COUNTRY RISK ANALYSIS

Indonesia

CREATING CONFIDENCE IN YOUR EXPORTS

COUNTRY RISK CATEGORY

3/7

The country risk categories range from 0 to 7. The lower number the better the credit rating of the country.

0 1 2 3 4 5 6 7

EKN'S POLICY

Sovereign risks: Standard risk assessment

Other public risks: Restrictive risk assessment

Bank risks: Standard risk assessment

Corporate risks: Restrictive risk assessment

See also "EKN'S POLICY" section

EKN'S OUTSTANDING GUARANTEES ON THE COUNTRY

Short-term transactions: SEK 89 million

Medium and long-term transactions: SEK 2972 million

DATE

24/10/2013

Economic slowdown ahead of the 2014 elections

Growth is slowing as the government has been compelled to tighten its economic policy in order to curb increasing external imbalances. During the good times, the pace of reform has been slow, and the country is now paying the price. With a growing exposure to volatile capital and commodity prices, Indonesia, like many other emerging markets with external deficits, has been affected by capital outflows and falling exchange rates. The country's external position has weakened, credit risks regarding currency-exposed companies are expected to increase and there is a certain risk of new financial turmoil. However, Indonesia has a resilient economy, a relatively sound banking system and moderate public and external debt. The country also has a history of being able to pursue coordinated macro policies in tight situations, and the ongoing austerity measures are expected to contribute to the stabilisation. The country's long-term growth potential remains strong. However, it is uncertain at what rate the country's leadership beyond the presidential and parliamentary elections in 2014 will be able to push through the improvements to the business climate and infrastructure that are required for the economy to achieve sustained higher growth levels.

STRENGTHS

- A cautious fiscal policy has led to low public debt
- Good long-term growth potential and relatively high resilience in the economy
- Manageable external debt
- A relatively healthy banking sector

WEAKNESSES

- Exposure to volatile capital flows and the commodity price cycle
- Difficult reform climate inhibits structural changes
- A weak business environment and neglected infrastructure

POLITICS

Reforms have lost momentum in the lead-up to the 2014 presidential election

The political stabilisation process in multi-ethnic and multi-religious Indonesia has continued during President Yudhoyono's two terms of office, which are coming to an end (2005-2014). Two peaceful presidential elections have been held, as well as regional and parliamentary elections. With a freedom of the press and expression that is one of the most liberal in the region, a civil society has emerged, which, in combination with an active anti-corruption authority, results in increased monitoring of the government. The peace process in Aceh has been successful, as has the security services' efforts to reduce the terrorist threat. The poverty rate has dropped, as has the proportion of unemployed and underemployed and an urban middle class has begun to emerge. Living conditions have improved for much of the population, particularly with the buoyant economy in recent years.

Indonesia needs the strong growth to continue in order to avoid creating fertile ground for social tensions. The increase in prosperity is relatively vulnerable, as a large proportion of the population is just above the poverty line while income inequality has increased. Growth in labour-intensive industry and service sectors is needed in order to be able to employ the young population and realise the growth potential in a situation where over half of the population is under 30.

Reforms are required for a long-term increase in the growth, but the political reform climate remains difficult. Reforms have lost momentum in the last two years. With a sprawling coalition at the helm, powerful vested interests within the bureaucracy, military and business elite have undermined the reform elements within the administration. The lack of progress is testimony to the difficulties in enforcing politically sensitive reforms in areas such as the overgrown state apparatus and the corruption affected judiciary and in eliminating costly energy subsidies in favour of productive investments. Instead, policies have been increasingly influenced by the upcoming parliamentary and presidential elections (April and July 2014). The President's support party has been torn by a series of corruption scandals and the President appears to prefer an expansionary growth policy to strengthen the position of his allies in the lead-up to the elections.

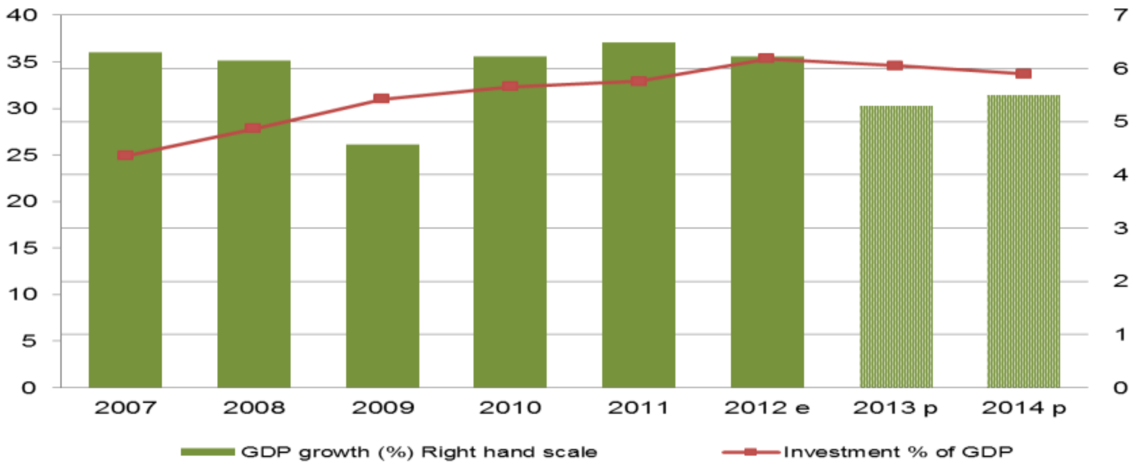
The line-up for the presidential election will probably not become clear until spring 2014. Judging by the opinion polls, voters appear disillusioned with the establishment, which has figured in a series of corruption scandals and delivered relatively few reforms in recent years. There is a worrying tendency towards nationalistic populism, which is leading to regulation that inhibits trade and investment. There is still some hope that a reform-oriented candidate may emerge. However, it is likely that the political system will continue to generate unruly coalitions with powerful vested interests to manage. Consequently, the direction of relatively sound macroeconomic policies is expected to continue, but the difficult reform climate means that the pace of structural reform will remain slow.

ECONOMY

The economy is slowing

A swelling current account deficit has arisen from overheating and a decline in prices of the major commodity exports. This development coincides with the global financial turmoil, particularly related to the uncertainty surrounding the U.S. monetary policy. The result has been large capital outflows and a significant weakening of the currency. The government has been forced to abandon its expansionary macro policy, in the face of high credit growth and a swelling subsidy bill. The monetary policy has been tightened considerably since June 2013. The government pushed through a revised budget with a long-discussed increase in fuel prices. This reduces the subsidy bill and allows scope for investments. The government's corrective measures also include measures to temporarily remove obstacles to exports of unprocessed metals that were recently introduced. The package also includes reinvention of earlier promises to review the restrictions that hinder foreign investment in a range of sectors. The policy has thus been adjusted to a less favourable external environment. The risk of financial turmoil persists and the political situation ahead of the elections could hamper the ability of the administration to take the steps that may be needed then. However, the weakening of the currency and austerity measures are expected to help reduce the macro imbalances. This will take place at the cost of slowing growth, which will fall from just over six per cent to around five per cent in the next few years.

GDP GROWTH AND INVESTMENTS



Growth and investment are slowing down as financial turmoil has forced a tightening of the macroeconomic policy. Data: IMF

The trend shows that macro stability cannot be taken for granted. During the good times, the pace of reform has been slow, and the country is now paying the price. Relatively underdeveloped domestic financial markets expose the country to volatile capital flows. In addition, an increased focus on exports of commodities is exposing the country to cyclical commodity prices and the now more uncertain growth outlook for China.

Strong long-term growth potential remains

The trend is not expected to lead to macro instability of such magnitude that the country's long-term growth prospects would be in serious jeopardy. Despite everything, the economy is fairly resilient to external shocks, with a moderate export orientation and a large domestic market. With a growing middle class, consumption is expected to remain a growth engine in the long term. Investment levels have also increased in recent years. In addition to the country's major potential in the area of commodities, the domestic market is also proving attractive. This has led to the manufacturing sector showing signs of life after years of stagnation. Furthermore, policy makers have a track record of pursuing coordinated macro policies in tight situations. The banking industry is relatively healthy, as are public finances. The budget deficit is small and public debt has been reduced to about 25 per cent of GDP. The remaining weaknesses in public finances are a relatively low level of income and large current spending, particularly on energy subsidies, which still exceeds investment expenditure. Large investment needs mean that a further reduction of public debt. Nevertheless, the improvement in public finances is expected to be long-term.

Bottlenecks need attention

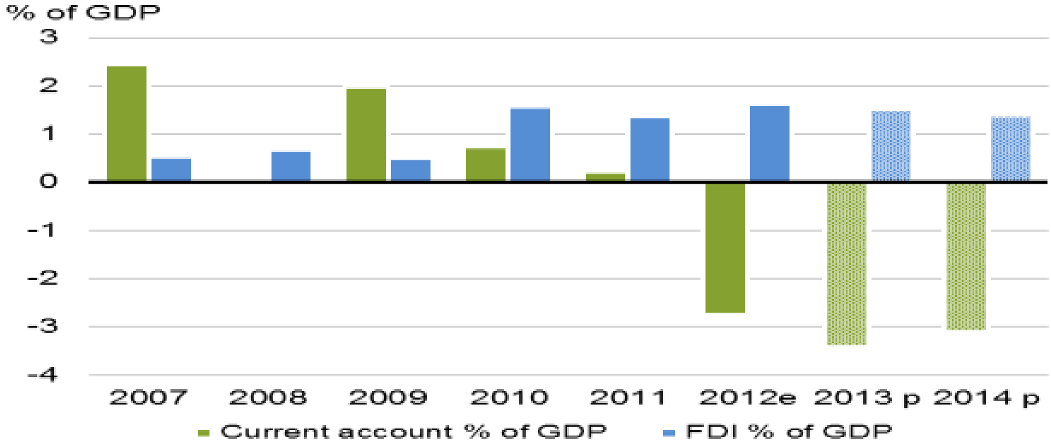
To achieve sustainable growth rates of 6 to 7 per cent, the next government will have to be able to remedy a number of structural deficiencies. These include uncertainty about the predictability of regulations, due to a lack of coordination between different parts of the administration, a nationalistic current in policy, corruption and a weak judicial system. The uncertainty is fuelled by the diversity of local rules emanating from the decentralisation process. Over the past decade, the situation has resulted in declining investment, primarily in the mining, oil and gas sectors. The neglected infrastructure is another bottleneck. Implementation of the ambitious infrastructure plan launched in 2011 is progressing, albeit slowly. Investment allocations are increasing, several projects have been initiated and new legislation is expected to eventually facilitate land acquisition for public projects. However, given the structural and political obstacles to reform, a significantly improved investment climate may only be achieved in the long term.

BALANCE OF PAYMENTS AND DEBT ISSUES

Weakened external position but stabilisation is likely

A current account deficit has arisen, which is expected to grow to just over 3 per cent of GDP in 2013. The deficit is partly structural in nature and is the anticipated result of strong domestic demand, a large investment need and increasing repatriation of profits from foreign investments. However, the deficit is worsened by the commodity cycle. Over the past decade exports have become more commodity-oriented (60 per cent of exports). While the manufacturing sector has been weak, the production capacity for coal, palm oil and rubber has expanded significantly and now exceeds oil and gas exports. With the slowdown in China and India, prices have fallen sharply. In addition, domestic overheating has driven imports. With uncertain prospects for commodity prices, domestic demand must be dampened. The austerity policies are expected to help reduce the deficit to more sustainable levels.

CURRENT ACCOUNT BALANCE AND FDI



The current account deficit has increased. The reduced capital flows are then adding to the pressure on the exchange rate and international reserves. Data: Bank of Indonesia and forecasts based on the IMF and a number of commercial banks and analysis institutes.

The deficit is increasing dependence on external funding, while the funding situation has deteriorated. This has resulted in a balance of payments deficit in 2013. Foreign direct investment has been dampened in the lead-up to the 2014 presidential elections. In addition, large volumes of capital have flowed out in response to the global financial turmoil during 2013. The risk of new outflows remains.

Foreign holdings of domestic government bonds amount to USD 29 billion (September 2013). In addition, there are long-term investments in the equity market at far greater amounts. To avoid any further erosion of international reserves, the central bank appears likely to reduce its interventions in the foreign exchange market. In September 2013, the reserves had declined to USD 92 billion (108 billion in December 2012). This still corresponds to about 100 per cent of the 2014 funding needs in terms of current account deficit and maturing debt. If the situation gets worse, the country should be able to access IMF support and currency swaps with countries in the region. Based on experience from the global financial crisis of 2009, it is expected that the magnitude of new outflows should be manageable. The authorities' resolute actions are expected to reduce the risk of large capital outflows and contribute to a stronger funding situation. Consequently, it is expected that large balance of payments deficits can be avoided in the next few years.

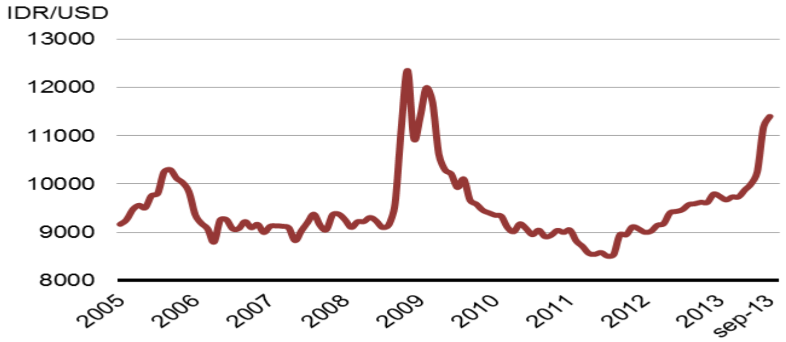
While Indonesia's external debt burden has ceased to diminish, it is now at manageable levels. Public external debt is low and mostly long-term. Private sector external debt has increased significantly in recent years, but the level in itself is not alarming. Almost 90 percent of private sector external debt is denominated in USD. With approx. USD 40 billion due within one year individual companies may find themselves in a stressful situation, particularly in the event of renewed financial turmoil and if currency depreciation takes off again.

CURRENCY POLICY

Large currency fluctuations

The rupiah (IDR) follows a *"managed float"* and the inflation target (3.5–5.5 per cent in 2013) is the anchor of the monetary policy. Historically, the currency has gone through several periods of turbulence. This is explained by the relatively free capital flows, exposure to volatile capital and a sometimes fragile confidence in the authorities' ability to curb inflation. The currency has weakened by 15 per cent against the US dollar since 2012. The central bank now appears to take the view that a weaker currency is necessary to curb external deficits. It is likely that the currency will stabilise at approx. IDR/USD 10,000 – 12,000 over the next year. The risk of renewed currency instability remains. The experience of the Asian crisis, when the country refrained from exchange controls for the private sector, means that transfer risk is considered low.

CURRENCY TRENDS



The currency is among the hardest affected by the financial turmoil that has shaken a number of emerging markets in 2013. Data: Bank of Indonesia

The currency is convertible for current account transactions, i.e., trade in goods and services. Although capital flows are relatively liberalised, the currency is not fully convertible. A system of capital controls is in place and the currency may not be transferred outside the country. There are documentation and authorisation requirements for currency conversion. EKN does not have any experience in guaranteeing transactions in local currency.

FINANCIAL SECTOR

Well-prepared banking system

The financial system is dominated by the banks, whose assets represent 75 per cent of the financial sector and correspond to 52 per cent of GDP in 2102. The size of the rest of the financial sector, such as the money market, pension savings and the corporate bond market, is small, also in comparison with a number of other emerging markets. A deepening the domestic financial markets is in progress. This may eventually reduce Indonesia's dependence on external capital for investment and financing, which in our view constitutes a vulnerability factor in the current situation.

The banking system has been strengthened over the past decade. A fairly liberal attitude towards foreign ownership has attracted investment, thereby raising the industry standard. Partial privatisation and other reforms have strengthened the state banks. A deposit protection scheme has been introduced, together with more stringent capital and reserve requirements, which are largely in line with Basel II.

Out of the country's 120 banks the ten largest account for just over 60 per cent of the system's assets. Four state-owned banks account for 35 per cent of these assets. There is limited reliance on external funding. Profitability is good. Capitalisation is adequate, as are provisions for non-performing loans, which are low (under 2 per cent of total loans). At the same time, there are a number of trends that should be monitored. Annual credit expansion has exceeded 20 per cent during the period 2007-2012 while the system's liquidity has declined. The property sector has shown some signs of overheating, while business lending in foreign currency has increased (16 per cent of loans in 2012). Overall, private sector debt is moderate, but growing. Some deterioration in the banks' asset quality is to be expected in light of the weaker macro environment, although overall the banking system is appears stable.

The credit environment and corruption represent structural deficiencies in the area of supervision. The transfer of banking supervision from the central bank to a new financial authority (OJK) entails certain risks in the transition phase. Politicisation in the aftermath of the bailout of a small bank in 2008 raises some uncertainty about the authorities’ willingness to support smaller banks in the event of distress. As far as EKN is concerned, most of the country's 10 large banks are acceptable, but risk assessment is restrictive for smaller banks.

BUSINESS ENVIRONMENT

Continuing weaknesses in the business environment

The economic situation with slowing growth, currency depreciation, rising interest rates and more cautious lending is giving rise to a more difficult macro environment for the corporate sector. This means that increasing credit risks are likely in certain quarters. Particularly exposed companies are those with high debt, especially if it is dominated by foreign currency while earnings are in domestic currency. Companies with a high import content but low export earnings may also be exposed. Mining companies are affected by declining commodity prices. Corporate sector debt levels have increased in recent years, particularly in the property, mining and telecom sectors, but are generally moderate.

Assessments of individual business risks should take into account the difficult business and credit environment. The gradual progress that can be noted is mainly due to improved regulations rather than practical implementation. Success in fighting corruption is largely seen at central level and in high public profile cases, while corruption within the state apparatus and the judiciary remains widespread.

Financial reporting requirements for listed companies and banks have been strengthened. The local standard (PSAK) is increasingly approaching the international standards (IFRS). In reality, the audit sector is weak and there is a lack of adequate transparency, with the exception of listed companies. The majority of companies outside Jakarta are not formally registered and therefore do not need to report even basic information. It also makes it difficult to identify related companies and stakeholders. The phenomena of ownership concentration, non-transparent corporate structures and family-owned conglomerates have diminished over time but are far from gone.

The regulatory environment is difficult. Laws and regulations are frequently overlapping and are sometimes contradictory. In addition, there is a tendency of changing interpretation of regulations and overlapping authority responsibility. There is a lack of centralised coordination and supervision of issued laws, even though initiatives to revise and rationalise the legislation are in progress. At times, the nationalist tendencies of the policies result in sudden amendments to regulations that change the conditions for foreign investment and ownership in sectors such as finance, telecom and natural resources. The decentralisation process means that local authorities can have considerable influence on the regulations. Corruption also inhibits equal application of regulations.

Sweden has a bilateral investment treaty with Indonesia and the country has acceded to the New York Convention *(The Convention on the Recognition and Enforcement of Foreign Arbitral Awards)*. This has a positive effect on companies' ability to insure investments with EKN's investment guarantees.

The legal environment has considerable deficiencies. Civil law is based on Dutch law from the colonial era, although it has undergone a number of updates and improvements over the past decade. These include an improved bankruptcy law (2004), which in itself is considered creditor-friendly. There is also legislation governing movable assets as collateral (Fiduciary Security Law 1999). However, application of the laws is uneven and the efficiency and reliability of the judiciary is generally low. The courts tend to come out on the side of the debtors, especially the country's elite. The Bankruptcy institute is rarely used and creditors tend to prefer settlements outside the court system. According to the World Bank's *Doing Business Indicators*, Indonesia has one of the region's lowest recovery rates (below 15 per cent of the claim), as well as high costs and lengthy processes for pursuing insolvency cases through the judicial system. This situation makes it difficult to enforce payment, foreclosure and insolvency proceedings. In the case of default, there is a risk of the final losses becoming high.

EKN'S EXPOSURE

Telecom dominates the exposure

EKN's exposure amounts to SEK 3.6 billion, of which 3.4 billion relates to outstanding offers and guarantees and SEK 117 million to Paris Club claims dating from the Asian crisis in the late 1990s. Telecom accounts for 80 per cent of the offers and guarantees. Other exposure includes supplies to the transport and power sector. Highly favourable financing conditions for the major telecom operators in recent years have reduced demand for EKN's cover. Indonesia has fallen from EKN's 10th largest exposure to 17th largest since spring 2012. There are some signs of growing demand from areas such as the power sector and mining and construction transactions. A slight deterioration in the financing environment could also boost demand.

EXPOSURE AT 31 DECEMBER, MSEK

The increased demand in telecom during the financial crisis has slowed and the exposure has decreased. Source: EKN

PAYMENT EXPERIENCE

EKN's payment experience in recent years has been relatively good, although several cases of payment problems among debtor companies can be noted over a longer period. EKN has issued guarantees totalling just under SEK 11 billion since 2003, 80 per cent of which relate to the telecom sector. Other guarantees include supplies of vehicles and construction machinery, which amount to approx. 10 per cent. A few payment arrears have occurred in individual transactions, but these have been subsequently paid. In a few transactions, EKN has contributed to reconstructions of payment plans. However, there are no indemnifications attributable to this period to report.

A little further back in time, EKN had significantly worse payment experiences with regard to corporate risks. These were partly due to the after-effects of the Asian crisis of 1997-1998, as well as a difficult credit climate with a weak judicial system. EKN settled considerable claims for transactions from this period during the 2000s. There were also attempts to obtain foreclosure through the courts – but without success.

EKN'S POLICY

EKN upgraded Indonesia to country risk category three from four in April 2012. This was in line with the assessment made in collaboration with other OECD countries. Indonesia, whose political and economic systems were badly affected by the Asian crisis in the late 1990s, began the 2000s in category seven, which is the highest risk category. With the positive trend over the past decade, EKN has successively upgraded the country risk category since 2002.

For transactions with banks, EKN does not have any specific general restrictions; instead, each transaction is assessed on its own merits. This applies whether the transaction has a short credit term (under one year) or a longer term. The same applies to transactions with central state debtors, such as the central bank or finance ministry.

The policy includes certain restrictions on other public purchasers (sub sovereigns such as other ministries or local governments) as well as companies. EKN normally requires government or bank guarantees for transactions with other public buyers. EKN's more restrictive approach is motivated by the difficulty in assessing authorities' ability to fulfil current contracts and the fact that Indonesian regulations do not normally allow local governments to take loans from foreign creditors.

For corporate risks, EKN applies a somewhat restrictive risk assessment of transactions, with particular consideration of the quality of the financial information and the buyer's currency exposure. This is due to the difficult business environment and the sometimes significant currency fluctuations.

OFFICIAL COUNTRY DATA AND CREDIT RATINGS

OFFICIAL COUNTRY DATA

Area: 1919 km² (4 times Sweden)

Population: 246.9 million (2012)

Population growth: 1.3 % (2008-2012)

GDP: USD 878 billion, 2012 (Sweden USD 525.7 billion, 2012)

GDP/capita: USD 3,420, 2012 (Sweden USD 56,210, 2012)

CREDIT RATING

	COUNTRY CEILING	SOVEREIGN RATING
Moody's:	Baa2	Baa3
S&P:	BBB-	BB+
Fitch:	BBB	BBB-

COUNTRY ANALYST

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DISCLAIMER

The country analysis is based on a range of sources and reflects information that is relevant to EKN at the time of publication. The responsibility for how the informa ion is used or interpreted rests solely with the user, and EKN cannot be held responsible for any loss or damages.

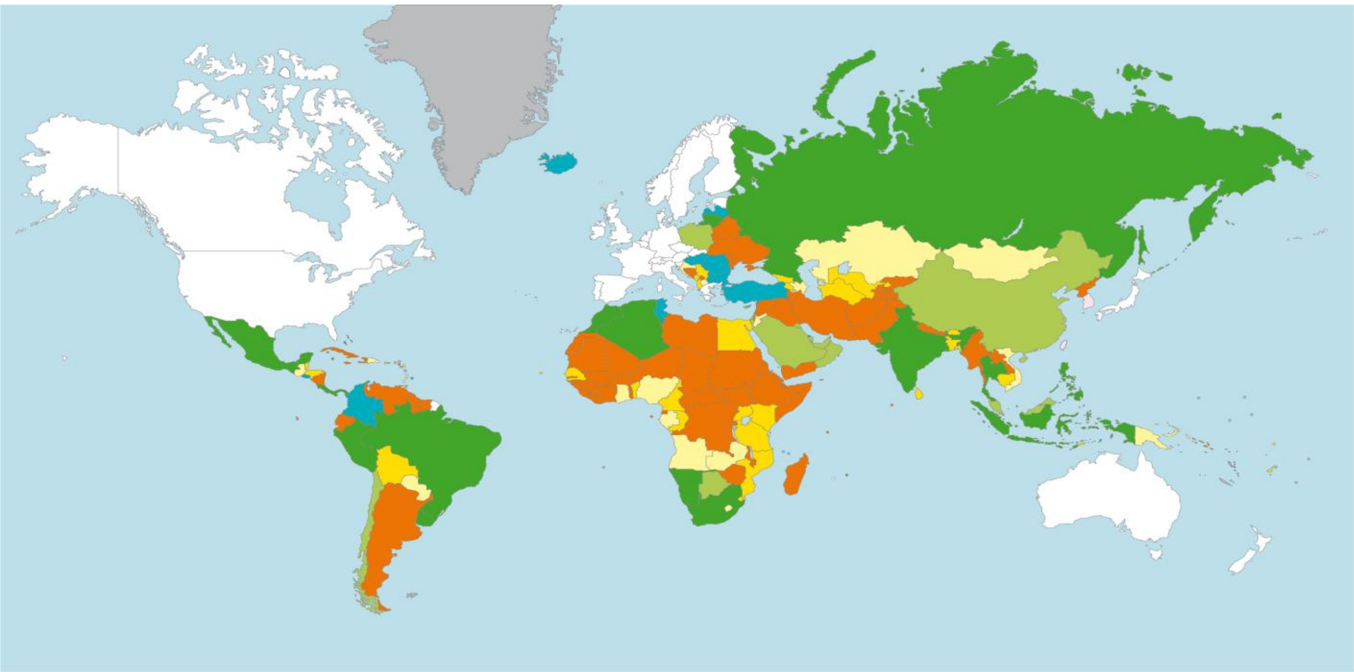
COUNTRY RISK ANALYSIS

Indonesia

DATE

24/10/2013

EKN'S VIEW OF THE WORLD



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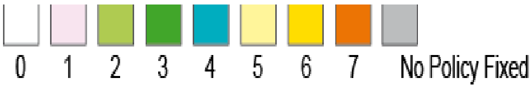

EKN – CREATING CONFIDENCE IN YOUR EXPORTS
EKN is a government agency that supports Swedish exports and the internationalisation of Swedish industry. This we do by offering exporting companies and banks guarantees for payment and financing, together with advice on business structure and risk management. Our services provide an extra level of confidence, increased competitiveness and more opportunities for successful export transactions.

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