 7, 2015, the IDR/USD rate traded between 14,263.80 and 14,307.00.

Chart 5: ROA and NPLs



Source: CEIC, MARC Economic Research

Chart 6: Private sector external debt and IDR/USD

Source: Bank Indonesia, Bloomberg, MARC Economic Research

External vulnerability is rising

Indonesia's CA balance, which first turned negative in 4Q2011 post-GFC, remains in deficit territory. In 2Q2013, it chalked a post-GFC high of -4.2% of GDP. There have been improvements though. Over the 2Q2014-1Q2015 period, it improved from -3.9% to -1.8% of GDP. As for the overall BoP position, Indonesia chalked up a BoP surplus of USD1.3 billion in 1Q2015, its sixth consecutive quarter of surpluses.

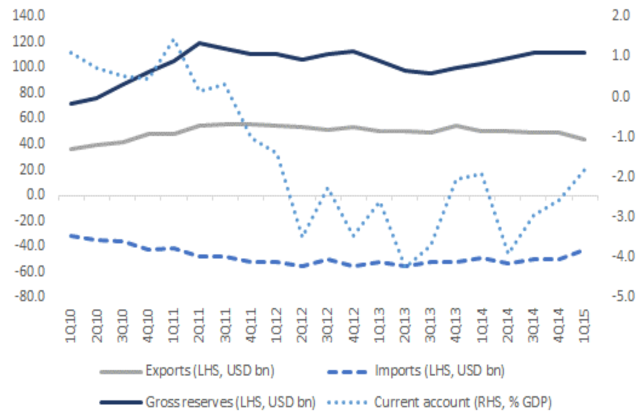
An improving CA balance and consecutive quarters of BoP surpluses indicate lower annual external financing requirements. Against a backdrop of still uncertain external developments, this is a credit positive development. However, with external developments remaining uncertain and the Indonesian capital market being not as large or deep as in some of its better developed regional neighbours, the country is likely to remain dependent on external financing at least for a while. Given the recent drastic market gyrations stemming from China's devaluation of the yuan and an impending rate hike by the United States, capital inflows going forward may not be big enough to ensure a BoP equilibrium.

Indonesia has always been vulnerable to international capital volatility whenever there is a rise in international financial uncertainty. This is definitely not an ideal situation because of the country's reliance on external financing. As mentioned previously, government funding needs have become increasingly reliant on foreign investors. And while gross external debt remains moderate at 34.4% of GDP (end-June 2015), it bears close watching because Indonesia's external sustainability, while robust against interest rate and GDP shocks, is sensitive to CA and exchange rate shocks. The structure of the external debt has also become more risky. At end-June 2015, the short-term external debt (by original maturity) to total debt ratio was 15.0%, compared to 13.2% at end-2007. Both short-term debt to reserve and GDP ratios were also higher at 42.2% (end-2007: 32.8%) and 34.4% (end-2007: 32.2%), respectively.

Indonesia's external vulnerability has been accentuated by rising international financial market uncertainties. According to the IMF, Indonesia's official reserve assets of USD111.9 billion at end-2014 were sufficient to deal with most shocks. The latest data shows official reserve assets falling to USD105.3 billion at end-August 2015. This 5.9% drop is a concern considering that the rupiah has been hitting new lows since the peak of the AFC, and debt-servicing costs have skyrocketed as a result. Going forward, the USD could strengthen further when the US Federal Reserve hikes the interest rate.

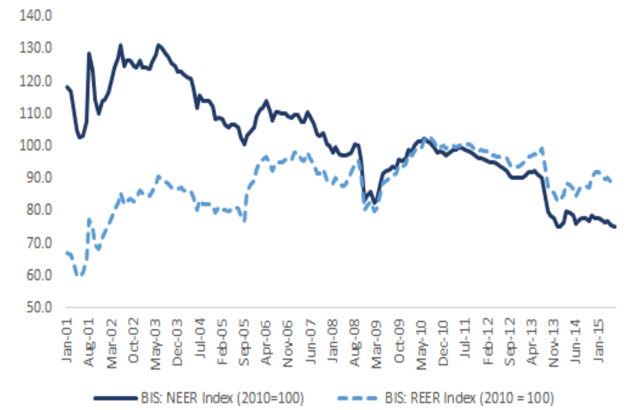
Also of concern is the fact that Indonesia's gross external debt of USD304.3 billion (end-June 2015), while still moderate as a percentage of GDP, is nearly three times the size of the country's official reserves. It is thus not surprising that investors are worried about a debt crisis in Indonesia. The fear is that this could trigger further capital outflows, leading to further rupiah depreciation and resulting in a self-fulfilling prophesy.

Chart 7: External developments



Source: CEIC, MARC Economic Research

Chart 8: NEER & REER indices



Source: CEIC, BIS, MARC Economic Research
Note: NEER: nominal effective exchange rate
REER: real effective exchange rate

Institutions are weak and business environment poor

Indonesia, by many accounts, has come very far in the last 15 years. It is the giant of Southeast Asia in terms of the size of its population and economy. That it had consistently punched below its weight diplomatically, at least up to until the previous president's last term in office, indicates the considerable challenges it faces. In October 2014, Indonesia saw the transfer of power from one popularly elected president to another.

Jokowi is a political outsider. Upon winning office, he had immediately issued bold reform promises. Jokowi has been vocal about wanting to return Indonesia to 7% growth. Against a backdrop of ongoing global economic uncertainties, that will be difficult. Making it more difficult are the various interest groups with political linkages that are resisting his reform efforts.

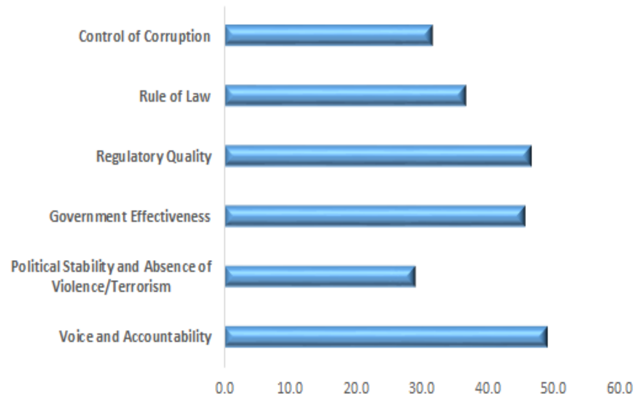
Indonesia continues to face structural issues. It was ranked 107th out of 175 countries in Transparency International's Corruption Perception Index 2014 (2013: 114th out of 177). It is thus not surprising that Indonesia did poorly in the World Bank's World Governance Indicators. In the 2014 Update, its percentile rankings in all six indicators were below 50. For the *control of corruption* indicator, for example, its percentile ranking was 31.58. And as expected, it is ranked low in the World Bank's Ease of Doing Business 2015 report. Ranked at number 114 overall (2014: 117), it did relatively well on investor protection and trading, but much worse in terms of business startups, construction permits, tax payments, and contract enforcement.

Jokowi will likely continue to face resistance in his reform efforts because not only does he head a minority coalition in the national parliament, he is also an outsider to the political establishment. However, we expect some of his reform efforts to bear fruit. For example, the government has capped the diesel subsidy and scrapped gasoline aid since the beginning of the year. This marked Jokowi's second act to fix Indonesia's energy subsidy system. In November 2014, he raised fuel prices less than a month after taking office. Jokowi has pledged to use the savings from subsidies to increase infrastructure spending and boost investment and economic growth.

The government has launched a massive infrastructure campaign designed to cut logistics costs and improve internal maritime connectivity. These efforts are expected to induce the inflow of badly needed investment that would also help fund the government's infrastructure targets. According to World Bank estimates, improvements in logistics, electricity and so on would add 2.0% to Indonesia's economic growth annually. Indonesia's progress in reducing the infrastructure gap has been hampered by, among other things, weak implementation capacity and poor inter-agency coordination. Actual execution of capital spending, for example, has been at only around 85%.

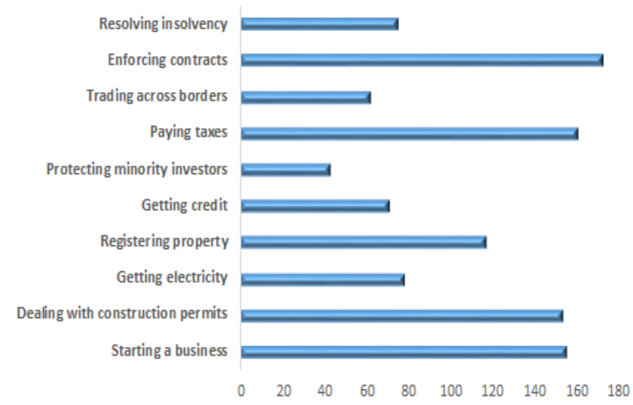
For Indonesia to reach its economic potential, it is probably not too much to say that the success of governance reforms may turn out to be the deciding factor. If reforms continue to lag, Indonesia's demographic dividend could go unrealised. The growing population could become a burden, and that could threaten growth and development.

Chart 9: World Governance Indicators, 2014 Update



Source: World Bank
Note: Percentile ranking; higher is better

Chart 10: World Bank Ease of Doing Business 2015



Source: World Bank
Note: Ranking out of 189 economies; lower is better

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