Turkey General Elections: The final countdown

Macroeconomic Research

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Key points

- Turkey's people will choose a president and members of parliament on 14 and 28 May in what appears to be a very tight race. Opinion polls show the opposition candidate Kemal Kılıçdaroğlu winning against incumbent President Recep Tayyip Erdoğan, but his lead is within the polls' margin of error

- The pro-Kurdish party running under the Green Left Party (YSP) banner will likely be the 'kingmaker' in the parliamentary configuration

- Whoever wins the race will face the task of improving Turkey's economic outlook, which has grown increasingly unbalanced in the past quarters – and years

- A recession in the second half of 2023 is on the cards, with more painful adjustments on the currency side likely, before Turkish assets again appear attractive for foreign investors. Improving the institutional framework will be key to implementing effective reforms. This looks likely to be a long and cumbersome process

A tight two-horse race for the presidential elections

Incumbent Recep Tayyip Erdoğan's list of opponents for the President of the Republic was confirmed in March when the Turkish Supreme Election Council published its final candidate list. For the first round on 14 May, Erdoğan will face Kemal Kılıçdaroğlu, president of the main opposition Republican People's Party (CHP), as well as two other contenders, Muharrem İnce – who ran and lost against Erdoğan at the last elections in 2018 as CHP candidate – and Sinan Oğan, elected as a Nationalist Movement Party (MHP) member of parliament, but now running as an independent.

Exhibit 1: Official candidates, parties and alliances

2023 official presidential candidates				
Candidate	Recep Tayyip Erdoğan	Kemal Kılıçdaroğlu	Muharrem İnce	Sinan Oğan
Party	AKP	CHP	MP Ex-CHP	Independent Ex-MHP
Coalition	People's Alliance	Nation Alliance	-	Ancestral Alliance
Coalition parties	AKP - MHP BBP - YRP	CHP - IYI DEVA - GP SP - DP	MP	ZP - AP ÜP - TÜİP

Source: AXA IM Research
AKP=Justice and Development Party, MHP=Nationalist Movement Party, BBP=Great Unity Party, YRP=New Welfare Party, CHP=Republican People's Party, IYI=Good Party, DEVA= Democracy and Progress Party, GP=Future Party, SP=Felicity Party, DP= Democrat Party, MP=Homeland Party, ZP=Victory Party, AP=Justice Party, ÜP= My Country Party, TÜİP=Turkey Alliance Party

More than 60 million voters will be called to the polls on 14 May – with a second round scheduled on 28 May – to elect a president and 600 members of the Turkish Grand National Assembly for a five year term. A century after the founding of the Turkish Republic and 20 years into the rule of the Justice and Development Party (AKP) under Erdoğan, the 2023 elections appear almost as a referendum in disguise. They present a possible turning point away from the current increasingly centralised executive presidential system introduced after the 2019 referendum, back towards a parliamentary democracy that the opposition alliance is committed to reinstate if they win the elections.

This is a decisive moment for a country currently facing multiple economic and financial imbalances and a tense political and democratic environment, while having been struck by a massive earthquake in early February that caused significant loss of life and added to the broader problems. In an intriguing historical *déjà-vu,* the AKP was itself formed 22 years ago in the wake of the 2001 economic crisis, following the 1999 Marmara earthquake.

Exhibit 2: What current polls say about voters' intentions

2023 Turkish presidential election polls			
Polls (%)	Recep Tayyip Erdoğan	Kemal Kılıçdaroğlu	Muharrem İnce	Sinan Oğan
First round	42.9	46.4	5.7	3.0
Second round	47.4	52.6	-	-

Source: Various polling firms' (MetroPoll, Saros, ASAL, Optimar, TAG, ORC, MAK, ALF, ADA, Aksoy, IEA) average results since mid-March, AXA IM Research.

Opinion polls (Exhibit 2) show voting intentions largely concentrated on the main two candidates, Erdoğan and Kılıçdaroğlu, suggesting neither of them is able to win outright in this first round – ex-CHP presidential candidate İnce has likely chipped away some CHP voters that would have supported Kılıçdaroğlu. A vast majority of polls nonetheless show Kılıçdaroğlu winning the second round against the incumbent president, although this prediction often lies within the margin of polling error and should be interpreted with care, especially as several polls indicate a large average of around 14% of undecided voters. President Erdoğan knows that every vote matters, after he won the 1994 Istanbul mayoral elections just a few votes ahead of his contenders. Nor should one underestimate the strength of the AKP's electoral machine; the faithful, traditionalist electorate to whom he still largely appeals; the weakening of the institutional landscape; and democratic backtracking visible since the 2016 military coup. Above all, the current new political system has not been tested yet.

A hung parliament and the pro-Kurdish party

Investors often fear the process of transfer of power away from populist presidents. Some comfort should be taken from the smooth transfer following the very controversial 2019 local elections in Istanbul where the AKP lost for the first time since 1994, although a presidential election clearly has more at stake than the race for Istanbul mayor.

However, this concentration of power in the hands of the president should not obscure the importance of parliamentary elections. The president would still struggle to rule in the case of a hung parliament, which for now is what polls seem to indicate. There are more than 30 parties in Turkey, but electoral law favours big parties. As such, the configuration of parliament will likely take some time to emerge as different alliances will be formed. So far, opinion polls point to the incumbent People's Alliance losing its absolute majority while the opposition coalition would score only two to three percentage points (ppt) better, although again such polling lies largely within the margin of error and is still short of a majority.

The third largest electoral force in the country is the pro-Kurdish opposition Peoples' Democratic Party (HDP) which has gathered an average of between 10% and 13% of votes since its first participation in legislative elections in 2015. For the eighth time, the party will enter this election under a different banner, that of the Green Left Party (YSP). This is due to a case in the Constitutional Court over allegations of ties with the Kurdistan Workers' Party (PKK), which is at war with the Turkish state, and through which the HDP could potentially face closure. Given the tight race between the two major coalitions, the pro-Kurdish party looks likely to play the role of 'kingmaker' in the parliamentary election. This should be to the opposition's benefit, and much-needed additional support given the very diverse composition of the opposition alliance. Indeed, this diversity complicates the opposition's decision-making process as shown in the difficulties encountered in naming a presidential candidate and its relatively vague political manifesto.

The final countdown for economic adjustment

The Turkish economic model had become increasingly unbalanced long before the COVID-19 pandemic and the Kahramanmaraş earthquake. The turning point for Turkey's political system has been the move to a presidential system with the constitutional amendment of 2017. Upon Erdoğan's re-election in 2018, reform momentum waned, and the President's efforts have increasingly turned to supporting growth with credit booms and demand stimulus, increasing internal and external vulnerabilities. The country has faced high private sector debt, persistent current account deficits and high inflation – all exacerbated by macro-financial instability since unorthodox monetary policies started being implemented in 2018. The pandemic further stretched these issues as the government made increased use of off-balance sheet tools and measures.

Turkeys impressive annual GDP growth of around 5.5% over Erdoğan's 20 years in power has been highly volatile with a strong dependence on the construction sector, which has been the central engine of growth until very recently (Exhibit 3). But many of the buildings damaged by the earthquake were built during this period.

Exhibit 3: Construction sector has been a major growth engine
GDP volume index by sector (1Y mav)
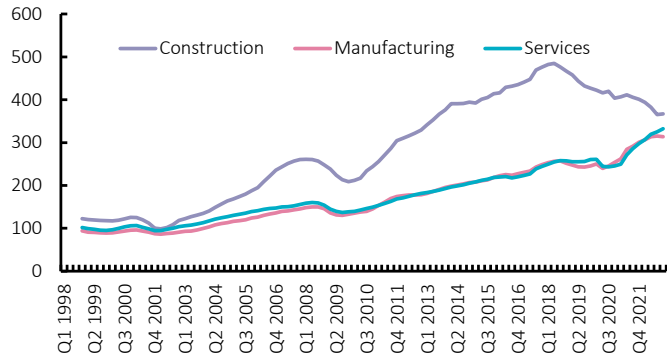

Source: Refinitiv Eikon, TurkStat, AXA IM Research, Q4 2022

Whoever wins the 2023 elections will have to put the economy back on track in a context of tight global financial conditions. External financing needs are particularly high and the central bank's reserves are beyond safety levels, hovering around two to three months' worth of imports. Turkey's inflation rate, albeit decelerating, stood at 43.7% in April 2023, with the policy rate at 8.5% and lending and deposit rates above 25%. The Turkish lira is currently trading around 19.4 against the US dollar; it was 17.5 in December 2021 but 7.5 at end-2020.

The apparent stability of the Turkish economy relies essentially on various capital mobility restrictions implemented at the end of 2021, ranging from currency-protected deposits schemes to currency sales by state banks, under what was termed the 'liraisation strategy'. In light of the decrease in the level of dollarisation of the economy (as per the share of foreign exchange deposits which currently stands at 40%, compared to nearly 70% in December 2021) and the limited depreciation of the Turkish lira, this strategy has been relatively successful. Yet, pressure on the currency resurfaced recently and will likely linger given still very negative real rates in Turkey and tighter global financial conditions.

We believe an additional adjustment in the Turkish currency will take place after these elections. Regardless of who wins, financial controls will have to be relaxed at some point, so domestic investors could naturally look to increase exposure to foreign currencies, while foreign investors will have to assess the fair valuation entry point, both for the currency and bond yields. Given the significant de-anchoring of inflation expectations and the measures that have been taken ahead of elections – such as minimum salary and pensions revaluations and energy tariff cuts – the path to disinflate the economy will

likely be protracted. As such, the real appreciation of the currency will be limited to this disinflation path. On the nominal front, as the central bank would also aim to rebuild its currency reserve buffer, it will not be able to completely absorb the oversupply of the lira. The easiest – and necessary – adjustment of monetary policy via a steep increase in rates will be the first step in limiting currency depreciation. Under the current monetary framework, the policy rate does not offer any real indication of banking conditions. The central bank may need to go beyond these levels in order to have a meaningful impact on the currency (Exhibit 4).

Exhibit 4: Policy rates versus real banking conditions
Turkey TRY interest rates
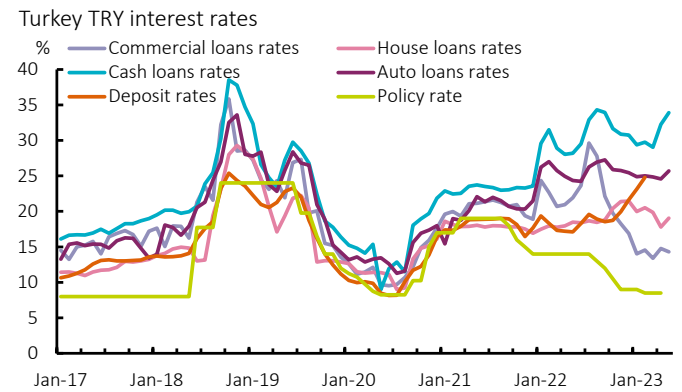
Source: Datastream and AXA IM Macrco Research, 21 April 2023

Meanwhile, economic activity will absorb the shock. In our 2.1% GDP growth forecast for 2023,[1] we have pencilled in a recession of a cumulative 4.5ppt of negative growth for the second half of 2023, which will have to be fine-tuned depending on the fiscal policy reaction function of the administration taking over and the market reaction. We are inclined to believe that markets will have a more positive reaction were the opposition to win, as the policy implementation will receive a dose of credibility compared to Erdoğan's administration, and consequently, this may allow for a swifter economic rebalancing into 2024 and thereafter.

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[1] The earthquake that hit Turkey in the beginning of the year in the Kahramanmaraş region affected 15% of the country's population and cost some 50,000 lives. According to the Turkish Enterprise and Business Confederation, this region accounts for 9% of the country's GDP, 11% of the total income tax and 14% of the income from agriculture and fisheries. Early estimates of the damage caused by the earthquake vary greatly, between $20bn and $85bn. The negative economic impact of the earthquake in 2023 will depend to a large extent on the fiscal response, which we expect to be rather strong and bold to try to counter the mass discontent caused by the slow reaction of authorities at the time of the event. The proximity to the election dates makes this more likely – the government has already committed some $5bn and Erdoğan has pledged to rebuild the 11 cities affected by the earthquake within a year. We assume less than a 0.5ppt negative effect on growth in 2023 from the earthquake in our projection of GDP growth of 2.1% for the full year.

Our Research is available online: www.axa-im.com/investment-institute

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