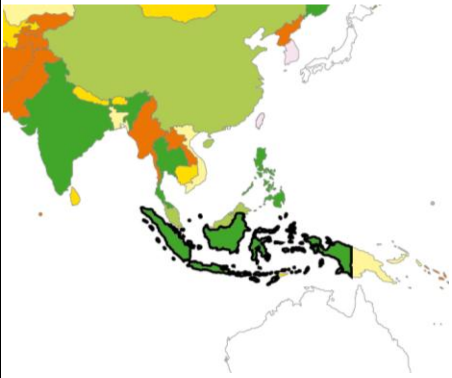
COUNTRY RISK ANALYSIS

Indonesia

CREATING CONFIDENCE IN YOUR EXPORTS



COUNTRY RISK CATEGORY

3/7

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

0 1 2 3 4 5 6 7

EKN'S OUTSTANDING GUARANTEES TO THE COUNTRY

SHORT-TERM TRANSACTIONS: SEK 14 MILLION

MEDIUM AND LONG-TERM TRANSACTIONS: SEK 1748 MILLION

DATE

24 OCTOBER 2014

Economy in adaptation phase as new president takes over

Growth has slowed down as important external drivers of the country's solid growth have begun to ebb away at the same time as the country has tightened its economic policies to stabilise the economy. The current account deficit increases the amount of financing needed from abroad. The fact that a large portion is financed with portfolio investments and other highly volatile forms of capital inflows increases the economy's vulnerability. The country's solvency is solid with a moderate amount of public and external debt. Structural reforms need to start moving forward to create new dynamics and realise the country's growth potential. All indications are that the president-elect Joko Widodo is reform-oriented and is expected to pursue growth-friendly and market-friendly policies. The lack of reforms in recent years is however a testament to the challenges. A confrontational opposition has the majority in the current fragmented parliamentary situation. It thus remains to be seen how strong the new government can be. It is projected that the country will stay the course in terms of economic policy with conservative macro-economic policies and solid reform ambitions, while the pace of reform risks being held back by political factors.

THE COUNTRY'S STRENGTHS AND WEAKNESSES

Strengths

- Long-term solid growth potential and relatively strong resilience in the economy
- Conservative fiscal policies have led to low public debt
- Moderate external debt

Weaknesses

- Underdeveloped financial markets and external deficits expose the economy to highly volatile capital
- Commodity-oriented exports expose the economy to the commodity price cycle
- Difficult reform climate getting in the way of structural improvements to a weak business environment and deficient infrastructure

EKN'S POLICY

EKN has placed Indonesia in country risk category 3. This is in line with the assessment undertaken in collaboration with the other OECD countries. For transactions with sovereign debtors, such as the central bank or the ministry of finance, and with banks, each transaction is assessed on its own merits. With respect to other public buyers, EKN normally seeks government or bank guarantees. This is justified by the difficulty in assessing the ability of authorities to fulfil contracts entered into, and Indonesian regulations usually do not allow local government to take out foreign loans. EKN also has a restrictive risk assessment policy for corporate risks. This is due to the difficult business environment and the periodically significant currency fluctuations.

WHAT MIGHT CAUSE A CHANGE IN THE COUNTRY POLICY?

The policy may be made less restrictive in the event of

- Substantial progress in structural reforms, such as in infrastructure and the investment climate, which strengthen the country's growth momentum
- A successful reduction of the current account deficit and a reduction in exposure to highly volatile capital

The policy may be made more restrictive in the event of

- A lack of structural reforms, which leads to a long-term deterioration of the country's growth prospects and public finances
- A substantial deterioration of the balance of payments which undermines the country's financial stability and external ability to pay

EKN'S EXPOSURE AND EXPERIENCE

Declining exposure

EKN's provision of guarantees has declined in recent years. EKN's exposure totals SEK 1.9 billion. Guarantees account for SEK 1.8 billion, with the rest consisting of offers. EKN has relatively positive experience. Weaknesses in the legal system and other factors in the credit environment are believed to potentially impact the chances of recovering claims.

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 information is used or interpreted rests solely with the user, and EKN cannot be held responsible for any loss or damage.

POLITICS

New president, old challenges

When Joko “Jokowi” Widodo begins his five-year term of office on 20 October, he will be doing so as Indonesia's second popularly elected president. The elections proceeded peacefully, and, in spite of a polarised election campaign, the opposition camp has accepted the constitutional court's ruling on the election results. This year's parliamentary and presidential elections cement the process of stabilisation and democratisation that progressed in the multi-ethnic and multi-religious country since the fall of dictator Soeharto in 1998.

Continued high economic growth is needed to avoid creating a hotbed for social tensions in the long term. In spite of several years in a row with solid growth and a reduction in poverty, the income gaps have increased. In addition, a large part of the population faces an unstable increase in the welfare, as it is just over the poverty line. Annual GDP growth of around 6 per cent is needed to realise the potential from the fact that over half of the population is under 30. Growth is especially needed in the labour-intensive industrial and services sectors to create productive employment for the 2 million people entering the labour force each year. The country's growth prospects have however slowed down and structural reforms need to start moving forward to create new dynamics. The lack of progress in recent years is however a testament to a difficult reform climate. Politically sensitive reforms are needed in areas such as the corruption-riddled legal system and the rampant and decentralised state apparatus, and to free up funds from costly subsidies in favour of productive investments. Resistance from powerful special interests in the bureaucracy, the military and business elite are however making reform efforts difficult. There is thus no shortage of long-term challenges for the new president.

The results of the presidential elections are considered positive. In Jokowi, Indonesia has a reform-oriented president who is expected to go in a pragmatic, growth-friendly and relatively market-friendly direction. It remains to be seen how strong the new government will be. The parliamentary situation is fragmented. The coalition that supported Jokowi's rival holds the majority and has thus far taken a confrontational position. Parts of the opposition may join Jokowi in forming the government and it is not impossible that Jokowi and his vice-president Kallas will eventually manage to patch together a parliamentary majority. The price of a broad coalition risks making the government weaker. The baseline scenario is thus continuity, to the extent that the government stays the course with conservative fiscal and monetary policies and solid reform ambitions, while the rate of reform risks being held back by the political realities.

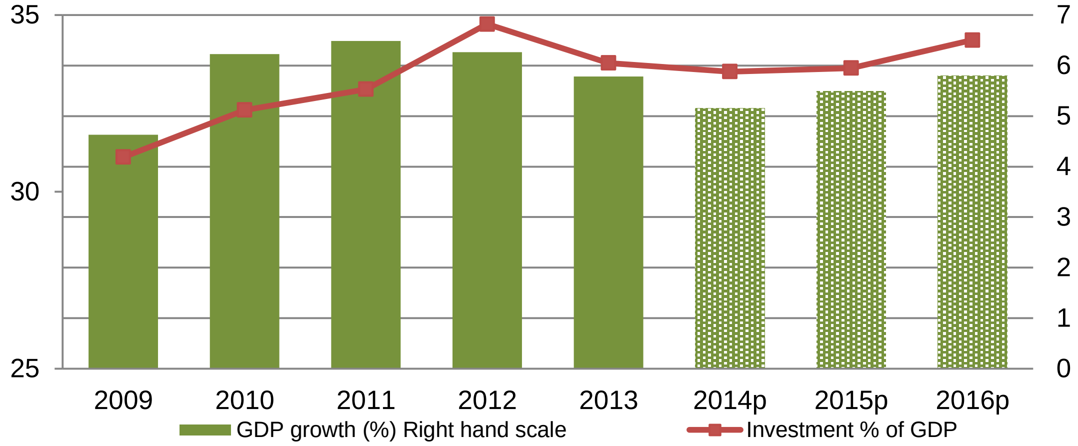
ECONOMY

Macro-economic policies have been adapted to safeguard economic stability

The new administration takes over the reins of an economy that appears to be heading for a soft landing. Overheating tendencies, growing external imbalances and large capital outflows in the spring of 2013 forced the previously expansionary economic policies to be made more restrictive. The central bank has acted especially forcefully. It made its monetary policies significantly more restrictive and, after some hesitation, allowed the currency to fall sharply against the US dollar. There is a certain degree of risk of renewed capital outflows and currency turbulence. One positive thing is that the authorities have once again demonstrated their ability to act in a coordinated manner under pressure and that there is readiness for new austerity. In this context it is a strenght that the public finances are in relatively good shape. Large investment needs and weak revenues result in the public debt burden no longer falling, but it is low, at just over 25 per cent of GDP. The country's history of limited budget deficits, which by law may not exceed 3 per cent of GDP, also strengthens the credibility of the country's fiscal policies.

Partially as a result of the crisis measures taken over the past year, the imbalances are beginning to subside. The price of this is that growth is slowing down to lower, but more sustainable levels, around 5 per cent in the coming years.

GDP GROWTH AND INVESTMENTS



Growth is slowing down as economic policies are being adapted to less favourable external conditions
Source: IMF

The development has exposed weaknesses in the economy. Key factors behind the previously strong growth, which periodically exceeded 6 per cent per year, included a protracted increase in commodity prices and solid access to international capital. This has contributed to a substantial increase in domestic demand. Progress in upgrading the country's deficient infrastructure and improving its weak business climate is far less impressive. Nationalistic political currents have resulted in a changing and uncertain regulatory environment for foreign investors, especially in the mining sector. Now that the external drivers are ebbing away, efforts on the reform front are needed to be able to return to a sustainably higher growth rate in the long term.

The country has good long-term growth potential

The country's economy has significant potential in the long term. Indonesia is Asia's fifth-largest economy. With a moderate export orientation and a large domestic market, the economy is relatively resistant. With a growing middle class with low debt, consumption is expected to remain an engine of growth in the long term. Furthermore, investment levels have increased in recent years. In addition to the country's great potential in commodities, its domestic market is attractive. This has led to renewed awakening in the manufacturing industry, which has been stagnant for a long time. With rising wages in China, the prospects for a more export-oriented industrial sector may once again be getting brighter. In addition, the country's demographic profile and high rate of urbanisation contributes to the growth potential, under the right conditions.

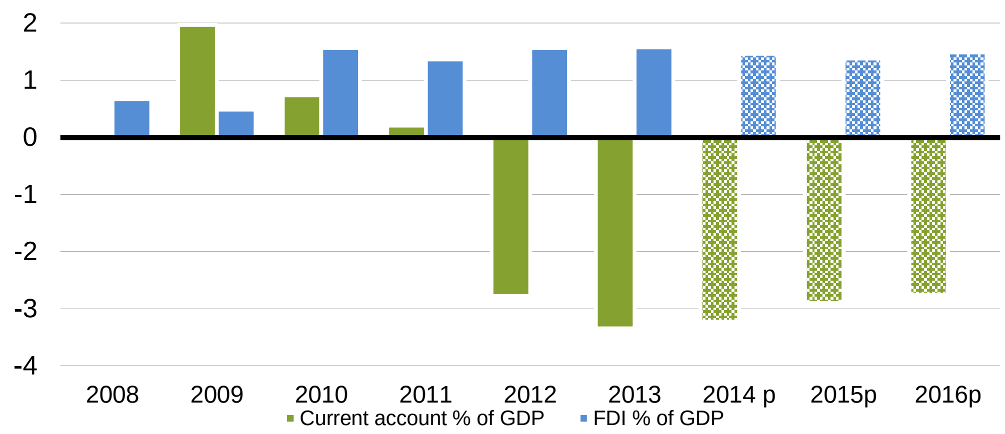
It is therefore promising that the president-elect has announced plans going in the right direction, such as administrative reforms designed to strengthen both national revenues and governance of the state apparatus. Additionally, the fuel subsidies will gradually be phased out over the coming five years. In recent years, they have amounted to over 2 per cent of GDP, or one-fifth of budget expenditure. Substantial amounts could thus be freed up for investments in social and physical infrastructure, which are currently budgeted at lower amounts than the subsidies. Moreover, a recurring problem with inflation, the budget and the balance of payments would be removed if Jokowi succeeds with this politically sensitive reform. The government's ability to implement structural reforms will partially depend on the extent to which the government succeeds in mobilising parliamentary support for its policies. It is highly likely that the reform policies will go in the right directions, but that the rate of the reforms will remain variable.

BALANCE OF PAYMENTS AND DEBT ISSUES

Increased amount of financing needed creates increasing vulnerability

The current account deficit the country has been running since the autumn of 2011 is partially of a structural nature and is the result of an increase in domestic demand and profits repatriated from foreign investments. The deficit is however growing due to falling commodity prices. Exports have become more commodity-oriented over the past decade (53% of exports in 2013). While the manufacturing industry has performed poorly, the production capacity for coal, palm oil and rubber has been greatly expanded and is now greater than oil and gas exports. The slowdown in China has resulted in the prices of Indonesian commodities falling steadily since 2011. There is no major increase in the cards in the coming years. In addition, metal exports have fallen in the past year. This is due to new regulations implemented in January 2014, which are designed to reduce exports of unrefined metals and in the long term increase the domestic rate of refinement. In part as a result of the austerity policies and the weakened currency, the deficit is also gradually decreasing to more sustainable levels just below 3 per cent of GDP for the coming years.

BALANCE OF PAYMENTS AND DIRECT INVESTMENT (% OF GDP)



The balance of payments is running a deficit. Over half is financed by more volatile capital inflows.
Source: Bank of Indonesia. EKN's forecast based on the IMF as well as commercial banks and analysis centres.

The deficits result in an estimated financing need, including loans falling due during the year, of around USD 80 billion per year for 2014-2015. More stable capital inflows in the form of direct investment has shown a positive trend and is expected to gradually increase in the future. This covers nearly half of the amount of financing needed. The economy is thus dependent on potentially more volatile financing flows. In 2014, the large outflows of portfolio capital changed into record-high inflows. Over 35 per cent of domestic government securities are held by foreign investors, which is equal to over USD 35 billion. The financing situation is estimated to have increased the vulnerability of Indonesia's balance of payments.

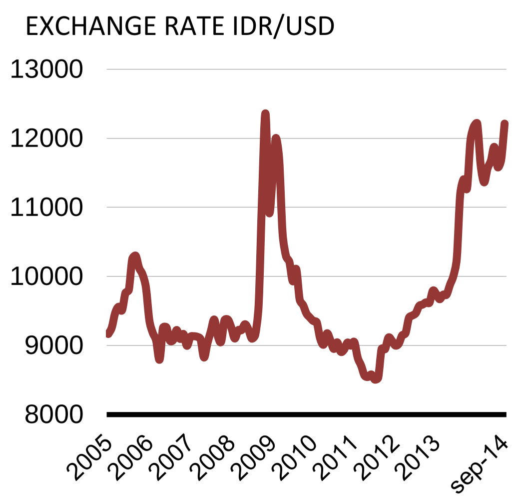
There is thus a certain degree of risk of new capital outflows and currency turbulence, especially as the volatility of capital flows to emerging markets has increased in recent years. Experiences from the 2009 financial crisis and the currency turbulence of 2013 indicate that the extent of any new outflows will be manageable. The central bank has signalled its readiness to once again raise interest rates and let the currency float. In addition, the recent inflows have allowed the re-accumulation of the international reserves, which were USD 111 billion in August. This is equal to 120 per cent of the external financing needed in 2015, which is considered a relatively good buffer. If the situation gets worse, the country has access to currency swaps with several countries in the region. Overall, the resolute action of the authorities and the reaccumulation of the international reserves reduce the risk of a serious balance of payments crisis in the coming years.

The country's external debt burden is no longer going down, but it is at manageable levels (34% of GDP). Public external debt is limited (14% of GDP) and mostly long term. Private sector debt has increased significantly in recent years, but the current level is not alarming per se. Over USD 40 billion is however due within one year. Individual companies could thus wind up in a tight situation in the event of new financial turbulence.

CURRENCY POLICY

A weakened currency

The rupee (IDR) is on a managed float and the inflation target (3–5% in 2015) is the anchor of the country's monetary policies. Historically, the currency has gone through several periods of turbulence. This can be explained by the relatively free capital flows, substantial exposure to highly volatile capital and periodically fragile confidence in the ability of the authorities to manage inflation.



Source: Bank of Indonesia

The central bank seems to be of the opinion that a weaker currency is necessary to reduce the external deficits. Since the currency turbulence in 2013, the currency has weakened by around 20 per cent against the US dollar. External factors, such as rising interest rates in the US, and therefore an increase in the divergence between the monetary policies of the euro zone and Japan, create uncertainty surrounding future capital flows, and there is still a risk of new currency turbulence. The baseline scenario is a slight weakening of the exchange rate, in the interval of 11,500–12,500 IDR/USD over the next year. As a result of experiences from the Asia crisis, when the country refrained from implementing currency controls for the private sector, the transfer risk is considered limited.

FINANCIAL SECTOR

Healthy banking system

The financial system is dominated by the banks, which account for over 75 per cent of the system's assets. The extent of the rest of the financial system, such as the money market, pension savings and the corporate bond market, is relatively limited. The domestic financial markets are in the process of strengthening, and this may reduce Indonesia's dependence on external capital for investment and financing in the long term, which is currently considered a weakness.

The banking system is also relatively small in relation to the economy. Assets are equal to 55 per cent of GDP, with loans to the private sector at a relatively low 35 per cent (2013). The system is concentrated, in spite of the large number of banks (120). The ten largest account for over 60 per cent of the system's assets, with four state-owned banks accounting for 40 per cent.

The banking system has been strengthened via reforms over the past decade. Depositor protection has been instituted and a phase-in of the Basel III capital adequacy requirements was initiated in January 2014 and is planned to be fully implemented in 2019. The banks have solid profitability. Dependence on external financing is limited. Capitalisation is adequate and the proportion of non-performing loans is low (below 2 per cent of loans). There are also a couple of trends that should be followed, especially in light of the weakened currency and the external financing issues. The rate of increase of lending has now subsided, but has been high for a long time (over 20 per cent per year from 2007 to 2013), which is why the system's liquidity has fallen. Corporate sector debt, including loans in foreign currencies, is increasing, as well as the exposure of the banks to the property sector. Overall, the level of debt is however moderate, as is the property exposure of the banks (below 15% of loans in July 2014).

The introduction of a ceiling on foreign ownership in the banking system in 2012 is a step back from a more liberal approach and can be expected to reduce interest in new establishments. Corruption serves as a structural deficiency in terms of banking supervision. The transfer of the responsibility for supervision from the central bank to a new government authority (OJK) as of 2014 poses certain risks in the transition phase, especially since the legal framework for crisis management is not yet in place. In light of the politicised aftermath of the bailout of a bank in 2008, the situation gives rise to a certain degree of uncertainty surrounding the willingness of the authorities to support small banks in the event of a problem.

Overall, we may see some degree of deterioration of the asset quality of the banks, but the banking system is considered stable overall. For EKN's part, most of the country's ten leading banks should be acceptable, but EKN's risk assessment policy is restrictive for smaller banks.

Weaknesses in the business environment remain

The economic situation is characterised by lower commodity prices, a weakened currency, rising interest rates and more careful lending. This results in a more difficult macro-economic environment for companies. The level of debt in the corporate sector has increased in recent years. It is therefore likely that credit risks will increase in some instances. Companies with high debt are especially exposed, especially if a large portion of the debt is in foreign currency, but earnings are in the domestic currency. Companies with high import contents, but limited export earnings, are also exposed. Companies with operations related to the mining sector are impacted by the declining commodity prices.

The assessment of individual business risks should take into account that the credit environment is difficult The gradual progress noted is concerned more with the introduction than the practical implementation of stronger regulatory frameworks. Successes in fighting corruption are noted mainly on the central level and in cases with a high public profile, while corruption in the state apparatus and legal system is by all indications widespread. In the IFC's Doing Business rankings, the country comes in 120th place out of 189 places, which is a worse ranking than comparable countries such as Vietnam and the Philippines.

Financial reporting requirements for listed companies and banks have been strengthened. The local standard applicable to public companies (SAK) is approaching the international standard (IFRS). There is however no formal schedule for full convergence with IFRS. An alternative standard (SAK-ETAP) is applicable to unlisted companies, which is considered to provide less transparency. In reality, the audit sector is weak, and, apart from listed companies, adequate transparency is rare. A credit information agency has been operational for some years, but it is not focused on corporate loans. The majority of the companies outside of Jakarta are not formally registered and therefore do not even have to report basic information. This also makes it difficult to identify related companies and stakeholders. The concentration of ownership with non-transparent corporate structures and family-owned conglomerates has decreased, but is far from gone.

The regulatory environment is complicated by several laws and regulations that overlap and partially contradict one another. In addition, there are tendencies toward alternative interpretations of the regulatory framework and overlapping responsibilities of government authorities. There is no central coordination and supervision of laws issued, even though initiatives to overhaul and rationalise legislation are on-going. The decentralisation process is bringing a situation where local government authorities can have major influence on the regulatory framework. Corruption is also hampering the uniform application of regulations. The nationalist political currents are periodically resulting in sudden changes to regulatory frameworks which change the conditions for foreign investments and actions, in sectors such as the financial sector, the telecom sector and natural resources. This is reflected in the fact that the country has fallen in 2013 and 2014 in the FDI Confidence Index (A.T. Kearney) which ranks how attractive countries are for investors.

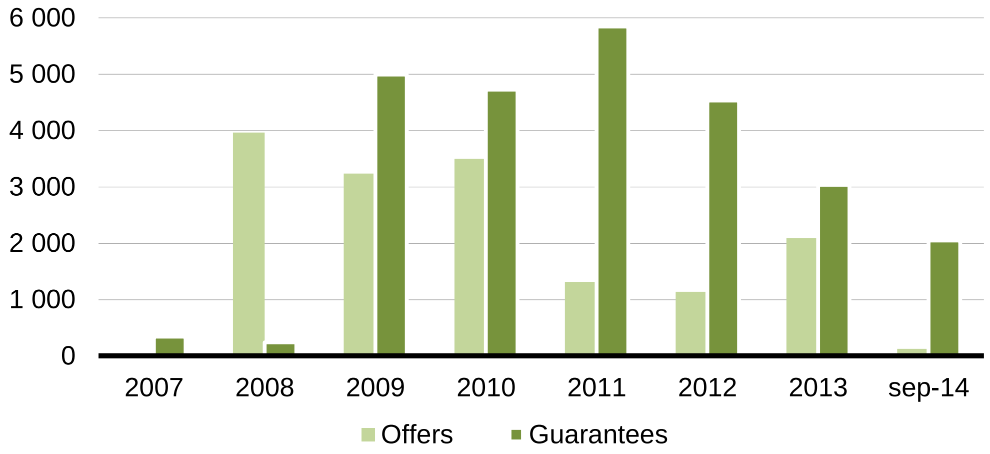
The legal environment has significant deficiencies. The country's civil law is based on Dutch law from the colonial period, but has undergone a series of updates over the past decade. This includes an improved competition law (2004), which is considered friendly to lenders and legal provisions for collateral in current assets (Fiduciary Security Law 1999). The application of the laws is however uneven and the judiciary's efficiency and reliability is generally low. The courts tend to favour debtors, especially the domestic elite. Bankruptcy is rarely used and lenders tend to prefer out-of-court settlements. In the IFC's Doing Business indicators, the rate of recovery of a claim is below 20 per cent, which is lower than the regional average. The indicators also indicate high costs and lengthy proceedings to enforce an insolvency case via the legal system. This situation complicates the ability to enforce payment and bring insolvency proceedings as well as to realise collateral. Final losses could be high in cases of claims.

EKN'S EXPOSURE

Telecom dominating exposure

EKN's exposure totals SEK 2 billion, with guarantees accounting for SEK 1.8 billion and offers accounting for SEK 125 million. In addition, there are SEK 110 million in claims. The majority are Paris Club claims on the government attributable to the Asia crisis in the late 1990s. The telecom sector accounts for the lion share of the exposure, 85 per cent, but transactions to the transport and power sectors are also covered. The financing terms on the market have been favourable for major telecom operators in recent years, which has reduced demand for EKN. Since 2012, Indonesia has fallen from being one of EKN’s top-ten largest exposures to the 22nd. Certain signs of an increase in demand can be seen in the telecom and power sectors. A more difficult financing environment may also increase demand for guarantees from EKN.

EXPOSURE AT 31 DECEMBER SEK MILLION



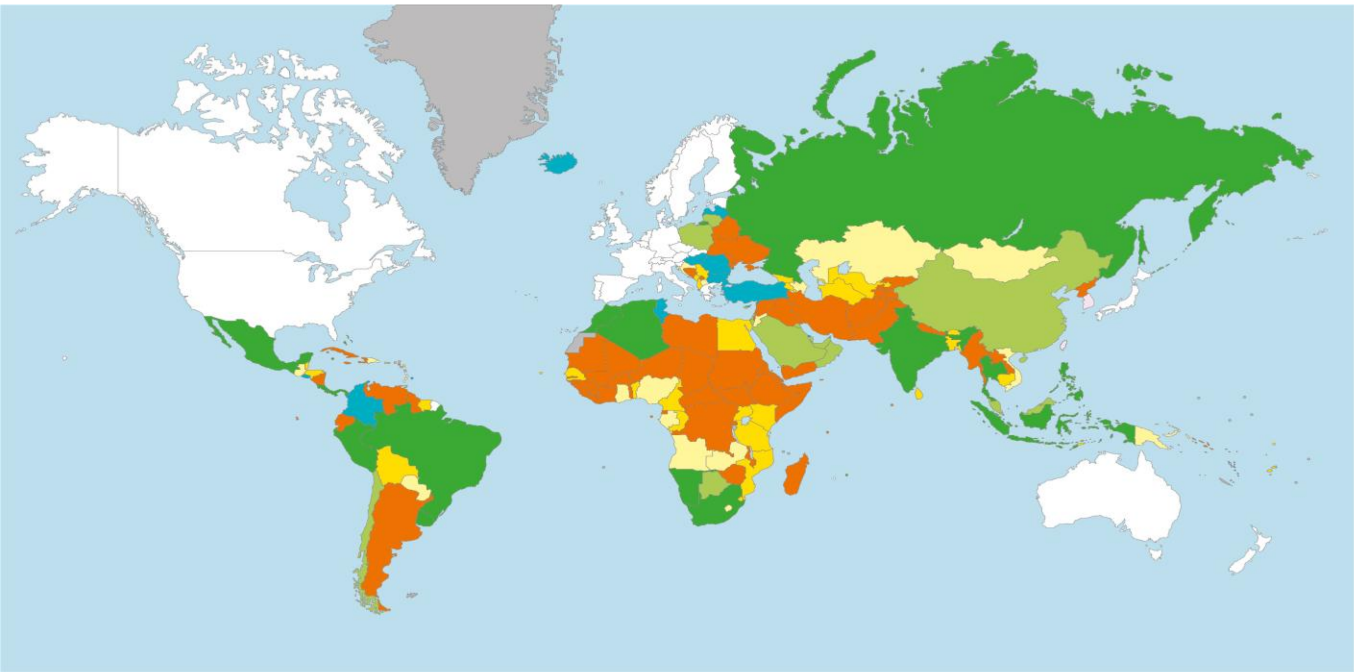
The increased demand during the financial crisis has subsided and EKN's exposure has fallen. Source: EKN

PAYMENT EXPERIENCE

EKN's payment experience has been positive overall, but many cases of payment problems among companies have been noted over a long period of time. Since 2004, EKN has issued guarantees for just below SEK 11 billion, with the telecom sector accounting for 85 per cent of them. Deliveries of vehicles and construction machinery account for ten per cent.

For transactions guaranteed in the same period, EKN has paid out SEK 30 million in claims. EKN has been involved in restructuring payment plans in a couple of transactions. If any general conclusions can be drawn from this experience, it is perhaps that the regulatory environment can be a risk factor in sectors where debtors are exposed, or where the business plans of the debtors are dependent on announced reforms actually being implemented. A little further back in time, EKN had significantly worse payment experience for corporate risks. This partially reflects the after-effects following the 1997-1998 Asia crisis, but also a difficult credit climate with a weak legal system. EKN paid out substantial amounts of indemnification in the 2000s for transactions from this time. There were also attempts to realise collateral in court – but without success.

COUNTRY DATA	CREDIT RATING (COUNTRY CEILING/SOVEREIGN RISK)
Area: 1,919,000 km² (4 times Sweden) **Population:** 250 million (2013) **GDP:** USD 868 billion in 2013 (Sweden USD 558 billion in 2013) **GDP/capita:** USD 3,580 in 2013 (Sweden USD 59,130 in 2013)	**Moody's:** Baa2/Baa3 stable **S&P:** BBB-/BB+ stable **Fitch:** BBB/BBB- stable



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

0 1 2 3 4 5 6 7 No Policy Fixed

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.

The Swedish Export Credits Guarantee Board
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