

# Turkey's Pivot to the West

by Ekaterina Zolotova - August 30, 2023

As a geopolitical actor, Turkey's greatest advantage is its domination of intersections. It sits at the crossroads of Europe, Asia and Africa, and it controls the passage of ships between the Black Sea and the Mediterranean. During the first year and a half of the Russia-Ukraine war, these features granted Turkey outsize influence. Immediately, Ankara blocked warships from transiting the Turkish straits in a bid to contain the conflict. It served as a mediator between the warring parties and, later, as a guarantor of the U.N.-brokered Black Sea grain corridor. As the West and Russia escalated their economic standoff, Turkey sensed an opportunity to serve as a transit point for the goods trade and voiced ambitions to establish itself as a natural gas trading hub.

But with the war dragging on, the perks of being Turkey are fading. In the short term, space for mediation has almost completely closed, while over the long term, Turkey's advantages are challenged by the emergence of alternative trade routes. If relative neutrality ceases to be profitable, it may prompt Ankara to seek stability through closer alignment with the United States.

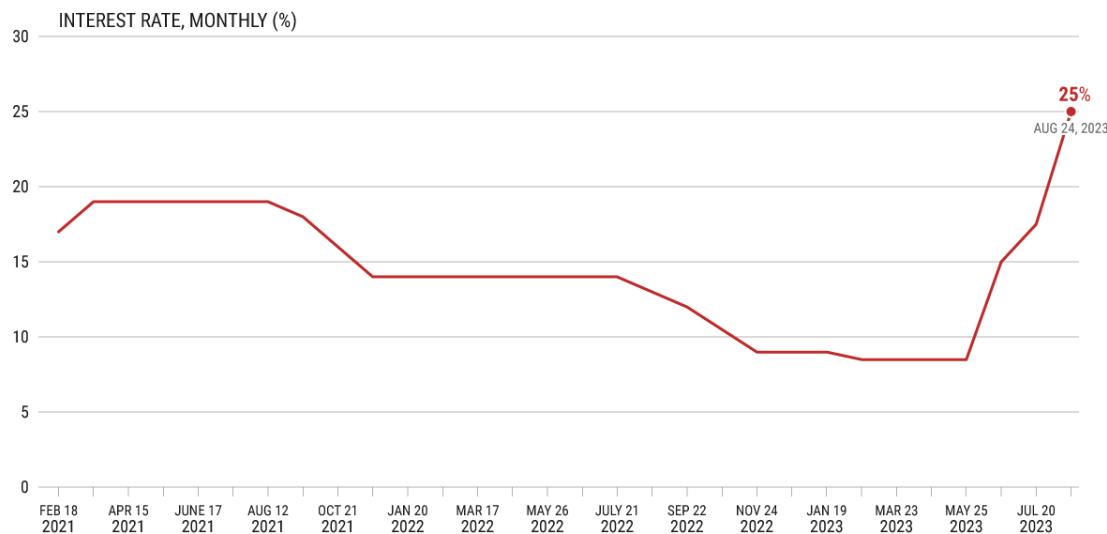
## End of the Road

Turkey's dream of regional leadership will be difficult to achieve if it is simultaneously battling energy price volatility, a fragile economy, an unstable society, and threats to regional trade stemming from an intensifying conflict in the Black Sea. Therefore, after years spent trying to defy economic gravity, newly reelected President Recep Tayyip Erdogan apparently has embraced serious reform.

The Turkish economy is weighed down by a significant trade deficit and extremely high inflation, which peaked in October 2022 at 85.5 percent and is forecast by the central bank to finish 2023 at 58 percent. After securing another five-year term in May, Erdogan assembled a new economic team charged with reducing the country's large external imbalances, restoring fiscal discipline and, most important, moving away from an unorthodox monetary policy. (Despite inflation creeping higher, Turkey's central bank beginning in 2021 cut interest rates to as low as 8.5 percent from 19 percent.) New Finance Minister Mehmet Simsek, a moderate who previously held the same post from 2009 to 2015, raised taxes and worked to charm foreign investors and executives. Meanwhile, new central bank chief Hafize Gaye Erkan embarked on the perilous path to wind down an expensive bank scheme that shields lira deposits from foreign exchange depreciation. She also hiked Turkey's key

rate for the first time since 2021; after an unexpectedly large increase last week, it now sits at 25 percent, up from 8.5 percent.

### Turkey | Interest Rate



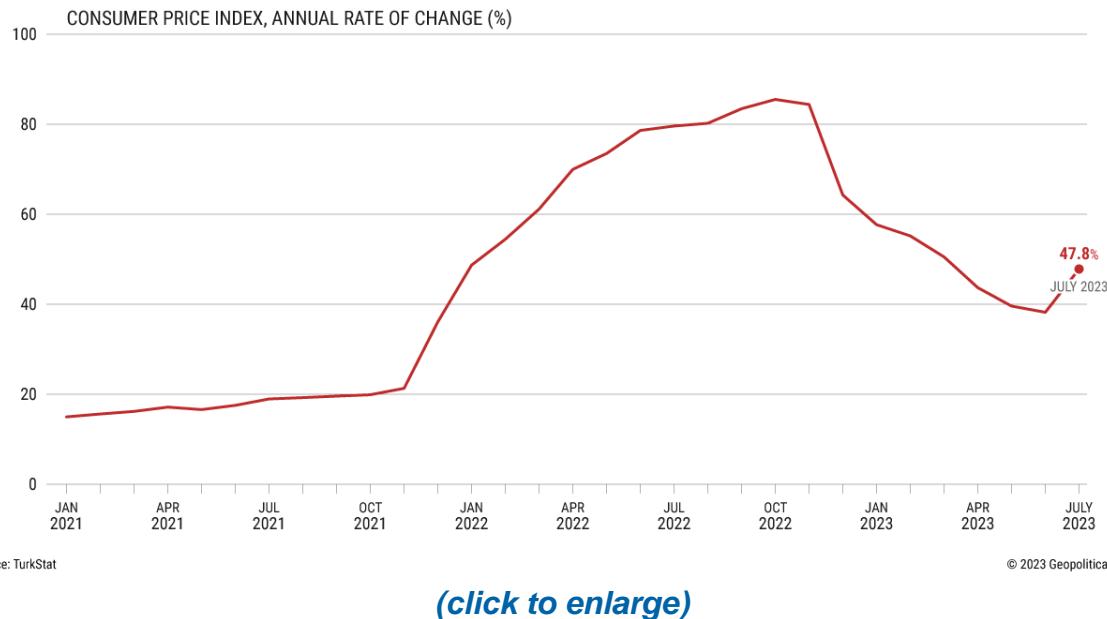
Source: Turkey's Central Bank

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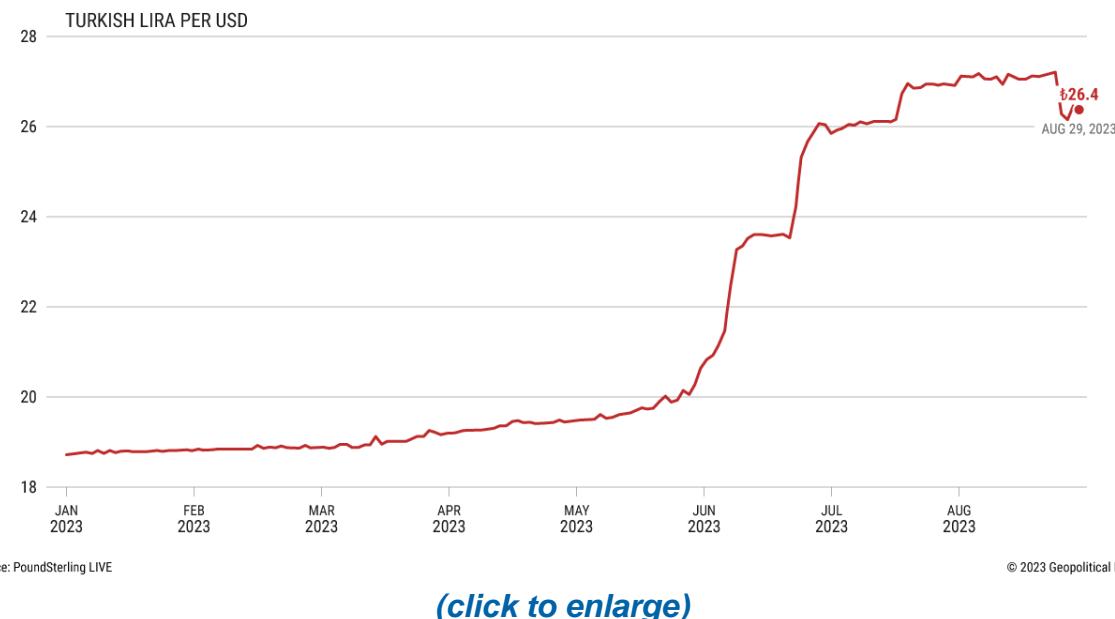
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So far, Turkey's policy normalization has not paid off. The first two rate hikes turned out to be too weak, and inflation started to accelerate again. Relative to last year, consumer prices rose 38.2 percent in June and 47.8 percent in July. Real estate prices have kept soaring, and consumer confidence fell in August. The Turkish lira accelerated its slide against the dollar, peaking at 27.2 per dollar. It strengthened to 25.5 lira per dollar after the most recent rate hike before weakening again the very next day.

## Turkey | Inflation



## Turkey | Exchange Rate



Besides inconclusive reforms, Ankara is threatened with the sudden diminution of its regional influence and transit-state status. First, the Bosphorus has ceased to be Russia's only warm-water

outlet for cargo. In August, the first Russian train carrying commercial cargo arrived in Iran through the Incheh-Borun border crossing with Turkmenistan en route to the port of Bandar Abbas and then Saudi Arabia. The route, part of the International North-South Transport Corridor, enables Russia to export goods to Saudi Arabia at nearly half the usual cost in customs tariffs. Separately, exports of Russian oil and oil products started to shift from the Azov, Caspian and Black seas to ports on the Baltic and in the Far East.

The second challenge to Turkey's regional status follows from the termination in July of the Black Sea grain deal, which facilitated the safe travel of Ukrainian grain through the sea's contested waters and elevated Turkey's significance as a transit country for grain from Eurasia to the developing world. Erdogan has nothing to show for his efforts to revive the deal but is due to visit Russia in early September to try again. In the meantime, Kyiv declared the waters around six Russian Black Sea ports to be part of the war zone. Moscow has repeatedly launched missiles and drones at Ukraine's seaports as well as port infrastructure on the Danube, which Ukraine and the West rely on to replace the Black Sea routes. Ukrainian and EU efforts to establish alternate routes can only further eat into Turkey's significance in the grain trade.

## Appeals to Foreign Investors

In summary, Turkey's temporary boost from bridging the divide between Russia and the West is fading, and its gradual return to economic orthodoxy is yielding few immediate benefits. Even if its policy U-turn reduces inflation and stabilizes the lira, it is unlikely to do away with Turkey's chronic trade deficit. Nor will it solve Turkey's government debt (about 31.2 percent of gross domestic product) or the debts of the central bank, which has borrowed a ton of foreign exchange from domestic banks and other governments to defend the lira. Therefore, to accelerate the repairs to the economy, Turkey will need to attract foreign investment.

But the circle of investors who are ready to put their money in Turkey is limited. Russia is not an option because of sanctions, the enfeebled **state of the Russian economy** and the volatility of trade flows. Simsek, the finance minister, said Turkey wants to restart EU accession talks, but the bloc has its own problems with inflation and a sluggish economy, and anyway, the accession process is measured in years and could be facing major reform.

Ankara has had more success with its new outreach to the Gulf countries. In July, Erdogan signed \$50 billion worth of deals during a three-day tour of the Persian Gulf. Turkey and Saudi Arabia recently implemented a plan to increase bilateral trade and signed a memorandum of understanding to cooperate on the mining of critical minerals. How many of these agreements will materialize is an

open question. The Gulf states will expect results from Turkey's economic reforms. Turks' rising hostility toward Arab migrants could also become an issue; the country still hosts approximately 4 million Syrian refugees and more than half a million Iraqis. Turkish authorities have started removing Arabic from business signs, and the interior minister said all Arabic shop signs would be replaced by the end of the year. Finally, Turkey's regional ambitions are not always popular with Arab states. For example, Egypt, the United Arab Emirates and Saudi Arabia are wary of Turkey's economic interests in Sudan and its increased presence in the strategically important Horn of Africa more generally.

The country with perhaps the most to offer is the United States. The U.S. is Turkey's second-largest destination for exports after Germany. The U.S. is ready to invest, especially in a country that hosts critical U.S. military bases and that plays a pivotal role in the ongoing confrontation with Russia. In addition, Turkey has an educated workforce and strong industrial base, but it could use help moving into more high-end manufacturing (more than half of Turkish manufacturers are engaged in low-tech production) – something that would also suit U.S. interests.

The main obstacle to greater U.S. investment in Turkey is the poor state of bilateral relations. A month before Turkey's elections in May, Ankara accused Washington of trying to create a Kurdish terrorist state near Turkey's borders, and Erdogan was furious when the U.S. ambassador to the country met with his main political rival and head of the opposition coalition. However, both sides seem ready to turn the page on this ugly chapter of relations. They recently held their largest joint military exercises in seven years, involving warships, Turkish F-16s and U.S. F-18s. Also, Selcuk Bayraktar, the head of the Turkish drone maker, toured the USS Gerald R. Ford at the U.S. ambassador's invitation while the carrier was visiting the port of Antalya.

Turkey has not set aside its ambition to become a significant Mediterranean power, but it was becoming too difficult to sustain its previous course. Under intense Western pressure, Russia is turning toward Asia and **the BRICS**, building trade routes that bypass Turkey and becoming less conciliatory on issues of common interest like the collapsed grain deal. Meanwhile, Turkey's new economic team is implementing reforms but can't deliver miracles. The country needs foreign investment, and investors are waiting for clarity – including on Turkey's strategic alignment. One way or another, Turkey will have to put things in order not just domestically but also in its international relations, especially with the United States.

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