Inside Indonesia

OCBC Bank

Hold the Confetti

S&P is not upgrading Indonesia for now

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- **The laggard keeps Indonesia waiting further. Its two peers may have upgraded Indonesia into investment grade territory years ago, but S&P decided not to follow their lead just yet.**
- **In its decision to hold back, S&P cites Indonesia's low per capita GDP as a "rating constraint" and hints at how its fuel subsidy reforms have not gone thoroughly enough.**
- **It has kept its positive outlook, however. An upgrade could still be had over the next 12 months, if – the usual fiscal rectitude metrics aside – it sees a "full and timely execution of the government's fuel subsidy reform."**

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Odd One Out

Fitch did it first in December 2011, and Moody's followed suit a month after, restoring Indonesia's sovereign ratings to investment grade after what was a 14-year wait. Since then, the expectation for a similar move by the hold-out S&P has come and gone. The latest episode really began about a year ago when the agency slapped a positive ratings outlook on Indonesia in May 2015, curiously barely a month after saying that it was not in any hurry to change its rating arguing that effects of policy reforms were yet to be seen.

The drumroll has grown louder in recent weeks after the ratings team's visit to Jakarta. According to Finance Minister Bambang Brodjonegoro, they were impressed by the government's reform efforts. This was echoed by SOE Minister Rini Soemarno, who said that she expects an upgrade by S&P in June.

Alas, the long wait looks set to lengthen further. S&P announced overnight that it is affirming Indonesia's previous rating of BB+, even as it keeps a positive outlook on it which signifies a continued potential for an upgrade within the next 12 months.

After all the build-up in expectation, there was indeed a palpable sense of disappointment with the announcement, naturally. In terms of immediate market impact, however, it is hard to characterize it as being all that strong beyond the initial knee-jerk reaction.

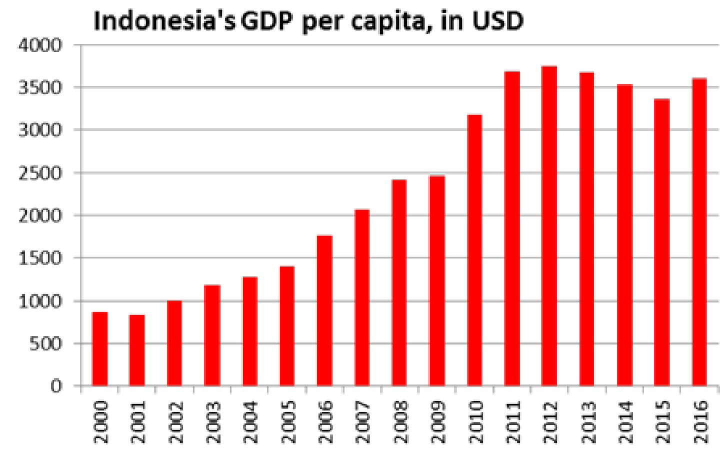
The 10-year yield for local sovereign bond moved up from 7.81 to around 7.84, while the JCI equity index gained some 0.1% - hardly anything noteworthy. The same can be said of the all-important Rupiah, which has also largely stayed unchanged. The fact that the two other rating agencies have continued to affirm Indonesia's investment grade status for so long now helped to counter any sense that S&P's failure to follow suit is indicative of underlying problems with the economy, and would have buffered against the blow.

Still, it's worth taking a closer look at why S&P did what it did. If nothing else, that might be useful in gauging which policies the Indonesian authorities would focus on more if they remain keen on getting the feather in the cap.

Missing Ingredients

Looking at the S&P statement accompanying its decision, it appears to us that it has placed an interesting emphasis on GDP per capita. In particular, in its view, Indonesia's low GDP per capita of USD3600 in 2016 is a "rating constraint." To the agency, this signifies how "past policies have not delivered prosperity for this resource-rich country."

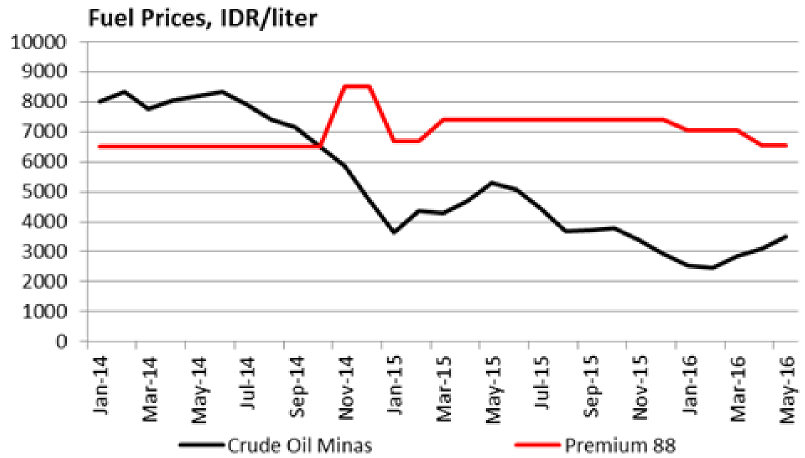
To us, that may be a somewhat strange emphasis. For one, when it first chose to put Indonesia's rating on a positive outlook, Indonesia's GDP per capita was already on the way to declining for the fourth year running, in USD terms. If a low GDP per capita is a so-called rating constraint, why was there a shift to positive outlook then? Moreover, going by its own estimate of USD3600 for this year, the measure would actually signal an upturn right now. Why the reluctance to carry through with an upgrade when the very metric it focuses on is improving?



Source: Bloomberg

The other missing ingredient that it cites may merit more attention. Its statement gives the impression that the agency feels that Indonesia's fuel subsidy reform is not thorough enough yet. In particular, it touches on the government's "apparent hesitancy to allow domestic gasoline prices to fully track international prices."

This might have arisen partly because there is a sense that the government continues to set the prices of the previously subsidized Premium-88 grade, tweaking it every few months than letting it float fully alongside global oil price fluctuations. The lack of exact framework in which the fuel price levels are decided adds to that, giving rise to the impression that fuel price is decided more by political calculations rather than economic ones. The last move, for instance, was a IDR500 per liter drop in April this year, even as global oil prices were starting to pick up.



Source: CEIC

The subtext from S&P's statement seems to be that, if the government is serious about getting an upgrade, then it had better get serious about fully floating the fuel price. In and of itself, that push should help to increase the chances of a more market-driven fuel price adjustment mechanism.

Outside of these factors, the agency cites the usual need for better quality government spending and improvement in fiscal framework, including better revenue performance via higher tax compliance and non-oil revenue. These factors are not new, but may prompt the government to redouble the efforts for fiscal reforms.

All in all, market would have been heartened by an upgrade from S&P. However, viewed from another angle, it is perhaps better that the agency leaves this carrot a-dangling. It should serve as a reminder to the Indonesian administration that, despite the zeal in which it has been initiating reforms of late, there is still much to be done, especially on the implementation and follow-through parts. The agency's focus on fuel subsidy reform alludes to that. After all, the abolition of fuel subsidy in November 2015 was President Jokowi's opening shot right after he was inaugurated, and yet the replacement mechanism is still not fully finalized and institutionalized yet.

Hopefully, the non-upgrade would act as a spur on the administration's overall reform efforts. If the economy starts to show more solid signs of improvement because of continued government policy enlightenment, the market would take notice and react likewise – with or without a bunch of analysts anointing it to be so anyway.