The Economic Aftermath of Erdogan's Quest for Power

Over the last couple of months Turkey has been greatly divided over President Recep Tayyip Erdoğan's proposal to augment the executive powers of his position. Ultimately, Erdoğan claimed victory by the slimmest of margins last Sunday as 51% of Turks stood by his side in a vote whose integrity is being questioned by many European lawmakers, as well as the Turkish opposition. Regardless, the outcome of this referendum will undoubtedly define the near future of the country on the global political scene, as well as set the course of economic policy. This article focuses on the latter, attempting to interpret how Turkey's economy will be affected by Erdoğan's confirmed status of power.

Monetary policy will be a big point of contention between the President and the Turkish Central Bank (TCMB) in the months ahead. Erdoğan is a vocal proponent of low interest rates, but the Central Bank contracted liquidity in January to raise the interbank overnight lending rate by almost 75bps to 9.25% (and emergency liquidity rate to 11%). This was an attempt to ease inflation which has jumped 2.5% since last November to 9.5%. Turkish inflation has historically been much higher than in western economies, averaging about 7.5% since Erdoğan's Justice and Development Party (known as AKP) took power in 2002. With the Turkish economy growing at a similar pace, however, inflation has not been much of an issue, but now GDP growth has halved to only 3.5% in the last year.

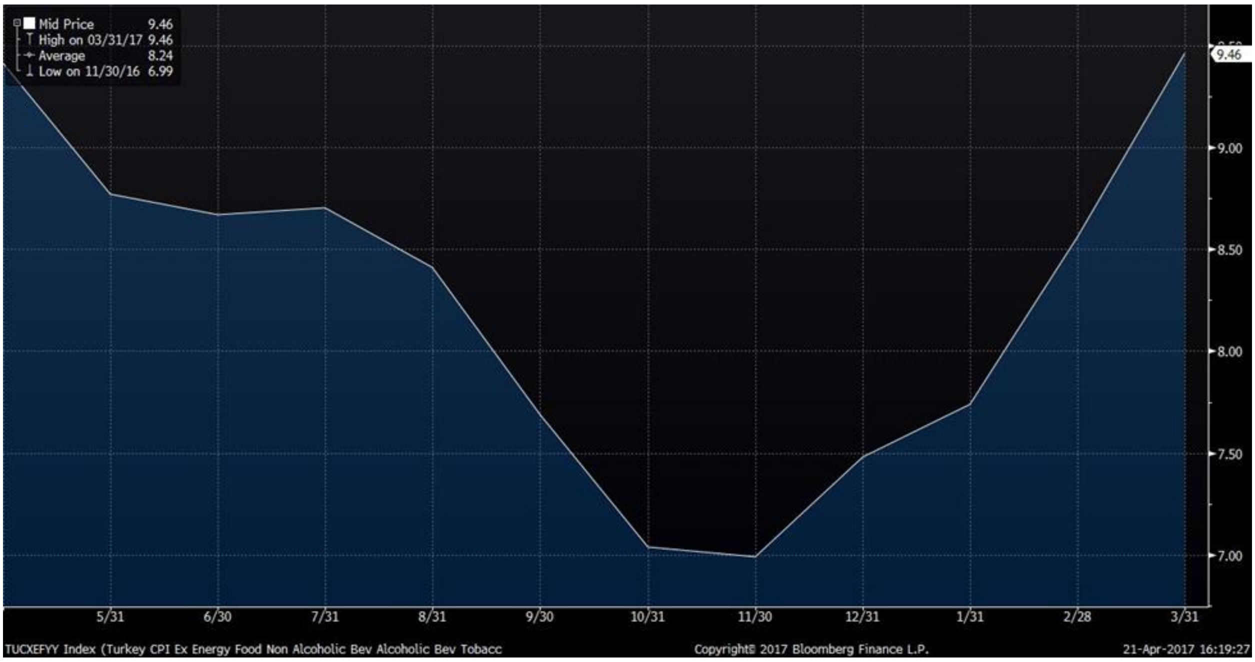

Chart 1: Turkey core CPI - Turkish inflation spiked again during Q1 2017, despite the January hikes (source: Bloomberg)

Over the past couple of months, investor pressure has been mounting on the TCMB to act strongly against inflation, but in spite of the lending rate hike, the overnight repo rate is untouched since January at 8%, something that is suspected to be due to Erdoğan's undue influence on the bank. Investors have been concerned with the fact that the Central Bank uses unconventional liquidity contractions to manage its upper lending rate rather than a traditional base rate hike, the underlying signal being that the Bank is unwilling to stand up to Erdoğan by elevating the interest rate directly.

In its Q1 2017 inflation report, the Central Bank revised upwards its end-of-year inflation expectations for 2017 and 2018 by 1.5% and 1% respectively (citing increased lira-denominated import prices), but projected inflation to fall to as low as 5% by 2019, signalling possible further monetary contraction. While Governor Murat Çetinkaya has confirmed his commitment to price stability on many occasions, his resolve is likely going to be tested by the empowered Erdoğan. With April's monetary policy meeting on the 26th and inflation report on the 28th, eyes will be on the TCMB to determine the future course of monetary policy, the question being whether they will raise rates further.

The Bank's decision about interest rates on the 26th will be very important for the Turkish currency. The lira has had a dismal run against the dollar since Donald Trump's election, depreciating more than 13% since. Admittedly, the dollar has gained ground against nearly all major currencies recently, but the lira has been among the hardest hit. Much of this has been due to general investor uncertainty surrounding the referendum, and now that the possibility of early elections has been dismissed, it seems the Turkish currency can hope for a recovery. In the days since the referendum the lira has been appreciating, gaining about 2% on the dollar since the vote.

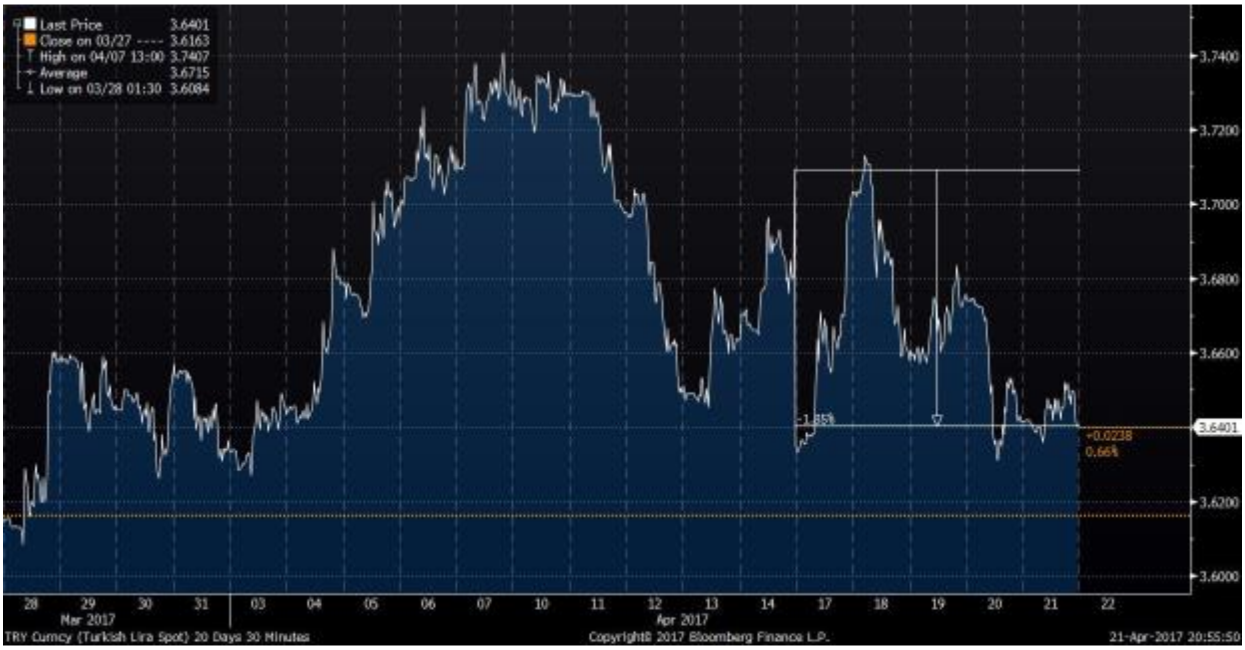

Chart 2: Turkish lira spot - The lira is showing signs of recovery after the referendum (source: Bloomberg)

If inflation is still on the upswing on the 28th of April, there is a good chance of further monetary tightening and lira appreciation. If price data comes in more stable – a possibility due to lower-than-expected aggregate demand in the run-up to the referendum – Erdoğan will have leverage over the TCMB to prevent the hike and maybe even advocate further rate cuts down the road.

So what is in for Turkish capital markets in the short term?

Altogether, the outcome of the referendum seems to have brought at least some stability to Turkey. The BIST 100 index of the Istanbul Stock Exchange rose to an all-time high, up 2.5% since the vote, following promises by the AKP leadership to make investor-friendly changes to labour and tax laws. Banks and heavy industry stocks were the biggest gainers.

Two additional initiatives by the government might also have helped boost investor confidence – the first is Turkey's own Sovereign Wealth Fund which will probably be used to inject banks and Turkish companies with additional equity capital where needed, and thus helping stock prices. The second initiative is the Credit Guarantee Fund (CGF), which aims to support a real sector that is struggling with paying off its dollar debts after the large loss of value of the lira. The CGF presents a pool of $35bn put together by businesses and the government that will be used to provide low-cost short-term and working capital funding. In announcing the CGF, Erdoğan's chief economic adviser Cemil Ertem praised it as the tool that would disprove the IMF and World Bank's predictions of lower growth for Turkey in 2017 (2.8% predicted by World Bank versus 4.5% by Ertem). While much of this was certainly pre-referendum talk to please the crowd, the CGF may already be helping Turkish equities. The fact that Ertem specifically mentioned banks as beneficiaries of the program surely played a part in the good performance of their stocks over the last week. If the CGF is further expanded to $55bn, as planned, bank and manufacturing share prices will likely increase even more.

It feels as if the referendum has given Turkish equities a short-term boost, but consistent performance still depends on the actual policies that will be implemented by the President's administration, as well as on Turkey's trade relationships with major partners, especially the EU. In the coming months, it will be important to look for signs of reconciliation between Erdoğan and European leaders. If sentiments deteriorate further, this is certainly a valid reason to doubt the future prosperity of Turkish companies, half of whose exports are meant for Europe.

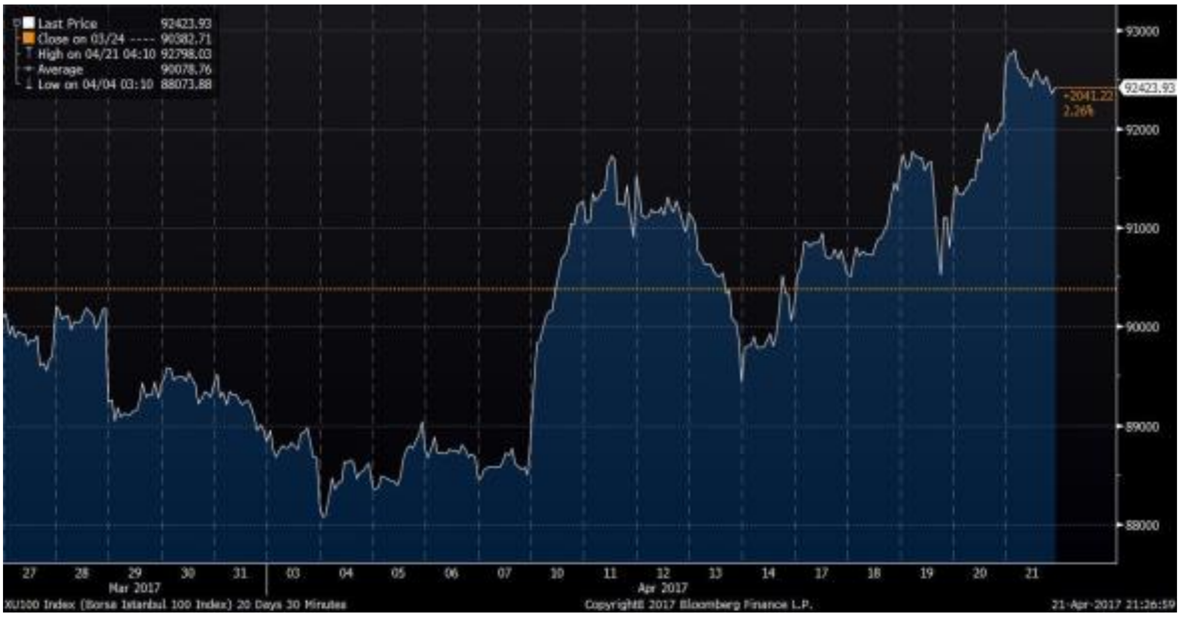

Chart 3: BIST 100 Index - The BIST 100 is up 4.5% since the beginning of April (source: Bloomberg)

In debt markets, Turkish dollar-denominated bonds of all maturities reached their highest prices since November, with 10-year to 30-year yields falling 0.5%. Still, bond investors seem divided over whether holding Turkish debt is worth the risk given that the country's future monetary policy is so unclear. After the major rating agencies stripped Turkey's bonds of their investment-grade status in January, many investors have pulled out of the market, shifting their funds to safer economies. While the stock market seems overly optimistic, bonds provide a more accurate picture of the current situation in the country. If things go right, the short-term boost of the referendum can spark a prolonged period of stability. However, if Erdoğan fails to yield his power responsibly, the Turkish economy might continue to find itself short of growth and stifled by inflation.

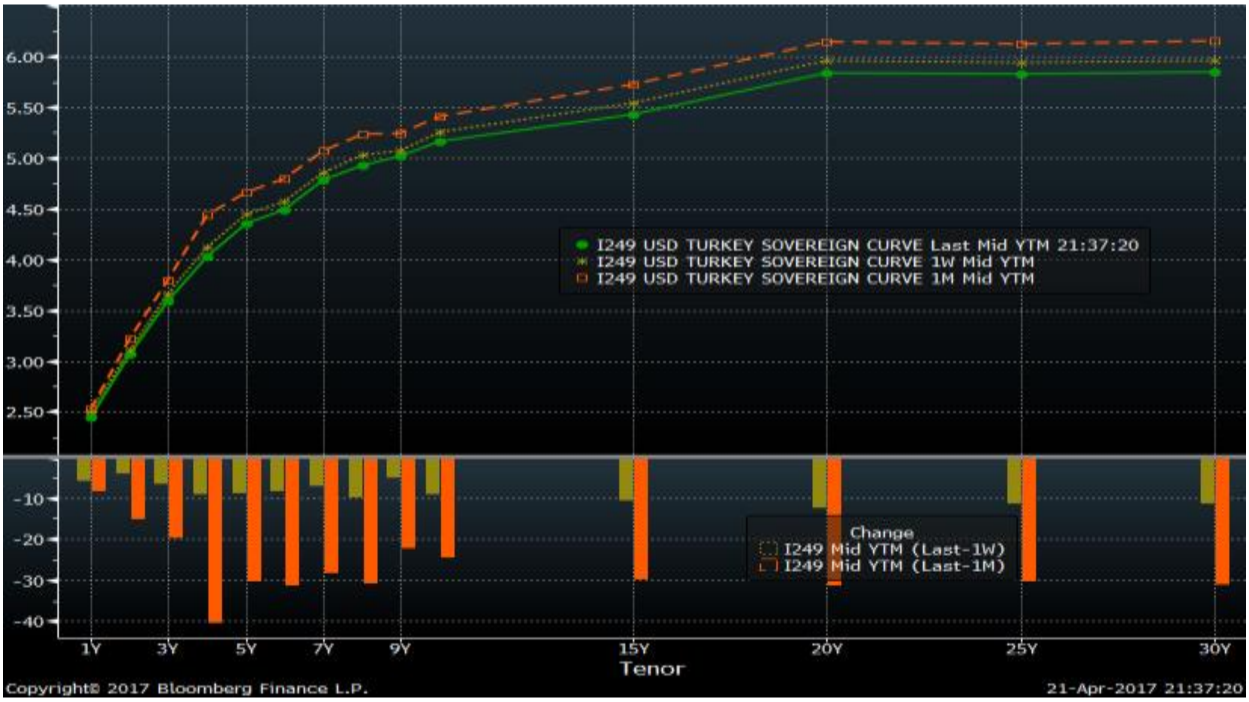

Chart 4: USD Turkey sovereign curve - Tightening around 0.5% across all maturities since a month ago (source: Bloomberg)

Erdoğan has been firmly in power in Turkey for a long time already, and the result of the referendum is unlikely to turn around his policies completely. However, this slim victory may be just what he needs to attract investor's attention and get a restart for Turkey's slowing economy. As we have seen this week, the referendum has already played its part in jumpstarting Turkish bonds and equities. The next few weeks will be crucial in determining what path Erdoğan will choose and how markets will respond. The first developments to look for are the Central Bank's meeting on the 26th and how inflation will turn out to be this quarter. These will give the first signals about the direction in which the Turkish economy is going. It is not completely clear how Turkish equities managed to perform so well amidst such a turbulent domestic political environment, but this goes to show that Turkey has much to offer to investors if Erdoğan and his party can steer the economy in a good direction. The Sovereign Wealth Fund and the Credit Guarantee Fund are also indicators of how involved government will be with markets and companies. While some aid may be appreciated initially, the Turkish government seems to be meddling with the economy too much at times. Now that the position of Prime Minister has been abolished, it is entirely up to the President to pave the way.

TAGS: Turkey, Erdoğan, AKP, referendum, inflation, TCMB, interest rates, Turkish lira, BIST 100, SWF, CGF, debt markets