



ECONOMICS: EMERGING EUROPE, MIDDLE EAST AND AFRICA PERSPECTIVES

## TURKEY AT THE CROSSROADS: WHAT HAPPENS AFTER THE ELECTIONS?

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As Turkey heads for an important election in early June, it stands at a crossroads politically, sociologically and economically. The electoral results could play a large part in determining the country's path for the next decade or two.

Turkey's parliamentary elections are fast approaching. They're scheduled for June 7, and the policy direction the country's next government takes could determine what type of society and economy Turkey will have in 10 or even 20 years. Turkey is (once again) at a crossroads politically, sociologically and economically.

In that sense, this is the most critical—and also the most uncertain—juncture in Turkey's recent history, second only to the summer of 2008. Back then, the military and the old “secularist” establishment tried to shut down the ruling Justice and Development Party (AKP), which only a year earlier had won a resounding victory (46.6% of the vote) in the country's parliamentary elections.

### AKP Rebound After Gezi Park

The Gezi Park protests of 2013 sparked broader social unrest in Turkey. This trouble, combined with a subsequent corruption scandal involving senior AKP officials, raised the level of political noise and uncertainty in the country. However, there was never much serious concern that the ruling party would come out of the incident mortally wounded.

The 2014 local and presidential elections proved that the opposite was true. Turkey (for better or worse) still lacks a credible and electable alternative to what the AKP has come to represent over its past 12 years in power. It's a party that successfully reflects the socially conservative and probusiness inclination of Turkey's median voter.

### A Challenge from Within the Party

At this juncture, the challenge and uncertainty seem very different from those of the earlier period. This time, they appear to be coming from inside the AKP, which has always been more akin to a movement than an ideologically homogenous entity, and are compounded by an evolving global environment, with global liquidity receding and external growth slowing.

This landscape will require any future government in Turkey to rely on an entirely new growth model to retain popular support. The electorate has become used to rising living standards and a generally more equitable income distribution that has been ushered in during the AKP's 12-year rule.

### Inflection Point for Political Power?

Politically, Turkey could now be at an inflection point, which may be viewed in the future as the start of an AKP power transition from the “founders' generation” embodied by President Recep Tayyip Erdogan (the party's long-time leader or “reis”) to a new generation of politicians. These officials had been catapulted to the political forefront by the AKP's very own three-term rule, which restricts the party MPs from running for parliament more than three times in a row.

This rule, which had been designed by the founders to help periodically rejuvenate the party and give a chance to fresh, young party cadres, will likely lead to major changes in the composition of the AKP parliamentary caucus and the future cabinet after the June elections. New Prime Minister (and official party chairman) Ahmet Davutoglu, is currently serving his very first term as an AKP MP, so he's one of the key politicians that AKP rule has now put forth to bear the bulk of the party's responsibility to the electorate.

The bulk of power within the party could stay in the hands of a few founders, and become further concentrated in the hands of one individual through the introduction of a presidential system of government that lacks strong enough checks and balances. Some fear that a development like this could pose a risk to Turkey's democratic credentials. The specific worry is that Turkey might eventually end up moving in the direction of Russia or the

totalitarian central Asian republics, drifting further from Western-style democratic values.

In contrast, the hope is that a successful transition of power to a new generation of political leaders will ensure that Turkey resumes building and strengthening its political and economic institutions. Some of these institutions have suffered the past couple of years, as government responded to what it perceived as a challenge to its legitimately won political power. Despite some of these setbacks, Turkey is still a substantially freer and more democratic country than it was prior to the AKP's ascent to power in 2002.

### A Country at a Sociological Juncture

Turkey stands at a critical juncture from a sociological perspective, too. It will need to finally make peace with its history as well as its cultural and religious (Ottoman) heritage. Voters' preferences clearly favor socially conservative and nationalistic parties (AKP and MHP). So Turkey's orientation will have to balance two influences: It needs to become more pro-(Middle) Eastern in terms of its trade ties as well as cultural and religious affiliation and role in the region. And it needs to remain pro-Western in terms of democratic values and basic civic freedoms—and trade ties.

While the AKP, including most of its factions and constituencies, has generally accepted this inevitable East-West nexus, some political groups (those associated with the pre-AKP social and economic elites) continue struggling to accept Turkey's roots in its Eastern/Islamic heritage. This hesitancy will likely remain in the foreseeable future.

### Kurdish Peace Question

It seems widely accepted that Turkey would benefit from making peace, literally and figuratively, with its large 10% Kurdish minority. Any advances in this effort ultimately depend on the progress of the Kurdish peace process initiative started by the AKP, and will hopefully be codified in the new constitution. The constitution, among other things, will have to grant equivalent rights to all of Turkey's minorities, both religious and ethnic. Whether the pro-Kurdish HDP party is able

to exceed the 10% electoral threshold or is effectively shut out of the next parliament after June 7 will most likely determine the speed of the peace process.

However, it seems that the momentum gained over the past several years will be hard to stop. Turkey is still far from realizing the full political and economic benefits of the "Kurdish peace dividend", but there's widespread awareness across the political spectrum that the electorate places a high value on the two years without major Turkish-Kurdish hostilities (no terrorist attacks). Any political force that reverses this positive change will be punished in the next election.

### New Growth Model Needed

Turkey is at an economic crossroads, as well. The government will have to formulate a new growth model to be able to deliver the better living standards the electorate has become accustomed to over the past decade. The improvements haven't been in a straight line, but the trend has clearly been upward over the past 12 years.

During this period, Turkey's economy grew because of two key factors. First, the AKP implemented many "low hanging fruit" (yet very critical) reforms during its first two terms in office. Second, the country enjoyed a tidal wave of strong global growth and generous capital inflows—with a sudden, brief interruption during the 2008–2009 global financial crisis.

At this point, however, these factors have arguably exhausted their potential. The country has already reaped the benefits of the initial reforms, global growth has shifted to a structurally lower gear (especially in the emerging-market space), and global liquidity is about to recede to more normal levels. The reduction in liquidity, in particular, will make it especially difficult for Turkey to grow through its hallmark boom-and-bust cycle—relaxed monetary policies and strong capital inflows followed by aggressive tightening in response to a large capital-outflow–driven currency selloff.

It's hardly a controversial statement to say Turkey will have to go back to the drawing board and push forward with fresh structural reforms to reap additional benefits within a few years. In doing so,

Turkey may have to forgo near-term growth potential for the sake of macroeconomic (and financial) stability. Performance of the AKP in the upcoming elections will likely determine whether the ruling party will have the patience to sacrifice near-term popularity.

Most critically, Turkey won't be able to afford to drive incremental growth in the coming year through increases in private sector leverage (especially through incremental cross-border borrowing in foreign exchange). The country is already among the most vulnerable emerging markets in terms of its gross external financing needs—the current account deficit plus the total external debt that must be rolled over within 12 months.

This is especially true when measured against the central bank's rather unimpressive stock of reserves. Moreover, the large open foreign-exchange position of the country's nonfinancial corporate sector is of particular concern. This is true even though the size of the position (about 20% of GDP) is likely exaggerated by underestimates of the corporations' foreign exchange assets as well as by natural (i.e. export) and financial hedges that may be in place, especially for the large firms where most of this position is concentrated.

### The Big Question: Structural Reform

Here's the key question for Turkey: What happens with structural reform after the elections? Will "Team Davutoglu" decisively push ahead with the very detailed and highly ambitious 25-point structural-reform agenda it presented over the past month? Or will the next economic team begin to experiment with more unorthodox approaches that seem driven by President Erdogan's advisors? These proposals include a heavy focus on large, government-led infrastructure projects and an emphasis on progrowth monetary policies, possibly supplemented by the creation of a state development bank.

The key risk in the second path is easy to see in Brazil's not-so-glorious experiment with directed lending. And, finally, will the focus on the economy (and reforms) be sidelined by the efforts to pass a new constitution and President Erdogan's desire to introduce a controversial presidential system? ■

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