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Indonesia – Shooting for investment grade

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- Indonesia may achieve investment-grade status by 2012
- We highlight the necessary economic and financial conditions for Indonesia to achieve this
- We discuss the impact on FX, rates and credit from such prospect

Rising from the ashes

The Asian financial crisis of 1997-98 plunged Indonesia into the abyss, and it struggled to regain investor confidence for years thereafter. However, a combination of positive political, financial and economic developments during 2007-10 has increased the chances that Indonesia will regain its investment-grade sovereign credit ratings. The country maintained positive economic growth throughout the latest global financial crisis due to its low exposure to exports and resilient domestic consumption. The lessons learned from the Asian financial crisis have put the government in a healthy fiscal position. Although Indonesia's foreign-exchange reserves are low relative to its neighbours', the depreciation in the Indonesian rupiah (IDR) and the spike in bond yields in 2008-09 were transitory. Politically, the re-election of President Bambang Yudhoyono for a second term in July 2009 was seen as a landmark event that relegated Indonesia's turbulent political past to the history books.

As a result, expectations that Indonesia will return to investment grade have escalated. However, this should not be taken for granted, as such status is earned strictly on merit. Further reforms and favourable economic and financial conditions will be needed in order for Indonesia to achieve it.

In this Special Report, we highlight the necessary conditions and reforms in order for Indonesia to achieve investment-grade status. If the authorities are able to achieve their policy goals, we believe it is realistic to expect Indonesia to reach BBB- (Standard & Poor's) and Baa3 (Moody's and Fitch Ratings) by 2012, versus BB+ (Fitch), BB (S&P) and Ba2 (Moody's) currently. We also look at the implications of this development for foreign exchange and the local rates, bond and credit markets.

Important disclosures can be found in the Disclosures Appendix

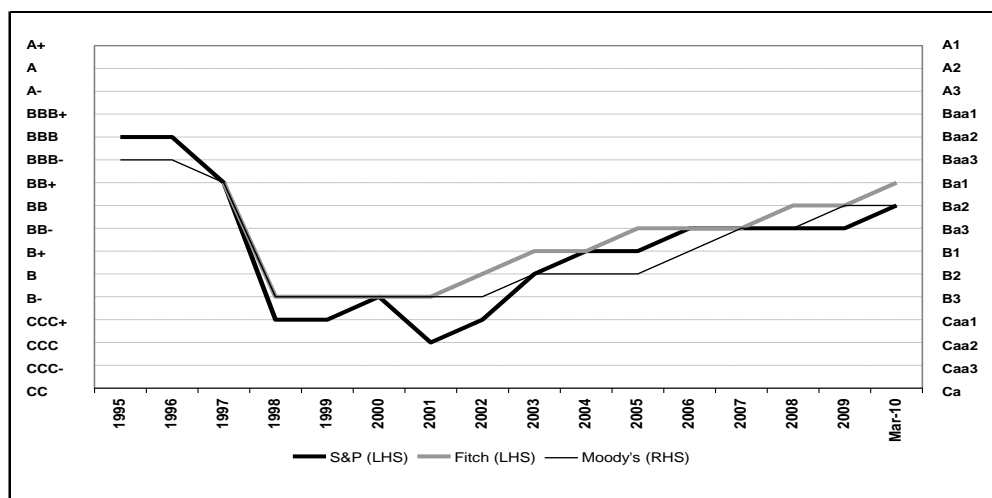


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Chart 1: Indonesia's sovereign ratings, 1995-2010



Source: Bloomberg

Economic, policy and political issues

Investment-grade status must be earned

Indonesia has increasingly captured the attention of global financial investors over the past 12 months. In 2009, the IDR rose by 16.1% versus the USD, making it Asia's best-performing currency, and the Jakarta Composite Index (JCI) gained 123% in USD terms, making it Asia's best-performing bourse. The IDR has strengthened by another 3.2% and the JCI by 12% so far in 2010. Indicating investors' improving perception of Indonesia's sovereign default risk, the credit default swap (CDS) on Indonesia's 5Y USD sovereign debt has declined from a peak of 1,256bps in October 2008 (at the peak of the global financial crisis) to 315bps in December 2009 and 150bps as of March 2010. Given the likelihood of further cross-border capital inflows, we expect the IDR to strengthen further to 8,800 by end-2010.

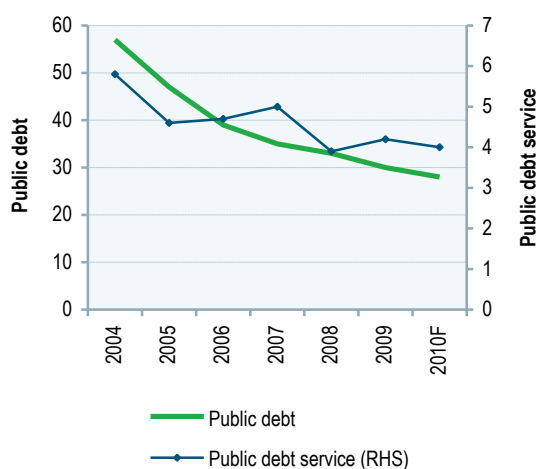
The rally in domestic financial markets has been supported by resilient economic fundamentals. While GDP growth slowed to 4.5% in 2009 from 6.0% in 2008 due to the global recession, it was still the third-highest in the G20 after China and India, and we expect growth to recover to 5.5% in 2010. Inflation slowed to 2.8% in December 2009 from 11.1% in December 2008, though it is expected to rise modestly to 5.5% by end-2010 on hikes in electricity tariffs and domestic fuel prices in H2. Most of Indonesia's country risk indicators have also improved. Between 2005 and 2009, the government's budget deficit was consistently kept below 2% of GDP (the constitutional cap is 3%), government debt fell to 29% of GDP from 47%, and Indonesia's foreign debt fell to 31% of GDP from 46%. Given these developments, on 12 March 2010, S&P upgraded Indonesia's sovereign rating to BB, with a positive outlook; this followed Fitch Ratings' upgrade in January to BB+, with a stable outlook. Following the latest upgrades, Fitch remains the most optimistic on Indonesia among the rating agencies, rating it one notch below investment grade. S&P and Moody's (which rates Indonesia Ba2, with a stable outlook) both have Indonesia two notches below investment grade.

The crucial question now is when Indonesia's rating will be raised to investment grade – namely, BBB- for S&P and Fitch and Baa3 for Moody's. Finance Minister Sri Mulyani Indrawati expects an investment-grade rating within a year or two. Indeed, given its optimistic outlook, S&P may upgrade Indonesia further within the next 12 months. While a continued improvement in economic fundamentals may warrant further upgrades, we believe the government must tackle key policy and political issues in order to obtain an investment-grade rating within the finance minister's timeframe.



Chart 2: Public debt and public debt service

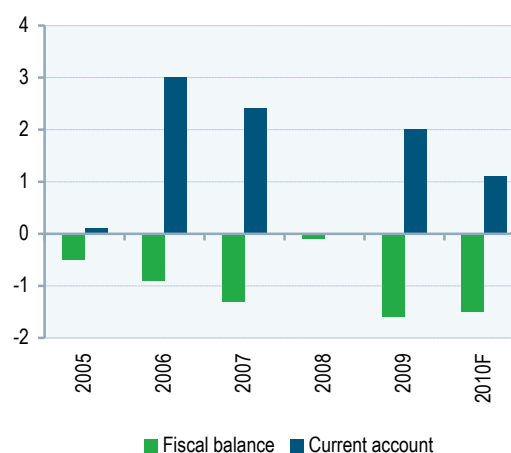
% of GDP



Sources: Ministry of Finance, Standard Chartered Research

Chart 3: Fiscal balance and current account

% of GDP



Sources: Ministry of Finance, Standard Chartered Research

Metrics suggest that Indonesia deserves a higher rating

On the basis of conventional country risk indicators, there is little evidence that Indonesia is lagging behind investment-grade economies. Indeed, Indonesia’s fiscal indicators are better than those of some investment-grade countries. With a fiscal deficit of 1.6% of GDP in 2009, Indonesia fared better than India (7.6%) and Russia (6.6%) – see Table 1. On the other hand, Indonesia’s relatively small FX reserves (USD 66.1bn in December 2009) and high ratio of short-term foreign debt to FX reserves (35.2%) clearly indicate its external fragility. That said, Indonesia’s FX reserves and its ratio of short-term foreign debt to FX reserves were better than, for example, those of South Africa (rated BBB+ by S&P), which had USD 32.4bn in FX reserves at end-2009 and a ratio of 70.8% in Q3-2009. This implies that conventional risk indicators are not the sole determinant of sovereign ratings.

Table 1: Country risk indicators, 2009

	South Africa	Thailand	Russia	Brazil	India	Indonesia
S&P rating (Mar-2010)	BBB+	BBB+	BBB	BBB-	BBB-	BB
Sovereign CDS (bps, Mar-2010)	123.0	104.5	132.0	115.8	-	155.0
GDP growth (Constant prices)	-1.8	-2.3	-7.9	-0.3	6.8	4.5
Inflation (Annual average)	7.4	-0.8	11.7	4.9	2.5	4.9
Public debt (% of GDP)	35.7	45.9	6.9	46.8	56.9	28.3
Fiscal balance (% of GDP)	-7.3	-5.3	-6.6	-3.3	-7.6	-1.6
Current account (% of GDP)	-4.3	7.4	3.6	-1.5	-2.8	2.0
ST foreign debt * (% of FX reserves)	70.8	16.0	11.7	14.2	18.9	35.2
FX reserves (USD bn, Dec-09)	32.4	131.5	437.7	239.1	259.0	66.1

* ST foreign debt as of Q3-2009; Sources: Bank for International Settlements, Bloomberg, Standard Chartered Research



How to earn an upgrade?

We believe that three crucial issues will determine the pace of further sovereign rating upgrades.

- 1. Fiscal flexibility to control energy subsidies.** While Indonesia is a net exporter of energy (oil, gas, coal and palm oil), it is a net oil importer. As a result, while higher global energy prices benefit Indonesia, they adversely affect the government's budget, causing government spending on subsidies for domestic energy consumption (fuel and electricity) to balloon. This could potentially widen the budget deficit and, if the gap between global and domestic oil prices widens sharply, trigger fuel smuggling offshore – which could widen the deficit further. Due to higher global oil prices, the government has raised its oil-price assumption for the 2010 budget, forecasting the average Indonesian crude price (ICP) at USD 77 per barrel (bbl) versus USD 66 previously (ICP is typically USD 2-3/bbl below NYMX WTI). As a comparison, we forecast an average NYMX WTI price of USD 82/bbl in 2010.

Based on the government's new assumptions, including unchanged domestic fuel prices throughout 2010 and a 15% hike in electricity tariffs in H2, spending on energy subsidies is expected to rise to USD 15.1bn, versus the previous assumption of USD 10.7bn. This is expected to widen the government's 2010 budget deficit to 2.1% of GDP from 1.6%. The government is legally allowed to hike domestic fuel prices if ICP is more than 10% above the budget assumption – i.e., if it exceeds USD 85/bbl this year. In such a situation, if the government is willing (as it has been in the past) to take the politically unpopular measure of hiking fuel prices and electricity tariffs to safeguard the budget, without triggering political unrest, the rating agencies are likely to reward it with ratings upgrades.

That said, we do not foresee severe budgetary pressures over the next two years. We expect the average global oil price (NYMX WTI) to rise modestly to USD 90/bbl in 2011 from USD 82 in 2010. Moreover, as seen over the past four years, the central and regional governments have a limited ability to spend their budgets due to slow progress on infrastructure projects (as a result of factors including slow land clearance and regional governments' weak technical capabilities.) Consequently, despite recording a budget deficit of 1.6% of GDP in 2009, the government had USD 4.1bn of undisbursed allocations at the end of the year. We therefore expect the 2010 budget deficit to be 1.5-1.8% of GDP, below the 2.1% target and the 3% constitutional cap. We also expect the government to raise domestic fuel prices by 30% and electricity tariffs by 15% as planned in H2-2010, as political tensions with the parliament over the Bank Century case (see below) ease.

- 2. Pace of accumulation and sources of FX reserves.** While FX reserves rose to a record USD 69.7bn in March 2010, they are still insufficient to minimise IDR volatility if Indonesia faced another financial crisis on the scale seen in H2-2008. Foreign investors hold USD 13.9bn of IDR government bonds and USD 7.2bn of BI certificates (SBIs), while they control almost 40% of the equity market, which has a market capitalisation of USD 225bn. Most of these investments are considered 'hot money' that could flow out of Indonesia in at a time of financial stress. Granted, not all foreign investment in listed equities is 'hot money', and Bank Indonesia (BI) has access to additional FX reserves through the Chiang Mai Initiative. However, it is important that Indonesia accumulate additional FX reserves not so much through foreign portfolio inflows, but rather through foreign direct investment (FDI) and bank financing, which are more stable forms of capital inflows.

We expect FX reserves to continue to rise to USD 77.9bn by December 2010, mainly as a result of a current account surplus and net foreign portfolio investment (even though both are expected to decline) – see Table 2. FX reserves may rise further to USD 88.9bn in 2011 and exceed USD 100bn by 2012. Many within the Ministry of Finance (MoF) and BI believe that the financial markets and rating agencies would be much more comfortable if FX reserves exceeded the psychologically important level of USD 100bn. That said, if the quality of the balance of payments continues to improve (via stronger FDI) and if the local FX market continues to deepen (helping to minimise volatility), Indonesia may be raised to investment grade before FX reserves reach USD 100bn.



3. Continued policy reforms. While investor-friendly policy and bureaucratic reforms in the real economy do not directly affect the government's ability to repay its debts, they improve the domestic investment climate and encourage FDI, helping Indonesia's balance of payments. The MoF has reformed the tax and customs regimes to minimise corruption, and Finance Minister Indrawati has won praise from the investor community for this. These reforms, however, are not enough. Structural issues such as poor infrastructure and labour-market rigidity are hampering more rapid investment. Investors expect further privatisation of the power sector (allowing private power plants to sell electricity directly to industry) and a restructuring of state electricity board PLN, including allowing it to raise electricity tariffs by 15% to improve its cash flow and accelerate the construction of Indonesia's first 10,000MW power plant (PLN expects Indonesia's electricity consumption to rise by 9.2% annually over the next 10 years). Other necessary reforms include a revision of labour laws to allow firms to lay off workers more easily, the acceleration of land clearance for infrastructure projects (particularly toll roads and geothermal power plants), and a continued crackdown on corruption, especially at the regional government level, by the anti-corruption commission, KPK.

Table 2: Balance of payments (USD bn)

	2005	2006	2007	2008	2009	2010F	2011F
1) Exports	87.0	103.5	118.0	139.6	119.5	129.0	140.0
2) Imports	-69.5	-73.9	-85.3	-116.7	-84.3	-98.0	-110.0
3) Trade balance = 1 + 2	17.5	29.7	32.8	22.9	35.2	31.0	30.0
4) Services balance	-17.3	-18.8	-22.3	-22.8	-24.6	-24.0	-26.0
i) Services (net)	-9.1	-9.9	-11.8	-13.0	-14.2	-13.5	-14.3
ii) Income (net)	-12.9	-13.8	-15.5	-15.2	-15.3	-15.5	-17.3
iii) Current transfers (net)	4.8	4.9	5.1	5.4	4.9	5.0	5.5
5) Current account balance = 3 + 4	0.3	10.9	10.5	0.1	10.6	7.0	4.0
6) Capital & financial account balance	0.3	3.0	3.6	-1.9	3.7	4.8	7.0
i) Foreign direct investment (FDI)	5.3	2.2	2.3	3.4	2.3	2.5	3.5
ii) Foreign portfolio investment (FPI)	4.2	4.3	5.6	1.7	10.1	8.8	9.5
iii) Other foreign investment (bank loans, etc.)	-9.5	-3.8	-4.8	-7.3	-8.8	-6.5	-6.0
7) Total balance = 5 + 6	0.6	13.9	14.1	-1.8	14.3	11.8	11.0
8) Errors & omissions	-1.1	1.6	0.3	-3.5	-1.7	0.0	0.0
9) Overall balance = 7 + 8	-0.5	15.5	14.3	-5.3	12.5	11.8	11.0
11) Change in FX reserves	-1.6	7.9	14.3	-5.3	14.5	11.9	11.0
12) FX reserves	34.7	42.6	56.9	51.6	66.1	77.9	88.9

Sources: Bank Indonesia, Standard Chartered Research

Table 3: Composition of parliament, 2009-14

	Party	Government or opposition	Ideology	Stance on Bank Century bailout	No. of parliamentary seats	% of parliamentary seats
1	Demokrat	Pro-government	Secular moderate	Supports	148	26.4
2	Golkar	Pro-government	Secular moderate	Opposes	106	18.9
3	PKS	Pro-government	Islamist conservative	Opposes	57	10.2
4	PAN	Pro-government	Islamist moderate	Supports	46	8.2
5	PPP	Pro-government	Islamist conservative	Opposes	38	6.8
6	PKB	Pro-government	Islamist moderate	Supports	28	5.0
7	PDI-P	Opposition	Secular nationalist	Opposes	93	16.6
8	Gerindra	Opposition	Secular nationalist	Opposes	26	4.6
9	Hanura	Opposition	Secular nationalist	Opposes	18	3.2
					560	100.0

Sources: General Election Commission, House of Representatives



The political issues

The government is moving in the right direction on these reforms. That said, as the current government is a fragile coalition working with a hung parliament, it is crucial that the various factions work together and avoid getting bogged down in politics. Political tensions recently intensified after 325 parliamentarians (59% of the total) from six of nine parties voted to confirm that the decision by BI and the MoF to bail out Bank Century, a troubled commercial bank, during the global financial crisis in November 2008 was improper.

The six parties include not only all three opposition parties (PDI-P, Gerindra and Hanura), but also three parties (Golkar; the Prosperous Justice Party, or PKS; and the United Development Party, or PPP) that support President Yudhoyono's coalition government. The three remaining parties (Yudhoyono's Demokrat party; the National Mandate Party, or PAN; and an Islamist moderate party, PKB) said the bailout was justified under the circumstances. The parliament only has the power to recommend that the police, the attorney general and the KPK further investigate the Bank Century case. Without clear evidence of illegality (critics of the bailout allege that some of the IDR 6.7tn in bailout funds were channelled to political parties and that the bailout decision itself lacked a legal basis), a formal investigation by law enforcement agencies seems unlikely. At a parliamentary hearing on 4 February, KPK Chairman Tumpak Hatorangan said that "there was no state corruption" in the Bank Century case.

While legal action against Vice President Boediono and Finance Minister Indrawati is not expected, the parties that oppose the Bank Century bailout may pursue the case via the political route, which could include recommending that parliament impeach Boediono. However, the Constitutional Court has already warned that the impeachment process would be complicated. Impeachment of the president or VP can only be initiated by a parliamentary vote, at which two-thirds of parliamentarians must be present. If the motion is supported by two-thirds of the quorum, the Constitutional Court will then decide whether there is enough legal evidence to approve it (after months of investigation, law enforcement units have not yet found any). Following the court's approval, parliament would have to reconvene – this time with a quorum of 75% of all members – to vote for impeachment. Given that the parties which openly support the bailout (Demokrat, PAN and PKB) control 41% of parliamentary seats, an impeachment is unlikely.

Despite the low likelihood of a constitutional or political crisis, the loss of parliamentary confidence is still a blow to the government and has adverse implications, at least temporarily. Firstly, the MoF's and BI's relations with parliament have been strained, and this is complicating the implementation of fiscal policy (parliament needs to approve the government budget) and banking policy (parliament is pressing for the establishment of an independent banking regulator by the end of 2010, despite BI's preference to postpone the deadline). Secondly, given the political backlash BI and the MoF are now facing for a bailout that was generally praised by financial markets at the time, they may be reluctant to rescue troubled banks in the future, even if the systemic risk is large.

Thus far, the strength of Indonesia's economic fundamentals has outweighed its political shortcomings. Moreover, as the chances of a political crisis dwindle, government-parliamentary tensions are likely to ease, as leaders of the coalition parties are expected to cut deals to preserve the government (and keep their ministers in the cabinet). Political tensions are likely to be limited to political rhetoric rather than disruption of government operations. The fact that Fitch and S&P recently upgraded Indonesia's sovereign ratings also shows that the rating agencies are shrugging off Indonesia's political situation – which is stable compared with, for example, the continuing unrest in Thailand. Given the low likelihood of a political crisis, we expect policy reforms to continue, which will encourage S&P, Moody's and Fitch to upgrade Indonesia to investment grade before the end of 2012.



The risks until the next presidential election (2014)

1. **Slow progress on reforms** – We believe this is the biggest risk, not because of a lack of political will but due to political circumstances: a fragile coalition government, a hung parliament, regional autonomy, a strongly populist media, and pressure from non-governmental organisations, to name a few. In short, there are far more stakeholders involved in the government now than under the Suharto dictatorship. That said, it is this fragmented political system that has created political stability over the last 10 years.
2. **Paralysis in government-parliament relations** – Given that President Yudhoyono's government is a coalition government and the parliament is a hung parliament, good government-parliament relations are crucial to effective policy implementation. Following the Bank Century case, however, these relations have weakened. This could reduce the effectiveness of government policy – the government budget needs parliamentary approval and more than 70 draft laws need to be passed by parliament. Opinion polls show that the public may attribute a failure of the government to an incompetent parliament. Hence, there is public pressure on both the government and parliament to work together.
3. **Political unrest and a military coup** – Highly unlikely. Since Indonesia embraced democracy in 1999 (it is now the world's third-largest democracy after India and the US), national and local elections have, by and large, been peaceful. The military, in particular the army, no longer plays a political role, while the police have been empowered by the rise of civil society. Parliamentary democracy has also become a political 'shock absorber', as the frequency of riots has declined and sensitive issues are debated in parliament. While terrorist threats remain, they appear to have subsided in recent years as the police have killed or captured key terrorist leaders. More importantly, Islamic organisations have publicly denounced terrorism as religious Jihad, which has reduced public support for Islamist extremists.

Market implications of achieving investment grade

Foreign exchange – BRL benefited, but results were mixed for INR and RUB

For the sake of comparison, we look at other economies which have recently attained investment-grade status.

1. Brazil was raised to investment grade by S&P in April 2008, by Fitch in May 2008 and by Moody's in September 2009. The improvement in Brazilian fundamentals and expectations of investment-grade status triggered a massive rally in the Brazilian real (BRL), which outperformed regional currencies from 2003-08.
2. India was raised to investment grade by S&P in January 2007, by Fitch in August 2006 and by Moody's in January 2004. The Indian rupee (INR) was among the worst-performing Asia ex-Japan (AXJ) currencies from 2004-06. However, in 2007, the INR was the second-best performer after the Philippine peso (PHP).
3. Russia obtained investment-grade ratings from S&P in October 2003, Fitch in January 2005 and Moody's in November 2004. The Russian rouble (RUB) performed in line with regional currencies from 2003-07. In sum, the BRL appears to have benefited from expectations of investment-grade status, whereas the impact on the INR and the RUB were more mixed.

Like the BRL, we expect the IDR to benefit from expectations of investment-grade status ahead of an actual upgrade. Dedicated emerging market (EM) real money funds are likely to increase their exposure to Indonesia ahead of the upgrade, which we expect by 2012. Structurally, this will add to the bullish outlook for the IDR. In addition, cyclical dynamics suggest that the IDR will strengthen over the next one to two years. This is why we recently upgraded our short-term (three- to six-month) FX rating on the IDR to *Overweight* from *Neutral*, whereas we kept our medium-term FX rating at *Overweight* (see **FX Alert, 11 March 2010, 'IDR raised to Overweight from Neutral'**). In our view, the global recovery and low interest rates in the West will support the IDR given strong Indonesian growth and positive carry. In addition, Indonesia's balance-of-payments (BoP) dynamics remain constructive given rising commodity prices and the fact that CPI inflation is likely to remain muted, which should support local asset markets. We forecast USD-IDR at 8,800 at end-2010. Over the medium to long term, we expect USD-IDR to average 8,700 in 2011, 8,300 in 2012, 7,800 in 2013, 7,500 in 2014 and 7,800 in 2015.



From an FX strategy point of view, we recommend that leveraged funds stay short USD-IDR at 9,280-9,300, around the 55-day moving average (MA) of 9,297. Meanwhile, real money funds should maintain an overweight IDR position due to the global growth recovery and strong Indonesian fundamentals. Finally, Indonesian corporates should raise hedge ratios on US dollar (USD), Japanese yen (JPY) and euro (EUR) receivables, especially on longer tenors.

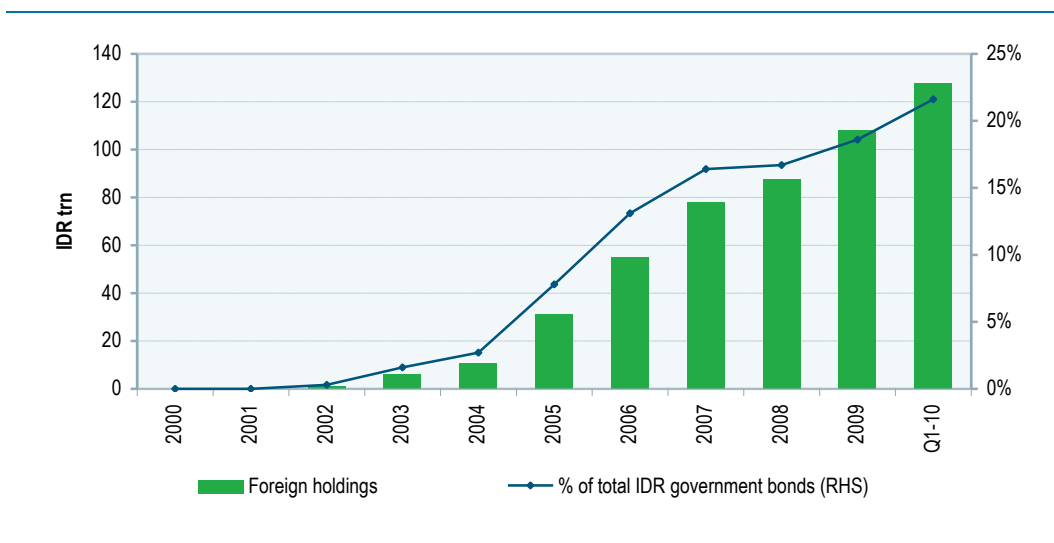
Local-currency government bonds and swaps – an additional positive, but fundamentals still matter

The decision by S&P to upgrade Indonesia to BB is in line with our positive outlook on the IDR government bond market. Although credit ratings may be just one factor in investment decisions, an upgrade to investment-grade status will widen the investor base in IDR assets to include, for example, pension funds. For instance, Thailand’s Securities and Exchange Commission limits outgoing investments to investment-grade issuer (guarantor and aval only), while Norway’s Government Pension Fund – Global limits fixed income investments in non-investment-grade entities to less than 1% of the market value of the fixed income part of the portfolio.

Having said that, Indonesian government bonds are not new to global investors. As of 15 March 2010, foreigners held around 21.6% of total outstanding IDR government bonds, a high since the global financial crisis. Various bond benchmarking indices also include IDR government bonds as a constituent. In fact, foreign participation in the IDR government bond market is the highest among the Asian bond markets under our coverage. Many bond-market participants have recently placed this asset class as an overweight play, driven in part by the expected improvement in the country’s credit profile.

Over the longer term, in addition to credit status, domestic inflation may be another factor determining whether single-digit yields on IDR government bonds are sustainable (using the 10Y tenor as a guide). The Indonesian 10Y government bond yield was about 270bps higher than the Philippines 10Y government bond yield, on average, between 2005 and 2009. Meanwhile, Indonesia’s y/y headline inflation was around 300bps higher than that of the Philippines during the same period – roughly in line with the difference in long-term yields. Similarly, if we chart the volatility and average yields of Asian government bond yields, they have a correlation with average inflation and inflation volatility – particularly in markets with high inflation volatility, such as Indonesia and the Philippines (for more detail, see **On the Ground, 23 February 2010, ‘Asia – Inflation volatility’**). While this analysis may over-simplify the situation (given that other factors, such as differing supply-and-demand dynamics, also affect yield levels), it is clear that an improvement in structural inflation over the longer term – along with a continued improvement in the sovereign credit profile – will be key in moving Indonesian interest rates, including bond yields, to a lower level.

Chart 4: Foreign participation in IDR government bonds



Source: Standard Chartered Research



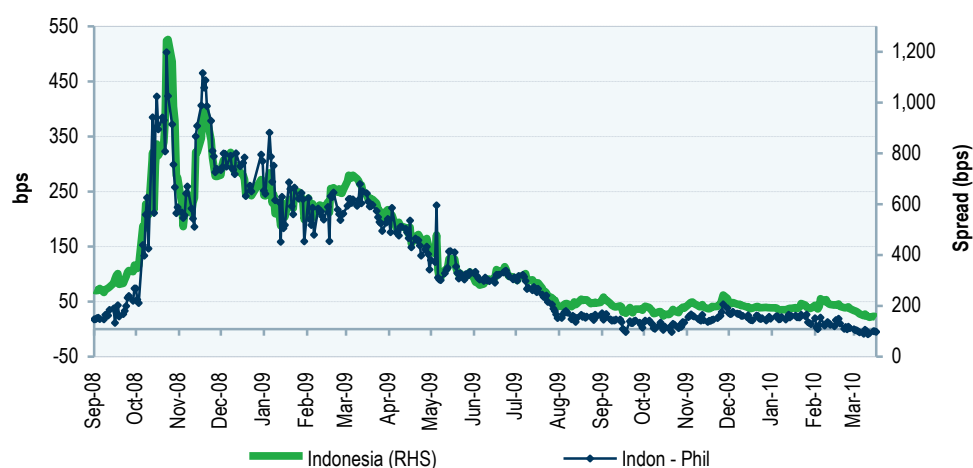
We reiterate our positive outlook on the IDR government bond market, underpinned by our favourable currency outlook. Funding has progressed very smoothly, with 34% of the full-year requirement already met. Including the planned USD 1.1bn Samurai bond, 40% of the year’s funding requirement will be met. In terms of domestic financing, the amount raised so far this year has reached IDR 41trn, more than the Q1-2010 target of IDR 37.6trn. On the inflation front, the outlook is benign. Even after taking into account a potential 30% hike in fuel prices and a 15% hike in electricity tariffs, inflation is expected to remain below 6% in 2010 (although we note that domestic inflation is volatile). While the possibility of domestic policy rate hikes and higher (albeit manageable) inflation may weigh on the bond market at some point this year, we maintain our positive outlook for now.

Credit – limited upside to sovereign spreads for now; focus on quasi-sovereign, corporate names

The Indonesia sovereign credit remains a favourite of EM investors. Following last year’s elections, investors have been very excited about prospects for further structural and economic reform. The re-election of President Yudhoyono has provided the country with a clear reform mandate. Investors are hopeful of progress on this front, which would move Indonesia onto a higher and more sustainable growth trajectory. Reforms will also be crucial in shifting the capital account financing mix away from portfolio inflows and into FDI. As we have highlighted above, capital flows have been very volatile in the past, resulting in extreme moves in the currency, equity markets and debt markets. We are confident that the authorities will make progress on reforms, which will significantly increase the probability of further rating upgrades.

The Indonesia 5Y CDS has performed strongly since end-2008 – and has significantly outperformed its peers in Asia, including the Philippines, over this period. After trading as wide as 500bps to the Philippines 5Y CDS in October 2008, the Indonesia 5Y CDS is trading flat to the Philippines. Although investors continue to allocate cash to the Asian sovereign space – in particular to the Philippines and Indonesia – sovereign spreads are arguably rich at current levels. With the overall credit markets already pricing in a lot of good news, we see limited upside to current spread levels and recommend exposure to some of the quasi-sovereign and pure corporate names rather than to sovereign debt. In particular, we recommend the PLN1J 7.75% of 2020s versus the INDON 5.875% of 2020s; the current spread differential between the two is around 140bps. Within the sovereign space, the only bond that offers value on the curve is the INDON 2014 sukuk bond. Finally, we continue to like the Indonesian commodity producers – in particular credits such as Adaro and Ciliandra.

Chart 5: Indonesia and Philippines CDS converge



Sources: Bloomberg, Standard Chartered Research



Disclosures Appendix

Regulatory disclosure

Subject companies: --.

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