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Turkey after the local elections

Erste AM Communications

The local elections in Turkey had been built up by President Erdogan to be a test of his policies. While Erdogan's AK Party took the lead in Turkey overall, the governing party did suffer losses in large cities. For example, the AK Party lost its hegemony in Ankara after 20 years, and while votes are still being counted, initial results suggest that the opposition is also ahead in Istanbul. The economic crisis in the wake of last year's currency crisis is definitely a major reason for the victory of the opposition. The economy is going through a severe recession, unemployment is on the rise, and inflation has increased above 20%.

Turkish assets under strong pressure

In the run-up to these elections, Turkish assets came under strong pressure yet again, much like throughout 2018. The lira has lost 3% against the euro since the beginning of March, the yield of the 5Y local currency bond has risen by 200bps to 18.50%, and the spread of USD-denominated government bonds has widened by 95bps to 495bps. The Turkish central bank was forced to tighten its monetary policy, intervened on the foreign exchange market, and the local banks were told to reduce the liquidity on the local TRY market. This caused the short-term interest rates on the local money market to rise above 1000%.

Turkish households have increasingly converted their savings from TRY to USD. As a result, net foreign exchange reserves have decreased further to currently only USD 24.7bn, despite strong issue activity by the government on international capital markets. While the current account deficit has almost disappeared due to the recession and thanks to the declining oil price (N.B. only 0.7% of GDP in January), the foreign exchange reserves fall significantly short of covering the short-term foreign debt of USD 130bn.

One factor that has been detrimental to any further improvement in recent months is the expansive fiscal policy. Disappointingly low tax revenues on the back of the recession and higher expenses that are partly due to the election cycle have pushed the deficit to a 10-year high. In order to improve the chances of President Erdogan's AK Party, the government-owned banks have been instructed to expand their lending volume (credit impulse of 2% of GDP), which has a stabilising effect on growth but at the same time has prevented a more significant adjustment of the current account.

Outlook:

we expect the situation to calm in the wake of the local elections due to the decrease in political risk. President Erdogan may have suffered a loss by not being able to capture the Mayor's seat again in Ankara and possibly Istanbul, but we do not think the overall result suffices to bring about long-term changes. A high nominal interest rate differential, positive real interest rates, a strongly improved current account, and a possible reduction of the election-induced stimulus measures are the local factors that should support Turkish assets. Also, the currently ongoing global loosening of the monetary policy should be supportive to countries like Turkey. The main risk factors are the still existing imbalances, possible mistakes in the monetary and fiscal policy, and the sanctions imposed by the USA over Turkey for buying Russian missile defence systems. Also, a further weakening of global growth, possibly in connection with a reversal of capital flows towards the emerging markets, might exert pressure on Turkish assets.

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