MEI
Middle East Institute

THE TURKISH ECONOMY UNDER THE PRESIDENTIAL SYSTEM

M. MURAT KUBILAY

October 2022

Introduction

Over the past decade, Turkey has been on a steadily downward trajectory both economically and politically. The deterioration in its macroeconomic indicators started in 2011, became visible in 2013, led to apparent authoritarianism in 2016, turned into an economic crisis in March 2018, and became a full-blown depression in March 2020, as the pandemic hit economies around the world. Throughout this long period of turmoil the government has pursued a range of different economic policies, most of which were inconsistent with one another, and the frequent changes have proven a challenge for companies and investors alike. However, all of the government's policies have two key common traits: They aim to promote economic activity and maintain the financial soundness of the banking system.

The current presidential system, claimed to be unique to Turkey, places an enormous amount of power in the hands of the president without any effective checks and balances. The system was approved by a narrow majority in a referendum in April 2017 and was officially implemented starting in July 2018. However, when tracing the development of the system, a better starting point is July 2016, when, after the failed coup attempt on July 15, President Recep Tayyip Erdoğan began to enact sweeping decrees without considering their constitutional validity.

This paper begins by laying out the current state of the Turkish economy. To highlight the shifts in economic policy over time, it examines the earlier periods of Justice and Development Party (*Adalet ve Kalkınma Partisi*, AKP) rule, before exploring the transition to the presidential system and examining the system's economic properties. The paper concludes with a discussion of the economic outlook for Turkey and potential solutions to the current crisis, as well as the opposition's role and ability to implement them, with an eye to the upcoming elections scheduled for June 2023.

This paper argues that the presidential system under Erdoğan has had a disastrous impact on Turkey's economic institutions and their decision making. The lack of consistency, continuous uncertainty, weak communication, and repeated mistakes have resulted in the loss of confidence by all economic actors — domestic and foreign, individuals and companies alike. Prosperity has been lost and institutionalism eroded. Without a comprehensive overhaul of the system and its administrators, there is no chance of a sustainable recovery for the Turkish economy. Public approval, business support, and suitable international conditions are also essential as well.

The Current State of the Turkish Economy

Turkey's current economic situation is dire. The country is heavily indebted to international investors — to the tune of $451 billion, according to the latest data.[1] The short-term external national debt is $185.3 billion.[2] Due to high energy and commodity prices, exacerbated by Russia's invasion of Ukraine in late February 2022, Turkey has a persistent current account deficit, although depreciation of the local currency has not reduced this. This means the higher cost of imported goods has not curbed demand sufficiently and the lower cost of the Turkish labor force has not provided domestic industry with enough of a competitive advantage to improve the current account deficit.

Mega-projects built through public-private partnerships (PPPs) have created additional conditional liabilities estimated at around $160 billion. The net official reserves held by the Central Bank of the Republic of Turkey (CBRT) when swap agreements are removed declined to $-52.3 billion in 2022, down sharply from $71.1 billion in 2011.[3] The Treasury and the CBRT have also introduced a costly mechanism to provide foreign exchange (FX) protection and guarantees for Turkish lira (TL) deposit account holders; as of late September 2022, FX-protected deposits totaled around $75.34 billion.[4]

Moreover, GDP calculations were significantly revised upward in both 2008 and 2016 and the new series are not considered reliable. Therefore, the ratio of the hard currency-denominated liabilities of the central government, central bank, and non-financial real sector to GDP figures may be underestimated. This means that when it comes to external borrowing, the Turkish economy is classified as only slightly better off than Sri Lanka and Lebanon, falling into the same group as Egypt and Pakistan. The credit rating for Turkey's long-term FX-denominated sovereign debt is B3 according to Moody's, which is the lowest it has been in the last 30 years, when the first credit assessment started.[5] The major problem on the horizon for foreign states and investors will be Turkey's ability to redeem its external debt on time without running into problems.

Turkey's potential GDP growth rate is about 3-3.5%, while its population growth rate is 1-1.5%. Bad infrastructure investment decisions, the poor quality of the education system, inefficient use of the government budget and state bank credits, and low confidence in the future limit the country's growth potential in the long run. Turkey is in an inflationary spiral: The current official inflation rate is 83.45%, the highest level in 24 years, and it could hit triple digits if there is a new currency shock.[6] The natural unemployment level is 10% and this exceeds 20% when discouraged workers are included. Two-thirds of employees earn around the minimum wage, equivalent to about $300 per month. Poverty is broad and given limited prospects, the youth population is determined to emigrate, particularly the best educated. To sum up the situation, sustainable growth and prosperity will be difficult to achieve, society is losing optimism about the future, and this has triggered a rush of young people looking to move to developed countries. International policymakers should take into account the possibility that Turkey will remain socially unstable throughout the 2020s.

From Crisis to Recovery and Back Again: Economic Developments from 2001-16

The AKP came to power in 2002 in the aftermath of one of the most economically difficult periods in modern Turkish history. February 2001 was the nadir of the deepest depression the country has experienced since it opened up its economy under President Turgut Özal in the 1980s. The central government ran into difficulties with fresh borrowing and the credibility of the banking system evaporated. The total collapse of the financial system and government finance was prevented by an International Monetary Fund (IMF) agreement and stability

1. Ministry of Treasury and Finance, External Debt Statistics, Accessed September 14, 2022, https://en.hmb.gov.tr/public-finance

2. Central Bank of Republic of Turkey, Short Term External Debt Statistics, Accessed September 14, 2022, https://www.tcmb.gov.tr/wps/wcm/connect/EN/TCMB+EN/Main+Menu/Statistics/Balance+of+Payments+and+Related+Statistics/Short+Term+External+Debt+Statisticss/

3. Central Bank of Republic of Turkey, International Reserves and Foreign Currency Liquidity, Accessed September 14, 2022, https://www.tcmb.gov.tr/wps/wcm/connect/en/tcmb+en/main+menu/statistics/balance+of+payments+and+related+statistics/international+reserves+and+foreign+currency+liquidity

4. Banking Regulation and Supervision Agency, Weekly Banking Sector Data, Accessed October 10, 2022, https://www.bddk.org.tr/BultenHaftalik/en

5. Trading Economics, Turkey - Credit Rating, Accessed September 14, 2022, https://tradingeconomics.com/turkey/rating

6. Turkish Statistical Institute, Consumer Price Index, Accessed October 10, 2022, https://data.tuik.gov.tr/Bulten/Index?p=Tuketici-Fiyat-Endeksi-Eylul-2022-45798

Photo above: An electronic board displays exchange rates information at a currency exchange bureau in the Eminonu district of Istanbul on September 20, 2022. Photo by Erhan Demirtas/Bloomberg via Getty Images.

program favoring free markets. Financial stability was achieved and a new period of growth began after global worries over the dotcom bubble and the impact of the 9/11 attacks passed. After years of coalition governments, one-party rule under the AKP starting in 2002 was one of the main pillars of stability in this period. However, the IMF program lacked a development pillar and the economic model was highly sensitive to portfolio inflows, meaning that any sudden outflow could be a critical threat to economic activity and financial stability.

Throughout the first period of AKP rule between 2002 and 2007, the government had a good record of growth figures and supported its fiscal targets by substantial use of privatization revenue from the sale of state-owned enterprises. However, strong demand among households for imported goods and the need by private manufacturers for imported intermediate goods led to a large trade deficit and external debt soared. As a result, the Turkish economy became increasingly dependent on the risk appetite of international investors. In 2007, Turkey was presented with a difficult test of its economic stability when the sub-prime mortgage crisis emerged in the U.S., and output contracted sharply the following year. Though the need for external finance increased, the IMF stand-by agreement was not extended.

One unexpected outcome of the global financial crisis was an unprecedentedly large monetary expansion that prompted hard currency funds to invest in risky assets, including emerging markets more broadly and TL-denominated assets more specifically. This enabled Turkey to finance its massive current account deficit, the third largest after the U.S. and the U.K. in 2011, without receiving any assistance from the IMF. The country's dependence on hot money became clear, however, and it soon began to be referred to as one of the "fragile five" emerging markets, along with India, Indonesia, Brazil, and South Africa. When Ben Bernanke, then the governor of the U.S. Federal Reserve, announced the beginning of monetary contraction in May 2013 after years of cheap money, investors woke up from the temporary lull provided by portfolio inflows. This reduced their appetite for high-yield emerging markets assets, especially Turkish ones, given concerns over the extent of the country's external financing needs and reliance on short-term funding.

Around the same time, Turkey's political stability was severely hit by the Gezi Park protests and the split between the AKP and the Gülenist movement, the followers of the U.S.-based Islamic scholar Fethullah Gülen, identified as a terrorist in Turkey. Amid the growing domestic turmoil, the major focus for the Erdoğan government became surviving by winning elections. The main economic tools employed in this effort were the use of state banks to boost aggregate demand and the financing of mega-projects through the public budget to further support growth. The PPP mechanism was widely used to finance these projects, as the resulting financial burden was not accounted for as a direct government liability, leading to an overestimation of the government's fiscal strength. These policies reduced the efficiency of the growth rate, but they were good enough to save the government's approval rating in the March 2014 local elections and win the snap parliamentary elections in November 2015.

The year 2016 was the main breaking point, and a state of emergency was proclaimed in July 2016 after the failed coup attempt. This time President Erdoğan officially and his son-in-law Berat Albayrak covertly were able to intervene in both setting macroeconomic policy and deciding on appointments to key posts. This put the institutional strength of macroeconomic administration in danger. Despite accommodative monetary and fiscal policies, the Turkish economy was about to enter a recession in late 2017. A credit guarantee fund was the key tool used to restart economic growth; not only state banks but also private ones became eager to lend more as the government promised to cover defaults, up to an extent. This created a sharp increase in credit growth — and thus in economic activity — and enabled the approaching economic crisis to be postponed.

In March 2018 some of Turkey's main business conglomerates were no longer able to pay back their hard currency debts and chose to apply for restructuring. This triggered an avalanche and the depreciation of the TL became inevitable. The government realized that this shock was stronger than the prior ones and would not be easy to overcome, and therefore snap elections were called. Erdoğan's credibility was strong enough to deny the approaching full-fledged currency crisis and assert himself as a savior. The June 2018 elections were a big victory for Erdoğan, his party, and its far-right ally, the Nationalist Action Party (*Milliyetçi Hareket Partisi*, MHP). Nonetheless, Turkey was diving deeper and deeper into economic crisis and the government was still underestimating its destructive potential.

General Economic Properties of the Presidential System

The defining characteristic of Turkey's new presidential system is one-man rule, meaning critical decisions on economic matters, as in many other areas, are made by the president and advisers in his inner circle. Convincing Erdoğan or his son and son-in-law is enough to change the decision of the state bureaucracy and thus the media financed by them. As a result, policies can easily be changed without any official announcement or approval from the public. Inconsistencies crop up frequently and sharp policy shifts are not broadcast in advance.

The president does not have to obey bureaucratic term limits when making new appointments, even when it comes to institutions with autonomy. Since the beginning of the economic crisis in March 2018, four different figures have served as governor of the central bank.[7] There is no long-term strategy, even though frequent references to far-off targets like 2053 or 2071, well into the next generation, give that appearance. The government has fallen far short of reaching targets for 2023, announced in 2018, such as the promise of increasing GDP to $2 trillion; in reality, as of 2021, GDP was just $815 billion.[8] Instead of planning for the long term, the government's main goal is much more immediate: keeping the economy afloat for the next elections.

Foreign policy maneuvers or compromises are one potential means of obtaining additional external funding to this end, as Ankara's recent outreach to the Gulf, and especially to Saudi Arabia and the UAE, has illustrated. Relations with Russia, at a time when the Western world has cut ties, are also pragmatic and aimed at obtaining financial support in terms of cheap gas and oil or suitable payment schemes. Foreign trade is a priority and bilateral problems cannot override it; for example, Turkey

7. "Revolving Door: Turkey's Last Four Central Bank Chiefs," October 8, 2021, *Reuters*, Accessed September 14, 2022, https://www.reuters.com/world/middle-east/revolving-door-turkeys-last-four-central-bank-chiefs-2021-10-08/

8. Sibel Kurtoglu, Etem Geylan, and Kenan Irtak, "Turkey aims to double current growth by 2023: Erdogan," April 21, 2018, *Anadolu Agency*, Accessed September 14, 2022, https://www.aa.com.tr/en/economy/turkey-aims-to-double-current-growth-by-2023-erdogan/1124659

has maintained strong trade relations with Israel despite numerous political clashes.

The government is business-friendly, although the fluctuations caused by frequent policy changes can undermine the benefits of this approach or even destroy them altogether. The use of unconventional policy tools is the new normal and there are attempts to address their side effects through temporary measures. Public expenditures on PPPs, salary increases for minimum wage earners, social transfers to the poorest households, state-owned bank credit growth, and a low central bank policy rate are the main mechanisms used. These will be implemented consistently to support the real sector until there is a shock in the financial markets.

An external balance-of-payments crisis or an inability to redeem external debt or pay for imported goods will eventually be a red line to stop these policies. The other red line is the soundness of the banking system. However, these rules can be broken unconsciously as clashes with international financial funds and foreign powers are common. There is no public or business confidence in the administration of the economy, nor in the reliability of the data released by the government. Erdoğan's rule under the presidential system looks like a struggle to survive in challenging international and domestic economic conditions. Long-term development or material economic success is not the goal; instead, the aim is to maintain the electorate's support until the next election through media manipulation aimed at hiding the real reasons for the country's worsening economic crisis. Erdoğan is quite pragmatic and his followers can easily adapt to his radical policy shifts. However, his insistence on a low interest rate policy is not flexible — he has stuck to his unorthodox views on the matter, despite the substantial economic costs[9] — even though soaring global inflation and the looming risk of recession have created headwinds to the growth trajectory of developing countries. As a result, a new financial shock will inevitably occur and reveal the real economic consequences of his rule under the presidential system. For the moment, however, those consequences are still largely unknown and unfelt. The critical question is whether the coming financial shock will occur before or after the next elections.

9. Onur Ant and Lynn Thomasson, "How Erdogan's Unorthodox Views Rattle Turkish Markets," November 25, 2021, *The Washington Post*, https://www.washingtonpost.com/business/how-erdogans-unorthodox-views-rattle-turkish-markets/2021/11/23/a6da3826-4ce0-11ec-a7b8-9ed28bf23929_story.html.

Economic Developments Since 2018

Officially, the first day of the presidential system was on July 9, 2018 when Erdoğan unveiled his 16-minister cabinet.[10] Erdoğan's son-in-law Albayrak was appointed as the minister of Treasury and finance in July 2018. He was the first minister to take control of both public finance and the Treasury since 1980. He was also influential in making appointments for the central bank and the banking and capital markets supervisory bodies. In short order, he became the country's most powerful minister and took on responsibility for managing its economic affairs, despite his limited experience. There was widespread apprehension about this given his vocal support for interventionism as a columnist at a government-aligned newspaper and his perceived overconfidence in his abilities. Albayrak's direct control of the economy was a major shift from previous periods of AKP rule.

His first challenge was to address the currency crisis that started shortly after his appointment. Even though the CBRT was not under his direct control, he ordered it not to hike interest rates by using President Erdoğan's authority. The fragility of the Turkish economy was clear and U.S. President Donald Trump wanted to use this to his advantage as he sought to extradite Andrew Brunson, an American pastor held in Turkish prison on charges of aiding terrorism. President Erdoğan resisted and in return President Trump openly threatened to ruin the Turkish economy.[11] This led to a sharp rise in volatility in the Turkish financial markets, which reached levels seen during the global financial crisis, and depreciation in the TL topped 50%. These developments forced Erdoğan and Albayrak to retreat. The CBRT made a dramatic policy rate hike in September 2018 and a Turkish court released Brunson in October 2018.[12] This helped to calm the financial markets, but it was too late to avoid a recession due to the broader loss of purchasing power among the population.

10. "Turkish President Erdogan Unveils 16-Minister Cabinet," July 9, 2018, *Anadolu Agency*, Accessed September 14, 2022, https://www.aa.com.tr/en/todays-headlines/turkish-president-erdogan-unveils-16-minister-cabinet/1199348

11. Henry Farrell and Abraham Newman, "Trump Doesn't Want to Be 'Responsible for Destroying the Turkish Economy.' Good Grief," October 16, 2019, *The Washington Post,* https://www.washingtonpost.com/politics/2019/10/16/trump-doesnt-want-be-responsible-destroying-turkish-economy-good-grief/.

12. Natasha Turak, "Lira Jumps After Turkish Central Bank Hikes Rates in a Bid to Save Tumbling Currency," September 13, 2018, *CNBC*, Accessed September 14, 2022, https://www.cnbc.com/2018/09/13/lira-jumps-as-turkish-central-bank-hikes-rates-to-24-percent.html

Photo above: Berat Albayrak, Turkey's Treasury and finance minister, center, applauds following a news conference in Istanbul on October 9, 2018. Photo by Kostas Tsironis/Bloomberg via Getty Images.

As a result, Albayrak lost the full support of investors and the public at the very beginning of his term. This pushed him to use unconventional monetary policy tools before the politically significant local elections in March 2019. He indirectly gained control of the CBRT's international reserves through a protocol, in violation of the laws governing the central bank. He then ordered that these foreign exchange reserves be sold to the financial markets covertly via state banks. This unprecedented move helped to achieve temporary financial stability at the cost of depleting Turkey's foreign exchange reserves — reserves that would likely be needed in a more important situation down the line. Despite the government's loss of a number of key municipalities in the local elections,[13] Albayrak and his team continued to use the same mechanism. State banks were also forced to expand credit and new mega-projects were tendered. Private and foreign banks faced pressure to pursue credit growth, first through verbal warnings and then by regulatory actions. By exceeding his power and using regulatory and supervisory repression against market participants, Albayrak largely gained control over both the CBRT's policy interest rate and the Banking Regulation and Supervision Agency's banking regulations.

The external economic environment was about to get much worse, however, as the onset of the COVID-19 pandemic in early 2020 created a sudden and harsh financial shock around the world. Since Turkey was structurally in need of external financing, its remaining FX reserves began to be used to offset the massive exodus of capital. Investors were in a panic and had no confidence in Albayrak's economic management. Net FX and gold reserves declined to $-48 billion when swap agreements were omitted. There was one more round of currency depreciation, as the CBRT failed to raise rates to calm investors. This part of the saga ended with a big surprise: First the CBRT governor and then Minister Albayrak were sacked.

Both posts were filled by pro-market names, Naci Ağbal and Lütfi Elvan, respectively, who were members of former governments. Conventional monetary policies were

13. Özgür Ünlühisarcıklı, "A New Political Landscape Out of Turkey's Municipal Elections," April 2, 2019, *The German Marshall Fund*, https://www.gmfus.org/news/new-political-landscape-out-turkeys-municipal-elections.

implemented immediately and markets reacted positively. President Erdoğan was pragmatic enough to make such a sudden change, although he remained fixated on cutting interest rates. Therefore, the period of market optimism did not last long and ended abruptly when CBRT Governor Ağbal was sacked without any convincing explanation. In a single but extremely volatile trading week, foreign investors lost up to 30% in the markets. This was the moment when they grasped that the Erdoğan administration could not provide sustainable stability. Even when global markets and international politics are calm, Turkish domestic politics or simply Erdoğan's erratic decisions can lead to unnecessary shocks, creating waves that can even affect the soundness of the global financial system.

Ağbal's replacement as CBRT governor, Şahap Kavcıoğlu, favored negative real interest rates, which means a lower policy interest rate compared to the realized and expected inflation rate. This generated the worst market volatility in the last 40 years over two months and the dollar/lira exchange rate doubled in just a few weeks' time. The minister of Treasury and finance was also sacked and Nureddin Nebati, a political scientist, businessman, and AKP member, was appointed to replace him. He had previously served as Albayrak's deputy and had no background in economics as an academic, market professional, or state bureaucrat. His appointment ushered in the second round of unconventional policies.

The depreciation of the lira stopped suddenly and the local currency began to gain value after President Erdoğan announced the introduction of a new mechanism for FX-protected deposits in late December 2021. The major aim of this mechanism is to provide a guarantee to bank depositors who keep their savings in TL in case of further depreciation of the local currency, with the Turkish Treasury or CBRT paying the excess between the change in the exchange rate and the yield. Furthermore, the sale of FX reserves started to support the appreciation of the lira as well. Once again market stability was maintained; however, it came at an extremely high cost, as the state undertook efforts to shore up the stability of the currency by using budget revenues. Moreover, this late stability did not create conditions that were good enough to support more real sector investments. Despite much lower interest rates compared to the inflation rate, investment confidence vanished, discouraging efforts to increase manufacturing output. To address this, state banks were once again called upon and renewed lending spurred economic activity. The most adverse effect of these policies was the start of an inflationary spiral and the loss of confidence in the CBRT's will and ability to fight inflation.

External factors also played an important role too, as the beginning of the war in Ukraine in late February 2022 raised the cost of imports, causing energy and commodity prices to soar. While harsh depreciation did not promote exports as expected, the import bill rose and the external surplus target became impossible to achieve. The complete lack of confidence in the management of the economy resulted in looming expectations of inflation and prompted people to keep their savings in hard currencies. Tourism revenues did not offset the capital outflow and Turkey's external debt position became extremely fragile.

Restricting capital mobility became compulsory as the use of foreign exchange and capital outflows increased. Exporters are now forced to sell 40% of their net FX incomes to the CBRT. Their access to cheap TL-denominated rediscount loans is conditioned on not buying any foreign exchange. Standard bank loans, which are relatively cheaper owing to the low interest rate policy, are provided to large corporations if their foreign exchange assets are less than 10% of annual sales and total assets.[14] Banks are pressured to convince their clients to use FX-protected deposits through the imposition of penalties if they have a high ratio of FX deposits. Interest rates for commercial loans are effectively limited to 30%. Required reserves for foreign exchange saving accounts have been increased so as to transfer most of the FX liquidity to the CBRT, while the same regulation is eased for TL deposits. State-owned enterprises are banned from accessing the market for FX purchases; instead, they are directed to knock on the door of the CBRT when they need to pay their import bills. All of these strict regulations have slowed down the dollarization of savings and the exodus of capital. However, there are growing rumors about the potential imposition of harsher capital controls, and both banking institutions and real sector enterprises are tired of adjusting their financial policies. The real sector's demand for loans to finance new investments is declining and private banks' appetite for new lending is weak. Credit conditions are getting tighter, and for this reason economic activity is cooling off.

14. Laura Pitel, "Turkish Bank Regulator Limits Lira Loans for Firms Holding Foreign Exchange," *Financial Times*, June 24, 2022, Accessed September, 14, 2022, https://www.ft.com/content/3af3d25a-a6bf-427f-bfa5-7dc537b6eb8a

Outlook for the Turkish Economy

The current stability in the Turkish economy relies on FX-protected deposits and FX sales by state banks. Both instruments are unsustainable and have clear weaknesses in the form of strong capital outflows and a growing current account deficit. External finance channels are still open but costs are high and maturities are short. The tendency to keep savings under the pillow is an ongoing trend, albeit at a slower pace. The war in Ukraine and its global inflationary consequences are also working against Turkey's economic stability. A new financial shock is likely, and the next one will be more damaging than its predecessors. The soundness of banking institutions and public finance could be at risk this time.

However, the government still has additional tools at its disposal, such as changes in foreign policy, achieved with the UAE and in progress with Saudi Arabia, to obtain funding to support external deficits. When there are no more tools left, the natural outcome will be either policy normalization or stricter capital controls. The first one will require the government to admit it made a major mistake, while the second one will come as a shock to foreign and domestic investors. The AKP's economic policies can be changed swiftly due to Erdoğan's notorious pragmatism; therefore, it is difficult to say where this story will end. The fact is under the current government and economic system, it is impossible to have financial stability, job-creating growth, reductions in inflation, and steady domestic and foreign policies at the same time.

Turkey's balance-of-payment crises in 1958 and 1978 ended with military interventions in 1960 and 1980, respectively. The last major crisis, in 2001, resulted in the collapse of the three parties in the coalition and the two parties in the opposition. There is only one case in Turkey's multi-party political history of the ruling party remaining in power after years of economic depression; it was after just World War II in 1946 and the democratic quality of the elections in question was dubious. A change in the government is thus likely if free and fair elections are held. Alternative scenarios involving social unrest and a financial crash should also be considered, however.

Solutions to the Current Economic Depression

Whoever is in government, their first task should be to preserve financial stability and control rising inflation. Without addressing these two issues, there will be no opportunity to create strong growth and improve economic well-being. Accommodative fiscal policy is also a must, as mass poverty and financially weak small businesses cannot be ignored either. For an economy like Turkey's that is heavily indebted in terms of hard currency, achieving this balance will be a very challenging task indeed. Realizing medium-term development targets will require addressing issues beyond the economy, such as education and foreign policy. IMF funds are an option for the opposition, but not for the Erdoğan government because of his unwillingness and the veto of the United States as part of the sanctions imposed under the Countering America's Adversaries Through Sanctions Act (CAATSA). International investors and markets will watch not only the upcoming presidential and parliamentary elections scheduled for June 2023, but also the local elections in March 2024 to be convinced that a new and more stable era is beginning.

If the opposition parties win in the 2023 elections, short-term policy normalization and confidence-building will be a relatively easy task as they already have a consensus on this. Their alliance will not have any difficulty realizing these short-term targets. Their harmony and unity will still be questioned and their potential success in the 2024 local elections will be a critical test of their cohesion and policy continuity. However, achieving medium-term targets will be significantly more difficult for the opposition since they will be handed a very financially weak state budget and a startling foreign debt. In addition, after more than four years of economic depression, society will have great expectations on a variety of fronts, which will be impossible to achieve at the same time. Though the economic policies of the opposition parties do not differ dramatically in the short run, their approach to policies regarding lending by state banks and provision of welfare could cause an intense debate. Thus, a new government should be viewed as a temporary truce instead of a permanent peace when it comes to debates over Turkey's economic policies.

The current government does not want to implement policy normalization, and even if it were to do so, it would likely have only a limited impact due to the lack of confidence in its policy continuity. Its vision does not include solutions to the country's medium-term economic problems and instead merely puts more pressure on them. In the event that Erdoğan wins in next elections, the government is likely to introduce tighter capital controls for foreign currency deposit accounts or look to build new financial ties by making compromises in the foreign policy arena. The government will not have enough room to implement structural reforms, thus it will likely try to eliminate the symptoms of the problem by harshly restricting free markets. Cheap labor and loans will be the main tools used to keep the economy working and public pressure will likely be ramped up to make the people obey.

Whoever emerges victorious in 2023, whether it is the current government or the opposition alliance, they will have to struggle for a better economy amid tough international financial conditions. The leading central banks of the Western world started their policy normalization after the COVID-19 pandemic. Inflation rates are at the highest levels in the last 40 years and this will increase the cost of external funding for Turkey. The European Union and British economies, which account for nearly half of Turkey's exports, are on the brink of recession. A mild recession for the U.S. is also likely in 2023 due to Federal Reserve's policy of monetary contraction. The Chinese economy, too, is losing its growth momentum, and other commodity-importing emerging markets, such as Sri Lanka and Lebanon, are already facing major balance-of-payments crises. Turkey is declining to the bottom among emerging markets and getting closer to the group of countries — including Pakistan, Tunisia, and Egypt — where foreign lenders are highly skeptical about their ability to pay debts back on time. Therefore, the right policies and strong public support will not be sufficient to achieve medium-run goals in this challenging international environment. Regardless of what happens in June 2023, Turkey faces a difficult road ahead economically.

M. Murat Kubilay is an independent financial advisor on the Turkish economy, a columnist in national media outlets in Turkey, and a Non-Resident Scholar with MEI's Turkey Program.