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SOCIO-POLITICAL UNREST AND ITS IMPACT ON THE TURKISH ECONOMY AND INVESTMENT STRATEGIES

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ABSTRACT

The purpose of this paper is to analyze the impact of socio-political unrest on the Turkish economy and the investment strategies by reviewing previous studies and interpreting them. The paper starts with a brief introduction to Turkish economy by examining it period by period from establishment of the republic until today. In addition to that, vulnerable structure of the Turkish economy is discussed briefly. In the main part, two different consequences of this unrest and their impacts are investigated by using data taken from previous studies. The work is finished with the interpretations of these data and the conclusion. As a result, it is found that sudden political disturbances have superior impact than the ones caused by terrorist activity. This can be interpreted as terrorist attacks have lower impact on changing the outlook of the country in the long term.

1. INTRODUCTION

Turkey used to be a poor country consistently shaken by financial and economic crises, however, since the beginning of 2000s, it has been showing a positive trend and in the last 10 years it ranked 17th among the World's greatest economies as result of reconstruction of the banking system, transformation of many cities into industrial zones, the dynamic young population and the capability of sustaining itself by domestic production.

It is obvious that the adjustments made in the beginning of the century changed the course of the economy and turned a poor country into a developing one. Yet, this does not mean that this growth will last consistently, especially in the presence of exogenous and endogenous factors. Turkey's geopolitical position makes the country exposed to several types of threats. The country can be defined as a bridge between the modern world and the more conservative minded middle eastern countries. Even though it sounds as an external factor, the country itself is divided into these two major mindsets.

In this paper, firstly the history of the Turkish economy will be reviewed in order to see what kind of a mindset was embraced which brought the economy to the position it is in today. After the brief history between the beginning of the republic period and the 2000s. Secondly, the economic situation and progress of the second era, AKP (Tayyip Erdogan) era, will be analyzed. We will see how their approach to fiscal and monetary policies changed the financial environment in the country. After a brief explanation of the current situation of the economy, vulnerability of the Turkish economy will be discussed. The purpose of these sections is to create the context of the economy and facilitate the understanding of the dynamics in Turkey that have a huge impact on investments. Which brings us to the core section of the paper. In this section, previous investment decisions will be reviewed and analyzed to see how they change according to the uncertain environment in Turkey. These uncertainties are mainly classified as socio-political events like a massive protest or a coup attempt and terrorist attacks. These are the two main factors that cause uncertainties in the country and impact the decision-making process of the foreign and domestic investors.

2. BRIEF INTRODUCTION TO TURKISH ECONOMY AND ITS HISTORY

Turkish economy is described as a developing economy by the International Money Fund. It is one of the fastest growing economies in Europe and it has been attracting many foreign investors from all over the world. Turkey has the 17th-largest nominal GDP and 13th-largest GDP by PPP. Turkey is also a founding member of the OECD (1961) and the G-20 (1999).

List by the International Monetary Fund (estimates for 2017)[5][6]

Rank	Country	GDP (millions of Current Int$)
	World	**126,687,917**
1	China[n 1]	23,159,107
	European Union[n 2]	20,982,857
2	United States	19,390,600
3	India	9,459,002
4	Japan	5,428,813
5	Germany	4,170,790
6	Russia	4,007,831
7	Indonesia	3,242,771
8	Brazil	3,240,319
9	United Kingdom	2,914,042
10	France	2,835,746
11	Mexico	2,458,357
12	Italy	2,310,902
13	Turkey	2,173,227
14	South Korea	2,029,032
15	Spain	1,773,906
16	Saudi Arabia	1,773,551
17	Canada	1,769,270
18	Iran	1,644,705
19	Australia	1,246,475
20	Thailand	1,233,737

Per the International Monetary Fund (2017)[17]

Rank	Country	GDP (US$million)
	World[20]	**79,865,481**
1	United States	19,390,600
2	China[n 1]	12,014,610
3	Japan	4,872,135
4	Germany	3,684,816
5	United Kingdom	2,624,529
6	India	2,611,012
7	France	2,583,560
8	Brazil	2,054,969
9	Italy	1,937,894
10	Canada	1,652,412
11	South Korea	1,538,030
12	Russia[n 2]	1,527,469
13	Australia	1,379,548
14	Spain	1,313,951
15	Mexico	1,149,236
16	Indonesia	1,015,411
17	Turkey	849,480
18	Netherlands	825,745
19	Saudi Arabia	683,827
20	Switzerland	678,575

Figure 1*: Ranking list of countries by nominal GDP and GDP by PPP*
Source: Wikipedia

The CIA classifies Turkey as a developed country. Turkey is often categorized as a recently industrialized country by economists. Moreover, Merrill Lynch, the World Bank, and *The Economist* describe Turkey as an emerging market economy. The World Bank had classified Turkey as an upper-middle income country in terms of the country's per capita GDP in 2007. However, recent developments have shown how vulnerable and fragile the economy is in Turkey. Therefore, it is essential to analyze the current situation in a proper manner; we need to know how this economy reached to the point where it stands today. The economic history of the Republic of Turkey should be divided with respect to a few sub periods designated by major reforms and changes in economic policy. These periods are i) 1923-1929, ii)1929-1950, iii)1950-1980 and iv) after 1980.

2.1 1923-1929

In 1923, after the War of Independence and the final collapse of the Ottoman Empire in the late 1910s, The Republic of Turkey was established. Despite the fact that the newly founded state had a share on the historical heritage of an empire, the leaders of the new state turned to contemporary.

Western methods and institutions immediately during the early stages of political and economic restructuring. Throughout the first years of the new republican regime, directed by the founding president M. Kemal Ataturk, had been characterized by drastic cultural and social reforms, of which most importantly, adoption of secular principles in the political and economic environment of the country. To put it bluntly, the national leadership was facing enormous tasks in the reconstruction of a war-ravaged and neglected economy. Over the course of the 1920s, the government scuffled with difficulties in two sets of economic policy: Firstly, the renegotiation of a colossal external debt; and secondly, the separation of the remaining parts of the so-called capitulations inherited from the Ottoman Empire. Restructuring process of foreign trade regulations and tax regimes was impaired because of these so-called capitulations which were enabling foreign powers to have the right to gain tax revenue and control import tariffs. These exogenously imposed tariff and tax restrictions were almost entirely removed by 1929. In order to compensate this poor economic performance in the 20's and to overcome the negative impacts of world economic depression, Turkey established new economic policies in the 30's, stressing the importance of production from the own resources.

2.2 1929-1950

In the sense of resource mobilization, industrial boost led by the government in the 1930s was quite successful and brought about growth and substantial structural change in output. Within the 1934-38 period, major investment projects were executed under the framework of the first industrial plan. In the mid 1930s, the government, along with the supreme regulatory elite, developed an official ideology, named etatism. This ideology was in pursuit of a middle way between comprehensive planning of Soviets and open market economy system of the West. Etatism appointed a pioneering role to the public sector in saving accumulation and in executing key entrepreneurial functions in industrial and technological development.
The political allure of etatism eventually prompted the evolution of a particular form of a composite economic system in Turkey which disseminated a substantial amount of anti-market bias in the foreign trade side and the financial system, at least until the liberalization period of the 1980s. Reasonable national security concerns related with the World War II impaired the potential attempts to implement a second industrial plan during 1938-1944. In order to maintain an impartial stance in the World War II, Turkey had spent a lot of political effort and energy. However, it was inevitable for Turkey to stay away from shattering economic effects of external factors and suffered from severe commodity scarcity and high inflation in the early 40s.

During the early post war years, two significant factors formed and shaped domestic economic policy. First, Turkey was granted with Marshall Plan and US bilateral assistance programs which were mainly based upon national defense. Secondly, the government commenced a change towards multiparty parliamentary structure after the pressure by the public which was discontent with one party governance.

Since the government was preoccupied with political changes, a preliminary form of five-year plan was terminated, and industrialization objectives were given up in the late 1940. After a major exchange rate adjustment in 1946, agriculture and liberal enterprise was favored by the government. Yearly average GNP growth rate was 7.4% in 1923-38, 1.2% in 1938-48 and 7.9% in 1948-53.

2.3 1950-1980

In the current situation of increasing public dissatisfaction, governmental switch to multiparty system inevitably resulted with the defeat of Republican Party and the triumph of recently established Democratic Party in 1950 elections. The majority of voters of this party consisted of rural conservatives. In terms of economic issues, the Democrat Party's plan was not to plan.

Turkish economy grew rapidly in the early 50's, mainly due to a huge rise in agricultural output and raw material export. However, following the great crop failure of 1954, economy faced with foreign exchange stringency and decreased GNP growth, in average about 4% per year between the years 1953-58. Internal policy and external debt management gained importance with the reliance on short term external borrowing and trade payables. Government policy of financing public entities and supporting agriculture expenditures resulted with high inflation which led to devaluation and stabilization program designed by IMF in 1958. The program was backed by a substantial package of foreign assistance and debt consolidation based on a multilateral arrangement.

On one side, Democrat Party triggered more extensive political participation and provided higher political and social status to the rural community. On the other side, the party governance became more restrictive along with the economic difficulties and increasing discontent of urban elite. The result was disastrous as it concluded with military takeover in 1960. This coup was terminated quickly after the adoption of socially revolutionary constitution in 1961 which asserted more strict checks on the overall political progress.

Even though some extent of the military interventions made in 1960 and 1971 was triggered by negative economic conditions, after both of the interventions the government escalated government spending, leading the economy to overheat. Due to the lack of serious structural reforms, Turkey had chronic balance deficits and these deficits were financed by external borrowing which boosted the country's external debt in every decade. To be clearer, debt had reached $16.2 Billion by 1980 which is also more than ¼ of annual GDP. Debt payment in that year amounted to 33% of export of goods and services.

By the end of 1970s, probably the economy had reached its worst situation after the fall of the Ottoman Empire. Against the huge increase in oil prices in 1973-74, authorities failed to take action as a countermeasure, on the contrary, they financed this deficit with short term foreign debts. Inflation had reached triple figure numbers, unemployment increased by 15%, industry was working at half capacity and the government was not able to pay even the half of the interest on foreign debts. Seemingly, Turkish authorities were doubted as of having the capability to execute and sustain required reforms.

2.4 1980-2000

In January 1980, the prime minister appointed his undersecretary Turgut Ozal who designed a reform program based on export led growth.

The strategy of Ozal aimed replacement of import substitution policies with policies generated to incentivize export that can support imports financially, thus giving Turkey an opportunity to recover from post war consequences of rapid growth and deflation. This strategy encouraged planners to hope that Turkey may experience export led growth in the long run. The pathway to these goals for the government consisted of a package; devaluation of Turkish Lira and enabling flexible exchange rate, maintaining positive real interest rate and strict control over the money and credit supply, liberalizing the prices charged by state entities, reforming the tax system and of course, encouraging foreign investment. Even though the policy was put on hold when Ozal left the office in 1982, the liberalization policy was effectuated after he was elected as prime minister in November. 1983.

The liberalization policy defeated the payment balance crisis, enabled Turkey to borrow from international capital markets, thus led the country to regenerated economic growth. Goods exports increased from $2.3 billion (1979) to $8.3 billion (1985). Import numbers have also increased in this period from $4.8 billion to $11.2 billion. Ozal policies had a positive impact on the services part of the current account. In spite of a jump in interest payments from $200 million to $1.4 million, there had been a increasing surplus recorded in the services account. Increasing inflow of foreign currency from tourists and pipeline payments from Iraq were the main reasons. Stabilizing the current account also facilitated to regain creditworthiness in global capital markets. Foreign investment, which can be considered negligible in 1970s, now had started to increase, even though it remained moderate in the 80s. Moreover, Turkey could borrow in global markets, whereas in the 70s, it could receive only assistance from IMF and other creditors.

The decrease in public expenditure, which was at the center of the stabilization policy, hindered the economy harshly in the late 70s and early 80s. Real GNP reduced 1.5 % in 1979 and 1.3% in 1980. The manufacturing and service sectors experienced the majority if this decline in income with manufacturing sector operating at 50% capacity. However, along with the relaxation of the external payments' constraints, the economy responded positively. Between 1981-85, real GNP increased 3% per annum, which was led by the manufacturing sector. With strict monitoring on earnings of workers and activities, the industrial sector commenced to utilize unfulfilled capacity and raised average output of 9.1% between 1981 and 1985. Another factor that increased economical competitiveness of Turkey was the devaluation of Turkish Lira.

Rapid regeneration of growth and improvement in the payment balance were not sufficient and effective to defeat unemployment and inflation, which posed serious threats. Even though the official unemployment rate fell from 15% to 11% in 1980, rapid boost in the labor force has acted contrarily to increase unemployment to 13% in 1985. Inflation decreased to around 25% in 1982 but it climbed back to more than 30% in 1983 and even more in 1984. Although it alleviated in 1985 and 1986, it remained to be one of the major concerns of the policy makers.

Trying to complete the ongoing liberalization process with 24th of January,1980 Decisions, Turkish economy prepared the substructure of many crisis under the effect of fragile economic structure due to short term foreign capital flows.

Salary increases made in the second half of 1989 boosted individual spending and effected industrial manufacturing in a positive way. As a result, Turkey has achieved the largest growth numbers in 1990. By timely intervention of the Central Bank, a potential exchange rate crisis, due to the Gulf Crisis in 1990 along with uncertainty created by 1991 early elections, was prevented. From 1989 to the year of crisis in 1994, there has been steep fluctuations in GNP numbers. Turkey entered 1992 with current account deficit that stemmed from the Gulf Crisis, almost zero growth, increasing public deficits and chronic inflation. Due to instant rise of aggregate demand in 1993, the insufficient limits of financial and real sources were pushed, and public authorities had to apply for extra funds to the Central Bank.

Following the year 1993, Turkey has encountered with the traditional scenarios of crisis. In this context, the budget deficit had increased, prices had risen, the balance between export and import had failed to the import side and foreign debt had increased. These developments had dragged the country to a severe economic crisis that was giving warning signs already. In order to overcome this crisis, a new consistency program was declared with the aim of reestablish consistency that was impaired by broken external balance and foreign currency market. Other than that, decreasing public deficit and inflation in the mid run and sustaining consistent growth in the long run was main goals of the program.

1994 Consistency program had left positive impressions in the first stage. In this regard, money and foreign currency markets had achieved consistency rapidly, exchange rate was taken under control, there had been a surplus of current account, public deficit had gone down, and foreign currency inflow had risen substantially.

However, positive performance of the program did not reflect to the long-term expectations. This was mainly because; social and structural reforms were not as successful as expected, financial discipline could not have been maintained completely and budget deficit increased. Main purpose of the program was to combat inflation, but it was not enough to alter inflation expectations or to find a solution for consistency. The program had failed also because of the lack of support from the public.

2.5 Economic Context from AKP Era Until Today

Turkey suffered from a harsh economic and political crisis in November of 2000 and also in February.2001. The crisis emerged when Turkey was in pursuit of an exchange rate-based disinflation program designed and monitored by the IMF. In 2001, the GDP retracted by 7.4% in real terms, inflation rocketed to 61.6% and the currency depleted 51% of its value against major currencies. Unfair consequences of the adjustment were felt by the laboring class as the unemployment rate rose by 2% in 2001 and 3% in 2002. There was a huge and abrupt fall of 20% in real wages in 2001 and has not been recovered since then.

The IMF was involved with the macro-management of the economy of Turkey both before and after the crisis by supplying financial assistance of $20 billion within the years 1999-2003. After the crisis, policy makers have enforced an orthodox strategy by increasing interest rates and keeping the exchange rate overvalued. The government was forced to implement a contractionary fiscal policy and made commitments to IMF to fulfill their demands; reduction of investment to agriculture, to privatize and reduction to the role of public sector in the economy.

The growth after 2001 had been high indeed. Real GNP growth per annum was average 7.8% during the period of 2002-2008. Growth, being rapid, had also very unique features; first of all, it was supported by a huge flow of foreign investment which was encouraged by substantially high rate of returns offered domestically, therefore, its nature was speculative. The main system was that the high interest rates in the Turkish market attracted short term investors and as a result, abundance of foreign currency circulating in the market led to overvaluation of Turkish Lira. Naturally, cheap foreign currency caused an import burst both in investment and consumption side.

Undoubtedly, realization of fiscal contraction in the light of severe enforcement of public non-interest spending was a pleasant event driving up the greedy expectations of the arbitrageurs. The second feature of post 2001 period was growing unemployment rates. The rate of unemployment had risen above 10% after the crisis and in spite of the quick growth, it had not come down to former levels of 6,5%. Moreover, along with the actual unemployment, disguised unemployment had also increased according to Turkstat data. Disguised unemployment was described as "people not searching for a job but ready to be employed if offered a job" and the number had risen from 1.06 million to 1,94 million between 2001 and 2006, making total unemployment rate 15,5%.

On top of rapid growth, another achievement of AKP government was disinflation. The Central Bank has commenced to pursue an open inflation targeting scheme since 2006. The bank's mandate is to manage a target of 5% inflation on the consumer prices. The inflation rate regarding the both the producer and the consumer had been under control in 2004. Especially, producer price inflation fell back to below 3% in 2005. Due to the disturbances and uncertainties asset markets in 2006, inflation rose up to 10% levels and could be brought back to 9,5% towards the end of 2006.

Despite the positive results on the disinflation area, adjustment of interest rate was lagging. For instance, the real interest rate on the government debt instruments lingered above 10%

over the period of post crisis and developed huge pressure against the fiscal authorities in satisfying their debt liabilities. On the other hand, the stubbornness of the real interest rates had been a facilitator in attracting bulky flows of short-term financial capital between 2003 and 2008. This norm continued until 2010s even stronger.

It goes without saying that the availability of cheap foreign currency and subsequent appreciation of Turkish Lira were the elements behind the quick upswing of the GDP per capita in US dollars terms. GDP per capita has risen from $3,500 in 2001 to more than $10,000 in 2010. However, consequent to the fall of real price of the dollar, majority of this development is overstated and came to a halt as the depreciation of Lira within the period of global recession.

Following 2006, the economy began to perform at a substantially high rate of current account deficit in pursuit of positive growth. This theory became clearer in 2012. Opposed to mild descent scenarios as anticipated by authorities and international speculators, this period exemplified a new benchmark in the process of turning Turkish economy into a foreign debt-ridden economy offering a paradise of cheap import and labor surplus. Moreover, it is observable that a particular discriminating feature of Turkish economy in this period was the correlation between foreign savings and the growth rose to higher thresholds in a permanent way.

As far as the history of the Turkish economy is concerned, traditionally, it was not an economy that was accumulating high current account deficits. For instance, during the 90s, the rate of growth of national income was 3,6%, whereas the proportion of current account deficit to GDP was below 1%. Beginning from 2003, yearly current deficit rose to the 3-4% range and made a peak to 6% after 2006. In 2009, the growth rate, subsequently to the global recession, was -4,8% as the current deficit decreased. Nonetheless, in 2010, the ratio of current account deficit to income once more started to increase.

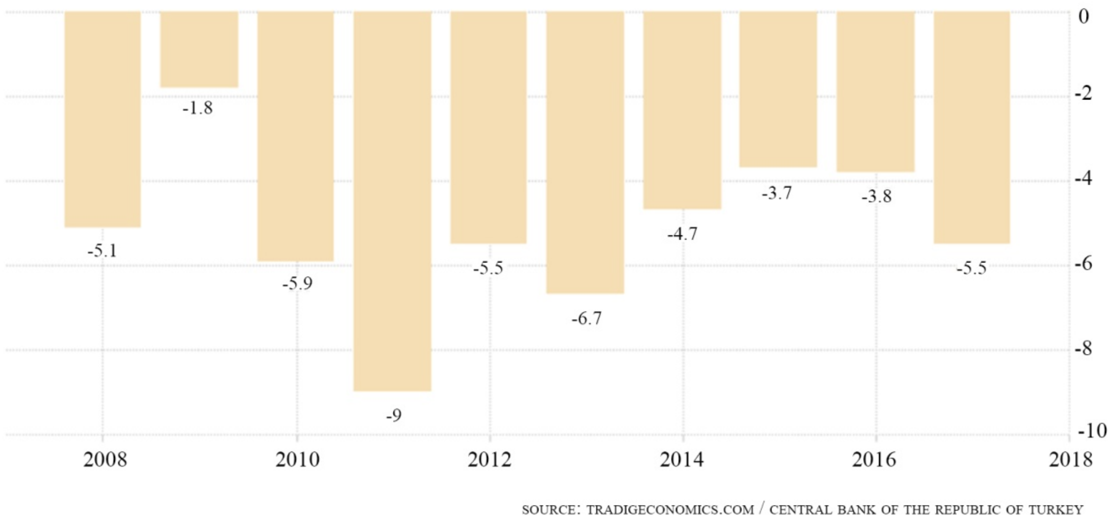

Figure 2*: Current account deficit / GDP*
Source : Tradeeconomics.com

What is alarming, other than the deficits mentioned was how poorly they were managed and financed. It is visible in the table that, 85% of the current account deficit for the year 2012, which was $48,5 billion, was financed by inflows of portfolio investments and unrecorded capital inflows. Nonetheless, in the hindsight, the proportion of the aforementioned items in the current account deficit was around 40% in 2010 and 2011.

Current account balance and selected financing items ($ Million)

	Current Account Balance	Portfolio Investments	Net Errors and Omissions
2010	-45,312	16,083	232
2011	-75,008	22,204	9008
2012	-48,535	41,012	346

Figure 3*: Financing of current account deficits*

Being dependent on the portfolio investments and unrecorded capital inflows, the flow of hot money presents the most uncertain and volatile type of capital, being also the most sensitive one to the speculations of foreign exchange. These forms of capital flows, as generated by hot money inflows based on speculative objectives, explain the reasons behind the excessive uncertainty and volatility in real the real sectors of the economy.

2.5.1 Assessment of the Monetary Policy

As soon as Turkey's stability program which was based on stable exchange rate hit the wall in 2001, the economy faced with a severe crisis which led to the free-floating Lira soon later. The bitter days of the crisis set off a chain of compulsory reforms which involved an amendment in the Central Bank Law of April 2001, liberating the Central Bank.

In the first days in office, the economy authorities of AKP took advantage of this 'independent Central Bank' motto as a part of their international strategy which was to rebuild confidence of the foreign investors. However, ironically, the independence of the Central Bank was under brutal attack by the same party after 10 years, only to reveal that despite 12 years that had passed, monetary policy management had not been institutionalized yet.

Poor performance associated with the static currency forced Central Bank to seek a different regime. Recently obtained independence guided the Central Bank to converge to Inflation Targeting which was preferred among the emerging market countries in the world. However, realizing the difficulties of achieving to fulfill the prerequisites of inflation targeting overnight, the Central Bank designed a transitioning period named implicit inflation targeting that took place between 2002-2005.

From 2002 to 2005, the Central Bank administered implicit inflation targeting and achieved to bring consumer inflation down to 7,7% in 2005 from 30% in 2002. During this period of implicit inflation targeting, annual inflation remained below the target levels, making the Central Bank gain confidence and credibility for the freshly introduced inflation targeting program. Therefore, as of 2006, implicit inflation targeting gave way to the explicit inflation targeting.

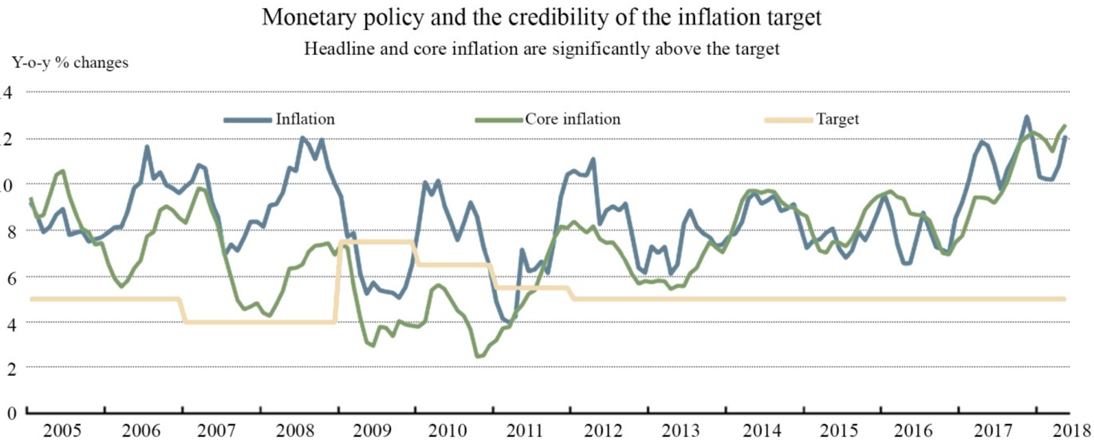

Figure 4*: Unreliable inflation targeting*
Source: OECD Survey of 2018

However, as the inflation went down to single figures, the challenging process of explicit inflation targeting was much more difficult with sticky prices and therefore, the Central Bank was not as successful as the past. Certainly, between 2006 and 2008, the Central Bank superseded the official targets in each year, brought the economy back to double digit inflation numbers as of 2008. The Central Bank blamed the supply side shocks for high inflation numbers and later revised the inflation targets for the upcoming years. Correspondingly, inflation targets were revised and set to 7,5% for 2009 and 6,5% for 2010, 4% more than targets of 2007 and 2008, respectively. Since then, the inflation rate keeps on being volatile, reaching double digits in 2011, followed by a historic low in 2012 and later, increasing and exceeding the target in 2013 and 2014.

2.6 Today in The Turkish Economy

The economy in Turkey has grown very rapidly between 2016 and 2018 in spite of the problematic shocks. That performance has been induced by policy incentives and a dynamic and well diversified business sector. Yet, the imbalance of current accounts stemming from over reliance on internal demand and external savings magnifies needs for foreign financing, therefore, drives up the risk and vulnerability to external shocks. Comprehensively, investment has been solid while being excessively funded by debt, raising concerns about its value and allocation. Meanwhile, inflation rate stays far beyond the target, jeopardizing the credibility of the monetary policy. Moreover, concerns regarding the quality of governance, uncontrollable exchange rate depreciations and uncertainties in the future expectations have piled up to increase perceived risk. Cautious and transparent monetary and fiscal policies are declared to keep the confidence level up in this volatile environment.

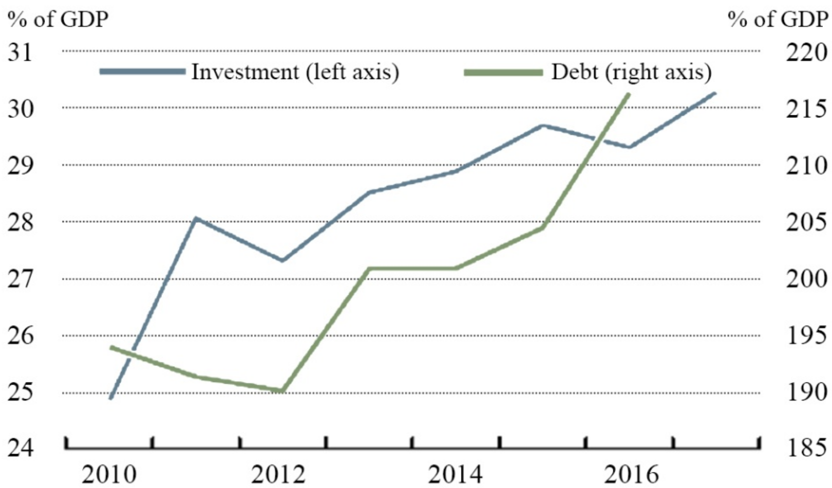

Figure 5*: Investment funded by debt*
Source: OECD Survey of 2018

Macroeconomic policies became heavily expansionary after the coup attempt in 2016. Along with substantial amount of increase in government spending, a series of consumption, employment and investment incentives have been implemented. Moreover, the government has also expanded loan guarantees, which are among the highest as a part of GDP, in the OECD. The medium run program of 2018-2020 anticipates fiscal constraint but the policy was pro-cyclical prior to the elections in 2018. As countermeasure against moving inflation expectations and intermittent sharp currency depreciations, the Central Bank strained the effective funding rate by 500 base points and declared the long-term monetary policy normalization around a standard rate. Restoring the full credibility of monetary policy will require the commitment from all of the stakeholders in favor of the independence of the Central Bank.

Key Insights

GDP per capita in Turkey has continued to reach up to the levels of more advanced OECD economies. Even though there have been multiple negative shocks involving political tensions at the southeast corner and avoided coup attempt in 2016, growth of GDP was recorded as 7% in average, over 2010-17.

With 7.4% annual GDP growth in 2017 and a powerful first quarter in 2018, real GDP growth has been one of the fastest in the world, overtaking the market expectations as well as projections. Vigorous foreign demand and abrupt exchange rate depreciations supported exports. Fiscal stimulus, along with a massive government credit guarantee scheme extension, amplified domestic aggregate demand.

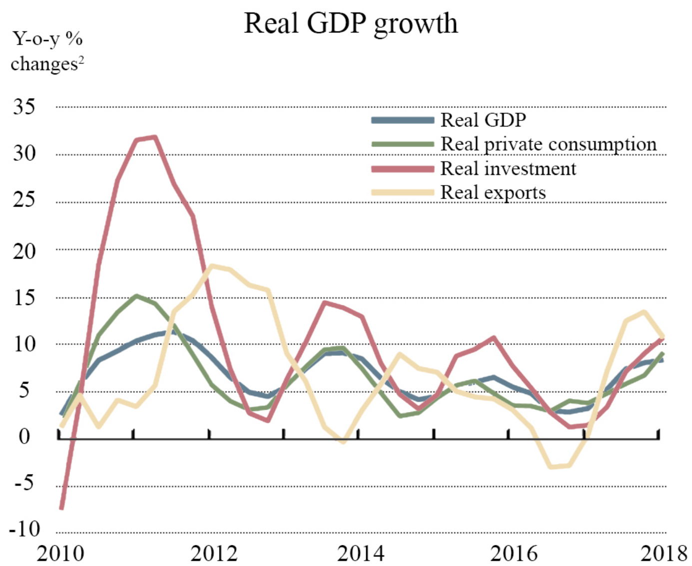

Figure 6*: Fluctuations in key indicators*
Source: OECD Survey of 2018

Private sector investments were toned down in majority of 2016-17, showing `wait and see` stance in the middle of various regional, national and international uncertainties. Nevertheless, it was restored in late 2017 and early 2018, thanks to strong export projections and significant government incentives.

One might think that, announcement of bringing forward the parliamentary and presidential elections from November 2019 to April 2018 would have diminished policy uncertainties by minimizing the pre-election period, however this has not been the case. On the contrary, it caused deviations from medium term program of 18-20 which had aimed decreasing government deficit from 2.4% (per GDP) to 1.9%. New concerns have also emerged on the purposes and conduct of the monetary policy. Abrupt decrease of exchange rate raised the debt amount and costs of borrowing of the non-financial firms having huge debts in foreign currency. In contrast, private consumption is expected to be supported by employment and pre-election social transfers. Unfortunately, the expected rise in inflation will burden households in terms of purchasing power.

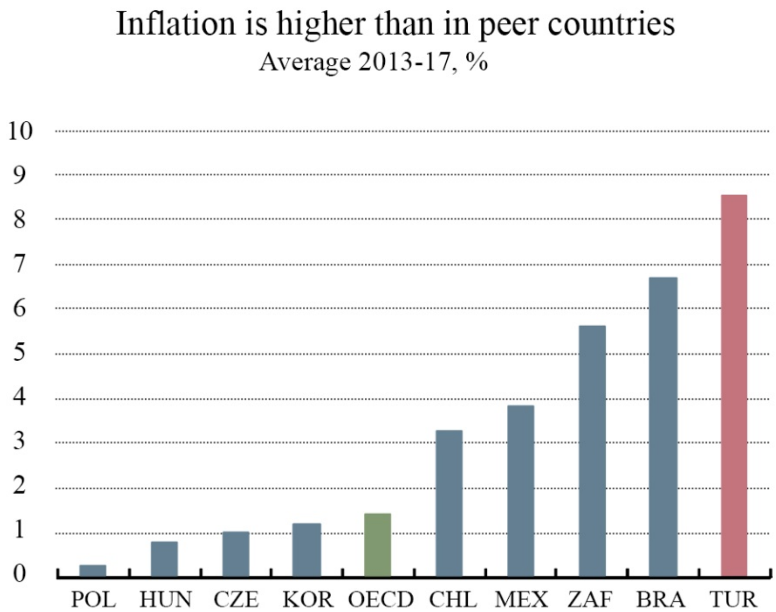

Figure 7*: High inflation among peer countries*
Source: OECD Survey of 2018

Reciprocal to these drawbacks, re-adjusting the macroeconomic policies to the medium-term program and maintaining reforms launched in early 2018 to line up the conditions with the international benchmarks shall facilitate restoring predictability and improve confidence in government body after the elections. Sharp spike in funding rate imposed by the Central Bank and simplifying the monetary policy to align with international standards will be helpful to turn things around. Preserving the desirable conditions for upcoming integration of

Turkish industry to the global value chains and subduing inflation to maintain competitiveness will be a crucial goal for the authorities.

Current Situation

Following one of the best economic growth performances among equivalent countries in the second quarter, the economy is revealing a slowdown which is perceived by investors to transform into a technical recession towards the end of the year.

Gross Domestic Product increased 5.2% during three months since June which has been in accordance with the median anticipation of 5.3% in a survey from Bloomberg. Although Turkey maintains its seat among the fastest growing economies, a thorough look into the data demonstrates that the consumers and the investors have started to hit the brakes. By keeping government spending and exports at a reasonable level, a more severe slowdown is prevented.

Turkish economists share that, the rapid depreciation of Lira, though being beneficial for exporters, will push government to diminish spending and Central Bank to increase borrowing costs to balance the financial markets.

“This is just a prelude to a deeper slowdown that will take hold in the second half,” Demir said. “I expect two consecutive quarters of contraction in the economy: a technical recession.”

The currency disaster came with some ramifications on Turkey’s real economy, causing a steep spike in the borrowing cost for corporations and consumers, and a huge decline in confidence. Economic outlook has deteriorated which resulted with negative revisions of growth estimates by financial institutions and credit rating agency, Fitch. As Berat Albayrak (Turkey’s Treasury and Finance Minister) said in a public statement, this slowdown in aggregate consumer demand will be more severe in the next quarter but rising revenues from tourism and exports will ignite the recovery of the economic balance. Moreover, he added that the current market volatility showed the significance of tackling high inflation and foreign trade inequalities.

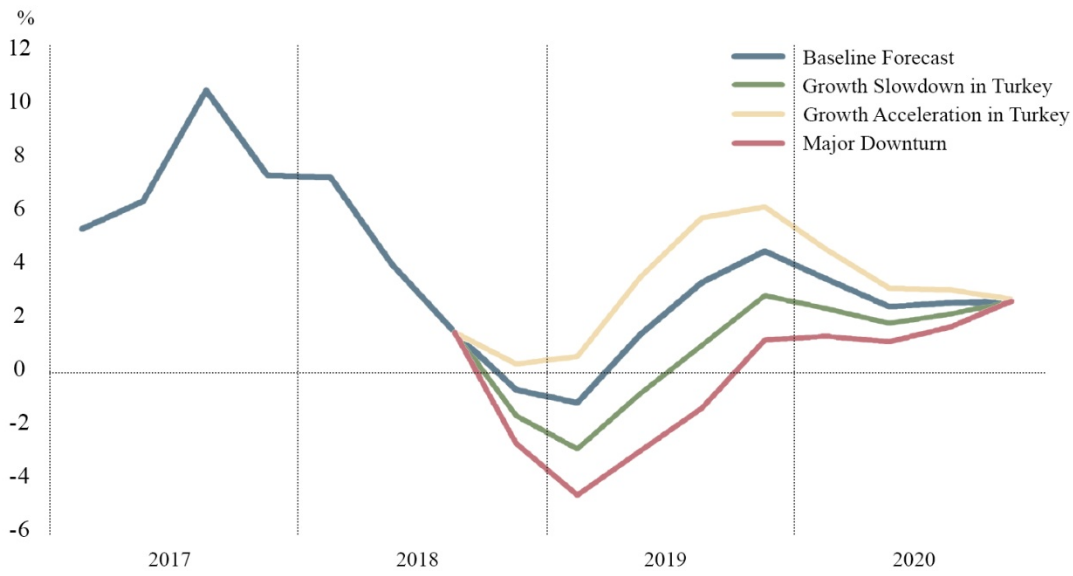

Figure 8*: Growth Forecast*
Source: Bloomberg.com

Stricter conditions and decreasing confidence in the private sector seem to be pushing the economy into contraction towards the end of 2018. The forecasters decreased the baseline GDP growth to 2.5-3.5 in 2018 and 1.3-2.7% GDP growth in 2019.

The baseline estimate is covered by major uncertainty. A worsening of the current sell-off in financial markets and bigger declines in private sector expectations would lead to sharper slowdown in growth. On the other side, an alleviation of the recent tensions with the US and a positive response from the investors to the medium-term fiscal program to be presented by the government in September may boost confidence and diminish interest rates.

Some reports show a stagnation in some sectors of business have started even before the market chaos really kicked in. Below are some points that summarize the current situation of Turkish economy (from Turkstat's GDP report):

- Private consumption, which is estimated to make up nearly two-thirds of the economy, grew 6.3 percent on an annual basis during the first three months of the year, slowing from a revised 9.3 percent in the first quarter.

- Government spending on consumption rose 7.2 percent from a revised 4.9 percent in the previous quarter.

- Spending on investments rose 3.9 percent from a revised 7.9 percent with construction expanding 6.6 percent and spending on machinery and other equipment inching up 0.6 percent.

- Exports rose 4.5 percent from revised 0.7 percent while imports increased 0.3 percent.

- Agriculture contracted 1.5 percent, compared with a 6.1 percent expansion; industries rose 4.3 percent, down from 8.1 percent.

- Expansion in services was led by banks and insurance companies whose economic output rose 12.1 percent, up from 3 percent.

3. EXTERNAL VULNERABILITIES OF THE TURKISH ECONOMY

Inadequate level of savings in Turkey continues to be the Achilles heel of the economy and most probably, will be in the future, driving a prevalent current account deficit. Credit Guarantee Fund, managed by the government, has boosted bank lending, therefore pushing banks' loan to deposit ratio up to more than 120% in 2018. In addition to increasing risks in the banking business, this circumstance also magnifies risks regarding the foreign exchange rates and impairs the rebalancing of the external deficit by boosting imports. Recovery of domestic consumption and recent rise in energy prices will create wider current account deficit in upcoming periods. Current account deficit/GDP ratio is 5.5% as of now, which, causes economy to be dependent on external financing and increases volatility in exchange rates. Exit plans and strategies of big central banks, considering also rising regional tensions, can easily repel investors, which in turn, limits foreign direct investments over the upcoming years.

After the first ten months, the total current account deficit in 2018 is $38.4 billion which is similar to $35.3 billion, value recorded within the same period in 2017. During the same period, the trade deficit stood at $51.1 billion which has enlarged the external gap, though revenues from tourism with $22 billion narrowed it. The largest portion of current account deficit belonged to deficits stem from gold and energy trading. Within the first 10 months of 2018, it was reported that trade deficits of $28 billion is from energy and $8 billion is from gold trade. Subtracting these factors results with 2$ billion of current account deficit. Gold is one of the major investments and saving instruments embraced by Turkish households. What is appealing to them about gold is its high convertibility when they need liquidity to match their liabilities. This high demand resulted with increase in gold imports.

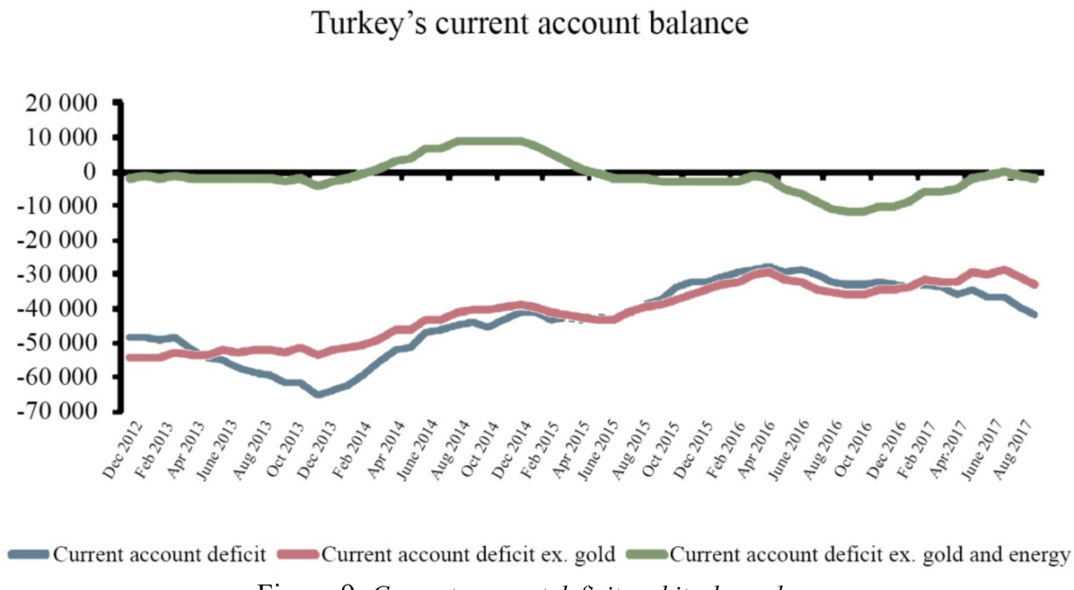

Figure 9*: Current account deficit and its dependency*
Source: Coface Turkey Report

The major vulnerability stem from the funding method of this current account deficit, as it is mainly financed by short term capital flows. In this period of 10 months, almost 70% of the deficit was backed by $25 billion of portfolio investments. There has been a slight decline in foreign direct investment and if this pattern prolongs, Turkey may become more reliant on short term capital to support the external gap. This factor inevitably would raise country's reliance on global investors and eventually aggravate its fragility against exchange rate shocks. In this circumstance. External funding provided by the banking sector will indeed continue to be essential financing source for the economy. Nonetheless, this flow of funds may become highly volatile should the domestic and regional instabilities escalate.

This obvious vulnerability of Turkey against external factors is very similar to those of Indonesia. South Africa and Mexico, countries with current account deficit but lower than Turkey. Although, Turkey is still able to attract foreign direct investments which is beneficial to cover some parts of its current account deficit. In spite of this positive factor, external debt of the country is going up and Turkey's gross external debt reached $456 billion which is equivalent of 53.5% of GDP. This will generate pressure on the future growth with the recent depreciation of Turkish Lira, especially when 25% of this debt is short term, which is high even among emerging markets.

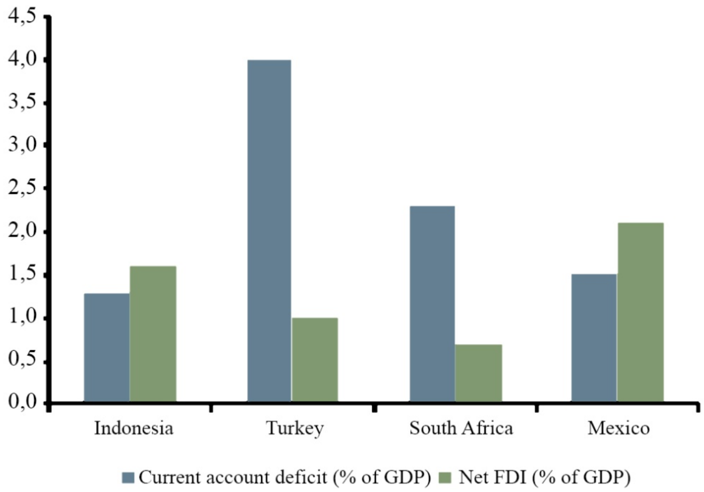

Figure 10*: Current account deficit vs FDI*
Source: Coface Turkey Report

All in all, it seems as the risks related to Turkey's short-term growth are sustained and debt levels are in a manageable level. Nonetheless, increasing inflation, unemployment and tax raises may damper private consumption. In the medium term, should the regional and domestic tensions hike, there will be an increase in the pressure of managing deficits. Along with these, the risk aversion of international financial markets to emerging markets and major central banks' policies will have a huge impact and they will be monitored. Last but not the least, another sharp depreciation of the Lira would have severe consequences in the future.

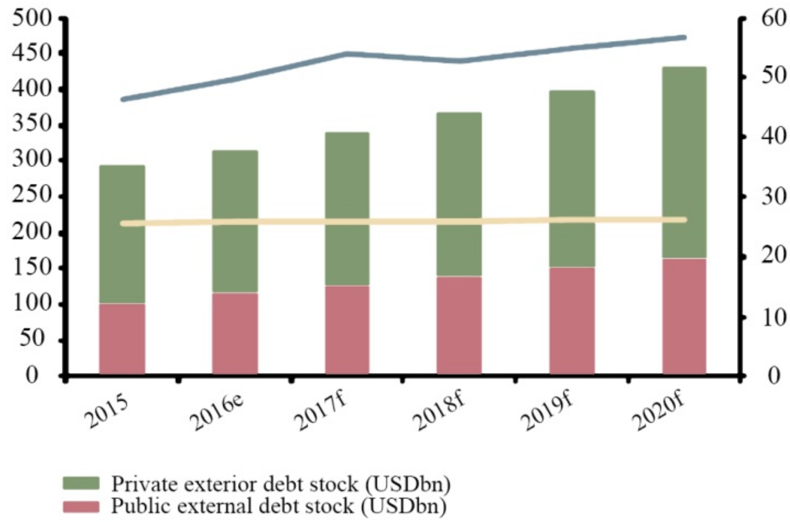

Figure 11*: External debt forecast*
Source: Coface Turkey Report

4. SOCIO-POLITICAL INSTABILITY AND ITS EFFECT ON FINANCIAL MARKETS AND THE ECONOMY

Political instability is globally considered by economist as a severe and serious discomfort which is harmful to economic performance. Political instability is very likely to abbreviate policymakers' anticipations leading to subpar short-term macroeconomic policies. Moreover, it can also initiate a pattern of frequent change of policies, creating uncertainty and volatility, thus, affecting economic performance negatively. Considering how damaging the consequences on economic performance, its scope of prevalence across the world and time is highly shocking. Political instability is measured by cabinet changes, meaning, the number of times within a year in which a new party is elected or 50% or more of the posts in the cabinet are occupied by newly elected ministers. This number understandably differ from region to region.

Unfortunately, concept of political instability and socio-political unrest coincides with the conditions prevailing in Turkey and its economy. Since 2015, the Turkish economy had to deal with successive two general elections, the notorious July 2016 attempted coup and its repercussions and many terrorist attacks with high fatalities. However, latest data shows that the Turkish economy attained a 2.9% real GDP growth in 2016. According to the policymakers, expectations were positive in 2017 and 2018 due to recovery anticipated at the end of 2016 with growing exports. In spite of the detrimental anti EU political quotes from some of the ministers, the economy team had pledged to strengthen economic relations with rejuvenation of Turkey-EU Customs Union. Meanwhile, low global oil prices and a moderate rise in interest rates in US are expected to alleviate foreign debt pressures, especially at corporate level. On top of that, business side has mostly welcomed the depreciation of Turkish Lira which is compensated by real appreciation between 2003-2010.

However, much like to any other Middle Eastern country, Turkey's geopolitical location and internal tensions always pose risks to this positive outlook. Externally, a probable bad management of the Syrian crisis or a sharp rupture in political relations with EU or one unpredictable move from Trump administration could cause a severe damage on the Turkish economy. Internally speaking, political instability was prone to be persistent irrespective of the results of the April referendum on presidential power. This constant election mode mentality is the main reason along with the habit of public statements of pointing internal and external enemies by every member of Justice and Development Party (AKP). Two other referendum about the EU and capital punishment are being discussed.

In the environment of this political instability, economic policy must be adjusted to be reactive to try and conquer domestic and regional disturbances and usual crises with trading partners. In fact, this was adequately demonstrated after a Russian jet was shot down in 2015 and reciprocally, Russia prohibited charter flights to Turkey temporarily which impacted tourism, 13% of export receipts, negatively. As a countermeasure, macroeconomic policy was set to address the shocks to growth and to gain votes by promoting credit and investment incentives. The disadvantage of this policy stand point is the chronic depreciation of currency and increasing inflation.

Huge foreign payments deficit (25% of GDP), along with the political risk, keeps on putting pressure on Turkish Lira. Although monetary policy was tightened, inflation hit shocking 25% by the end of October, 2018 due to depreciation and fiscal stimulus. This is mainly due to multiplying import prices therefore overall prices in the country.

Monetary policy is trapped between internal pressures to maintain growth and global markets searching more definitive action. The central bank, in the meantime, seems to be working on alleviation of volatility created by speculations. The CB is accepting the depreciation of Lira caused by global powers like capital flows and fluctuations in the US.

In the meantime, prudential policy is utilized to dampen the negative domestic impacts of the weak currency. This is a reasonable stance, considering limited foreign currency reserves of Turkey. Nevertheless, in order to function properly and to be protected by rapid depreciations, the policy needs to have a stricter fiscal stance rather than constantly resorting to fiscal stimulus.

Another weakness of the current policy mix is that mostly domestic demand is driving the growth since the global financial crisis. This situation aggravated by global slowdown of the economy and negatively affected exports by regional conflicts. This led to the accumulation of imbalances. Credit has grown very fast, relative to the GDP it has nearly doubled in the last ten years to about 80%. There is definitely a room for credit growth especially in an economy with the size of Turkey's, however, its pace is concerning in cyclical sectors such as real estate and construction. Even though the public debt is low, rising state investments attributed to list of mega infrastructure projects suggest that liabilities must be controlled.

4.1 Events That Changed the Course of Economy

In this part, we will examine the events that changed the course of economy and how they affected investment decisions of both domestic and international investors. These selected events took place in recent years and they are mostly popular in all over the world. We will start with Gezi Park Protests of 2013, proceed with the Coup Attempt of 2016 and finish with Pastor Brunson Incident of 2018.

4.1.1. Gezi Park Protests and Its Impact on the Economy

This government, who took over the power after an economic crisis, was aware that in order keep its electorates, it was necessary to maintain prosperity feeling in public. This feeling was created by the rising in overall production. Following the end of this economic program of previous government in 2008, the economy was in lack of a feasible program. Realizing that the 2009 economic crisis was in fact affecting the governments voter base, they decided to employ expansionary policies with the support of fiscal and monetary policies. The main common feature of these policies was to encourage aggregate demand rather than increasing production. As a natural consequence, rising appetite and demand for consumption led to foreign debt and eventually trade deficit.

Two main instruments of the government in this expansionary policy were public spending and construction business by both public and private. This wild construction is unfortunately noticeable in every corner of the country. The most popular type of new structures is malls and the growth can be seen in Figure 12. Another reflection of this process is that private investment has been focusing on real estate and construction rather than R&D or industry. Bottom line is that government did not only spend on construction but also lured private business into this process.

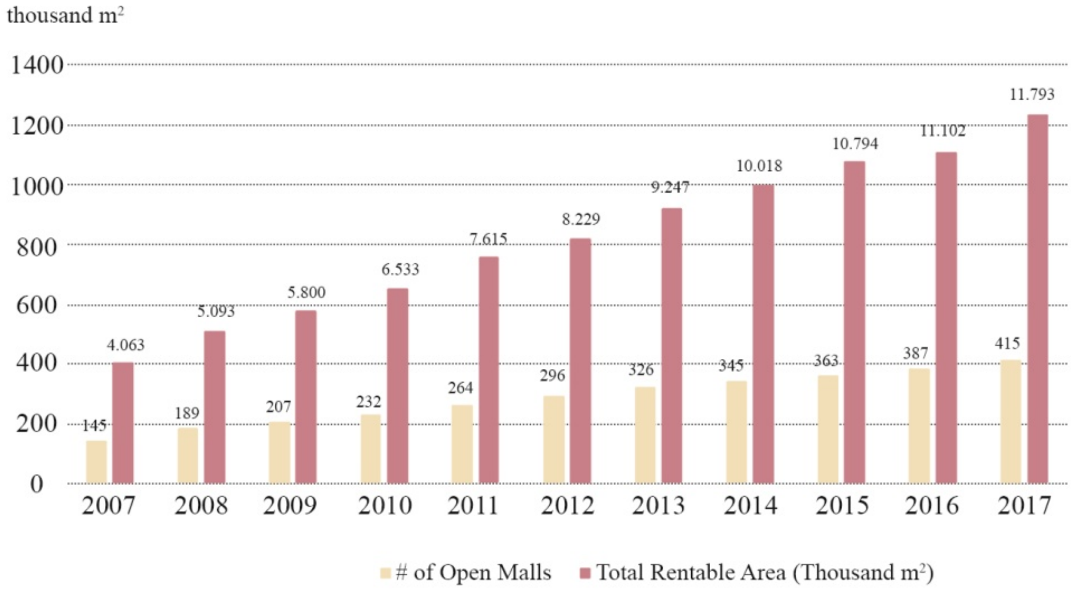

Figure 12*: Number of malls in Turkey*

This was the background which eventually led to the protest. Two significant points we need to highlight are the huge debt causing the deficit and its leverage effect leading to vulnerable state of the economy and increasing demand due to construction projects and public spending. Therefore, it was not a surprise that the reason why these protests started was the reaction to this mentality. This mentality is just a delusion that boosts the economic indicators but in a severely unsustainable way. Considering that construction sector comprises the biggest part in production and fund transfers, the non-proportional reaction of the police is understandable against the protests.

It is reasonable to think that the domestic and foreign lenders would be highly sensitive to politic situation in the country, considering how dependent the Turkish economy is on foreign funding. During the protests, in a time in which the risk perception and sensitivity spiked, as it has always been, domestic and foreign investors immediately disposed of highly liquid stocks and bonds and bought foreign currency which led to fall in stock market, rise in bond interests and Lira depreciated quickly against foreign currencies. One should realize that the reason behind this is the lack of structural reforms which should improve production capacity rather than encouraging consumption and effort to finance the trade deficit with portfolio investments.

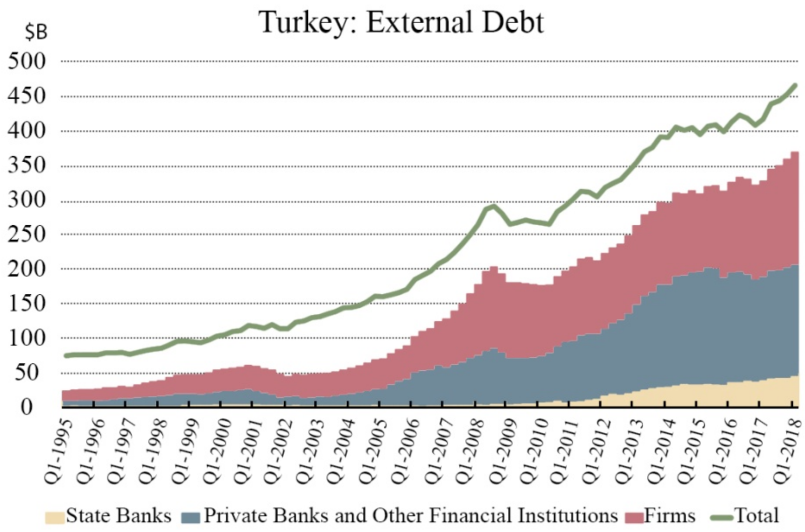

Figure 13*: Breakdown of external debt*
Source: Turkish Treasury Website

4.1.2. The Coup Attempt

A coup d'état was intended on July 15th, 2016 in Turkey in opposition to government and its institutions and the president Recep Tayyip Erdogan. The attempt was conducted by a fiction embedded in the Armed Forces of Turkey that established their group as the Peace at Home Council. They had attempted to take control of multiple critical places in Istanbul, Ankara, and many other major cities but failed thanks to loyal informal forces defeated them.

There was quite a shock within the nation due to this unexpected uprising. It would not be wrong to say that no one was anticipating something this organized and potentially dangerous. It was not easy to predict how the financial markets would react to this major incident and since this happened on Friday, the anxiousness prolonged 2 days more until the money markets opened.

Following the failed coup attempt of July 15th, day to day economic activity seemed to bounce back to normal surprisingly quickly. There were no queues at banks even though there were rumors that banks were going to confiscate funds temporarily; public services have continued to be functional and shops reopened immediately after violence stopped and airports resumed normal services. Nonetheless, this unexpected military coup attempt and the corresponding reaction of the government which involved a declaration of three months of state of emergency have increased uncertainties about economic and political outlook for Turkey which had already instabilities before the event. Consequently, aforementioned anxiousness about the financial markets was so high that, given the severity of the events, it did not result as bad as expected. Turkish Lira which was trading at about 2,88 against US$ before the coup stood at 3,08 on July 21st. In the four days of trading from July 18th until 21st stock prices in the BIST 100 fell by 9,6%, counteracting all the gains accumulated in a period that initiated in mid June. In the meantime, the yield on the two-year government bond fell back by about 100 basis points to 9.6 percent.

The nervous response of the financial markets had indicated that the failed coup attempt would impact the economy more in the long term rather than short term. On July 18th, while trading resumed after the attempt, shares of Turkish Airlines fell 12.5%. Istanbul's main airport which had to be closed due to coup attempt took weeks to operate at its full capacity. Even before the coup attempt, number of foreign visitors had already been low by standards, affected severely by sanctions imposed by Russia and numbers of terrorist attacks. Therefore, this incident caused more discouragement in visitors' eyes which dampened economic growth and boosted unemployment.

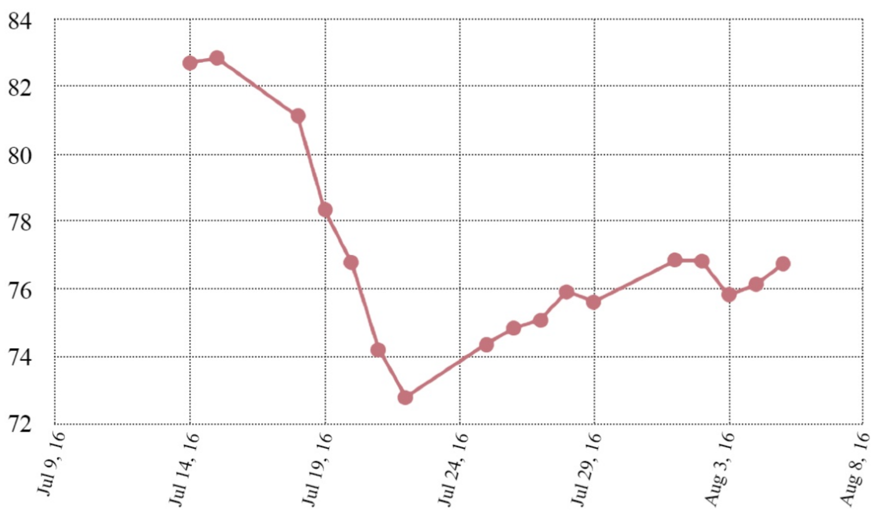

Figure 14*: Istanbul stock exchange after the attempt*

On top of everything, rating agency S&P downgraded Turkey's credit rating from BB+ to BB after the coup attempt stating that: "Following the attempted coup in the Republic of Turkey on July 15, we believe the polarization of Turkey's political landscape has further eroded its institutional checks and balances. In addition, we expect a period of heightened unpredictability that could constrain capital inflows into Turkey's externally leveraged economy. The negative outlook reflects our view that Turkey's economic, fiscal, and debt metrics could deteriorate beyond what we expect, if political uncertainty contributed to further weakening in the investment environment, potentially intensifying balance-of-payment pressures."

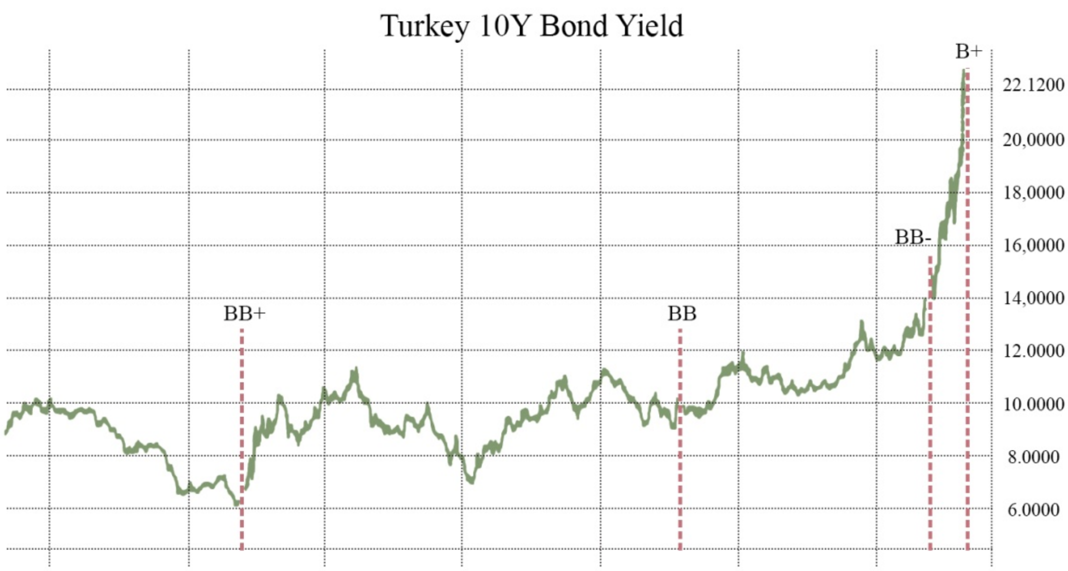

Figure 15*: Credit ratings of S&P*
Source: Zerohedge.com

4.1.3 Pastor Brunson and Trump Incident

Interest rates in developed economies have been at historical lows after the global financial crisis of 2008. International investors have been turning to emerging markets to chase more fruity rates of return on their investment. Turkey has been a compelling destination thanks to the economic reforms in the early 2000's with an increasing growth at 6.9% average between 2010-2017 and its large domestic market. However, Turkish banks and major companies have been borrowing heavily from international investors, usually in US dollars. Turkey's massive annual current account deficit has been supported by foreign financing which was easily found due to country's conditions. Increasing reliance upon external financing made its economy vulnerable to changes in availability of credit. Furthermore, Turkey's cost of financing rose as the FED started increasing the interest rates. In addition to this, Turkey's creditworthiness in the eyes of investors has deteriorated by large amount. Investors began to question the sustainability of the construction boom and expansionary monetary and fiscal policies in the period prior to June 2018 elections. Rising political tensions between US and Turkey also aggravated the investor confidence. In August 2018, Trump administration ruled sanctions on two Turkish ministers held accountable for detaining and American pastor whose release was demanded by President Trump.

As investors grew more hesitant to invest in Turkey, demand for Turkish Lira began to fall very quickly and currency depreciated. Following that, the nominal value of Turkey's debt rose which increased concerns of the investors even more and made them more reluctant, therefore pushing the value of Lira more in a vicious cycle. On August 10th, President Trump shared his concerns about Lira's depreciation while announcing on Twitter a doubling on tariffs of aluminum and steel imports under national security concerns. Immediately after the tweet, Turkish Lira fell even further.

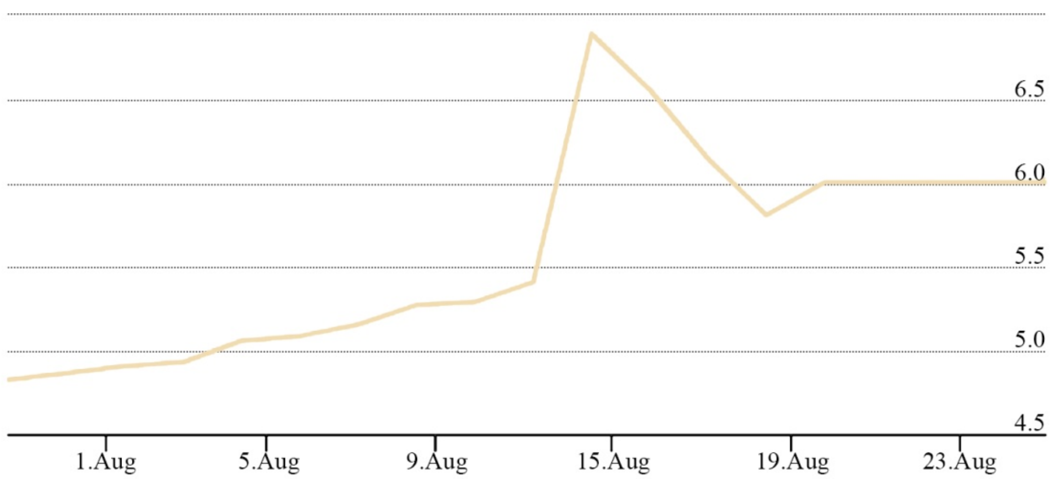

Figure 16*: Quick depreciation of Turkish Lira vs. US Dollars*

4.2. How Does Terrorism Effect the Economy and Investment Strategies?

While considering the economic aftereffects of terrorism, first aspect that comes to mind is the uncertainty that appears in every part of the entire economy. According to a research (Blomberg, Hess 2004) the more the number of attacks, the less the number of investments and the more government spending. Considering from the companies' point of view, from raw materials to end products, the entire supply chain is under severe risk of terrorism. According to Simon (2002:56), multinational corporations are more vulnerable against terrorism because companies and corporate symbols are highly attractive to terrorists. Advanced financial centers, airports and petrol distribution channels also carry high risk of terror attacks. An attack against factories, production and distribution systems and IT systems may cause severe harm to the economy. In addition, increased risk and uncertainty due to terrorism limits the employment in the entire country.

In some cases, even though the risk of terrorism is diminished, extra security measures may be perceived by the public as if there is still a threat. This perception is reflected upon consumer behavior. Those extra measures that leads to insecure feelings change the capital allocation plans and investments can be postponed.

When we look at the previously applied policies against terrorism threat, we observe that mainly border and customs controls have been reinforced and immigration policies became stricter. These precautions inevitably lead to rising international operating costs up to 3%. Domestic market is also affected by this increase in transaction costs. Additionally, transportation costs related to the destinations of high risk rise accordingly which causes an impact on insurance premiums that are major parts of investment costs.

Increasing risk of terror will have a negative impact on operation strategies. Risk assessment has always been one of the primary actions taken by international entities prior to their investment decisions for critical countries. Most popular index is BERI (Business and

Environment Risk) for this purpose. Slightest hint about the situation in a country may alter massive investment decisions which also leads to changes in foreign trade.

The threat of terrorism also amends the type of an investment. Not only the number of investments decrease over time but also, they change into short term investments. Subsequent to the uncertainties related to the hostile environment, entities avoid making long term plans and organize itself to be ready to move to another location anytime necessary.

4.2.1. Changes in Consumer Behavior

The impact of terrorism on consumer behavior and psychology is also a crucial determinant of economic success of a country as it affects investment strategies and subsequently the economic growth. Consumption and savings may be affected by terrorism in various ways. It increases perceived risk. Mostly affected fields by the consumer concerns have been service sector which includes tourism, transportation and insurance. Due to the heightened perceived risk, consumption level in this sector decreases which leads to withdrawal of funds to these fields that impedes economic growth. Moreover, terror threat may encourage individuals to invest in tax heaven countries rather than consuming.

4.2.2 Impact on Foreign Trade

Terrorism may pose various types of threats to foreign trade. First of all, trade costs hike because of the damaged environment of trust. Secondly, operating costs increase due to escalated security measures. Thirdly, there is an imminent danger for the goods and services that are used in the foreign trade. One example can be the attack made to petrol pipeline which impaired the exportation of petrol.

4.2.3 Impact on Foreign Direct Investment

Another investment mode that is negatively affected by terrorism is the foreign direct investment. Common consensus is that in an environment without trust and confidence, capital inflow would be minimized by the foreign investors. Some studies have supported this phenomena and 25 of the 28 models used to support this idea have shown that there has been at least 10% decline in FDI/GDP ratio (Abadie and Gardeazabal.2005,1).

On the other hand, the mentality of foreign investors has not always been risk oriented, on contrary, some of the investors values profitability and finding new trade partnerships. Even though global terror has been considered as a huge factor for investment decisions, this factor has not retained investors from investing in developing countries after 9/11 attacks. According to UNCTAD, foreign direct investment in developing countries has risen 200% between 2000-2004. In the same period, FDI in developed countries fell 27%. One should consider these numbers with the fact that most of the attacks occur in developing countries like Turkey.

Research Data from Turkey

There have been several studies analyzing the correlation between terrorism and its impact on foreign direct investment. One of these studies (Omay, Takay. 2014) considers the data recorded in between 1991 and 2003. The research aims to contribute to the literature by checking the existence of a potential non-linear relationship between terrorism and foreign direct investment. The data used to determine the severity of terrorism were collected from newspapers and therefore it is somewhat limited in terms of signaling. Empirical evidence from the linear and non-linear models confirms that it has a massive negative impact on foreign direct investments.

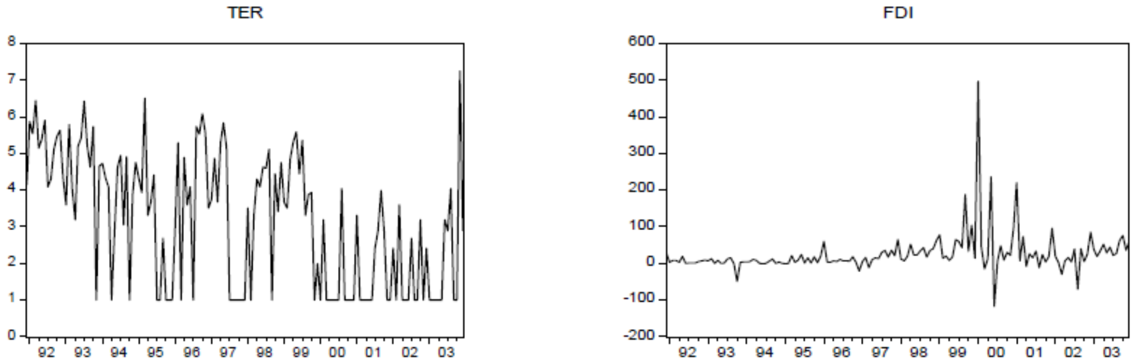

Figure 17*: Correlation between terror activity and FDI*
Source: The effects of terrorist activities on foreign direct investment: nonlinear evidence

One of the many studies done in this area investigates the relationship among terrorism, foreign direct investment and portfolio investment (Akinci, Yilmaz, 2015). The causality analysis between the mentioned variables indicates the correlation between them. As the results demonstrate, terrorism increases the risk factor and decreases the reliability of the country and therefore has a negative impact on the economy of developing countries.

Panel				
Model / Değişken	22		23	
	Katsayı	*t* İstatistiği	Katsayı	*t* İstatistiği
C	1.15E+09	0.512	-4.34E+08	-0.197
ΔFDI(-1)	0.367^{***}	5.847		
ΔPI(-1)			0.132^{*}	1.907
ΔTEROR	$-7.51E+08^{*}$	-1.964	$-1.37E+08^{**}$	-2.341
ΔTEROR(-1)	$-1.07E+09^{**}$	-2.561	$-4.04E+08^{*}$	-1.927
ΔFA	2.036^{*}	1.983	0.001	0.032
ΔTEROR x ΔFA	0.167^{**}	2.308	0.112^{**}	2.240
EC(-1)	-0.766^{**}	2.242	-0.337^{*}	-1.890
Birim Etkisi	Evet		Evet	
Zaman Etkisi	Evet		Evet	
Modele İlişkin İstatistikler				
R^2: 0.674 F: 2.190^{***} (0.000) DW: 2.057			R^2: 0.447 F: 2.336^{***} (0.000) DW: 2.117	

Figure 18*: Negative Correlation between FDI and Terrorism*
Source: terörizmin doğrudan ve dolayli yatirimlar üzerindeki etkisi

There is another research conducted to investigate the causality between terrorism and foreign direct investment (Ak & Inal, 2017). This investigation was carried out by using co-integration and causality tests for the period between 1980-2015. On contrary to the current literature, the relationship was primarily analyzed with hidden co-integration approach and the results showed that there is no co-integration bond between terror attacks and foreign direct investment. Secondly, asymmetric causality relationship was analyzed only to show that there is also no causality between terrorism and FDI in contrast to the current studies in literature. The authors explain the results in three points: a) Economic factors are the main actors affecting the amount of FDI, not the political factors, b) Since terror attacks in Turkey are concentrated mainly in regional areas, only FDI of that region is generally affected and c) Terror attacks that do not directly aim the FDIs are not affecting FDI.

4.2.4 Impact on Stock Market

We always see the news of fall in stock market prices after the terror attacks. Stock prices represent the future profit expectations. Due to terror attacks;

1. Increasing safety measures bring up operating costs also decrease the aggregate demand which leads to downfall in profits.
2. Increasing uncertainty boosts risk premium.

Especially after 9/11 attacks, risk perception by the public and the investors has changed and diminished the demand for airways and hotels. In the meantime, insurance companies increased the premiums seeing that planes are usable in the attacks. This has caused a fall in stock prices of major airlines. Stocks of these airlines has shown to be exposed to more systematic risks than other stocks which forced investors to avoid them in their portfolios. This was the second source of pressure on airline company values.

Due to the rapid flow of information, uncertainty in the capital markets may affect the decisions so quickly that it can lead to panic. Since the investors have immediate access to information, they usually neglect the firms' current and future performance while assessing them in terms of their coping ability with political, social and economic changes. Market indexes and foreign exchange rates reflect the individuals' capital allocations and portfolios and therefore, a negative or a positive movement of a market represent the total allocation of capital and the liquidity in the market determines the magnitude of negative impact of terror attacks. Higher liquidity facilitates to bring back confidence in the market.

Research Data from Turkey

There are several studies that demonstrate how the terror attacks had an impact on stock markets in Turkey. In this part, we will analyze the results of some of the studies and reach a conclusion as to how much of an impact terror attacks impose on securities market.

There is a statistical analysis conducted to monitor the correlation between terror attacks in Turkey and stock exchange of Istanbul (BIST)(Korkmaz & Erer, 2017). The data collected for this study covers BIST-100 closing prices recorded between January 02, 2009 and December 31, 2014. The data were taken from the database of the Central Bank and the Global Terrorism Index. The authors benefited from EGARCH and GJR-GARCH statistical models to analyze the impact of terrorism on the volatility of financial markets and its sensitivity to positive and/or negative events. According to the results of this study, there is not a considerable correlation between terror attacks and changes in stock prices. Also, the authors think that terror is not a significant risk factor in the financial markets.

Another study also examined the potential existence of correlation between terrorism and BIST (Algan,Balcilar,Bal&Manga, 2017). In this research, daily closing prices were taken as the main data recorded between January 4, 1988 and May 24, 2016. Return series were acquired from Thomson Reuters database and were calculated as logarithmic return percentage. Regarding the terror index, they used the formula created by Eckstein and Tsiddon (2004) which involves number of deaths, number of injured and number of terror attacks. For these inputs, data were extracted from Global Terrorism database. The results of this study show that there is no apparent correlation between terror attacks and volatility of the financial markets. It is also found that there are clear impacts exerted by terrorism upon tourism and food industry which in the long term, due to uncertainties, have a negative impact on financial sector.

Last study that worth mentioning was conducted by Mine Aksoy in 2014. The data collected was recorded in between 1996 and 2007 and it was obtained from BIST-100. In the paper, the author focused on the impacts of terrorism on the stock exchange market volatility of returns. The author used two different methodologies which were abnormal return and time series analysis. According to the results of this study, although some of the incidents in the sample gave high negative returns, most of them were not significantly abnormal in statistical terms in the day of incident (t=0). However, after consideration of an extended period as 5 or 10 days, cumulative abnormal returns showed that they are statistically important and proved that stock market had declined the following days of the incident and it is sensitive to terror attacks in a relatively longer term.

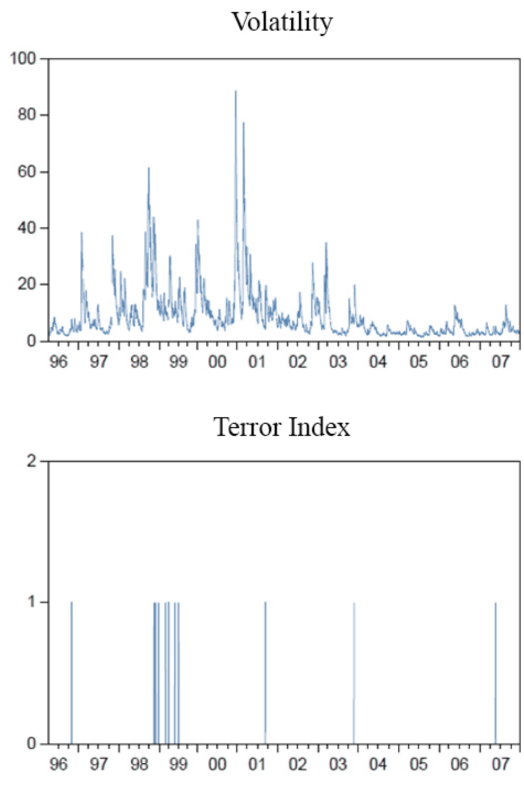

Figure 19*: BIST-100 vs terror activity*
Source: The effects of terrorism on Turkish stock market

4.2.5 Impact on Gold Market

The most important reason of the demand for gold as an investment instrument is to make profit out of it. In the times of high future expectations for the gold market attracts investors and speculators to increase demand. These investors and speculators buy gold with the current level prices just to sell it at the levels that they have anticipated. While This investment can be performed as purchase of bullion or coin it can also be done via directly a bank with opening a gold account.

Determinants of demand for gold in a global market can be listed as the price of the gold, interest rates, inflation rate, economic growth, exchange rate and international political tension which can be considered as macro and micro factors. Returns from other investment instruments are also significant factors in the determination of demand for gold. It is usually observed that demand for gold is higher when the one for other options is lower. Moreover, when the return of real interest rate is negative, stock prices are going down and attention on securities market is low, interest for gold spikes and vice versa.

In the Turkish market, expectation is the most significant determinant in pricing. Keeping in mind that gold is a protection vehicle from the adverse effects of inflation and uncertainties, future expectations of inflation and uncertainties definitely increase the demand for gold. Characteristics such as being independent, highly liquid and moveable increase the demand in difficult times. For instance, the 9/11 attacks and a declaration from US government saying that they would not avoid any military operation against Iraq, created an apprehension in the financial markets which led to high demand fot gold as a safe investment instrument.

Research Data from Turkey

It is not an easy task to find many studies analyzing the potential correlation between terror attacks and gold prices however there is a research done to investigate the relation between these two concepts. The author accepts the fact that terrorism incidents create uncertainty and volatility of the financial markets which increases the motivation of investors for safer investment instruments. In the environment of uncertainty, rational investors are expected to avoid risky instruments such as long-term bonds and prefer safer ones such as precious metals. Therefore, the demand for gold is expected to be higher in times of uncertainty. This study tries to depict the impact of news of terrorism on the gold market. The author follows Granger Causality method to analyze the big data taken from BIST database and news archives. As a conclusion, it was found that there is no any causality effect of terrorism news on the gold prices.

Dependent variable: ALL

Variable	x^2	df	Prob.
ALL_D_Gold	2.328611	2	0.3121
ALL_D_Silver	2.219737	2	0.3296

Dependent variable: TR

Variable	x^2	df	Prob.
ALL_D_Gold	5.072083	2	0.0792
ALL_D_Silver	1.602067	2	0.4489

Dependent variable: TR

Variable	x^2	df	Prob.
ALL_D_Gold	1.792837	2	0.4080
ALL_D_Silver	2.603508	2	0.2721

Figure 20*: Gold prices vs. Terrorism*
Source: The Effect On Precious Mine Markets On Terrorism News

4.2.6 Foreign Exchange Rate

Economy in Turkey has been able to sustain its growth patterns since banking crisis of 2001 even though there have been low growth rates occasionally. However, negative indicators in macroeconomic sense such as inflation, interest rates and unemployment have also risen over this period and in recent rimes. In this environment, foreign exchange rate possesses high significance among the financial indicators. Foreign exchange currency rates were fixed before 2001 and after that year it increased slowly until 2013 and boosted rapidly after 2014 in Turkey. They have reached their maximums in the summer of 2018. The increase in foreign exchange rates usually forms as a spike rather than slow trends. Uncertainties and uneasiness in the country impacts negatively the economy hence, the foreign exchange rate.

Rapid fluctuations in exchange rates induce uncertainties and uneasiness on the economy and the households. Abrupt rise of exchange rates directly increases the price of imported intermediate goods which leads to higher prices of finished goods. This increase in prices inevitably decreases competitiveness of domestic producers in global markets. Therefore, instant changes in exchange rates cause severe damages on the economy and disturb the economic indicators. In this extent, especially the central bank, always try to stabilize the rates by using monetary policy instruments.

One of the factors creating aforementioned uncertainties is the threat of terrorism. In this part we will examine the studies done to analyze the correlation between exchange rate fluctuations and terror attacks.

Research Data from Turkey

One of studies (Cinar, Yilmaz, 2017) investigates the effect of terrorist attacks in Turkey on the foreign exchange rate fluctuations between the period of 2001 and 2017. Using expected volatility model, the results shows that volatility rises in times of uncertainty resulting from attacks or crisis. However, high volatility is observed mainly when there is no consistency or stability in the economy. Therefore, the results point out that consistency has a positive impact on exchange rate volatility. After this point, it is not difficult to make the connection with the terror attacks as to it is apparent that increase in the number of attacks also increases foreign exchange rate volatility, but they are more effective in the times of economic inconsistency.

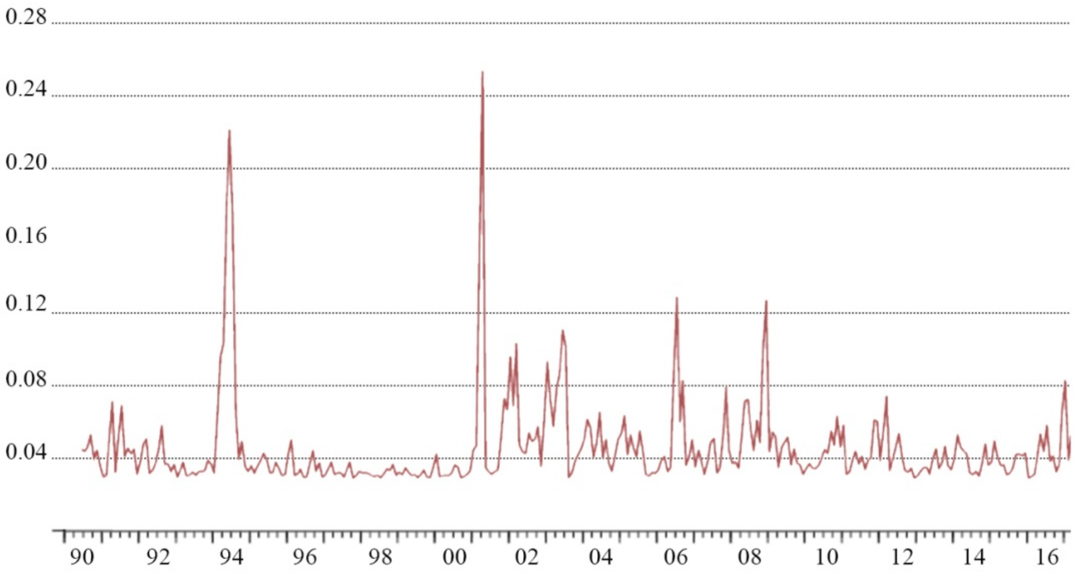

Figure 21*: Foreign Exchange Volatility*
Source: The Influence of Terrorist Events on the Volatility of Foreign Exchange Market

One other study of many also examines the impact of terrorist attacks on exchange rates, specifically Pound Sterling (Maitah, Ugur, 2017). On top of its main objective, this study also aims to contribute to literature, policy making and business. What makes this study different than the others is that instead of generic exchange rates, the author is examining the correlation between terrorism and Pound Sterling and aims to provide information to the policy makers and business world for timely and effective interventions. In order to achieve these objectives, the author employs the ARDL (Autoregressive distributive lag) bound testing as an estimation technique. According to the results of this study, the analysis shows that terror attacks have negative impact on the exchange rate, both in the short run and the long run, although the effect on long term is much superior than the one on short term.

Dependent variable: D(EXC)

Variable	Coefficient	Std. Error	t-Statistic	Prob.
D(TER)	-0.002117	0.000663	-3.192802	0.0018
C	0.010292	0.007391	1.392620	0.1666

Figure 22*: Statistical results of the correlation*
Source: The Impact of Terrorist Attacks on Foreign Exchange Rate

4.2.7 Summary of Impacts on Exchange Rates, Gold Prices and Stock Market After Incidents

Studies have shown that there is a correlation between foreign exchange rates and terrorist attacks. It is reasonable to think that massive negative incidents that leads to chaos and uncertainties would affect aggregate reliability of a country and therefore causes its currency to devaluate against foreign exchange rates. In order make these studies clearer, it is highly beneficial to examine how the situation was in that specific time of an individual incidents. There have been seven major attacks between 2015 and 2017 with big number of fatalities. From the numbers, we can see that foreign exchange rates have gone up after every single event. This shows that demand for Turkish Lira declines after each terrorist attack. Reasonably, investors consider these attacks as a negative sign for the country's future hence their investments. However, even though usually changes in exchange rates reflect on gold prices, this is not the case after the terror attacks, at least not immediate as the exchange rates. Individual examples show that there is not any apparent immediate impact of incidents on gold prices. This makes sense from the point of view of Turkish household as they prefer gold as a long-term investment, not as a daily precaution instrument. Lastly, when we look at the reaction of the stock market, it is obvious that after every major incident, there is a crash in the market. This observation means that trust is not lost only to the country but also to the firms. Since, the stock market dynamics rely on the future expectations and speculations, it is obvious how these negative incidents have an impact on the stock market.

5. INTERPRETATION AND CONCLUSION

Turkish economy has always had its ups and downs throughout its history. With the beginning of the republic period, it has always been in a development stage especially after 2000 reforms. As many other developing economies, Turkish economy has always found itself uncertainties resulting from always-changing political environment, modernization of public mentality, socio-political unrest in every corner of the country and most importantly, external factors.

In this paper, the focus was on the uncertainties generated by socio-political unrest and terrorist attacks and their impacts on the economy in general, along with the investment decisions made by individuals and institutions. It goes without saying that, uncertainties always pose a threat to the economy and its stability. Investors tend to play safe or play risky to earn higher returns on their investment. However, the condition of the economy in Turkey changes so quickly and abruptly that it is difficult to anticipate the uncertainties. However, looking at the results of many studies, we can see that socio-political unrest factor is much more dominant and decisive on the financial stability rather than terrorist activity. This may be because of the fact that the country has become immune to these kinds of news and they have little or no impact on the course of economy. On the other hand, protests, uprisings or political frictions cause tremendous damages that may not be recoverable in the future. They affect the exchange rate and cause the depreciation of the Lira or cause stock market to crash and repel the investors. These kinds of disturbances are less expected than the terrorist attacks thus they cause more damage. But why is Turkish economy so vulnerable and sensitive to any uncertainty? First of all, Turkey is not self sufficient enough and too dependent on external financing. Huge current account deficit is mainly financed by foreign portfolio investments. Not only financing but also Turkey is dependent in terms of energy supply to foreign powers. If a country has these many bonds with foreign factors it is exposed to severe risks including the financial risks. Secondly, there is no political or social peace in the country. When there too many opposite and highly diverse ideas or opinions in the public, disturbances will always happen.

Consequently, as long as the GDP of Turkey depends on construction business or any other unsustainable field and as long as the individuals of the country are not able to find a common idea to support, Turkey will always be fragile and vulnerable to any internal or external threats. It is crucial for this country to be self sufficient and politically and socially be stable in order to return to its rapidly developing characteristic.

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