The majority of the analysis on Turkey’s general elections, to be held on June 7, has focused on the domestic political ramifications of President Recep Tayyip Erdoğan’s bid to forge a presidential system that would enable him to consolidate power. But the outcome of this election will also be hugely consequential for the Turkish economy.

In the United States, financial institutions have been rattled by Turkey. Notably, the United States Federal Reserve launched a probe in September 2014 into the New York branch of Turkey’s largest state-run bank, Ziraat Bankası. The bank was ultimately forced to shut down its (admittedly small number of) retail accounts in the United States. No explanation was given.

Six months later, Citigroup sold its stake in Turkey’s Akbank. The American financial juggernaut had been Akbank’s second largest shareholder. Beyond these headlines, the government continues to advocate for lower interest rates. Turkish Prime Minister Ahmet Davutoğlu took an unannounced trip to New York in a bid to soothe investors’ jitters.

All of this came on the heels of revelations in 2013 that Turkey’s state-owned Halkbank had been facilitating gas-for-gold transactions that helped Iran evade sanctions. The transactions were officially legal, but raised questions about Turkey’s financial practices. Those questions only compounded after the release of a leaked Istanbul prosecutor’s report in 2014, suggesting that Turkey may have been at the center of a large illicit finance network that also served to benefit Iran.

In other words, after more than a decade, Erdoğan’s authoritarian tendencies are not just headline generators. The Islamist leanings, majoritarian practices, and abuses of power by Erdoğan’s Justice and Development Party (AKP) have had major economic implications including weaker foreign direct investment and greater economic volatility.

Erdoğan’s own Deputy Prime Minister for Economic and Financial Affairs Ali Babacan has warned that the president’s challenges to rule of law could have negative effects on the economy. The Financial Times notes, “Erdoğan continues to confound international investors by publicly fighting with the country’s central bank over monetary

1. This analysis is coauthored by the FDD’s Center on Sanctions and Illicit Finance and Roubini Global Economics. As an independent economics research firm, Roubini Global Economics does not take a view on which policies the U.S. should adopt with respect to Turkey. FDD is a non-profit, non-partisan, policy institute whose experts have written on U.S. policy toward Turkey. Both organizations believe that a better understanding of Turkey’s economy can help inform policy choices.

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policy in a bid to consolidate his power.” Given term limits, Babacan himself is likely to leave the government after these elections.

The report below, penned by Roubini Global Economics, sketches out three political scenarios following the Turkish elections, explains what economic results each could bring, and highlights key signposts to watch. Turkey’s forthcoming elections could help or hinder the country’s economy as much as it helps or hinders Erdoğan’s attempts to consolidate power. As this report makes clear, the two are inextricably intertwined, making the stakes for this election particularly high.

**Summary of Analysis**

- The June elections provide a key time to assess Turkey’s economic policy trajectory. The results of the election and government formed after it will frame any reform opportunities and shape variety of economic outcomes. Decisions taken after the June elections will be key to Turkey’s economic trajectory. This report presents the three economic scenarios (summarized in Figure 1) for the next 3-5 years and the signposts to watch.

- Turkey’s present policy trajectory is undermining domestic financial stability and growth and perpetuating a cycle of economic volatility and underinvestment. The standoff between President Recep Tayyip Erdoğan and the Central Bank (CBRT) over monetary policy and reliance on consumption and credit is fueling domestic economic imbalances (overreliance on consumption), increasing the vulnerabilities stemming from the funding composition of the external deficit, and limiting the cyclical benefits from lower oil prices. Turkey’s reliance on the shortest-term capital flows leaves it exposed to external shocks such as the tightening of global financial conditions.

- In this report, we explain what drives the chronic financial and economic pressures that leave Turkey highly exposed to shifts in global market sentiment and consider how the government’s policy choices can change Turkey’s resilience and growth outcomes.

- **Baseline: Muddle-Through, Micromanagement Brings Economic Volatility (70%).** The ruling Justice and Development Party (AKP) continues to tinker with macroeconomic policy to avoid an economic crisis but implements little reform. GDP continues to grow at 3.5-4% average over the next five years, with the economy suffering bouts of stagflation and failing to absorb the new entrants in the workforce. The country attracts sufficient short-term investment to meet its financing needs (at the cost of high interest rates that cool domestic demand), but fails to attract meaningful long-term capital due to institutional issues, the centralization of power, corruption and competitiveness issues. Absent meaningful structural reform to build savings and increase economic resilience, we expect Turkish growth and assets will remain vulnerable to shifts in global sentiment that change capital flows.

- **Upside: Reform-Friendly Shift Ensures Steadier, More Balanced Growth (10%).** Under this scenario, the AKP re-commits to economic reform and implements its roadmap (Vision 2023), resulting in stronger, less volatile growth (4.5% over five years) and higher incomes and savings over the medium term. Steady growth and stronger institutions make Turkey a more attractive proposition for both short- and long-term investments, in turn increasing the economy’s resilience against shocks.

- **Downside: Confrontation Spurs Currency Crisis and Recession (20%).** In this scenario, micromanaging fails due to the overreach of the executive in monetary policy and/or the over-
centralization of power. Erdoğan continues to encroach on the CBRT’s territory with demands for lower interest rates, further undermining the bank’s credibility and leading to another sell-off in Turkish financial markets. Over the medium-term, this policy mix undercuts public confidence. Capital outflow precipitates a financing crisis, necessitating a significant tightening of economic policy that leads to a fall in demand and recession. Corporate defaults climb, sparking an increase in nonperforming loans (NPLs) in the banking system and, possibly, a liquidity crisis.

**Figure 1: Medium-Term Turkey Scenarios at a Glance**

<table>
<thead>
<tr>
<th>Assumptions</th>
<th>Base Case - 70%</th>
<th>Upside Case - 10%</th>
<th>Adverse Case - 20%</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Muddle Through Brings Economic Volatility</strong></td>
<td>°No meaningful reforms</td>
<td>°Inclusive governance, AKP shifts policy preference to reform</td>
<td>°AKP micromanaging failing, risking policy disarray</td>
</tr>
<tr>
<td><strong>Economic Outcomes</strong></td>
<td>°Weak business investment climate, growth volatile and reliant on external short-term capital</td>
<td>°Investor-friendly business environment, more stable financing of the external balance (FDI)</td>
<td>°Possibility of coalition government risks early elections</td>
</tr>
<tr>
<td>°Weak job creation, rising inequality, stagnating real incomes</td>
<td>°Sustainable employment generating growth acceleration</td>
<td>°Institutional collapse</td>
<td>°Rising unemployment and falling real wages.</td>
</tr>
<tr>
<td>GDP and Inflation Forecasts (average 2015-19)</td>
<td>GDP: 3.5%, CPI: 7%</td>
<td>GDP: 4.3%, CPI: 6%</td>
<td>GDP: 2%, CPI: 9%</td>
</tr>
</tbody>
</table>

**Source:** Roubini Global Economics

**State of Play: Policy Dilemma**

Turkey's economy is volatile, with GDP growth having dropped off to the mid-3% range in 2014 (down from an average of 6.9% in 2003-07). While this is still a relatively high growth rate in the global context, most of this surge has been driven by a rapid expansion of credit that was channeled into consumption and unproductive investment (particularly construction). Meanwhile, the increase in nominal GDP per capita has stagnated since 2008 (Figure 2).
Turkey’s growth volatility stems from its broadly recognized domestic and external imbalances (a wide and poorly financed current account deficit, and high inflation). Although both deficits have narrowed since 2012, thanks mainly to oil prices, they remain above comfort levels.

These imbalances reflect deep-seated structural weaknesses. Excessive consumption and low savings rates, especially among households (12% of total GDP), leave little space for investment, and the country’s dependence on energy imports presents another point of vulnerability. These imbalances leave Turkey heavily dependent on foreign creditors; the composition of the financing of the current account deficit (short-term portfolio and bank flows rather than stable foreign direct investment (FDI), despite FDI incentives announced in 2012) is a symptom of the country's poor business environment, which is marred by endemic corruption and poor implementation of reforms. The probe into government corruption launched in December 2013 is a testament to the deterioration of Turkey’s institutional robustness. The scale of the investigation is unprecedented, involving many prominent business figures and relatives of AKP ministers.

In addition, domestic and international political risk is running high. Domestically, President Erdoğan, focused on consolidating power, is stretching the limits of the current constitutional regime and using state resources in controversial ways. Of key concern to investors has been the adoption of laws that have effectively weakened constitutional checks by giving the government greater control over the judiciary. The government is also in the midst of purging the public and banking sectors of the supporters of Fethullah Gülen, a former AKP ally now accused of turning on the party and concocting a coup plot in December 2013. This purge has removed a vast number of public servants, depriving institutions of valuable human capital, and could be quite disruptive as it puts pressure on institutions and individuals to prove their loyalty. Similarly, the government’s seizure of the country’s largest Islamic lender, Bank Asya, in February on questionable charges has reinvigorated concerns about the local investment climate.
Meanwhile, the government’s reconciliation process with the Kurdistan Workers Party (PKK), aimed at ending the decades’ long armed conflict between the Turkish state and Kurdish militants, appears to have stalled at least until after the June elections.

Domestic political risks have been exacerbated by Turkey’s involvement in regional crises (Iraq, Syria, Iran, Israel-Gaza). Turkey’s involvement has often been unpopular, both domestically and internationally. Some of Turkey’s attempts to boost the country’s role in the Middle East by supporting groups in Syria and Libya, as well as Hamas, have isolated it from key regional players/potential investors (GCC) and worsened the relationship with the United States and with European countries.

The above vulnerabilities have not stopped capital from flowing into the country and portfolio investors have continued to be drawn to its high nominal interest rates (relative to those in other emerging markets; Figure 3) and still-growing economy. Structural limitations have, however, resulted in limited appetite for long-term investment in Turkey, reinforcing the volatile financing profile of the current account deficit and other competitiveness issues.

**Figure 3: Yield on Turkish Local Bonds Above the Emerging Markets Average (%)**

![Chart showing yield on Turkish local bonds above the emerging markets average.](chart.png)

*Source: Bloomberg Data as of May 12, 2015*

The country’s dependence on volatile foreign capital flows can only be reduced through a policy adjustment that would prioritize savings, increase competitiveness, and boost long-term investment from local and foreign players, feeding into better long-term growth prospects. However, dominated by Erdoğan, policies over the past few years have reinforced rather than reduced structural inefficiencies, weighing on investment and growth. In the absence of meaningful progress on reform, the CBRT has done the policy heavy-lifting to manage economic stress.

**Scenario Drivers: What to Watch For in the Next 12 Months**

Our three scenarios hinge on the policy preferences of the AKP government after the June elections, which it is likely to win, and its ability to implement these policies. Depending on the scenario, these policy choices will increase or decrease Turkey’s resilience against global shocks.
The signs on the ground are not encouraging. The current government is spending political capital on repudiating corruption charges and tightening its grip on power while weakening judicial oversight and journalistic freedoms. Meanwhile, it is not advancing the structural reform agenda needed to make GDP growth more sustainable, reduce dependence on foreign financing, boost employment, and address the country’s deep social divisions. Moreover, Erdoğan’s continued criticism of the CBRT for being reluctant to lower interest rates only adds to investors’ doubts about the bank’s independence and Turkey’s institutional strength more broadly.

In the near term, the following factors would change the probability of our core scenario:

- Institutional tensions: Signs of further friction (or a rapprochement) between Erdoğan and CBRT Governor Erdem Başçi would help define the extent of the CBRT’s autonomy.
- Economic growth: We will monitor the trajectory of growth expectations and shifts in growth drivers in addition to the strength of incoming data. Further constraints on consumers’ spending capability would undermine the AKP’s popularity, potentially providing a boost to rival parties.
- Controversial legislation: The approval of the security bill enhancing police powers would lead to a build-up in socio-political tensions.
- Intra-AKP dynamics: Signs of internal tensions over policy would undermine policy implementation and investor confidence.

The figure below shows how GDP growth would perform under our three scenarios.

**Figure 4: Medium-Term Growth Paths Under Different Scenarios (RGE Forecasts for 2015-19)**

*Source: International Monetary Fund, Roubini Global Economics*
**Base Case (70%): Muddle-Through, and Micromanagement Stoke Economic Volatility**

In our base case scenario, reform and adjustment efforts will remain minimal, particularly as many reformers (particularly Deputy Prime Minister Ali Babacan) exit government due to the three-term limit. The preferences of the officials chosen to succeed Babacan on the AKP’s economic team will shed light on the extent to which reforms will take precedence over maintaining the status quo in the post-election period.

This scenario implies continued reliance on short-term policy fixes, with no real adjustment of economic imbalances, which could, in fact, widen. Turkey settles into a holding pattern with sub-par growth (below 4%, with risks to the downside) and faces recurrent mini-crises sparked by volatile capital flows. In this context, the Turkish economy and bank profits stagnate. Tighter interest rates and slower growth limit bank profits and credit quality, contributing to some exits of foreign financial institutions as they seek out either higher growth or greater stability markets.

**Figure 5: Growth to Stabilize—at a Lower Pace (GDP, y/y % change, 2015-2019 Forecast)**

![GDP Chart](chart.png)

*Source: Haver, Roubini Global Economics*

The lack of structural reforms will keep Turkey over-reliant on foreign credit-fuelled consumption (Figure 5) and vulnerable to boom-bust cycles, as its unfavorable business climate hinders its ability to attract FDI. This inability to attract FDI is problematic in two ways: First, it sustains the weak quality of external financing. In turn, this poor quality of finance reflects the quality of growth (little investment activity), leaving growth volatile (and below potential) and vulnerable to capital outflows triggered by domestic or external shocks.

The AKP’s focus will remain on centralizing governance, but Erdoğan’s plans to transform the country’s parliamentary system into a strong presidential or semi-presidential system are not sure to succeed. According to the latest independent polls, even if the pro-Kurdish HDP undershoots the 10% party vote threshold, the AKP will not
secure the three-fifths parliamentary majority (330 deputies) needed to unilaterally make constitutional changes. This does not imply an immediate referendum, however, the government will only appeal to its loyal conservative powerbase to push through the change if there is a credible threat that the Parliament could undermine President Erdoğan's authority.

We expect little progress in resolving the Kurdish issue, which will continue to hinder social and economic inclusion. Turkey’s involvement in the region’s ongoing crises (most notably Syria’s civil war) and the tenuous relationship between the government and various regional groups will exacerbate Turkey’s high political risk perception, limiting appetite for long-term investment.

**Figure 6: Turkey Remains Over-Reliant on Consumption (%)**

![Figure 6](image)

*Source: Haver*

**Figure 7: Scenario 1: Parliament Seat Distribution, If HDP Passes 10% Threshold (% votes, Number of Seats)**

![Figure 7](image)

*Source: Metropol, [http://secim.demokrasidenetcileri.org](http://secim.demokrasidenetcileri.org), Roubini Global Economics*
Upside Case (10%): Reform-Friendly Shift Ensures Steadier, More Balanced Growth

A pro-reform strategy would imply a gradual shift away from volatile credit-led growth toward steadier, more sustainable investment-led activity, with growth holding steady above 4% and increasing over a five-year horizon, leading to a significant boost in average incomes. In fact, average growth rates might rise further. This scenario requires an unlikely change of policy from the AKP, based on an assessment that the current course is unsustainable, prompting the party to pursue reform from within instead, implying a gradual incremental change.

Under this scenario, we would assume the structural reform drive would re-commence after the election. Over the medium term, implementation of reform would lead to an improvement in the business environment, encouraging long-term productivity-enhancing capital and building on Turkey’s strong demographics, ensuring a steady increase in growth. Below, we summarize the key reforms needed (out of the 417 micro steps presented in late 2014 by Prime Minister Davutoğlu). There are no clear timelines for these steps, but any of the following measures would signal that Turkey is heading in the right direction.

- Labor market: Increase flexibility, bring more people into formal employment to reduce the workforce in uncompetitive firms, where labor productivity is lower; boost female labor-force participation.
- Education and skills: Invest in research, development, and innovation.
- Business environment: Lower the costs of starting a business and doing business, and reduce red tape.
- Infrastructure: Boost infrastructure investment to improve the productivity of the private sector.
- Manufacturing: Offer preferential treatment to local firms.
- Energy efficiency: Reduce energy dependence by increasing domestic energy capacity (renewables), introducing technologies that save energy, and improving the efficiency of the energy sector, all of which would reduce import dependency.
- Tax base: Reduce reliance on consumption taxes and tackle tax evasion.
- Savings rate: Extend savings incentives to boost the pool of capital available for investment.

**Figure 9: A Faster, Steadier Growth Rate (GDP, y/y % change, 2015-2019 Forecast)**

Source: Haver, Roubini Global Economics

Although some of the reforms would require some time to have an effect, all of these measures would allow more resilience to shocks, while nurturing social and economic cohesion. These measures would allow an increase in investment, spreading growth across the country and reducing the role of illicit smuggling, which has increased since the start of the Syrian civil war, and includes oil trade with radical groups, including the Islamic State.

**Downside Case (20%): Confrontation Spurs Currency Crisis and Recession**

The downside scenario would be consistent with a severe institutional crisis, as micromanaging fails due to the overreach of the executive in monetary policy or a possible policy mistake on centralization of power. This could be triggered by Erdoğan asking Central Bank Governor Erdem Başçi (or other reformist government members who enjoy investors’ confidence, such as Ali Babacan or Finance Minister Mehmet Şimşek) to step down. Even absent high-profile resignations, the loss of confidence in the AKP government could create policy deadlock. Policy disarray would precipitate economic anxiety and investor exit, weighing on financing and growth. In turn this would precipitate a sharp increase in interest rates, hitting growth.
The AKP is already engulfed in an internal struggle, purging its departments and agencies of the supporters of one-time ally Gülen, now considered leader of the “parallel state,” accused of turning against the AKP and having concocted a coup plot in December 2013. This fight against Gülen, which the government lists among its top policy priorities, could turn into a witch-hunt and deprive the government of significant expert talent in economic and other affairs. The absence of qualified and competent centrist leaders (as many promotions have occurred based on political patronage rather than merit) could result in weaker growth outcomes, undermining AKP’s popularity in the aftermath of the elections.

The AKP has continued to win the traditional conservatives, but the divisions among the Islamists may deepen. Although there is no alternative political group to appeal to the traditional conservative AKP voter at present, and existing opposition parties do not have credible track records of economic management, grievances could spark unrest, potentially precipitating a political deadlock. The collapse of the Kurdish peace process, if neither side is ready to compromise, would further weigh on the AKP’s flagging reputation.

Regional political developments could also fuel a domestic crisis, particularly if ties with NATO allies fray further over allegations of sponsoring terrorism, triggering sanctions on more influential individuals/systemically important banks or companies, with the cost of illicit fund flows hitting Turkey’s overall financing. Although outright sanctions on any major financial institution remain unlikely, delays in processing payments remain a risk, and measures to temper financing to the Islamic State and other extremist groups could pose costs for the financial system. At the minimum, the ongoing conflicts in the neighborhood may increasingly strain Turkey’s political climate, sharpening social divisions and leading to recurrent protests. These trends could put more pressure on
foreign financial institutions possibly precipitating their exits. Unlike in our base case scenario, where exits reflect a response to slower growth of assets and profits and global retrenchment of the banks, in this scenario, regulatory changes might make the environment more adverse.

We see low chances of formal domestic political splintering in the near-term, but this scenario will become more plausible in the medium term (2-3 years). While poll results ahead of the June elections indicate another victory for the AKP, the risk of a confidence crisis in the party will grow over time, particularly if the economy weakens further, amid slow domestic and external demand.

Policy unpredictability would increase the risk perception of Turkey’s vulnerabilities. It could precipitate withdrawal of capital, exacerbating economic volatility. In our view, however, a disruptive price action (lira sell-off), would impact the business community and broader economy more extensively, if coupled with an external shock, and deterioration in market sentiment in general.

The fall in the lira would potentially precipitate a financing crisis and necessitate a significantly tighter economic policy, which would lead to a fall in demand and to a recession. The outflow of capital would further weaken the exchange rate, boding ill for consumption, amid dented consumer sentiment, and investment, extending the negative growth momentum (taking growth down to an average of 2%), weighing on employment. Discontent over job losses or the cost of living, in general, especially if food prices continue to rise, may give way to street protests, like those in the summer of 2013, and possibly upheaval, more meaningfully destabilizing the government.

**Figure 11: Sharp Rise in FX Loans Points to Fragilities in Turkey’s Commercial Property Sector (billion)**

![Figure 11](chart.png)

*Source: Haver*

The main risk from lira depreciation stems not from the government or household sectors, both of which have fairly robust balance sheets, but from the corporate sector and the spillover into the banking sector. The FX exposure of non-financial companies has risen; their short FX position stood at $183 billion (about 23% of GDP) at end-
2014, with the highest exposure in the transportation and construction sectors. Corporate FX loans, which include commercial property loans almost doubled in 2014 (Figure 11).

The construction sector, though underpinned by strong underlying demand for residential stock, may face a downturn in the face of the depreciating lira, tightening domestic and global financial conditions, as well as rising leverage. A climb in financial distress among the affected companies (defaults) could in turn spark an increase in nonperforming loans in the banking system and, in the worst case, a liquidity crisis.
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