MOODY'S
INVESTORS SERVICE

Rating Action: Moody's upgrades Indonesia's rating to Baa2, changes outlook to stable

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Singapore, April 13, 2018 -- Moody's Investors Service ("Moody's") has today upgraded the Government of Indonesia's long-term issuer and senior unsecured ratings to Baa2 from Baa3. The outlook is changed to stable from positive.

The upgrade to Baa2 is underpinned by an increasingly credible and effective policy framework conducive to macroeconomic stability. Together with a build-up of financial buffers, prudent fiscal and monetary policy strengthens Moody's confidence that the sovereign's resilience and capacity to respond to shocks has improved. As a result, Indonesia's credit metrics are more comparable to sovereigns at the Baa2 level.

Concurrently, Moody's has upgraded Indonesia's senior unsecured MTN rating to (P)Baa2 from (P)Baa3. Moody's has also upgraded to Baa2 from Baa3 the senior unsecured and backed senior unsecured ratings of the US dollar trust certificates issued by Perusahaan Penerbit SBSN Indonesia III, a special purpose vehicle established by the Government of Indonesia; and the senior unsecured MTN programme of Perusahaan Penerbit SBSN Indonesia III to (P)Baa2 from (P)Baa3.

The payment obligations associated with these certificates are direct obligations of the government, and their ratings automatically reflect changes to Indonesia's sovereign ratings.

Moody's has also raised Indonesia's long-term foreign currency (FC) bond ceiling to A3 from Baa2 and its long-term FC deposit ceiling to Baa2 from Baa3. In addition, Moody's has raised the short-term FC bond and deposit ceilings to P-2 from P-3. These ceilings act as a cap on the ratings that can be assigned to the FC obligations of other entities domiciled in the country.

Indonesia's local currency bond and deposit ceilings remain unchanged at A1.

RATINGS RATIONALE

RATIONALE FOR THE UPGRADE TO Baa2

Effective policy emphasis on macroeconomic stability increases resilience to shocks.

Moody's expects that the focus of Indonesia's fiscal and monetary policy around preserving macroeconomic stability and building financial buffers that has become increasingly apparent in recent years will remain. These policies and larger financial reserves are strengthening Indonesia's capacity to respond to shocks.

On the fiscal front, the government has maintained strict adherence to the 3.0% budget deficit cap since its institution in 2003; Moody's expects the focus on fiscal prudence to remain in place and contribute to macroeconomic stability. Sustained low deficits keep the debt burden low and, combined with a long tenor of funding, reduce financing needs and risks. Although weak revenue remains a long-standing credit constraint, including by eroding debt affordability, Moody's forecasts that Indonesia's government debt will hover around 30% of GDP in the next few years, below the median of 39% of GDP for all investment grade sovereigns and 46.2% for the Baa-rated median.

Contingent liability risks related to state-owned enterprises (SOEs) are likely to increase as SOEs assume more leverage in the implementation of infrastructure projects, but does not pose a significant risk to Indonesia's fiscal strength in the next few years. Moody's also expects that some SOEs and infrastructure projects will continue to face financing constraints, resulting in less ambitious infrastructure spending plans. While negative for medium-term growth, a scaled-down infrastructure implementation will limit potential contingent liability risks.

On the monetary policy front, Bank Indonesia (BI), the central bank, has established a track record of prioritizing macroeconomic stability over promoting short-term growth. Inflation targets have been met for the past three consecutive years and inflation expectations have proved to be anchored at moderate levels when headline inflation increased sharply as a result of the subsidy reform in 2014. A number of factors, including the central bank's more flexible approach towards currency intervention since the episode of global financial market turmoil in mid-2013 (the so-called taper tantrum), and more effective policy coordination between BI and the central and regional governments keep inflation stable at low levels.

Going forward, temporary price pressures may emerge in a less benign external price environment. However, the central bank has displayed greater willingness to use macro-prudential tools in response to shocks, which suggests a lower risk of a large and persistent rise in inflation than in the past.

Moreover, a strengthening of Indonesia's external position and build-up of reserve buffers also enhances the country's resilience to potential shocks. While some of the acceleration in exports in 2017 is accounted for by the cyclical strengthening of global demand and recovery in commodity prices, structural improvements, including some diversification of the export base away from commodities and towards the manufacturing sector, have also played a role in narrowing the current account deficit. This is reflected in a steady increase in the share of manufacturing exports to 72% of total exports in 2017 from 62% in 2013, while the share of commodity exports had moderated. We expect the current account deficit to be broadly stable, at low levels, around 1.8% of GDP.

As a result of the narrowing current account deficit and robust investment inflows, foreign reserves increased to $119 billion at the end of March (gross international reserves increased to $126 billion), a level consistent with measures of reserve adequacy. Moody's External Vulnerability Indicator for Indonesia, which measures the ratio of long-term debt maturing over the next year and short-term debt relative to the stock of reserves, is 51.3% for 2018, which indicates ample buffers and limited external vulnerability.

A credible policy focus on macroeconomic policy backed by substantial financial buffers reduces the risk of a sharp and sustained depreciation of the currency.

The policy framework and financial buffers complement Indonesia's large economic size, robust and stable GDP growth around 5.0-5.3% and a sound banking system in fostering the sovereign's capacity to absorb economic or financial shocks.

RATIONALE FOR THE STABLE OUTLOOK

The stable outlook reflects balanced risks at Baa2. The stable outlook incorporates downside risks from political challenges to the implementation of further broad economic, fiscal and regulatory reforms. While we expect effective reforms to proceed relatively slowly, further delays or reversals compared with our expectations could happen, especially - although not only - ahead of next year's elections, when reforms involve increasing competition with a negative impact on incumbents.

The stable outlook also takes into account upside risks from a potential improvement in competitiveness as a result of effective announced and planned reforms.

The present administration has passed various policy packages targeted primarily at improving the environment for investment. The effectiveness of these policies in improving the attractiveness of Indonesia as a place to invest has yet to become clear. Policy-makers' perseverance in this direction is key to ensuring that GDP growth moves towards the country's potential levels.

WHAT COULD MOVE THE RATING UP/DOWN

The stable outlook indicates that rating changes are unlikely in the foreseeable future.

Over time, indications that fiscal policy measures can durably and significantly raise government revenue would put upward pressure on the rating. Higher revenue would enhance fiscal flexibility and provide more direct financial means for the government to address large social and physical infrastructure spending needs. An upgrade would also potentially result from materially stronger growth potential, commensurate with the country's population growth and income levels, including through a deepening of financial markets and improved competitiveness.

Downward pressure would arise if: 1) evidence built up that the strengthening of Indonesia's policy framework and institutions is on hold or reversing; 2) Moody's concluded that the prospects of some broadening of the revenue base over the medium term are very limited, indicating limitations to policy effectiveness and posing continued constraints to economic growth; and/or (3) SOEs' financial strength materially worsened pointing to a rising likelihood of crystallization of material contingent liabilities on the government's balance sheet.

GDP per capita (PPP basis, US$): 11,717 (2016 Actual) (also known as Per Capita Income)

Real GDP growth (% change): 5.0% (2016 Actual) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 3% (2016 Actual)

Gen. Gov. Financial Balance/GDP: -2.5% (2016 Actual) (also known as Fiscal Balance)

Current Account Balance/GDP: -1.8% (2016 Actual) (also known as External Balance)

External debt/GDP: 34.3% (2016 Actual)

Level of economic development: High level of economic resilience

Default history: No default events (on bonds or loans) have been recorded since 1983.

On 10 April 2018, a rating committee was called to discuss the rating of the Indonesia, Government of. The main points raised during the discussion were: The issuer's economic fundamentals, including its economic strength, have increased. The issuer's institutional strength/framework, have increased. The issuer's fiscal or financial strength, including its debt profile, has decreased.

The principal methodology used in these ratings was Sovereign Bond Ratings published in December 2016. Please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

The weighting of all rating factors is described in the methodology used in this credit rating action, if applicable.

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