KfW Research
Focus on Economics

››› Turkey after the elections: What are the chances for new economic policies?

No. 218, 18 July 2018

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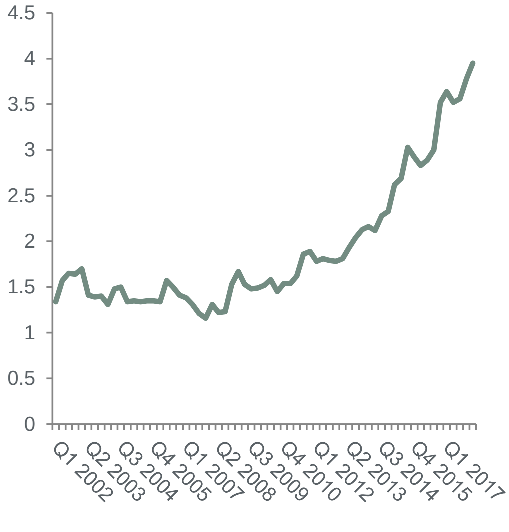
After winning the parliamentary and presidential elections, the re-elected president was sworn into office in Ankara last Monday. The newly elected government faces big challenges. To stabilise the economy, the government needs reforms and to regain trust. The situation in Turkey and the world economy are not very supportive of reforms, particularly since the election campaign is only taking a short break before the upcoming local elections in March 2019.

The newly elected president, Recep Tayyip Erdoğan, was sworn into office last week in Ankara. This marks the final step towards the new constitution, through which the president extends his power over the executive and judicative institutions. Whether the new concentration of power will lead to more consistent economic policies that will allow Turkey to reconnect with its more prosperous economic past remains the central question for both domestic and international investors. The election cycle is not over yet, as local elections are due in March 2019. Reforms could therefore be delayed. The backlog of economic reforms and the pro-cyclical economic policies are the reasons for economic problems and fading investor confidence. This is reflected in the performance of the Turkish lira (Figure 1)[i].

Figure 1: Exchange rate TRY / USD



Source: Datastream Reuters

The Turkish economic miracle is fading

Turkey's economic miracle of recent years (2002–2014) was based on the reforms and the infrastructure projects of the AKP government (Table 1). The party has broken with the consensus of the previous years and ushered in reforms in politics, the bureaucracy and the economy. At the same time, it firmly placed Turkey in the world economy. This was supported through the EU accession process.

Table 1: Largest AKP reform projects 2002–2007

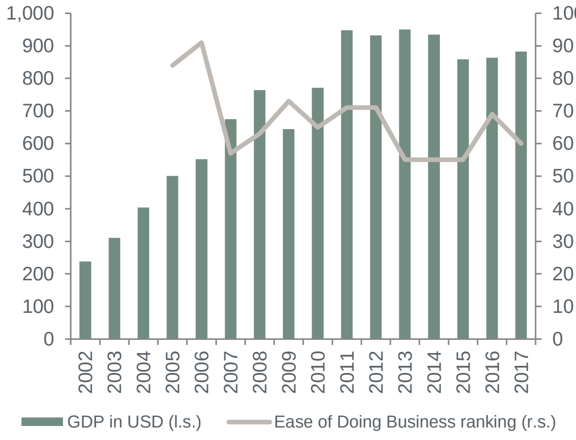
Project
Investments in transport and housing
Increased spending on education, incl. student loans
Extended and improved medical services, especially in rural communities
Privatisation and liberalisation of the economy
Modernisation of the justice system a part of the EU accession process
Macro prudential reforms, incl. state-of-the art central bank policies (inflation targeting)

As a result of these reforms and because of the positive global economic conditions that predominated leading up to the global financial and economic crisis, the Turkish economy managed to grow by over 30 % between 2002 and 2009 (Figure 2). In the same period, the country improved its position within the World Bank's "Doing Business" indicators. This is a direct consequence of the liberalisation of the economy and the modernisation of the bureaucracy under the leadership of Recep Tayyip Erdoğan – the newly re-elected president. In comparison with other emerging economies, especially in Central and Eastern Europe, Turkey recovered much quicker from the global financial and economic crisis. The quick implementation of Turkey's own measures and measures agreed under the G20 to support economic growth were important policy steps.

The phase of economic success appears to be coming to a close despite continuing high rates of growth. The enthusiasm for reform has cooled down or rather has been focussed on other policy areas, such as revising the constitution. The last big economic reform took place in 2007. As a result, Turkey's image as a reforming country has suffered. A large share of the population sees the economic problems that this deadlock causes. These doubts have led to a decline in consumer confidence and rise in dollar denominated bank accounts within Turkey.

Figure 2: GDP and business location

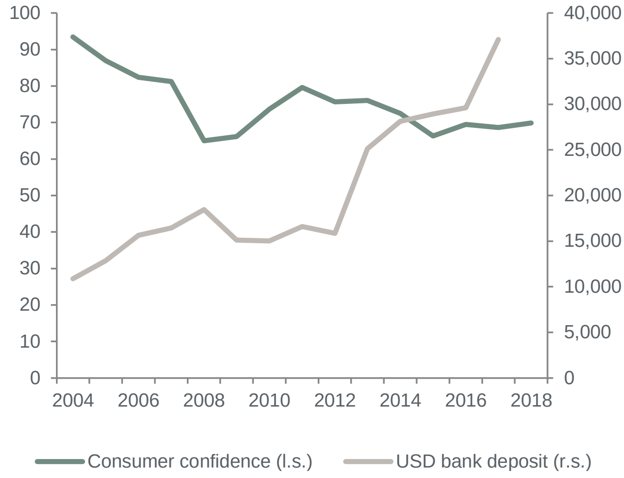
In USD billion and ranking



Source: World Bank

Figure 3: Confidence indicators

In per cent and USD billion



Sources: TürkStat / Thomson Reuters

The new government under the leadership of the re-elected president needs to regain the trust of this part of the Turkish population.

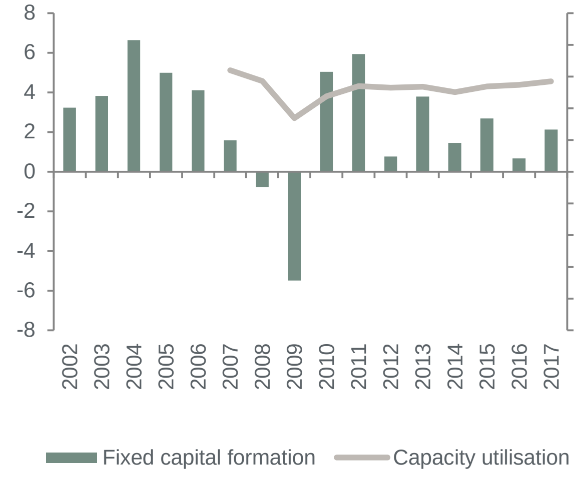
An economic policy that is too pro-cyclical additionally weakens long-term growth

Since changes made to national accounting standards in 2017, the Turkish Statistical Office does not differentiate between private and government gross capital formation. Because of the myriad of ongoing state-funded infrastructure projects, it can be assumed that the government share of total capital formation is high. Total government spending on these infrastructure projects is approximately USD 110 billion – that corresponds to around 10 % of Turkey's GDP in 2017. The biggest projects include the two nuclear power stations, a new airport for Istanbul and the extension of the road infrastructure (Table 2).

The private sector appears to be more reluctant to make investments. Capacity utilisation of the production sector has remained stagnant since 2010. If the private sector were making large investments, this figure would drop and recover again with time. However, the figure is currently rising again in Turkey and that means that utilisation is slowly rising (Figure 4).

Figure 4: Investments and capacity utilisation

In per cent and in index values



Sources: TürkStat / Thomson Reuters

Table 2: Five largest infrastructure projects

	Project	Cost
1	Sinop nuclear power station	USD 22 bn.
2	Akkuyu nuclear power station	USD 20 bn.
3	Istanbul–Izmir motorway	USD 16 bn.
4	Istanbul Canal	USD 15 bn.
5	New Istanbul Airport	USD 10 bn.
	Total	USD 73 bn.

Source: Halkbank

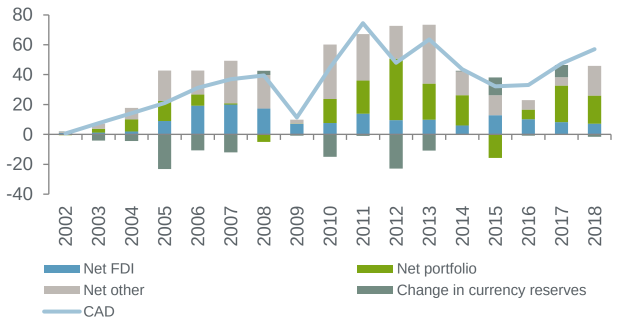
The government not only supports economic growth with its own investments but also by encouraging private consumption with temporary tax breaks. Soon after the unsuccessful military coup in 2016, the government undertook initiatives to support household consumption through a temporary VAT break using its very low level of public debt (which is one of the lowest amongst emerging markets at approx. 30 % of GDP). This negatively affects the primary balance of the government, which rose to roughly 1 % in 2016 and 2017. Apart from 2008 – the year the global crisis hit Turkey – the figure had always been positive. The IMF predicts that this negative trend will continue over the next few years.

On the back of these pro-cyclical economic policies, inflation and the current account deficit (Figure 5) continue to grow. As an energy importer, Turkey has always had problems with its current account deficit, especially at times of high oil prices. However, the structure of the current accounts deficit has changed compared with the noughties. The growing importance of private consumption and state-led investments, for example the use of foreign technology to build nuclear power plants, are currently pushing up the deficit, which has been financed by more volatile portfolios since 2010 (Figure 4). In light of tightening monetary policies in the advanced economies, especially in the US, Turkey experiences a lot of international pressure. Another risk factor lies in the deleveraging of the Federal Reserve's balance sheet and the imminent pressure on dollar denominated bonds. This could impact on the refinancing conditions for Turkey in the coming year, especially if it continues with its expansive fiscal and monetary policy.

In the noughties Turkey was still able to attract large sums of foreign direct investments to finance its deficit (Figure 5). Thanks to the many privatisation projects, investors were able to find investment opportunities. However, on the government side, the interest in a new wave of privatisation in Turkey has declined considerably. Interest from international businesses has also been better. On the investor side, Turkey's changing geo-strategic and economic importance can be held partly responsible here.

Figure 5: Current account deficit and financing

In USD billion



Source: Turkish Central Bank

To sum up, investment and fiscal policy promotes growth but currently results in a growing macro-economic instability consisting of inflation devaluation and growing private sector corporate debt. Another alarming sign, which indicates an overheating economy, is the declining growth potential of the Turkish economy on the basis of falling private investments. Questions regarding Central Bank policies further add to the growing insecurities.

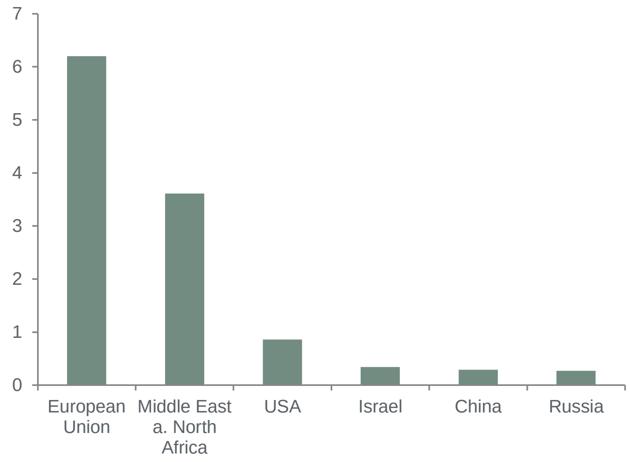
Diminishing support from the global economy

Compared to in the noughties, Turkey is finding it increasingly difficult to live up to its image as "the bridge" between Europe, the US and the Middle East. This is not exclusively linked to the loss of the institutional anchor, the EU. This potential was crucial to many investors during the first years of the AKP government. As a consequence of the global economic and financial crisis, however, Turkey's image amongst investors changed.

Opinions on Turkey changed following the economic and financial crisis. Due to the Arab Spring in 2011, Turkey was soon able to seize new growth opportunities outside Europe. Its links to the Middle East and North Africa rested on the political and cultural proximities to the governing Muslim Brotherhood in Egypt, the Ennahda party in Tunisia and the Assad government in Syria. These countries saw Turkey as a model for development. In the meantime, the government in Egypt has changed again and looks more towards Saudi Arabia than to Turkey. Syria, once one of Turkey's most important export markets, is embroiled in a vicious civil war. In the Middle East, the United Arab Emirates (UAE), Iraq and Iran remain important export markets for Turkish goods. For the time being, however, a partnership with all these countries cannot be forged at once. As a result, the Middle East and North Africa remain Turkey's second most important trade partners after Europe (Figure 6).

Figure 6: Exports by regions and countries in 2017

In USD billion



Source: TürkStat

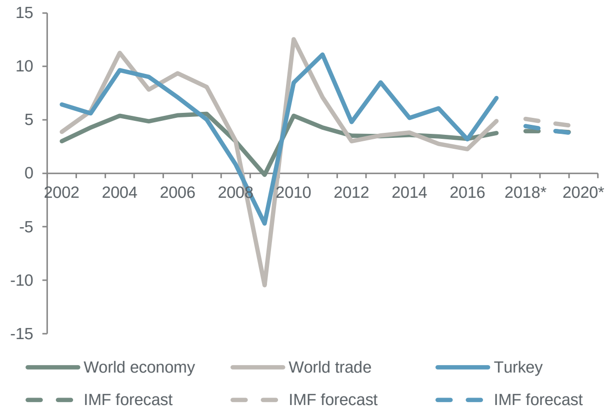
The relationships with these, as well as with the EU and the US, are far from easy. Turkey's strong bond with Iran especially creates tensions with USA and Saudi Arabia. This bond could potentially risk the economic relations with both of these countries, as well as the entire Gulf Cooperation Council (GCC), including the UAE. In the face of these tensions, Turkey is at risk of losing additional export markets and sources of hard currencies.

Despite the difficult geopolitical situation, the Turkish export sector has shown some resilience over recent years. For example, the long-running difficult situation with Russia could be improved which would increase the number of Russian tourists coming to Turkey. The sale of the 10th largest Turkish bank to an investor from the United Arab Emirates earlier this year shows that the economic ties are alive. With respect to the rising infrastructure spending in the Gulf region, Turkish constructions firms could capitalise on this opportunity and provide a boost for Turkish exports.

The opportunity to boost economic growth with exports currently remains limited despite the low value of the lira. The reason for this is the slowing economic growth globally and especially in the European Union, Turkey's biggest export market (Figure 6). In the face of the high level of foreign corporate debt, which accounts for about 80 % of GDP, it is becoming difficult to remain positive. Growing exports could help to pay off foreign debt and reduce the foreign account deficit. In the noughties, the boom of the global economy and trade helped to pay off Turkey's large sovereign debt from the 1990s. But since the world economy appears to be entering a phase of slower growth, it is hard to see how foreign corporate debt could be paid off quicker and the current account deficit could be reduced faster.

Figure 7: Growth Turkey, world GDP and trade

In per cent



Source: IMF

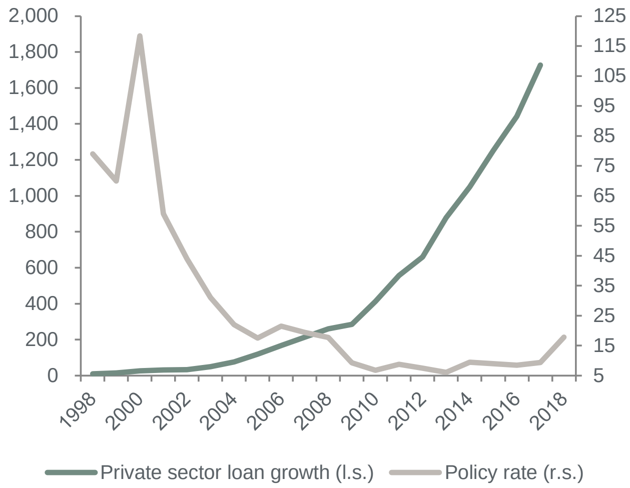
The return to more stability-oriented policies will not be easy

The economic and banking crisis in 2001 was the turning point for many extensive reforms in the Turkish banking sector. Part of these reforms was the independence of the Central Bank and improved banking regulations. The latest challenge of the Central Bank's independence has undermined the trust in the government amongst Turkish and international investors. Whether the new government will return to the old policies, despite the recent rate hike on 6 June and the reassuring words of the former Deputy Prime Minister, Mehmet Simsek, regarding the independence of the central bank remains the most disputed question amongst investors. Inflation will continue to grow and put pressure on the lira, if the Central Bank remains weakened. However, if the Central Bank adopts a different path, it may have to jam on the brakes in order to regain any credibility. The risk of a recession is likely to grow under such a scenario. In the face of the local elections in spring 2019, both scenarios have the potential for further economic conflicts, such as sudden fiscal compensatory measures.

The policies of the Banking Supervision Committee were also different during the first phase of the AKP government. For example, limits were created to slow and even prevent the accumulation of private household debt. Experts on the Turkish banking sector emphasis that these rules and regularities especially had a much bigger influence on the level of borrowing than for example the Central Bank's fiscal policy. If you take a look at the acceleration of lending the corporate sector after 2010, you see some truth in that (Figure 8). After the financial and economic crisis 2010, Central Bank interest rates were at a very low level. Lending continued to accelerate, especially since the tight controls and rules were slightly lifted or more liberally interpreted.

Figure 8: Bank loans and policy rate

In TRY billion and per cent



Sources: Turkish Central Bank/Thomson Reuters

The loss of experienced state sector employees – especially within the banking supervision – is another example of the ongoing and future personnel and institutional changes within the Turkish bureaucracy, also as a result of changes to the constitution.

A hard landing becomes more likely without real reforms and a clear timeline

The private investment cycle in an internationally favourable interest environment is coming to an end. Recently supported by pro-cyclical fiscal policies, this has resulted in high inflation, a growing current account deficit and rising levels of corporate foreign debt. The structural economic problems of the country result in falling indicators of trust and declining domestic and international capital flows.

The newly elected government faces big challenges. To stabilise the economy, the government needs reforms and to regain trust. Fiscal, monetary policies and bank lending has to be brought back into line. Internationally, the newly elected government should try to bring Turkey closer to the EU (its main trading partner) and NATO, as this would certainly improve Turkey's image worldwide. Turkey's excellent relations with countries in the Middle East could be very helpful in this regard. The risks within this process should not be underestimated as the international surroundings are getting more challenging. The upcoming local elections in early 2019 could potentially hinder the eagerness for reform. Should the new government not be able to deliver on these polices and provide some hints on a reform agenda for 2019, then a hard landing is very likely. ■