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What the Turkish referendum means for the capital markets

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A “Yes” to Erdogan’s planned constitutional amendment in Turkey would constitute a double-edged sword for investors: the planned presidential system could mean a short-term relief for the markets and for the economy. However, in the long run, this scenario harbours big risks. That being said, a “No” would not help investors either.

How the coup added fuel to an already tricky situation

2016 was one of the most difficult years Turkey had ever faced – and the economy could not escape that fact either. The attempted coup in July and the state of emergency imposed in its wake led the conflict with the Turkish Workers Party PKK to intensify: an increasing number of terror attacks resulted in a 30% decrease in tourism revenues. And tourism is one of the most important source of foreign exchange for Turkey. After all, this sector has generated more than a tenth of the Turkish gross domestic product (GDP) in recent years. The stepped-up military engagement in Syria and the resumed diplomatic relations with Russia, which are burdening the relationship with the West, are also burdening the economy: both consumer confidence and consumption were significantly down in Q3. Since the coup attempt in July, the 2016 GDP expectations have been gradually revised downwards from 3.5% to currently 2.5%.

The Turkish equity market has seen a remarkable performance in the year to date, as manifested by the YTD performance of the Borsa Istanbul 100 index of +13.28%. However, this development is mainly due to the fact that some shares, especially in the financial sector, have been traded below their historical average and thus been picked up by investors buying on undervaluation. Also, these have likely been market movements in the run-up to the referendum. The market sentiment is in favour of a "Yes" vote – and many market participants seem to be hoping for stimulus measures from the strengthened President Erdogan. While this scenario might materialise, the current movements in the market distort the view on the actual state of the Turkish real economy. The Misery Index of Turkey, i.e. the sum of inflation and unemployment rate, shows a more revealing picture. While the Misery Index for Turkey was still at 16 points in July, it has meanwhile increased above 23.

What is at stake at the referendum

A "No" vote in Erdogan's referendum would not only preserve the status quo of the constitution, but also that of the current political uncertainty. An accordingly negative sentiment on the financial markets would be likely, given that Erdogan is unlikely to give up his political ambitions easily. A resignation like in the case of Matteo Renzi in response to the failed Italian referendum seems completely improbable. The persistent political upheaval would continue to have negative effects on economic growth and thus also on asset prices on the Turkish stock exchange.

In case of a "Yes" vote, financial analysts share the same opinion: the planned constitutional amendment should bring about relief in terms of domestic politics and for the diplomatic relations with the European Union. The amendment would come with extensive consequences for the structure of the High Council of Judges and Prosecutors, which represents the highest authority in the judicial system. It would empower the President to decide on the members of the High Council and would does bestow him with judiciary power. The executive powers would also be transferred from the Prime Minister to the President. With this form of centralised power, Erdogan could abolish the Council of Ministers, would thus be solely responsible for the public budget, and could focus on structural reforms. In this case, the currently ailing economic growth could stabilise. Rising consumer confidence could also result in an appreciating Turkish lira. We are describing the exact scenario that the markets seem to be focusing on at the moment.

Short-term stimulus measures could become ineffective in the long run

In the long run, however, the transition to a presidential system would create two problematic areas that investors should also be aware of: the power centralised in the office of the President could trigger a random course of politics in combination with stronger control over the judiciary system. This would burden the business environment in Turkey and curb productivity growth, given that investments would fail to come through. Also, the President would have more power over the fiscal and monetary policy of the country. He would probably be directly responsible for the appointment of the future governor of the central bank. This could result in a looser monetary policy, especially since Erdogan has often and publicly stated his desire for lower interest rates. Given that the reserve capacities are exhausted, higher demand would lead to higher inflation. And at more than 8%, inflation is already a clear problem.

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