

# Turkey: Constitutional referendum and the TRY

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***The TRY is likely to suffer in the run-up to the 16 April constitutional referendum and the immediate aftermath, but not necessarily thereafter. Here is our take on the political risks and the outlook for the TRY.***

On Sunday 16 April 2017, the Turks will vote on 18 amendments to the constitution, suggested by the government. If the vote passes, the current parliamentary system will be replaced with an executive presidency “a la Turca”, led by the incumbent President Erdogan, who will then be both head of state and head of government, potentially until 2029.

The opposition claims that President Erdogan is creating a sultanate, while the government claims to increase accountability via direct elections and provide a much needed strengthened leadership. The EU’s relations with Turkey are already strained, and accession negotiations could be broken off entirely. The TRY is likely to suffer in the run-up to the referendum and in the immediate aftermath, but not necessarily thereafter.

## **Executive presidency to replace the current parliamentary system**

The most important amendment is the replacement of the current parliamentary system with an executive presidency “a la Turca” led by the incumbent President Erdogan who will then be both head of state and head of government. The president can serve a maximum of two five-year terms, and the next elections will be held on 3 November 2019.

### **Other amendments include:**

- Raising the number of parliamentary seats from 550 to 600
- Increasing the parliamentary terms to five years from currently four, with presidential and parliamentary elections to be held on the same day.
- Abolishing the prime minister’s office and introducing one or more vice presidents and ministers appointed directly by the president.

- Increasing presidential influence over the High Council of Judges and Prosecutors, and at the same time adding judicial neutrality to the constitution.

## **A sultanate or direct accountability to the people?**

Critics claim that the amended constitution will grant President Erdogan too much power over the parliament and hence executive as well as legislative bodies: Under the amended constitution the president will be allowed to keep her/his affiliation with a political party, be able to dissolve parliament, and be very hard to impeach. And with increased control of the judiciary there would be little separation of powers. The opposition claims that President Erdogan is essentially creating a sultanate.

The judicial system will come under even more severe political influence, and the freedom of the press has already been sharply reduced in recent years. The question is therefore – critics claim – whether the foundation for democracy will be undermined. The leader of the Republican People’s Party (CHP), the main opposition party, said that the Erdogan-controlled media will position the “no” campaign as “running against the state.”

The Turkish government on the other hand claims that the so-called checks and balances will be stronger under the amended constitution, but also that it allows a stronger leadership. Moreover, the leaders will be more directly accountable to the people via direct elections of the president, and judicial neutrality is explicitly included in the amended constitution.

## **Turkey and the EU**

Concerns in the EU relate to the degree that democracy suffers under the amended constitution. EU accession negotiations are already frozen, and no one expects Turkish membership for many years, if ever. Negotiations started in 1993 and have not come very far.

Still, according to European Commission President Juncker, negotiations will be broken off completely should President Erdogan follow through on his campaign promise to introduce the death penalty if the 16 April referendum passes. That would be a big deal for the relationship between the EU and Turkey.

EU concerns also relate to the more short-term issue of refugees, especially at the midst of a heavy election calendar. The EU’s

deal with Turkey from last year has led to a sharp deceleration of refugee inflow to the EU.

However, Turkey has several times threatened to end the deal: First when Greece refused to extradite Turkish officers accused of participating in the coup attempt on President Erdogan last summer, and more recently when Germany and the Netherlands blocked Turkish officials from entering their countries to campaign for a “yes” in the referendum in which Turks living abroad are eligible to vote.

The refugee concern probably makes it less likely that the EU turns more confrontational on Turkey, both in terms of democracy and potentially breaking off EU negotiations, though rhetorics are very sharp at the moment.

The long game could be a deal for Turkey similar to what the UK will get rather than actual EU membership. At least that is what German Foreign Minister Gabriel recently alluded to.

### **TRY will suffer in the near term**

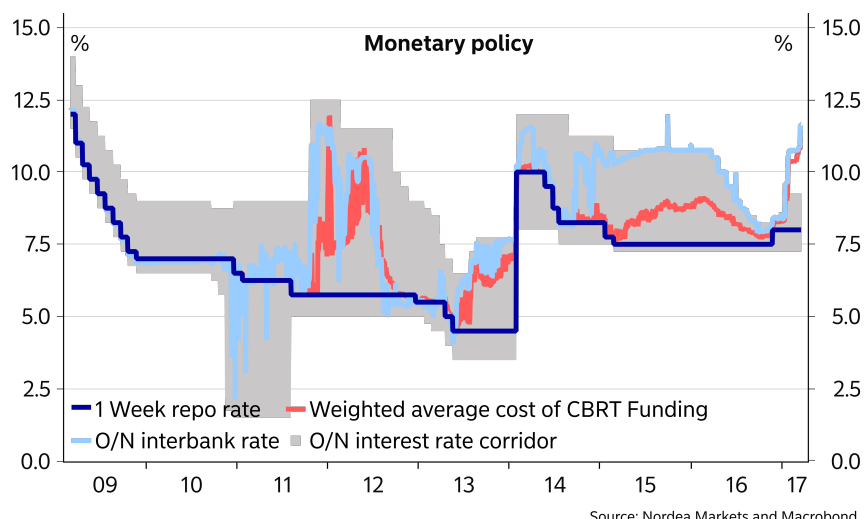
We believe the TRY will come under increased pressure in the run-up to the 16 April referendum and in the immediate aftermath until it becomes clear how President Erdogan will use his new powers.

In our baseline scenario, we expect the TRY to strengthen gradually during the remainder of the year. The key argument is that interest rates have been allowed to increase to the levels of early 2016 and will be allowed – we believe – to rise further if necessary.

Moreover, we believe that Mr Erdogan has been the sole leader of Turkey for more than ten years already and that many issues related to democracy and the freedom of the press as well as EU accession were already huge concerns before the proposed constitutional amendment. Positive expectations about improvement on these issues have most likely not been the key reason why current investors hold TRY-denominated assets in the first place.

As we stated during most of last year, the main threat to the TRY did not come from higher political risks, but from gradually reduced compensation for the high political risks stemming from the central bank’s simplification strategy. The strategy was maculated in November, and the central bank is once again supporting the TRY.

**Chart 1. TRY support from monetary policy**



The risks to our baseline scenario include potential escalation in terms of political confrontation between the EU and Turkey even if we believe the effect of such escalation would be fairly short lived. A complete end to the accession negotiations would increase uncertainty and add significant pressure to the TRY for a longer period.

Risks also include rating agencies' decisions. Moody's changed its outlook on Turkey to negative on Friday, citing erosion of institutional strength as one of three highlighted factors. The perception of institutions coming under increased political control could lead to actual rating downgrades, although Turkey's rating is already fairly low.

Tourism could suffer if political turmoil extends much beyond 16 April although also tourism is already suffering immensely from political risks and the extended state of emergency.

**Chart 2. Tourism is already suffering**



Finally, and perhaps most importantly for the medium-term outlook, the central bank could once again come under pressure to keep interest rates too low. However, we believe the central bank has learned from its 2016 experience: If rates are to be structurally lowered, then inflation has to reach target most years, FX loans have to be dealt with first and rate cuts have to be much more gradual.

In sum, political risks are elevated, the TRY is likely to come under pressure in the run-up to and the constitutional referendum and in the immediate aftermath, but we believe interest rates are high enough to foster a gradual strengthening of the TRY during the course of this year.

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