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Political Risk and Monetary Policy: A Case Study of Turkiye

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Abstract

Political risk can be defined as political volatility and instability in the domestic as well as the international front, which may impact a certain country. The impact and effect of political risk on the economic stability and monetary policies of a country cannot be ignored, as an increasingly politically volatile environment can inevitably hit the markets and thus the stability of the financial stage, which pushes financial institutions to address the issues via monetary policies.

This paper is focused on understanding the correlation between political risk and instability and monetary policy, with a specific focus on Türkiye during the 2010-2020 period. This period is deliberately selected as a time of profound political developments and volatility in Türkiye, as well as very impactful economic and financial reforms and transformations. The primary focus on understanding the role of political risk on monetary policy will be through analyzing the inflationary spikes and the policies of the central bank.

The findings of the paper portray the importance of political stability in both domestic and regional sense, highlighting the impact that increased political risk may have, while at the same time, demonstrating the effectiveness of the monetary policies already undertaken, as the political risk levels steadily increased. While the paper clearly shows a correlation between political risk and monetary policy, the importance of strong financial institutions and decisive policy decisions is also highlighted as a way to mitigate the impact that political risks may create.

Keywords: Political risk, monetary policy, inflation rates, emerging markets, volatility

Introduction

Türkiye has faced many political difficulties in recent years. Among these, domestic political disturbances have extended to geopolitical tensions. One of the important roles in the shaping of Türkiye is monetary stability, and the effects of this are important for the long-term economic perspective of political decisions and financial markets. Political risk can be defined as the uncertainty of the decisions taken by governments, regime changes, election results, or political activities, directly or indirectly affecting the country's economy. When we talk about macroeconomics, risks are effective in many areas. If we give examples of these, the investor's perspective is exchange rate stability, inflation trends, etc. Turkey, which is one of the developing countries, is one of the first factors that come to mind when political risk is discussed, especially the domestic and international effects. When developed countries are generally mentioned, we see that they are more organized within the framework of institutionalization. In developing countries, we see how important political risks have become. If we consider Türkiye's situation, it is not very difficult to see the interconnectedness of the political and economic systems. Current movements in politics, wars in the region, and political unrest affect Türkiye's market and economic planning very easily. It is not possible to avoid negative results if stability is not found, as political power is centralized, and economic management is subject to frequent changes. We see that Türkiye is geopolitically important in the region and actively involved. For this reason, it has to make many strategic and regional alliances. The alliances it has made have political and economic effects in the international sense. Some of these examples are access to the global market, the effect of foreign investments, and sanctions made by other states affect Türkiye's ability to easily manage macroeconomic stability and price stability. When implementing monetary policy, controlling price stability and inflation is very important and reaches the most vulnerable levels in times of political risk. It is not difficult to say that the central bank has clearly faced many difficulties throughout history. External shocks and untimely movements in domestic politics have caused difficulties in managing inflationary pressures due to deficiencies in efforts to stabilize the currency and manage liquidity. In general, it is not difficult to see that positive or negative political events lead to capital outflows, currency depreciation, and inflationary jumps. When traditional monetary policy weakens, these issues also affect interest rate adjustment and open market operations. When political pressures affect the policy independence of the central bank, the security of the central bank and inconsistency in monetary policy practices are significantly effective.

When we consider that inflation is a permanent problem in Türkiye, one of the developing countries, political risk can one day give more negative effects to the already existing deficiencies in monetary management and increase and worsen the problems. If there are some political interventions in the decision-making process of the central bank, the following areas can be affected. It is inevitable that it will contradict the price stability directed by maintaining artificially low interest rates and unconventional monetary policies that have not been implemented before. Such political dynamics certainly do not only affect the monetary policy in Türkiye but also reduce the confidence of foreign investors, and it is not difficult to see that Türkiye will face more difficulties in terms of attracting foreign capital. In addition, if we give a few more examples, the relationship between political risk and macroeconomics is bound to create feedback in terms of instability. Market fluctuations and inflationary pressures increase, affecting the decision-making mechanism of the central bank, and instead of taking proactive measures, it takes reactive measures. In short, when political instability appears, complications arise in long-term economic planning in this cycle. Targeted consistent inflation rates may be damaged, and since it will be difficult to achieve currency stability, the effectiveness of monetary policy naturally weakens. When alliances are in question in Turkish politics, frequent changes occur, and uncertainty increases, naturally affecting government policies in the same way. Unpredictability and changes in government policies create problems in long-term monetary policy implementation targets. When intervention in monetary policy is considered, it is realized that Türkiye is an important case study in these matters, considering the relationship between politics and economic performance. As a result, political risks are important challenges to the stability of the Turkish economy, and this challenge manifests itself through its impact on monetary policy. Turkey, a developing market, seems to be highly likely to face both domestic political turmoil and external geopolitical pressures. The relationship between political risk and economic instability requires careful monetary policy management to ensure price stability, control inflation, and protect investor security. This complex structure is extremely important in terms of current political challenges in Türkiye's economic course.

Problem Statement

It has been proven and proven that political instability is an important factor in shaping monetary policies. When we examine Türkiye's current geopolitical situation and changes in domestic politics, the weight of the effect of political risk is seen when making monetary policy decisions. It is inevitable to consider it as a convincing case study to present this effect. The information written in the article is as follows:

1. What are the main political risks that affect monetary policy in Türkiye?

2. To what extent is Türkiye's long-term and economic stability and monetary control affected by the degree of political risk?

Research Methodology

This research adopts a mixed-method approach, combining both qualitative analysis of political events and quantitative analysis of their impact on key monetary indicators like inflation, exchange rates, and interest rates in Türkiye.

Data Collection:

Qualitative Data: Historical political events and government policy decisions in Türkiye from 2010 to 2020.

Quantitative Data: Macroeconomic indicators, including inflation rates, central bank interest rates, and Türkiye's political risk index from international sources like the IMF, World Bank, and Türkiye's Central Bank.

Literature Review

A study by Avcı (2021) focused on the impact of the political economy, highlighting the agricultural policies of Türkiye in line with the EU standards. The paper aimed to understand the relation between economic policy and political dynamics and how this has influenced the economic platforms in Türkiye. Which provides a clear correlation between political influence and monetary policies, as well as the economy beyond.

Following a period of financial strain and crises in the 90s, as well as guidance from international organizations, Türkiye opened up the road to new financial and economic beginnings with profound monetary and financial reforms (Öniş, 2009), influenced by the new political establishment of the new millennium, with the AK Party and the new prime minister, Erdogan.

Türkiye has taken steps in addressing the volatile financial markets of the 2000s with certain steps, such as creating a monetary policy exit strategy, which is seen as one of the crucial institutional steps taken to exit the crisis mentality that existed before (TCMB, 2010; Başçı, 2011).

Following global recovery from the 2008 financial crisis and a period of restructuring, Turkey introduced its roadmap, which was aptly titled the Roadmap for Normalizing Monetary Policies (TCMB, 2015). The road map is an important step in aligning the Turkish financial system with global markets while also attempting to reduce the possibility of increased risks. Authors such as (Gürkaynak et al., 2015) have pointed out the process of the Turkish financial structure moving from the conventional and simple tools for monetary policy to more complex tooling and approaches with examples such as the shift from short-term interest rates to the one-week repo rate, the interest rate corridor and the Reserve Option Mechanism (ROM) as very important developments in the mechanism of the state in order to mitigate and minimize the possibility of financial shocks and turbulences in the case of global crises, volatility and even domestic risks. Authors (Alper et al., 2013) have also pointed out the willingness of the central bank to adjust the financial policies in the face of global volatility and shocks, as well as domestic political developments, further supporting the studies previously mentioned. The Central Bank further demonstrated its willingness to enact financial flexibility in the face of extraordinary developments, such as the measures taken during the COVID-19 pandemic period, in which the Central Bank utilized instruments to prevent a further deepening of the crisis, as covered by other authors (Bulut, 2021).

What can be seen and has been demonstrated by previous studies prior is that the financial institutions in Türkiye have not shied away from utilizing its instruments, enacting necessary reforms and adopting new approaches to its understanding of economic and financial policies in the face of new developments in the global as well as domestic markets but also, more relevant to the study of this paper, the financial institutions have taken into account the political risks while enacting monetary and financial policies.

Findings

In this paper, the focus will be on data collected from the Central Bank as well as other international financial and academic sources in order to analyze and find answers to the research questions while also trying to find a legitimate correlation between levels of political risk and the financial market, thus the monetary policies of the state through the case study of Türkiye, specifically focusing on the years between 2010 and 2020 for an efficient study of the topic. The years beyond 2020 are not included in the study in order to forego the impact of the pandemic, which could disrupt the findings.

The first data collected indicates the inflation rates and the monetary policy, in other words, the interest rates set by the Central Bank in accordance with the stated inflation rates, which can be found in Appendix 1. The data and the table demonstrate that the Central Bank has taken measures to reduce the rising inflation rates, which took a dramatic turn between 2017 and 2018, resulting in a huge spike in the inflation rate, which also led to a steady increase in the interest rate designated by the Central Bank in order to tackle inflation. However, the measures taken did not produce expected results, with the inflationary rate continuing its steady increase, which leads to the reality of institutional ineffectiveness and inefficiencies, as well as entrenched inflationary problems beyond what can be addressed through the conventional interventions of the Central Bank.

In Appendix 2, the level of political risk in Türkiye is demonstrated with the utilization of the political risk index, again taking into account the years from 2010 until 2020. One can first notice a steady increase in the political risk index, having in mind the turbulence of these years on Turkish political institutions. The steady increase of the political risk index indicates that Türkiye, with its financial institutions, has been facing these challenges throughout the decade.

The examination of the association between political conditions and inflation dynamics in Türkiye over 2010–2020 by comparing the Political Risk Index (ICRG) and CPI inflation, which can be found in Appendix 3. The figure suggests a negative correlation between the political risk (ICRG) score and inflation, implying that periods of weaker political conditions, designated by lower ICRG scores as higher political risk, tend to be in tandem with higher inflation rates. While this descriptive evidence does not establish a direct and obvious link, it is consistent with the view that political uncertainty can worsen inflationary pressures through expectations, exchange-rate movements, and risk premia, potentially prompting the central bank to adjust its policy stance. At the same time, the magnitude and timing of inflation movements indicate that additional macroeconomic factors beyond political risk also play an important role in explaining Türkiye's inflation dynamics.

To answer my first research question, *What are the main political risks that affect monetary policy in Türkiye?* The increasing trend of political risk, especially in the period from 2010 to 2020, in which the political index for Türkiye shows a rise from 45 in 2010 to 75 by 2020, can be impacted by many aspects of the political environment in and around Türkiye. First of all, the existence of turbulence and regional conflicts in the Middle East, as well as extraordinary political developments on the domestic front, such as the 2016 coup attempt and many other politically unstable events, have all contributed to the steady increase in political risk in Türkiye, which all collectively influences the monetary policies as such.

To answer my second research question, *to what extent is Türkiye's long-term and economic stability and monetary control affected by the degree of political risk?* The Turkish financial institutions have long employed monetary and financial policies aimed at directly addressing the possibility of financial and economic volatility and the possible impact of political developments, as well as the impact of political risk. Having this in mind, the extent to which political risk has impacted the economic stability and the monetary control of Türkiye cannot be understated. Volatile political events such as the 15th of July Coup Attempt and internal political disputes along with the Syrian civil war and the influx of Syrian migrants into Türkiye and not to mention the burden on the state for taking care of said migrants have all been a part of the political risk factor which has in turn been significantly detrimental for the economic stability as well as the consistency of monetary policies in Türkiye. Having that in mind, it should also be mentioned that although an undeniable impact of political risk on monetary policy exists, underlying economic shortcomings and lack of strong financial institutions are also in play.

Conclusion

In conclusion, this paper has focused on researching and analyzing the political risk factor and how it impacts the financial and economic developments in Türkiye, and thus its impact on the monetary policies employed by Türkiye.

The study conducted by the paper has found that, considering the period between 2010 and 2020, the political risk level has consistently increased in Türkiye, taking into account both domestic and regional developments. This increase has been coupled with a steady increase in the rate of inflation and the corresponding monetary policies by the Central Bank to address and tackle the increase.

The study has found that Türkiye should focus on addressing the underlying economic factors which may contribute to the ineffectiveness of the undertaken monetary policies to tackle the rising inflation rate but at the same time the impact of political instabilities and thus the increase of political risk should not be ignored, as demonstrated by this paper, political risk has an effect on monetary developments and thus monetary policy.

In addressing these issues, Türkiye and its financial institutions must proceed with careful steps and strengthen the financial instruments, while political actors should try to increase the independence of financial institutions, further ensuring monetary policies which are not effected by political pressures, on the other hand, the resolve of the Turkish financial institutions in the face of continued domestic and regional political volatility which have shown a steady rate of increased political risk.

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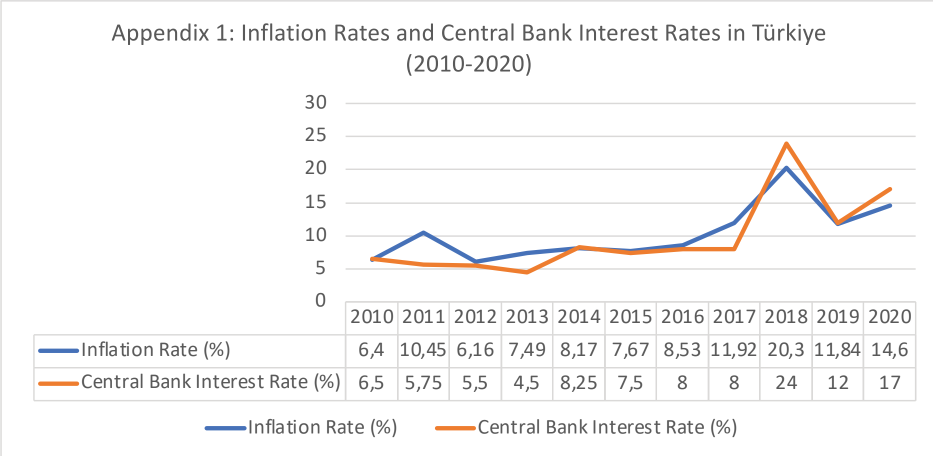
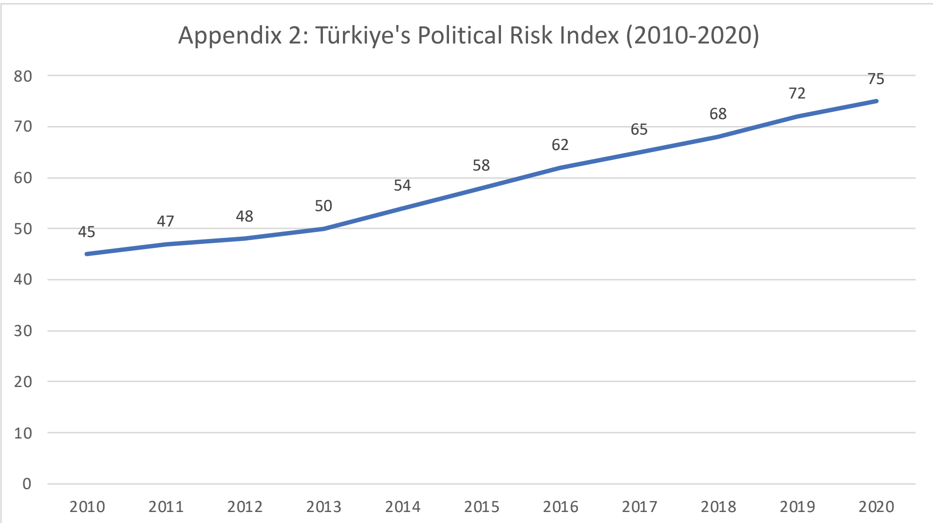
APPENDICES

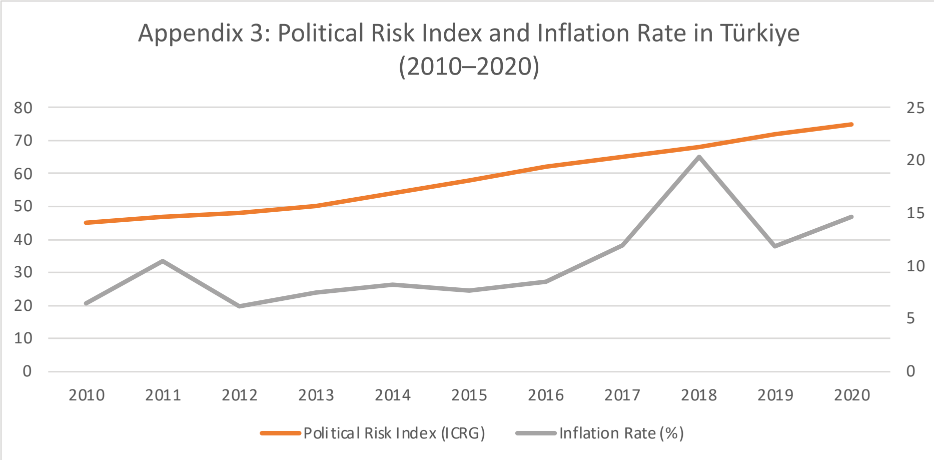


	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Inflation Rate (%)	6,4	10,45	6,16	7,49	8,17	7,67	8,53	11,92	20,3	11,84	14,6
Central Bank Interest Rate (%)	6,5	5,75	5,5	4,5	8,25	7,5	8	8	24	12	17

Note. Adapted from (Turkish Statistical Institute (TurkStat), 2026 & Central Bank of the Republic of Türkiye, 2026)



Note. Adapted from (The PRS Group)



Note. Adapted from (The PRS Group; Turkish Statistical Institute (TurkStat), 2026)