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Jokowi pledges reforms to help grow Indonesian economy

By Anthony Prayugo

In less than 3 months, Indonesians will cast their ballots to choose their next president and representatives in their general election. The incumbent President Joko Widodo, who is popularly known as Jokowi and running for reelection, presented himself as a reformer upon entering office 5 years ago. Jokowi promised to get Indonesia's economy back on track to a target growth of 7% amid an economy that was slowing down after the 2000s commodity boom.

Commodity was and remains one of the most important sectors in the Indonesian economy. In 2014, the year Jokowi became president, commodities made up more than half of the export products of Indonesia, signifying its importance for the economy. However, amid China's economic slowdown, commodities prices fell. Jokowi's heavy spending in developing infrastructure across Indonesia's archipelago was part of his agenda to boost Indonesia's GDP growth. Unsurprisingly, the government's infrastructure spending budget has almost tripled from IDR 154.7tn in 2014 to a planned IDR 415tn in 2019. Furthermore, the government managed to cut the energy subsidies from 18.66% in 2014 to 4.26% in 2018 of its yearly state budget to free up some funds for its infrastructure projects.

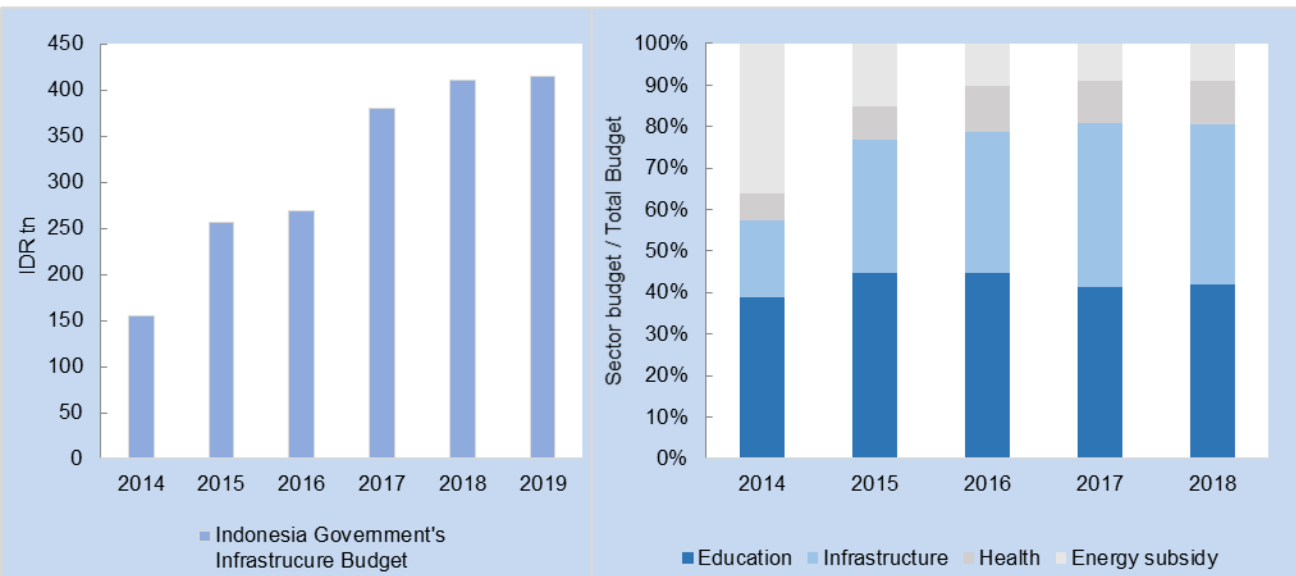

Figure 1a (LHS): Indonesia government's yearly infrastructure budget. Figure 1b (RHS): Indonesia government's yearly sector's budget percentage. *Source: Databoks.co.id*

Many of these projects, which include building tolls, seaports, and airports, are commissioned to the state-owned contractors. As a result, the combined revenue of the 4 major publicly listed state-owned contractors jumped 57% by the end of 2017. In 2017, these 4 major contractors boasted a combined revenue of IDR 108.05tn, which was equivalent to around 58% of the total industry revenue. Despite experiencing tremendous growth in revenue, the inability of the government to fund the whole project immediately forced these contractors to seek their own funding. However the revenue generated was insufficient to cover their project requirements for the next five years. Contractors borrowed heavily and the combined total debt for these 4 companies rose from around IDR 10.6tn in 2014 to around IDR 69tn in 2017. Meanwhile, average total debt/ T12M EBITDA for these 4 companies also rose from 2.86 in 2014 to 4.63 in 2017, indicating that it will they would need for time to pay off their debts.

One of the tools used by some state-owned firms such as Wijaya Karya to attract foreign investors was issuing Rupiah-denominated global bonds known as Komodo Bonds. These bonds offered global investors a higher coupon rate compared to its US dollar denominated bond to offset investors' worries about the Rupiah's fluctuation. Last year, Wijaya Karya issued IDR 5.4tn Komodo Bonds with a 7.7% coupon rate maturing in 2021.

Reflecting the increasingly leveraged nature of these state owned firms, the NUS-CRI 1-year aggregate Probability of Default (PD) for publicly listed state-owned contractors increased at a faster rate compared to the whole Indonesian construction sector (see Figure 2).

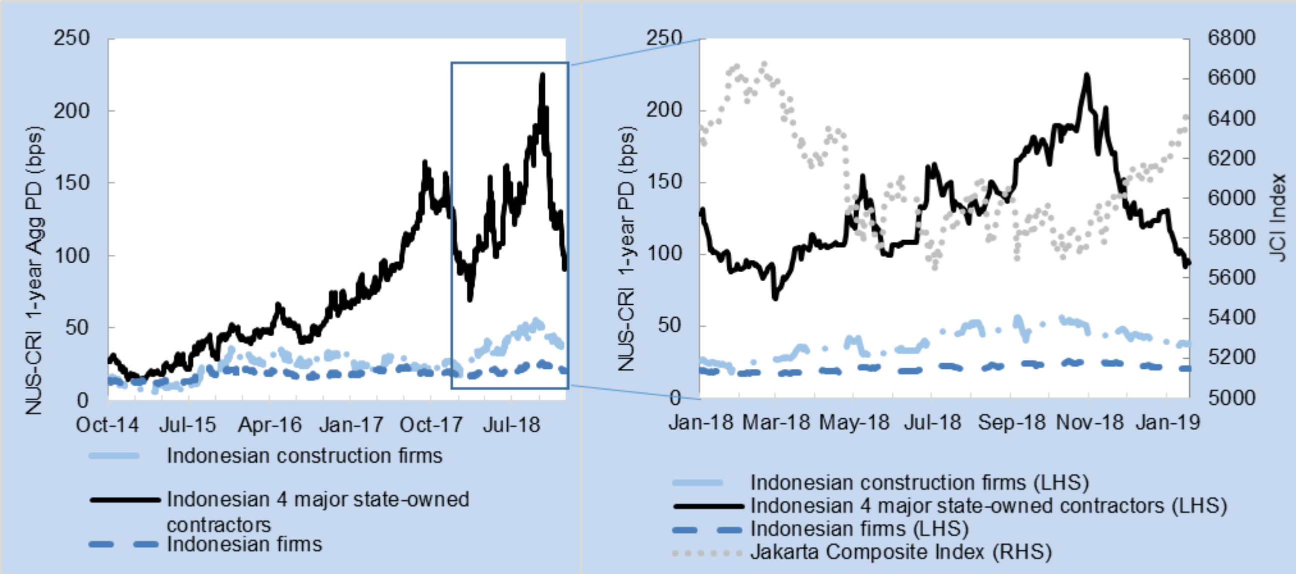

Figure 2: NUS-CRI 1-year aggregate PD for Indonesia state-owned construction firms and the whole Indonesia construction firms against all Indonesian firms and Jakarta Composite Index. *Sources: NUS-CRI, Bloomberg*

The Fed's interest rate hikes caused the biggest foreign investor exodus from Asia's emerging market since 2008. Against the backdrop of higher foreign investment outflows, the Indonesian stock exchange JCI index fell and the Indonesian Rupiah depreciated against US dollar. In November 2018, the Jakarta Composite Index (JCI) was approximately 12% lower than during its peak in February 2018. This affected many firms in Indonesia as a significant portion of their debt are in foreign currencies including US dollar. Bond yields of newly issued Rupiah denominated global bonds such as those from state-owned construction companies have increased in tandem with the higher US dollar.

However, some policies introduced by the Bank of Indonesia and the Indonesian Ministry of Finance such as raising interest rates and import taxes on several consumer goods have managed to stabilize the Rupiah. The currency rebounded from its lowest point in November last year and is currently one of the top year-to-date performers in the emerging markets region. The return of foreign investors starting from November 2018 was followed by the strengthening of the Indonesian Stock Market index and Rupiah, which was also reflected by the decline of the NUS-CRI 1-year aggregate PD for Indonesian firms. Lower oil prices (since Indonesia is a net oil importer), recovering loan growth, with combined effects from the election stimulus such as increased in welfare subsidies before the general election, might have cemented bullish views from investors on Indonesian stocks.

Current polls show that Jokowi is leading by a large margin over his opponent Prabowo Subianto. Both candidates also currently built their campaign around economic nationalism. Jokowi touted his success in taking over gold producer PT Freeport Indonesia controlling stake to counter Prabowo's criticism that Indonesia became overly dependent on foreign investments under Jokowi's administration. Moreover, Jokowi changed course last year by increasing the widely popular energy subsidies expenditure by 69% while slowing down spending growth in infrastructure. Although these measures might be vote-winning strategies, these policies could also put off foreign investors to invest in Indonesia in the long-run.

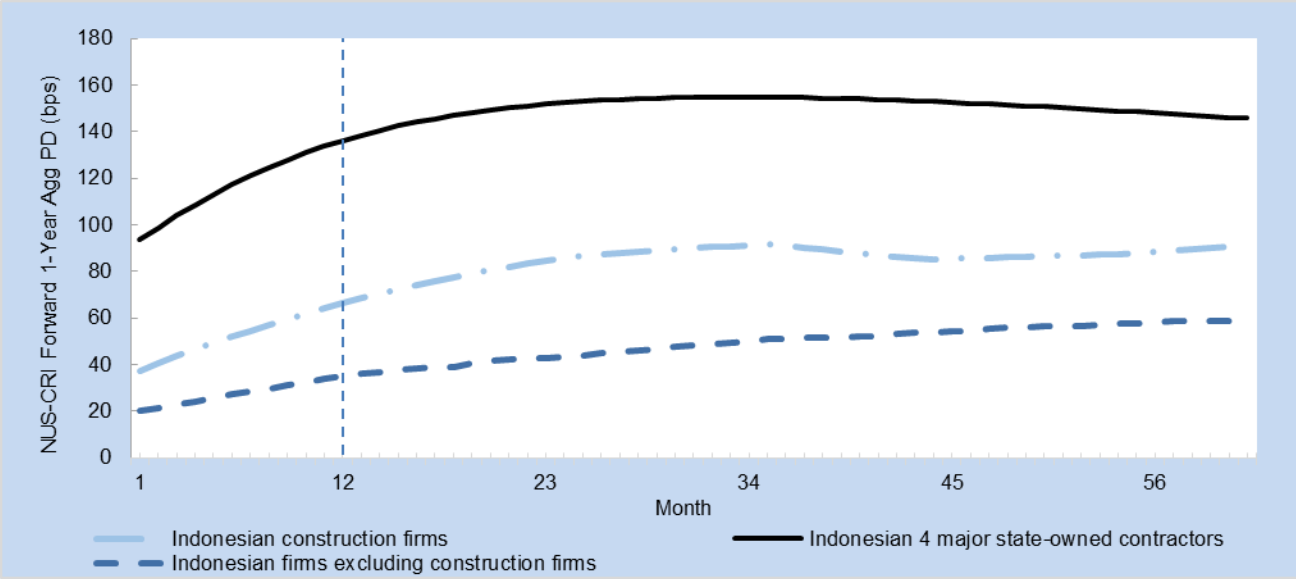

Figure 3: NUS-CRI Forward 1-year PD term structure for Indonesian firms on January 18, 2019. *Source: NUS-CRI.*

Figure 3 above illustrates the term structure of the NUS-CRI Forward 1-year Aggregate Probability of Default (Forward PD) for Indonesian firms. As illustrated in Figure 3, based on available market information as of January 18, 2019, the default risks of the 4 major state owned contractors could increase at a faster rate than Indonesian construction firms within the next 9 months. The shape of the Forward PD works similarly to a forward interest rate. For instance, the 9-month Forward 1-year PD is the probability that the firm defaults during the period from 9 months onwards to 1 year plus 9 months, conditional on the firm surviving the next 9 months. The figure asserts that the credit quality of the Indonesian sectors will deteriorate in the upcoming months. While this alone cannot be wholly attributed to Jokowi's policies, it suggests that Jokowi needs to do more to improve the credit quality of Indonesian firms.

Credit News
Chinese corporate bonds set for another wave of defaults **Jan 17.** Chinese private companies may face a more challenging environment in the domestic bond market in 2019 as billions of renminbi in maturing issuance conspire with reduced risk appetite, threatening an even bigger wave of defaults. Last year, nearly 90% of the USD 22.3bn defaults in China was issued by private sector companies, reflecting how the sector has been hurt by the tightening credit conditions. In light of private sector's vulnerability, People's Bank of China is lowering the reserve requirement ratio again this month, releasing CNY 800bn in frozen deposits to support small and private companies. However, the measure, which was also implemented rigorously last year, has yet to significantly improve the market conditions for private companies. (FT)
Jiayuan crash underscores China property risks **Jan 17.** Jiayuan International, a Chinese property developer, experienced a sharp decrease in its maket capitalizision by 81%, engulfed by concern that Jiayuan would struggle to repay a USD 350mn bond that was due this week. Investors are raising concerns over the sector that is staggering under vast debts just as the world's second-biggest economy slows. Chinese developers have about USD 55bn of maturing onshore debt in 2019 and life have been hard for developers. China's property market is cooling after a boom in recent years. The cost of refinancing is also quite expensive and recent stimulus measures by the central bank are aimed at only the very big developers, making lower-rated companies harder to repay debt. (FT)

China's new loans in December beat forecasts, hits record USD 2.4tn in 2018

Jan 15. Chinese banks extended USD 2.4tn of new loans in 2018 to cash starved companies in the midst of a slowing economy. Credit conditions however remained tight. Broad money supply grew at its slowest record rate of 8.1 percent while the growth of total outstanding social financing dropped to an all time low of 9.8 percent in November. Moving forward, banks may be less willing to issue more loans as the proportion of non-performing loans has climbed to a ten year high. But economists believe that the central bank will likely cut lending rates to ease any lending pressure. (Reuters)

PG&E will file for bankruptcy

Jan 15. PG&E, the San-Francisco-based utility group linked to the deadliest wildfire in California's history, saw its market capitalization plunged by more than half to USD 4bn after announcing that it will file for bankruptcy protection. While PG&E reportedly has USD 1.5bn in cash and expected EBITDA of USD 6bn this year, it is currently facing USD 30bn potential liabilities relating to the wildfires as well as USD 22bn debt. In light of its worsening credit profile, S&P and Moody's downgraded its rating to junk. (FT)

US banks wake up to an easy money hangover

Jan 15. As the Fed raises rates and quantitative easing has shifted into reverse, short-term credit costs are rising. Long-term loan rates have not risen as much, resulting in tighter profit margins for lenders. But the increases have been enough to raise the costs of auto and home loans, which has made those two sectors perhaps the weakest in the otherwise healthy US economy, while damping loan growth for banks. While the Fed kept rates low, companies took advantage and borrowed as much as they could on the longest terms they could find, often in yield-starved capital markets rather than at banks. As a result, demand for more debt is subdued. (FT)

US fund investors put most cash in 'junk' since late 2016 (Reuters)

China December total social financing rises to CNY 1.59tn (Reuters)

Euro zone bond investors exercise caution ahead of Brexit vote (Reuters)

Regulatory Updates

Basel Committee completes review of Principles for sound liquidity risk management and supervision

Jan 17. The Basel Committee on Banking Supervision has completed a review of its 2008 "Principles for sound liquidity risk management and supervision", and confirmed that the Sound Principles remain well-suited for purpose. The review concluded that the global liquidity standards introduced under Basel III complements the Sound Principles. In addition, certain developments in the financial markets, such as increasing digitization of finance and payment systems, are likely to be relevant in a bank's liquidity risk management consideration. The Committee also suggests that banks' risk management and supervisors' practices should be applied consistently and rigorously through the economic cycle, regardless of market liquidity conditions. (BIS)

EBA publishes final guidance regarding the exposures to be associated with high risk

Jan 17. The European Banking Authority (EBA) published its guidelines regarding the types of exposures to be associated with high risk under the Capital Requirements Regulation (CRR). Through such guidelines, EBA hopes to enable a higher degree of comparability in terms of current practices in identifying exposures associated with high risk and to facilitate the transition to the upcoming regulatory revisions. The guidelines consist of two sections – the first section clarifies the notions of investments in venture capital firms and private equity, while the second section identifies the types of exposures to be associated with high risk under the CRR. (EBA)

ECB lays out bad loan deadlines for Eurozone banks (FT)

US government shutdown is starting to hurt Trump's financial deregulation agenda (CNBC)

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