



Causality Relationship Between Government Stability and Trade Openness: The Case of Turkey



Hükümet İstikrarı ve Ticari Açıklık Arasındaki Nedensellik İlişkisi: Türkiye Örneği

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Abstract

International trade is very exposed to political risk and the existence of political risk components in a given market may cause problems in both export and import activities. Government instability is one of the political risk components that is related with trade openness. The paper examines the government stability-trade openness nexus for Turkey using Vector Error Correction Model (VECM) and VECM based Granger Causality test covering the period of 1984-2016. Results have shown that there is a unidirectional causality in the long run from trade openness to government stability. Because Turkey's production of final goods usually is based on imports, an increase in exchange rate usually floats trade openness in favor of imports. This creates foreign trade deficit. Worsening economic conditions affects the government stability. Due to the unfavorable picture and economic crises in Turkey, the average duty time of the governments established between 1990-2003 was one year. Despite this, export-led growth and highest amount of foreign direct investment within three election periods starting from 2002, enabled the individuals to grasp the importance of stability in governance. During the 2010s, Turkey struggled with the foreign trade deficit, high inflation and unemployment rates brought about by the high exchange rate, and the deteriorating economic situation caused the ministers in the cabinet and even the presidential system to change. Thus, the study concluded that trade openness may affect the policy-relevant implications and create government instability for Turkey through changes in exchange rates and depreciation of Turkish lira.

Keywords: Government stability, political risk, trade openness, Turkish economy, vector error correction model

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Öz

Uluslararası ticaret siyasi riske çok fazla maruz kalmaktadır ve belirli bir piyasadaki siyasi risk bileşenlerinin varlığı hem ihracat hem de ithalat faaliyetlerinde sorunlara neden olabilmektedir. Hükümet istikrarsızlığı, ticarete açıklıkla ilgili siyasi risk bileşenlerinden biridir. Makale, 1984-2016 dönemini kapsayan Vektör Hata Düzeltme Modeli (VECM) ve VECM tabanlı Granger Nedensellik testi kullanılarak Türkiye için hükümetin istikrar-ticaret açıklık bağımlı olarak incelemektedir. Elde edilen sonuçlar, uzun vadede ticarete açıklıktan hükümet istikrarına doğru tek yönlü bir nedensellik olduğunu göstermiştir. Türkiye'nin nihai mal üretimi genellikle ithalata dayandığından, döviz kurundaki artış genellikle ticaret açıklığını ithalat lehine dalgalandırır. Bu da dış ticaret açığı yaratmaktadır. Kötüleşen ekonomik koşullar hükümetin istikrarını etkiler. Türkiye'deki olumsuz tablo ve ekonomik kriz nedeniyle 1990-2003 yılları arasında kurulan hükümetlerin ortalama görev süreleri bir yıl olmuştur. Buna rağmen, 2002 yılından başlayarak üç seçim dönemi içinde ihracatın liderliğinde büyüme ve yüksek miktarda doğrudan yabancı yatırım bireylerin hükümet istikrarının önemini kavramalarını sağlamıştır. Türkiye 2010'lu yıllar boyunca da yüksek döviz kurunun getirdiği dış ticaret açığı, yüksek enflasyon ve işsizlik oranları ile mücadele etmiş, kötüleyen ekonomik durum kabinedeki bakanların ve hatta cumhurbaşkanlığı sisteminin değişmesine neden olmuştur. Bu nedenle çalışma, Türkiye için ticari açıklığın politikayla ilgili sonuçları etkileyebileceği ve döviz kurlarındaki değişim ile Türk lirasının değer kaybı aracılığıyla hükümet istikrarsızlığı yaratabileceği sonucuna ulaşmıştır.

Anahtar Kelimeler: Hükümet istikrarı, politik risk, ticari açıklık, Türkiye ekonomisi, vektör hata düzeltme modeli

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1. INTRODUCTION

The concept of risk, used as a variant of performance, is widely used in strategic management. According to Knight (1921), risk is a part of randomness that can be fully securable. The part of randomness that is not securable Knight defines as uncertainty. As a different definition, Miller (1992) stated "risk" concept as unpredictable results or changes in performance. Risk can occur as a result of organizations' exposure to internal or external factors. In this respect, risk sources are expressed with the concept of risk. For example, with the concepts of "political risk" and "competitive risk", risk sources are indicated. These two concepts relate the unpredictability of organizations' performance with uncertain environmental components (Miller, 1992).

Political risk, another subtitle of country risk alongside economic and financial risks, refers to the importer's failure to make the payment to the exporter or delay due to political problems such as coup, civil war in the importing country or the war situation between trade partners (Çalışkan, 2009: 19). Political risk can have an effect on various foreign firms and it can be in various ways, such as import and export controls, licensing, investment constraints and the movement of currency management (Yahaya, 2016).

Government instability is one of the political risk components and there are two complementary factors behind the relationship of government instability to the economy. First, government instability narrows the horizons of policy makers and causes them to implement suboptimal macroeconomic policies. Second, government instability shortens the visibility of monetary and fiscal authorities, leading them to make decisions that have no long-term impact (Aisen and Vega, 2011: 3). As a matter of fact, all actors in the goods and money markets cannot make sound predictions in an environment of instability and act restrictedly with the psychology of avoiding risk. In other words, governments that tend to constantly change their laws and economic regulations and shape the country's economy with their decisions constitutes risk for foreign investors (Ozbozkurt and Satrovic, 2018: 198).

At this point, political risk has an obscure impact that raises trade costs and decreases international trade activities. In the case of government instability, exports increase while imports decrease due to the increase in exchange rates. However, the decrease in imports due to the increase in the prices of the goods and services to be imported in terms of national currency will occur depending on the degree of dependence on imports of a country. The net effect of the change in import and export values will show itself on the current account balance. In addition, the increase in exchange rates will increase the value of foreign debt payments in terms of national currency, and this will have an impact on the external deficit (Şanlısoy, 2010: 209-210). While the effects of economic and financial risks on trade have been thoroughly analyzed, there has been little mention of political risk in the literature. For this reason, it is important to examine the relationship between government instability, which is one of the political risk component, and foreign trade in countries like Turkey whose exports are dependent on imports. In fact, there are just a few researches on the impact of foreign trading activities of countries (Bilgin et al., 2018: 486).

Turkey's most important partners in exports are European Union (EU) countries, the USA, Israel and some neighbor countries like Iran and Iraq. Turkey's main partners in imports are China, Russia, the USA, Iran and EU countries (Koşar, 2018: 23-25). From time to time, Turkey and its trading partners may face various political problems-government stability, corruption, bribery, coup attempts, terror incidents, ideological stratification etc. in their governance as well as they may experience a political crisis between themselves. Turkey-EU Syrian refugee crisis, Turkey-Russia aircraft crisis, Turkey-Israel Palestinian crisis, Turkey-Iran-Iraq regional crisis and Turkey-USA Iraq war crisis and visa restriction issues are among some main political problems for Turkey in the last three decades.

Government stability is a kind of common risk component in Turkish political history. The lack of longevity of the governments established in Turkey also affects the behavior of both national and international economic actors. It is expected that government stability affects international trade

activities for Turkey. Thus, this study aims to provide initial evidence regarding government stability-trade openness nexus for Turkey. Political risk in Turkey is not so much mentioned in the economics literature. Therefore, it will be a guide for future studies in terms of seeing the impact of government stability and other political risk measures (corruption, bribery, internal and external conflicts etc.) on international trade. The form of the paper is as follows: Section 2 includes a short overview of the literature. Section 3 lays out the data and methodology. Empirical findings and results are discussed in section 4. Concluding remarks are set out in the final part.

2. LITERATURE REVIEW

Although risk assessment is specific to businesses in political terms, the study of political risk in economic and financial literature for countries dates back to the 1960s. Although the conceptual boundaries of political risk have been studied since the 1970s, uncertainty seems to prevail in the early literature (e.g., Kobrin, 1978; Simon, 1984; Chermack, 1992). For countries, political risk assessment is basically focuses on discontinuities. Political risk can shape the trade of nations and determines the degree of risk (Fitzpatrick, 1983).

As stated in the previous section, there is a lack of literature on the effect of political risk on trade openness. In the empirical literature, there are a few studies on the export side of a trading activity. Among them, Fosu (2003), examined the effect of political instability on export activities in 30 Sub-Saharan Africa countries. The model was analyzed cross-sectionally for the period 1967-86. The paper concluded that there is an adverse effect of political instability on export growth. Moser et al. (2008), clarified that German public export credit guarantees have a statistically positive effect on exports. Besides, they opined that political risk is a strong factor for exports; therefore, political risk should be considered in empirical models of international trade. Bilgin et al. (2018) analyzed the determinants of Turkish exports to 43 member countries of the Islamic Development Bank from 1996 to 2015. The authors examined the influence of various policy risk initiatives on Turkey's overall exports in the importing countries. Political turmoil in the importing countries has been seen to be adversely correlated with Turkish exports.

There are also a few empirical studies on the import side of an economic activity regarding political risk-trade nexus. For example, Sidek and Hanif (2013), investigated the impact of political risk on imports in Malaysia. The paper used fully-modified OLS regression technique. As a result, they opined that the impact of political risk has an impact on imports in the long run and socio-economic conditions, law and order, and accountability should be improved to boost trade. Can et al. (2019), showed the impact of political relations on the foreign trade volume for the period 2005-2017 between Turkey and Russia, which is especially an important country for Turkey's imports. They used a time series regression analysis. The research concluded that the political crisis has a major and detrimental effect on the volume of foreign trade.

In general sense, the previous findings show that the existence of political risk in a country is considered as one of the main factors for withdrawal of exporting or importing activities. In fact, Al-Marhubi (2005), suggests that the standard of governance is strongly linked to openness in international trade. Bönnal and Yaya (2015) explored that increases in trade openness affect the stability of government. Besides, Şimşek (2015), in the study using panel data analysis for 66 countries between 2002 and 2013, states that government instability has a negative effect on foreign trade and investment by affecting economic relations negatively. Therefore "government stability" can be a leading factor in analyzing political risk-trade openness nexus. Using a simple two-period model combining a version of Armington international trade model, Grechyna (2017), found that higher political distortions lead to higher volatility of trade openness. Özek (2019), studied the trade openness-political stability nexus for EU member transition economies and found that there is a one-way causality relationship from trade openness to government stability for Bulgaria and Estonia. The increase in welfare in the transition economies where export-led growth takes place enables

individuals to grasp the importance of political stability. Furthermore, government stability may increase the level of economic development. For instance, Bayar and Yener (2019) investigated the impact of government stability on tourism sector development in Mediterranean countries including Turkey over the period 2002-2015. Using panel cointegration and causality analysis, they explored a bidirectional causality between tourism development and government stability.

Recently, Dankumo et al. (2020), examined the impact of governance in Sub-Saharan African countries on trade using panel data within the range of 1996 and 2017. They found that government instability reduces trade for Low Governance Index countries while it does not affect trade in Very Low Governance Index countries. Qadri et al. (2020) also investigated the impact of government stability on foreign trade and investment for Pakistan from 1976 to 2016. They applied ARDL model and found that government instability blocks both foreign trade and investment activities in the long-run. Besides, the government instability significantly hinders the foreign portfolio investment and exports in the short-run.

There are some theoretical studies (Kartal and Öztürk, 2017; Sürmen, 2019), empirical works (Arslan, 2011) regarding the impact of government stability on economic growth and empirical works (Ozbozkurt and Satrović, 2018) regarding the relationship between FDI and political stability in Turkey. However, the current literature does not have an empirical study regarding foreign trade-government stability nexus. Therefore, it is necessary to study this subject empirically.

3. RESEARCH METHODOLOGY

3.1. Data set

The data is comprised of time series data of political risk (POL) and trade openness (TRO) for Turkey annually. The data ranges from 1984 to 2016. "Government stability" is chosen as a political risk component for Turkey and the data is extracted from International Country Risk Guide Table published by The PRS Group. Trade openness means the sum of exports and imports of a country in a given period of time. Trade openness data as a percent of GDP for Turkey is obtained by the Global Economy Website. The logarithm of all series are taken in order to purify the series from small fluctuations and make them linear. Accordingly, LPOL denotes the government stability as a political risk measure and LTRO denotes trade openness of Turkey.

Table 1: The Data Used in the Model

Variables	Symbol	Source	Usage Style
Political Risk Component (Government Stability)	LPOL	The PRS Group	Logarithmic
Trade Openness	LTRO	Global Economy Website	Logarithmic

Source: Author's Compilation

3.2. Methodology

If the variables used in the econometric analysis are not stationary, there will be a regression fallacy problem, so it is essential to examine the stationarity of the data before starting the analysis. Various unit root tests are used to study stationarity. In the literature, ADF (Dickey and Fuller, 1979) and PP (Phillips and Perron, 1988) tests have been used extensively to find out the stationarity status of the series. Both tests may not be accurate for small sample data set due to their poor size and power characteristics (De Jong et al., 1992). Therefore, a newly proposed test, NG Perron (2001) is also applied alongside ADF test in this paper.

In the Johansen test, a long-term relationship between non-stationary variables is applied, provided that it is integrated into the same degree. The fact that the variables have such a linear composition means that there is a cointegration relationship between the variables (Engle and Granger, 1987). For this reason, Johansen method is a frequently used method to determine a long-term nexus between variables (Ari and Yıldız, 2018).

Johansen proposed two types of statistics to calculate the number of cointegration vectors. These statistics are the Maximum Eigenvalue and Trace statistics. If the trace test statistic is greater than the critical value and the eigenvalue statistic is greater than the critical value, the null hypothesis of no cointegration is rejected. Thus, the error correction model is applied after a long-term relationship is determined between the variables (Hjalmarsson and Österholm, 2007).

Granger (1988) claimed that in the case of a co-integration relationship between variables, it would be reasonable to use the Vector Error Correction Model (VECM) to evaluate the short-term causal relationship between these variables. The error correction model makes it possible to differentiate between long-term and short-term dynamics between variables and to determine short-term dynamics. For this function, an error correction term is inserted between the explanatory variables, representing the adaptation to the long-term balance, by taking into account the variations of the non-stationary variables in the first order. If there is a cointegration relationship, at least one directional causality relationship must be found (Karamelikli and Kesingöz, 2017). The error correction model adapted to the variables used in the study is expressed as follows:

$$\Delta POL_t = \alpha_0 + \sum_{i=1}^{p-1} \alpha_{1i} \Delta LPOL_{t-i} + \sum_{i=1}^{p-1} \alpha_{2i} \Delta LTRO_{t-i} + \Phi 1EC_{t-1} + \varepsilon_{1t} \quad (1)$$

$$\Delta TRO_t = \beta_0 + \sum_{i=1}^{p-1} \beta_{1i} \Delta LTRO_{t-i} + \sum_{i=1}^{p-1} \beta_{2i} \Delta LPOL_{t-i} + \Phi 2EC_{t-1} + \varepsilon_{2t} \quad (2)$$

For this purpose, Granger Causality Test based on VECM was applied for lagged values of variables (LTRO and LPOL) in Model (1) and Model (2). Statistically significant t values indicate a long-term Granger causality (Lebe and Akbaş, 2014; Topallı, 2015). Hypotheses are as follows:

H₀: Government stability (LPOL) is not the Granger cause of trade openness (LTRO)

H₀: Trade openness (LTRO) is not the Granger cause of government stability (LPOL)

4. RESEARCH FINDINGS AND RESULTS

Table 2 presents descriptive statistics. It can be observed that average government stability, as a political risk component (LPOL) is 1.99 % with standard deviation of 0.24 % and maximum of 2.31 %. Besides trade openness (LTRO) has a mean value of 3.74 % with a standard deviation of 0.18 % and a maximum of 4.00 %. Probability values of the Jarque-Bera statistics of LPOL and LTRO are greater than 0.05. This indicates the normal distribution of the variables. Distributions of LPOL and LTRO are slightly left-skewed. Kurtosis of LFDI and LTRO are lower than 3. This means that the distribution is platykurtic. The kurtosis of LPOL is greater than 3. This implies that the distribution is leptokurtic. In brief, it can be interpreted that variables are distributed normally because all the kurtosis values are close to 3.

Table 2: Descriptive Statistics

	LPOL	LTRO
Mean	1.998682	3.742134
Median	2.042518	3.819908
Maximum	2.310553	4.006788
Minimum	1.300192	3.381335
Std. Dev.	0.244413	0.187269
Skewness	-0.902259	-0.533260
Kurtosis	3.536414	1.879020
Jarque-Bera	4.873040	3.291830
Probability	0.087465	0.192836
Sum	65.95651	123.4904
Sum Sq. Dev.	1.911606	1.122232
Observations	33	33

Source: Computed by author using E-views 10.0.

ADF unit root test and NG Perron unit root test are employed in order to examine the integration level of the variables.

Table 3: The Results of ADF Unit Root Test

Unit Root Test	Augmented Dickey-Fuller			
Country	Variables	Level	1st Difference	2nd Difference
Turkey	LPOL	-2.015684	-4.303514*	
	LTRO	-1.679982	-5.172268*	

Note: Significance at 1 % is denoted by *.

Source: Computed by author using E-views 10.0.

Table 4: The Results of NG Perron Unit Root Test

Level	MZa	MZt	MSB	MPT
LPOL	-6.56774	-1.81190	0.27588	3.73119
LTRO	-3.95535	-1.35200	0.34182	6.23911
First Difference				
LPOL	-26.0851	-3.59509	0.13782	0.99204
LTRO	-15.4580	-2.77009	0.17920	1.62234

Source: Computed by author using E-views 10.0.

The unit root tests checked in Table 3 and Table 4 reveal that all series are non-stationary at level, so it is necessary to take their first difference [I(1)] to make them remain stationary. The precondition of the Johansen test is that all variables in a study must be integrated in the same degree or all variables must not become stationary at the level. Thus, they are adequate and sufficient for Johansen Cointegration Analysis.

Table 5: Optimum Lag Length

Lag	LR	FPE	AIC	SC	HQ
0	NA	0.001641	-0.736595	-0.641438	-0.707505
1	47.06073	0.000333	-2.333310	-2.047838*	-2.246039
2	9.767845*	0.000292*	-2.472285*	-1.996498	-2.326832*
3	2.779011	0.000345	-2.318905	-1.652802	-2.115270
4	3.549273	0.000390	-2.219994	-1.363577	-1.958179
5	3.255952	0.000447	-2.125806	-1.079074	-1.805810

LR: Likelihood Ratio Criterion, FPE: Final Prediction Error Criterion AIC: Akaike Information Criterion, SC: Schwarz Information Criterion, HQ: Hannan-Quinn Information Criterion

Source: Computed by author using e-views 10.

The maximum length was taken as five while determining the appropriate lag length. As a result of all information criteria, it has been concluded that the appropriate lag length is 2. Table 6 shows the results of the Johansen cointegration test.

Table 6: Johansen Cointegration Test

Trace Statistics			
	Statistics	0.05 Critical Value	Probability
H ₀ : r=0, H ₁ : r=1	29.95279	25.87211	0.0147
H ₀ : r=1, H ₁ : r=2	2.871895	12.51798	0.8914
Max- Eigen Statistics			
	Statistics	0.05 Critical Value	Probability
H ₀ : r=0, H ₁ : r=1	27.08090	19.38704	0.0031
H ₀ : r=1, H ₁ : r=2	2.871895	12.51798	0.8914

Source: Computed by author using e-views 10.

According to the trace and max-eigen statistics results, there is a cointegration relationship between LPOL and LTRO. This cointegrated relationship means that government stability and trade openness have a long-term relationship in Turkey. According to the Johansen cointegration test, since there is a cointegration relationship between LPOL and LTRO variables, the error correction models of these variables are estimated and shown in Table 7. In the short-term relationship, the error correction term EC_{t-1} coefficient is interpreted. The sign of the coefficient of the error correction term is found as "-" between 0 and -1 in equation 1 and equation 2 as shown in Table 7.

If the sign of the error correction term's coefficient is "-", it means that the deviations between the series that acting together in the short term disappear in the long term and the series converge to the long-term equilibrium relationship. Therefore, analysis show that deviations occurring in the LPOL and LTRO series, in which the error correction mechanism works and moves together in the long term, disappear and the series converge.

Table 7: The Results of Vector Error Correction Model (VECM)

Equation (1), Dependent Variable: LPOL		Equation (2), Dependent Variable: LTRO	
Variable	Coefficient	Variable	Coefficient
EC _{t-1}	-0.111923* (0.00741)	EC _{t-1}	-0.898605** (0.02516)
LNLTRO (-1)	-0.692957*** (0.05741)	LNLPOL (-1)	-0.377757** (0.01673)
Constant	0.597142	Constant	-2.988134

Source: Computed by author using e-views 10.

Note: Significance at 1 % is denoted by *, significance at 5 % is denoted by **, and significance at 10 % is denoted by ***.

The error correction mechanism, which shows the short and long term adaptation process, tests the validity of the short-term causality relationship. In this framework, in the study, since the series are cointegrated, Granger causality test based on Vector Error Correction Model was applied at Table 8.

Table 8: The Results of Vector Error Correction Granger Causality /Block Exogeneity Wald Tests

Dependent Variable	Independent Variable
	LPOL(-1)
LTRO	(0.3943)
X ²	0.7257
Dependent Variable	Independent Variable
	LTRO(-1)
LPOL	(0.0272)
X ²	4.8788

Source: Computed by author using e-views 10.

“ H_0 : Trade openness (LTRO) is not the Granger cause of government stability (LPOL).” hypothesis is rejected. That means LTRO is the Granger cause of LPOL for Turkey. However, “ H_0 : LPOL is not the Granger cause of LTRO.” hypothesis is accepted since probability value is greater than 5 %. In the case of Turkey, there is a long-term unidirectional causal link between openness to trade and government stability. In other words, there is a one-way causal relationship from trade openness to government stability for Turkey. This means that there may be other factors affecting trade openness rather than government stability for Turkey.

3. CONCLUSIONS

This paper analyzed the linkage between government stability and trade openness in Turkey for the period of 1984-2016. The relationship between government stability and trade openness was evaluated using the Vector Error Correction Model (VECM) and VECM based Granger Causality test. The empirical findings showed that there is a unidirectional causality flowing from trade openness to government stability in the long run.

Politics in Turkey could not be established on solid foundations. The duration of duty of the established governments is very short. Government instability is the underlying cause of the unfavorable picture and economic crises in Turkey, especially since 1990.

One of the most likely reasons for this economic turmoil in the 1990s and 2000s is the foreign trade deficit. Because Turkey’s production of final goods usually depends on the imported raw materials and intermediate goods, a rise in exchange rate increases trade openness in favor of imports. This made the foreign trade deficit worse and deepen. Despite this, Turkish ruling party achieved political stability within 3 election periods starting from 2002. As in East European transition economies mentioned by Özek (2019), export-led growth and highest amount of foreign direct investment in these periods enabled the individuals to grasp the importance of stability in governance.

During the mid-2010s, high exchange rate created foreign trade deficit, high inflation and unemployment rate in Turkey. The worsening economic situation caused changes in the council of ministers and even changes in presidential system. Turkey is still facing vulnerabilities in the balance of payments.

Monetary indicators are more striking in today's economies. Exchange rates are one of these indicators. Changes in the exchange rate, depreciation of the national currency, high rate devaluations are not preferred by the governments. Because these are seen as indicators of the failure of governments by both the opposition and the public. A development that emerges in this way may create pressures on the governments, such as holding elections or withdrawing from the government, which may create political instability. This situation can be considered as a channel running from external trade balance to political instability.

As a result, this study suggests that trade activities may have an impact on the sustainability of government in Turkey. Exportation of high value-added goods, production of raw materials and intermediate goods and development of industry can be beneficial for improving the political climate of Turkey. Furthermore, improved relations with Turkey’s major trade partners, the EU and Russia, could have a positive impact on government stability for Turkey. For a good governance and political stability, the Turkish government shouldn’t constantly change the laws and economic regulations. In this sense, certainty and predictability of decisions made by Turkish government are important elements of political stability as well as duration of the government. Government stability and trade openness increase with the level of economic development.

Evidence in the paper needs to be confirmed. Therefore, the study will be a guide for future studies in terms of seeing the impact of government stability and other political risk components such as democratic accountability, ethnic and religious tensions, bribery etc.

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