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The Cornerstone of Economic Performance: Political Stability

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- **What are the main transmission channels between political uncertainty and economy?**
- **What are the common examples to the influence of political stability in the world economy?**
- **What have the results of the stability in Turkish economy been in the recent period?**

POLITICAL INSTABILITY: THE ENEMY OF ECONOMIC PERFORMANCE

Economists define political instability as a serious malaise which undermines economic performance. The reason lying behind it can be analyzed in two perspectives. Firstly, decision-makers' horizons are limited in an environment of economic uncertainty; therefore, they put into force suboptimal macro-economic policies. The political uncertainty, which narrows the horizons of monetary and fiscal authorities and causes them to make short-sighted decisions, also negatively influences other economic actors. As a matter of fact, actors in both goods and capital markets fail to make accurate forecasts in an atmosphere of instability, and they are forced to be engaged in limited activities in order to avoid risks. This is largely related to frequent changes in political decisions and high volatility.

Political stability has different levels and definitions. A span of these definitions includes a wide range of phenomena from wars, revolutions, coups and assassinations to the fall and change of governments. [1]

It must be underlined here that a government change may include several alternatives such as the replacement of a party in power with a different one, and a cabinet change, that is, the appointment of a new prime minister and/or a change of 50 percent or more of the cabinet members Furthermore, in a number of academic studies, the existence of different ideological opinions within the government (e.g., when there is a coalition government) is also considered a political instability because the resulting chaos environment, as a matter of course, slows down or interrupts the deci-

1. Carmignani, F. (2003), Political Instability, Uncertainty and Economics, *Journal of Economic Surveys*, 17(1), 1-54.

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sion-making mechanisms. All these forms of instability, without doubt, were seen both in Turkey and other countries in the world in the 1900s and the 2000s, and significantly shook up national economies. However, this analysis will focus on the economic influences of the political stability model that is defined to be shaped by the forms and changes of government.

CHANNELS THROUGH WHICH STABILITY AFFECTS ECONOMY

A large number of academic studies have focused on the influence of political stability or instability on national economies. One of the leading arguments of these studies is that uncertainty halts economic decision-making on a wide range of variables such as investment, production and labor supply. As a matter of fact, a high propensity of a change of government provokes uncertainty about the new policies to be adopted by the new government. As a result, risk-averse economic agents may hesitate to take economic initiatives and even invest abroad by exiting the economy. [2] Moreover, foreign investors who prefer political stability; which is a signal of reliability, may leave or not prefer that country in such a case. All these adversely influence the GDP growth.

To sum up, one of the theoretical factors lying behind the relationship between political uncertainty and economic performance can be defined as “investments” which are directly proportional to the level of stability as well as the national income growth affected by them. This also has significant effects on the growth of per capita income; in other words, the level of welfare. Accordingly, empirical studies, which analyzed up to 179 countries during various periods from the 1960s to the 2000s, proved that political instability adversely affects the growth of GDP per capita.[3]

In this respect, Argentina is the most common example given in regards to the negative effects of political uncertainty and chaos on the national income growth. As a matter of fact, Argentina is known to be one of the world’s wealthiest countries as a commerce giant at the beginning of the 1900s. In this sense, Argentina was among the leading economies with high levels of GDP per capita., it is well known that later in the century Argentina lost momentum yet still was ranked in the top 20 during the 1960s, with a higher level of income than Japan. However, the decades-long political instability in Argentina seriously impeded the investments in the country and hence the growth rate expected to be boosted through them. Japan, on the other hand, adopted a single-party model for years maintaining the political stability during the same period, which positively affected many related policies. Accordingly, Japan is observed to have enjoyed high levels of growth rate. Thus, the current position of Argentina, compared to that of Japan, which used to lag behind it, has always been the most used case study to analyze the relationship between political stability and economic success.

On the other hand, it should be underlined that similar results follow when Argentina, the country of political chaos, is compared to some other countries such as Italy and Brazil which had also lagged behind it at the beginning of the 1900s. Aside from the obvious comparison with Italy, which is one of the largest economies of Europe today, the case of Brazil also indicates that the political unrests adversely affected Argentina. These two neighboring countries who had a similar economic status in the 1970s, later began to differ from each other in terms of political uncertainties. In this sense, it can be expressed that Brazil has since then enjoyed a relatively stable political environment while Argentina has suffered from instability. Given this differential, Brazil has ended up with a more powerful economic performance than Argentina during this period.

Findings in the literature imply that the negative effects of political instability in an economy are primarily observed on investments and national income, followed by fiscal budget and debts. Within this scope, in the existence of an unstable political environment, administrations fail to make effective public invest-

2. Alesina ve diğerleri (1996), “Political Instability and Economic Growth”, *Journal of Economic Growth*, 1, 189-211.

3. Aisen, A. ve F.J. Veiga (2010), “How Does Political Instability Affect Economic Growth?”, *IMF Working Papers*, WP/11/12

ments due to the lack of predictability, hence budgets are more allocated to consumption and the problem of high levels of debt stock persists as well. Besides, the third negative effect of instability that the studies focus on is inflation. Studies reveal that inflation is observed to be higher during the periods of instability due to certain reasons such as the likely inability of economic authorities to adopt effective long-term monetary policies and the increasing dependence on seigniorage revenues. [4]

POLITICAL STABILITY & ECONOMIC PERFORMANCE RELATIONSHIP IN TURKEY

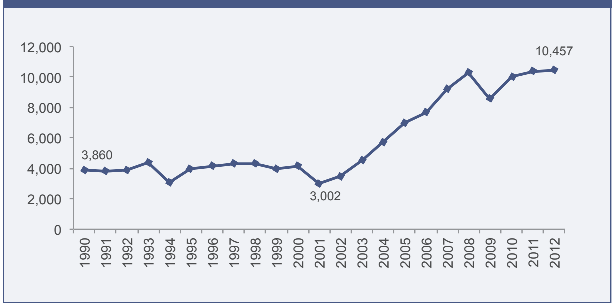
While there are numerous examples around the world which prove the correlation between political stability and economic success; it would be also beneficial to briefly analyze it for the case of Turkey. As well known, throughout its history Turkey has witnessed most of the aforementioned political unrests including the most aggressive ones. However, it would be more meaningful to analyze the recent history of the country here, given the purposes of this study. Accordingly, this analysis will focus on the 1990s and the 2000s, which constitute two incompatible periods in terms of their political stability nature. This is because comparing the period of a series of coalition governments which lasted from the 1990s to 2002 with the singleparty rule that can be defined as the post-2002 period will help us understand the effect of political stability on the economy in Turkey.

At the beginning of the 1990s, governments were formed by right and left parties under the influence of completely different ideological policies. During this period Turkey seriously suffered from chronic inflation problem and the debt stock increasingly went up. The escalated current account deficit accompanied this period too, which ended up with the 1994 economic crisis that caused a significant economic shock. Later in 1994, governments continued to be changed and many short-term governments, each of which lasted for 3 to 5 months, followed each other. It should be mentioned that those coalition governments were formed of either political parties with different ideologies or those with similar point of views. Nevertheless, the most remarkable factor of instability during this period can be claimed to be the frequent government changes rather than the level of ideological fragmentation. Plus, given the subsequent political chaos strengthened by the February 28 process the economic devastation became imminent. The multi-party governments assigned in the following periods administered an economy with increasing public debts, high levels of inflation and a fragile financial system, leading to the break out of the 2001 economic crisis. In summary, Turkey was ruled by instable coalition governments until the end of 2002; which can be defined as a period of political instability. At this point it is clear that Turkey performed poorly in the macroeconomic indicators, which the literature. defines to be associated with instability

In this sense, the indications summarized above such as national income per capita income, budget deficit and inflation, in the pre and after 2002 periods clearly show that there is a close relationship between political stability and the management of economy in Turkey. Within this scope, Chart 1 which exhibits the performance of per capita national income clearly indicates why the 1990s are regarded as the "lost years" of Turkey. As can be seen in the graph, the Per capita income during this period remained between 3 thousand and 4 thousand dollars with ups and downs as the economy was stuck in lower-middle income levels.

4. Aisen, A. ve F.J. Veiga (2006), "Does Political Instability Lead to Higher Inflation? A Panel Data Analysis", *Journal of Money, Credit and Banking*, 38(5), 1379-1389

CHART 1. PER CAPITA INCOME IN TURKEY



Source: Ministry of Treasury

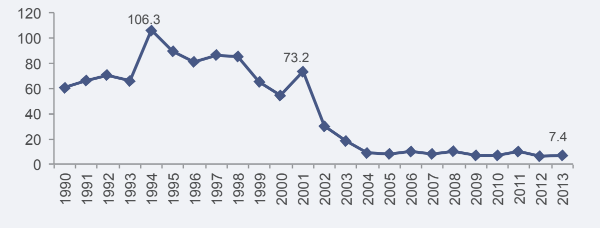
In the post-2002 period, however, it rapidly escalated with growth rates reaching double-digits and hence exceeded the 10 thousand dollar threshold

Furthermore, it should be underlined that a strikingly positive trend in investments was observed in the post-2002 period. In addition to the increasing national private investments, Turkey enjoyed record levels of foreign capital inflows. . Particularly in 2004, after reaching a high level GDP growth, direct investments incrementally increased with the support of privatizations. Accordingly, investments in 2002 increased from 1.1 billion dollars to 22.1 billion dollars in 2007. Foreign capital inflows, which had a decline during the global crisis followed, began to increase in the post-crisis period. However, it should be noted that as Turkey aims to attain higher and sustainable growth rates; foreign direct investments should be accelerated in the upcoming period. At this point, political stability should be attached a great importance to. As a matter of fact, the influx of global investments to more stable developed countries both in the 1990s and the 2000s also indicates that reliability is the primary factor affecting investments all around the world.

Statistics on budget and debts during the two periods also exhibit a parallel relationship between stability and economy in Turkey. As a matter of fact, the deteriorated public financegreatly contributed to the collapse of the economy in 2001 and the Gross public debt stock escalating during this period reached to 73.7 percent of the GDP in 2002. Besides, the ratio of the budget deficit to GDP increased to 10.2 percent, indicating a lack of sustainable and effective fiscal discipline. However, upon the arrival of the single party rule, the indicators rapidly improved As of 2013. the ratios related to public finance were still observed to remain below the Maastricht criteria.

Furthermore, as stated above, international studies argue that political uncertainty and chaos also contribute to inflation, The pattern of the inflation rates in Turkey during the mentioned period, indeed proves this argument sincen the 1990s, inflation excessively increased (Chart 2) as the coalition governments failed to adopt successful and effective policies. During the 1994 crisis, inflation rose to more than 100 percent and Turkey experienced double-digit inflation levels until the 2000s. At this point it should be reminded that the inflation rate was 73.2 percent following the 2001 crisis. Afterwards, Given the economic recovery and effective policies in the post-2002 period, Turkey finally managed to witness single-digit rates of inflation.

CHART 2. CONSUMER INFLATION IN TURKEY (PERCENT, 1990-2013)



Source: Ministry of Treasury

Consequently, a large number of international academic studies proved that political instability impedes economic success. This result also follows for Turkey, when the 1990s and the 2000s, which are two incompatible periods for the country in terms of political stability. As a result, for the period to come, it can be conluded that Turkey has no choice but to maintain its political stability, which is the main factor lying behind its economic success. It is also critical for Turkey to give positive stability signals to the world, in order to preserve the economic development achieved in the last 11 years and to reach the future goals.

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