Flash Comment

Turkey: another election, another inconclusive outcome?

Another round of elections amid political and religious tensions

Following fruitless efforts to form a coalition government following the 7 June parliamentary elections, Turkey is heading for another round of elections on Sunday. The political stalemate is prompted by the fact that the Justice and Development Party (AKP) lost its majority in Parliament in the June election for the first time since the party's creation in 2002 (see Chart 1). Attempts to form a coalition between the AKP and the main opposition party, the Republican People's Party, CHP, ran aground on a disagreement over how long the coalition should be in place. The CHP wanted a four-year period while the AKP wanted a shorter timeframe.

The campaign leading up to Sunday's election has been marred by political and religious violence. Following the June election, the worst violence in years broke out in Turkey between Kurdish militants and government authorities. Turkey suffered its worst terrorist attack on 10 October, when 102 people were killed following a bomb explosion during a peace demonstration. The attack has prompted mutual criticism between the different parties, worsening the political climate in Turkey.

Despite the troubles for the Turkish economy, economic issues have taken a less prominent role. The critical issue for the Turkish economy is reinvigorating economic growth through structural reforms amid a slowing economy as a debt-fuelled boom comes to an end. During the campaign the different political parties have been outbidding each other with populist fiscal promises, calling for higher wages and pensions.

What are the likely scenarios following Sunday's vote?

In our view there are three possible outcomes:

1. Outright AKP majority or minority government (unlikely).
2. Some kind of coalition between AKP and one of the opposition parties (somewhat likely).
3. Continued political stalemate and another election (somewhat likely).

Most polls predict another hung parliament following Sunday's election. According to the most recent polls, AKP actually stands to lose further compared with the June election, obtaining only 251-254 seats versus the 258 seats won in the June election. The number of seats would be far below the 276 majority threshold in parliament. Hence, if the polls are right, an outright AKP majority or minority-led government is quite unlikely in our view. The main opposition party, CHP, is predicted to win additional seats compared to the June election.

We think a coalition between the AKP and CHP with a strong economic team would be regarded relatively favourably by investors. The political parties will be under pressure to break the political stalemate and form a coalition. The latest indications from the two main political powers, AKP and CHP, suggest increased willingness to compromise and we see that as the most plausible coalition outcome.

Today's key points

- Elections are likely to produce another hung parliament and hence a challenging political environment, with the AKP failing to regain a majority according to our reading of recent polls.
- A coalition government is in our view likely in such a situation, potentially consisting of AKP and CHP.
- If the economic team of such a coalition government is pro-reform, market sentiment could be favourable going forward, which could support the lira. If not, market perception would remain negative even with a coalition government.
- However, given mutual distrust between parties, a continuing political stalemate cannot be precluded.
- If political stalemate continues, the Turkish currency would remain highly vulnerable, especially as the Fed hike approaches.

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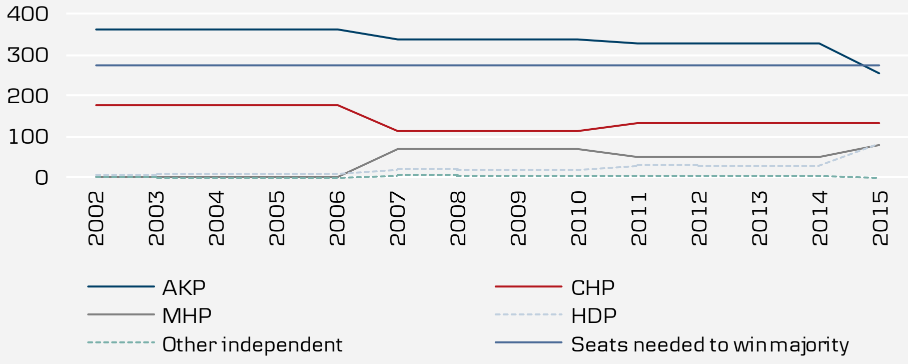
Chart 1. The AKP lost its majority in parliament for the first time since 2002



Source: Danske Bank Markets

Both AKP and CHP have relatively strong pro-reform and market-friendly economic teams. A coalition may in our view help moderate the movement seen by many observers toward more state control and autocratic policies from the AKP. It may also temper the current pressure from the presidency on the independence of central bank policies. The downside of a coalition is the risk of political instability from a weak coalition.

However, a coalition between the two parties is by no means a certain outcome, given the mutual distrust. The CHP has during the campaign publicly criticised the AKP for lack of transparency in fiscal accounts and an incorrect tax policy, relying excessively on indirect taxes. Furthermore, CHP has concern about Erdogan's control over Turkish politics. The AKP, on the other hand, seems to have difficulty coming to terms with sharing power after many years with full power.

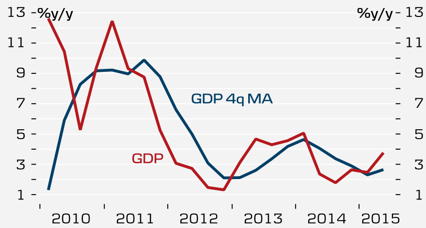
A continuation of the political stalemate and prospects of a third election cannot be precluded. Such an outcome would negatively influence investor sentiment toward Turkey, as the country needs a pro-active structural reform agenda to reinvigorate economic growth and tackle external imbalances. Delaying these reforms may prompt further pressure on the lira, especially as the Fed hike in December or January comes closer.

Macro outlook: affected by politics and global headwinds

Turkey's final economic growth figures for Q2 15 surprised positively as GDP expanded 3.8% y/y versus 2.6% y/y (revised) a quarter earlier. Domestic demand continued to be a strong driver while foreign demand and inventories were still decreasing. However, consumer lending growth is slowing, signalling a cooling down in consumer confidence, in our view.

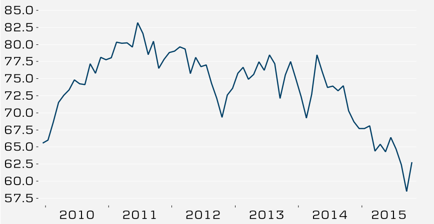
As Turkey is holding the second parliamentary elections this year and the country has been militarily active on its borders, business sentiment remains fragile, limiting private investments. Thus, we expect the economy to grow 2.8% y/y in 2015 while seeing considerable downside risks to our growth forecast, as political uncertainty and global EM vulnerability to China's woes and the Fed's upcoming tightening may restrain investment activity further.

Chart 2. Turkey's GDP growth surprises positively



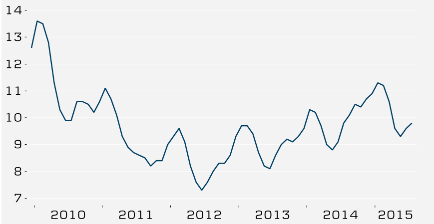
Source: Macrobond Financial, Danske Bank Markets

Chart 3. Turkey's consumer confidence slid lower



Source: Macrobond Financia,l Danske Bank Markets

Chart 4. Unemployment remains high



Source: Macrobond Financial, Danske Bank Markets

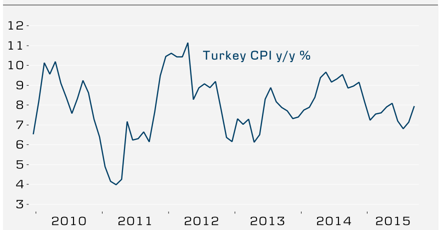
The future Turkish government will have to deal with many internal economic problems which require structural reforms. Turkey's unemployment rate continues to stay around 10%, seeing an upward trend since 2012 and being very dependent on seasonal factors. The current economic activity has not been enough to change the trend, and weakened business sentiment is weighing further on the labour market.

FX outlook: politics and Fed to give the direction

Inflation increased in September, climbing to 7.95% y/y from 7.14% a month earlier. The upward inflation pressures stem so far from the lira's continuing slide due to political uncertainty and the prospect of the Fed's upcoming tightening. We have not yet seen a moderation in inflation expectations from the lira's recent short-lived rally.

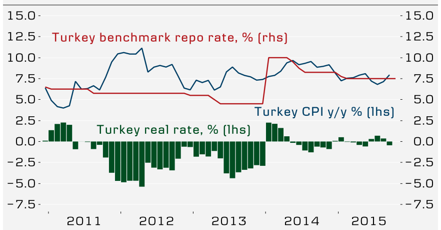
Over the past year, the Turkish central bank (TCMB) has found itself in a tight spot. Given the significant pressure on the exchange rate and high inflation, a cautious monetary policy stance is needed. However, in the run up to the summer 2015 elections the central bank was under significant political pressure to ease monetary policy in order to help heavily leveraged local companies and support economic growth. On 21 October, the Turkish central bank (TCMB) kept its policy rate unchanged at 7.50% as we expected. However, given the high inflation outlook, the policy rate has turned slightly negative.

Chart 5. Turkey inflation is accelerating on volatile lira



Source: Macrobond Financial, Danske Bank Markets

Chart 6. Accelerated inflation pushed real rate to negative territory



Source: Macrobond Financial, Danske Bank Markets

We believe the TCMB could continue to be under political pressure at a time when vigilance is needed. As stated above, we think that a coalition between AKP and CHP with a strong economic team in charge of economic policy making may help moderate political pressure on the central bank. The unstable lira, accelerating inflation and global EM volatility may well trigger an emergency rate hike from TCMB as the Fed's imminent tightening approaches.

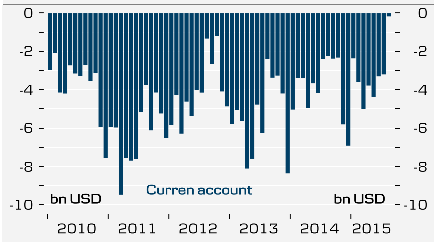
We think that the exchange rate pressure would persist or even intensify on the back of the election, if the political stalemate continues. The June election result caused a big upward move in the USD/TRY, making the Turkish lira the second-worst performer in the EM universe, losing 20% of spot returns against the USD as of 28 October since the beginning of 2015. The pressure has been relieved somewhat from a narrowing of the current account deficit, which shrank significantly to its lowest level since mid-2004 on the back of the weakening lira and sliding commodity prices (as we expected). The August data showed the deficit went to USD0.16bn from USD3.2bn (revised) a month earlier. However, the capital account balance has deteriorated in January-August 2015 as portfolio investments dropped causing almost a USD9bn outflow on global EM aversion and political instability.

Our base case is for the lira to weaken on a three-month horizon as we expect the Fed to hike in Q1 16. However, we forecast a correction in the USD/TRY in the long run on Turkey's sustainable macro indicators.

Risk factors

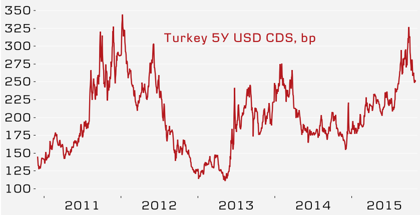
Uncertainty around the new elections scheduled for 1 November and Turkey's crossborder military operations could fuel further political uncertainty. The strengthening of the US dollar and a Fed rate hike are clear risks to the TRY versus the dollar, as appetite for EM assets could deteriorate in the future. A rising oil price would put renewed pressure on the current account. Unexpected central bank rate hikes to curb inflation and support the lira would also be a risk for sustainable economic growth.

Chart 7. Current account deficit approaches zero



Source: Macrobond Financial, Danske Bank Markets

Chart 8. Turkey CDS are more sensitive to global EM aversion than politics



Source: Macrobond Financial, Danske Bank Markets

Disclosure

This research report has been prepared by Danske Bank Markets, a division of Danske Bank A/S ('Danske Bank'). The authors of the research report are Jakob Ekholdt Christensen, Chief Analyst, and Vladimir Miklashevsky, Analyst.

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