

## Indonesia Presidential Elections 2019: Repeat showdown but repeated issues?

Wednesday, February 13, 2019

### Highlights

- Polls are indicating that Jokowi is likely to win the April presidential race.
- The challenge for the winner would be maintaining short-term currency stability whilst continuing to build the country's capacity.
- This would involve keeping the current account and fiscal deficit at manageable levels whilst ensuring quality investment continues at a manageable pace.
- While polls suggest the incumbent is likely to win the upcoming election, he may still be constrained by his party not holding the simple majority in parliament.

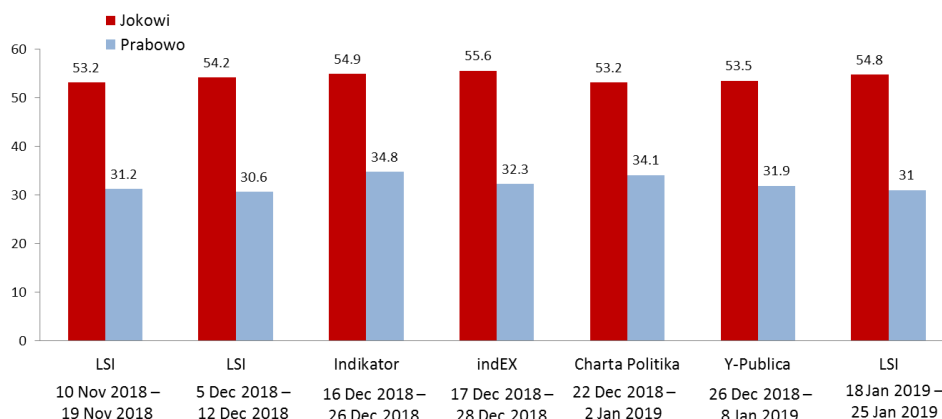
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After five years, Indonesia is facing another presidential election again in April 2019. It will be a repeat of the same candidates with Jokowi facing off against Prabowo. Both sides are promising to similarly improve the economy through developing infrastructure, cutting corporate taxes and etc. Not surprisingly, the big issue of this election and going forward is the economic situation, including the IDR stability. In this note, we provide some background on the election and the economic challenges that the winner would face.

### Who looks the favourite to win?

The latest election survey polls (see chart 1) are showing that Jokowi is leading well ahead. In fact, this appears to have been the case since even mid-2018. Even after the first presidential debate on 17<sup>th</sup> January 2019, the latest poll by LSI still shows Jokowi leading well ahead of Prabowo.

**Chart 1: Various election survey polls**



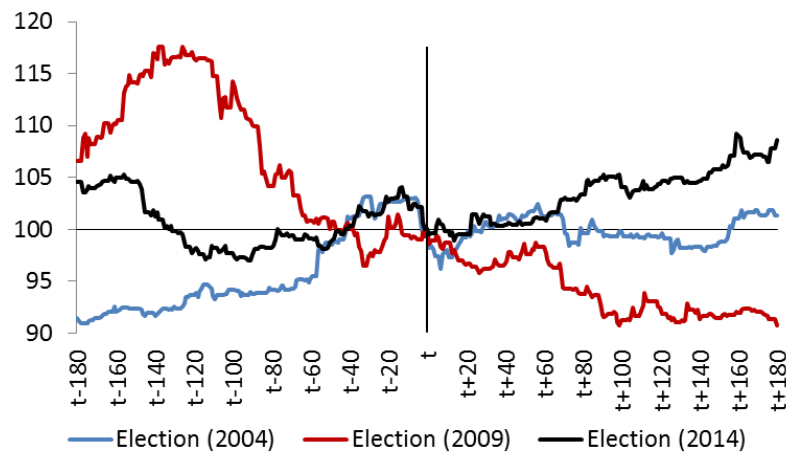
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Source: Various polling and news websites

### How do asset classes react to the elections?

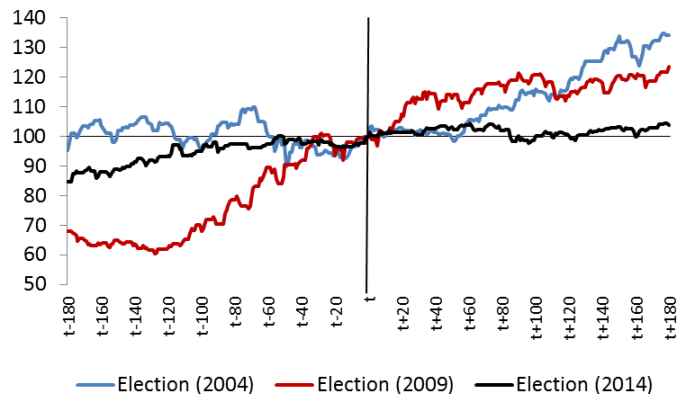
While the election is a closely watch event, historically financial asset classes do not appear to be disrupted in terms of their direction or trends prior to or following from the elections (see charts 2, 3, 4 and 5), with the exception of the 10 year government bond yield in 2004. Moreover, the external factors such as the Fed's Quantitative Easing (QE) policy in 2009 may have contributed more to overall market direction. As such, barring an election surprise, it may be business as usual for financial markets post-elections as economic policies may not deviate significantly.

**Chart 2: USD – IDR 6 months before and after elections, election day =  $t = 100$**



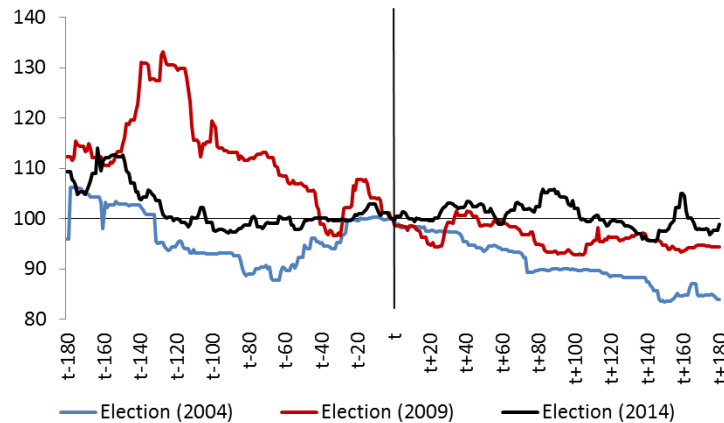
Source: CEIC, Bloomberg and OCBC

**Chart 3: Jakarta Composite Index 6 months before and after elections, election day =  $t = 100$**



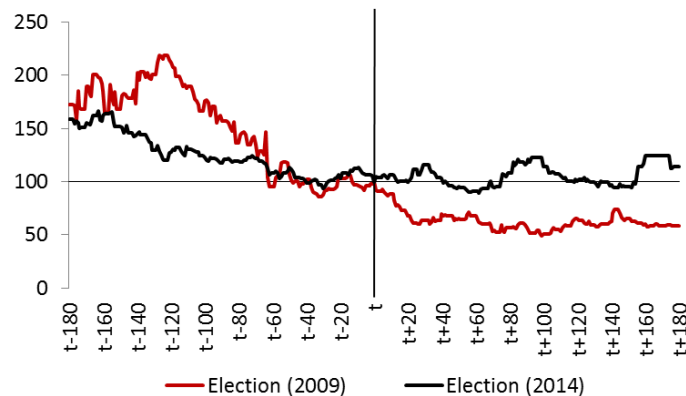
Source: CEIC, Bloomberg and OCBC

**Chart 4: 10 year government yields 6 months before and after elections, election day =  $t = 100$**



Source: CEIC, Bloomberg and OCBC

**Chart 5: 5 year CDS 6 months before and after elections, election day =  $t = 100$**



Source: CEIC, Bloomberg and OCBC

### Reducing IDR volatility is key for ensuring macro stability

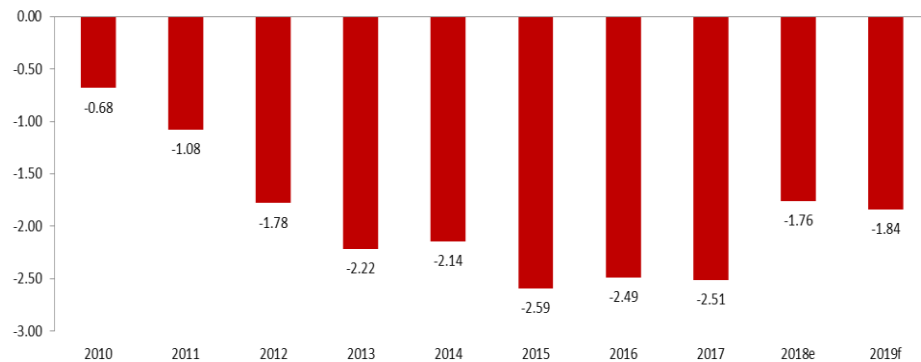
In 2018, the IDR crossed the 15,000 mark, the highest it had been since 1998 in the midst of the Asian Financial Crisis. Since October 2018, the IDR has gradually appreciated and even fallen briefly below the 14,000 mark recently. Still, the IDR remains sensitised and vulnerable to external events given investors' focus on the country's twin deficit situation (fiscal and current account deficit) even if domestic macroeconomic fundamentals suggest otherwise. Therefore, the winner of this election will have to continue to address the twin deficits challenge.

### Narrowing the fiscal deficit

After running a fiscal deficit above 2.0% of GDP for the last few years, the government has narrowed it to 1.76% of GDP for 2018 (see chart 6). However, Finance Minister Sri Mulyani has admitted that higher oil prices and a weaker rupiah had boosted the state revenue collection. Indeed the government had made an oil price assumption of US\$48 and the IDR to be at 13,400 against the USD. However, the IDR has been weak and the oil price was much higher last year than levels assumed. Tracking revenue collection between January – November 2018 (see chart 7), we see that oil and gas related revenue had surpassed the initial target at 152%. Overall, the dependence on resource related

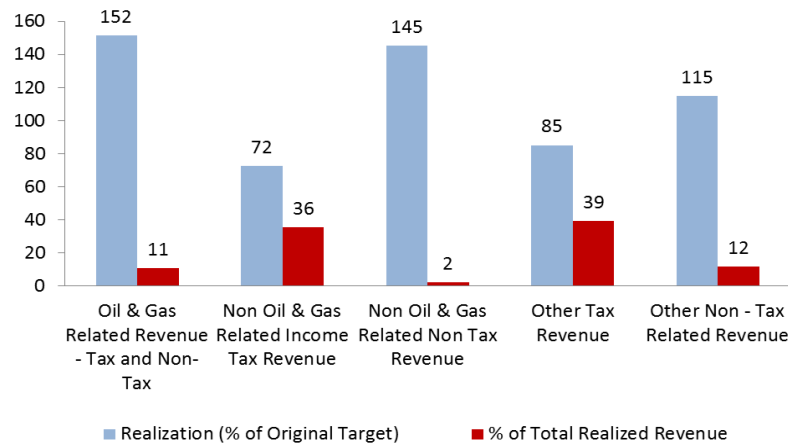
income (see chart 8) can risk making the government revenue volatile. The government did try to address this issue by starting the tax amnesty program in 2016 which helped improve revenue growth in that year. Regardless, Sri Mulyani herself has mentioned that there is a “need to be careful” for 2019 as uncertainties around exchange rates and oil prices remain.

**Chart 6: Fiscal deficit, % of GDP**



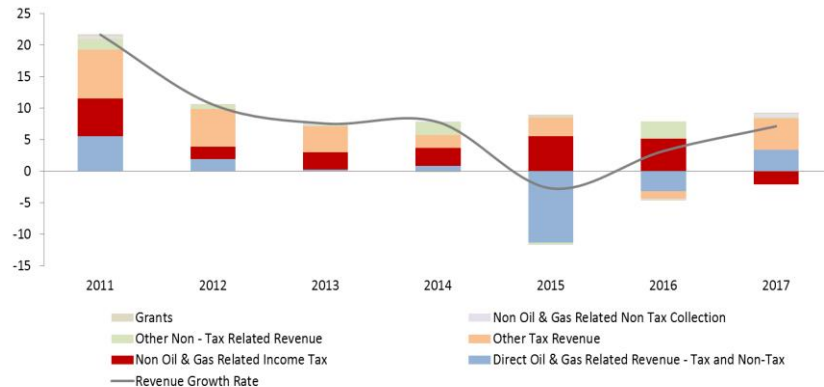
Source: CEIC, Bloomberg and OCBC

**Chart 7: Revenue collection rate January – November 2018**



Source: CEIC, Bloomberg and OCBC

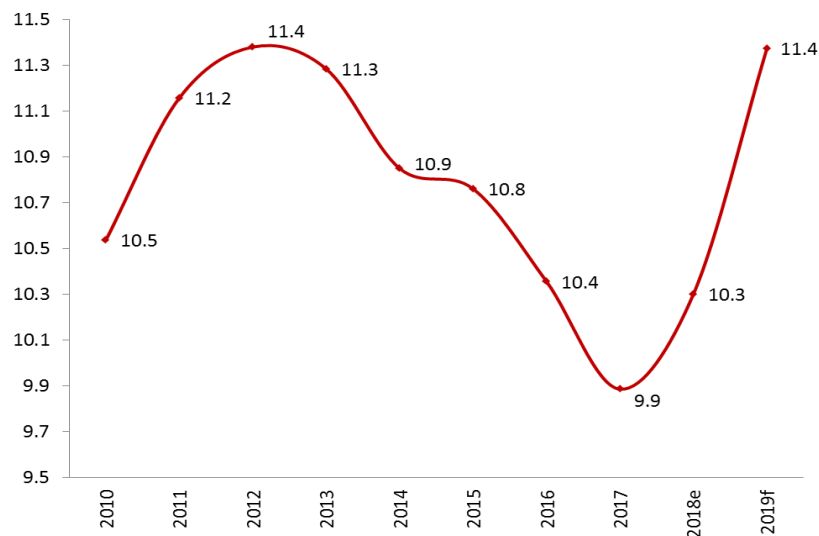
**Chart 8: Contributors to revenue growth, % yoy**



Source: CEIC, Bloomberg and OCBC

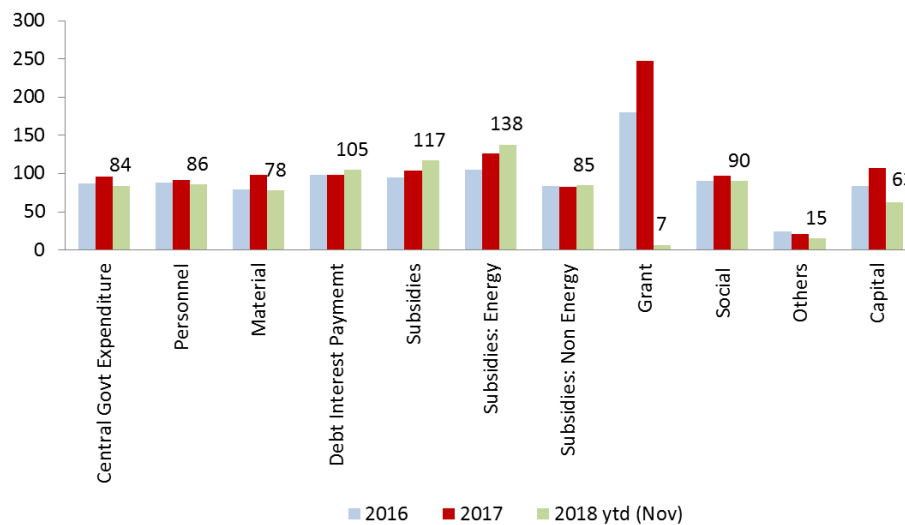
Going forward, it is imperative the new president would have to look to diversify income sources for the state budget. Currently, Indonesia's tax collection as a percentage of GDP (see chart 9) remains low and volatile. Prabowo has suggested that corporate and individual income tax be slashed by 5 to 8 percentage points. His argument is that this move can improve compliance, raise the collection from less volatile sources and make Indonesia more tax-competitive. It is difficult to say if this alone can improve compliance as that could really be related to the cost of evading taxes. The cost of evasion itself is also related to the level of government enforcement. Jokowi had himself renewed a pledge to cut corporate taxes although he had also promised to cut it to 17% back in 2016 following the tax amnesty program. Currently, Indonesia applies a flat corporate tax rate at 25% whilst individual income is taxed on a progressive system with the rates ranging from 5% to 30%.

**Chart 9: Tax collection, % of GDP**

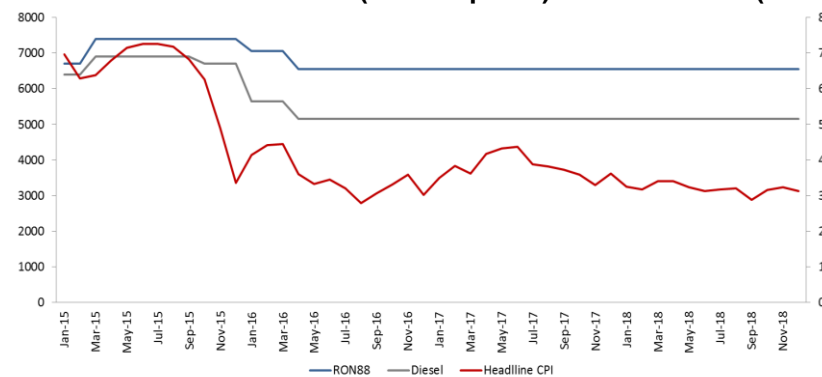


Source: CEIC, Bloomberg and OCBC

On the spending side, the government has claimed to hit a 99% utilization level but when we similarly track spending from January to November 2018, utilization was uneven across the different categories (see chart 10). In particular, energy subsidies had well surpassed its allocation at 138% as the government committed to freeze fuel and electricity prices until the end of 2019. There is also the risk of fuel subsidy costs being borne by Pertamina. Subsidies can significantly weigh down on government expenses and the election winner may have to look into the subsidy policy in place. However, freezing fuel prices may have helped kept inflation moderate and stable (see chart 11).

**Chart 10: Spending utilization January – November 2018, % of total initial allocation**

Source: CEIC, Bloomberg and OCBC

**Chart 11: Subsidized Fuels (LHS – Rp liter) & Headline CPI (RHS - % yoy)**

Source: CEIC, Bloomberg and OCBC

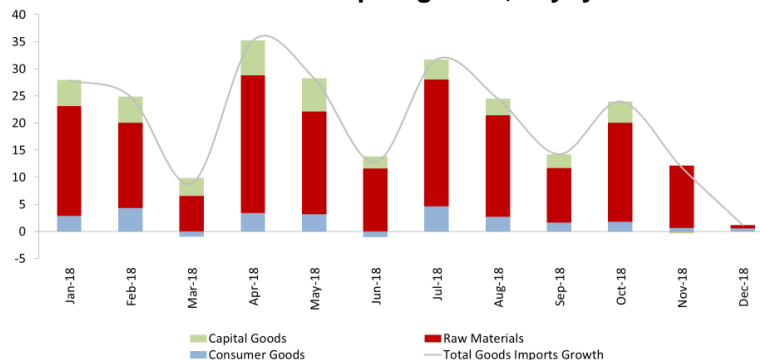
**Keeping the current account deficit at a manageable level**

Indonesia has run a current account deficit since the late 2011. The recent deficit in 2017 and 2018 could have been heavily driven by higher import growth of capital goods. This is not necessarily bad for Indonesia as higher capital goods imports can be linked to higher investment. However, the challenge going forward is to ensure that investments are channeled into strong export-oriented industries and that imports stay at a manageable level.

Managing import levels are key for the government although it appears that the government intends to bring it to manageable levels and not choke imports of essential goods. Measures to reduce import levels though have yielded mixed results. Actions undertaken by the government include delaying power and oil & gas projects in their attempt to limit capital goods imports. So far, there has been some noticeable decline (see chart 12). However, it is still early days to determine the full impact of measures to reduce raw materials imports such as the B20 biodiesel measure or the ruling for all contractors to sell fuel to Pertamina. The World Bank has also claimed in its Indonesia Economic Quarterly December 2018 report that the removal of fuel subsidies can lead to

a drop between US\$2 – 2.5bn worth of diesel and gasoline imports (due to more efficient usage of fuel). The data (see chart 12) so far only showed a large decline in raw material import growth in December. Consumer goods imports remain strong and some may attribute it to the growth of e-commerce. The government is looking at taxing e-commerce firms starting from April 2019 but successful taxation may not be straightforward given the difficulty of determining the tax jurisdictions of such firms. Going forward, there are still substantial challenges that the next president would face in controlling import levels.

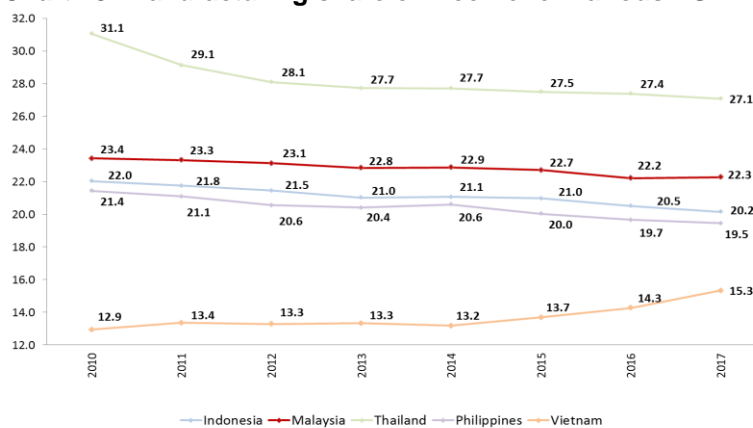
**Chart 12: Contributors to import growth, % yoy**



Source: CEIC, Bloomberg and OCBC

Beyond just controlling import levels, the country would also have to work to ensure that investment is made into productive industries that can help raise the country's export level. Over the years, export orientated industries such as manufacturing has declined as a share of GDP (see chart 13). This has occurred even though the country's income level remains well below that of other peers such as Malaysia and Thailand. Indonesia's income level is close to that of Vietnam, which in contrast has been seeing a rise in manufacturing as a percentage of overall GDP. The issues behind this decline of export orientation are broad and wide which include but are not limited to infrastructure deficiency, investment restrictions and import tariffs. Given the long term nature of building national capacity, it would be imperative for the next president to start working on this.

**Chart 13: Manufacturing share of income for various ASEAN countries, % of GDP**

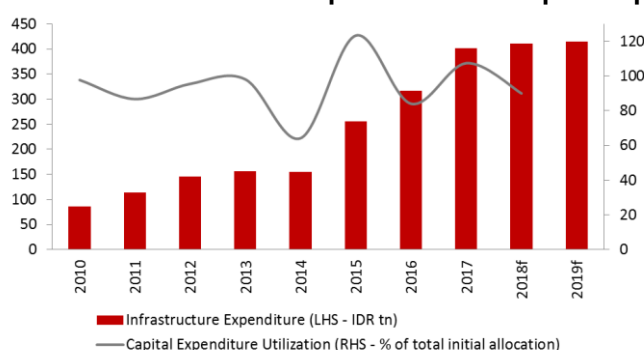


Source: CEIC, Bloomberg and OCBC

### Pushing infrastructure development

Around 5 years back when Jokowi was first elected, he had committed to push aggressively with developing the nation's infrastructure. Indeed, data shows (see chart 14) that infrastructure spending has drastically risen under the Jokowi administration. However, there isn't expected to be any major increase in spending in 2019. Multiple reasons could explain this including that infrastructure development is being limited in order to control import levels. There is also the matter of allocation utilization in the last few years. As an indication, capital expenditure utilization has been fairly inconsistent over the years (see chart 14). Whatever the case is, the allocation in 2019 is more than two and the half times the level in 2014 when Jokowi first came into office. The challenge for the winner would be to continue prioritizing allocations to infrastructure and ensuring project delivery.

**Chart 14: Infrastructure expenditure and capital expenditure utilization**



Source: CEIC, Bloomberg and OCBC

### What is the current political alignment?

Pushing crucial reforms though requires strong political will and support. As it stands, the coalition supporting the Jokowi government has more than 60% of the seats in the Dewan Perwakilan Rakyat or the country's parliament. Given the country is a presidential republic with a separately elected presidency and legislature, the president's party may not necessarily have a simple majority in parliament.

**Table 1: Breakdown of the seats controlled by the various parties**

Political Party	No of Seats
Government	338
PDIP (Jokowi's Party)	109
Golkar	91
PKB	47
PPP	39
Nasdem	36
Hanura	16
Opposition	161
Gerindra (Prabowo's Party)	73
PAN	48
PKS	40
Unaligned - Demokrat	61
Total	560

Source: <http://www.dpr.go.id/>



**Can the winner drive ahead with implementing the required policies for Indonesia?**

In a way, the challenges to be faced by the winner is not any different from five years ago. In the short run, the winner has to ensure the stability of the IDR, but in the longer term, he would have to build the country's economic capacity. For the former, he will have to continue to ensure that the current account and fiscal deficit remains at manageable levels to reduce the vulnerability of the currency to external risk events. As for the latter, he will have to oversee that investment is channeled into infrastructure and export oriented industries whilst also ensure that it is undertaken at a manageable pace so as not to also jeopardize short-run stability. However, ensuring that the needed policies be implemented to achieve these goals would require strong political will and support. Hence, overall, this election is not just about who wins but about whether the winner has the political strength and will to address the challenges ahead and push through the needed economic reforms.

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