

## Economics

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# Turkey Macro View

## June Election: Scenarios and Their Market Implications

- As we get closer to the June 12 general election, it may prove useful to review the most recent poll results and discuss the implications of various scenarios for market sentiment.
- The recent poll results suggest that the AKP (Justice and Development Party) has a substantial lead over the CHP (Republican People's Party) and the MHP (Nationalist Movement Party). According to the recent polls, support for the AKP ranges between 46% and 52%, well above the CHP (between 25% and 29%) and the MHP (between 9.8% and 12.6%).
- Based on the recent polls and what we see as reasonable assumptions, we carry out simulations to shed some light on the potential picture of the new Parliament. Our findings suggest that the AKP's presence in the Parliament may range between 320 and 372 seats, followed by the CHP (135 and 154 seats) and the MHP (0-54 seats). We note that since our simulation results are based on the recent polls, the final composition of Parliament could be very different if there are big surprises in the June general election.
- In our view, amid growing concerns about Turkey's current account gap and the absence of a meaningful policy response, maintaining the status quo in the management of the economy after the June election is not a viable option. As a result, we believe that the new government is likely to take certain measures to alleviate these concerns. Given the light positioning and the quest for yield, we would expect the immediate market response to the introduction of such a package to be positive, even if it is not sufficiently ambitious.
- However, whether or not there is an improvement in the secular outlook for Turkish assets will depend on the government's willingness to put forward a comprehensive reform agenda to address the underlying structural causes of Turkey's vulnerabilities. Specifically, we argue that the new government will need to rethink Turkey's growth model, which has been relying on foreign savings and large current account deficits. We argue that a shift in fiscal policy aimed at raising the structural surplus of the public sector to promote a permanent rise in Turkey's savings rate should be an important component of the new growth strategy. This will need to be supported by structural reform efforts directed at increasing Turkey's productivity and competitiveness.
- All in all, another AKP government is widely expected. However, we believe that the jury is still out on the political will of such a government to press ahead with a comprehensive reform package aimed at bolstering macroeconomic stability and changing Turkey's growth strategy. In our view, this will be crucial for improving the secular outlook for Turkish assets, as the country needs a new credible story to reach investment-grade status and beyond.

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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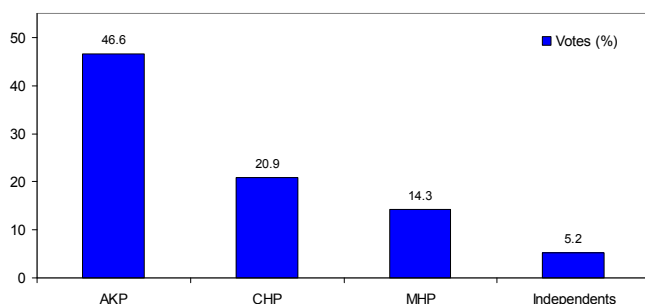
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## Overview

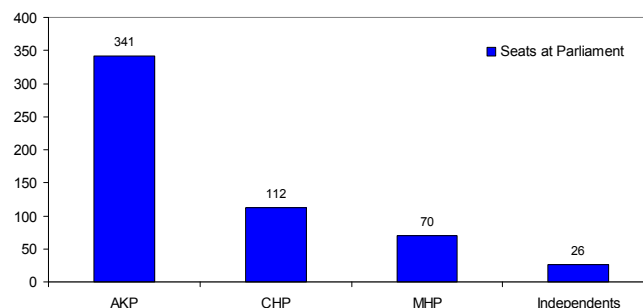
As we get closer to the June 12 general election, this note reviews the most recent poll results and discusses the implications of various scenarios for market sentiment. Before tackling these issues, it may prove useful to recall the outcome of the 2007 general election as a relevant reference point for the assessment of the recent poll results. As can be seen from Figure 1, the AKP's landslide victory in the 2007 general election enabled the party to have 341 seats in Parliament. With this outcome, the AKP (Justice and Development Party) was in a comfortable position to govern the country and push for amendments to the constitution, which require the support of least 330 deputies.<sup>1</sup> However, the AKP fell short of obtaining a so-called super majority (at least 367 deputies), which would allow the party to change the constitution unilaterally without holding a referendum.

Figure 1. 2007 General Election Results (% of national vote)



Source: High Election Board

Figure 2. 2007 General Election Results: Seat Distribution at Parliament



Source: High Election Board

## Taking Stock of Recent Poll Results

Next, we turn to the most recent poll results, which are summarized in Figure 3. The results suggest that the AKP has a substantial lead over the CHP (Republican People's Party) and the MHP (Nationalist Movement Party). According to the polls, support for the AKP ranges between 46% and 52%, well above the CHP (between 25% and 29%) and the MHP (between 9.8% and 12.6%). The noted backdrop, coupled with the AKP's ambition to change the constitution, suggests that the 2011 general election will be less about who wins than about the AKP acquiring a big enough majority to change the constitution.

Figure 3. A Review of Recent Poll Results (% of the national vote)

|                    | Marmara | GENAR | Sonar | Andy-Ar | Pollmark | IKSara* |
|--------------------|---------|-------|-------|---------|----------|---------|
| AKP                | 46.4    | 48    | 50.9  | 52.3    | 47.4     | 47.6    |
| CHP                | 27.6    | 25.3  | 25.8  | 24.8    | 25.2     | 29.0    |
| MHP                | 11.6    | 10.8  | 12.5  | 9.8     | 12.6     | 11.5    |
| BDP + Independents | 6.4     | 6.3   | 4.9   | 6.7     | 6.5      | 6.6     |
| Other              | 8.0     | 9.6   | 6.0   | 6.4     | 8.3      | 5.2     |

Source: Marmara, GENAR, SONAR, Andy-Ar, Pollmark and IKSara. \*Undecided voters are distributed by us.

<sup>1</sup> More precisely, this is the number required to make amendments that then have to be ratified in a popular vote.

## Various Scenarios for the General Election

In view of the above picture, we review the likely seat distribution implied by the recent poll results.<sup>2</sup> Based on the recent polls and what we see as reasonable assumptions, we carry out simulations to shed some light on the potential picture of the new parliament.<sup>3</sup> Our findings suggest that the AKP's presence in the Parliament may range between 320 and 372 seats, followed by the CHP (135 and 154 seats) and the MHP (0-54 seats). We note that since our simulation results are based on the recent polls, the final composition of Parliament could be very different if there are big surprises in the June general election.

Figure 4. Seat Distribution Implied by Recent Poll Results

|              | <i>Range</i> | Number of Deputies |               |
|--------------|--------------|--------------------|---------------|
|              |              | <i>Average</i>     | <i>Median</i> |
| AKP          | 320 - 372    | 336                | 329           |
| CHP          | 135 - 154    | 144                | 143           |
| MHP          | 0 - 54       | 39                 | 45            |
| Independents | 22 - 34      | 32                 | 34            |

Source: CIRA using the recent poll results from Marmara, GENAR, SONAR, Andy-Ar, Pollmark and IKSara.

In light of our simulation results, we consider market implications of various scenarios. This is admittedly a difficult exercise, which is subject to a great deal of uncertainty. With this caveat in mind, we think that since Scenario 1 and Scenario 2 capture the most widely discussed possibilities, their market impact would be neutral to positive. In this respect, it is worth highlighting that gaining at least 330 deputies would strengthen the AKP's hand in pressing ahead with its ambition to rewrite the constitution through a referendum even without the support of the opposition.<sup>4</sup> Turning to Scenario 3 and Scenario 4, we think the market impact would likely be negative. In the case of the former, the AKP could choose to pursue a more confrontational approach, which would not bode well for political stability, in our view — particularly considering the AKP's aim to change the constitution, for which a more conciliatory/inclusive approach would be preferable. In the case of the latter, the country would need to be governed by a coalition to which, given Turkey's political history, we would expect markets to react even more negatively.

Figure 5. A Review of Alternative Scenarios

|            | Number of AKP Deputies<br>at Parliament | Probability Assigned | Market Implications |
|------------|---|----------------------|---------------------|
| Scenario 1 | 276-329                                 | 40                   | Neutral/positive    |
| Scenario 2 | 330-366                                 | 40                   | Neutral/positive    |
| Scenario 3 | 367 and above                           | 15                   | Negative            |
| Scenario 4 | lower than 276                          | 5                    | Very Negative       |

Source: CIRA

<sup>2</sup> We note that for a party to form a government by itself would require at least 276 deputies in Parliament. Moreover, it is worth noting that Turkey has a 10% election threshold.

<sup>3</sup> In our simulations, we implement the D'Hondt method and make the following assumptions: (i) we assume that the proportional relationship between national and regional votes is the same as in the 2007 election; (ii) we distribute undecided votes in proportion to votes in the polls; and (iii) since we consider total votes for independents instead of individual candidates, there is an inherent upward bias in the seat numbers for independents, for which we make an adjustment using the 2007 results.

<sup>4</sup> In this respect, the AKP would probably feel more secure about the outcome of such a referendum if the party gets closer to the 50% threshold in the June election.

## Beyond Elections: A New Story Is Needed

**In our view, amid growing concerns about Turkey's twin macroeconomic challenges of rising inflation risks and a widening current account gap, maintaining the status quo in the management of the economy after the June election is not a viable option.** As a result, we believe that the new government is likely to take certain measures to alleviate these concerns.<sup>5</sup> In our view, such measures are likely to include: (i) fiscal action in the form of administrative price adjustments and a commitment to restrain primary spending; (ii) involvement of the BRSA (Banking Regulation and Supervision Agency) through macro-prudential measures to help the CBT's efforts to bolster financial stability; and (iii) signals suggesting the CBT's intention to return to orthodoxy. Given the light positioning and the quest for yield, we would expect the markets to respond positively to the introduction of such a package along the lines highlighted above.

**Leaving this possible cyclical opportunity aside, however, whether or not there will be an improvement in the secular outlook for Turkish assets will depend on the government's willingness to put forward a comprehensive package to address the underlying structural causes of Turkey's vulnerabilities.** Specifically, we argue that the new government will need to rethink Turkey's growth model, which has been relying on foreign savings and large current account deficits. As we have seen during the recent financial crisis, even moderate reliance on foreign savings can leave the domestic economy vulnerable to sudden stops and external shocks. Consequently, *we think policy efforts will need to focus on promoting a permanent rise in Turkey's savings rate so that the country can reduce its reliance on foreign savings to finance growth.*

**The most obvious way through which domestic saving can be increased is to raise the structural surplus of the public sector.** This suggests that the government's new Medium-term Fiscal Framework will need to target a more ambitious primary balance surplus, which would also enhance the CBT's ability to keep interest rates at a lower plateau in a sustained manner.<sup>6</sup> While such a shift in fiscal policy will be an important component of the new growth model, it needs to be supported by structural reform efforts aimed at increasing Turkey's productivity and competitiveness. In this regard, there seems to be consensus on a number of challenges such as *strengthening institutions, improving labor market flexibility and liberalizing heavily regulated products markets*, among other things.<sup>7</sup>

**All in all, another AKP government is widely expected.** However, we believe that the jury is still out on the political will of such a government to press ahead with a comprehensive reform package aimed at bolstering macroeconomic stability and changing Turkey's growth strategy. In our view, this will be crucial for improving the secular outlook for Turkish assets, as the country needs a new credible story to reach investment-grade status and beyond.

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<sup>5</sup> In fact, Deputy PM Babacan's recent comments seem to corroborate this view (see, for instance, *Vatan* daily newspaper, June 8, 2011).

<sup>6</sup> It is worth noting that the country would benefit from reducing discretion in the conduct of fiscal policy through adoption of a fiscal rule.

<sup>7</sup> Please refer to recent OECD and IMF reports on Turkey for a more comprehensive discussion of Turkey's main challenges on the structural front.

## Appendix A-1

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