

# Challenges Ahead for Turkey?

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Turkish asset prices may face headwinds as the three pillars of Turkey’s economic success story—prudent fiscal management, central bank credibility and political stability—are tested over the next nine months.

Turkey embarked on a strong path of economic and structural reforms after its banking and exchange rate crisis in 2001. The program had a rocky start, despite the International Monetary Fund’s financial backing, due to disagreements among the governing coalition parties. But reform took solid hold after the 2002 elections that gave a majority to the now-ruling Justice and Development Party (AKP).

### Years of Remarkable Progress

By the end of 2008, Turkey had cut its public sector debt almost in half—to 39.5% of gross domestic product (GDP) from over 75% in 2001. The government did this by running primary budget surpluses of 2–5% of GDP and pushing ahead with privatization that increased non-debt financing for the budget by an average 2% of GDP for 2005–2008

**(Display 1).** The country also reduced its inflation rate to single digits from an average of more than 50% during the previous three decades **(Display 2)**. This is largely due to skillful monetary management and the independent central bank’s

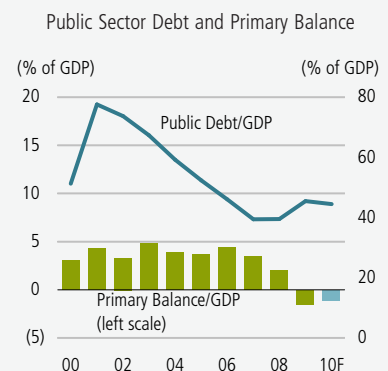
increased credibility, which includes a formal inflation targeting framework introduced in 2005.

Along with a freshly restructured and recapitalized banking sector, these economic reforms put Turkey in a relatively strong position to weather the 2008 credit crisis, despite the country’s heavy reliance on external financing. But now, Turkey faces several challenges that will test the strength of the three pillars on which this economic success story has been built: prudent fiscal management, central bank credibility and political stability.

### Temptation to Boost Fiscal Spending

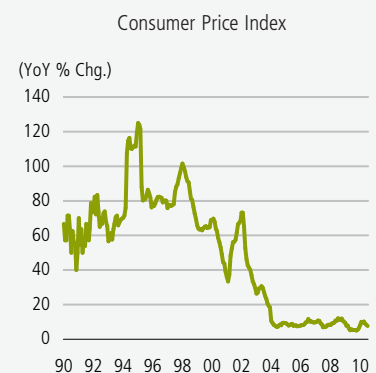
We may see a relaxation of the fiscal policy stance in the run-up to next year’s general elections, as happened ahead of the local elections last year. Some recent opinion polls show an uncomfortable narrowing in AKP’s lead over the opposition Republican People’s Party (CHP). This has delayed the implementation of a budget-tightening fiscal rule designed in consultation with the IMF. The cabinet has decided to

Display 1  
Reforms Halved Public Debt to GDP



Source: Haver Analytics, IMF, Turkish Treasury and AllianceBernstein  
As of April 2010

Display 2  
Central Bank Policies and Credibility Broke the Back of Inflation



Source: Haver Analytics and AllianceBernstein  
As of July 2010

postpone submitting the rule to Parliament, presumably to afford itself some flexibility ahead of the elections.

Temptation to boost fiscal spending ahead of the elections may increase if the government fails to secure several important constitutional amendments in the upcoming September 12 referendum. Most observers had seen this vote as a forgone conclusion until fairly recently. But it's now becoming too close to call, and the reenergized opposition is framing the referendum as a vote of confidence in the AKP government.

### Central Bank's Challenge

To date, the central bank has been vindicated in its "lower for longer" policy stance by benign inflation developments. But domestic demand is set to pick up—fueled by the revival of a credit extension at very low domestic real rates (**Display 3**), so the central bank will need to begin policy rate normalization before too long to keep inflation inside the target band. And that challenge becomes even more daunting next year, when the target band is set to be lowered by a full percentage point to a range of 3.5–7.5%.

To preserve its credibility, we believe the central bank should stay ahead of the curve, especially with the uncertainty surrounding next year's election and the risk of any unexpected pre-election fiscal stimulus. Another complication that will add to the central bank's woes is that the current bank governor's term expires early next spring. The transition in this post did not go smoothly four years ago, which in turn undermined the bank's credibility and thrust Turkey in the eye of the storm during the mid-2006 emerging market sell-off.

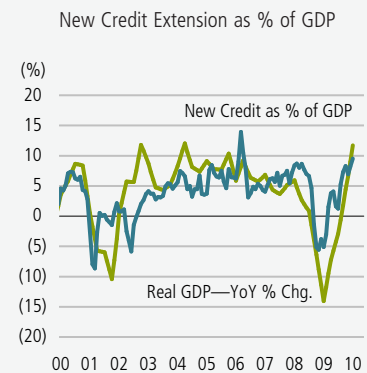
### A Specter of Coalition Politics

The largest opposition party—the staunchly secularist, left-leaning CHP has recently undergone some important leadership changes, and opinion polls show them gaining on the incumbent AKP (**Display 4**). The new CHP leader, Kemal Kılıçdaroglu, is more reform-minded than the previous long-time leader, and is likely to transform CHP into a more viable alternative to the incumbent AKP. We believe that a further rise in CHP's popularity could result in a deadlocked parliament after next year's elections as we do not expect AKP and CHP to cooperate, due to deep ideological and personal differences.

A coalition of CHP and the third-largest Nationalist Movement Party (MHP) would require additional support from independent parliamentarians who represent the Kurdish vote and hence would find it difficult to work with MHP. Alternatively, AKP and MHP might possibly form a majority coalition. In either case, politics may become less predictable, which is likely to slow down any legislative progress including the new fiscal rule that's needed as a policy anchor to replace the past IMF programs and the elusive EU membership.

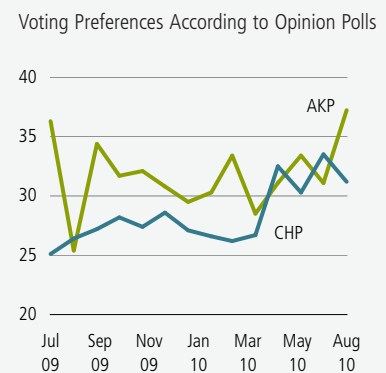
The Turkish economy is in a dramatically better shape now than it was before the crisis of 2001–02, and it would be difficult for any new government to alter the general direction now—a courtesy of far reaching reforms. But history—and a still very politically charged and polarized society—would caution against ignoring the prospect of a coalition government in Turkey. ■

Display 3  
Credit Back to Stimulating the Economy



Source: Turkish Statistical Institute  
As of March 2010

Display 4  
Political Race Set to Intensify



Source: Sonar  
As of August 2010

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