Indonesia—Update

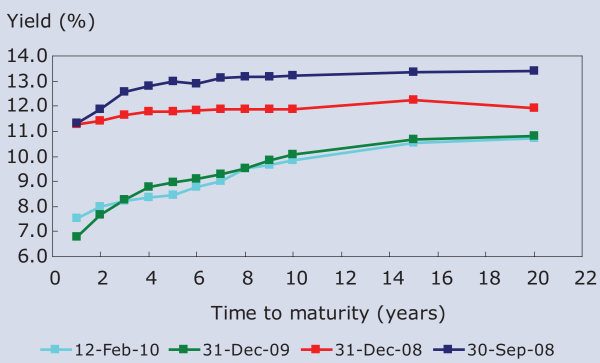
Yield Movements

Indonesia's government bond yield curve fell modestly for most maturities in mid-February from end-December levels **(Figure 1)**. Yields fell the most for 5-year maturities, shedding 51 basis points. However, the shorter-end of the curve rose 75 basis points for 1-year maturities and 33 basis points for 2-year maturities. Thus, the yield spread between 2-year and 10-year maturities narrowed to 183 basis points in mid-February from 241 basis points at end-December.

Rising yields at the short-end of the curve reflect, in part, expectations of price pressures in the near term amid renewed strength in domestic economic activity. Nonetheless, the overall downward shift in the yield curve from the belly through the end of the curve since September 2008 can be attributed to positive market sentiments related to (i) the appreciation of the Indonesian rupiah, and (ii) an improved economic outlook.

Indonesia posted 5.4% year-on-year (y-o-y) gross domestic product (GDP) growth in 4Q09, the fastest pace in 5 quarters. Full year economic growth in 2009, however, fell to 4.5% compared with 6.0% in 2008. Growth in household consumption declined to 4.9% at the end of 2009 compared to 5.3% one year earlier. However, household consumption continued to play a dominant role in GDP (58.6%). Meanwhile, government consumption climbed 15.7% in 2009. According to the Central Statistics Agency, Indonesia is coping with the global economic crisis better than neighboring countries due to strong consumer spending and the government's fiscal stimulus package. For 2010, the government's economic growth forecast is 5.5%.

Figure 1: Indonesia's Benchmark Yield Curve—Local Currency Government Bonds



Source: Bloomberg, LP.

Consumer price inflation in Indonesia climbed to 3.72% y-o-y in January and 3.81% y-o-y in February amid rising costs for food and commodities, particularly rice and sugar. The uptick in inflation levels, however, was still below Bank Indonesia's (BI) target inflation range for 2010 of 4.0%–6.0%. BI has held its benchmark interest rate steady at the historically low level of 6.5% since August of last year.

Size and Composition

As of end-December, the size of the local currency (LCY) bond market in Indonesia had expanded 19.4% y-o-y and 7.3% quarter-on-quarter (q-o-q) **(Table 1)** as the total volume of Indonesia's LCY bond market reached IDR930.06 trillion (USD98 billion).

Outstanding government bonds rose 19.2% y-o-y to IDR841.6 trillion in 2009 on account of strong growth in both central government bonds (issuance by the Ministry of Finance) and central bank bills (issuance by BI in the form of *Sertifikat Bank Indonesia* [SBI]). As of end-December, the stock of central government bonds had grown 10.7% y-o-y and 2.5% q-o-q. On a month-on-month (m-o-m) basis, however, central government bonds remained flat in December.

The Ministry of Finance suspended treasury issuance in mid-November after fully meeting its 2009 gross issuance target of IDR144.54 trillion. The government was able to frontload much of

Table 1: Size and Composition of Local Currency Bond Market in Indonesia

	Amount (billion)								Growth Rate (%)						
	Sep-09		Oct-09		Nov-09		Dec-09		Sep-09		Oct-09	Nov-09	Dec-09		
	IDR	USD	IDR	USD	IDR	USD	IDR	USD	y-o-y	q-o-q	m-o-m	m-o-m	y-o-y	q-o-q	m-o-m
Total	866,973	90	892,947	94	911,282	96	930,063	98	17.7	0.1	3.0	2.1	19.4	7.3	2.1
Government	788,043	82	814,245	85	832,709	88	841,612	89	19.6	0.3	3.3	2.3	19.2	6.8	1.1
Central Govt Bonds	567,367	59	574,967	60	581,758	61	581,748	61	4.7	2.6	1.3	1.2	10.7	2.5	(0.0)
Central Bank Bills	220,676	23	239,279	25	250,951	27	259,864	27	88.7	(5.2)	8.4	4.9	44.3	17.8	3.6
Corporate	78,930	8	78,701	8	78,573	8	88,452	9	1.3	(1.2)	(0.3)	(0.2)	21.2	12.1	12.6

m-o-m = month-on-month, q-o-q = quarter-on-quarter, y-o-y = year-on-year.
Notes:
1. Calculated using data from national sources.
2. Bloomberg end-of-period LCY—USD rates are used.
3. Growth rates are calculated from LCY base and do not include currency effects.
Source: Bank Indonesia, Indonesia Stock Exchange, and Bloomberg LP.

its bond issuance early in 2009. Meanwhile, the stock of central bank bills was substantially higher, growing 44.3%, y-o-y and 17.8% q-o-q.

The government tapped various treasury instruments in 2009 to finance its budget deficit. The Revised State Budget for 2009 fixed the deficit at 2.4% of GDP (equivalent to IDR129.8 trillion). However, the actual deficit was equivalent to about 1.6% of GDP. For 2010, the budget deficit is projected to be IDR98 trillion (equivalent to 1.6% of GDP).

The government continues to issue *shari'a*-compliant debt instruments through Islamic treasury auctions, retail Islamic bonds (*sukuk)*, and global Islamic bonds. In February, the government sold IDR8.034 trillion in 3-year *sukuk* to retail investors. The retail *sukuk* carried a coupon of 8.7%. The issue was well received with bids nearly tripling the initial target of IDR3 trillion. This was the second retail *sukuk* issuance by Indonesia.

The stock of corporate bonds significantly rose this year, increasing by a notable 21.2% y-o-y and 12.1% q-o-q.

As of end-December, the top 10 corporate issuers in Indonesia accounted for about 50% of total corporate bonds outstanding **(Table 2)**. State power firm PLN was Indonesia's top corporate issuer of LCY bonds at IDR9.1 trillion. This was equivalent to 10% of total corporate bonds outstanding in 4Q09.

Telecommunications firm PT Indosat ranked second with bonds valued at IDR8.1 trillion, while toll operator Jasa Marga was third with outstanding bonds amounting to IDR4.2 trillion. Five banks made it to the top 10 list of corporate issuers, with their aggregate bonds outstanding valued at IDR16.3 trillion.

In 4Q09, corporate issuance reached more than IDR12 trillion. Of this amount, about IDR10 trillion was issued in December. Notable issues during 4Q09 are listed in **Table 3**. Data from the Capital Market and Financial Institutions Supervisory

Table 2: Top 10 Corporate Issuers as of December 2009

Top 10 Corporate Issuers	Outstanding Amount (IDR billion)
PLN	9,100
Indosat	8,090
Jasa Marga (Toll operator)	4,150
Bank Panin	3,950
Indofood Sukses Makmur	3,610
Bank Mandiri	3,500
Perum Pegadaian (Pawnshop)	3,270
Bank Tabungan Negara	3,250
Bank Ekspor Indonesia	3,050
Bank Rakyat Indonesia	2,500

Source: Indonesia Stock Exchange.

Table 3: Notable Corporate Issuance in 4Q09

Issuers	Outstanding Amount (IDR billion)
Bank Mandiri	3,500
Bank Rakyat Indonesia	2,000
Indosat	1,500
Oto Multiartha	1,200
Bank Panin	800
Pupuk Kaltim	791
Bank Tabungan Pensiunan Nasional	750
Salim Ivomas Pratama	730

Source: Indonesia Stock Exchange.

Agency (Bapepam-LK) showed that IDR26.3 trillion was raised through the issuance of bonds in 2009, which exceeded the IDR15 trillion target set by Bapepam-LK for the year.

Foreign Currency Bonds

In January of this year, the government sold USD2 billion of 10-year bonds at a yield of 6.0%, which was about 2.28 percentage points higher than comparable US treasuries. The yield on Indonesia's global bond issue was also higher than the yield on Philippine 10-year bonds, which were sold a week earlier at 5.67%. Indonesia's 10-year bond issue was 2.3 times oversubscribed with demand reaching USD4.5 billion. The government had also planned to offer 30-year bonds, but cancelled the issue.

The government still plans to issue *samurai* bonds up to a maximum of USD1.1 billion in late April this year.

Rating Changes

In January, Moody's Investor Service (Moody's) said the outlook for Indonesia's Ba2 rating remained stable. Moody's last rating action on Indonesia was taken on 16 September when it upgraded the foreign currency (FCY) and LCY sovereign debt ratings to Ba2. On 26 January, Moody's also changed the industry outlooks for 12 of the banking systems in Asia and the Pacific, including Indonesia's, from negative to stable.

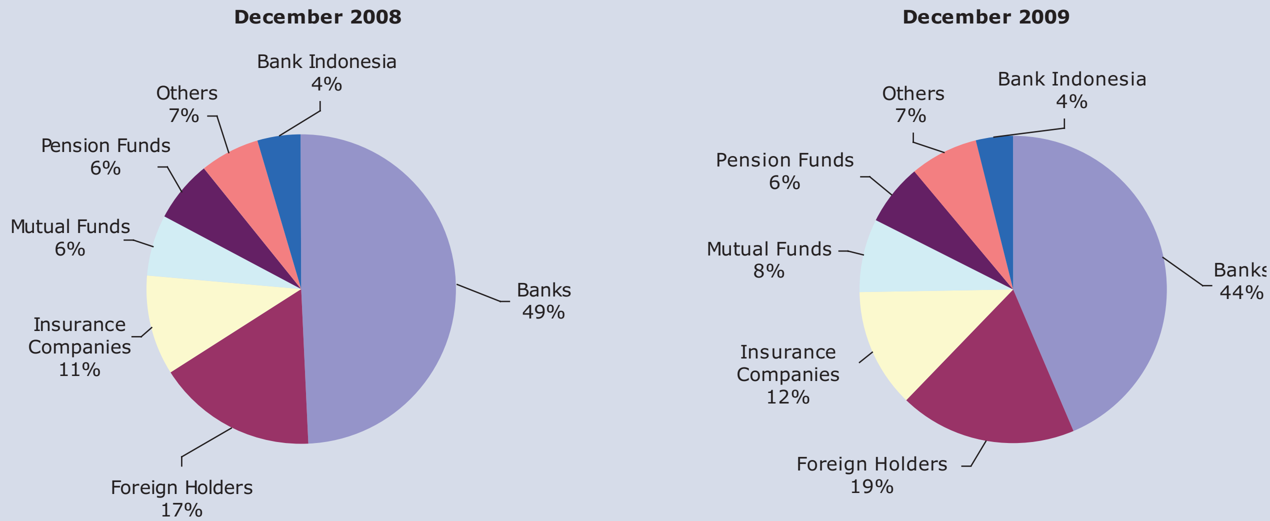
Fitch Ratings upgraded Indonesia's long-term FCY and LCY issuer default ratings to BB+ from BB on 25 January **(Table 4)**. The outlook on the ratings was stable. This brought Indonesia only one step away from reaching investment grade. Fitch also raised the country ceiling to BBB- from BB+ and affirmed the short-term FCY rating at B. According to Fitch, the rating action reflects Indonesia's relative resilience to severe global financial stress in 2008/2009, which has been underpinned by continued improvement in the country's public finances and a material easing of external financial constraints. Fitch also raised the ratings of eight local banks' foreign debt to BB+ from BB. The eight banks include PT Bank Mandiri, PT Bank Internasional Indonesia, PT Bank CIMB Niaga, PT Bank Rakyat Indonesia, PT Bank Central Asia, PT Bank Danamon, PT Bank OCBC NISP, and PT Bank UOB Buana.

Table 4: Selected Sovereign Ratings and Outlook for Indonesia

	Moody's	S&P	Fitch
Sovereign FCY LT Ratings	Ba2	BB	BB+
Outlook	stable	positive	stable

FCY = foreign currency and LT = long term.
Source: Rating agencies.

Figure 3: Investor Profile for Local Currency Government Bonds



Source: Indonesia Debt Management Office.

In March, Standard and Poor's rating agency (S&P) upgraded Indonesia's long-term FCY rating by one notch to BB from BB-. S&P based this upgrade on the resilience of the Indonesian economy over the last year.

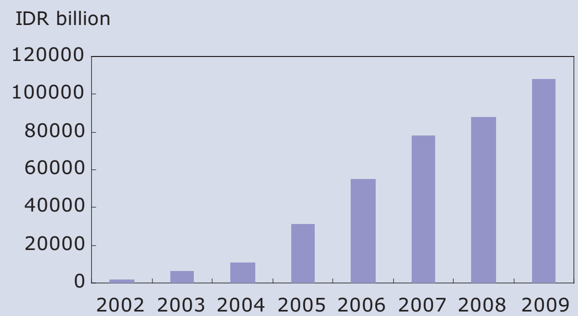
Investor Profile

As of end-December, banking institutions continued to be the major holder of Indonesian LCY government bonds, with holdings equivalent to 44% of total government bonds outstanding **(Figure 3)**. Although bank holdings still represent a significant share, this share has declined dramatically in recent years. In 2002, banks were holding as much as 82% of total government bonds outstanding.

Bonds held by foreign investors—the second-largest holder of Indonesian government bonds—increased to 19% from 17% in 2008. As of end-December, bonds held by foreign investors reached IDR108 trillion, the highest level to date **(Figure 4)**.

The share of LCY bond holdings of insurance companies and mutual funds also rose during 2009.

Figure 4: Foreign Holdings in Government Bonds



Source: Indonesia Debt Management Office.

Policy, Institutional, and Regulatory Developments

Scrapping of Double Taxation on Transactions in Islamic Financial Markets

In September, Indonesia's parliament passed a revised law on value-added taxes. The law scrapped double taxation on transactions in Islamic financial markets. The law will come into effect sometime in April 2010.

Auction of Islamic Bonds

Beginning mid-October, the Finance Ministry commenced holding regular auctions of government *shari'a*-compliant debt instrument known as *sukuk*. The issuance of *sukuk* will follow the sale-and-lease structure of *ijarah*. The underlying assets to be used in the auction of *sukuk* will be state properties approved by the House of Representatives.

Secondary Reserve Requirement

Effective 24 October 2009, banks were required to set aside 2.5% of IDR deposits as a secondary reserve requirement for unexpected liquidity needs. This raised banks' reserve requirement with Bank Indonesia to 7.5%. The secondary reserve requirement may be held in the form of treasury bonds, treasury bills, SBI, or excess reserves.

New Tax Regulation to Prevent Tax Evasion

In January, a new rule to prevent tax evasion came into effect. The new regulation requires more detailed information from bond issuers to determine whether they are entitled to withholding tax rates below the standard rate of 20%. Borrowers setting up an offshore unit in a jurisdiction with a lower tax rate and with a double taxation treaty with Indonesia need to prove the unit was not set up only for the purpose of reducing taxes. This new regulation applies to both new issues and existing bonds.