



## Turkey's gathering geopolitical storm

### Introduction

There was a time not so long ago when Turkey was cited as a model of democratic development and economic growth for other developing countries to follow. Today, this is no longer the case.

Turkey is now confronted by a multitude of overwhelming challenges. These include tensions with Kurds both within Turkey and in neighbouring Syria, the growing authoritarianism of President Recep Tayyip Erdogan, a currency in freefall, high levels of external debt, and rising inflation.

### The economy runs into serious headwinds

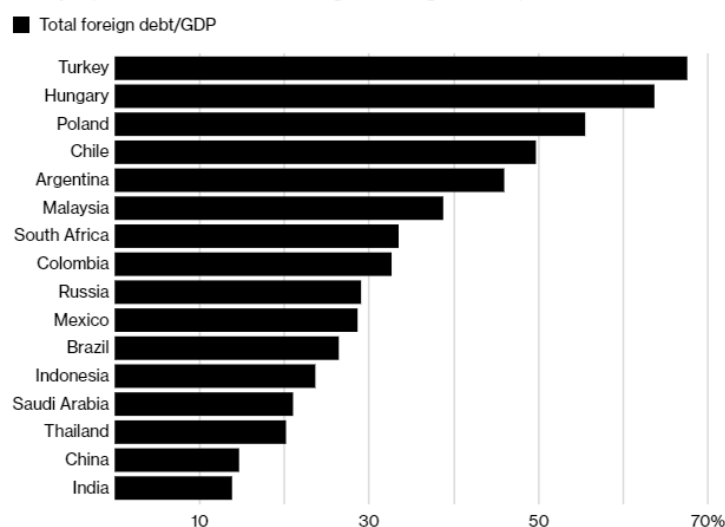
Erdogan owes much of his political success to the fact that he has presided over a long period of strong economic growth. Since becoming prime minister in 2002, per capita GDP in Turkey has gone from \$3,800 to close to \$11,000,<sup>1</sup> while the economy has grown at an average annual rate of 6%. Inflation, for its part, dropped from 30% to single digits in 2017. Furthermore, his government has significantly increased spending on healthcare, pensions, and transportation infrastructure.

In 2017, to the surprise of many, Turkey's economy expanded a whopping 7.4% (compared with 6.9% for China) thanks in part to government-subsidized loans made to small and medium-sized businesses.

**However, there are growing fears that Turkey's economy rests on increasingly shaky foundations.**

While government debt levels (28% of GDP) remain well below the average for most European countries, Turkey depends heavily on foreign capital. Its current account deficit (one of the largest in the world) stood at 5.6% at the end of 2017, up from 3.8% the previous year. **The country's external debt (both private and public) nearly doubled from 38% of GDP in 2008 to almost 70% today (\$450 billion) - the world's largest foreign debt load relative to GDP for an emerging economy. The private sector accounts for 70% of this debt.**

Turkey tops the EM list to have the highest foreign debt exposure to GDP



Source: IIF, IMF

NOTE: Foreign debt includes corporate and government borrowings

Source: "Emerging-Market Stress Just Begun as Record Debt Wall Looms," Bloomberg, May 22, 2018

<sup>1</sup> World Bank data, 2018

Complicating matters further, most of the foreign investment in Turkey is comprised of short-term portfolio flows into stocks and bonds, as opposed to more stable long-term investment in companies and infrastructure.

While these vulnerabilities are not new, the changing dynamics of the global economy has increased their risk. For starters, monetary policy tightening in the United States is pressuring the currencies of emerging markets: the Turkish lira is down more than 18% against the USD year-to-date (and more than half its value since 2013). This in turn makes it harder for Turkish companies to service their foreign debt. Currency depreciation coupled with rising oil prices have also contributed to widening the country's current account deficit. Turkey's energy imports as a proportion of total energy use have risen from 12% in 1960 to 75% today.<sup>2</sup> At the end of April, inflation stood at almost 11%, more than double the central bank's 5% target.

This dynamic has likely been worsened by Erdogan's unconventional economic view that higher interest rates are what drive inflation, not the other way around. It is also suspected that he wanted to avoid raising the cost of mortgage payments and credit card bills just before the June 24 elections.

However, Erdogan was recently forced to capitulate to market pressures and finally allow the Turkish central bank to raise interest rates by 300 basis points to 16.5% in an attempt to halt the slide of its currency. We can now expect Erdogan to blame the currency rout on foreign powers.

There are two alternatives to raising interest rates in order to stem this decline: either draw on the country's foreign currency reserves to buy liras or implement capital controls. The former risks draining reserves to dangerously low levels and offers no guarantee of success. Turkey's foreign currency reserves are presently at \$85 billion (down from \$102 billion last August).<sup>3</sup> While the potential negative market reaction to capital control means this option is likely to be employed only as a last resort. In the short term, we feel the most likely scenario is for further rate hikes.

**The IMF estimates Turkey's economic growth will slow to 4.3% this year from 7% in 2017. However, it is important to note that this projection was made before the country experienced a sharp currency devaluation and a spike in inflation. More recently, Moody's downgraded its forecast for Turkey's GDP to 2.5% this year, down from a previous estimate of 4%.**

## Turkey faces a double security threat

As if these economic challenges were not enough, Turkey is also grappling with the threat of ISIS terrorist attacks and of Kurdish armed separatists from its largest ethnic minority. The Kurds, who are ethnically distinct from Turks and Arabs, live primarily in southeastern Turkey and in nearby parts of Syria, Iran and Iraq.

Turkey's Kurdish conflict raged throughout much of the 1980s and 1990s, but largely subsided in intensity during the 2000s. In 2012, a cease-fire was negotiated and it seemed peace was at hand. In 2015, the truce was broken and hostilities between the two flared up again. Turkey claims that the aim of the Kurdistan Workers' Party (PKK) is to create an independent state carved out of its territory, whereas the PKK insists it only wishes to gain greater autonomy for the Kurdish regions.

Finally, while much has been written about the influx of refugees into Europe, their numbers pale in comparison to the nearly 3.5 million Syrian refugees that have poured into Turkey.

## The aftermath of the failed coup

Since the failed coup attempt of July 2016, Erdogan has used emergency rule to tighten his control over media outlets and government institutions. More than 150,000 government workers have been fired and/or arrested, and over 100 media outlets have been closed.<sup>4</sup>

The 2016 failed coup attempt is the latest in a long line of coups that occurred in 1960, 1970, 1980, and 1997. This time around, however, the vast majority of the population (including non-supporters of the government) were strongly opposed to it. Erdogan has accused followers of Fethullah Gulen, a Muslim cleric exiled in America, of being behind the attempt.

## U.S.-Turkish relations under strain

Both as a member of NATO and due to its strategic location, Turkey has long been considered a crucial ally of the United States. However, this alliance has recently come under strain for one main reason. The United States considers the People's Protection

<sup>2</sup> "Turkish Lira Recovers After Rise in Key Interest Rate," Wall Street Journal, May 24, 2018

<sup>3</sup> "A wise autocrat knows what he does not control," Financial Times, May 23, 2018 and IMF

<sup>4</sup> "Turkey Sentences 104 People to Life in Prison Over the 2016 Coup Attempt," Time Magazine, April 24 2018

Unit (PPU), a Syrian Kurdish rebel group, to be a vital ally against ISIS, whereas the Turks consider it be a terrorist group with close ties to the PKK, the group waging the Kurdish insurgency in Turkey. Fears that the PPU would attempt to form an independent Kurdish state on its border has led Turkey to occupy militarily the Afrin region of northwestern Syria previously held by the Kurds.

## Turkey's upcoming elections

Since coming to power in 2002, the Justice and Development Party has won four general elections under Erdogan's leadership. It also won a narrow referendum victory in 2017 to change the country from a parliamentary system to a presidential one. After this election, Turkey will abolish the role of prime minister and significantly strengthen the next president's powers, which include the authority to unilaterally issue legally binding decrees and appoint high-level officials.

Erdogan's aspirations to further consolidate his power hinge on winning both the presidency and the parliamentary elections scheduled for June 24. Despite the recent economic turbulence, he still remains the heavy favourite, though some polls do show him falling short of the 50% needed to avoid a second-round run-off vote. **His chances of winning are bolstered by his near-total control over the media and government institutions, and by the probability that the main impact of Turkey's recent economic troubles will not be felt until after the elections.** Indeed, one of the main reasons he moved the election date forward from November 2019 was to lower the odds of an economic downturn damaging his electoral prospects. Victory could pave the way for Erdogan to remain in power for the foreseeable future and would take him one major step closer to realizing his goal of becoming the most important leader of modern Turkey since its founder, Mustafa Kemal Ataturk.

## Conclusion: instability in Turkey adds to Europe's woes

In conclusion, a combination of political instability and high external debt has significantly heightened the risk surrounding Turkey, the world's 17th-largest economy (\$850 billion GDP with a population of 80 million).

Further, Turkey's troubles only add to the long list of challenges facing the EU with countries in or near Europe. These include the formation of Eurosceptic governments in Italy and elsewhere, Brexit negotiations and continued instability in the Middle East/Africa, which is the main driver of migration.

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# Geopolitical Briefing

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