Euler Hermes Economic Research

Country Risk Analysis

Indonesia

Ongoing depreciation and outflow of foreign exchange reserves raise concern

General Information

GDP	USD878.0 billion (World ranking 16, World Bank 2012)
Population	246.86 million (World ranking 4, World Bank 2012)
Form of state	Republic
Head of government	Susilo Bambang YUDHOYONO
Next elections	2014, presidential and legislative

Strengths

- Relatively good international relations (access to foreign assistance if needed)
- Track record of solid fiscal policies and relatively low public debt
- Banking system has shown overall resilience to the global financial crisis
- Relatively low external debt

Weaknesses

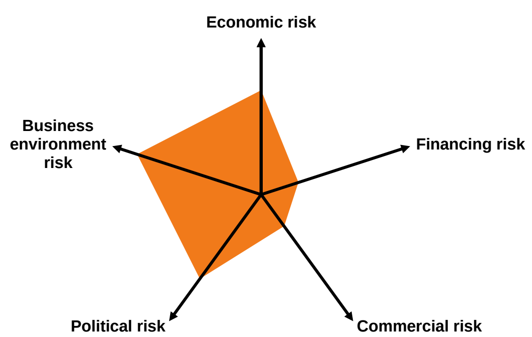
- Ongoing (often violent) social, religious and/or ethnic conflicts in several provinces
- Vulnerability to natural disasters (earthquakes, volcanoes, tsunamis)
- Exchange rate volatility and vulnerability to external shocks
- Vulnerability to (sudden) shifts in investor sentiment towards emerging markets or Indonesia in particular
- Ongoing outflow of foreign exchange reserves since late 2011
- Weaknesses with regard to administrative capacity and efficiency, corruption, the legal system and infrastructure

Country Rating

C3

Country Grade | **Country Risk Level**

Risk Dimensions



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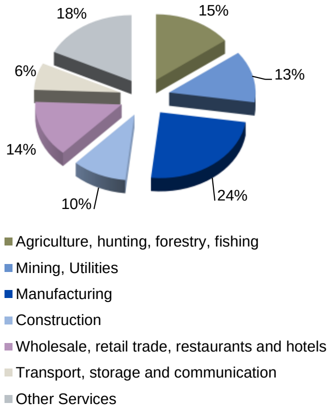
Economic Structure

GDP breakdown (% of total, 2011)



Sources: UnctadStat, Euler Hermes

Trade structure (% of total, 2011)

Exports		Rank		Imports
Japan	17%	1	23%	Singapore
China	11%	2	16%	China
Singapore	9%	3	10%	Japan
United States	8%	4	7%	Korea, Republic of
Korea, Republic of	8%	5	5%	Thailand

Exports		Rank		Imports
Coal, coke and briquettes	13%	1	23%	Petroleum, petroleum products and related materials
Gas, natural and manufactured	11%	2	6%	Electrical machinery, apparatus and appliances, n.e.s.
Fixed vegetable oils and fats, crude, refined or fractionated	10%	3	5%	Iron and steel
Petroleum, petroleum products and related materials	9%	4	5%	Specialised machinery
Crude rubber (including synthetic and reclaimed)	6%	5	5%	Road vehicles

Economic Forecasts

	2009	2010	2011	2012	2013f	2014f
GDP growth (% change)	4.6	6.2	6.5	6.2	5.8	6.0
Inflation (%, end-year)	2.8	7.0	3.8	4.3	7.5	5.0
Fiscal balance (% of GDP)	-1.8	-1.2	-0.6	-1.3	-2.8	-2.2
Public debt (% of GDP)	28.6	26.8	24.4	24.0	23.6	23.1
Current account (% of GDP)	2.0	0.7	0.2	-2.8	-3.3	-3.3
External debt (% of GDP)	33.2	27.5	25.2	28.5	28.0	27.0

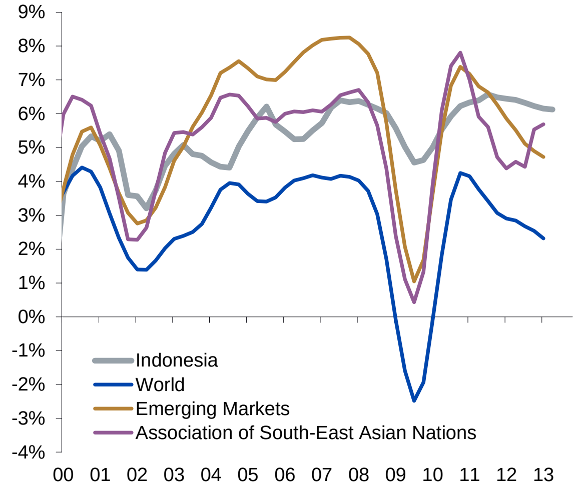
Sources: IHS Global Insight, national sources, Euler Hermes

Economic Growth

GDP growth eased slightly in H1 2013 but will remain robust

Supported by solid economic policies, the economy showed marked resilience to the global economic crisis in 2008-2009, growing by a comparatively very sound 4.6% in 2009. Real GDP growth accelerated to 6.2% in 2010 and 6.5% in 2011 and maintained a strong pace of 6.2% in 2012. In H1 2013, growth eased slightly to +5.9% y/y. The expansion of private and public consumption remained nearly stable in H1, at +5.1% y/y and +1.4% y/y, respectively, while fixed investment slowed to +5.2% y/y from +9.8% in full year 2012. The latter was compensated for by increased external demand. Real exports expanded by +4.2% y/y in H1 (up from +2% in full year 2012) while imports grew by just +0.3% y/y (down from +6.7% in 2012). As a result net exports contributed +1.7pps to growth in H1, after subtracting -1.5pps in 2012 as a whole. EH expects full-year growth of about +5.8% in 2013 and +6% in 2014.

GDP growth (% y/y, 4 qtrs cumulated)



Sources: IHS Global Insight, national sources, Euler Hermes

Economic Policies

Appropriate monetary policy in recent years

The monetary policy framework is based on inflation targeting but, in practice, the central bank also aims a certain degree of exchange rate stability. From June to August 2013, the key policy interest rate was raised by a cumulative 125bps, to 6.5%, in order to support the currency and to pre-empt inflation expectations.

Elevated inflation due to fuel subsidy cuts

Consumer price inflation has picked up somewhat in early 2013, owing to higher food prices, and increased sharply from 5.9% y/y in June to 8.6% in July and 8.8% in August as a result of the reduction in fuel subsidies in late June. The subsidy cuts have led to sharp price hikes for gasoline (+44%) and diesel (+22%). We expect headline inflation to remain elevated until the end of 2013 before gradually falling back into the authorities' 4.5% ± 1pp target range in 2014.

Still rapid credit growth

Real domestic credit growth has decelerated from a temporary high of 24% y/y in mid-2012 but has remained heightened, at 16% y/y in April 2013, requiring continued monitoring.

Depreciation of IDR accelerates in the wake of emerging market sell-off in mid-2013

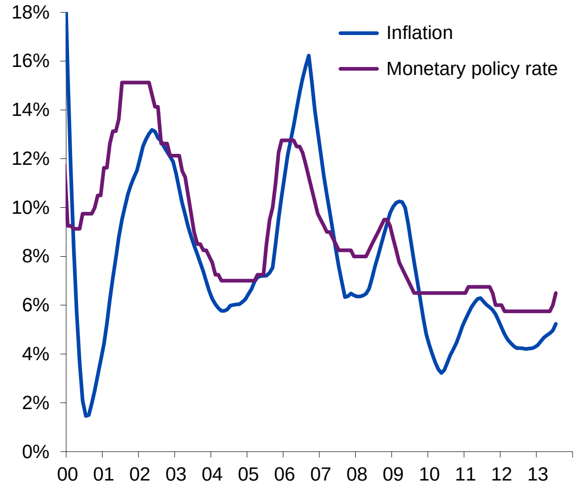
The IDR has gradually depreciated against the USD over the past two years, largely as a result of the weakening in the external accounts. Since May 2013, downward pressure on the IDR has increased further as a result of hints by the US Fed that the latest round of Quantitative Easing will be slowing down. The IDR fell by 5.6% against the USD from early May to end-July—less than several other emerging market currencies thanks to massive central bank intervention, however, this caused a 13.8% (USD14.3bn) decline in foreign exchange (FX) reserves in May-July. During August the rate of depreciation accelerated to 10% while FX reserves remained stable. EH does not expect a full-blown currency crisis, but corporate insolvencies and non-performing loans are likely to rise as the servicing of FX-denominated debt will become more difficult for weaker companies. Close monitoring is required.

More generally, exchange rate volatility is relatively high, caused by, often sudden, shifts in investor sentiment towards emerging markets or Indonesia particularly. At times of overall positive investor sentiment large short-term, often speculative capital inflows, including carry trades, are registered, creating upward pressure on the currency. If then investor sentiment swings for some reason, the earlier short-term capital inflows can easily be reversed, thereby causing downward pressure on the currency and thus exchange rate and refinancing risks.

Solid public finances

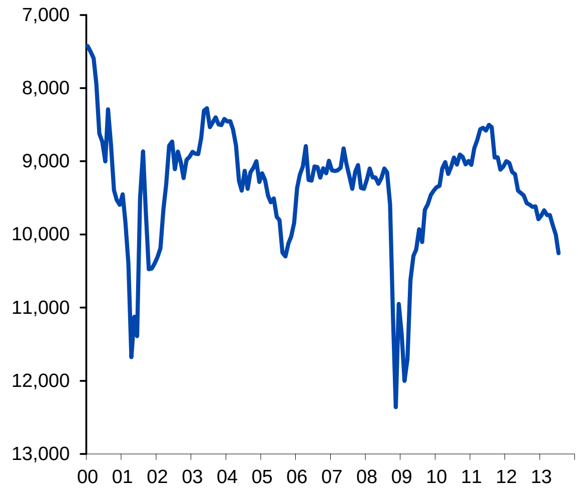
Fiscal policy was appropriately loosened at the height of the 2008-2009 global economic and financial crisis in order to mitigate the impact on the local economy. Even so, the annual fiscal deficit remained below 2% of GDP in 2009, as it did in 2010-2012 when the fiscal stimulus was gradually cut back. In 2013-2014, the annual deficits are forecast to rise to an average 2.5%, owing to weaker revenues and some election-related spending. However, the financing of such comparatively still low deficits appears manageable. Public debt is below 25% of GDP.

Inflation rate (12-month moving average, %) and policy interest rate (%)



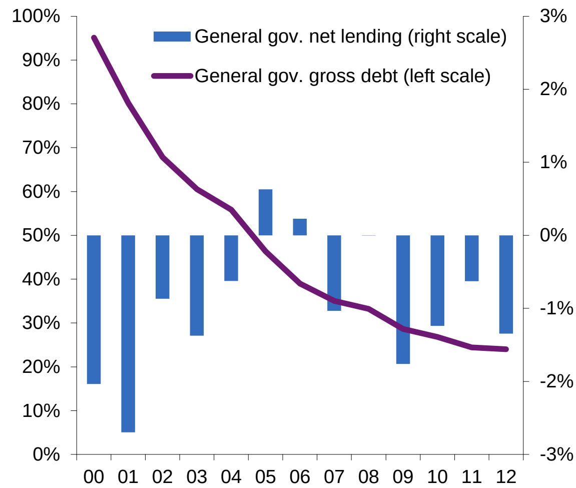
Sources: IHS Global Insight, national sources, Euler Hermes

Exchange rate (IDR/USD)



Sources: IHS Global Insight, national sources, Euler Hermes

Fiscal balance and public debt (% of GDP)



Sources: IHS Global Insight, national sources, Euler Hermes

External Sector

The current account will remain in moderate deficit

As a result of weakening export performance, quarterly trade surpluses have narrowed and the current account has recorded deficits since Q4 2011 as the services and income accounts have continued to register sizeable shortfalls. The current account deficit amounted to 2.8% of GDP in 2012, but 59% of it was covered by net foreign direct investment (FDI) inflows. In Q1 2013, the deficit was 2.4% of GDP and the net FDI coverage was 64%. We expect still manageable annual external shortfalls of about 3.3% of GDP in 2013 and 2014.

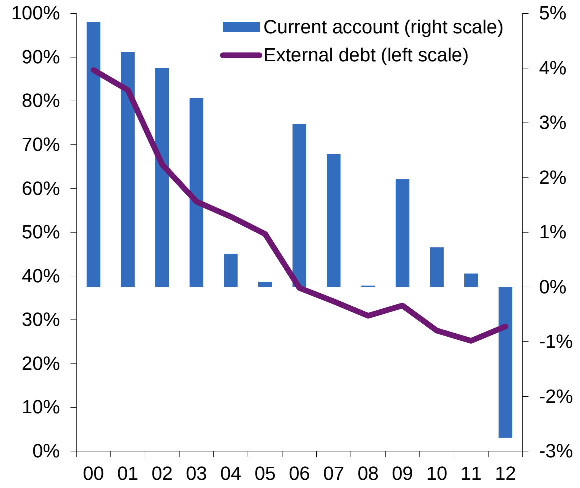
External debt burden is manageable

Gross external debt is moderate in relation to GDP (28.5% at end-2012) and export earnings (115%). The debt-service ratio is forecast at about 16% in both 2013 and 2014.

The continued decline in foreign exchange (FX) reserves is worrisome

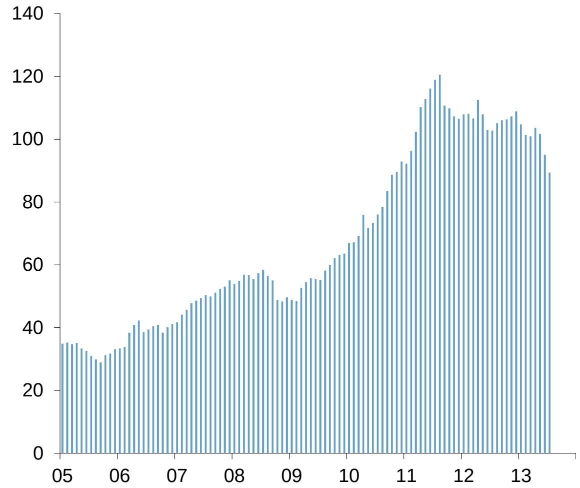
Official FX reserves almost doubled from USD64bn at end-2009 to USD121bn in August 2011, albeit to a large extent owing to short-term capital inflows. Since September 2011, however, some reversal of short-term capital inflows and occasional central bank intervention to stabilise the IDR/USD exchange rate have resulted in a cumulative drop of FX reserves to USD89bn in July 2013. Particularly sharp were the most recent monthly declines in June (6.5% or USD6.6bn) and July 2013 (6% or USD5.7bn). Currently, the level of FX reserves is still comfortable with regard to import cover (more than five months). In other terms, reserves are still sufficient to cover the estimated external debt payments falling due in the next 12 months (estimated at about USD85bn). However, this could change soon if the decline in reserves continues. Hence close monitoring is required.

Current account and external debt (% of GDP)



Sources: IHS Global Insight, national sources, Euler Hermes

Foreign exchange reserves (USD billion)



Sources: IHS Global Insight, national sources, Euler Hermes