Turkey Watch

Group Economics
Emerging Markets Research

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Policy uncertainty to take over

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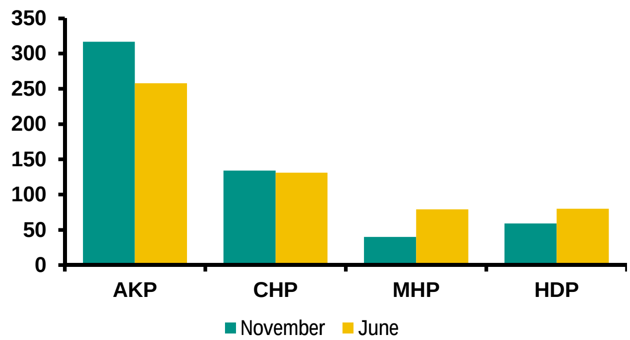
- **The AKP secured a majority in parliament during the elections**
- **Political uncertainty has been replaced by policy uncertainty**
- **Economy not affected by turmoil surrounding elections**
- **Monetary policy to remain tight**

AKP seized a majority in parliament during the elections

Unexpectedly, the AKP seized back the majority in parliament during the 1 November elections. While polls had indicated a large probability that the elections would lead to another hung parliament, the AKP secured 49.5% of the vote, which translates into 317 of the 550 seats in Turkey's parliament. In contrast, during the 7 June elections, when the AKP lost its majority in parliament as voters rejected President Erdogan's plans to strengthen the role of the Presidency, the AKP won only 40.9% (or 258 seats) of the votes. We believe the that the renewed popularity of the AKP reflects voters' desire for political stability following the suicide attacks in Ankara, the resurgent conflict with the PKK, and the failed coalition talks following the outcome of the June elections. The latter also explains why the support for the Nationalistic Movement Party, the MHP, has fallen significantly. The MHP is generally perceived as having been inflexible during the coalition talks following the June elections. Finally, although the Kurdish HDP managed to surpass the constitutional threshold of 10% to enter parliament, it also lost support during the latest round of elections. Most likely, this reflects that the HDP failed to distance itself sufficiently enough from the PKK movement.

AKP grasps majority during latest elections

Seats in the Grand National Assembly



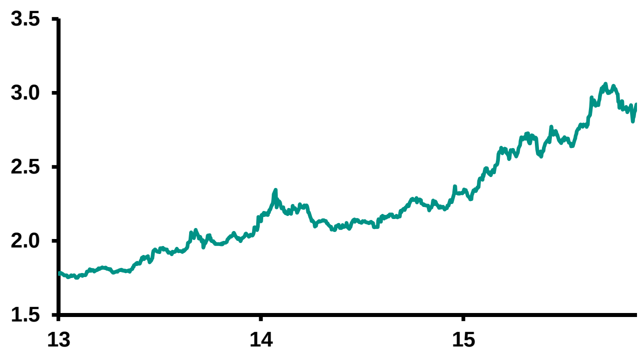
Source: Various media sources

Political uncertainty has receded,…

The victory of the AKP has clearly reduced political uncertainty, even though its majority fell short of a constitutional majority. Indeed, as the AKP secured a majority in parliament there is now no need to enter cumbersome coalition talks that could ultimately trigger new elections. Also, there is no change that a formed coalition could break down further down the road. Finally, political stability is being bolstered by the fact that both the President and the majority in parliament stem from the same party. All this explains why a lower political risk premium helped to support the lira and the Turkish stock market in the imminent aftermath of the elections.

Turkish lira has strengthened as political risks have eased

Turkish lira to $US



Source: Thomson Reuters Datastream

…but at the expense of more policy uncertainty

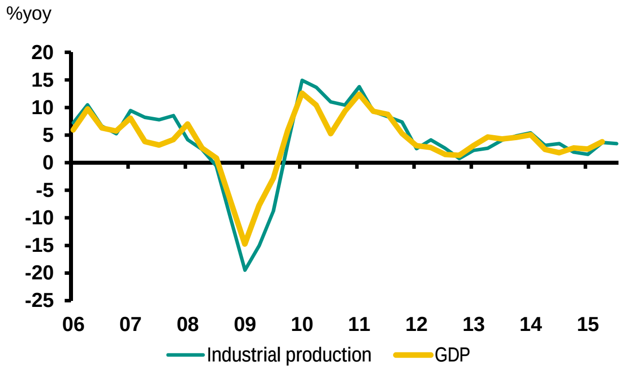
Unfortunately, the victory of the AKP is likely to lead to more policy uncertainty down the road. This is because it is now very likely that President Erdogan will try to amend the constitution in order to strengthen the role of the Presidency. Although Erdogan has been active in the campaign in the run up to both elections, the function of the President in Turkey has, originally, been largely a ceremonial office. However, President Erdogan wants that the Presidency holds substantially more responsibilities, broadly comparable to a Russian or US-style Presidency. Opposition parties, while open to changing the constitution, fear that changing the role of the President would erode the checks and balances in Turkish political system. This would give President Erdogan too much power. While the AKP is unlikely to find enough support in parliament to gather the backing of the 367 deputies needed to change the constitution directly, it takes only the approval of 330 members of parliament to take the proposal to a nationwide referendum. Early polls suggest that such a referendum would be unsuccessful, as a majority of the Turks favour a parliamentary system over and above a presidential one. Still, an attempt by the AKP to try to strengthen the role of the Presidency could lead to a further polarisation of Turkish society and spark civil unrest. Another fear relates to the ongoing erosion of the power of Turkish institutions. In particular, the central bank has frequently been put under pressure to loosen policy, or refrain from tightening in order to support economic growth. Ultimately, this could jeopardize its independence.

Economy not affected by uncertainty surrounding elections

Despite the uncertainty in the run up to the elections, the economy seems not to have been affected too much. In particular, industrial production, after surging by 7.2% YoY in

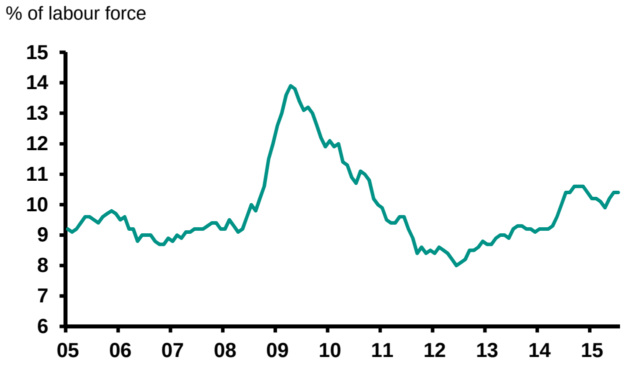
August, rose by 2.8% in September. This helped industrial production to grow by 3.4% in the third quarter of this year, only marginally lower than the 3.6% that was recorded in the second quarter. Given the close relationship between GDP growth and industrial production growth, this suggests that the economy slowed only slightly in the third quarter. After growing by a healthy 3.8% in the second quarter, we therefore think that growth slowed to around 3.5% in the third quarter of this year.

Economic performance not affected by elections…



Source: Thomson Reuters Datastream

…but too weak to push down unemployment rate



Source: Thomson Reuters Datastream

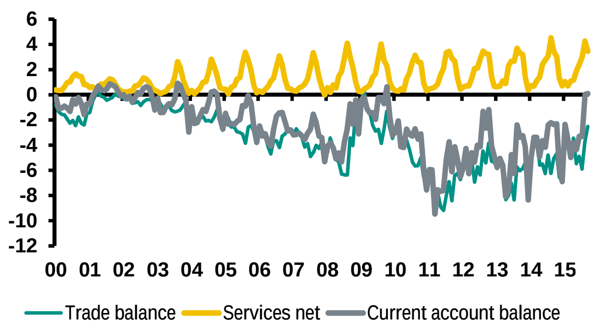
However, while such an outcome would keep growth moving broadly sideways, the performance of the economy has not been strong enough to push down the unemployment rate in a sustainable manner. Although the economy is generating a fair share of jobs, gains in employment have been outpaced by growth in the labour force. This has pushed up the amount of persons that are unemployed recently. The economy therefore would need to see the implementation of structural reforms to perk up its growth rate. In particular, the savings rate is too low, there is an overreliance on the low value added construction sector, and labour market regulation is too rigid. While the election outcome has managed to buttress sentiment, it is therefore crucial that the new government will embrace a credible reform agenda to continue to support the economy.

Fall in the lira has temporarily pushed current account balance in surplus

More positively, the fall in the lira has temporarily pushed the current account balance in surplus. In September of this year, it rose to $0.095bn, up from $0.027bn in August, and from$ -3.3 bn in July. Diving a bit deeper into the statistics that drive the current account balance, we can see that the improvement stems from two factors. Firstly, the balance on goods has become significantly less negative. This reflects that due to the weakening of the lira it has become more expensive to import goods, while the fall in commodity prices has also depressed imports. At the same time, a lower lira makes exported goods cheaper, boosting Turkey's competitive position. The other factor is that seasonal influences currently favour developments in the current account. The services balance was close to its historical high in September. This, however, reflects that around August, due to the tourism season, the services balance tends to peak. In turn, this implies that as the services balance comes down again due to the end of the tourism season, Turkey's current account balance is likely to fall into a deficit again. This also helps to explain why on a 12-months rolling basis, which averages out seasonal influences, Turkey still had a current account deficit of $40.6bn in September, representing 5.7% of GDP, though – admittedly – this measure puts less emphasis on recent developments.

Current account balance has improved…

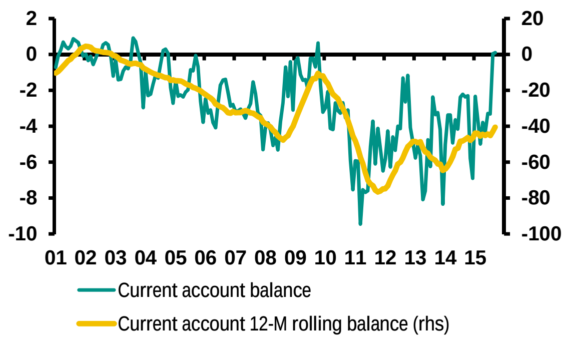
$ billion



Source: Thomson Reuters Datastream

…helped by better trade and services balance

$ billion



Source: Thomson Reuters Datastream

Risks surrounding our current account deficit forecast tilted to the downside…
While being extremely volatile and therefore difficult to forecast, recent developments suggest that the risks surrounding our current account deficit forecast of 5.5% of GDP for this year and 5.0% of GDP for next year are tilted to the downside. This is because even as the services surplus deteriorates, this will be partly offset by an ongoing narrowing of the good deficit on the back of the weak lira. We would like to await more data, but if these developments were to play out and the current account deficit were to improve considerably next year, this would take away a major negative for the Turkish lira.

But fall in lira has pushed up external debt

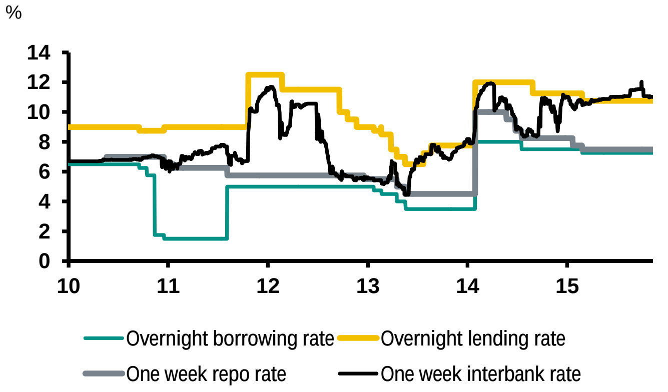
% of GDP

Source: EIU

…but weak lira and current account deficit have pushed up external debt
However, while helping the current account balance to improve, this year's slide in the lira in conjunction with Turkey's current account deficit will push up external debt ratios. According to the EIU, external debt is expected to rise from 50% of GDP in 2014 to 57% of GDP in 2015, while the debt-to-exports ratio should increase from 1.8

to 1.9 in 2015. Overall, Turkey's external vulnerabilities will thus remain elevated (*see also ABN AMRO: The top 6 emerging markets at risk, 8 September 2015*).

Monetary policy to remain tight



Source: Thomson Reuters Datastream

Monetary policy to remain tight…

Meanwhile, we think that monetary policy will remain tight in the foreseeable future. Despite it falling back from 8% in September to 7.6% in October, inflation has remained stubbornly high, and well above the central bank's target of 5%. What is more, the significant weakening of the lira that we saw during the past months, suggests that upward pressure on consumer prices is likely to continue to persist in coming time. In addition, we think that the central bank (CBT) will opt to keep monetary policy tight as the Fed starts to normalise its policy, which we think will advance in December of this year. This explains why the CBT has continued to push interbank rates against the upper bound of its interest rate corridor.

…as CBT simplifies policy framework

Interestingly, the CBT has expressed its intention to simplify its monetary policy framework during the time that the Fed starts normalising rates. This is because Turkey's monetary policy framework is opaque, to say the least, and the central bank would like to express a clearer message to investors during what could become turbulent times. In particular, the CBT wants to make the interest rate corridor more symmetric around the one week repo rate, and wants the width of the corridor to be narrowed. As due to elevated inflationary pressures, external vulnerabilities, and Fed lift off, monetary policy needs to remain tight, the CBT, in our view, has no other choice than to hike the one-week repo rate in coming months. This would bring it closer to the level of the one-week interbank rate, which is the most indicative of the current monetary policy stance.

Key forecasts for the economy of Turkey	2012	2013	2014	2015e	2016e
GDP (% yoy)	2.1	4.1	2.9	3.0	3.0
CPI inflation (% yoy)	8.9	7.5	8.9	7.5	7.5
Budget balance (% GDP)	-2.1	-1.2	-1.5	-1.5	-2.0
Government debt (% GDP)	38	37	35	33	33
Current account (% GDP)	-6.2	-7.9	-6.0	-5.5	-5.0
Gross fixed investment (% GDP)	20.3	20.4	20.1	19.8	19.7
Gross national savings (% GDP)	20.2	20.7	20.2	19.8	19.7
USD/TRY (eop)	1.8	2.1	2.3	3.1	2.9
EUR/TRY (eop)	2.3	2.9	2.8	3.4	2.9

Budget balance, current account for 2015 and 2016 are rounded figures
Source: EIU, ABN AMRO Group Economics

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