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Indonesian Business Council

FINANCIAL DEVELOPMENT FOR STRONG
AND EQUITABLE GROWTH:

POLICY PAPER 4

NAVIGATING THE ROAD TO IMPROVE SOVEREIGN CREDIT RATING

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Financial Development for Strong and Equitable Growth:

NAVIGATING THE ROAD TO IMPROVE SOVEREIGN CREDIT RATING



This policy paper is part of a series derived from the “**Financial Development for Strong and Equitable Growth**” white paper, launched in February 2024. By employing the IMF’s Financial Development Index framework, which encompasses depth, access, and efficiency dimensions, each paper offers a comprehensive analysis of critical financial development issues. These papers propose targeted strategies to enhance Indonesia’s financial landscape and foster sustainable economic growth.

The policy paper series consists of:

1. Financial Product Innovation to Enhance Financing Options
2. Increasing MSME Access to Credit through Collateral Assets and Credit Information System
3. Enhancing Financial Efficiency through Banking Consolidation
- 4. Navigating the Road to Improve Sovereign Credit Rating**
5. Leveling Taxation Playing Field between Financial and Non-Financial Sectors
6. Managing Non-Performing Loan (NPL) through Asset Management Companies
7. Expanding Financial Coverage through Reform Programs
8. Leveraging the Potential of Green Financing

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Executive Summary

Indonesia has historically experienced volatile credit ratings, often lower than its Southeast Asian neighbors. Standard & Poor's (S&P) rated Indonesia below investment grade until 2016, while Fitch and Moody's assigned investment-grade ratings in 2011 and 2012, respectively. Since 2016, Indonesia's credit ratings have steadily improved, reflecting enhanced economic stability and creditworthiness. Nonetheless, Malaysia and Singapore have significantly higher credit ratings, while Indonesia's ratings are also slightly below Thailand and Philippines.

The factors determining a country's sovereign credit rating by agencies like S&P, Moody's, and Fitch include macroeconomic stability, fiscal policies, government debt, and economic performance. The key components include consistent economic growth, controlled inflation, and robust fiscal policies with manageable debt levels. Participation in Global Value Chain (GVC) also plays a crucial role by enhancing competitiveness through access to international markets and technology. Moreover, structural reforms that promote a favorable investment climate, economic openness to trade and Foreign Direct Investment (FDI), along with political stability and effective governance, are essential for a high sovereign credit rating.

In Indonesia, several main issues could hinder the accuracy in assessing the sovereign credit rating. First, the Indonesian economy is highly dependent on the commodity sector, making it vulnerable to global price fluctuations and heightening risk perceptions among international investors. Second, the low tax ratio in 2022 (10.39% of GDP) presents challenges in raising sufficient fiscal revenues to support public services and infrastructure. Third, the decline in regulatory quality due to uncertainty erodes investors' trust in the stability of the business environment. Fourth, the lack of control over corruption affects government's quality and investor confidence. Fifth, the persistent twin (current account and budget) deficits threaten economic stability. Sixth, low liquidity in the financial market resulting from suboptimal foreign exchange of exports proceeds (DHE). Lastly, the lack of effective communication between the Indonesian government and Credit Rating Agencies (CRAs) further hampers effective assessment.

To improve Indonesia's sovereign credit rating, several strategic steps need to be taken by the government and other related institutions. First, reducing dependence on the commodity sector by promoting existing manufacturing industries as well as potential sectors to diversify the economy. Second, increasing the efficiency of tax collection through proper implementation of Law on Harmonization of Tax Regulations (UU HPP) and intensive tax awareness campaigns. Third, improving transparency and legal certainty in the licensing process to create a friendly and trustworthy investment environment. Fourth, enforcing regulations regarding corruption practices to make ensure integrity. Fifth, ensuring Balance of Payment (BoP) remains healthy by designing new incentives for foreign investors. Sixth, increasing market liquidity by strengthening law enforcement regarding export proceeds. Lastly, maintaining active communication with international sovereign rating agencies to convey clear and reliable information regarding economic policies, financial stability, and national development progress. By implementing these strategies in a coordinated manner, Indonesia could accelerate its financial development and improve its sovereign credit rating.



Image credit: Canva

1. Background and Problems Identification

The global economy, characterized by interconnected markets and cross-border investment, places great significance to financial development. The IMF framework highlights different dimensions on financial development, which are financial depth, access, and efficiency. Sovereign credit ratings, as indicators of financial health, reflect the government creditworthiness, and are crucial for determining a country's access to international capital markets. In addition, these ratings provide valuable insights into the political and economic risks associated with investing in a particular country, navigating investor decisions and shaping market dynamics. Thus, credit ratings have significant influences on financial development, especially in terms of financial efficiency.

In 2024, Indonesia is working to improve its sovereign credit rating to foster more efficient financial development, as its rating remains lower than its neighboring countries.¹ As illustrated in Table 1, Malaysia, Thailand, the Philippines, and Singapore possess superior credit ratings compared to Indonesia. According to S&P, Indonesia holds a BBB rating with a stable outlook, which is lower than Malaysia's A-rating. Meanwhile, Thailand and the Philippines both have higher ratings of BBB+ with stable outlooks. Singapore, with its AAA rating and stable outlook, represents the highest possible creditworthiness, indicating an extremely low credit risk. Moody's ratings present a similar comparative analysis with Indonesia holding a Baa2 stable rating, which is below Malaysia's A3 stable rating. Thailand's Baa1 stable rating is also one notch higher than Indonesia's Baa2, while Philippines shares the same stable Baa2 rating as Indonesia, suggesting a similar level of credit risk.

Table 1. Credit Rating of ASEAN-5 Regions²

Country	S&P Rating	Moody's Rating
Singapore	AAA stable	Aaa stable
Malaysia	A- stable	A3 stable
Thailand	BBB+ stable	Baa1 stable
Philippines	BBB+ stable	Baa2 stable
Indonesia	BBB stable	Baa2 stable

Sovereign credit ratings are crucial because of their significant influence on global markets' perception. Consequently, they affect a country's borrowing costs and its attractiveness to foreign investors. These ratings are correlated with a country's economic trajectory and affect FDI inflows, debt costs, and overall economic stability. A higher rating signals that a country demonstrates greater stability and credibility, thus attracts foreign investments. For example, Indonesia's foreign investment to GDP ratio is notably lower compared to other ASEAN nations at 1.87% as depicted in Figure 1. This is in line with its lower credit ratings relative to other countries at BBB stable. In contrast, Singapore, which is the only developed economy in the region, has the highest FDI at 29.84% and credit ratings among ASEAN member states at AAA stable.

1 Indonesia Business Council, 2023

2 Countryeconomy, 2024

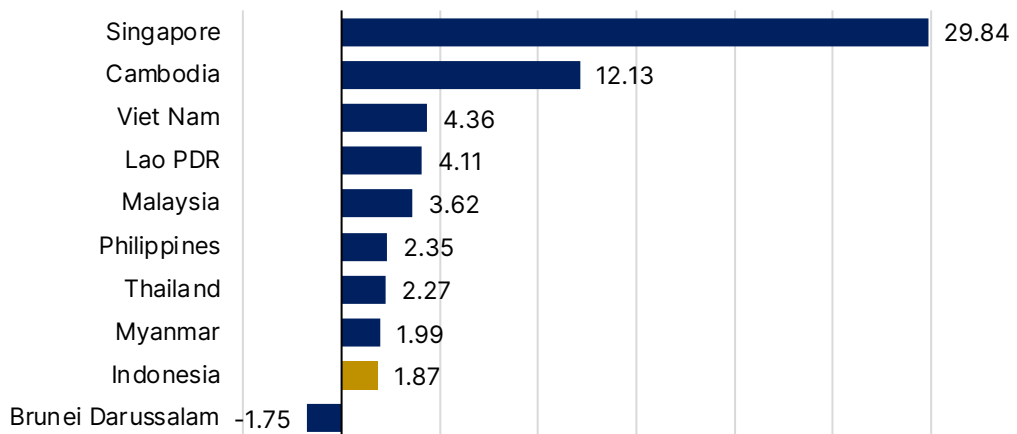


Figure 1. Foreign Direct Investment, Net Inflows (% of GDP)³

The long-run trend of each CRA's assessment shows an overall upward trajectory from 2006 to 2023 (see Figure 2). However, there have been periods of stagnation over the years, including in the recent 2020 to 2024. Indonesia currently holds ratings above investment grade, which is favorable for the investment environment in Indonesia. Nonetheless, these ratings have not yet achieved the competitive level seen in other countries within the ASEAN region. This is particularly noteworthy given the increasing flow of investment into developing economies across ASEAN over the past decade. If Indonesia fails to enhance its ratings to a more competitive standard, it risks missing out on this growing investment trend, potentially leading to a shift of investment opportunities to neighboring countries that are perceived as more favorable by investors.

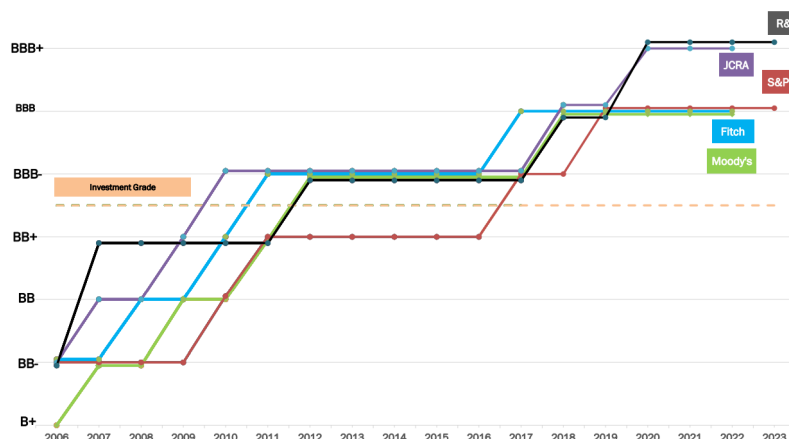


Figure 2. Indonesia's Credit Rating History⁴

There are several issues that have been identified as factors contributing to the difficulty in raising Indonesia's sovereign credit rating.

1.1 Dependence of the Indonesian Economy on the Commodity Sector

Indonesia faces serious challenges due to its heavy reliance on commodities, which significantly influences its economic performance and stability. As shown in Figure 3, compared to other neighboring countries, Indonesia has the largest agricultural sector contribution in its GDP. This dependence renders the Indonesian economy particularly vulnerable to fluctuations in global commodity prices. When commodity prices experience a decline, the revenue generated from exports diminishes

3 World Bank, 2022

4 Moody's, Fitch, S&P, JCRA, R&I

correspondingly, leading to a reduction in national income. Such instability fosters a perception of increased risk among investors, which can result in Indonesia's sovereign credit rating being lower than neighboring countries with more diversified economic structures.

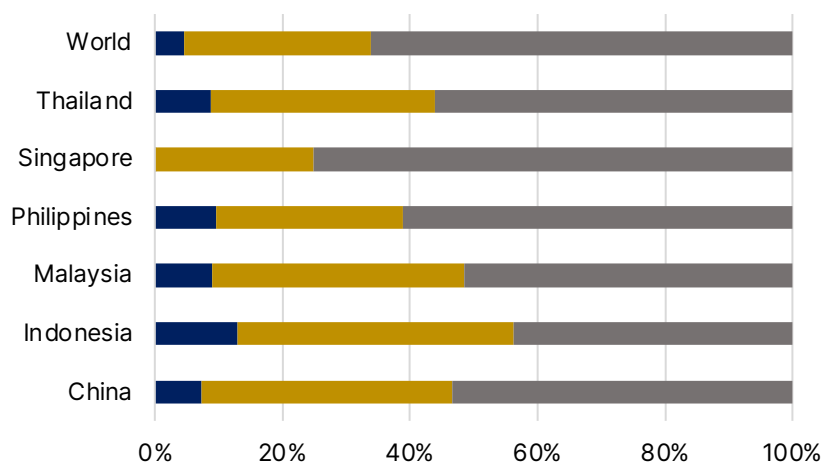


Figure 3. Selected Countries GDP Composition, 2022⁵

1.2 Low Tax Ratio and Fiscal Sustainability

In 2022, Indonesia's tax to GDP ratio stood at 12.1%, markedly lower than many of its many regional peers and global benchmarks, as shown in Figure 4. The relatively low tax ratio signifies that Indonesia collects a smaller share of its GDP in tax revenue compared to other nations. Consequently, limitation in fiscal revenue impacts the government's ability to adequately fund essential public services and infrastructure projects.

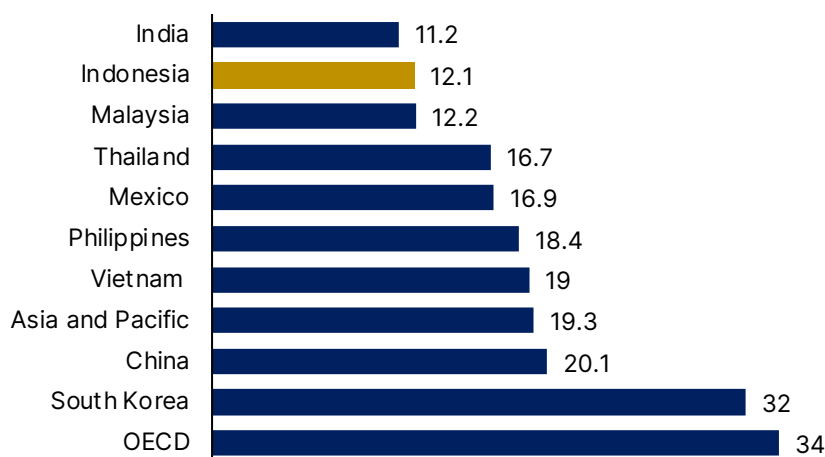


Figure 4. Tax to GDP Ratio of Indonesia and Other Countries, 2022⁶

In addition, Indonesia's debt-to-GDP ratio was 39.70% in 2022, placing it lower than most regional counterparts except Vietnam. However, Indonesia faced a problem with high-interest payments on its debt. In 2021, these interest payments took up 16.99% of the country's total revenue. This means that

5 World Bank, 2022

6 OECD, 2024

a significant portion of the money the government makes is used to pay interest on the debt, which makes it harder for the country to use its money for other important needs. Moreover, medium-term fiscal risks are present, driven by uncertain fiscal policies and costly presidential campaign promises, such as the provision of free nutritious lunches. These factors could potentially erode Indonesia's fiscal capability.

The Indonesian government has taken some policy measures to improve tax management, such as the Law on Harmonization of Tax Regulations (*Undang-Undang Harmonisasi Peraturan Perpajakan/ UU HPP*). However, significant challenges remain within the country's taxation system. Persistent issues such as tax avoidance, regulatory complexity, and administrative inefficiency continue to impede successful implementation of a robust tax system.

1.3 Poor Regulatory Quality and Certainty

Regulatory quality reflects perceptions of the government's capacity to design and enforce effective policies and regulations that facilitate and encourage the growth of the private sector.⁷ Indonesia has made notable progress in this area, particularly evident between 2019 and 2021, as illustrated in Figure 5. However, it still remains relatively low compared to countries like Singapore and Malaysia. The difference demonstrates a persistent gap in regulatory practice, which may be attributed to various systemic, structural, or institutional factors. In contrast, superior regulatory environments of Malaysia and Singapore, characterized by stability and predictability, contribute to more favorable sovereign credit ratings from agencies.

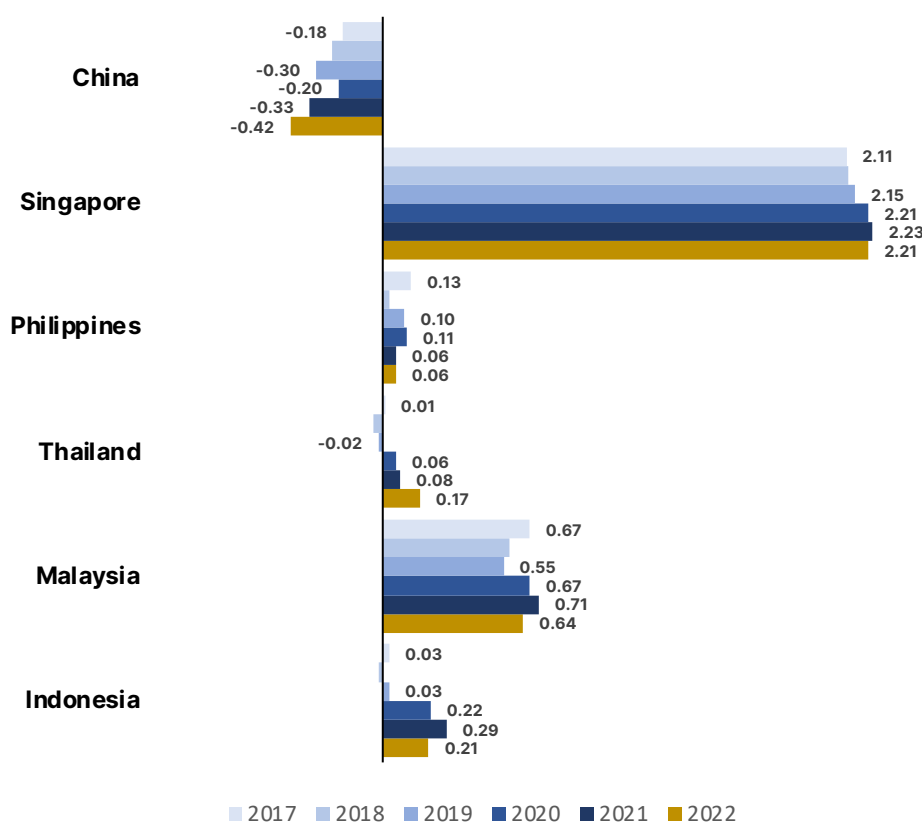


Figure 5. Regulatory Quality⁸

7 World Bank, 2023

8 ibid

To attain higher sovereign credit ratings, Indonesia must fortify its regulatory framework, as this provides an enabling condition for achieving such improvements. A strengthened regulatory framework is essential for nurturing a dynamic and competitive private sector since it ensures that policies and regulations are both transparent and predictable. This stability not only facilitates business operations but also reduces barriers to entry for new firms and encourages existing businesses to expand and innovate. Additionally, such enhancements are instrumental in diminishing risk perceptions, and amplifying attractiveness to the market since investors are more likely to commit capital in environments where there is confidence in the consistency and fairness of the regulatory process.

1.4 Decreasing Indonesia’s Control of Corruption

Indonesia also grapples with substantial corruption challenges. As it is shown in Figure 6, corruption control in Indonesia remains notably weaker compared to neighboring countries, such as Singapore and Malaysia. The implementation of Law Number 19 of 2019, which modifies the framework of the Corruption Eradication Commission (KPK) introduces stricter oversight and procedural changes, including requiring supervisory board approval before the KPK can conduct wiretapping and investigations. Although intended to enhance transparency and accountability, it raises concerns about the potential weakening of the KPK’s independence and effectiveness in combating corruption.

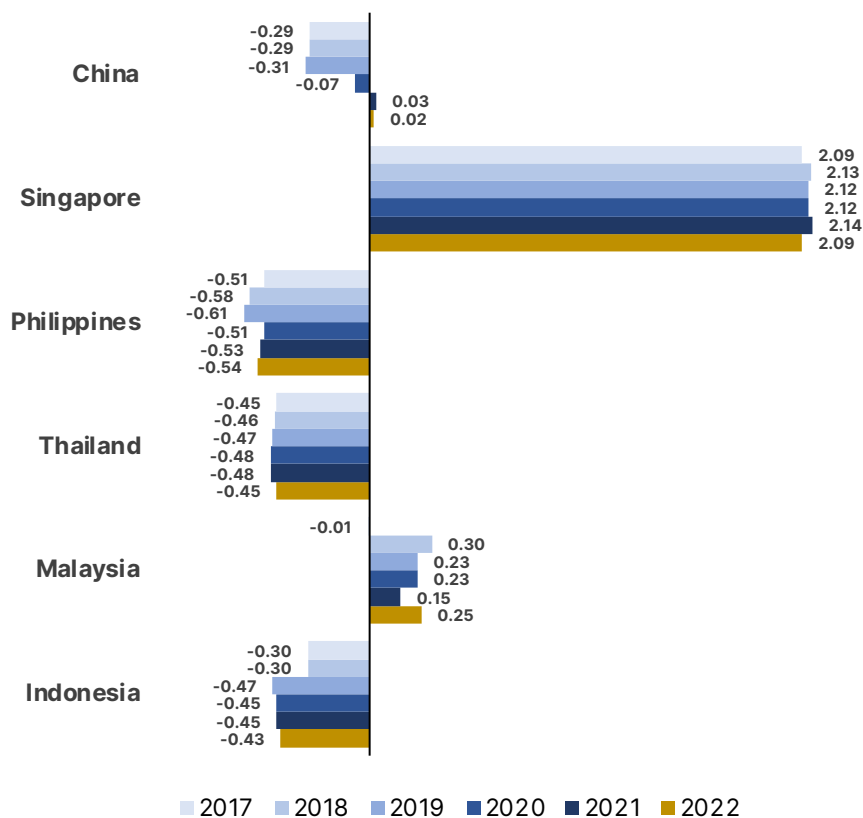


Figure 6. Control of Corruption in ASEAN 5+ and China⁹

A weakened KPK could undermine investor confidence by heightening perceived corruption risks. Investors might anticipate less effective enforcement of anti-corruption laws, leading to higher risks of bribery and fraudulent practices within both public and private sectors. This, in turn, may prompt agencies such as Moody’s, S&P, and Fitch to downgrade Indonesia’s sovereign credit rating. Such downgrades reflect concerns over regulatory enforcement and compromised government contracts, increased likelihood of governance-related disputes.

⁹ ibid

1.5 Persistent Twin Deficit Problems

Indonesia faces persistent current account and budget deficits, known as the twin deficit, further undermine the country's economic stability. BI reported that Indonesia has faced a continuous current account deficit since the second quarter of 2023, culminating in a deficit of 3.02 billion USD in the second quarter of 2024, as depicted in Figure 7. This ongoing shortfall can be attributed to a rise in imports and an expanding imbalance in services trade and primary income accounts. Notably, the increase in imports and widening current account deficit were influenced by increased seasonal demand during the Christmas and New Year holidays in the fourth quarter of 2023.¹⁰

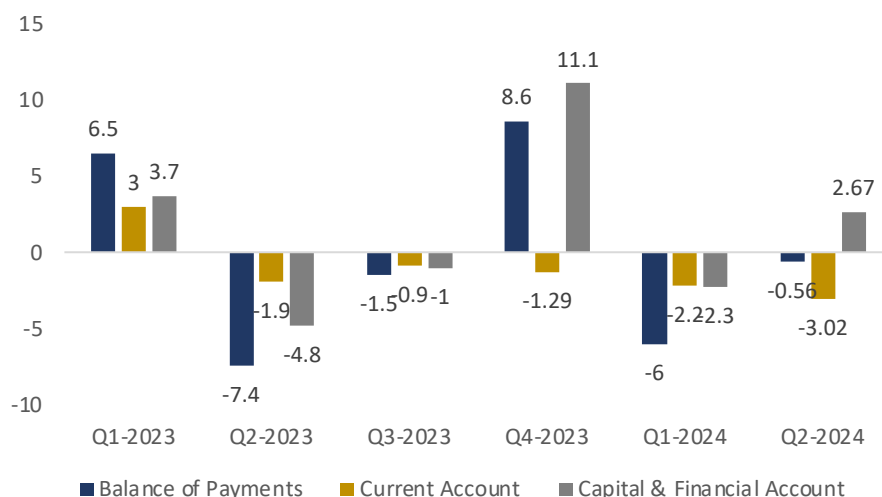


Figure 7. Indonesia's Balance of Payments, Current Account, and Capital and Financial Account (Billion USD)¹¹

As depicted in Figure 8, the budget deficit stood at -1.61% in 2023, with projections of a worsen to 2.7% in the following year, driven by increased government expenditures. The weakened rupiah aggravates these issues by raising the cost of servicing foreign debt and increasing the import bill, thereby worsening deficits.



Figure 8. Indonesia Government Budget (% to GDP)¹²

1.6 Low Financial Liquidity and Shallow Financial Sector

Indonesia's financial sector also faces challenges in the form of low liquidity and a shallow market. As it is shown in Figure 9, Indonesia's stock market capitalization stood at 46.3%, which is the lowest

¹⁰ Bank Indonesia, 2024

¹¹ ibid

¹² Ministry of Finance of Republic Indonesia, 2024

among the ASEAN 5 countries and China, and falls below the global average of 106.2%. Consequently, citizens may struggle to access financial services due to a significant reliance on traditional banking, especially for financing needs.

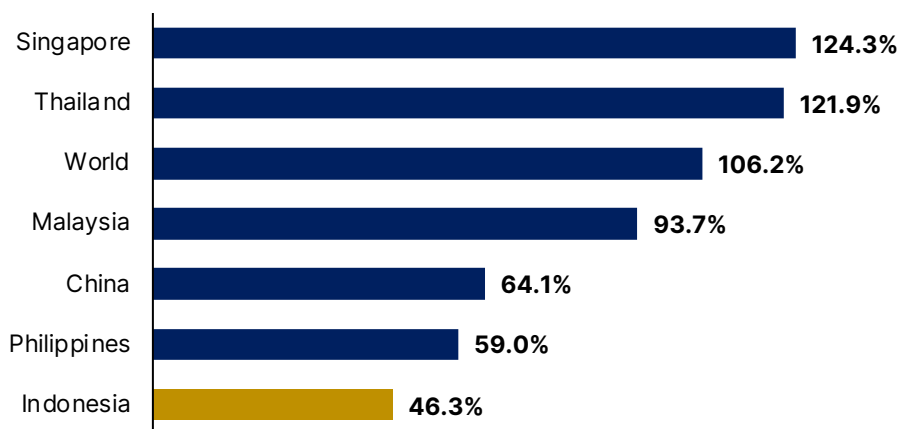


Figure 9. Stock Market Capitalization (% to GDP)¹³

As of June 2024, the money supply is reported at 2,692.39 trillion rupiah for M1 and 9,026.21 trillion rupiah for M2.¹⁴ This information indicates the amount of money available in the economy; M1 holds the most liquid forms of money, such as cash and checking deposits, while M2 holds both M1 and less liquid assets, including savings accounts and time deposits. While these numbers might initially seem unremarkable, they mask deeper issues in Indonesia’s financial liquidity.

As shown in Figure 10, Indonesia’s liquidity ratio is only at 42.2% in 2023 while the global average stood at 139.9%, placing Indonesia well behind many countries, including its ASEAN peers. For instance, Malaysia and Thailand exhibit significantly higher liquidity ratios, at 123.9% and 142.2%, respectively. These higher ratios suggest that these countries have a greater amount of money relative to their economic output, thereby providing more financial flexibility or capacity to support economic activities. The considerable gap in the liquidity ratio may suggest that Indonesia’s financial system is relatively more constrained and further exacerbate its low sovereign credit rating.

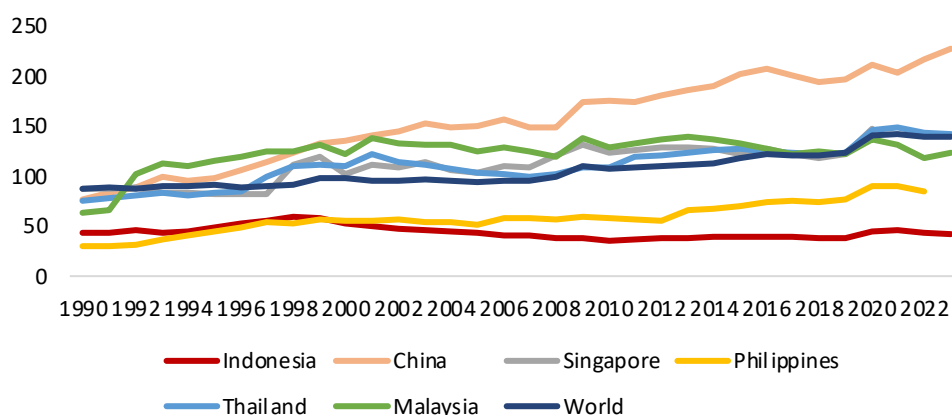


Figure 10. Broad Money (% GDP)¹⁵

13 ibid
 14 Bank Indonesia, 2024
 15 World Bank, 2024

1.7 Lack of Effective Communication with the International Sovereign Rating Agency

In emerging markets, the impact of subjectivity in credit assessment can be profound, given the inherent uncertainties associated with evaluation models.¹⁶ Such ambiguities often result in biased opinions that can severely hinder these nations' access to essential financing sources. Therefore, effective communication between emerging economies and CRAs is critical since it can provide a more accurate assessment of the actual socioeconomic progress in the countries.

The stagnation of Indonesia's sovereign credit rating may stem from insufficient communication with CRAs. When information about fiscal policy, economic reform, and stabilization measures is not presented clearly and transparently, rating agencies may have an incomplete information of Indonesia's economic conditions and prospects. Consequently, this informational deficit may prompt a more conservative assessment and a lower expected rating.

Indonesia, as a prominent emerging market, has also established an Investor Relations Unit (IRU) under Bank Indonesia (BI). IRU's primary role is to bridge the communication gap between Indonesia, investors, as well as international CRAs. Despite the establishment of IRU, Indonesia continues to experience stagnant credit ratings.



2. Literature Review

The significance of sovereign credit ratings lies in their provision of insights into a country's creditworthiness and financial health. This is important for investors, policymakers and stakeholders as they navigate the complex international financial landscape. Gaining a deep comprehension of critical concepts and factors that impact credit ratings is essential for grasping the broader implications of a nation's financial strategy and economic policies. Such insights not only inform investment decisions and policy formulation but also provide a clearer picture of how a country's political and economic choices affect its global position and reputation.

2.1 Factors Influencing Sovereign Credit Rating

Sovereign credit ratings are influenced by a range of critical factors that reflect a country's economic health and stability. Significant determinants of sovereign credit ratings include fiscal balance, current account balance, external debt, freedom index, GDP per capita, real exchange rates, and gross domestic savings.¹⁷ A study also found that fiscal health, reflected in public debt and budget balance, significantly determines countries' credit rating.¹⁸ Public debt, in particular, is linked to potential government default, impacting sovereign risk, especially in emerging economies.¹⁹

Fiscal credibility, which enables governments to stabilize expectations and mitigate upward pressure on long-term interest rates, is essential for reducing financial risk. The credibility is significantly supported by a robust, disciplined, and effective fiscal policy.²⁰ Another research in Brazil revealed that increased fiscal credibility directly correlates with improved credit ratings due to lower perceived risks by agencies.²¹

Empirical research also shows that governance indicator significantly influences sovereign credit ratings, and improving these aspects of institutional quality can lead to more accurate and potentially higher ratings for developing countries.²² Additionally, evidence suggests that corruption undermines the creditworthiness of sovereign bonds by diverting resources from productive initiatives to less efficacious purposes, thereby eroding overall financial integrity and stability.²³

In addition to institutional factors, commodity price volatility is a significant source of socio-economic instability, especially in developing countries. It directly affects government, business, and consumer policies. Over the long term, volatility can impact growth and development, as well as the achievement of sustainable development goals. Economic diversification is important for increasing resilience and reducing risks associated with the commodity sector.

2.2 Agency-Specific Criteria

Different rating agencies prioritize different factors, leading to variations in ratings across S&P, Moody's, and Fitch. Table 2 shows the significance and sign of variables in all three models. A positive sign indicates a positive correlation (yellow) with the credit rating, while a negative sign suggests an inverse relationship (blue). The Gross Domestic Saving to GDP (SAVGDP) variable has opposite signs in the S&P and Fitch models due to different economic development levels, with middle-income European countries showing positive signs and low-income countries showing negative ones.

17 Solikin & Michel, 2019

18 Montes, Oliveira & Mendonça, 2016

19 Mendonça & Machado 2013; Montes & Souza 2020

20 Mendonça & Machado, 2013; Montes & Acar, 2018

21 Montees & Costa, 2020

22 Ozturk, 2014

23 Connolly, 2007

Table 2. Criteria Significances of CRAs' Variables ²⁴

Variables	Definition	S&P	Moody's	Fitch
CATGDP	Coefficient for fiscal balance and current account deficit to GDP	**		**
DEF	Inflation as calculated from GDP deflator			
EXDGNI	External debt to gross national income		**	**
FHI	Freedom Index	**	**	**
GDPPC	Gross domestic product per capita	**	**	**
REXR	Real exchange rate	*	**	
SAVGDP	Gross domestic saving to GDP	**		**

Note: **=sig. 1%, *=sig. 5%

The credit ratings assigned by the two leading agencies, Moody's and S&P, are compared in Table 3, with distinctions made between investment-grade and speculative-grade categories. Investment-grade ratings, awarded to entities with a low risk of default, are considered as safer investments. This category is further divided into four tiers: highest quality, high quality, strong payment capacity, and adequate payment capacity. The highest quality ratings are Aaa from Moody's and AAA from S&P, indicating the lowest credit risk. High quality includes ratings from Aa1 to Aa3 by Moody's (AA+ to AA- by S&P), while solid payment capacity ranges from A1 to A3 by Moody's (A+ to A- by S&P). Meanwhile, Baa1 to Baa3 by Moody's (BBB+ to BBB- by S&P) denotes adequate payment capacity.

Table 3. Rating Symbols for Long-Term Debt

Interpretation	Moody's	Standard and Poor's
INVESTMENT-GRADE RATINGS		
Highest quality	Aaa	AAA
High quality	Aa1	AA+
	Aa2	AA
	Aa3	AA-
Strong payment capacity	A1	A+
	A2	A
	A3	A-
Adequate payment capacity	Baa1	BBB+
	Baa2	BBB
	Baa3	BBB-
SPECULATIVE-GRADE RATINGS		
Likely to fulfill obligations, ongoing uncertainty	Ba1	BB+
	Ba2	BB
	Ba3	BB-

High-risk Obligations	B1	B+
	B2	B
	B3	B-

Conversely, speculative-grade ratings are assigned to entities exhibiting a heightened risk of default, rendering them comparatively less reliable as investments. This category is divided into two tiers—those likely to fulfill obligations with ongoing uncertainty and those with high-risk obligations. The former includes ratings from Ba1 to Ba3 by Moody’s (BB+ to BB- by S&P), while the latter encompasses B1 to B3 by Moody’s (B+ to B- by S&P).

2.3 Comparative Analysis of Indonesia’s Sovereign Credit Ratings

Through comparative analysis, Indonesia’s relative position within the global economic landscape can be clarified revealing its strengths, areas for improvement, and potential concerns. In this context, sovereign credit ratings emerge as a pivotal metric, offering a comprehensive reflection of the nation’s financial stability, governance quality, and overall economic health. The implications of these ratings will offer insights into Indonesia’s economic prospects relative to its peers.

Indonesia’s sovereign credit ratings are Baa2 from Moody’s, BBB from S&P, and BBB from Fitch (see Table 4). These ratings place Indonesia in a middle-tier position compared to other countries. For instance, countries like Malaysia (A3/A-/BBB+), China (A1/A+/A+), and Chile (A2/A/A-) are rated higher, indicating stronger creditworthiness. On the contrary, Brazil (Ba2/BB/BB-), South Africa (Ba2/BB-/BB-), and Turkey (B3/B/B) have lower ratings, suggesting weaker credit profiles.

Table 4. Sovereign Credit Rating by Country²⁵

Countries	Sovereign Credit Rating		
	Moody’s Rating	S&P Rating	Fitch Rating
Brazil	Ba2	BB	BB-
Chile	A2	A	A-
China	A1	A+	A+
Colombia	Baa2	BB+	BB+
Hungary	Baa2	BBB-	BBB
Indonesia	Baa2	BBB	BBB
Malaysia	A3	A-	BBB+
Peru	Baa1	BBB	BBB
Philippines	Baa2	BBB+	BBB
Romania	Baa3	BBB-	BBB-
South Africa	Ba2	BB-	BB-
Turkey	B3	B	B
US	Aaa	AA+	AAA

Indonesia’s sovereign credit ratings are comparable to Philippines (Baa2/BBB+/BBB), Hungary (Baa2/BBB-/BBB), Peru (Baa1/BBB/BBB), Colombia (Baa2/BB+/BB+), and Romania (Baa3/BBB-/BBB-). These similarities indicate that Indonesia and these countries share a moderate credit risk profile and relatively stable economic prospects. Positioned centrally within this spectrum, Indonesia demonstrates superior creditworthiness compared to certain emerging markets, though it does not rival the robustness of leading global economies, such as the United States.

²⁵ Countryeconomy, 2024

2.4 Regulatory Framework Supporting Indonesia's Economic Growth

Indonesian government has undertaken a comprehensive legislative reform agenda with the main objective to foster economic growth and enhance financial stability. This includes maintaining fiscal discipline, strengthening the financial sector, and creating jobs through certain initiatives. These reforms are intricately linked to long run developmental goals, aiming not only to spur economic activity but also to ensure that such growth is sustainable

2.4.1 Law Number 17 of 2003 on State Finance

Under the provisions of Law 17/2003, the Government is permitted to incur a budget deficit under specific conditions, contingent upon the prevailing financial and economic circumstances. To ensure that the budget deficit or the amount of borrowing do not negatively impact macroeconomic stability in the short and medium term, both the deficit and total borrowing need to be strictly regulated. Adhering to established principles of fiscal management, the law stipulates that the cumulative budget deficit must not exceed 3% of GDP, while cumulative government borrowing is capped at 60% of GDP.

2.4.2 Law Number 4 of 2023 on Development and Strengthening of the Financial Sector (P2SK Law)

P2SK law is a component of the structural reform initiative, aimed at leveraging Indonesia's demographic potential and drive progress towards its development goals by 2045. The reform agenda articulated through this law is underpinned by five key pillars: (i) fortifying the authority and autonomy of financial sector institutions, (ii) reinforcing governance to increase public trust, (iii) promoting the long-term accumulation of financial sector funding for welfare and support, (iv) ensuring robust consumer protection, and (v) advancing financial literacy, inclusion, and sectoral innovation.

The law is designed to tackle existing challenges within Indonesia's financial sector while addressing the escalating risks posed by global economic uncertainties. It incorporates measures to manage the rapid evolution of innovation and digital technology in the financial realm. This law is intended to strengthen the stability of the Indonesian financial system in facing challenges and shocks. Additionally, it aims to accelerate the development and deepening of the financial sector by increasing financial literacy and inclusion.

2.4.3 Law Number 6 of 2023 on the Stipulation of Government Regulation in Lieu of Law Number 2 of 2022 on Job Creation

This law aims to harness the potential of the Job Creation Act to maximize employment opportunities for Indonesians amidst increasingly competitive global markets. It involves adjusting various regulatory aspects related to enhancing the investment ecosystem, facilitating and expediting national strategic projects that are oriented towards national interests, including the implementation of risk-based business licensing. The scope encompasses several pivotal areas. Firstly, it aims to enhance the investment ecosystem and business activities. Secondly, it addresses crucial labor-related concerns. Thirdly, it aims to facilitate, protect, and empower cooperatives as well as micro, small, and medium enterprises (MSMEs). Additionally, the regulation simplifies business processes, supports research and innovation, and deals with land acquisition. It also focuses on economic zones, central government investments, and the acceleration of national strategic projects. Furthermore, it details the implementation of government administration procedures and establishes frameworks for the imposition of sanctions.

2.4.4 Law Number 19 of 2019 on the Corruption Eradication Commission (KPK)

This law amends Indonesia's regulatory framework of the Corruption Eradication Commission (KPK), introduces increased oversight and procedural changes. The law requires KPK to obtain approval from a supervisory board before conducting wiretaps and other investigative actions. While intended to increase transparency and accountability, these changes have raised concerns about potentially diminishing the KPK's operational independence and effectiveness in combating corruption.²⁶

2.4.5 Government Regulation Number 24 of 2018 concerning the Integrated Electronic Business Licensing Services (PP OSS)

The Online Single Submission (OSS) regulation, created under Government Regulation Number 24 of 2018, is facing inconsistencies with Law Number 25 of 2007 on Investment and Law Number 23 of 2014 on Regional Government. The centralization of business licensing authority under Government Regulation OSS is in conflict with the Investment Law, which delineates responsibilities between central and regional authorities for delivering one-stop integrated services (PTSP) across different government tiers. Additionally, the Regional Government Law endows regional governments with the jurisdiction to oversee and regulate local affairs, including business licensing. The misalignment creates inconsistency and confusion in the implementation of licensing regulations, as Government Regulation OSS requires all licensing processes to be centralized through the OSS institution, overriding the previously established regional licensing procedures.²⁷ These conflicts underscore a lack of alignment between the OSS framework and existing legislative provisions.

2.4.6 Law Number 24 of 1999 on Capital Flow Mobility System

The law stipulates that foreign exchange transactions conducted within the country must conform to the legal payment methods prescribed by BI. Furthermore, it obligates all residents to report their foreign exchange transactions either directly or through duly authorized representatives designated by BI. Additionally, the law requires BI to propose the exchange rate system for government approval. In Indonesia, the government has embraced a free-floating foreign exchange traffic that aims to enhance the country's attractiveness to international investors. The approach is supported by mandates from the IMF which advocate for a more liberalized exchange rate system.

2.4.7 Government Regulation (PP) Number 36 of 2023 on Foreign Exchange from Export Earnings of Natural Resource Management, Administration, and/or Processing Activities

The regulation was designed to support ongoing development and ensure optimal use of natural resources for the benefit of the public. To achieve this, a coordinated approach is necessary for managing the entry and placement of foreign exchange from export earnings related to natural resource activities into Indonesia's financial system. Exporters must deposit these earnings into a Special Foreign Exchange Account at either the Indonesian Export Financing Agency or banks that handle foreign exchange transactions. This requirement applies to exporters with foreign exchange earnings of at least USD 250,000 or its equivalent. The deposit must be made no later than the end of the third month following the registration of the export activities.

²⁶ Erza, 2023

²⁷ Pawestri, et al., 2024

The introduction of Foreign Currency Term Deposits (TD Valas) DHE monetary instrument on 2023 incentivizes exporters to retain their DHE within the country, which increases liquidity within the domestic market. Government Regulation (PP) Number 36 of 2023 mandates that at least 30% of DHE derived from the exploitation, management, and processing of natural resources must be deposited domestically. To encourage compliance, the Ministry of Finance offers tax incentives to exporters. These incentives are intended to offset any potential costs associated with domestic deposits, thus promoting adherence to the regulation.

Regulations governing DHE have been proven somewhat effective and have impacts on the current account, which is a key component to the BoP. However, their current application is confined to natural resources. As of March 20, 2023, BI reported that DHE from natural resources amounted to USD 1.95 billion. Additionally, the number of companies participating in domestic DHE deposits has also increased to from 158 to 160 exporters as of February 2024. This increase in participants underscores Indonesia's potential to enhance export revenues. Nonetheless, the regulations remain limited in scope, excluding other sectors that could significantly contribute to DHE.

2.5 Theory of BoP and Budget Deficit

According to IMF manual on BOP, BoP is a systematic record of all economic transactions during the period between residents of the reporting country and residents of other countries, referred to for convenience as foreigners. It is broken down into three main counterparts, which are current account, capital account, and financial account. The current account shows flows of goods, services, primary income, and secondary income between residents and nonresidents. The current account is an important grouping of accounts within the BoP. The capital account shows credit and debit entries for nonproduced nonfinancial assets and capital transfers between residents and nonresidents. It records acquisitions and disposals of nonproduced nonfinancial assets, such as land sold to embassies and sales of leases and licenses, as well as capital transfers, that is the provision of resources for capital purposes by one party without anything of economic value being supplied as a direct return to that party. The financial account shows net acquisition and disposal of financial assets and liabilities

Under the double-entry accounting system that underlies the balance of payments, each transaction is recorded as consisting of two entries and the sum of the credit entries and the sum of the debit entries is the same. The different accounts within the BoP are distinguished according to the nature of the economic resources provided and received. The balance on these accounts is known as the current account balance. The current account balance shows the difference between the sum of exports and income receivable and the sum of imports and income payable (exports and imports refer to both goods and services, while income refers to both primary and secondary income).

The sum of the balances on the current and capital accounts represents the net lending (surplus) or net borrowing (deficit) by the economy with the rest of the world. This is conceptually equal to the net balance of the financial account. In other words, the financial account measures how the net lending to or borrowing from nonresidents is financed.

On the other hand, a budget deficit occurs when government expenditures exceed its revenues, forcing the government to increase debt to cover the shortfall. A budget deficit is not always a negative indicator of economic health. Some of the implications of a budget deficit are the sign of increasing aggregate demand, higher taxes in the future, higher interest rate and bond yields in the future. Budget deficit may be used to finance expansionary fiscal policy and boost the economy during recession.

There are two important theory of budget deficit, Ricardian Equivalence Theory and Crowding Out Effect Theory. According to Ricardian Equivalence Theory, using budget deficit or borrowing to stimulate the economy exerts no effect. It relies on many assumptions, including one that states that the government will increase taxes to pay off the current deficit. According to Crowding Out Effect Theory, an increase in government spending and borrowing leads to a decrease in investments from the private sector. It is because governments borrow by selling bonds to the private sector and by borrowing from foreign sources, such as other countries and international banks. However, it often results in higher interest rates, as well as higher spending on bonds by the private sector – which leads to lower funds for private sector investments and a higher cost of borrowing (due to higher interest rates).

A budget deficit also can affect the current account if it increases the demand for imported goods. For example, a budget deficit caused by government spending on infrastructure projects may lead to a higher demand for imported materials and machinery. This in turn can worsen the current account deficit as the country imports more goods. Additionally, if the government borrows money to finance its deficit, it may need to repay the debt with foreign currency, which can further strain the current account.



3. Research Findings and Discussions

Indonesia's economic recovery momentum remains strong despite global challenges. The nation's economic performance has rebounded to pre-pandemic levels and is expected to continue improving. In the first quarter of 2024, Indonesia's GDP expanded by 5.11% year-on-year, with forecasts suggesting further economic growth throughout the year.

Inflation fell below 2% between 2020 and 2021 due to the pandemic's dampening effect on market demand, which eventually led to deflation in Indonesia from May to September 2024. As of August 2024, inflation was recorded at 2.12%, marking a decrease from 5.95% in 2022 and 2.28% in 2023 (see Figure 11). In 2022, it surged to 5.95% due to supply chain disruptions from European geopolitical conflicts, cooking oil shortages, weather anomalies, and higher oil prices. By mid-2023, inflation began to moderate, driven by declining global commodity prices and the implementation of effective government measures. These included targeted deficit spending, fuel subsidies, strategic market operations, and prudent monetary policies.

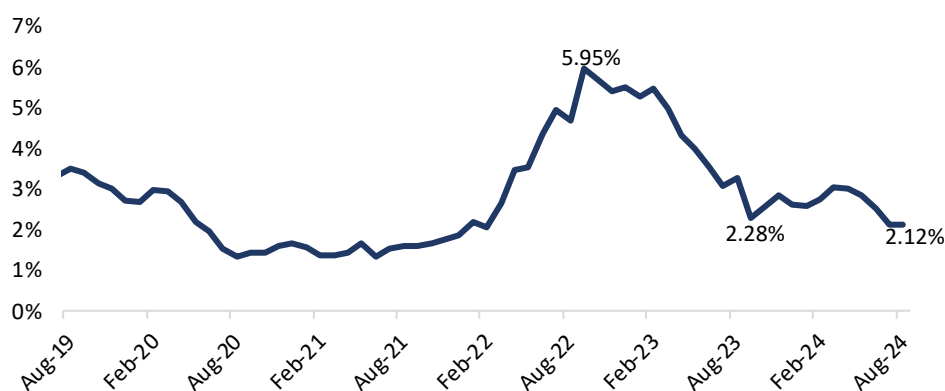


Figure 11. Indonesian Inflation between 2019 and 2024 (YoY)²⁸

Indonesia's external sector, including export and import, also remains robust. The nation maintains ample reserves, a healthy balance of payments, and manageable external debt levels. Fiscal performance improved notably in 2023, characterized by a reduced fiscal deficit, a primary surplus, and enhanced debt management practices. BI has been diligent in reinforcing its monetary policy to control inflation and stabilize the rupiah, thereby contributing to financial stability and economic growth. The government is constantly advancing its structural reform agenda, which aims to foster resilient, inclusive, and environmentally sustainable economic growth.

Indonesia's primary policy focus is on expanding its industrial sector to enhance the value-added processing of critical downstream commodities. The government intends to extend this strategy to other raw materials with significant value-added potential, including copper, bauxite, tin, and agricultural products. This expansion is anticipated to yield benefits in terms of regional development, FDI, job creation, and export growth. However, it is important to consider that the advantages associated with job creation and regional development may be tempered by trade and market distortions, environmental and social costs.

The medium-term development plan relies on improving the business climate to increase the manufacturing share and diversify the economy. The success of this strategy will be seen in real growth, which is expected to increase on a sustainable basis. Achieving this ambitious growth will require a significant improvement in the current trend of declining productivity.²⁹

28 BPS, 2024
29 LPEM, 2024

To enhance Indonesia's productivity and avoid the middle-income trap, the nation must strengthen the global competitiveness of its manufacturing sector. This can be done through labor-augmenting technological advancements. Additionally, Indonesia must integrate the manufacturing sector into regional value chain network of Southeast Asia and enhance the global competitiveness and export orientation of its MSMEs. By pursuing these strategies, Indonesia can ensure a more sustainable economic resource base and drive long-term economic growth.³⁰

Additionally, Indonesia can engage in GVC through various external channels, including trade, FDI, and productivity spillovers. This engagement promotes greater openness to foreign markets and aiding in the adaptation to international standards and regulations. Furthermore, the existence of GVC can also open access to cheaper input goods and technology, and encourage knowledge transfer.³¹

China exemplifies the effective implementation of GVC strategies. Since the 1980s, it has developed its policies by promoting free trade and deregulating foreign investment. The country has made substantial investments in infrastructure and established trade zones to enhance its competitiveness. China has also systematically formed partnerships with both domestic and global companies, including small and medium-sized enterprises focused on exports. Furthermore, the nation has prioritized research and development while facilitating the transfer of technology from global to local firms. This evolution is supported by the local workforce and entrepreneurs, following the requirements of future industrial demand.³²

3.1 Minimizing Reliance on Commodities Sector to Foster Economic Diversification

Indonesian government has undertaken significant efforts to downstream manufacturing within the country in order to reduce its dependence on commodities sector. The step aims to enhance the value-added of domestic products and reduce reliance on foreign imports. This initiative involves implementing various policies and incentives designed to encourage local industries to focus more on processing rather than merely exporting raw materials. While these measures are seen as necessary for generating additional employment opportunities and strengthening domestic supply chains, they have also led to disputes at the international level. Nevertheless, the push towards increasing domestic value addition is viewed as a strategic step to elevate competitiveness and Indonesia's role in the GVC.

To tackle this challenge, a targeted strategy emphasizing niche economic diversification is crucial. One of the foremost solutions lies in promoting innovation and technology in non-commodity sectors such as manufacturing and services. The government should actively encourage the development of these industries, alongside establishing implementation regulations that support potential sectors for diversification. By investing in research and development, the government can stimulate startups and established businesses to explore alternative markets and create value-added products. This shift not only mitigates risks associated with commodity price volatility but also positions Indonesia as a competitive player in the global marketplace.

Another vital strategy is enhancing education and vocational training to equip the workforce with the necessary skills for emerging industries. By aligning educational programs with market demands, Indonesia can cultivate a talent pool that supports sectors such as technology, renewable energy, and creative industries. Public-private partnerships can play a pivotal role in this transformation, ensuring that training programs are relevant and effective.

30 Verico, 2017

31 Elisabeth, 2023

32 Ahmad, 2021

Finally, the government should consider implementing policies that incentivize investments in non-commodity sectors. By promoting investment in sectors with high added value, the government can reduce reliance on highly volatile commodities. Tax breaks, grants, and subsidies for businesses prioritizing innovation and diversification can stimulate interest and participation in these areas. By creating a conducive environment for economic diversification, Indonesia can build a resilient economy that not only withstands global market fluctuations but also thrives in a rapidly changing world.

3.2 Increasing Tax Ratio and Fiscal Sustainability

In 2022, Indonesia's tax ratio stands at 12.1%.³³ According to OECD data, this tax ratio is lower than Malaysia (12.2%), Thailand (16.7%), Philippines (18.4%), and Vietnam (19%). Additionally, it is significantly below the regional average for Asia and the Pacific (19.3%) and the OECD average (34%). However, according to the Ministry of Finance, Indonesia's tax ratio in 2023 declined to 10.21%, marking a reduction compared to the previous year. The decrease suggests a weakening in the government's fiscal capacity.

A low tax ratio can indicate a narrow tax base, inefficiencies in collection, or a deliberate policy choice to keep rates low to stimulate economic activity. However, it also implies limited fiscal capacity to fund public services and infrastructure, which can affect long-term economic development and social welfare. The low tax ratio, which has experienced a downward trend over the past decades, also affects the country's debt rating and investor confidence in government-issued bonds.

The IMF recommends a tax ratio of 15%, a figure significantly higher than Indonesia's.³⁴ Increasing tax ratio would enhance the government's ability to collect revenue, thereby improving its financing capacity. By achieving a higher tax ratio, Indonesia would be better positioned to address its development needs and reduce its dependency on external debt.

In terms of fiscal health, Indonesia's debt-to-GDP ratio in 2022 is relatively moderate at 39.70% when compared to other countries in the region. For instance, Malaysia (61.10%), Thailand (60.90%), Philippines (57.40%), India (86.54%), South Korea (49.60%), China (77.08%) and Mexico (48.30%) have higher debt-to-GDP ratio (see Figure 12). Only Vietnam, with a ratio of 37.10%, has a lower debt burden compared to Indonesia.



Image credit: Canva

33 OECD, 2024

34 IMF, 2016

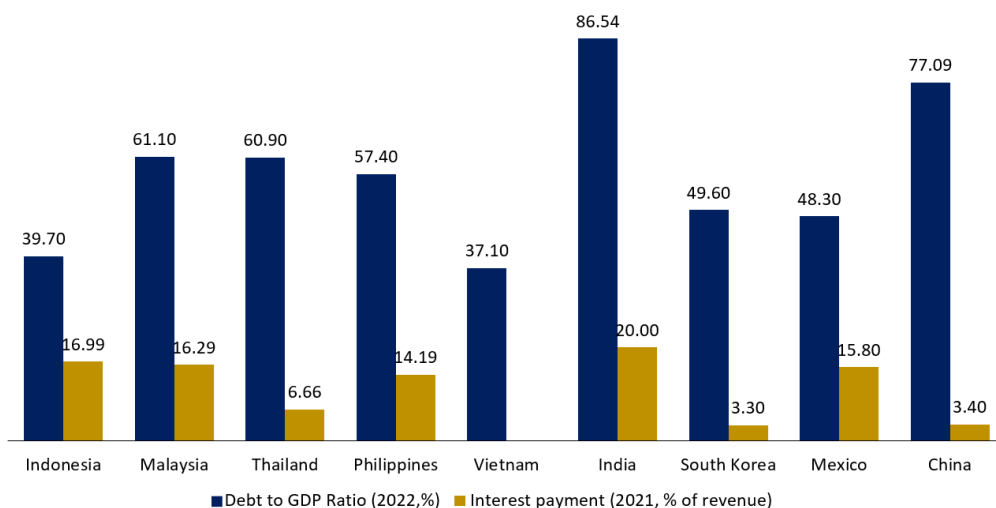


Figure 12. Debt to GDP Ratio and Interest Payment of Selected Countries³⁵

Indonesia also faces a significant challenge with high interest payments, which constituted 16.99% of its revenue in 2021. This indicates that Indonesia is spending a disproportionate amount of its revenue on debt servicing. In contrast, Thailand (6.66%), China (3.40%), and South Korea (3.30%) have significantly lower interest payment percentages. Malaysia (16.29%) and Mexico (15.80%) have interest payment levels comparable to Indonesia's, despite having higher debt-to-GDP ratios.

The combination of a moderate debt-to-GDP ratio and high interest payments indicates that while Indonesia does not bear an excessively large debt, the cost associated with servicing debt is significant. To a great extent, the burden also has been driven by the low tax ratio, which limits the base of governmental revenues and therefore heightens the fiscal pressure coming from interest-related obligations.

Improving the efficiency of tax collection and broadening the base may, therefore, help in countering these problems. A better tax ratio would expand fiscal capacity and improve the ability to reduce the proportion of revenue spent for interest payments. Consequently, with an extended fiscal space, debt can be managed more sustainably, and there will be ample opportunities for investment in public services and infrastructure.

The government's reforms under the Law on Harmonization of UU HPP significantly contributed to the current success in tax revenue collection, encompassing both taxes and customs duties (*bea cukai*). Key provisions of the HPP Law include the integration of Population Identification Numbers (NIK) with Taxpayer Identification Numbers (NPWP), adjustments to income tax rates applicable to additional income accruals, modifications to corporate income tax rates, increases in value-added tax (VAT) rates, and the introduction of a carbon tax. Collectively, these measures are designed to streamline tax administration and enhance fiscal stability.

3.2.1 The informal sector largely dominates the Indonesian economy

Despite these advancements, over 55% of Indonesian workers are employed in the informal sector, as shown in Figure 13. While the informal workers contributing positively to GDP by creating business opportunities, reducing unemployment, and increasing purchasing power, they remain outside the formal taxation system. Informal sector's exclusion from the taxation system means that it does not contribute to the tax base, potentially limiting government revenue. The absence of the

35 World Bank, 2024

informal sector from the tax system also means that a substantial portion of economic activity goes unregulated and untapped, which can lead to disparities in tax compliance and revenue collection. Addressing this issue requires targeted government action to help transitioning the informal sector into the formal economy.

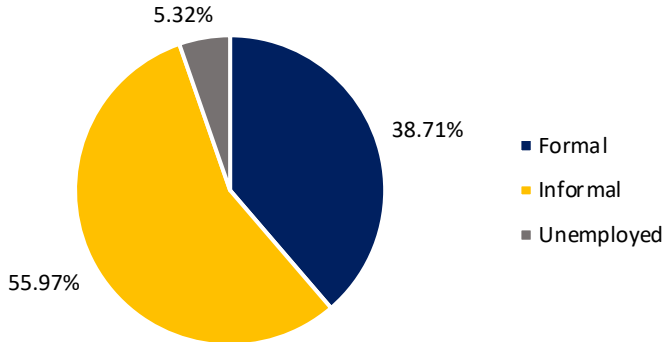


Figure 13. Indonesian Workforce by Employment Status, August 2023³⁶

3.2.2 Limited Tax Compliance and Awareness

The lack of tax compliance is an important issue faced by many countries, including in Indonesia. The total number of Annual Income Tax Return (*Surat Pemberitahuan Tahunan/SPT PPh*) submission by taxpayers reached 73.61% in 2024, representing a growth of 7.15% compared to the previous year.³⁷ The increase in SPT submissions indeed reflects improving tax compliance since it indicates that more taxpayers are fulfilling their obligations. However, there is still room for improvement to further enhance compliance rates.

A survey indicated that 22.9% of respondents reported a lack of understanding about taxes, while 24.9% said they were unclear about the benefits of tax.³⁸ The finding suggests that a substantial segment of the Indonesian population lacks a comprehensive understanding of taxation and its implications. The knowledge gap could hinder effective tax compliance as individual may fail to recognize the vital role taxes play in funding essential public services and infrastructure development.

To address this, it is essential to enhance the organizational capacity of tax authorities and foster tax cooperation. Such measures can help reduce tax avoidance and preserve the existing tax base. Research indicates that trust in government plays a crucial role in shaping individuals’ perceptions of the fairness of the tax system as well as their decisions regarding tax compliance.³⁹ When citizens have greater confidence in their government, they are more likely to view the tax system as fair and adhere to tax regulations. To build this trust, tax officials must demonstrate integrity and professionalism, and they should be subject to stringent penalties for any violations.

3.2.3 Inadequate Capacity of the Tax Authority in Collecting Taxes

Experts have highlighted that the Directorate General of Taxes (DJP) struggles with tax collection.⁴⁰ The Ministry of Finance has suggested creating a special agency to manage taxes and state revenues, but this plan has not yet been put into action. Establishing such an agency would

36 BPS, 2023
 37 Sembiring, 2024
 38 Hanjarwadi, 2022
 39 Jimenez & Iyer 2016
 40 Experts interviewed by team

require clear criteria for success, including targets for increasing tax revenue, improving the tax ratio, and enhancing tax compliance.

The Ministry of Finance is reforming tax administration through the Core Tax Administration System (CTAS) since the existing information system in use is outdated and lacks an integrated accounting system. CTAS is expected to be launched in January 2025 aiming to make tax processes more convenient, improve public services for tax obligations, and enhance supervision and taxpayer compliance. The program supports research in 2021, which shows that improving tax administration can be more effective than raising tax rates for increasing revenue.⁴¹ In Indonesia, moving leading regional firms to “Medium Taxpayer Offices” (*Kantor Pelayanan Pajak Madya*) with high staff-to-taxpayer ratios resulted in more than doubling tax revenue. These findings highlight that enhancing tax administration can yield substantial returns for developing countries, emphasizing the importance of strengthening administrative capabilities in addition to exploring rate adjustments.

Additionally, there are valuable lessons to be learned from OECD countries regarding the efficiency of tax collection. Major strategies include guarantees tax authority independence, tax service simplification and digitalization, and effective tax education.⁴² OECD member states’ data shows that, on average, their personal income tax contributions are 24% higher than corporate taxes. However, in Indonesia, the largest share of tax revenues in 2022 came from corporate income tax, which accounted for 28.8%, while personal income tax contributed just 13%.⁴³

3.3 Improving Indonesia’s Institutional Quality

Regulatory quality is an indicator that reflects public perceptions on the government’s ability to formulate and implement sound policies and regulations that promote private sector development.⁴⁴ Key aspects of regulatory quality encompass various interrelated elements, such as unfair competitive practices, discriminatory tariffs, investment freedom, labor regulations, etc. Indonesia, although making progress, still needs to strengthen its regulatory framework to attain better sovereign credit ratings.

One fundamental approach is by instituting transparency and accountability in decision-making processes. The new incoming government administration should implement mechanisms that ensure policies and regulations are developed in an open manner, incorporating inputs from diverse stakeholders while adhering to principles of good governance. This includes the enhancement of institutional capacity, such as sufficient knowledge of market dynamics, private sector needs, and modern policy analysis techniques.

Additionally, developing efficient information systems to monitor and evaluate policy implementation is crucial to ensure that regulations stay relevant and adaptable to evolving economic and market conditions. The step is necessary to practically address the challenges of regulatory inconsistency and overlapping regulations. Additionally, the establishment of a comprehensive regulatory framework can simultaneously ensure coherence across existing and new regulations.

41 Basri, et al., 2021

42 Martinez, Arzoz & Arregui, 2022

43 OECD, 2024

44 World Bank, 2024

3.4 Boosting Financial Integrity

Findings from the Financial Transaction Reports and Analysis Centre (PPATK, 2023)⁴⁵ and Global Financial Integrity (2019)⁴⁶ highlight Indonesia's proactive efforts to enhance financial integrity and reduce illicit financial flows. These efforts encompass various measures such as improving transparency through Know Your Customer (KYC) practice, tax compliance enforcement, anti-corruption initiatives by KPK, legal reforms, and adherence to international standards like those set by the Financial Action Task Force (FATF). The implications of such enhanced financial integrity on Indonesia's sovereign credit rating are significant. Increased transparency and accountability help mitigate financial risks related to corruption and money laundering, positively impacting Indonesia's financial stability perception by international CRAs. A positive reputation for financial integrity encourages agencies to view Indonesia's reforms more favorably, leading to improved risk assessments and a higher sovereign credit rating.

Another important issue is that as digital information traffic increases, addressing density and wireless coverage becomes crucial, along with prioritizing data security concerns. Indonesia's digital literacy index, currently at 3.49 out of 5, indicates considerable potential for improvement because of a shortage of skilled workers, uneven technological infrastructure, and an underdeveloped regulatory framework. To advance digitalization effectively, regulatory reform must adopt a flexible approach, with strong collaboration between authorities, regulators, economic actors, and industry.

3.5 Sustaining Healthy Balance of Payments (BoP)

Indonesia's Q1 2024 BoP remains maintained amidst increasing global uncertainty with a record deficit of 6 billion USD. Foreign exchange reserves also remained robust at \$140.4 billion at the end of March 2024, sufficient to cover 6.2 months of imports and debt payments, exceeding the international adequacy standard of 3 months of imports. The current account registered a deficit of \$2.2 billion (0.3% of GDP), while the capital and financial account showed a controlled deficit of \$2.3 billion, influenced by increasing global financial market uncertainty. Meanwhile, the trade in services balance recorded a deficit of US\$ 5.1 billion in the second quarter of 2024 (see Figure 14), representing a widening deficit from previous quarter.

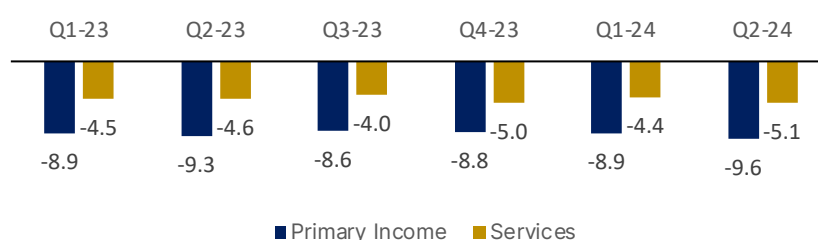


Figure 14. Indonesia Current Transactions (Billions of USD)⁴⁷

BI estimates that in 2024, the BoP deficit will be maintained within the low range of 0.1% to 0.9% of GDP. Additionally, a surplus is anticipated in the capital and financial accounts, supported by increasing foreign capital inflows as global financial uncertainty eases and investor confidence in the national economic prospects and investment returns remains high.⁴⁸ Looking ahead, BI will continue to monitor global economic dynamics that could impact the BoP and aims to enhance the policy mix through close collaboration with the government and relevant authorities.

The government has also revised its fiscal deficit target for the second half of 2024, increasing

45 PPATK, 2023

46 Global Financial Integrity, 2019

47 ibid

48 Bank Indonesia, 2024

it from the initial 2.3% to 2.7%. This adjustment follows a fiscal deficit of IDR 77 trillion, or 0.34% of GDP, recorded in the first half of the year. The primary driver of the revision is higher-than-expected expenditures, which have reached 102% of the State Budget (APBN), while revenues are projected to meet the budget targets. By year-end, tax revenues are estimated to reach IDR 1,921.9 trillion, or 96% of the target, with non-tax revenues projected at IDR 549.1 trillion, exceeding the target at 111.6%.

In the latter half of 2024, significant spending on social programs and subsidies is planned, including an extension of rice aid until December 2024, expected to cost IDR 11 trillion, and fertilizer subsidies projected at IDR 24 trillion. Despite the growing deficit, the government has assured that the debt burden will remain manageable. This is due to the utilization of the Excess Budget Balance (SAL) of IDR 100 trillion from 2022-2023 and the lower issuance of Government Securities (SBN) compared to the 2024 ceiling, which is set at IDR 664.8 trillion.

Rupiah depreciation is one of the key factors contributing to the increase in subsidy spending. As of June 28, 2024, the exchange rate was IDR 16,421 per USD (BI middle rate), reflecting a year-to-date depreciation of 6.35%. While this depreciation is relatively moderate compared to the South Korean won, Thai baht, Brazilian real, and Japanese yen, it is more pronounced compared to the Malaysian ringgit, Philippines peso, Chinese yuan, and Singapore dollar.

To address these challenges, several strategic measures should be implemented. First, the government should enhance the management of dividend payments by negotiating with foreign investors to reinvest profits domestically or by instituting policies that favor reinvestment over repatriation. Second, diversifying the export sector is essential to increase the added value of exports and lessen reliance on primary commodities. Third, adopting prudent fiscal policies is critical to maintain budget balance and prevent excessive debt accumulation, thus reducing dependence on foreign loans. Finally, creating a conducive business environment to stimulate domestic investment and reduce dependence on FDI. With such steps, it is expected that Indonesia will be better positioned to deal with these key aspects and create a more stable path toward sustainable economic growth.⁴⁹

3.6 Enhancing Financial Liquidity

Market liquidity is crucial for financial market growth, and its benefits are clear for different players.⁵⁰ For investors, liquid markets mean lower trading costs, easier buying and selling of assets, reduced price swings, and better price setting. For companies issuing stock, liquid markets lower the costs of raising money and help set share prices more accurately. Higher liquidity makes markets more appealing to issuers and investors, which boosts market activity, confidence, and revenue from trading fees. On a broader scale, economies gain as companies can get affordable capital, leading to more investment, job creation, and overall economic growth.

A downgrade in a country's sovereign credit rating can have significant implications for the banking sector. It can lead to a reduction in the value of collateral held by banks, as government bonds and other sovereign debt instruments, typically used as collateral, become less valuable. It can worsen bank's Capital Adequacy Ratio (CAR) and loan supply, especially if banks rely heavily on short-term funding during a crisis.⁵¹ These liquidity shocks can quickly spread among banks and internationally.

NPL and sovereign credit rating are also interconnected. High levels of NPL that represent loans that are unlikely to be repaid, signals systemic risk as they indicate potential vulnerabilities within the financial sector. A significant rise in NPL could lead to a downgrade in the sovereign credit rating since CRAs may factor the risks posed by an unstable financial system. NPLs influence decisions beyond the

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ibid

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Oliver Wyman, 2016

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Drago & Gallo, 2017

effects of other macroeconomic and financial variables such as uncertainty, GDP growth, government debt-to-GDP ratio, investment-to-GDP ratio, and the fiscal balance-to-GDP ratio.⁵²

Market liquidity can be enhanced through financial innovations that expand the range of available instruments in the capital market. Encouraging companies to conduct Initial Public Offering (IPO) is crucial, considering the volume of stock trading in Indonesia is also still lagging behind other countries as depicted in Figure 15. Therefore, innovation in financial instruments is pivotal to increase liquidity in the capital market, especially in Indonesia. With various innovative financial instruments, the market will be more liquid. This can also encourage more investment and more dynamic economic activity. Encouraging more companies to list on the stock exchange can enhance market capitalization, making the capital market more stable and attractive to investors. Therefore, policies that support innovation in financial instruments and increase the number of listed companies need to be strengthened to ensure sustainable and robust growth in the financial market.

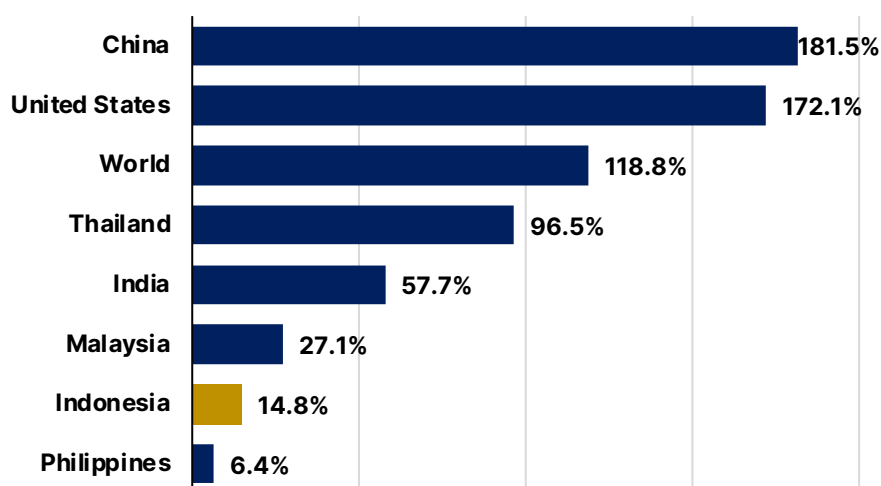


Figure 15. Total Value of Stocks Trading in 2022 (% of GDP)⁵³

Exchange rate systems are commonly classified into two primary categories. On one side, there are fixed exchange rate regimes, while on the other, there are flexible exchange rate systems. The fixed exchange rate regime could be in the form of hard pegs, where a country directly adopts another nation’s currency, often the dollar. Another approach is currency board arrangement, where the central bank is mandated to hold foreign assets at least equal to the amount of local currency in circulation and in reserves⁵⁴. The flexible exchange rate system, on the contrary, doesn’t require the monetary authority to holding large foreign exchange reserve. This is because the domestic currency value is determined by the forces of supply and demand rather than by government interventions.

Indonesia has adopted the flexible exchange rate regime. In this system, exchange rate movements are strongly influenced by capital flows and the proceeds from net exports. This approach allows market dynamics to drive currency values, creating a responsive and flexible trading environment. Consequently, this free-floating exchange rate can enhance market liquidity and depth, as the absence of government controls encourages more active trading and investment.

52 Boumparis, Milas & Panagiotidis, 2019

53 OJK, 2024

54 Stone, Anderson & Veyrune, 2008

Table 5. Comparison of Capital Flow Mobility Systems Across ASEAN Countries⁵⁵

	Indonesia	Thailand	Philippines	Malaysia
Exchange Rate Regime	Free floating	Pegged	Free floating	Free floating
Export	Restricted Exporters are obligated to have their trade transactions accepted by domestic foreign exchange banks.	Restricted Export receipts equivalent to USD 50,000 or more must be promptly returned after payment is received. Export proceeds must also be either sold or deposited into a foreign currency account at an authorized bank in Thailand.	Restricted Every resident is prohibited from importing or exporting amounts exceeding PHP 5,000 without authorization from the central bank.	Restricted Exporting companies are only permitted to hold 25% of their non-domestic receipts in the form of foreign currency; the remainder must be converted into ringgit. Residents with export income exceeding RM 50 million are required to report to Bank Negara Malaysia (BNM).
Import	Restricted Commercial banks establish import payment transactions, whereas the government administers import licenses.	Restricted Thailand Government implement the import tax rate in accordance with the Thai Customs Department and import licenses for 26 categories of imported goods.	Restricted Import payments may only be executed following the issuance of the import permit by the appropriate government authority.	Restricted Payments for the import of goods and services must be made in foreign currency.
Capital Market	Unrestricted Foreign investors may purchase shares issued by Indonesian companies without restriction.	Unrestricted Transfers in foreign currency for direct investment and portfolio investment in Thailand are permitted without restriction.	Restricted Foreign currency allocated for portfolio investments must be remitted into the country and converted into pesos.	Restricted The issuance of bonds in foreign currency denominations is limited to a maximum amount of RM100 million.
Direct Investment	Unrestricted There are no restrictions.	Restricted Thai companies and individuals may invest in foreign currency in foreign enterprises where Thai companies own at least 10% of the shares.	Restricted Certain direct investments, including those in oil, gas, and geothermal energy development, require a Bangko Sentral Registration Document (BSRD) from the Bangko Sentral ng Pilipinas (BSP) to confirm investment registration.	Restricted Residents are permitted to invest in foreign currency assets of any amount within Malaysia. For investments abroad, there are no limits if the funds used are sourced from outside the country. However, investment amounts are restricted if the funding is obtained through domestic ringgit loans.
Direct Investment Liquidation	Unrestricted Repatriation of capital, transfer of profits, and transfer of costs related to foreign labor are permitted.	Unrestricted Repatriation of investment funds and repayment of foreign loans are permitted upon submission of supporting documents to an authorized bank.	Restricted Only foreign investments registered with the BSP are eligible for full repatriation and must be conducted in foreign currency.	Restricted Non-residents may remit proceeds from divestments, profits, dividends, or other investment income from Malaysia, provided that these transactions are conducted in foreign currency.

While Indonesia’s free-floating exchange rate regime can indeed enhance financial deepening, it also brings some notable downsides. Emerging markets and developing countries often avoid floating exchange rates because sudden changes in currency value can be especially harmful to their economies. Without government intervention, the exchange rate can fluctuate wildly in response to global capital movements and market moods, making it tough to predict and manage.⁵⁶ This unpredictability can be challenging for businesses and consumers, who might face unexpected costs or risks in their trade and investment decisions. Additionally, this regime allows for easy capital outflows as well.

Indonesia’s foreign exchange reserves are significantly lower than its neighboring countries, although it remains marginally higher than Malaysia and Philippines, as shown in Figure 16. The difference is a key factor behind the policy of Indonesian government to retain a portion of DHE domestically. However, the current implementation of DHE policies is primarily restricted to the natural resources sector, despite the significant potential offered by other sectors.

⁵⁵ Bank Indonesia, Bank Negara Malaysia, Bank of Thailand, and Bangko Sentral ng Pilipinas

⁵⁶ Ghosh & Ostry 2009

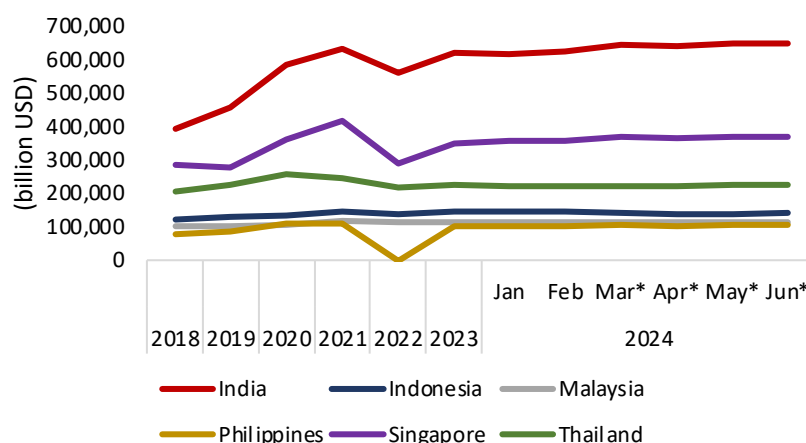


Figure 16. Foreign Exchange Reserves of Selected Countries

The implementation of DHE which requires the export proceeds to be retained within Indonesia will strengthen the economic sector and contribute to the national economy. DHE from natural resources can be used by domestic firms that comply with the regulation to secure financing and export-import facilitation services from the Export Financing Agency of Indonesia (LPEI). When a country has higher foreign exchange reserves from retained DHE, it can lead to a strong BoP and current account. This, in turn, helps stabilize the national currency and improve sovereign credit ratings⁵⁷.

Beyond the management of foreign exchange, strategies to increase liquidity can also be pursued through the capital markets. For instance, in August 2023, OJK introduced the “*Aku Investor Saham*” campaign, building upon the success of previous initiatives such as “*Gerakan Nasional Cinta Pasar Modal (GeNTa Pasar Modal)*” and “*Yuk Nabung Saham*”. This new campaign’s goals are to expand the investor base while fostering the continued growth and development of Indonesia’s capital market.

Additionally, the Indonesia Stock Exchange (IDX) has implemented several strategies to focus on market deepening and regional synergy. It has a large distribution network across Indonesia, consisting of 29 representative offices, 847 investment galleries, and 380 investment communities. Key initiatives include the development of cloud computing to meet the growing demands of the capital market, enhanced utilization of IDX data for information dissemination, product optimization, and improvements to trading and surveillance systems. In terms of ESG efforts, IDX is advancing carbon trading, offering ESG scoring on its website, and hosting showcases and exhibitions to promote sustainable investing.

3.7 Synchronizing Communications and KPIs of Related Institutions

Managing negative sentiment in financial markets is inherently challenging. A key issue is the need for a Single Point of Contact (SPC) within economic authorities to consistently update investors on the current data and information.⁵⁸ In response to this need, BI initiated the formation of the IRU in 2005. This unit was established under BI’s coordination and supported by a dedicated team comprising personnel from BI and various government institutions.

The IRU grew in scope and effectiveness with the integration of additional key agencies in 2007. This expansion included the strengthening of the IRU’s functions through a Memorandum of Understanding (MoU) on efforts to improve Indonesia’s sovereign credit rating and country risk classification, signed

57 Falianty, 2024
58 Darwis, 2012

by Bank Indonesia, the Coordinating Ministry for Economic Affairs, and the Ministry of Finance, as a formal support for the IRU. Currently, the Investment Coordinating Board (BKPM), the Ministry of State-Owned Enterprises, the Ministry of Trade, and the Ministry of Energy and Mineral Resources are also involved as shown in the Figure 17.

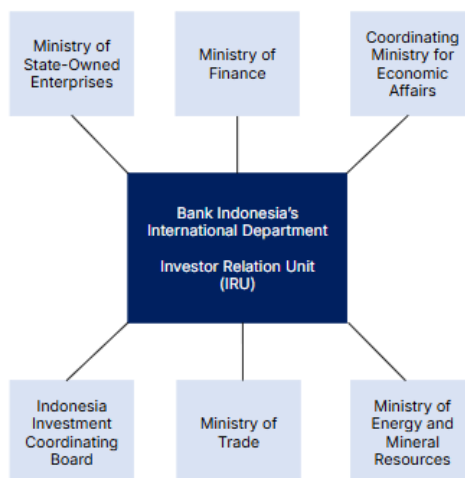


Figure 17. Existing Structure of IRU

The collaborative effort within the IRU has enabled a more comprehensive and unified approach to managing investor relations. However, despite the coordinated efforts, Indonesia has experienced stagnation in its credit ratings. This persistent challenge suggests that while the IRU and related initiatives have enhanced the accessibility and integration of economic information, they have not yet sufficiently addressed the underlying factors impacting the country's sovereign credit rating. Although BI plays a significant role in the economy and investor communication, in this context, BI does not have direct involvement with the ministries. This can lead to ineffectiveness in internal communication within the IRU.

To address these issues more effectively, it is essential for the President to assume a direct leadership role, as shown in the right side of Figure 18. It is recommended that The Ministry of Finance should spearhead these efforts, as it is better positioned to address the issues within the real sector as it is better positioned to tackle issues within the real sector and has authority over the state budget. Unlike BI, which primarily focuses on monetary policy, the Ministry of Finance has a broader mandate and deeper insights into fiscal policies and sector-specific challenges, making it more suitable as the single point of contact. The President should direct the Ministry of Finance (MoF) under the Investor Relations Unit of the Directorate General of Financing and Risk Management (IRU DJPPR). Accordingly, the MoF should collaborate with the Coordinating Ministry for Economic Affairs to deliver a cohesive strategy. Lastly, it is essential to involve other relevant institutions, as addressing sovereign credit rating concerns requires extensive and varied information across different sectors. For instances, the Ministry of Law and Human Rights for regulatory certainty purposes and Ministry of Foreign Affairs for diplomatic purposes.

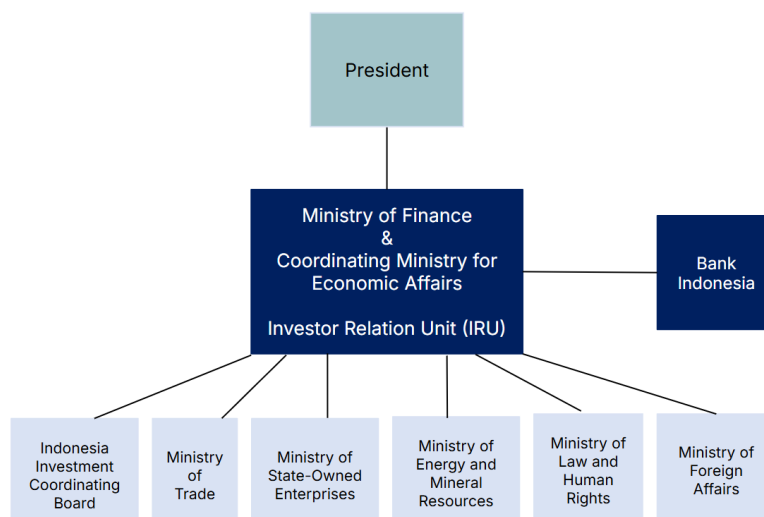


Figure 18. Recommendation for Adjustments in IRU's Institutional Leadership⁵⁹

Although The Ministry of Finance is proposed to spearhead the IRU, the relationship between ministries remains equal. Figure 18 illustrates how a coordination system can be implemented to make communication more efficient.

Additionally, maintaining effective communication across institutions and harmonizing key performance indicators (KPIs) related to credit ratings is crucial. By establishing clear and unified KPIs, institutions can better track progress, identify areas for improvement, and present a coherent narrative not only to investors, but also CRAs. Regular communication to align KPIs are needed as market dynamics change over time, ensuring that institutions remain responsive and adapt to evolving conditions.

Based on FGD with business players, there are several proactive strategies that could be implemented.⁶⁰ First and foremost, fostering a culture of transparent communication is essential. This means sharing straightforward and honest information and providing detailed action plans for addressing potential issues. Clear and proactive communication helps mitigate inaccurate assessment of CRAs. Additionally, integrated communication could minimize negative perception that can have significant adverse effects on economic perceptions and investor confidence.

Maintaining intensive communication with CRAs can also significantly strengthen ties and facilitate good relationship. This kind of connections often lead to more open and honest dialogue, which is crucial in navigating discussions and resolving misunderstandings that may arise. Corporations should prioritize developing these interpersonal relationships with rating agencies, creating an environment of collaboration and trust that encourages candid conversations about expectations and assessments.

Investing in quality human resources who are well-versed in market dynamics is also crucial for effective negotiations with rating agencies. These individuals should be well informed, possess a unique blend of assertiveness and confidence, and also understand the cultural nuances that play a role in negotiations.

The government plays a critical role to encourage Indonesians to pursue executive roles within rating agencies. Having Indonesians in influential positions within rating agencies can bridge cultural gaps and improve effectiveness of communication. By offering incentives to attract members of the

⁵⁹ The placement of the ministry names does not indicate any form of hierarchy.

⁶⁰ based on FGD with business players conducted for this study

diaspora to participate actively in CRAs, the government can leverage the expertise of Indonesians abroad who understand both the local context and international standards.



4. Conclusion and Recommendations

Recognized with an investment-grade rating by major agencies such as Fitch, Moody's, and S&P, Indonesia's macroeconomic stability and promising growth position it favorably. Despite this, Indonesia has many rooms of improvements to address the stagnation of its sovereign credit ratings in recent years. Considering the current massive investment inflow to the developing economies, this should be a crucial moment for Indonesia to raise its sovereign credit rating and be a key player in the global economy.

4.1 Reducing Dependence on Volatile Commodities Sector

- The Coordinating Ministry for Economic Affairs should reduce dependence on the commodity sector by encouraging the development of industries such as manufacturing and services.
- The Coordinating Ministry for Economic Affairs should implement regulations for the development of potential sectors to diversify the economy.
- The government should encourage economic diversification by promoting investment in sectors that have high added value to reduce dependence on highly volatile commodities.

4.2 Improving Tax Collection Efficiency

- The government should ensure that the harmonization of Tax Regulations Law can be implemented properly to increase the tax base.
- The Ministry of Finance should increase the capacity of the Directorate General of Taxes or form a special agency that manages taxation and state revenues.
- The Directorate General of Taxes should intensify public awareness campaigns to educate taxpayers about the importance of tax compliance and the benefits of proper tax implementation.

4.3 Enhancing Quality and Certainty of Regulation

- The Ministry of Law and Human Rights should ensure that regulations are consistent and do not overlap.

4.4 Enforcing Strict Measures Against Corruption

- The Ministry of Law and Human Rights should support for stricter law enforcement regulations for corruption violators.

4.5 Maintaining Healthy BoP

- The Ministry of Finance should continue to ensure that the BoP does not experience a deficit.
- The Ministry of Finance and BI should design new incentives for foreign investor to ensure retained earnings can remain in Indonesia and not become a new capital outflow.
- Coordinating Ministry for Economic Affairs and Ministry of Trade should increase the country's foreign exchange from exports in various sectors, especially the manufacturing sector.
- The Coordinating Ministry for Economic Affairs and the Ministry of Trade should enhance law enforcement regarding corporate transparency and accurate reporting of financial statements, especially regarding export revenue.

4.6 Encouraging Financial Depth through Liquidity

- The Ministry of Investment should speed up the business licensing process for foreign investors through the use of digital technology to create a better foreign investment environment.
- The IDX should continue to focus on developing its operation to meet the growing demand of capital market.
- OJK should commit to further enhancing its campaign and promoting Indonesia's capital market.

4.7 Increasing Effective Communication with International Sovereign Rating Agency

- The government and relevant institutions involved in sovereign credit rating assessments should establish effective communication channels with international CRAs. This will promote cohesive and accurate exchanges of information, helping to prevent miscommunication. Additionally, enhancing Indonesia's sovereign credit rating should be a key performance indicator for these institutions.
- The government should encourage the participation of Indonesian experts in managerial and executive position at International Sovereign Rating Agency.
- The government should invest in quality human resources who are well-versed in market dynamics with advanced negotiation skill, especially negotiation with International Sovereign Rating Agency.





5. Recommendations for Regulatory Adjustments

The structured approach aims to enhance Indonesia's investment climate, tax efficiency, regulatory quality, economic strength, financial integration, and inclusion, aiming to improve Indonesia's sovereign credit rating.

Table 6. Recommendations for Regulatory Adjustments

No	Problem	Solution	Existing Regulations	Recommended Change in Regulation	Policy Adjustment Timeline
1.	High dependency on the commodity sectors	Reduce dependence on volatile sectors like commodities by developing other industries such as manufacturing and services.	Existing regulation in Government Regulation Number 14 of 2015 about national industrial development master plan 2015 - 2035 has encouraged the development of the national industrial sector, but in terms of implementation, it is still less than optimal.	The Coordinating Ministry for Economic Affairs should update Government Regulation Number 14 of 2015 that supports the development of these sectors, including incentives for research and development (R&D), as well as easy access to financing for technology startups.	Mid to Long-Term
			Existing regulation in Presidential Regulation Number 74 of 2024 regulates the National Industrial Policy for 2020-2024, which is valid for five years. This policy is a guide to achieving phase II industrial development goals for 2020-2024 in the 2015-2035 National Industrial Development Master Plan. However, an updated national industrial policy is needed after 2024.	The government should collaborate with various parties to update Presidential Decree Number 74 of 2022 to adapt to the development of Industrial Policy for the future.	Short to Mid-Term

2.	<p>Low tax ratio and ineffective collection</p>	<p>Encourage the implementation of the Tax Regulation Harmonization Law (HPP Law) to increase the tax base</p>	<p>Existing regulation in Law Number 7 of 2021 concerning Harmonization of Tax Regulations (HPP Law) has encouraged a fairer and more predictable taxation system and implemented tax administration reform to increase the tax base, but its implementation is still less than optimal.</p>	<p>The Directorate General of Taxes should establish regulations to ensure effective implementation of the HPP Law.</p>	Mid to Long-Term
3.	<p>Low level of regulatory quality and certainty</p>	<p>Increase the capacity of the Directorate General of Taxes or create a special agency that handles tax collection.</p>	<p>Existing regulations in Law Number 16 of 2009 concerning General Provisions and Tax Procedures have introduced the Directorate General of Taxes as a transformative law enforcer in taxation, but the capacity of the Directorate General of Taxes is still limited.</p>	<p>The Ministry of Finance should update Law 16/2009 to boost the capacity of the Directorate General of Taxes in tax collection or encourage the establishment of a special agency tasked with tax collection with comprehensive success indicators and governance.</p>	Mid-Term
		<p>Increase policy consistency and improve coordination between government agencies to ensure quality regulations.</p>	<p>Existing regulation in Law Number 12 of 2011 have established principles and procedures for developing, enforcing, and evaluating regulations. However, current regulations are still inconsistent and often overlap between regulations.</p>	<p>The Ministry of Law and Human Rights should strengthen the implementation of Law 12/2011 to make regulations more consistent and not overlapping.</p>	Mid-Term

4.	Inadequate control of corruption	Reduce the level of corruption by improving law enforcement, increasing transparency, and ensuring a fair legal process in handling corruption cases to increase investor confidence.	Existing regulation in Law Number 30 of 2002 has encouraged the eradication of corruption. However, in terms of corruption, there are still a lot of violations due to the lack of strict law enforcement.	The Indonesian Ministry of Law and Human Rights should revise Law Number 19 of 2019 to increase stricter law enforcement for corruption violators.	Mid-Term
5.	Persistent current account deficit	Prevent dividend repatriation and encourage reinvestment of returns in domestic asset instruments to maintain Retained FDI Earnings.	Existing regulation under Law 25/2007 grants investors the right to transfer and repatriate dividends and other income. To mitigate capital outflow and avoid a deficit in the BoP, incentives such as tax breaks or subsidies have been provided. However, PMK 168/2023, which addresses income tax relief, does not include provisions of tax incentives for foreign investors who reinvest profits, bank interest, dividends, and other income without transferring or repatriating them.	The Ministry of Finance and BI should update PMK 168/2023 to design new incentives that provide specific tax incentives or subsidies for foreign investors who reinvest dividends in Indonesia.	Mid to Long-Term

6.	Low economic liquidity and shallow financial development	Develop various capital market instruments to increase economic liquidity.	The regulations in POJK 3/2021 Article 1 mention various types of securities instruments. However, to deepen the financial sector and increase liquidity, various innovative new securities are needed.	OJK should update the POJK 3/2021 regulations to add various types of innovative new effects and encourage the development of various types of instruments.	Mid to Long-Term
7.	Unclear KPIs of sovereign credit rating	Synchronization of KPI regarding sovereign credit rating for related institutions, such as BI, OJK, and government.	The existing communication system is led by the IRU from BI, in coordination with the Investment Coordinating Board (BKPM), the Ministry of State-Owned Enterprises, the Ministry of Trade, and the Ministry of Energy and Mineral Resources.	Government should establish a new regulation and institutional setting that assign MoF as the lead of coordination for international rating agencies.	Mid-Term

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