

Indonesia Flash

A year of macro stabilization with a tight presidential race

Growth momentum of Indonesia's economy disappointed in the first quarter (5.2% y/y; 2013 Q4: 5.7%), recording its slowest pace in the past four and half years. **Subdued export performance** was the biggest drag on growth, due to combined effects of a policy ban on exports of raw materials, easing commodity prices, weaker external demand from China and severe floods earlier in the year. However, **domestic demand remains reasonably strong**, underpinned by robust household consumption and improving fixed investment. Bank Indonesia has lowered its growth projections for 2014 to 5.1-5.5% from previous estimate of 5.5-5.9%, to reflect a weaker-than-expected external sector in Q1.

Headline inflation edged down in April (7.25% y/y; March: 7.32%) as food prices decelerated. Inflationary pressures are likely to ease further although from a high level. In fact, inflation is to remain above Bank Indonesia's target range of 3.5-5.5%. The central bank has already kept benchmark rates unchanged for two consecutive quarters at 7.5% after 175bps in cumulative hikes from June 2013 to November 2013. Looking ahead, BI will stay vigilant against upward risks from adjustments to administered prices and possible extreme weather conditions although it still considers its stated target to be achievable.

Current account deficit has showed signs of stabilization in the past two quarters through Q1 2014, shrinking to a more sustainable level (-2.0% of GDP) from -3.3% recorded last year. Indonesia is considered as one of the most exposed economies to capital outflows on QE tapering in Asia, but has fared well since May-August 2013 after aggressive policy adjustments. BI expects CA deficit to improve modestly below -3.0% of GDP for the full-year of 2014, on the back of a mild external recovery, slower pace of economic growth and easing headline inflation. That should help in shielding Indonesia from potential turmoil if the FED tapering or interest rate hikes were to accelerate. Encouraging macro stabilization together with upbeat expectations of a new pro-reform president (which has been termed the "Jokowi effect") seem to have restored investor sentiment towards Indonesia so far, evidenced by sharp appreciation of the rupiah (4.6% ytd) and bull rally of the domestic stock market (Jakarta Composite Index up by 16.2% ytd) (Chart 1).

On the political front, after the results for the Indonesia's April 9 parliamentary election where the Democratic Party of Struggle (PDI-P) lost more than expected, two main alliances have been established with corresponding presidential candidates before the nomination deadline (May 20). The first coalition is composed by the PDI-P and three other parties, representing 207 parliamentary seats. Jokowi is the candidate for the Presidency and Kalla for the vice presidency in the **PDI-P-led coalition**. As the former vice president with good reputation for strong execution, Kalla is considered to be complementary to the Jakarta governor Jokowi whose inexperience at national level politics is a weakness often exploited by rival parties (see our previous [Indonesia Flash](#)). The second coalition is larger with a combination of six parties, including the Gerindra, the Golkar party and other four Islamic parties. The **Gerindra-led coalition** has secured 292 seats in the new House, nominating its founder Prabowo Subianto as the presidential candidate to compete with Jokowi. The incumbent party (DP) has decided to stay on the sidelines but should be considered as a crucial partner to either coalition wins this tight presidential race after July (Chart 2). Although the attitude of both alliances towards foreign direct investment has not been very positive so far, we believe that the Jokowi-Kalla one should probably be more open to foreign control and certainly more prone to reform.

One of the key challenges for Indonesia's future government is to facilitate investment in order to accelerate GDP growth close to its long-term potential of around 7%. 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 underscored by Indonesia's low rankings in business surveys. The upgrading of infrastructure (especially power generation, ports and roads) is a priority, as are improvement to fiscal management including the poorly targeted fuel subsidy scheme. Thus, an efficient government able to decisively implement constructive reform measures will be the key for Indonesia to address its macroeconomic imbalances and financial stability risks, improving thereby growth prospects in the medium-term.

Chart 1

Strong performance of the rupiah and JCI in 2014



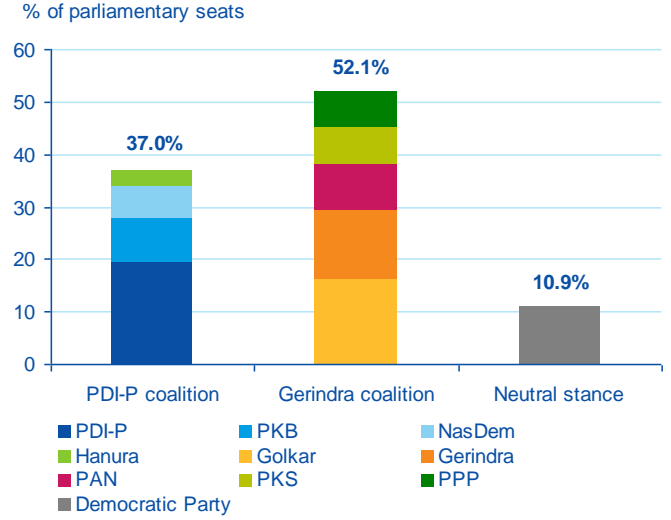
Source: Bloomberg and BBVA Research

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Chart 2

A tight presidential race between two coalitions



* PBB has gained no seat during the April parliamentary election
 Source: The General Election Commission (KPU) and BBVA Research



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