

4. Balance of Risks

Economic and global market risks support the return to neutrality

The overall balance of risks is neutral. On the domestic front, the end of uncertainties after the April referendum should now lead the Government to focus on economic policies and reforms at least in the short term as the new election cycle is not so far away. The potential lagged impact of the rapid credit growth and ongoing fiscal stimulus will help support activity. However the still high unemployment rate levels will keep the Government alert since general economic confidence would continue to be one of the key points ahead of the new election cycle. This is why we are maintaining our 2018 GDP growth estimate close to the potential level. However, the risks are clearly on the upside as the carry-over from the statistical low base of last year and the higher than expected impact from policy stimulus could put growth clearly above potential. If this materialises, the government should start seriously restraining policy stimulus (particularly regarding fiscal and macroprudential stimuli) to avoid financial stability woes in the coming years.

On the external front, financial tensions remain contained across the board, both in developed markets and in emerging ones, supported by both the positive economic data in major economies (including China, the EU and the US) and the fact that policy commitments in the US were not fulfilled ahead of the Presidential election. Accordingly, the sell-off in bond markets in recent weeks, triggered by the hawkish messages of global central banks to proceed with normalisation have increased volatility, but only marginally as markets continue to perceive this trend as mostly accommodative. Nevertheless, the likelihood of an immediate response of financial markets to the possible steps of the normalisation process with a faster than expected inflation path is still a potential source of market volatility.

Turkey's political agenda is increasingly volatile as the new election cycle nears

While political uncertainty has diminished after the referendum and the security climate is calm, political parties will start to take positions for the next elections. With the referendum behind it, Ankara is now focusing on the next election cycle. There were three main developments in this quarter that may tend to affect political calculations for the next two years. First of all, with the approval of the new constitutional amendments President Erdogan became the chair of the ruling AK Party. Secondly, the main opposition secular CHP initiated a "Justice March" and vowed to continue protesting against the Government's implementations after the FETO coup attempt and the referendum. And, last but not least, the political clash of figures within the nationalist MHP led opposition chaired by Meral Aksener to form a new center-right political party presumably before the year ends. In 2019, it is expected that there will be three elections and two of them (presidential and parliamentary) will be held together on November 3, 2019 according to the constitutional amendments. The third one is that for the local elections that would be held no later than March 2019, according to President Erdogan's speeches.

Regarding domestic security, the country has been calmer due to Turkey's successful anti-terror operations against the PKK and ISIS inside the country and in northern Syria. This quarter, Turkey experienced no major terror attack and the calmer security environment helped market perception and the tourism sector recover.

Middle East quagmire dominates Turkey's foreign policy agenda

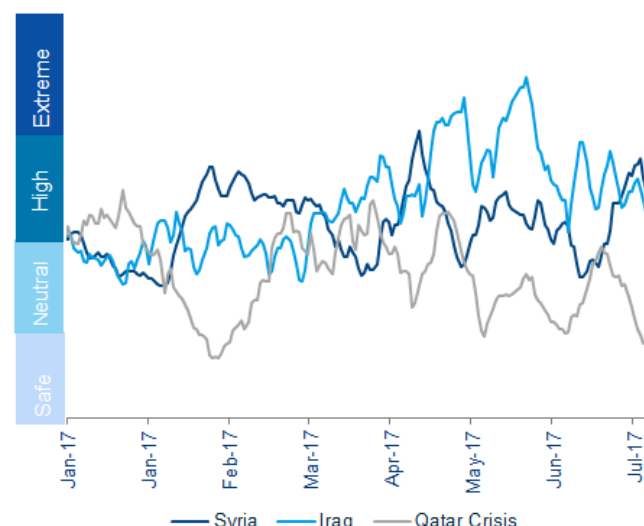
The Middle East and Eastern Mediterranean regions remain highly volatile and Turkey's involvement has gradually increased in what are still very complex scenarios. At the same time, Ankara has been successful in containing terrorist activities in Turkey, which has proved to be positive for market perception and the tourism sector. Yet, the possibility of an escalation in regional crises and the challenges in the EU agenda could underline any uncertainties ahead.

Figure 4.1 Foreign Affairs Index (US, EU, Russia)



Source: Garanti – BBVA Research & GDELT

Figure 4.2 Foreign Affairs Index (SYR, IRQ, Qatar Crisis)



Source: Garanti – BBVA Research & GDELT

ISIS is bleeding in Syria and Iraq but the post-war period will also be challenging. Mosul, ISIS's last main stronghold, was liberated on July 9. Meanwhile, the US-backed YPG (which was originally a PKK affiliate and considered to be a terrorist organisation by Turkey) surrounded Raqqa (the ISIS stronghold in Syria). Any terrorist attacks by Kurds in Turkey or close to the border can trigger more serious retaliation measures by Turkey. Whilst ISIS is losing ground, major powers that are operating on Syrian territory (Iran and Russia on the one side and the US on the other side) are competing to hold as much land as possible in order to have the upper hand in determining the country's future. It is noteworthy that the race is fierce along the Iraq-Syria border. Alas, this competition fuels the risk of confrontation. Overall, uncertainties regarding the future of the war in Syria remain.

The Qatar crisis is the new hot topic but fortunately, it is somehow being contained. As the new generation is flexing its muscle in Saudi Arabia and is now ruling the country, and the war in Syria has summoned all major powers

into the region, the cards are being reshuffled, and some countries are feeling the spillover effects. Some Gulf countries including Saudi Arabia, the UAE and Egypt initiated a policy of containment against Qatar. Turkey and Iran's material support (both of them have sent food supplies and Turkey has opened a military base and deployed troops in Qatar) and Washington's diplomatic attempts (despite President Trump's initial backing of Saudi Arabia against Qatar) helped the crisis maintain its non-escalatory level.

The EU agenda continues on the table with many ups-and-downs. Turkey's EU bid has not progressed this quarter. No new chapters had been opened. However, cooperation between Ankara and Brussels is still being maintained. First of all, the EU and Turkey are still able to keep the refugee deal alive despite the verbal conflict that emerged during Turkey's referendum process in April. Second, Turkey and the EU have initiated a new negotiation cycle to update the Customs Union. The partnership is still positive on economic and security issues. Yet, failed talks in Cyprus and Greek Cypriot unilateral gas drilling in the Eastern Mediterranean pose challenges for bilateral ties between Turkey and the EU.

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