Economic Analysis

Indonesia's Election: Raising the stakes for the new President

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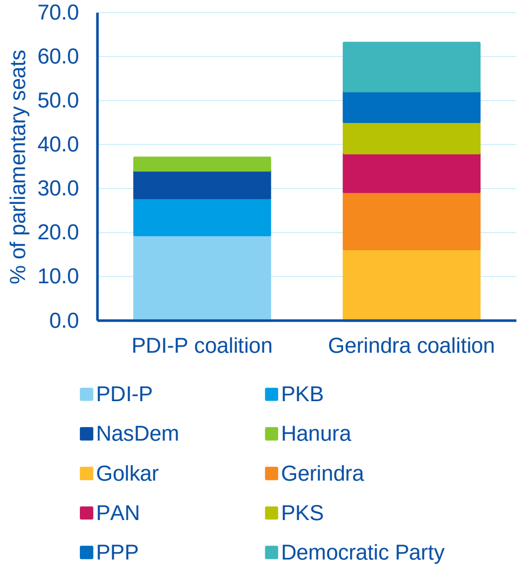
Indonesia, the largest economy in ASEAN, will go to the polls on 9 July 2014 to choose its new President. The results of the election will have important repercussions to the future shaping of the Asia Pacific region. Increasing competition pushes candidates to raise the stakes, increasing uncertainty amid investor fears.

Competition intensifies further, leading to higher uncertainty

The elections are bound to be a tight race between PDI-P's (Indonesia Democratic Party of Struggle) Joko (Jokowi) Widodo and Gerindra's (Indonesian Movement Party) Prabowo Subianto. Despite a disappointing result in the April Parliamentary Elections, where the PDI-P won 18.95% of parliamentary votes (see our previous Indonesia Flash), Jokowi managed to secure sufficient support to run for office by appointing VP candidate Jusuf Kalla – former chairman of the Golkar Party. However, Jokowi's lead over Subianto in polls has slipped from 25 points three months ago to just 4 points last week.

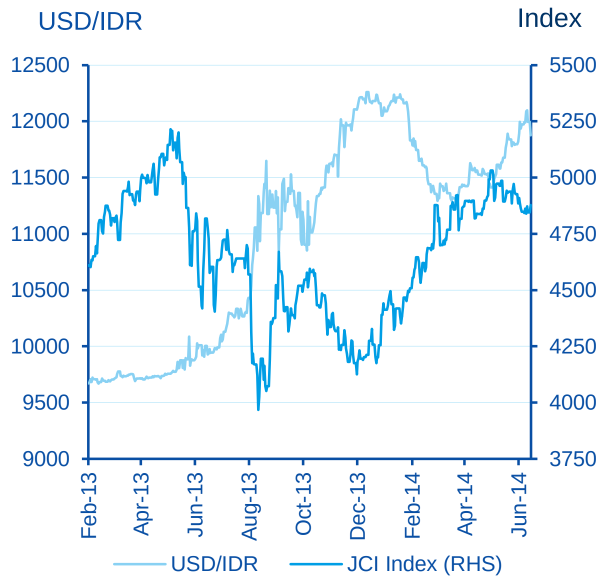
A recent turn of events may topple the scales, providing Subianto with some tailwind. The Democratic Party led by the outgoing president Susilo Bambang Yudhoyono (10.9% of total parliamentary seats), announced its support for Gerindra (see Chart 1). This announcement is significant as it could put impetus behind undecided voters, potentially giving Subianto an edge over Jokowi. While the overall sentiment still favors Jokowi, a less decisive victory and a fractured parliament could undermine the post-election reform process.

Chart 1
A tight presidential race between two coalitions



Source: The General Election Commission (KPU) and BBVA Research

Chart 2
Weakening Rupiah and JCI Index



Source: Bloomberg and BBVA Research

Increased uncertainty in the face of frail economic rebalancing

A tight presidential competition between the two coalitions implies rising political uncertainties in the largest economy in ASEAN. Rising uncertainties have already translated into increased volatility in the country's key financial markets. The Rupiah fell against the US$ while Indonesian Stocks dropped (see Chart 2). Increased uncertainly will not help Indonesia's plan to implement much needed rebalancing measures in 2014 in order to address structural issues and boost growth.

Indonesia's growth momentum disappointed in 1Q14, leading the Bank of Indonesia (BI) to lower its growth projections for 2014 to 5.1 – 5.5% from 5.5 – 5.9%. The slowdown in 1Q14 was due to a contraction in real exports (oil, gas and mining products), consequence of sluggish Chinese demand as well as the effects of Indonesia's own policy to restrict exports of raw materials. Investors fret that Indonesia has stuck to its 'dig-and-ship' model for too long, neglecting its manufacturing sector which now accounts for less than 25% of GDP (Thailand's share is 35%). This has led to a worsening of Indonesia's trade deficit, despite a marginal surplus in May's figures due to imports declining at a faster pace that exports (-11.4% y/y and -8.1% y/y respectively). Indonesia's unsustainable Current Account Deficit (CAD) has showed signs of stabilization in 1Q14, shrinking to -2.0% of GDP (vs. -3.3% in 2013). We expect the CAD to improve modestly below 3.0% of GDP for the full-year of 2014, led by recovery in developed economies and easing headline inflation (6.70% y/y in June vs. 7.32% in y/y in July). Despite some macroeconomic headwinds, Indonesia remains attractive to foreign investors. Last week, Indonesia's sovereign Euro bond issue drew an overwhelming response, selling Euro 1 bn of 7 year bonds at a low yield of 2.87% with nearly Euro 7 bn in subscriptions. However, the new leadership's attitude towards further restructuring together with the slowdown of China will continue to pose downward risks to Indonesia's commodity dependent economy.

What to expect from the July 9 elections?

The two presidential candidates possess markedly different personal styles and often disagree over a number of matters. However both coalitions lack detailed economic planning, a concern raised by many investors (see Table 1). The key difference between Jokowi and Subianto is that the former offers more practical solutions while Subianto has a radical vision of transforming Indonesia. Jokowi is the current Governor of Jakarta, comes from a humble background and represents a new class of leadership. His hands-on approach and successful two terms as Mayor of Surakarta (2005-2012) make him a promising candidate in the eyes of many Indonesians. He represents change and transparency, a break from traditional political elites and cronyism. However, Jokowi is relatively inexperienced in national level politics and lacks support from the rest of the groups in parliament – the real driving force behind policy formulation in Indonesia. Furthermore, it is not clear whether Jusuf Kalla (Jokowi's second in command) has enough leverage within Golkar to push for necessary reform.

Subianto is in many ways the antithesis of Jokowi. He used to be a Lieutenant General in the Indonesian National Army Special Force (Kopassus) and is married to former President Suharto's daughter. After leaving the military, Subianto pursued a career in business and is now a successful entrepreneur controlling much of Indonesia's energy, palm oil and fishing resources. He is more experienced than Jokowi, having already run for president on two occasions, and has strong support from the country's Islamic community. However, Subianto has been implicated in various high-level controversies regarding his role in the riots of 1998. In addition, his campaign has been adopting an increasingly nationalistic tone, with references to measures that favor local enterprises over international competitors. While this is not good news for international investors, this rhetoric is probably just a means to attract more voters than anything else. In practice, economic policy will need to be carefully discussed with the different groups in parliament and will be reflective of the country's economic priorities.

Table 1
Key economic stances of the two coalitions

Area	PDI-P	Gerindra
Economic outlook	At least 7% economic growth but need to improve investment environment	7% – 10% economic growth by raising income per capita to Rp60mm and reducing income disparity
Fiscal Policy	Reduce government debt Boosting investment by increasing national savings and improving investment environment. Improve revenue sharing between national and local government Tax ration 16% of GDP	Reduce budget deficit by 1% of GDP by 2017 Increase spending to build special economic zones featuring integrated tourism, property, creative industries, retail and education. Reform and expand tax system Reduce new foreign loans to zero by 2019 Tax ration 16% of GDP
Foreign Investment	Domestic market not dominated by foreigners	Limit foreign investment
Government spending	Increase the proportion of government spending on infrastructure developments, education and housing,	Increased government spending to 19% of GDP in 5 years on infrastructure developments, education and housing
Finance and Banking	Support national banks overseas and regulate sale of national banks to foreign investors based on reciprocity.	Strict reciprocity for foreign investment in banking sector. Develop Indonesia's Sharia financing sector
Energy	Reduce fuel subsidy Promote energy sovereignty, develop domestic energy infrastructure, develop downstream capacity Revise oil and gas legislation to prioritize development of national capacity Expand the use of renewable sources Increase state revenues from mining sector	Support fuel subsidy but introduce reductions based on income levels. Promote energy sovereignty, develop domestic energy infrastructure, develop downstream capacity Revise oil and gas legislation to prioritize national business in the management of expired concessions Government will have stronger say in transfer of resources from foreign entities to domestic entities
Agriculture	Achieve food security via import controls and development of exports Develop agricultural infrastructure Implement land reform program Open up 1 million acres of land to rice production Set up Development and Infrastructure Bank for agriculture	Enhance competitiveness of downstream industries in palm oil, rubber, cocoa, paper and pulp Prioritize budget allocations to agricultural sector Encourage financial institutions to lend to the agricultural sector Open up 4 million acres of land to agricultural production

Source: Official reports, media reports and BBVA Research

The bottom line is that Indonesia needs to achieve its long-term potential of 7% in order to sustain reform, reduce poverty and create jobs. More investment will be required in order to boost GDP growth. Upgrading infrastructure (especially power generation, ports and roads) will be useful and is featured as a priority for both coalitions. However given Indonesia's need to rebalance its economy by curbing its CAD, it is unlikely that the type of investments required to boost GDP growth to its long-term potential will be possible without increased foreign direct investment. The country has come a long way in earning its place as a favored investor destination, but a better investment climate is still needed, as reflected by Indonesia's low rankings in business surveys. This is an area where both candidates fall short. Finally, there needs to be improvement to the country's fiscal management, including its bureaucratic efficiency and poorly targeted fuel subsidy scheme. Whether the new president elect will chose pragmatism over nationalism remains to be seen.