Indonesia

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The economy has continued a steady path and will likely reach a growth rate of around 5% in the current year in line with previous years. Recent general elections brought the incumbent back to the presidential office. That has bolstered investor confidence that the reform drive is set to continue for another five years raising the prospects for higher sustainable growth into the next decade.

Summary and conclusion

Steady economic growth: Last year growth ticked in at 5.1% supported by domestic demand with activity strengthening toward the end of the year. The momentum continued into the first quarter of the current year, spearheaded by private and government consumption. Boosted by an election result broadly seen as business friendly, investor sentiment has improved and been further underpinned by a new jump in the World Bank's ease of doing business indicator.

No overheating: Cautious macroeconomic policies have so far prevented the good times turn into overheating. The rate of inflation is well within the central bank's target range of 3.5%± 1pp, the twin deficit is within 2% of GDP, while reserves continue rising to around 7 months of imports. Overall national debt is kept prudently within 30% of GDP.

Structural policies about to see light: The government has begun to implement an ambitious infrastructure program including new highways and railways. These are aimed at boosting productivity and is the reason for upbeat growth prospects including from the rating agencies.

Outlook looks better: Based on the positive developments noted above, all the three rating agencies have now upgraded Indonesia to well within investment grade. This is also relevant for country risk. But observers also point to potentially fragile government finances due to an extraordinary weak tax collection of only 15%/GDP which has forced the fiscal to unload its finances on the many state-owned enterprises. Fortunately, banks are sound and should not pose contingent liabilities on the government's balance sheet.

Ratings: The strong government effort to set in motion an ambitious infrastructure program has been awarded with upgrades around the clock for a sovereign that was in default and deep debt less than two decades ago.

Recent economic developments:

Steady economic growth: Last year growth ticked in at 5.1% supported by domestic demand with activity strengthening toward the end of the year. The momentum continued into the first quarter of the current year, reaching a high of 5.4% yoy (year-on-year) spearheaded by retail sales and government consumption while private investments slowed due to political uncertainty ahead of second quarter general elections. External trade also weakened in sympathy with rising global tensions.

These trends prompted the government to boost expenditures including through state owned companies' infrastructure projects while announcing plans for tax cuts and tax incentives for companies to invest in skills training. That helped underpin domestic demand which was also boosted by an election result broadly seen as investor friendly inasmuch as it reduced political uncertainty. In the event growth upheld reasonably well at more than 5% yoy according to preliminary estimates. That will support expectations of continued steady growth to the end of the year underpinned by recovered investor sentiment after elections and more vigorous household spending following recent real wage hikes.

Price pressure remains moderate despite strong employment growth and wage hikes: Prices have continued growing in a moderate fashion around 3% on an annual basis in the current year according to the consumer price index (CPI). That is despite strong employment growth since 2018 seeing total employment rising to 66% of the labor force and average wage hikes reaching 5% nationwide with certain sectors like manufacturing registering 7% higher wages yoy in Q1. One reason for the moderate price pressure could be related to recent improvements to the network of highways and other transportation routes including new sea lanes. They are now helping to more efficiently distribute last spring’s bumper harvest in agriculture and gives hope for a more long lasting effect of moderate food-prices.

External developments

Current account balance back to normal: Last year the current account deficit nearly doubled to 3%/GDP. That was a result of weaker exports as global demand began to suffer in the shadow of the incipient trade dispute between the US and China while domestic investment demand, by contrast, boosted capital imports. This prompted the government to impose special curbs on imports such as demanding deliveries of oil and gas to be replaced by domestic bio-fuels including palm oil. At the same time import fees on consumption goods were hiked by 50% to 7.5pp (percentage points).

These regulations were extended into the current year with the effect to reduce real imports by nearly 8% in the first quarter alone. On the export side the escalating US-Sino trade war made a more sizeable footprint also because of falling world prices of key Indonesian export products such as coal, base metals and palm oil. That could be compounded by a worsening services balance should the inflow of foreign tourists – including many Mainland Chinese – continue to shrink into the second half of the current year. However, as the reduction of the import bill is likely to dominate, the current account deficit is still heading for an improvement to an estimated 2.5%/GDP before year end in line with the results of recent years.

Capital account set to recover: Indonesia's capital account is vulnerable to global investors' sentiment toward emerging markets which often reflects relative yields more than idiosyncratic developments in these countries themselves. Last year, tightening of US monetary policies prompted many investors to withdraw from emerging markets and rather place funds in USD. This year, by contrast, perceptions of a more dovish Fed appear to have reversed the flow of money to the benefit of a capital hungry country like Indonesia. As a result, since late 2018 the government has been able to place several bond issues in international markets for a total of more than $8bn. while keeping the spread to Treasuries fairly constant. Private corporate borrowers seem also to have benefited from the same trends enabling them to attract $1.4bn of inflows to the equity market. Foreign direct investments (FDI)will hopefully recover following last year's dip to only $2bn. of net inflows.

Rising reserves: As a result of a lower current account deficit and the prospects for increasing net capital inflows, the total balance of payments is set to improve in 2019 perhaps by as much as $10bn. Already in the first half of the year, reserves were up by roughly $5bn to $125bn. - enough to cover more than six months of imports and scheduled debt repayments through the rest of the year. Total external debt has grown gradually over time to around 37%/GDP in line with the country's strengthening credit fundamentals.

Policies

Budget deficit under control: Aided by stronger commodity prices and tax administration the government was able to rein in the budget deficit to 1.9% of GDP in 2018, and expectations are for that result to be largely repeated in the current year. New measures to streamline tax collection are aimed at raising total budget revenues to almost 15% of GDP in the current year still very low in an international comparison with peers in roughly the same sovereign risk class.

Low government revenues: Government revenues are rising but from a low level. Increasing the tax take has become one of the highest fiscal priorities not least to enable the government to finance its multi-year ambitious infrastructure program estimated to cost more than $400bn. With total expenditure mounting to less than 17% for the current year the deficit should be well contained within 2%/GDP. That is despite expenditure rising sharply in the first months of the year in response to some pork-barrel fiscal stimuli leading up to the general elections in April. This is still unlikely to mean that the government will relax on its target to keep the budget balance under control but as in 2018 rather slow on project implementation. Under any circumstances the self-imposed deficit limit of 3%/GDP is very unlikely to be breached. That should facilitate continued access to global capital markets. .

Deficit financing unlikely to present any major challenge: The results of government borrowing operations in the first half of the current year signal continued access to international and domestic capital markets despite ups and downs in investor appetite for emerging markets debt. That is supported by an overall low debt ratio at 30% of GDP down from more than 100%/GDP after the Asian crisis two decades ago. This debt ratio started to grow again although very slowly about a decade ago. It still serves Indonesia well that this rise has been accompanied by tight control and in line with growing opportunities for the economy. As a result, foreign investors have welcomed new government bond auctions and bought almost half of the outstanding. Some 40% is placed in US dollars or other foreign currencies.

Contingent liabilities, growing but from a moderate level: The banking sector is in reasonably good shape and is not considered an important contingent liability on the government's balance sheet. That is in contrast to the debt of SOEs (State Owned Enterprises) which has begun to grow more rapidly and the part of it guaranteed by the sovereign has reached 3%/GDP. Out of this around half is held by foreign investors and 60% is denominated in foreign currencies. That trend largely reflects the government's lacking capacity to finance the ongoing rapid infrastructure developments without incurring larger deficits. Nevertheless, the constitutional limit set by Parliament for such guarantees, is twice as high as has been utilized so far.

Cautious monetary policy: Last June, Bank of Indonesia (BI) – central bank –cut its main policy rate by 25bsp. (basis points). That was, however, after a streak of rate hikes in 2018 of a cumulative 175 bsp which had brought the policy rate to 6% pa. by year-end. The latest move was clearly in response to the incipient easing by global central banks against the backdrop of the recent strengthening of the Rupiah while the rate of inflation has edged down to within Bank Indonesia's target rate between 2.5% and 4.5% pa.

Managed float. Since the exchange rate debacle of 2014, when the BI was perceived as fighting market forces, Indonesia's exchange rate policy has neither been pegged not free floating. As sentiment turned against emerging market currencies in 2018, BI let the exchange rate slide by 6% but at the same time cushioned the fall by intervening for more than $5bn, some 4% of reserves. That contrasts with the current year when the central bank has remained chiefly on the buyer's side. This has built trust with the investor community not least because it has been coordinated with other macro-prudential policies such as curbs on banks' lending to large corporates, repatriation requirement on commodity exporters while upholding previously introduced hedging requirements on short term foreign exchange liabilities. These policies have been underpinned by the recent trimming of the current account deficit and the impression of a 4% underestimation of the rupiah according to the latest IMF country report.

Banking system – small but profitable: The banking system is relatively small even for a low-income emerging market country, representing less than 60%/GDP and with total credit extension standing at less than 40%/GDP. However, it is reasonably profitable with return on assets at 2.5% reflecting mostly decent loan quality. NPL (Non-performing loans) stand at 2.6% of the loan book although the latter rises to 9% including also restructured and special mention loans. In the first quarter of the current year loan growth decelerated to 12% yoy in part due to macro-prudential measures from the central bank. CAR (Capital Adequacy Ratio) at 12% shows solid albeit not outstanding capitalization. The banking system has implemented Basel III requirements.

Structural issues:

There are already signs that the reform drive of recent years is starting to effect on the economy. For instance, last spring new toll-roads and railways helped a lot to distribute an unexpected bumper harvest that might otherwise have been left to rotten in warehouses. In addition to the construction of physical infrastructure, the government has also implemented administrative reforms with positive impact on businesses including:

- reduction in number of procedures and time it takes to invest
- a standard formula for hikes in the minimum wages based on nominal GDP growth at the regional level

For these and other measures the country was last year awarded with a whopping improvement on the *Ease of doing business indicator* from 91st to 72nd place among 180 countries in the World Bank's annual global annual survey.

That said, though, Indonesia’s productivity and growth prospects are still constrained by structural challenges in labor and product markets including

- still complex regulations from local governments and restrictions on FDI
- strong presence of SOEs with the effect to thwart faire competition
- Complex processes to start a business and obtaining construction permits
- proper investor protection, integrity of contracts and property rights still leave much to be desired.

Another overarching problem is low tax- collection that inhibits government spending. To that end the government has launched a medium-term revenue strategy (MTRS) to raise revenue by 1%/GDP over five years with the aim to pay for more spending including on infrastructure and education.

Outlook:

For the near term the economy is likely to continue along its steady path with growth around 5% a year and a twin deficit well in line with recent developments around 2% of GDP, well below the underlying economic rate of expansion, while annual inflation remains contained in the range between 3% and 4%. With government and private sector leverage moderate at the outset the economy can continue on its present path for the medium to longer term able future. Also, renewed political stability should allow the government freer hands to implement its large-scale investment programs with the potential to lift the annual growth rate closer to 5.5% a year before the middle of the next decade. That is without jeopardizing hard-won improvements to financial indicators.

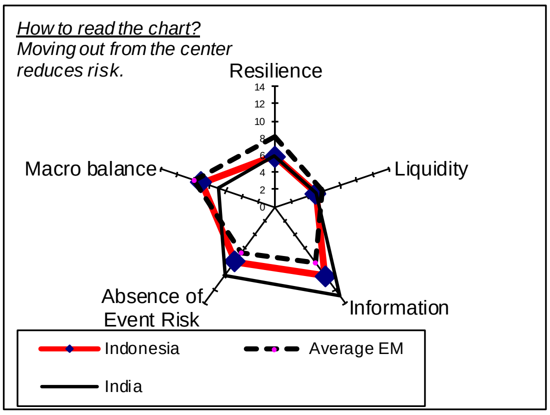
On the domestic side the main obstacle to this future is the low level of government revenues relative to the size of the economy. At only 15%/GDP they leave little for the government's capital budget, including spending on infrastructure. That has so far been resolved by letting SOEs step in to finance significant parts of infrastructure developments including in transportation and IT. Even though they still have room to finance more, eventually that will reach the constitutional limit of 6%/GDP perhaps with a few years which should prompts a rethinking from the government before the end of the new presidential term.

The external environment could also bring greater risks in coming years. While Indonesia is not directly in the cross-hairs should the US-Sino trade war escalate further – As mainly commodity exporter, disruptions to the regional supply chains means less for Indonesia than other regional peers, including Thailand, Vietnam and Malaysia.

Ratings:

After Standard&Poors raised the sovereign rating to BBB from BBB- of last May, all major rating agencies agree on Indonesia in a secure investment grade. Against a background of steady improvement to nearly all credit metrics for almost a decade, this should not come as a surprise. This argument also benefits country risk which is further underpinned by rapid improvements to the business climate as indicated by the World Bank's *Ease of doing business* and similar indicators.

Key ratios	**2019**
Population (mill.)	270
GDP/capita ($)	4356
GDP (change)	5,1%
Inflation	4,0%
Curr.Acc. Balance/GDP	-1,7%
Reserves/imports (months)	8,8
Budget balance/GDP	-2,4%
Government debt/GDP	33%



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

Peers:
Philippines
India
Mexico

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

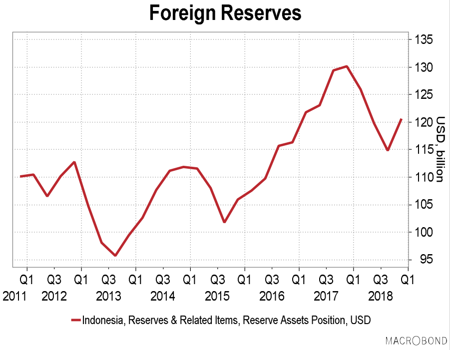
Key data:	2013	2014	2015	2016	2017	2018	2019	2020	2021
GDP (mill.US$)	918	892	861	933	1016	1076	1176	1276	1389
GDP/capita (US$)	3638	3491	3329	3568	3842	4027	4356	4683	5048
GDP (change)	5,6%	5,0%	4,9%	5,0%	5,1%	5,1%	5,1%	5,3%	5,3%
Investments/GDP	33%	32%	32%	32%	33%	33%	33%	34%	34%
Government Finances									
Budget balance/GDP	-2,2%	-2,2%	-2,6%	-2,5%	-2,6%	-1,9%	-2,4%	-2,2%	-1,9%
Govt debt/GDP	23%	26%	28%	31%	32%	33%	33%	34%	34%
Money & Prices									
CPI inflation (%)	6,4%	6,4%	6,4%	3,5%	3,8%	3,4%	4,0%	4,1%	3,8%
Money demand (%)	13,3%	11,6%	12,6%	7,8%	9,8%	8,6%	9,1%	9,0%	8,7%
Stock prices (%change	252420	255518	258531	261461	264327	269872			
Interest rates	5,9%	7,9%	7,5%	7,2%	6,3%	5,8%	6,5%	6,6%	6,5%
Exch. Rate ($)	10420	11850	13394	13304	13379	13757	13771	13891	13950
Structural									
Trade/GDP (%)	39%	39%	33%	29%	31%	33%	33%	32%	31%
Oil price (Brent)	$109	$99	$52	$44	$54	$71	$70	$67	$68
Balance of Payments (US$ bil)									
Export of goods	182 089	175 293	149 123	144 470	168 888	188 152	206 475	218 666	231 892
Imports of goods	176 256	168 311	135 076	129 152	149 995	170 756	183 186	195 417	205 043
Other:	-34 942	-34 492	-31 567	-32 270	-36 186	-37 403	-42 762	-44 375	-49 579
Current account ($ mill	**-29 109**	**-27 510**	**-17 520**	**-16 952**	**-17 293**	**-20 007**	**-19 473**	**-21 126**	**-22 730**
(% of GDP)	-3,2%	-3,1%	-2,0%	-1,8%	-1,7%	-1,9%	-1,7%	-1,7%	-1,6%
FDI	12 170	14 734	10 704	16 136	20 151	22 194	23 871	25 660	27 505
Loan repayments	-33 741	-52 818	-45 162	-57 213	-63 942	-68 015	-68 642	-69 226	-69 699
Net other capital flows	37 895	64 670	59 784	62 060	80 022	80 731	75 799	79 243	80 692
Balance of payments	**-12 785**	**-924**	**7 806**	**4 031**	**18 938**	**14 904**	**11 556**	**14 551**	**15 769**
External debt and liquidity									
Reserves	96 144	105 162	103 950	109 193	122 888	124 097	134 444	138 648	150 213
Total debt	260 706	287 647	304 424	323 643	341 070	354 558	358 489	361 894	364 643
o/w short term debt	44 364	45 086	41 272	40 427	46 451	49 580	50 095	50 692	51 053

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

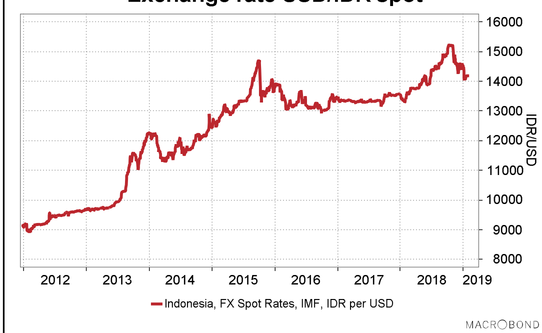
Rating history						
Fitch (eoy)	BB	BB+	BBB-	BBB-	BBB-	BBB
Moody's	Ba2	Ba2	Ba1	Baa3	Baa3	Baa2

Type of government: Presidential Democracy
Next elections 2024
Other:
Latest PC deal 2005
Latest IMF arrangement 2003 SBA

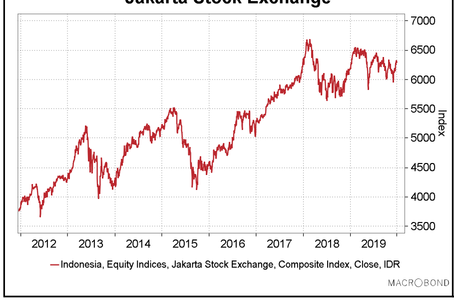
Foreign Reserves



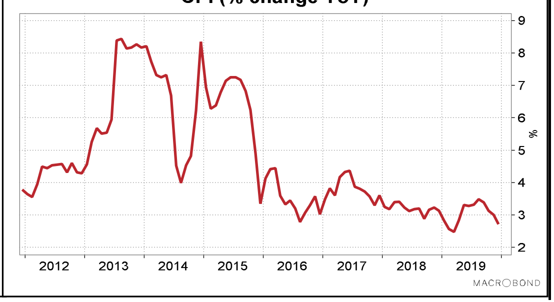
Exchange rate USD/IDR spot



Jakarta Stock Exchange



CPI (% change YoY)



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