Economic Research

KDN No.: PP14787/11/2012(030811)

MALAYSIAN RATING CORPORATION BERHAD
(364803-V)

Vol.: ER/008/2016

Country Risk Monitor: Indonesia

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19 August 2016

In a nutshell

- The Indonesian economy, the largest in Southeast Asia, remains resilient. The economy did relatively well in 2015 despite falling international oil prices, episodic capital outflows, and turbulent global financial markets. There are a number of key reasons for Indonesia's economic resilience. It has the world's fourth largest population and a growing middle class. Urbanisation has been rapid. The urban population, as a percentage of the total, increased from 23% in 1981 to 42% in 2000. By 2014, it had risen to 53%. The population is also relatively young, the third youngest in East Asia. Going forward, Indonesia's demographic dividend is expected to remain a growth driver. Meanwhile, research has shown that Indonesia's domestic demand is resilient to external influences. Empirical data show that, 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. The central bank sees gross domestic product (GDP) growing at between 5.2% and 5.6% in 2016, while the government has set a growth target of 5.2%.

- Another key strength is Indonesia's manageable and sustainable public debt, thanks to a prudent fiscal stance that is anchored by a fiscal rule that caps the general government deficit at 3.0% of GDP a year. In 2015, public sector debt stood at just below 27% of GDP, and we foresee it remaining at a manageable level going forward. It is highly unlikely that, at its current growth pace, the fiscal rule that caps general government debt at 60.0% of GDP will be busted any time soon. We also foresee external government debt to remain relatively stable (2011-15 average: 10.4% of GDP) going forward, barring significant rupiah depreciation. In addition, contingent liabilities appear manageable and unlikely to pose an immediate threat to debt sustainability. For example, debt guarantees related to the financing of electricity and water infrastructure projects up to March 2014 totalled only 1.5% of GDP. Standard stress tests by the International Monetary Fund (IMF) suggest that public debt dynamics are robust to macroeconomic shocks.

- Meanwhile, Indonesia's risk outlook continues to be affected by ongoing global economic and financial uncertainties. There are considerable downside risks emanating from, among others, potential further declines in commodity prices, further slowing of demand from its main trading partners, especially China, and the possibility of renewed financial market volatility.

- The Indonesian banking sector remains profitable and well capitalised. However, there are tougher times ahead, with credit risk remaining the main risk. Besides sluggish growth and rupiah depreciation, the corporate sector has had to contend with low commodity prices and tighter funding conditions. The doubling of foreign currency-denominated (FX) corporate debt to 20% of GDP over the 2010-2015 period is also a risk concern. This is particularly true in the case of corporates whose FX debt are not completely hedged, and who do not have healthy balance sheets. While the banking system's capitalisation, profitability and large deposit base continue to provide buffers, an analysis of both aggregate and bank-by-bank data does suggest that a group of smaller banks are vulnerable to deterioration in bank asset quality and liquidity conditions. It should be noted, though, that the government remains committed to maintaining financial sector stability. For example, domestic systemically important banks (DSIB), assuming the full incorporation of capital conservation, countercyclical and DSIB capital surcharges, are required to raise their minimum common equity Tier 1 ratio to 12% by January 2019, from 5.75% currently.

- As the global economic and financial backdrop looms more threateningly, Indonesia's external vulnerability continues to rise. While there are signs that oil prices may have stabilised, uncertainties remain, and the World Bank expects Indonesia's current account (CA) deficit for 2016 to worsen to 2.3% of GDP. This essentially means that Indonesia remains dependent on external financing, and is especially sensitive to exchange rate depreciation. According to the IMF, a 30% depreciation of the rupiah in 2016 could raise Indonesia's external debt to GDP ratio to about 51.5%. Indonesia's gross external debt of USD310.7 billion (end-2015) is a concern because it is nearly three times the size of the country's official reserves. As a percentage of exports, its rise has been dramatic. Based on a scenario of favourable real GDP growth and slower non-bank private sector debt build-up on account of less favourable global financial conditions, the IMF sees external debt as a percentage of GDP stabilising at around current levels before declining to 33.75% by end-2020. However, government external debt may increase if there is increased reliance on external financing for funding infrastructure development projects.

- Weak institutions and a poor business environment are also risk concerns. While the government is working hard on jump-starting growth and attracting foreign investors, such efforts are being stymied by issues that include weak implementation capacity and poor inter-agency coordination. It continues to face criticism over creeping protectionism and regulatory flip-flops. In the mid-February 2016 move to open the doors wider to foreign investment, for example, the government opened 35 sectors to foreigners but closed 20 others. In addition, President Joko Widodo (Jokowi) who heads a minority coalition in the national parliament is an outsider to the political establishment. He will likely continue to have to struggle to get around entrenched vested interests and face resistance in his reform efforts. Meanwhile, terrorism continues to be a threat despite stronger democratic governance, a more stable political environment and steady economic development. While there are claims that poverty no longer plays a big part in driving Indonesians towards radical Islamic causes, economic incentives could become an effective recruitment tool as crippling poverty remains.

Table 1: Selected economic indicators

	2011	*2012*	*2013*	*2014*	*2015*
Real GDP growth (% y-o-y)	*6.2*	*6.0*	*5.6*	*5.0*	*4.8*
Inflation rate (%, annual average)	*5.4*	*4.0*	*6.4*	*6.4*	*6.4*
Unemployment, total (% of labour force)	*7.4*	*6.1*	*6.2*	*5.9*	*6.2*
Fiscal balance (% GDP)	*-1.1*	*-1.8*	*-2.2*	*-2.2*	*-2.5*
Public sector gross debt (PSGD) (% GDP)	*23.1*	*23.0*	*24.9*	*24.7*	*26.8*
Current account (% GDP)	*0.2*	*-2.7*	*-3.2*	*-3.1*	*-2.1*
International reserves (USD bn)	*110.1*	*112.8*	*99.4*	*111.9*	*105.9*
External debt (% GDP)	*26.4*	*27.4*	*29.1*	*33.0*	*36.1*

Source: World Bank, IMF, Bank Indonesia, CEIC, MARC Economic Research

Key Strengths

Resilient economy

The Indonesian economy did relatively well in 2015 despite falling international oil prices, episodic capital outflows, and turbulent global financial markets. In addition, it had to contend with moderating consumption, subdued investment, and sluggish global demand.

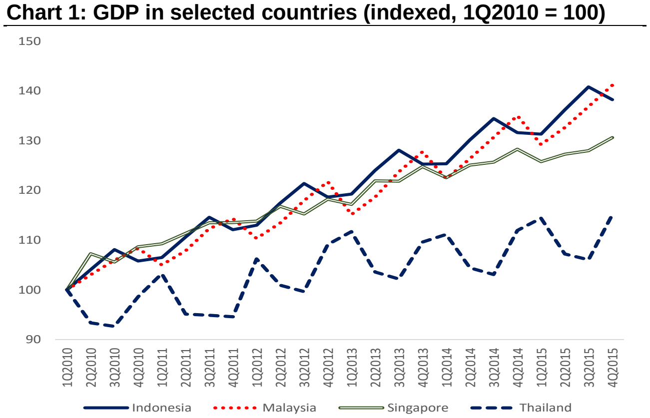
GDP growth in 2015, while admittedly sluggish, slowed down only slightly to 4.8% p.a. (2014: 5.0%). As efforts to improve budget execution rates kick in, growth should pick up in the later part of 2016. The construction of key infrastructure projects that include roads, ports, dams and power plants have begun. In addition, investor sentiment should improve on account of the series of policy packages of regulatory reforms that have been unveiled, including the liberalisation of some rules on foreign investment in mid-February 2016. The central bank sees the Indonesian economy growing at between 5.2% and 5.6% in 2016, while the government has set a growth target of 5.2%.

There are a number of key factors keeping the economy resilient. Indonesia has the world's fourth largest population (2015: 258 million) and a growing middle class. Urbanisation has been rapid. Indonesia's urban population, as a percentage of the total, increased from 23% in 1981 to 42% in 2000. By 2014, it had increased further to 53%. Urbanisation and growth go together because it fuels a rise in incomes and the ability of consumers to spend more on discretionary items.

The population is also relatively young, the third youngest in East Asia. Going forward, its demographic dividend is expected to continue driving growth. Meanwhile, research has shown that Indonesia's domestic demand is resilient to external influences. For example, 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.

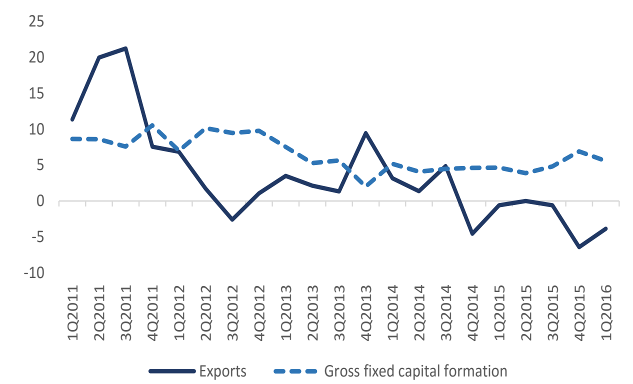
Notwithstanding its resillience, risks to the Indonesian economy remain tilted to the downside in the near term. There are threats of potential further declines in commodity prices and slowing of demand from its main trading partners, especially China. There are also risks of renewed financial market volatility, which could have a disproportionately large effect on Indonesia, compared to its regional neighbours, given its dependence on external financing.

Chart 1: GDP in selected countries (indexed, 1Q2010 = 100)



Source: CEIC, MARC Economic Research

Chart 2: Exports and gross fixed capital formation (% y-o-y)



Source: CEIC, MARC Economic Research

Manageable and sustainable public debt

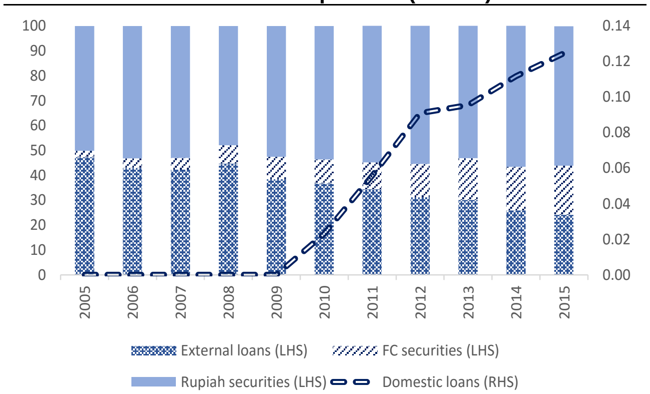
Public sector debt remains relatively low, thanks to the prudent fiscal rule that caps the general government deficit at 3.0% of GDP a year. In 2015, public sector debt stood at just below 27% of GDP, a far cry from around 95% in 2000. Indonesia's debt consolidation process over the years had been made possible primarily because of both low interest rates and high real GDP growth rates. The 2.8-percentage point increase in 2015 above the 2010-14 average of 24.0% was due to a larger primary deficit, recapitalisation of state-owned enterprises (SOE), and exchange rate depreciation.

To limit the financing risks of a higher-than-targeted deficit in 2015, the government frontloaded bond issuance and borrowing from multilateral donors. It also raised USD3.5 billion to pre-finance its 2016 budget. The latest data show that loans from the World Bank and the Asian Development Bank make up 29.6% and 17.0%, respectively, of the government's total external loans in 2015. Meanwhile, multilateral loans make up 48.1%, while bilateral loans make up 45.2%. Commercial loans therefore do not figure prominently in the government's external loans profile. However, it is on a rising trend. In 2015, it made up 6.7% of the government's total external loans, compared to 3.0% in 2008.

The government is depending less on loans. As a percentage of total government debt, the proportion of loans, which are largely external, has fallen from 44.6% in 2008 to 24.1% in 2015. The proportion of government debt securities, on the other hand, has risen from 55.4% in 2008 to 75.7% in 2015. During the same period, the proportion of foreign currency-denominated government debt securities to total government debt securities rose to 26.0% from 13.5%, while that for rupiah-denominated debt securities fell to 74.0% from 86.5%. Non-residents hold about 60% of total government debt.

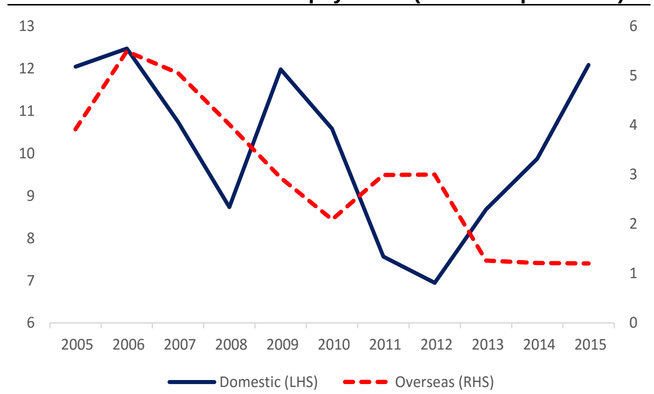
Contingent liabilities appear manageable. Available data suggest that the level is unlikely to pose an immediate threat to debt sustainability. For example, debt guarantees related to the financing of electricity and water infrastructure projects up to March 2014 totalled only 1.5% of GDP. According to the IMF's projections, fiscal risks associated with government contingent liabilities remain moderate going forward.

Chart 3: Government debt components (% total)



Source: CEIC, MARC Economic Research
Note: FC: foreign currency

Chart 4: Government interest payments (% total expenditure)



Source: CEIC, MARC Economic Research

Major Risks

Rising macro-financial risks

The Indonesian banking system remains well capitalised with end-2015 data showing that the system had on average a capital adequacy ratio of 21.3%, the highest in the post-Global Financial Crisis (GFC) period. Banks also remain relatively profitable, with return on assets (ROA) and return on equity (ROE) at 2.2% and 17.3%, respectively.

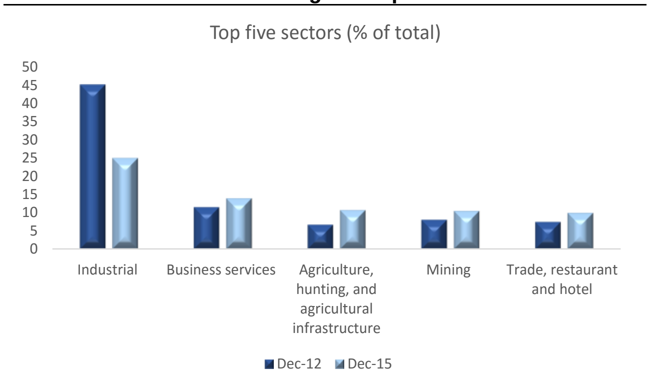
However, there are speed bumps ahead. IMF analysis suggests that bank non-performing loans (NPL) in Indonesia are affected mainly by GDP growth and rupiah performance. With growth prospects remaining soft and global uncertainties on the rise, the vulnerability of the banking system is expected to increase further. The Financial Services Authority's (OJK) directive to banks to cap time deposit rates and reduce lending rates to single digits by year-end is not good news for the sector. This is because bank lending rates are based on risk-based pricing, and the move may jeopardise the risk profiles of banks.

Credit risk remains the main risk facing Indonesian banks, more so against a backdrop of rising corporate leverage. In 2015, the corporate sector's debt to equity ratio rose to 1.44 times from 1.12 times in 2012. At a time of falling profitability – the sector's return on equity in 2015 had fallen to 7.8% (2012: 12.2%) – this is worrisome. The corporate sector will continue to be affected by sluggish growth, rupiah depreciation, tighter funding conditions and low commodity prices.

With commodities accounting for two-thirds of Indonesia's exports, the sharp fall in commodity prices has had a significant impact on Indonesia's commodity trading firms. The doubling of FX corporate debt, which includes FX debt to domestic banks, to 20% of GDP over the 2010-2015 period is a cause for concern. However, the results of empirical analysis show that the risk of disorderly defaults by systemically connected corporates defaulting and creating negative spillovers and damaging confidence is small.

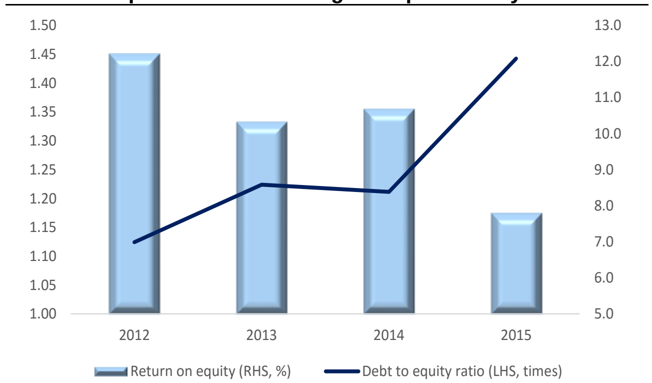
While the banking system's capitalisation, profitability and large deposit base continue to provide buffers, an analysis of both aggregate and bank-by-bank data does suggest that a group of smaller banks are vulnerable to deterioration in bank asset quality and liquidity conditions. As the government remains committed to maintaining financial sector stability, there is every reason to believe that it will come to the rescue of financially stressed banks, especially DSIB.

Chart 5: Bank credit to 100 largest corporate debtors



Source: Bank Indonesia, MARC Economic Research

Chart 6: Corporate sector leverage and profitability



Source: Bank Indonesia, MARC Economic Research

Higher external risks

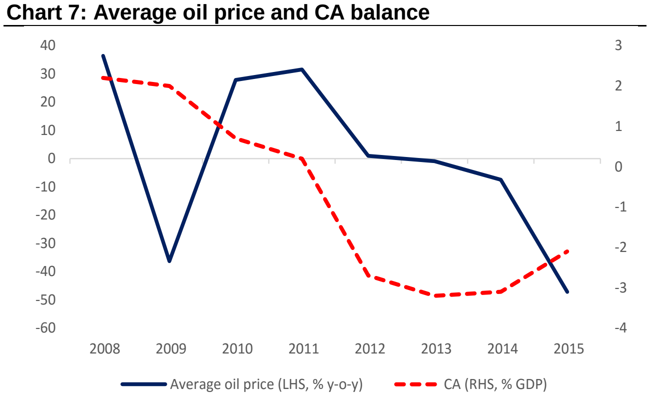
The outlook for Indonesia's external position remains challenging. Subdued global growth, low commodity prices and uncertain global economic and financial conditions will likely continue to weigh on its external balance sheet. Its external financing risks remain elevated, more so because of its shallow financial markets. Drastic financial market gyrations could slow down capital inflows to such an extent that flows may not be big enough to ensure balance of payments equilibrium. In 2015, fleeing capital resulted in Indonesia's financial account balance falling to USD17.1 billion, the second lowest in the post-GFC period, from USD45.0 billion in 2014.

The World Bank sees Indonesia's CA deficit worsening to 2.3% of GDP in 2016, a level that is lower than the post-GFC high of -3.2% in 2013. In 2015, the CA balance had narrowed to -2.1% of GDP from -3.1% in the previous year, an indication of lower annual external financing requirements. As of June 2015, Indonesia's net international investment position (NIIP) remained in a net debtor position at -48% of GDP (end-2014: -47%). The NIIP was stable overall in 1H2015 thanks to strong net portfolio inflows comprising mainly government debt, which offset other net outflows. Demand for Indonesian debt has thus not waned despite rising global uncertainties.

Indonesia's external debt-to-GDP ratio has steadily increased from 26.4% at end-2011 to 36.1% at end-2015. Its gross external debt of USD310.7 billion (end-2015) is a concern because it is nearly three times the size of its official reserves (USD105.9 billion). Based on a scenario of favourable real GDP growth and slower non-bank private sector debt build-up due to less favourable global financial conditions, the IMF sees external debt as a percentage of GDP stabilising at around the 2015 level of 36.1% before declining to 33.8% by end-2020.

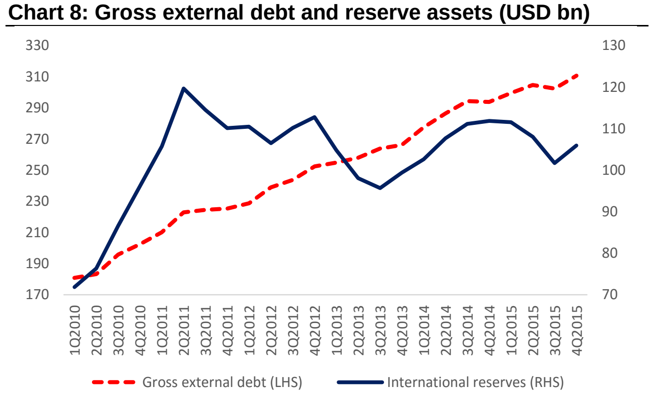
While Indonesia's external position remains sustainable, as indicated by the level and composition of the NIIP and gross external debt, global volatility remains a threat. For example, Indonesia's external sustainability is, according to the IMF, especially sensitive to exchange rate depreciation. Research shows that a 30% depreciation of the rupiah in 2016 could raise the external debt to GDP ratio to about 51.5%. It is also a risk concern that government external debt may increase if there is increased reliance on external financing for funding infrastructure development projects.

Chart 7: Average oil price and CA balance



Source: IMF, CEIC, MARC Economic Research

Chart 8: Gross external debt and reserve assets (USD bn)



Source: CEIC, MARC Economic Research

Still weak institutions and business environment

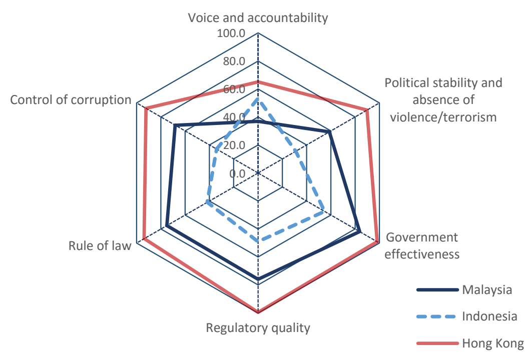
Indonesia continues to do poorly in the World Bank's World Governance Indicators (WGI), although there have been improvements. In the 2015 update, the percentile rankings of two out of six indicators rose to above 50, where there had been none previously. The percentile ranking of the *government effectiveness* indicator, for example, improved to 54.8 from 45.5 in the earlier report. However, Indonesia still has a long way to go. As a result of its poor showing in the WGI, it continues to rank low in the World Bank's Ease of Doing Business report. In the latest 2016 report, it ranked at number 109 out of 189 economies covered.

While the government is working hard on jump-starting growth and drawing investors, its efforts are being hampered by structural issues that include weak implementation capacity and poor inter-agency coordination. It continues to face criticism over creeping protectionism and regulatory flip-flops. In its mid-February 2016 move to open the doors wider to foreign investment, for example, it opened 35 sectors to foreigners but closed 20 others. Jokowi, who heads a minority coalition in the national parliament, will likely continue to have to struggle to get around entrenched vested interests and face resistance in his reform efforts.

For Indonesia to reach its economic potential, it will need to improve the quality of its governance and institutions. The government should, for example, complement its expanded infrastructure spending with improved financial management of public investment and stronger governance at SOE and capacity at local governments. The results of recent studies suggest that higher sub-national spending on roads has not led to improved road conditions. Government effectiveness therefore remains woefully inadequate.

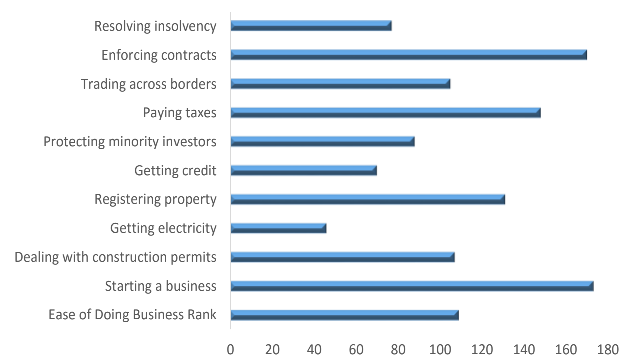
Terrorism continues to be a threat despite stronger democratic governance, a more stable political environment and steady economic development. If the threat is not contained, political, economic and social stability in Southeast Asia's largest economy could be affected. While there are claims that poverty no longer plays a big part in driving Indonesians towards radical Islamic causes, economic incentives could become an effective recruitment tool as crippling poverty remains. According to the World Bank, Indonesia's poverty rate in 2014 was 11.2%. About 28.6 million Indonesians live below the poverty line, while approximately 40% of the total population remain clustered around the national poverty line, which is set at 330,776 rupiahs per person per month (USD22.60).

Chart 9: World Governance Indicators, 2015 Update



Source: World Bank

Chart 10: Indonesia: Ease of Doing Business 2016 ranking



Source: World Bank

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Published and Printed by:

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