Better Late than Never
S&P Upgrades Indonesia

May 19, 2017

- **It's about time. After years of shying away from pulling the trigger, S&P has finally done the right thing and upgraded the sovereign rating of Indonesia.**
- **With that, the country is now squarely in the investment grade territory under the metric of all three major rating agencies. In itself, that should broaden the appeal of Indonesian assets and help to deepen the financial markets.**
- **Now, what's next? In fact, more upgrades are possible, with Fitch and Moody's potentially moving Indonesia up the scale further into investment grade. All these may be a cause for a raucous celebration, but also quiet reflection. Tough reforms got Indonesia to this point. More is needed to power it further.**

Happy Friday to you too!

When it refrained from upgrading Indonesia in the last few rounds of review, the reasons S&P gave were multi-fold, ranging from somewhat understandable non-performing loans risk in the banking sector to the more quixotic talks about GDP per capita level.

When the ratings agency finally saw the light and upgraded Indonesia from BBB- to BB+ and hence into investment grade today, however, the motivation seems to be straightforward enough.

In its own words, the upgrade is said to be reflecting its "assessment of reduced risks to Indonesia's fiscal metrics." It added that "The government's new focus on realistic budgeting has lowered the risks that budget deficits will widen significantly when government revenue disappoints."

These seem to be code-words for "we like the way the Finance Ministry is run now" and should be seen as kudos to Sri Mulyani Indrawati.

After taking over the finance portfolio in the middle of last year, she executed a reality check on the 2016 budget. Among the tough decisions she had to make was to undertake a fairly sharp pullback of government spending halfway through the budget year, as revenue shortfall threatened to force the overall deficit too close to the legally mandated 3% of GDP level for comfort. The decision for H2 2016 austerity dampened overall GDP growth significantly, bringing about tail effects on government spending that still bore imprints in Q1 2017's relatively lacklustre 5.01%yoy growth.

For 2017's budget, however, the chances of having to execute another sharp U-turn on government spending policy have been reduced by imbuing it with reality checks. Rather than over-promising only to under-deliver, we half-joked that she had learned the importance of doing the reverse from her time leading a bureaucratic behemoth of World Bank. (See our 23 Aug 2016 report, "On Firmer Ground" for details).

It is that spirit of being upfront and realistic, we believe, that has ultimately won over the hitherto skeptics at S&P.

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In terms of market impact, the immediate reaction has been undoubtedly and rightly positive. Rupiah strengthened by a quarter of a percentage point against the USD and Jakarta Composite index showed stocks rallying by a chirpy 2.6%. This shows that, even though the upgrade is largely expected – for a long time now, it should be seen as a matter of when, not if – the actual action itself is nevertheless serving as a welcomed booster shot.

Having an all-around investment grade from the three major rating agencies matters more than just the practical ease of not having to remember whose grade stands at which side of the divide anymore. It also would potentially open up Indonesia to a broader – and stickier – base of investors, including funds that could not invest in the country before because of investment grade provisions in their mandates. It would also help to bolster the government's efforts in improving the appeal of Indonesian assets to previously untapped groups of investors. This includes retail investors in major developed markets. For its recent initiative to sell its first dollar-denominated bonds to US retail investors by registering with the SEC, for example, the upgrade is helpful to say the least.

Going forward, the good thing is that the story of upgrades is not over yet. Not so much from the relatively shy S&P, but from its competitors, Moody's and Fitch ratings. These two have not only upgraded Indonesia into investment grade territory more than 5 years ago, they both now have an active positive outlook in their assessments. Our sense is that there are enough reasons for them to move Indonesia further up in the scale of investment grade this year, particularly if Sri Mulyani and her team manage to continue keeping the budget in shape in the coming months.

Overall, while there will be those who worry that S&P's upgrade may take away the impetus for the government to undertake further reforms, we think that concern is overblown. If anything else, celebratory atmosphere aside, it appears that there is enough realization that this upgrade has been hard-won and but a milestone in a long journey.

Having gone through tough decisions such as cutting away oil subsidy that was a parasitic leach on scarce government resources, to the undertaking of an ambitious and largely successful tax amnesty program, the next phase will be to fundamentally reshape Indonesia's tax base that remains too narrow. With the tax law changes supposedly ranking among the high priority agenda in the nation's parliament, may this upgrade be a reminder to the country's lawmakers of the importance in engaging less of distracting politics and more of important economics.