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Turkey's Economic Problems before the Elections

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In May, the Turkish lira reached a record low to the U.S. dollar. Turkey's growing economic problems stem from Turkish politicians' preference for political goals over economic ones. For now, the authorities have begun to undertake actions to regain investors' trust, but in the longer term, Turkey's economy needs to undergo deep and probably unpopular structural reform. The country's economic problems may significantly influence the parliamentary and presidential elections set for 24 June.

State of the Economy. Since the beginning of the year, the Turkish currency, the lira, has lost around 20% of its value (as of May). Up to December 2017, investors had been regarding an exchange rate of 4 lira to 1 U.S. dollar as a "psychological barrier," but on 23 May, the rate reached 4.93 to 1. This was the result of a coincidence of a few trends unfavourable to Turkey's economy.

According to the Turkish Statistical Institute (TÜİK), the Turkish economy's growth in 2017 was an impressive 7.4%. At that time, it raised investor concern that it was overheating, which resulted in calls to raise interest rates. They also cited the quite high inflation, which was 10.9% in April. That together with the devaluing lira are partly why GDP growth has not translated into improving Turkish household economic conditions. Moreover, Turkey has even bigger, structural problems. According to recent data, unemployment has reached 10.6%, hovering even around 19% among young Turks. Income inequality is also pretty high: According to the World Bank, the Gini index is 41.9 (compared to 31.8 in Poland) while the percentage of people living under the poverty line is 21.2% (TÜİK data from 2016). Turkey's economic problems also stem from its dependence on the inflow of capital from abroad and a large current account deficit, reaching $47 billion in 2017 (around 5.5% of GDP).

Politics over the Economy. Since 2014, Turkey has been stuck in an election cycle, with the next election the sixth in four years. The atmosphere of never-ending campaigns has not favoured the introduction of structural reform. It also has impaired trust among investors, who have been in constant anticipation that Turkish authorities would finally execute their long-overdue promise to introduce serious reforms after elections.

Foreign investors' worries have also been raised by other events and processes. The first was the failed coup and fallout, including the state of emergency and consolidation of power under President Recep Tayyip Erdoğan. Alarm was raised in particular by the government's straying from the rule of law and by the weakening independence of the Turkish Central Bank (TCB). These issues, among others, were cited by rating agencies Fitch, S&P, and Moody's in their decision to lower grades on Turkish bonds. Additional pressure has been on the TCB by President Erdoğan, a declared opponent of interest rates in general and who has an unorthodox economics view that high interest rates lead to rising inflation. His opinion on that subject is often described as stemming from his religion because Muslims are not supposed to earn income from interest-bearing loans. While that is not insignificant, the political context seems even more important. It is possible that with the state of permanent campaigning, the Turkish president has preferred lower interest rates because they fuel consumption and influence the cost of credit. He probably calculated that lower interest rates keep him favourable with the electorate and are needed for the stable financing of infrastructure projects, which play an important role in his vision of Turkey's development.

The next issue is the tensions between Turkey and its Western allies, which have not helped build investor confidence. Quarrels between Turkey and the U.S. over the "Zarrab case" were particularly important.[1] Speculation ramped up that Turkish banks, reportedly engaged in evading American sanctions on Iran, would be fined by such a hefty amount that it would shake Turkey's economic stability. Yet, the real cause of the Turkish lira's slide was Erdoğan's own statements to investors in London in the first half of May. The president again not only portrayed himself as an opponent of interest rates but also announced that he would exert even more control over monetary policy after the elections, proving investors' worst fears.

Authorities' Reaction. Initially, the Turkish government tried to restrain the market panic linked to the lira's sharp slide with rhetoric, first of all, by drawing attention to the GDP growth, arguing the lira rate does not reflect economic reality. It also encouraged Turkish citizens not to sell lira as their patriotic duty. Then, it claimed the lira's slide was caused by a conspiracy of external powers. This tactic seems to have been effective to some extent within Turkey, as shown by a public opinion survey in May by Metropoll which found that around 42% of Turks, including 60% of the ruling party's electorate, believed the claim.

The central bank has long been undecided on whether to raise interest rates. It did so only on 23 May when it decided to raise what is called the LLW rate (late liquidity window) from 13.5% to 16.5%. Soon after, the authorities backed its actions. The president claimed that "Turkish institutions are committed to the free global market, its rules, and institutions," and Deputy Prime Minister Mehmet Şimşek, together with the bank's head, Murat Çetinkaya, travelled to London to meet with investors. The TCB's took its next action on 28 May. It decided the one-week repo rate (discount rate) would be the central bank's policy rate and that it would be set at 16.5% (up from 8%). This calmed the market and the lira strengthened, reaching 4.6 to the dollar.

Prospects and Conclusions. Turkish authorities are likely to continue to try to calm the market because they cannot allow economic problems to be so spectacularly visible during the election campaign. The TCB probably will raise interest rates one more time in the first half of June. Yet, this does not mean the economy is stable. The recent events have shown that the lack of structural reform means the state is greatly dependent on the trust of investors, who clearly are concerned by Erdoğan's consolidation of power. Thus, a breakdown in the economy cannot be completely excluded until the Turkish authorities decide on structural reforms and guarantee the central bank's independence.

The lira's slide seems to have already impacted the electorate's preferences. A survey carried out in May by MAK Consulting shows that 45% of Turks think the economy is the country's biggest problem. This does not bode well for the ruling party, as recent experience shows that in the hierarchy of problems, this factor hurts the Justice and Development Party's (AKP) election chances. In the June 2015 elections in which the AKP lost its parliamentary majority (it regained it in November 2015), this was the main factor, ahead of terrorism, regarded by Turks until then as the biggest problem. If this situation is repeated in the upcoming elections, the opposition, which has been charging the government with economic negligence, may win the parliamentary part. Faced with the very probable re-election of Erdoğan, this would mean a period of cohabitation. This, in turn, might lead to another snap election and further delay in structural reform.

Under these conditions, Turkey's authorities may be interested in distracting the electorate's attention from the state of the economy. Turkish media have been speculating that operations directed at the terrorist Kurdistan Workers' Party (PKK) in Iraq may serve this aim, since the Turkish army's presence in that country has been steadily growing. Another scenario discussed in media is connected to the possibility of increasing the tensions in Turkey's relations with Greece, which lately have been pretty intense.[2] Yet, while a new operation directed at the PKK cannot be ruled out, it seems unlikely that the tensions between Turkey and Greece would intensify. President Erdoğan may be not interested in intensifying a quarrel connected to the EU, which is still the source of around 65% of foreign direct investment in Turkey.

The fluctuations in the lira's exchange rate have influenced Turkish companies' debt levels since they tend to get longer-term loans in dollars (their total debt is estimated to be around $225 billion). A further slide in the Turkish lira might hurt their ability to conduct economic activity abroad, threatening, for example, plans to double trade between Poland and Turkey from $5.6 billion today. Polish entrepreneurs with Turkish partners should closely follow the next elections and see if the Turkish authorities initiate structural reforms after them.

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[1] K. Wasilewski, "Turkey-U.S. Relations Overshadowed by the Reza Zarrab Sanctions Evasion Case," *PISM Bulletin*, no. 123 (1063), 8 December 2017, www.pism.pl.

[2] K. Wasilewski, "Turkey's Relations with Greece and Cyprus: Old Challenges Resurface," *PISM Bulletin*, no. 60 (1131), 23 April 2018, www.pism.pl.