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POLITICAL RISK FACTORS AFFECTING THE BEHAVIORAL PATTERNS OF INVESTORS ACCORDING TO INFORMATION INFLOW IN ISE

Yüksek Lisans Tezi

DENİZ GÖKÇELER

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Danışman: YRD. DOÇ. DR. R. CEYDA ÖZTÜRK

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ABBREVIATION

ARM Adjustable Rate Mortgages

BRSA Bank Regulatory and Supervisory Agency

CAAI Cumulative Average Abnormal Index Values

CAAR Cumulative Average Abnormal Returns

CDO Collateralized Debt Obligations

CRM Country Risk Management

EMH Efficient Market Hypothesis

FDI Foreign Direct Investment

GDP Gross Domestic Power

IFI International Financial Institutions

IMF International Monetary Fund

IPE International Political Economy

ISE Istanbul Stock Exchange

MBS Mortgage-Backed Securities

PBC Political Business Cycle

PSBR Public Sector Borrowing Requirement

RPC Rational Partisan Cycle

SDIF Savings Deposit Insurance Fund

VaR Value at Risk

SYMBOLS

AI Abnormal Index Values

It Index Values at Time t

$\bar{I}_t$ Average Index Values of the Pre-Election Period

M Mean Sample to be Standardized

μ Population Mean

SE Standard Error of the Mean

σ Standard Deviation

n Sample Size

Xi Observations at General and Local Election Times

1. INTRODUCTION

Political risk has long been a familiar term in the lexicon of international business. International enterprises are increasingly recognizing the importance of political risk elements in many investments and operating decisions. The mention political risk is most likely to bring to mind the business environment characteristic of the newly independent and less developed nations. With two-thirds of the world's population, these areas are not insignificant for international business even though they are relatively low income areas. But political risk is much more persuasive issue for the multinational enterprise.

Starting in the early eighties, the analysis of political risk has become an important topic of economic research. The interest in the determinants and consequences of governments' decisions to seize foreign investors' revenues or assets – using outright nationalization or more subtle measures of "creeping expropriation"– was certainly triggered by hostile policies pursued by many developing countries throughout the seventies. Creeping expropriation is the continual restriction of private property rights gradually over time by a government and involves legislation, regulation, and taxation, which together over time make it difficult for a person or business to own property. Creeping expropriation, where it exists, makes it increasingly difficult to conduct commerce. This experience highlighted the specific perils associated with international investment and brought up the question why, in face of such risks, cross border investment is taking place at all.

From the point of foreign direct investors' view; political risk refers to the risk that, political events and processes within the host country and changing relationships between the host and the home country, as well as between the host country and third countries, will influence the economic well-being of the parent firm. Political risk can be classified as macro political risk and micro political risk. Macro political risk is country-specific political risk and will influence all foreign firms in the host country alike. Macro risks include expropriations of all foreign firms in a country, non-discriminatory measures such as changes in tax laws, price controls, environmental regulations and constraints which affect foreign firms only such as limitations on the repatriation of capital, restrictions on expatriate employment and foreign ownership and local content regulations. Micro political risk is specific to a certain industry, firm or project. Political risk may affect the ownership of the assets, via full or partial forced divestitures, of the operations of the firm. While macro is more visible, micro risk is of more importance to firms. By explaining economic well being in terms of cash flows; political risk is defined as unexpected changes in future cash flows due to political events in the host country. Political risk may thus lead to unexpected increases or decreases in future cash flows.

Political risk exists because there is no legal recourse if the foreign governments choose to expropriate an asset or otherwise increase the cost for foreign firms. The alternative for host governments to alter the cash flows from foreign operations range from reducing cash flow due to higher taxes to completely eliminating any cash flows in case of full expropriation. Foreign governments will likely choose to do so only if the expected benefits of the expropriation or other cost to the multinational firm exceed the expected costs to the foreign government of these actions. The focus in most of the studies examining the motivation of host countries to impose political costs has been on the effects of expropriation.

Many of the international ventures; of both governments and private companies alike are fraught with political risk. In recent years, the experiences of oil companies particularly in developing countries have perhaps been the most visible. Their overseas operations have increasingly become the targets of political actions by host governments and by foreign opposition groups, both of which have had serious impacts on the economic viability of the ventures. Oil export restrictions, taxation changes, price controls, production constraints and expropriations are now quite the usual operating circumstances. Hence the assessment of future political risks in the business environment of a potential host country is becoming a crucial topic in the deliberations of these companies. Likewise, at the governmental level foreign policies and ventures must be evaluated in the light of political risk considerations. In many countries a government agency does exist for the purpose of providing such advice to both the pubic and private sectors. Traditionally however, the major commercial banks have experts in overseas political risk and make their opinions available to their clients. In attempting to recognize the precursors of these politics; actions, the forecaster must investigate the social and political conditions from which they result.

1.1. POLITICAL RISK AND LITERATURE REVIEW

Investors put assets at risk to achieve their objectives and the analysis of these risks, including political risks, is a key to successful operations. Weighing up opportunities against potential losses becomes possible after an initial political risk assessment. Of course, the nature of risks an investor might face depends upon the project; the factors present in a host country's investment climate that are associated with the project; cultural prevalence; and the individuals that make up the organization. Opportunities and risks are often a double-edged sword, and the management of political risks is but one of the challenges a multinational company faces in a host country.

A firm's foreign investment strategy deals with the positioning of the organization in an uncertain host country environment and investment climate. As such, organizational strategic choices determine the size of a firm's exposure to uncertain environmental and organizational components that impact on company performance.[1]

1.1.1. Defining Political Risk

Political risks are arbitrary or discriminatory actions taken by home or host governments, political groups, or individuals that have an adverse impact on international trade or investment transactions (Wagner [1999])[2].

Political risk can encompass many factors and events such as blocked funds, repatriation constraints in the form of exchange controls, expropriation or nationalization of property and resources, inconvertibility of currency, war damage, civil strife, actions against personnel as kidnapping, limits on remittances, government interferences with contractual terms, discriminatory taxation, politically-based

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[1] Charlotte H. Brink, **Measuring Political Risk: Risks to Foreign Investment**, Ashgate Publishing Limited, 2004, p.148

[2] Tillmann Sachs, Robert Tiong and Daniel Wagner, **The Quantification and Financial Impact of Political Risk Perceptions on Infrastructure Projects in Asia**, The Journal of Structured Finance, Winter 2008, p80

regulations on operations and the loss of copyright protection (Howell and Chaddick 1994)[3]

Jodice (1985)[4] defines political risk as:

"Changes in the operating conditions of foreign enterprises that arise out of a political process, either directly through war, insurrection or political violence or through changes in government policies that affect the ownership and behavior of the firm. Political risk can be conceptualized as events in the national and international environments that can affect the physical assets, personnel and operations of the foreign firm."

Investors expectations about the future by the extent of political risk and also current economic policy of the host country play an important role on their decision making process.

Lessard (1993) defines political risk as "…the risk of political discontinuities resulting in losses through expropriation or major policy shifts." While sharing the notion that political risk arises from changes of the existing business environment, Kobrin (1982) emphasizes that these changes may arise from regular or irregular transfers of power, but that they may also be a result of "routine policymaking". Howell and Chaddick (1994) also point out that it is not only the possibility of expropriation that threatens foreign investors. More generally, they define political risk as "…the responsibility that political decisions, events or conditions in a country, including those that might be referred to as social, will affect the business environment such that investors will lose money or have a reduced profit margin." (Howell and Chaddich, 1994:71) Oseghale (1993) provides a list of the various measures that lead to a "creeping expropriation" of foreign investors and mentions operational restrictions, restrictions on the repatriation of profits, branches of contracts by the host government, and discriminatory taxation. Finally civil strife and social unrest represent shifts in the

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[3] Howell, L. D. & Chaddick, B. **Models of Political Risk for Foreign Investment and Trade**. The Columbia Journal of World Business 29, 1994, p. 70–90

[4] David A. Jodice, **Political Risk Assessment: An Annotated Bibliography**, Greenwood Pres, USA, 1985, p.5

business climate that may be no less damaging to foreign firms than deliberate measures of a government.[5]

Most of the time political risks lack historical or numerical data and are often defined intuitively by project equity' investors, lenders, or equipment suppliers. Conventional qualitative risk assessment methods such as checklists, score cards, and interviews or quantitative actuarial methods such as stress tests or stochastic simulations may provide some information on the possible impact or criticality of specific risk factors. Actuarial methods depend on reliable data to derive robust probability distributions that serve as input to actuarial models and allow for reasonable stochastic simulation. In the absence or scarcity of numerical and historical data as input, actuarial methods are difficult to apply and lose their value.

The assessment of political risk has traditionally been more of an art than a science, taking into account a range of variables—such as payment risk on the part of the obligor, the economic environment, socio-cultural considerations, developmental benefits, and history— to arrive at a subjective conclusion about the probability of loss. Often, a combination of qualitative and quantitative analysis is used to arrive at the conclusion, which prevents reliance on traditional actuarial methods either to arrive at or to verify a conclusion. It is therefore at times desirable to rely on two or more expert opinions either to verify a conclusion or to obtain a different perspective.[6]

Risk can be explained as the manifestation of doubt regarding the frequency and consequences of undesirable events and risk management as the outcome of plans or strategies implemented to maintain an acceptable level of risk associated with an investment project. Political risk is a term that links unpredictability of investment performance to specific uncertain factors of the investment environment where uncertainty about both environmental and organizational variables impact negatively on the ability to predict corporate performance, thus increasing the probability of risk occurring.

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[5] Philipp Harms, **International Investment, Political Risk and Growth**, Kluwer Academic Publishers, Copyright 2000, pp.72–73
[6] Sachs, Tiong and Wagner pp.80–81

It is important to identify country risk and political risk from each other. This point is necessary to clearly define the difference that country risk factors could be included as variables in a political risk analysis as well, although the political risk factors are used as indicators of country risk – using the two in tandem during a project profiling process can provide invaluable.

Most political risk authors seem to agree that political risk broadly supposes the probability that business will either earn less money or suffer losses in profit as a result of stakeholders within a political system's inactions or reactions to events, decisions and policies.

Political risk is not only present in macro environments but can also be industry (micro) specific. Macro-level political risks have similar impacts across all foreign actors in a given location. While these are included in country risk analysis, it would be incorrect to equate macro-level political risk analysis with country risk as country risk only looks at national-level risks and also includes financial and economic risks. Micro-level risks focus on sector, firm, or project specific risk. It can vary among different industries within a single country, depending on the nature of the foreign investment and the kind of market it wishes to enter. Some organizations may offer goods and services that become crucial to the direct functioning of the host economy, such as public service providers or crop growers. Organizations that play a critical role must be aware of the danger of being subject to government demands due to a feeling of resentment against foreign dominance or exploitation by foreign economies.

Macro-level political risk looks at non-project specific risks. Macro political risks affect all participants in a given country. A common misconception is that macro-level political risk only looks at country-level political risk; however, the coupling of local, national, and regional political events often means that events at the local level may have follow-on effects for stakeholders on a macro-level. Other types of risk include government currency actions, regulatory changes, sovereign credit defaults, endemic corruption, war declarations and government composition changes. These events pose both portfolio investment and foreign direct investment risks that can change the overall suitability of a destination for investment. Moreover, these events pose risks that can alter the way a foreign government must conduct its affairs as well.

Micro-level political risks are project-specific risks. In addition to the macro political risks, companies have to pay attention to the industry and relative contribution of their firms to the local economy. An examination of these types of political risks might look at how the local political climate in a given region may impact a business endeavor. This type of risk includes project-specific government review (such as the Committee on Foreign Investment in the US (CFIUS) process in the United States), the selection of dangerous local partners with political power, and expropriation/nationalization of projects and assets.

Political risk is also relevant for government project decision-making, whereby government initiatives (be they diplomatic or military or other) may be complicated as a result of political risk. Whereas political risk for business may involve understanding the host government and how its actions and attitudes can impact a business initiative, government political risk analysis requires a keen understanding of politics and policy that includes both the client government as well as the host government of the activity.

Political risk is unfortunately easily confused with country risk, which in turn can be defined more precisely by referring to sovereign, credit and transfer risk. Country risk differs from political risk in the sense that country risk can be explained as potential financial losses due to problems arising from macro economic events in a country (Calverly, 1985; Coplin and O'leary, 1994; Kennedy, 1991; Krayenbuely, 1985). Balance of payments sheets, country credit worthiness and data on debt servicing ratios are the most widely used tools in country risk analysis. Coplin and O'leary (1994) comment that too many current models of risk analysis focus too narrowly on these aspects, and in doing so, disregard combined political, economic and social micro risk factor indicators.[7]

[7] Brink, p.18

1.1.2. Country Risk Management (CRM)

Country risk focuses on national-level risks and also financial-economic risks as well. There are both macro- and micro-level political risks in the range of country risk analysis. Macro-level political risks have similar impacts across all foreign actors in a given location. Micro-level risks focus on sector, firm, or project specific risk. Firms commonly do business abroad to diversify and expand their sources of revenue-profitability and also hedge their risks. Doing business abroad exposes the firm to country risk and raises the potential for financial loss. Country risk refers to the risk of investing in a country, dependent on changes in the business environment that may adversely affect operating profits or the value of assets in a specific country. For example, financial factors such as currency controls, devaluation or regulatory changes, or stability factors such as mass riots, civil war and other potential events contribute to companies' operational risks. Country risk is a more general term than political risk. Basically country risk is the risk that economic, social, and political conditions and events in a foreign country will affect an institution.

In the last years, country risk management (CRM) has benefited from the introduction of powerful new assessment models and management techniques. However, a through analysis of risk practices at Fortune 500 and Global 1000 firms reveals that managers continue to systematically mismanage their exposure to this type of risk. What is so different about country risk that financial and non-financial firms fall prey to one crisis after another? Given the stakes, economists and policymakers in International Financial Institutions (IFIs), central banks and regulatory bodies have a vested interest in ensuring that firms get it right. So far, risk managers have not. Based on the experience of corporate CRM in the past, the situation is not likely to improve without regulatory intervention. Country risk refers to the political, economic and financial aspects of doing business in a specific country. Traditionally, risk managers in non-financial firms focus on political risk and FDI, mostly in Central Asia, the Middle East and Africa. Those in financial firms look at the impact of all three variables on credit risk, specifically sovereign and transfer risk in Asia's and Latin America's emerging markets. Limiting country risk to an emerging markets' phenomenon is astoundingly myopic. First, country risk can spread from emerging markets to the G7 through its impact on the operations of G7 firms in the developing world and the spillover effects, or contagion, of political, economic and financial crises. Second, country risk can be indigenous to the G7. For example, during the last decade, a major instance of political risk has been changing public perceptions of corporate social responsibilities in advanced economies such as that of the USA.

To protect their firms against these new instances of political risk and the changing nature of country risk, managers can rely on new risk assessment models and management techniques. Such assessment models use market risk analysis techniques and allow managers to perform systematic stress tests of their firm's credit risk exposures. They draw from historical or hypothetical scenarios to forecast the impact of specific events, such as devaluation, financial crises, illiquid markets and armed conflicts on a firm's portfolio or direct investments. Results are normally expressed in terms of value-at-risk (VaR) assessments referring to a firm's likely worst-case loss for any given scenario. While stress tests and VaR are used increasingly by banks and brokerage houses, they can be adapted for non-financial firms. In such cases, specific FDI ventures are employed, in lieu of market and credit positions, and aggregated to provide an assessment of a firm's risk exposure.

Political risk, and growth correlation is the major determinant of international investments to developing countries. Political risk is the source of a strong bias among investors against lower-income countries that has so far limited their access to international capital, even in light of financial liberalization. Specifically, political risk is responsible for inconsistent investment patterns and risk appetites that fail to exploit growth opportunities in certain developing countries, pursuing instead inferior investments in a privileged group of developing or advanced economies. The ability of specific groups to influence state policies and political risk by focusing on generational cleavages has been analyzed by analytical frameworks integrating political risk within International Political Economy (IPE), a field from which it has been largely absent. Without doubt, the main contribution is empirical study of the effects of political risk on international investments and an analytical framework allowing forward-looking country risk assessments.

So far, an understanding of country risk has increasingly become important given the global nature of investment portfolios. Investors, lenders and managers when evaluating the risk of a country, generally base their assessment on the political, economic and socio-cultural factors. A lot of empirical work has been done during the past twenty years on country risk measures and the extent to which country risk measures can predict periods of intense instability.

It is argued in empirical literature that political risk is a subset of country risk arising from political risk factors. Political risk factors mainly include – a focus on government action and the extent of political stability, action by a broader group of political leaders, probability of change of government, threat of war etc. Government stability is the most important factor, which attempts to capture the extent ‘ to which government is able to carry out its policies as well as stay in office. Corruption is another important factor as it is a threat to the investment climate because of its ability to distort the economic and financial environment and also destabilize the government.

Assessing the cost and benefits of doing business abroad entails analyses of political, financial and economic risk. Political risk analysis is intended to assess the political stability of a country and includes criteria such as government stability, corruption, domestic conflict, religious tensions and ethnic tensions. Financial risk analysis investigates a country's ability to finance its debt obligations and includes factors such as foreign debt as a percentage of GDP, loan default and exchange rate stability. Finally, economic risk analysis determines a country's current economic strengths and weaknesses by looking at its rate of growth in GDP, per capita GDP, inflation rate, and the like. Analysts then calculate a composite country risk rating based on these three categories of risk. This composite rating provides an overall assessment of the risk of doing business in some country.[8]

[8] Robert J. Carbaugh, **International Economics (12th Edition)**, South Western Cengage Learning, Copyright 2009, p.28

1.1.3. Political Instability-Uncertainty and Financial Crisis

Political instability and political uncertainty are properties of political risk, where the former refer to biased uncertainty about the probability of political events taking place. Frank Knight concludes that it is "uncertainty", rather than the common but mistakenly used, term "risk", that characterizes the activity of assessing the basic of income attached to entrepreneurial activity. Thus he defines "risk" as measurable uncertainty, where the distribution of outcomes in a group of instances is known by calculation. "Uncertainty", on the other hand, is immeasurable, because the distribution of outcomes is not known, which is usually because it is impossible to form a group of instances to calculate from.[9] Basically, political uncertainty, according to Howell (1986)[10], results from an inadequacy of information, whereas political risk is rather a more objective measurement of the amount of doubt, in contrast to the more subjective nature of instability and uncertainty. Political instability refers more to unexpected or unforeseen changes in leadership succession, government policy, or in a government's implementation of power.

Computational social scientist Claudio Cioffi-Revilla defines political uncertainty as "the puzzling lack of sureness or absence of strict determination in political life". The examples he gives span domestic and international spheres and include elections, wars, governmental processes, threats and collective action. There is uncertainty both about the issue or outcome itself, and about the probability of its occurring. For Cioffi-Revilla, political uncertainty is consequential because it has significant consequences in people's lives and fortunes, it is ubiquitous because no area of politics is immune from chance, and it is ineradicable because politics can reduce uncertainty, but can never eliminate or expunge it.[11] According to Yi Feng[12] private

[9] Catherina Althaus, **Calculating Political Risk**, University of New South Wales Press Ltd, 2008, London-UK, p.40
[10] Llewellyn D. Howell, **The Handbook of Country and Political Risk Analysis**, Third Edition, PRS Group, 2002
[11] Althaus, p.36, 37
[12] Yi Feng, **Political Freedom, Political Instability, and Policy Uncertainty: A Study of Political Institutions**, Blackwell Publishing on behalf of The International Studies Association, International Studies Quarterly, Vol 45, No 2, June 2001, p.276

investment operates in a political environment in which political freedom, political stability and policy certainty all play some fundamental role**.**

Foreign investment is heavily influenced by a nation's level of political instability and the extent of its market potential.[13] Political instability is the main indicator that the probability of political risk occurring. Foreign investors must take precautions as carefully manage or avoid operating in a context of physical conflict that might evolve from political instability. Investors should take into account that there is always a possibility that, this political disequilibrium might result in governmental limitations on producing profits for foreign organization. Not only is political instability a political risk factor that can contribute to losses incurred by foreign investments, such losses can also be a result of host government nationalization and confiscation actions, the repudiation of contracts or even a loss of mineral rights for investors in the extraction industry of a host country. Another political risk factor would be taxation, the imposition of harsh import and export restrictions, currency regulations and controls over employment practices

Political stability can be measured by monitoring incidents of internal and external conflict; social unrest; orderly political transfers; politically motivated violence; government stability; policy stability; socio-economic conditions; military in politics; religion in politics; law and order, ethic tensions; and international disputes. Government stability is a measure of both the government's ability to carry out its declared policies, as well as its ability to retain office. This is influenced by the type of governance; the cohesion of the government and governing party or parties; the proximity of the next election; government's command of legislature; and popular approval of government policies whilst still governing responsibly. Thus political risk exists not only as an externalized policy concern that must be managed by the political process. Political risk calculation is the stuff of which the continual judgments of politicians and policy makers are made. Political risk calculation is about more than just

[13] Peter D. Bennett & Robert T. Green, **Political Instability as a Determinant of Direct Foreign Investment in Marketing**, Journal of Marketing Research, Vol. 9, No. 2, (May 1972), published by American Marketing Association, p.182

dangerous external risks. It is a way of thinking and dealing with all issues and policy within a context of political uncertainty.[14]

Ivo K. Feierabend and Rosalind L. Feierabend defined political instability in terms of the type and number of politically relevant, aggressive behaviors occurring within a nation over a stipulated time period. Also, they identified thirty types of politically destabilizing events and assigned each a weight from 0 to 6 according to their level of intensity. An event at the zero level connects no accompanying instability, such as in an orderly change of political officeholders.[15]

Regime legitimacy also contributes to political stability. A political system under fundamental stress from severely disaffected groups and the laws of the land being questioned might pose strains on the legitimacy of a regime. A change in government that would bring to power a set of leaders with different political philosophy, or a new strategy of economic development that could undermine investor confidence and upset policy continuity, does not bode well for foreign investment. If a change of regime brings to power supporters of debt repudiation, a country's investment climate will surely not remain untouched.

While political uncertainty takes many different shapes and forms, such as changes in the government and changes in its domestic and foreign policy, national elections is the one particular kind of political uncertainty.

In a democratic system, national elections are a major political event for redistribution of political power, which has important implications for the future political and economic course of a country. As a result, it presents a major uncertainty to both domestic and foreign investors. While the same statement can be made for developed as well as emerging markets, there are several reasons to believe that there is more political uncertainty in emerging markets. First of all, democracies are relatively young political institutions in many emerging markets, which had long histories of military or one-party rule and only recently have made the transition to democracy. As a result, many of the checks and balances for a fully functional democracy are not in

[14] Althaus, p.39
[15] Benett & Green, p.183–184

place and a smooth transition of political power is far from certain. Second, there is a stronger incentive trying to stay in power, since political power comes with economic windfalls under crony capitalism. Hence, voter buying and backroom dealings are often more rampant in many countries during elections. Constantly erupting political scandals tend to shake investor confidence. Third, lack of press freedom and social justice make election an ideal time for voicing political discontent, adding to political tension. In order to appease voters, it is more likely for the governments to pursue expansionary economic policies, which may not be consistent with stable currencies. Political uncertainty during election period contributes to currency crisis. While there are many ways political uncertainty can affect currency values, several economic models may shed light on the mechanism through which political uncertainty can help trigger or exacerbate a financial crisis.

In "first generation" currency crisis models, the government uses its money printing machine to finance a budget deficit while also trying to maintain fixed exchange rates by using limited exchange reserves. Foresighted speculators, recognizing these unsustainable conflicting policies, launch a speculative attack, which quickly exhaust the country's reserves and force an abandonment of the fixed exchange rate. Within such models, one can see that crisis is more likely to happen during elections, since this is when a democratically elected government would have the strongest incentive to engage in the following inconsistent policies. To appease voters, the government would pursue expansionary monetary and fiscal policies to hold down unemployment. But they would also try to have exchange rates fixed to ensure price stability or other policy objectives. As a result, currency crises are more likely to happen during political elections or during the post election transition when the country's reserves are likely to be exhausted due to currency market interventions.

In the so-called 'second generation' model, there is a tension between the government's desire to abandon its fixed exchange rate on one hand and its desire to defend its exchange rate on the other. The reason the government may like to depreciate its currency could be due to a large domestic debt burden or high unemployment rate. As a result, it may be tempted to inflate away the debt burden or to pursue a more expansionary monetary policy by abandoning the fixed rate. In such a model, the cost of defending the currency increases when people suspect that the government is leaning towards abandoning the fixed rate. Given the strong temptation for re-election, foreign and domestic speculators may perceive a strongest government tilt towards expansionary policies while being reluctant to take costly policy actions to defend the currency during elections. As a result, they will sell the currency thus making it more costly for the government to defend the currency, and the increasing difficulty in defending the currency would in turn convinces more people to sell. Thus, political election could affect investor expectation and change market behavior.

Crises are transitional phases, during which the normal ways of operating no longer work. Crises involve three key components: threat, uncertainty and urgency. A crisis occurs when some form of core value, or a life sustaining system of a community, such as health or security or fairness, is shaken by violence, destruction or adversity of an immediate nature and this is accompanied by a high degree of variety in the ways that people perceive this damage and engage with it. The disruption in normality demands leadership of some kind, often from the public domain, if the devastation is widespread or communal in nature, until normality is returned. Bio-terrorism, breakdowns in information and communication systems, traditional natural disasters (floods, earthquakes and tsunamis) are examples of natural and man-made crises.[16]

A relevant class of crisis model is related to self-fulfilling exchange rate crises. In such a model, an individual investor will not pull his money out of the country if he believes that the currency is unlikely to devalue, but he will do so if a currency drop seems likely. A crisis, however, will happen if many individual investors do pull out. As a result, either optimism or pessimism will be self-confirming. It is worth noting that countries with strong fundamentals and high credibility are unlikely to be subject to investor pessimism. It is only when fundamentals are sufficiently weak that the country is vulnerable to a speculative attack. This could happen due to either a deteriorating government fiscal position or a perception of lack of political commitment to the fixed rate regime or other factors.

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[16] Althaus, p.12

Uncertainty is the common point of both "crisis" and "risk". A risk is inevitably some form of engagement with uncertainty. Whether one uses technical mathematical calculations or gut feelings to determine probability and consequences, a risk emerges whenever someone is attempting to place some measure of control over future uncertainty using reasonable or informed estimated or past experiences. Uncertainty is also a feature of crisis, as crises occur predominantly without warning or regularity. Risk does not always involve threat or danger. They also involve a positive potential for gain. A natural disaster, for example, need not be a political risk. Nor does risk always have to involve urgency. Long-term risks are just as valid as those that might be defined as short term. When crisis and risks are compared, the difference in threat and urgency between them suggests that risk calculation is a phenomenon worthy of separate investigation.[17]

As pointed in the previous paragraphs, political elections may very well change that perception. While the above analysis emphases the role of government policy and the psychology of investors in currency markets, models of contingent investment or 'real options' suggest political uncertainty may also affect real investment decisions. Since most foreign direct investment is to a large extent irreversible, foreign investors may choose to delay their investment amid increasing political uncertainty (e.g. changes in tax policy, foreign ownership restrictions, protection of ownership rights, etc.). The higher the political uncertainty, the more it pays to delay the investment. This will tend to reduce the demand for local currency in emerging markets and slow down growth. This view is supported by the study of Bittlingmayer (1998)[18], who shows that political risk increases market volatility and reduces investment and real output.

The occurrence of crises in international financial markets in the 1990s has stimulated an intensive discussion about the causes, the characteristics and the consequences of such crises. Turkey also experienced turmoil in currency markets and financial markets. Currency crises occurred in very different economic environments and thus triggered an intense debate about both the causes of such crises and indicators

[17] Althaus, p.13

[18] George Bittlingmayer, **Output, Stock Volatility, and Political Uncertainty in a Natural Experiment: Germany, 1880-1940**, Published by: Blackwell Publishing for the American Finance Association, The Journal of Finance, Vol. 53, No. 6, Dec. 1998, p.2243-2257

that could be used in early warning systems. In many cases currency crises were accompanied by crises in other financial markets. Given the causes of crises and contagion, multi lateral institutions such as the IMF and the World Bank have increased their efforts of surveillance and crisis prevention.

While there are such different mechanisms through which political uncertainty could affect currency value, in reality, a crisis may proceed with a complex interaction of many different factors and political uncertainty could affect financial crisis through a mixture of these mechanisms, with different mechanisms perhaps playing a different role at different stages of the crisis. There is no doubt that political uncertainty does play a role in currency crisis.

2. POLITICAL RISK FACTORS AND THEIR SOURCES

There are so many uses for political risk analysis that most high-level government and business officials think about political risks on a day-to-day basis. It is often necessary to produce general country studies that all of those concerned can read in order to get the necessary back-ground to ask specific questions about their own particular problem.

Political risks not only encompass politics, but also economics, socio-economics, social and societal factors, environmental factors, as well as the nature and industry-specific scope of the particular business involved in foreign investment initiatives. As these elements are constantly undergoing change, the assessment of risk necessitates detailed analysis of the various features of particular cases. The reality of time and costs however, often limit the depth and scope of analysis. There is thus often a need for political risk factors and analysis models that are easy to handle and readily available, without compromising the integrity, validity, quality and accuracy of a political risk assessment.

2.1. MAIN SOURCES OF POLITICAL RISKS

Main sources of political risks are defined below:

a. Regime Change

b. Political Turmoil

c. Governmental Restrictions

d. Economic Policies

e. Elections

Each has a different impact on the host country's economic situation and international businesses. The factors of political risks and their possible effects are summarized in Table 1.

Table 1

Political Risk: A Conceptual Framework

Factors of Political Risk	**Groups through which political risk can be generated**	**Political Risk Effects: Types of influence on International business operations**
Competing political philosophies (Nationalism, socialism, communism)	Government in power and its operating agencies	Confiscation: loss of assets without compensation
Social unrest & disorder	Parliamentary opposition groups	Expropriation with compensation: loss of freedom to operate
Vested interest of local business groups	Non-parliamentary opposition groups	Operational restrictions: market shares, product characteristics, employment policies, locally shared ownership, etc.
Recent and impending political independence	Non-organized common interest groups: students, workers, peasants, minorities, etc.	Loss of transfer freedom: financial (dividends, interest payments) goods, personnel or ownership rights.
Armed conflicts and internal rebellions for political power	Foreign governments or intergovernmental agencies such as the EEC	Breaches or unilateral revisions in contracts and agreements, damage to property or personnel from riots, insurrections, revolutions and wars
New international alliances	Foreign governments willing to enter into armed conflict or to support internal rebellion.	Discriminations such as taxes, compulsory sub-contracting

2.1.1. Regime Change

Regime change can occur through scheduled elections or through such extra legal methods as conquest by a foreign power, revolution, military coup, assassination or reconstruction following the failure of a state. Regime change may replace all or part of the state's existing institutions, administrative apparatus, bureaucracy and other elements leading to a major shift in the political leaders responsible for running the country. In some countries of course extra legal and legitimate blend into one.

The threat posed by regime change is both the circumstances surrounding the change itself and the economic and political consequences resulting from the change. An extra legal change in government or defensive reaction against an attempted overthrow can disrupt normal economic activities causing banks, custom houses and borders being closed. Bureaucracies can stop processing papers. In cases where a civil war erupts from the attempted coup, delays can be even more serious and possibly permanent. At a minimum, these kinds of disruptions can delay payment, but could lead to destructions of facilities or even government expropriation. Change through legal processes rarely produces the same impact. Even so, in some countries the bureaucracies slow down their activities just before elections as they wait for the new government to organize itself and establish policies.

Even more serious ones are the political and economic consequences flowing from the change in leadership. (Such consequences can be as extreme as the 1979 Iranian revolution where the open economy and free-spending activities disappeared along with the Shah. Or they may be the negligible consequences that usually accompany government changes in Western democracies.) Nevertheless, any change in regime can signal a change in the rules of the game for governmental investments and international trade. New government policies regulating trade, determining the value of the currency, controlling the conversion of currency, managing the economy, and increasing taxes or restrictions on business could alter conditions that directly or indirectly affect terms of credit and market opportunities.

A change in regime can also affect international investors' and currency speculators' views of a country's economic future, causing major fluctuations in the currency markets. Regime change can cause currency to loose or increase value. In some cases, the increase or decrease in the value of the currency that results from such perceptions and speculation is temporary, while in others it has a long-term effect.

Different regimes can also change the ability of an exporter to market his product in the host country. New regimes are often inclined to be more protectionist than their predecessors. A government may decide to create regulations aimed at reducing export opportunities from a particular country. A change in regime may also mean that sales agents, once successful in marketing their product no longer have the favor of the government.

2.1.2. Political Turmoil

Political turmoil is chaos, uncertainty and high tension in politic arena causing business or financial disruption through violence or illegal actions. It ranges in intensity and destructiveness from peaceful demonstrations, a general strike or violent strike activity, and violent demonstrations to riots, terrorist activities, guerrilla actions, civil war and international war.

There are political systems used to live with prolonged, low-level political turmoil so that the disruption of commercial activity is minimal. Political turmoil damages the economic system and leads to a breakdown in law and order. Turkey, before the generals took over in September 1980, was plagued with killings by both the right and the left wing which led to a weakened economic position. Turkey's volatile political backdrop has long represented a risk to business activity and investment. Its 2001 crisis was also triggered by a political stand-off between the president and prime minister, while the long history of military involvement in politics has stymied the maturation of governmental structures.[19]

[19] Middle East Monitor, **Political Crisis: Impact On Turkey's Risk Profile,** June 2007, Volume 17, Issue 6, p.5

Both indirect and direct effects of political turmoil should be considered by risk analysts. A buyer's business may be physically damaged during an outbreak of violence; but the more likely risk is from the deterioration of the economy and the legal and administrative processes necessary to carry on international trade. When political turmoil threatens the life and property of commercial leaders, this produces sustained capital flight, which in turn weakens the currency and could ultimately lead, as it did in Turkey, to prohibitions against the transfer of currency. The lawlessness and corruption that accompanies extensive political turmoil also hinders the ability of the government to implement the routine procedures required for currency exchange, trade licensing and orderly customs procedures. On occasion political turmoil can be directed explicitly at foreign citizens. The most widespread problem is the kidnapping of high-level officials, usually done by extremist groups to gain publicity and raise money to buy weapons.

Political turmoil is a chronic problem in many developing countries or any other country undergoing significant political reforms. Economists have often ignored this important issue when modeling empirical studies of price information in financial markets. The degree of price volatility in financial markets can be expected to be different across countries and over time. In developing economies or those under-going extensive economic and political reforms, we may expect large fluctuations in financial prices because of recurring social or political turmoil. For instance, the recent wave of economic reforms in Eastern Europe and China has not been without substantial political upheavals. One such heavily affected financial market is the foreign exchange market. Political and social changes in east Europe, China and other developing countries can be viewed as signals to market participants that change the expected future profitability associated with taking positions in foreign currencies and, thus, create large swings in exchange rates. In other words, the market price of political uncertainty in these countries can be immediately reflected in the current spot prices. The inability to incorporate political instability variables indicates a potentially serious misspecification of models used to determine the formation of prices in financial markets.

2.1.3. Governmental Restrictions

Although they are evaluated as less important form of risk, political restrictions are potentially more devastating to foreigners than either regime change or political turmoil.

Governments can restrict foreign businesses and trade for two relatively distinct reasons; economic and ideological. Economic reasons include attempts to increase revenues, protect domestic business or jobs, maintain control over natural resources and protect the value of the currency. Ideological reasons arise from both nationalistic and anti-capitalist sentiment in which foreign trade may be viewed as a threat not only to the economy but to the social and political values of the society. The motive for restrictions has been more economic than ideological.

Regardless of motivation, the fact remains that governments frequently change the international economic rules of the game. Rule changes can be grouped into three categories. First, tariff levels are altered in accordance with the economic needs of the government and its attitude toward protection of local procedures. Countries with chronic balance of payment deficits are likely to have high tariffs, at least on luxury goods, to keep the middle and upper classes from sending too much money out of the country in search of jewellery, high-priced automobiles, furniture, and designer clothing. If deficit reach crisis proportions, governments may also raise tariffs on consumer goods generally. However more often than not, they put for a second type of restriction; non-tariff barriers. Such restrictions as prohibiting the importation of certain goods or establishing import quotas are implemented. Import licensing regulations can be changed or as is more often the case, the administration of them can be tightened and processing slowed. A third area of rule changes is official interference in the transfer of currency. Countries with weak balance of payments positions frequently require approval of the central bank for the release of currency. Actions sometimes result in payment delays of several months and, in the case of Turkey in the late 1970s and early 1980s, years.

In addition to these types of regulations, government policies toward smuggling, corruption and administrative efficiency can also be extremely important. Black market activities in goods and currencies grow out of government policies and their inability to implement them. They also play a major role in the climate for the foreign businesses

Governments also change the rules against foreign businesses operating in their country. One set of rules has to do with foreign ownership. In many countries, foreigners can own only a minority share of the business. Other countries permit 100% ownership by foreigners but not in all sectors. Communication and defense equipment are frequently off limits to foreign investors. Governments also place regulations on corporations concerning how many non-nationals or expatriates they can employ, where they can buy the raw material they use in manufacturing, and what kinds of products they can produce. Also governments may provide tax breaks to foreign corporations in order to attract their investments. They may also tax the profits of foreign countries or in some cases prohibit foreign companies from sending profits back home. Companies learn to live with these rules and regulations. However, the most critical concern is the chances that the rules will change. Companies can adjust to existing restrictions but protecting their investment from changes in government policies can be harder.

2.1.4. Economic Policies

Political considerations cannot be treated as to lie outside the purview of economics. Governmental policies of a country give shape to the economic outlook. Political stability plays an important role in the sustainable success of a government's policies. The danger signal in this regard is a pattern of economic policies that creates inflation, usually characterized by deficit spending and heavy international borrowing. Governments may pursue this pattern for a number of reasons including: Poor economic management either because officials do not understand the requirements to maintain a healthy currency or because they are unable to implement their goal, insufficient economic capability as a result of heavy import needs of food or energy, lack of political will to control expenditures, especially in a country where political forces are so fractionalized that no strong government can come to power, political temptation to overspend occurs when governments pursue policies they know will lead to economic disaster. Governments undertake heavy welfare expenditures or subsidies for consumer needs to maintain political support. To some extent, this occurs in every country regardless of the political or economic system.

While overspending can lead to a weakened currency and payment difficulties, as well as a currency risk for exporters, a policy of under-spending can lead to a reduction in market size and the risk of non-payment by importers who are threatened with bankruptcy. In case where the government imposes austerity measures to correct previous policies of overspending, the exporter to the country is faced with an economy beset by low growth and high unemployment. As the economy slows, the demand for imports recedes and ultimately the government might implement protective measures to stem the growing tide of unemployment.

2.1.5. Elections

In democracies policy decisions reflect the preferences of the majority of voters. In order to ensure this, the voters are regularly consulted through elections. Changes in the outcome of elections and therefore in the composition of the government, will most likely result in policy changes. This should affect economic variables such as unemployment, growth, and inflation. Therefore election results contain information about future policies. In electoral systems characterized by majority representation and single-party governments as in the United States, the election results allow a straightforward prediction of future economic policies. However, stock prices only change to the extent that election results contain unexpected news that forces investors to alter their view on these policies.

In countries with proportional electoral systems, the information on future policies contained in election results is generally limited since the main political event is the composition of the multi-party coalition. This is difficult to predict from the election results. Election results may, however, still have some effects on the stock market since the uncertainty related to the event ‘‘election’’ is eliminated. Since stock prices anticipate and capitalize policy changes, the analysis of the effects on the stock market of political events could indicate the economic importance of expected changes in economic policy.

A government usually attempts to steer its economy. Hibbs (1977)[20] avers that macroeconomic results are not entirely the consequence of the economy itself but are also dependent on the long- and short-term policy choices of the government. Therefore, political party differences in economic policy have the potential to move the economy along different time paths, which should manifest in different returns to stockholders.

Economic policies of the political parties in the United States significantly vary from each other. Hibbs (1986)[21] reports that Democratic administrations are more likely to pursue expansionary policies than are Republican administrations. Conversely, he reports that Republicans are more adverse to igniting inflationary pressures than are Democrats. Evidence of these differences in philosophies is seen in the real economy. Chappell and Keech (1986)[22] report that Democratic administrations are associated with average inflation rates that higher than Republican administrations. Alesina and Sachs (1988)[23] report that, from 1948 to 1984, the first two years of a Democratic administration are associated with higher annual rates of gross national product (GNP) growth than the first two years of a Republican administration.

If electorates are well informed and assessing the government's policies and economic performance before voting, democracy can be considered as well-functioning in that country. However, when assessing government's policies, the voters give similar weights to growth and inflation or they consider the entire tenure of a government but mostly just its recent performance or they vote strategically to diffuse power.

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[20] Douglas A. Hibbs, **Political Parties and Macroeconomic Policy**, American Political Science Association, The American Political Science Review, Vol. 71, No. 4, Dec., 1977, p.1467-1487,

[21] Douglas A. Hibbs, **Political Parties and Macroeconomic Policies and Outcomes in the United States**, Papers and Proceedings of the Ninety-Eighth Annual Meeting of the American Economic Association, The American Economic Review, Vol. 76, No. 2, , May 1986, p.66-70

[22] Henry W. Chappell, Jr. and William R. Keech, **Policy Motivation and Party Differences in a Dynamic Spatial Model of Party Competition**, American Political Science Association, The American Political Science Review, Vol. 80, No. 3, Sep., 1986, p.881-899

[23] Alberto Alesina and Jeffrey Sachs, **Political Parties and the Business Cycle in the United States**, 1948-1984, Blackwell Publishing, Journal of Money, Credit and Banking, Vol. 20, No. 1, Feb., 1988, p.63-82

When the electorate emphasizes growth over inflation, and recent past over distant past, the governments will be provided with incentives to undertake populist policies before an election and deal with their adverse long-run effects after the election, giving rise to political business cycles. The administrations then will also be motivated to postpone, until after elections, the adjustments that are necessary for the long-run health of the economy, if such measures involve some short-run hardships.

If all parties in a coalition government are not considered equally accountable, this could lead to irresponsible behavior by some parties in power and may create friction between the coalition partners, which in turn can lead to the dissolution of the government and to political instability.

Incumbents lose votes over time, just for being in power and making the hard decisions. As a result, the lifetime of governments will be shortened as they stay in power and instability will be observed in the system. Thus the country will be exposed to frequent elections and then will be steered by inexperienced parties and leaders.

When voters vote strategically to diffuse power, for example by voting in local elections against the parties in the central government, while creating more checks and balances for democracy, they also create a rift between central and local administrations. Then the coordination of policies at the central and local levels will be more difficult.

Consequently, a considerable amount of research is devoted to investigating the voter response to economic conditions but there are very few studies on economic voting in Turkey. Most of them addressed the question of whether economic conditions prevailing at the time of an election affect its outcome; some considered in addition the issue of voter myopia. In this study, ISE response to the general and local elections and the fluctuations before and after the election time periods in Turkey will be investigated.

3. POLITICAL RISK EFFECTS ON STOCK MARKETS

It is well established in the financial literature that stock market volatility can be explained by economic events. But economic news is not the only news that influences stock market movements. Political events are repeatedly considered responsible for such movements. There is a rich empirical and theoretical literature about the effects of political cycles on the macroeconomy.[24]

As Anderson (1991) and Chicken (1986) explain, economies do not exist in isolation of politics, or purely for their own sake. They have effects on the future of the environment and societies which are of definite importance, as society and the environment provide the inputs and resources any economy is reliant upon, be they labor or natural resources. Thus the human and natural perspectives of economics imply the use of social and environmental factors to enable the measurement of a country's economic prospects and economic performance, alongside such factors as capital and current accounts, account deficits, reserves, and gross national product statistics. (Nash 1994)[25]

3.1. POLITICAL NEWS AND STOCK PRICES

Two models of political economic cycles are developed, analyzing the scope for government macroeconomic policies. The ''political business cycles'' (PBC) model (Lindbeck, 1976[26]; Nordhaus, 1975[27]) stresses the opportunism of policy-makers trying to maximize their popularity and/or their probability of re-election. Political business cycle basically suggests that politicians manipulate an economy (usually by increasing or decreasing money supply) to achieve personal ends, especially during an election

[24] Fotios Siokis & Panayotis Kapopoulos, **Parties, Elections and Stock Market Volatility: Evidence from a Small Open Economy**, Blackwell Publishing Ltd, MA, USA, The Authors Journal Compilation, Economics & Politics, Volume 19, March 2007, p.123
[25] Brink, p.80
[26] Asar Lindbeck, **Stabilization Policy in Open Economies with Endogenous Politicians**, American Economic Association, The American Economic Review, Vol. 66, No. 2, Papers and Proceedings of the Eighty-eighth Annual Meeting of the American Economic Association, May 1976, p.1-19
[27] William D. Nordhaus, **The Political Business Cycle**, The Review of Economic Studies Ltd., The Review of Economic Studies, Vol. 42, No. 2, April 1975, p.169-190

period. Expansionary monetary and fiscal policies have politically popular consequences in the short run (tax cuts, falling unemployment, falling interest rates, new government spending on services for special interests, etc.). Unfortunately these policies, especially if pursued to excess, can also have very unpleasant consequences in the long run (accelerating inflation, an unsustainably low rate of savings to support future investment, damage to the foreign trade balance, long-term expansion of government's share of the GNP at the expense of people's disposable incomes, etc.). So immediately after the election is over (and the next election is far away), politicians tend to “bite the bullet” and reverse course by raising taxes, cutting spending, slowing the growth of the money supply, allowing interest rates to rise, etc. Thus the regular holding of elections tends to produce a boom-and-bust pattern in the economy because of the on-again-off-again pattern of government stimulus and restraint encouraged by trying to schedule an artificial boom at every election time.

Governments of developing countries engage in expansionary fiscal policies to enhance their re-election prospects. This raises the fiscal deficit and fiscal consolidation follows after the election. Developing country governments also adapt their macroeconomic policy decisions to changes in the incentive structure as, for example, determined by the openness to international trade or agreements with the international financial institutions.[28]

The PBC model suggests that in pre-electoral period, high growth and low employment and increasing inflation will occur in the economy, accompanied by postelection recessions, regardless of the political orientation of the government. Later, the PBC model was enriched with rational expectations, placing greater importance on information asymmetry between the government and voters. In this extended model, politicians know their own level of competence, while the voters, who are endowed with rational expectations conditional on the information set available to them at any given time, discover the level of politicians’ competence only after the elections.

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[28] Ludger Schuknecht, **Political Business Cycles in Developing Countries**, Kyklos, 1996, Vol. 49 Issue 2, p.167

According to Rogoff and Sibert (1988)[29], voters are forced to base their judgments on observed economic outcomes, giving opportunistic governments the incentive to manipulate macroeconomic policy variables in an effort to appear competent before elections. Unlike the traditional PBC, in the rational opportunistic PBC, variables like spending, deficits and money supply are expected to increase before elections, while seigniorage is expected to increase in post-elections, as governments act to finance pre-election expansions.

The political business cycle (PBC) model as developed by Nordhaus (1975)[30] suggests incumbent politicians have an incentive to stimulate the economy to bolster their reelection chances. This coincides with empirical evidence that favorable economic conditions impact upon incumbent popularity and voting patterns in an advantageous manner. If voters do behave in this fashion, politicians should be aware of this and consequently help themselves by spurring growth prior to an election. However, any stimulus the politicians can provide is expected to be short lived; economic booms during the election period are followed by busts in the next period as the reelected government attempts to eliminate the newly created inflationary pressure on economy.[31]

The PBC model has been criticized by Hibbs (1977)[32], who challenged the notion that politicians are purely opportunistic, to the exclusion of partisan preferences over policy outcomes. Hibbs argued that left-wing socialist parties systematically prefer low unemployment at the expense of higher inflation. In other words, his ‘‘partisan cycles’’ model implies the systematic and permanent differences in the inflation/unemployment combination chosen by different political parties (on a left-right axis). In a two-party system, the left-wing party places more emphasis on lower unemployment and not on inflation, as compared with right-wing parties. In a rational version of the model, Alesina and Sachs (1988)[33] argue that, with nominal wage

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[29] Kenneth Rogoff and Anne Sibert, **Elections and Macroeconomic Policy Cycles**, The Review of Economic Studies Ltd., The Review of Economic Studies, Vol. 55, No. 1, Jan., 1988, p.1-16
[30] Nordhaus, p.169-190
[31] Jac C. Heckelman and Hakan Berument, **Political Business Cycles and Endogenous Elections**, Southern Economic Association, Southern Economic Journal, Vol. 64, No. 4, Apr., 1998, p.987
[32] Hibbs, **Political Parties and Macroeconomic Policy**, p.1467-1487
[33] Alesina and Sachs, p.63-82

contracts, changes in the inflation rate with changes in governments result only in temporary, post-election differences in output and unemployment. In the post-election period, the outcomes are the same regardless of the party in power.

Although there is extensive empirical literature testing the Political Business Cycle (PBC) hypothesis for major developed countries, there is a serious lack of similar studies for developing countries and emerging markets with developing markets and institutions. This study mainly investigates the market performance in the Electoral Political-Business Cycles in Turkey and the effects on ISE as a developing country and an emerging market.

As stated before there are two main schools of thought concerning the common notion of politic intervention in economic policy. One is the Partisan Business Cycle initiated by Hibbs (1977), which suggests that ideological preferences of the governments shape their economic policies. Empirical results showed no significant evidence of Partisan PBCs in Turkey.

Nordhaus (1975)[34] and Lindbeck (1976)[35] presenting the Electoral PBC hypothesis, argues that incumbent government would like to show good economic performance before elections and applies expansionary economic policies in order to influence voters and maximize its chance of reelection. The opportunistic manipulations done in the pre-electoral period may have important effects on post-electoral economic performance. Political parties in power could enact economic policies either by facilitating their re-election or by maximizing the welfare of their own constituencies.

The electoral uncertainty increases in the pre-electoral period due to investors' anticipation of policy changes. In addition, during the pre-election period, the government usually engages in an aggregate consumption increase, raising transfers for instance, cutting various taxes and increasing government spending in public projects with high immediate visibility. This action results in an inflation increase and/or an increase in the employment level but also raises the uncertainty in the stock market, which consequently changes investors' sentiment during the pre-election period. When

[34] Nordhaus, p.169-190
[35] Lindbeck, p.1-19

the rate of inflation begins to rise after the elections as a result of expansionary fiscal and monetary policies the incumbent government could try to decrease inflation by applying post-electoral contractionary fiscal and monetary policies, leading to a recession in the post election period. As a result, the economy would be ready for a new pre-election upswing before the next elections. Hence, Electoral PBC theory suggests that there are systematic variations at some certain macroeconomic indicators, coinciding with election periods.

It is commonly argued that the reported evidence of stock price dependence during the political calendar as by the literature in modern political economy, which has shown, mainly in the United States, that macroeconomics and politics are very much interconnected. To the extent that stock prices are affected by the macroeconomy and by policy choice, it is reasonably expected that stock returns to vary with the political calendar.

From literature review it is clearly seen that many other studies matches that political events are very important in explaining the behavior of the stock markets. Elections and governmental actions are some of these events that give information about future economic policies. Most of the studies especially on developed countries have strong evidence on partisan and electoral effects on stock prices. Political regimes impact the conditional variances of the stock market index. Volatility increases more in the pre-election period as we approach the time of the elections, interaction on volume can be determined.

The stock market index aggregates individual stock prices. When uncertainty is taken into account, these prices discount investors' expectations concerning possible future corporate developments. In efficient markets, investors predict in a rational way by making use of all available information and prices react instantaneously to news.

News affects the stock market index through adjustments to the stream of expected dividends or the expected return. The model used by investors need not be specified since it is in their own interest that they choose the ''correct'' model. Systematic prediction errors can therefore be excluded. It would be a difficult and tedious task to enumerate all the information that investors consider. Expected government policies are obviously part of it. As a result of the investors' long-term view, temporary policy changes only exert a marginal effect on stock prices. Policies that reduce the stream of dividends in the short run, but stimulate it in the long run, increase the stock market index if the present value of the second effect dominates the first. Owing to the uncertainty surrounding policies – within at most four years new elections will be called so that a new government may cancel some or all of the policy changes – one is inclined to assume that the short term effects will frequently dominate the long-term ones.

As Hibbs (1977)[36] stated, a government usually attempts to steer its economy, averring that macroeconomic results are not entirely the consequence of the economy itself but are also dependent on the long and short-term policy choices of the government. Therefore, political party differences in economic policy have the potential to move the economy along different time paths, which should manifest in different returns to stockholders.

The relation among political rhetoric, economic policy, and economic outcomes is important. Political theorists frequently argue that the path to electoral success is to design policies that appeal to the greatest number of likely voters—the political center (Buchanan 1967). If such a strategy were followed by both major party candidates, there might be little substantive difference in the post-election economic policy or outcomes, and ergo, election outcomes would have little effect on common stock returns. On the contrary, empirical evidence shows that differences in rhetoric are followed by differences in economic outcomes. This suggests a link between common stock returns and political outcomes.[37]

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[36] Hibbs, **Political Parties and Macroeconomic Policy**, p.1467-1487

[37] Jinliang Li and Jeffery A. Born, **Presidential Election Uncertainty and Common Stock Returns in the United States**, Blackwell Publishing Ltd., Journal of Financial Research, Winter 2006, Vol. XXIX, No. 4, p.609

3.2. RELATION BETWEEN ELECTION CYCLES AND STOCK PRICES

Most of the authors who have investigated the impact of elections on the stock market consider US data, frequently presidential elections on their studies, supporting the four-year election cycle theory in stock returns. Most of the time only the effects of the actual election are considered. The result of the elections of the incumbents or the ideologies of the election winners are not taken into account. Some exceptions exist, but the results are mixed. Riley and Luksetich (1980)[38], support the view that the stock returns are higher under Republican presidents. Their study also does not pay any attention either to the election system or to the parliamentary system. Mostly data for the United States or politically similar systems are used. In these two-party systems with majority representation and therefore single-party governments, elections remove all uncertainty concerning future policies.

In countries with a proportional electoral system, however, governments are mostly multi-party coalitions. The election results do not, therefore, lead to a straightforward prediction of the composition of each new coalition. This implies something of a variable time lag between the election and the stock market reaction. Furthermore, since coalition-based political systems are less stable, government changes occur without an election taking place. Such changes lead to comparable effects on the stock market in the same way as government changes following elections.

Two well-known theories of public choice can be extended to allow for the effect of political events on stock market returns. Whereas the first approach is based on the theory of the political business cycle, the second has its roots in the partisan theory of economic policy.

‘‘Political business cycle’’ correlating a simple relationship between political events and stock prices is based on the assumption that voters consider their financial situation when voting. Policy-makers may thus generate a rising stock market by

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[38] William B. Riley, Jr. and William A. Luksetich, **The Market Prefers Republicans: Myth or Reality**, Published by: University of Washington School of Business Administration, The Journal of Financial and Quantitative Analysis, Vol. 15, No. 3, Sep., 1980, p.541-560

manipulating policy instruments, or by promising to do so after being elected or re-elected, that increase the stream of expected dividends or lower the expected return. For example, the anticipation of lower taxes on labor or profits will increase expected dividends. Since investors are rational, we should be very critical about the ability of policy-makers to create systematic surprises in the stream of expected dividends and/or returns.

Empirically, the political business cycle interpretation of the relationship between political events and the stock market thus implies that policy-makers systematically aim for a rise in stock prices in periods preceding elections. A second empirical implication is that stock prices should not react to changes of government that occur without an election being held. Finally, the composition of the coalition should be unimportant. A rejection of this application of the political business cycle does not imply that none of these policies has been pursued. Indeed, empirical tests combine the existence of a political business cycle with the impact on the stock market. That no political effect on the stock market is detected does not mean that policy-makers have not used policy instruments for their re-election, or that a political business cycle does not exist in real variables. It only shows that investors have not adjusted their perception of the stream of dividends and/or the expected return to policy moves.

The previous extension of the political business cycle to the impact of elections on the stock market leads to comparable empirical implications as the ‘‘uncertain information hypothesis’’ developed by Brown et al. (1988)[39]. This approach holds that uncertainty is resolved as the election date approaches since the results become less uncertain. Brown et al. (1988) argue that ‘‘subsequent price changes tend to be positive on average, regardless of the nature of the catalyzing event’’ Election results as such are thus not important.

A second view of the impact of political events on the stock market stresses uncertainty over the policies that the next government will pursue. A requisite is that the ideology of a government (in brief, either right-wing or left-wing) has a distinct effect

[39] Keith C. Brown., W. V. Harlow, and Seha M. Tinic, **Risk Aversion, Uncertain Information, and Market Efficiency**, Journal of Financial Economics 22, 1988, 355–385

on economic policies. As a result, differences in the ideological composition of a government will be reflected in policy differences and therefore in stock price determinants (the stream of future dividends and/or the expected return). This is an illustration of the ‘‘partisan effect’’: ideological differences between parties lead to different policies. No policy-maker will deny this effect. A distinction should be made between ‘‘traditional party-models’’ and ‘‘rational party-models’’. In the former, the effects on economic variables are permanent while in the latter they are not. Table 2 summarizes the main differences between the traditional and rational perspectives for opportunistic and partisan models.

The idea of the partisan approach is that political parties address themselves to voters with different preferences. Left-wing parties are assumed to overweight employment in their policy goals, whereas right-wing parties presumably favor low inflation. Investors thus expect that in comparison with left-wing parties, right-wing parties will pursue more pronounced supply-side policies. All things being equal, an extension of a right-wing government will thus imply stable, if not rising, stock prices. An expected switch from a left-wing to a right-wing government could stimulate stock prices additionally since investors might assume that the new coalition will implement some supply-side policies.

This partisan approach leads to the impact of a new government on the stock market depending on the ideological composition of the coalition and relates to the distinction between traditional and rational party models, if the effects are present, permanent or temporary. A final implication to be verified is whether investors only modify their view of the expected policies of a new government after elections have been called, or if this also occurs with government changes when no elections have been called. This is a characteristic feature of partisan models: any government change, even without a preceding election, that alters investors’ views concerning future policies will have an impact on stock prices.

Table 2

Main Differences between the Traditional and Rational Perspectives for Opportunistic and Partisan Models

Opportunistic (Electoral) PBC	
Traditional - Nordhaus (1975)	**Rational - Persson & Tabellini (1990)[40]**
Voters are myopic.	Forward looking.
Past information is used. (Retrospective decision making)	Past and present information used.
Opportunistic behavior shapes the cycle	Information asymmetry shapes the cycle.
Voters consider only election time conditions.	Voters consider future economic performance.
Adaptive inflation expectations.	Rational inflation expectations. (Voters form their expectations by using all available information)
Partisan PBC	
Traditional - Hibbs (1977)	**Rational - Alesina (1987)**
Backward looking.	Forward looking.
Adaptive inflation expectation.	Rational inflation expectations. (Voters form their expectations by using all available information)
Cycles occur because of different party preferences.	Cycles occur because of uncertainty of election outcomes.
Effects of partisan shifts in governments tend to persist.	Effects of partisan shifts in governments are temporary.

The uncertainty of the expected policy changes and the changing nature of this uncertainty over time must be taken into account while evaluating the empirical results. Since the stock market penalizes uncertainty, this by itself will affect prices negatively. So, for example, if the policy uncertainty associated with a left-wing to right-wing government change is substantial, stock prices will react only marginally.

[40] Torsten Persson and Guido Tabellini, **Macroeconomic Policy, Credibility and Politics**, Harwood Academic Publishers, The Netherlands, 1990.

It is possible that stock price movements prior to elections are influenced by expectations of the election outcome, resulting in two-way causality between the popular vote and stock prices. Stock prices are then partly a proxy for the expected outcome of the election. Biley and Luksetich (1980)[41] note that stock prices do seem to respond to popular vote immediately following presidential elections. Other things being equal, stock prices tend to rise simply because of the removal of the election outcome uncertainty and stock prices also tend to rise if a Republican wins and they tend to fall if an incumbent loses. In addition, correct anticipation of the election outcome provides opportunity for trading profits. These findings suggest that there is some causality from the popular vote to stock prices following, not prior to the election.[42]

3.2.1. Political Business Cycles and the Information Content of the Electoral System

The impact of political events on the stock market differs in a majority-based electoral systems that result in single-party governments and proportional representation that produces coalition-based political systems. In majority-based electoral systems which are frequently associated with two-party systems, elections are crucial political events since their outcome removes the uncertainty surrounding the next government and therefore future policies.

In other words, investors are able to predict future policies fairly accurately on the basis of the election results. On the other hand, in systems based on proportional representation, the main political event is the formation of the coalition and not the election itself since the results do not, in general, lead to a straightforward prediction of the new government.

Notwithstanding this, election results can have an impact on the stock market since investors may modify their expectations of future policies. Important political events occur more frequently in coalition systems as compared to two-party systems

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[41] Riley and Luksetich, p.541-560

[42] Richard F. Gleisner, **Economic Determinants of Presidential Elections: The Fair Model**, Springer, Political Behavior, Vol. 14, No. 4, Dec. 1992, p.386

because the election outcome and the disappearance of uncertainty about future policies no longer coincide. The political events that can affect the stock market in coalition systems are:

1. The election results. Election results are the first source of information about future policies. This is the only source of uncertainty in a majority-based election system.

2. The time required to form a coalition. The formation of a new coalition requires an unknown period of time.

3. The composition of the coalition. The relation between the election results and the composition of the coalition is, by definition, not necessarily unambiguous. Most of the time the new coalition will be either left-wing or right-wing, especially when a centre party is part of the political scene.

4. The new government's policies. This is obviously crucially important to investors. The announcement of the composition of the new coalition may already give a fairly good indication of their policy priorities, but investors will have to wait until the coalition's programme has been made public to obtain a complete and correct view of future policies. A lack of precision in the negotiated compromises may well prolong the period of uncertainty.

5. The new government's performance. The fulfillment of investors' expectations and government's attitude on keeping its pre-electoral promises is another important factor affecting the stock market behavior. Situations in which promises given and actions taken by the government are contradictory, investors can response reactive which causes stock market volatility and abnormal price fluctuations.

Investors form expectations about each one. A change in investors' expectations concerning one or more of the five events and their uncertainties will have an immediate effect on the stock market, possibly even before an election is held. For example, the expectation that politicians will need more time to form a new coalition government will depress the stock market. The reaction of the stock market to the election results is therefore difficult to predict since, in contrast to a two-party system, uncertainties are not eliminated in a coalition-based system. Essentially, this depends on the impact that the election results have on investors' expectations of the next coalition. If the election results are interpreted as a sign that the new coalition will probably be more right-wing, the stock market will react positively. When experience shows that earlier elections did not contain information about the composition of the subsequent coalition, stock prices will hardly react to the election outcome.

Dramatic changes in the composition of the government without the benefit of an election are unlikely in a two-party political system but common in proportional ones. Their effect on the stock market depends on the sign and size of the policy surprise effect expressed as the difference between the new and the previously announced policy.

Opportunistic PBC considerations suggest that agencies are more likely to downgrade developing country sovereign ratings in election years, due to general concern that incumbents will implement spending sprees beneficial to garnering votes at the polls, but detrimental to post-election sovereign creditworthiness.

By contrast, partisan PBC considerations suggest that elections provide no basis for ratings changes. Agencies look primarily at the partisan orientation of incumbents, assess the favorability of their policies for investors, and consider the implications of any switch in policies should the incumbents be ousted at election. It is commonly assumed that right-wing parties tend to adopt more "investor-friendly" policies than left-wing parties. Thus, agencies will favor likely electoral transitions to the rightwing and to penalize likely transitions to the left-wing. This follows from development of a conceptual framework integrating opportunistic and partisan PBC considerations from an agency perspective. (As stated before, the idea of a partisan business cycle was first developed by Douglas Hibbs, "Political Parties and Macroeconomic Policy", American Political Science Review 71 (1977), 1467-87)

Opportunistic PBC theory originated with Nordhaus (1975)[43], who contended that election-period economic policy choices were motivated by the general support they would generate from voters with largely homogenous preferences. While early models assumed naive voters with adaptive expectations, and thus, limited capabilities to anticipate incumbent policies during election periods, models developed later by Rogoff and Siebert (1988)[44] posited voters with rational expectations and relative ease at anticipating election-period spending sprees by politicians. Politicians in these models are undifferentiated by ideology, and seek office for its own sake.

Traditional partisan PBC models originated with Hibbs (1977, 1987), who argued that politicians seeking election tended to adopt economic policies according to ideological preferences. According to traditional partisan PBC models, incumbents may stil use economic policy to garner voter support, but their policy decisions are based on their partisan political orientation, which can lead to very different emphases.

Partisan PBC research often articulates these differences in terms of a simple Phillips curve approach with left-wing incumbent policies tending to favor employment at the expense of inflation, and with right-wing incumbent policies favoring inflation at the expense of employment. Because voter preferences are assumed to be heterogeneous based on these types of partisan preferences, such policy differences can generate substantial differences in political support during election periods, substantial differences in employment, inflation and economic growth after elections, and substantial right-left partisan swings across several election periods.

Alesina and Sachs (1988)[45] refined traditional partisan PBC models to be consistent with rational-expectations assumptions. So-called rational partisan cycle ("RPC") models assume a less exploitable Phillips curve compared to traditional partisan PBC models. Thus, the main difference between traditional partisan PBC and RPC models is that real effects of partisan shifts in government tend to persist in traditional models, but is temporary in rational models.

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[43] Nordhaus, p.169-190
[44] Rogoff and Siebert, p.1-16
[45] Alesina and Sachs, p.63-82

While left-right partisan differences in policy preferences are most commonly articulated in terms of the inflation-employment trade-off, they proxy for a more comprehensive range of right-wing policy preferences generally favoring the interests of the investors versus left-wing policies generally favoring the interests of workers. Hibbs (1977)[46] for example, argued that the major supporters of right-wing parties are typically middle- and upper-class individuals with higher incomes and investment wealth, a considerable part of which is typically in nominally fixed assets. Left-wing supporters typically have lower incomes and wealth, aside from human capital tied closely to the employment relationship. Based on this distinction, it is easy to expand the list of partisan distinctions to a range of right-wing fiscal, monetary and related policies including, but not limited to lower inflation, favoring investor interests, and a range of left-wing policies including, but not limited to higher employment, favoring worker interests.

Recent reviews of the PBC research chronicle a growing empirical literature, but with more growth in the opportunistic rather than partisan PBC branches, and with much more work in both branches in industrialized country rather than developing country contexts. While evidence supporting opportunistic PBCs in industrialized countries is, to date, mixed, empirical studies in developing countries consistently find support for the proposition that incumbents may employ expansionary monetary, fiscal and related policies during election periods to gain voter support on the final election day.

Partisan PBC models differ from opportunistic PBC models by their explicit treatment of right-wing versus left-wing policy preferences and their economic implications when there is a transition in power following an election. From a partisan PBC perspective, agency assessments of sovereign risk are generally presumed to be more favorable with right-wing incumbents since their policy preferences, which include lower inflation, are more investor-friendly and decrease the likelihood of default. Agency assessments of sovereign risk are generally presumed to be less

[46] Hibbs, **Political Parties and Macroeconomic Policy**, p.1467-1487

favorable with left-wing incumbents since their policy preferences, which tolerate higher inflation, are less investor-friendly and increase the likelihood of default.

According to the electoral cycle approach, incumbents seek to synchronize the timing of economic benefits and government profligacy with elections so as to improve their chances of being re-elected to office. The partisan cycle approach correlates the ideology of the party in office with the size of government budgets. A third approach offers a synthesis of the electoral and partisan cycle approaches: incumbents normally pursue partisan policies but switch to electoral policies when nearing an election. (The idea of an interaction between electoral and partisan influences was formalized in a series of articles by Bruno Frey and Frederich Schneider.[47])

3.2.2. Electoral (Opportunistic) and Partisan Political Business Cycle Effects

In a coalition-based system the policy-surprise effect occurs when the coalition is announced, but in a two-party system this effect seems to happen on the eve of an election. Thus compared to a two-party system, investors face additional uncertainty as the amount of time required to form a coalition.

A study of the effects of political events on the stock market requires a quantification of the surprise effects linked to elections, to the formation of coalitions and to possible policies. In addition, one should test for the impact of the difficulty in forming coalitions and examine whether changes in a coalition contain important information that could affect the stock market.

Since coalition-based political systems are less stable as compared to two-party systems, also the fact that elections are frequently held unexpectedly must be taken into account. Also, a new coalition may be formed without an election taking place. The election is then ‘‘skipped’’ and the formation of the new coalition starts when a political crisis breaks out.

[47] François Petry, Louis M. Imbeau, Jean Crête and Michel Clavet, **Electoral and Partisan Cycles in the Canadian Provinces**, Canadian Political Science Association and the Société québécoise de science politique, Canadian Journal of Political Science / Revue canadienne de science politique, Vol. 32, No. 2, Jun. 1999, p.273-274

In USA it is well known that the stock market prefers Republicans to Democrats. Most corporate executives and stock traders are Republicans, and many Republican policies are perceived to be favorable to stock prices and capital formation. Democrats are perceived to be less amenable to favorable tax treatment of capital gains and more in favor of regulation and income redistribution.[48]

An even more damaging argument against the view that expectations of the election outcome drive stock prices is found in the empirical results of the model. The stock price parameter is positive, implying that a high (low) incumbent party candidate vote corresponds to a high (low) percentage growth in stock prices. To serve as a proxy for election outcome expectations the challenger (whether Democrat or Republican) can never be perceived as "good" for the economy. This is so because if the challenger is perceived as good for the economy, and if the challenge is expected to win the election, the stock price parameter should be negative, not positive – a low vote share for the incumbent party candidate but rising stock prices.

3.3. THE ELECTORAL POLITICAL BUSINESS CYCLES IN TURKEY AND ITS HISTORICAL BACKGROUND

3.3.1. The Electoral Effects in Turkey

The partisan effects and especially the electoral effects have an important role in stock price volatility in Turkey. The electoral cycle view claims that governing incumbents in majority systems can improve their re-election chances by giving direction to macroeconomic conditions through conducting subjective and opportunistic policies prior to elections. Partisan cycles occur as a result of ideological differences between political parties. According to this perspective, the election outcome surprises voters, which in turn injects exogenous shocks into the economy, at least partially.

Nordhaus (1975)[49] states that the incumbent party seeks to maximize its re-election chances by producing the best short-run combinations just before the election. Accordingly, the government wants to stimulate the economy on the eve of an election

[48] Jeremy Siegel, **Stocks for the Long Run**, 3rd Edition, McGraw Hill, NY USA, 2002, p.221
[49] Nordhaus, p.169-190

to become more competent in the eyes of voters. Nordhaus' model predicts that governments launch contraction policies in the first half of their terms, and expansionary policies in the second half. Nordhaus' model implies that people who vote for the incumbent party act with 'irrational myopia'. (Nordhaus also emphasizes that no simple mono-casual model can capture the complex reality of political business cycles as the voters are not rational - and should not be modeled as such- and partisan effects are of secondary importance relative to opportunistic behavior.[50])

Many studies found evidence in the favor of an electoral cycle in the USA. Besides the cycles in the level of economic activity, many studies have recently been focused on economic policy cycles on the eve of elections. From the political business cycle perspective, the incumbent government likes to cut taxes, but increase expenditures as the election comes closer (Rogoff, 1990)[51]. Castro and Veiga (2004)[52] present evidence that both the timing of stabilization and the choice of the nominal anchor are affected significantly by the incumbent party's intention to secure re-elections.

According to Tufte (1978)[53] there is an electoral rhythm to the national economic performance of many capitalist democracies. The electoral cycle causes substantial macroeconomic fluctuations. For having an effective means of influencing government popularity, opportunistic policies must yield clear and immediate economic benefits to a large number of people. It is believed that expansionary government spending can easily be observed, so politicians can gain direct credit for it. Studies, such as Tuffe (1978), provide support for policy cycles in the USA. Schuknecht (2000)[54] investigates developing countries and provides evidence that most governments use fiscal policies to enhance their electoral prospects before the election.

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[50] William D. Nordhaus, Alberto Alesina and Charles L. Schultze, **Alternative Approaches to the Political Business Cycle**, The Brookings Institution, Brookings Papers on Economic Activity, Vol. No. 2, 1989, p.50

[51] Kenneth Rogoff, **Equilibrium Political Budget Cycles**, American Economic Association, The American Economic Review, Vol. 80, No. 1, Mar., 1990, p.21-36

[52] Vitor Castro and Francisco Hose Veiga, **Political business cycles and inflation stabilization**, Economics Letters, Vol. 83, Issue 1, Apr 2004, p1-6

[53] Edward R. Tufte, **Political Control of the Economy**, 2nd Edition, Princeton University Pres, Princeton New Jersey, 1978, p.26–27

[54] Ludger Schuknecht, Fiscal **Policy Cycles and Public Expenditure in Developing Countries**, Kluwer Academic Publishers, Public Choice 102, Netherlands, 2000, p115–130.

Also in Turkey, evidence in favor of electoral cycles is found and it is discovered that Turkish governments prefer either to manipulate the economy or to seek the right time for an election. It is found that politicians prefer launching expansionary policies rather than waiting for the right time in order to boost their popularity. Ergun (2000)[55] investigated economic policy indicators especially budget items like government expenditures and tax revenues and Telatar (2003)[56] used policy instruments (real money supply and real expenditure) and policy targets (inflation rate and real output growth rate) as data set for the election periods in their studies.

According to the efficient market hypothesis that is introduced by Eugene Fama (1970), securities' prices fully reflect all kinds of information and so that the investor will not receive any abnormal return which states that it is impossible to "beat the market" because stock market efficiency causes existing share prices to always incorporate and reflect all relevant information. According to the EMH, this means that stocks always trade at their fair value on stock markets, making it impossible for investors to either purchase undervalued stocks or sell stocks for inflated prices. As such, it should be impossible to outperform the overall market through expert stock selection or market timing, and that the only way an investor can possibly obtain higher returns is by purchasing riskier investments.

However, the recent empirical studies on this issue argue that the efficient markets theory does not work and there are many anomalies. These anomalies (technical anomalies, calendar anomalies etc.) are also used to test the market efficiency. In an inefficient market; by using the information on historical prices, other information that are freely available for all investors and information inside the company, investors can receive abnormal returns. There are three levels of information that might be reflected in stock prices: "the weakly efficient markets hypothesis assume that all historical information is reflected in security prices, which means that future prices cannot be predicted by analyzing price from the past and excess returns can not be earned in the long run by using investment strategies based on historical share prices

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[55] Mine Ergun, **Electoral Political Business Cycles in Emerging Markets: Evidence from Turkey**, Russian and East European Finance and Trade, Vol. 36, No. 6, Dec 2000, p.6-32

[56] Funda Telatar, **Political Business Cycles in the Parliamentary Systems**, Emerging Markets Finance and Trade, Vol. 39, No. 4, August 2003, p.24-39

or other historical data. “The semi-strong efficient markets hypothesis assume that all public information is reflected in security prices; it is implied that share prices adjust to publicly available new information very rapidly and in an unbiased fashion, such that no excess returns can be earned by trading on that information. “The strong efficient markets hypothesis” assumes that all information including public and private is reflected in security prices and no one can earn excess returns.

Many previous studies approve that, ISE is not an efficient market and there are many anomalies which terminate the market efficiency, leading to opportunities that investors could receive abnormal returns in this market. As those anomalies exist and new anomalies occur, the investors will keep on having the chance to beat the market. As Fama argued that stock prices in an efficient market would fully reflect all relevant and available information hence, successive one-period stock return or prices are independently distributed. If the market is inefficient, these successive one-period stock return or price observations are not independent and carry a ‘memory’ of all the events that preceded it. This long-term memory theoretically last forever and is quite unlike the ‘Markovian’ short-term memory. More recent events have greater impact than distant events even though, the residual influence is still present.

Researches approve that most of the time investors are in the expectation of outstanding price fluctuations in the financial markets on the bend of general elections. If the outcome of elections seems uncertain, or suspended, recession or withdrawals from the market may be expected until this uncertainty is resolved. Moreover, if there is a chance to predict the election results, the market may become very active even before elections. Usually, as the election results are clearly declared, financial market recovers its energy and effectiveness and behavioral pattern of investors shift to a positive and hopeful direction.

It is strongly believed that in Turkey, elections influence financial market along a short period. Because of that, it is not surprising to see the investors purchase and gain high profits under this positive atmosphere. Also, in the Turkish media editorials or statements have promoting headlines that the investors succeed to gain high profits from their investments in the financial market.

However, the literature is lack of satisfying scientific studies, analyzing the correlations between the election periods and stock price fluctuations in Turkey. This study aims to fill this gap in literature. So, price volatility of ISE-100 index before and after the general elections which have been arising in Turkey since the general elections dated year 1991, are held.

General elections are the most critical political risk that can affect the financial markets. Political risk refers to the complications businesses and governments may face as a result of what are commonly referred to as political decisions, or "any political change that alters the expected outcome and value of a given economic action by changing the probability of achieving business objectives".[57] Political risk faced by firms can be defined as "the risk of a strategic, financial, or personnel loss for a firm because of such nonmarket factors as macroeconomic and social policies (fiscal, monetary, trade, investment, industrial, income, labor, and developmental), or events related to political instability (terrorism, riots, coups, civil war, and insurrection)." Portfolio investors may face similar financial losses.

Moreover, governments may face complications in their ability to execute diplomatic, military or other initiatives as a result of political risk. Political risk grows as governments conduct interventions in the economy such as barriers to capital flows, exchange and portfolio flow controls, taxes etc. In addition, political turmoil, government restrictions, local elections, cabinet or regime changes and faulty government actions are all considered as political risk as stated before in section 2.1.. Speculation in emerging markets is another form of political risk as well.

In literature, enormous number of studies exist, which examine the impacts of economic factors (such as GNP, inflation, exchange rates, real money supply - real expenditure, policy targets and interest rates as well as growth rates) over financial markets. However, the number of studies which examine the effects of political factors on financial markets is limited and most of the studies concerning this issue are especially on U.S and/or other major developed markets. Some other studies support the

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[57] Samuel A. DiPiazza Jr & Ian Bremmer, **Integrating Political Risk into Enterprise Risk Management**, PriceWaterHouseCoopers and Euroasia Group, 2006, USA, p.5

idea that political factors may affect the stock markets much more than economic factors especially in the emerging markets. Political risk inevitably causes economic risk in the emerging markets. In these markets, control of economic policies and political stability often rest in the hands of a government leader. If the leaders do not seem to keep their promises and fulfill their duties, markets can respond violently.

Foester and Scmitz (1997)[58] presented that the stock returns had been higher during the third and the fourth year than those during the first two years by examining the four-year U.S. election cycle. There are other studies supporting the idea that elections are the most important source of uncertainty for the stock market, claiming that stock returns are lower or sometimes negative in the election year and positive in the years following elections and also it is found out that volatility is higher in the election year. Santa-Clara and Valkanov (2003)[59] examined the excess return in the stock market under both Democratic and Republican presidencies in US by moving from the data collected since 1927 and questioning the existence of any symbiotic relation between stock returns and presidential elections. They found that there was no significant evidence on meaningful stock price changes immediately before, during and immediately after elections.

3.3.2. Historical Background

Before the elections on October 6, 1983, a military government was in Office; therefore, it did not need to manipulate the economy to impress voters. Besides, there was a lack of politic competition among the parties in this election because some ex-party leaders were prohibited from taking part in politics. Full political competition in Turkey restarted in 1987 when the referendum allowing pre-1980 era party leaders to campaign took place. Full political competition is necessary to test political-business cycles, because its absence may lead the incumbent government to decide on economic policies and outcomes without any political anxiety. The government may realize that it

[58] Stephen R. Foerster and John J. Schmitz, **The Transmission of U.S. Election Cycles to International Stock Returns**, Palgrave Macmillan Journals, Journal of International Business Studies, Vol. 28, No. 1 (1st Qtr., 1997), p.1-27
[59] Pedro Santa-Clara and Rossen Valkanov, **The Presidential Puzzle: Political Cycles and the Stock Market**, Published by: Blackwell Publishing for the American Finance Association, The Journal of Finance, Vol. 58, No. 5, Oct. 2003, p.1841–1872

has no strong opposition; therefore, it may not find it worthwhile to put on its best performance.

Five general elections and also three local elections are covered under the scope of this study. The first general election took place on October 20, 1991; the second was held on December 24, 1995; the third was on April 18, 1999; the fourth and fifth elections were on November 3, 2002 and July 22, 2007 respectively. And the dates of the local elections are March 27, 1994; March 28, 2004 and March 29, 2009 respectively.

Although the electoral system for each election differed in some ways, their characteristics were basically the same. First of all, the Turkish election system is flexible; therefore, the government has the chance to call for early elections. In fact, with the exception of the one in 1987, all the elections were early and were announced approximately three or four months before the election date. The second common characteristic of the election was the "10 percent minimum." A party had to get at least 10 percent of the votes around the country to be represented in the parliament. In fact, high party fragmentation made it difficult for some parties to exceed this 10-percent minimum. As a result, some popular parties that did not temporarily merge with other parties were not able to meet this requirement, and were not represented in the parliament following the 1991, 1995, 1999, 2002 and 2007 elections.

4. POLITICAL BACKGROUND OF TURKEY

4.1. GOVERNMENT AND POLITICAL CONDITIONS

The government of Turkey is based on the principle of democratic representation, and divides power between several ruling bodies. In 1923, Turkey was established as a republic and since then has maintained strong secular credentials. The constitution of Turkey administers the legal framework of the country. The legislative power of Turkey is enshrined in the 550-seat Grand National Assembly of Turkey (Turkiye Buyuk Millet Meclisi), which represents the 81 provinces of the country. The president is the head of state, and is elected every seven years by the Grand National

Assembly. Turkey has a multi-party system, with several different political ideologies represented across the various factions.

Turkey was dominated by the Ottoman Empire from the Middle Ages to the 20th century. The imperial reign began to deteriorate in the 19th century when the Ottoman Empire, under pressure from the West, implemented a series of reforms (called Tanzimat) during 1839–76. The dissatisfaction created by the resulting bureaucratic absolutism led the Young Ottoman movement to turn towards the creation of a more liberal, Western-style, secular government and improve the country's relations with Europe, although these changes were later stifled by Sultan Abdulhamid II in the 1870s.

In 1876, Turkey formed a parliamentary constitution under the leadership of Abdulhamid, who was later forced to summon a parliament in 1908 by the Young Turks movement. He planned a counter revolution in 1909, but failed and on account of this was banished to Salonika. Abdulhamid was succeeded by Enver Pasha, who emerged as the new leader of the country. During 1909–12, the European powers took advantage of the weak Ottoman government to occupy most of the empire’s remaining territory in southeastern Europe. During World War I, the coalition with Germany caused Britain, France, and Russia to declare war on the Ottoman Empire.

Mustafa Kemal, celebrated by the Turkish State as a Turkish World War I hero and later known as "Ataturk" or "father of the Turks," led the founding of the Republic of Turkey in 1923 after the collapse of the 600-year-old Ottoman Empire and a three-year war of independence. The empire, which at its peak controlled vast stretches of northern Africa, southeastern Europe, and western Asia, had failed to keep pace with European social and technological developments. The rise of national consciousness impelled several national groups within the Empire to seek independence as nation-states, leading to the empire's fragmentation. This process culminated in the disastrous Ottoman participation in World War I as a German ally. Defeated, shorn of much of its former territory, and partly occupied by forces of the victorious European states, the Ottoman structure was repudiated by Turkish nationalists brought together under the leadership of Mustafa Kemal. The nationalists expelled invading Greek, Russian, French and Italian forces from Anatolia in a bitter war. After the proclamation of the

Republic of Turkey the temporal and religious ruling institutions of the old empire (the sultanate and caliphate) were abolished.

The leaders of the new republic concentrated on consolidating their power and modernizing and Westernizing what had been the empire's core--Asian Anatolia and a part of European Thrace. Social, political, linguistic, and economic reforms and attitudes decreed by Ataturk from 1924-1934 continue to be referred to as the ideological base of modern Turkey. The continued validity and applicability of Ataturk's revolutions are the subject of lively debate in Turkey's political life.

Turkey entered World War II on the Allied side shortly before the war ended, becoming a charter member of the United Nations. Difficulties faced by Greece after World War II in quelling a communist rebellion and demands by the Soviet Union for military bases in the Turkish Straits prompted the United States to declare the Truman Doctrine in 1947. The doctrine enunciated American intentions to guarantee the security of Turkey and Greece and resulted in large scale U.S. military and economic aid under the Marshall Plan. After participating with United Nations forces in the Korean conflict, Turkey in 1952 joined the North Atlantic Treaty Organization (NATO). Turkey is currently a European Union candidate.[60]

At the conclusion of World War II, Stalin demanded partial control of the Çanakkale (Dardanelles), a strategic passage between the Black Sea and the Mediterranean. Since British assistance to Turkey had ended in 1947, the U.S. dispatched military aid to ensure that Turkey would retain chief control of the passage. The aircraft carrier Franklin D Roosevelt was sent to join the Missouri, accompanied by $100 million in economic and military aid to Turkey.

The 1982 Constitution, drafted by the military in the wake of a 1980 military coup, proclaims Turkey's system of government as democratic, secular, and parliamentary. The presidency's powers are not precisely defined in practice, and the president's influence depends on his personality and political weight. The president and the Council of Ministers, led by the prime minister, share executive powers. The current

[60] Oral Sander, **Siyasi Tarih (1918-1994)**, İmge Kitabevi, 2009, p.257-259

president, who has broad powers of appointment and supervision, was elected by Parliament in August 2007 for a seven-year term. Pursuant to a constitutional amendment package approved by voters in an October 2007 referendum, the president is directly elected by the voters for a term of 5 years and can serve for a maximum of two terms. The prime minister administers the government. The prime minister and the Council of Ministers are responsible to Parliament.

The 550-member Parliament carries out legislative functions. Election is by the D'Hondt system of party-list proportional representation. (The D'Hondt method is a highest averages method for allocating seats in party-list proportional representation. The method is named after Belgian mathematician Victor d'Hondt. This system is less proportional than the other popular divisor method, Sainte-Laguë, because d'Hondt slightly favors large parties and coalitions over scattered small parties. Legislatures using this system include those of Albania, Argentina, Austria, Belgium, Brazil, Bulgaria, Chile, Colombia, Croatia, Czech Republic, Denmark, East Timor, Ecuador, Estonia, Finland, Hungary, Iceland, Israel, Japan, Republic of Macedonia, Republic of Moldova, Montenegro, the Netherlands, Northern Ireland, Paraguay, Poland, Portugal, Romania, Scotland, Serbia, Slovenia, Spain, Turkey, Venezuela and Wales.)[61]

To participate in the distribution of seats, a party must obtain at least 10% of the votes cast at the national level as well as a percentage of votes in the contested district according to a complex formula. The president enacts laws passed by Parliament within 15 days. With the exception of budgetary laws, the president may return a law to the Parliament for reconsideration. If Parliament reenacts the law, it is binding, although the president may then apply to the Constitutional Court for a reversal of the law.

4.2. ECONOMIC LANDSCAPE

There has been a significant decline in the GDP growth of Turkey over the period 2004–2007. The GDP growth dropped from 9% in 2004 to 5.1% in 2007 and is expected to further decline to 4% by 2012. The GDP calculated for the period 2008 Q4 was declined by %6.2, as compared to the same period of the previous year. 2009 Q2

[61] **http://en.wikipedia.org/wiki/D'Hondt_method**

was also declined by 7.0% in comparison to the previous year's same period. The GDP in terms of current prices for the year 2008 was calculated as 950.098 Million TL with an increase of 12,7%, and in terms of constant prices 102.164 Million TL with an increase of 0,9%.[62] The expected slowdown in GDP is due to the increase in commercial bank interest rates itself caused by the weakening of financial conditions globally and growing domestic political uncertainty. The service sector dominates the economy, making a contribution to the GDP. This is followed by the industrial and agricultural sectors. There has been an improvement in the business environment and competitiveness of the economy over the years. Turkey, with its prudent fiscal policy and rising tax revenue, is well on course to attaining a favorable fiscal position.

The Turkish economy lagged during World War I, primarily due to the underdeveloped agricultural sector and poor-quality livestock that the country possessed. Turkey was dependent on very few factories for certain provisions like sugar and flour, and these were under foreign control. Prior to 1923, the economy was disordered to a large extent, with the agricultural output reaching a nadir. During 1923–85, the economy grew at an average annual rate of 6%, due to the implementation of proactive government policies which gave a boost to agricultural, industrial, and service production. Post- 1950, the country experienced economic disruptions, and in the 1970s witnessed a balance-of-payments crisis. Following inadequate structural reforms, Turkey was left with current account deficits, which it financed by international borrowings that led to an increase in the country's external debt. The Turkish government failed to take sufficient measures to tackle the increase in world oil prices during the 1970s and accepted short-term loans from foreign lenders. With the rise in inflation and unemployment, the government found it difficult to repay the interest on these loans. During the 1980s, the government initiated a liberalized program which helped overcome Turkey's balance-of-payments crisis.

The Turkish economy faced a crisis in the 1990s, primarily due to a significant increase in inflation. The surge in inflation was followed by an increase in imports and a slowdown in the expansion of exports. The trade deficit and the current account deficit

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[62] **www.tuik.gov.tr**

both grew in 1993. Inflation was around 54% during 2001 as Turkey's currency, the Lira, continued to receive a hammering at the hands of international investors. With little social protection and the presence of a large informal sector which absorbed millions of workers into marginal and low-paid jobs, the real rate of unemployment was probably far higher. As the falling domestic demand helped to contain import growth, the current account balance surged from a deficit equivalent to some 5% of GNP in 2000 to a surplus of more than 2% in 2001. Public finances witnessed an improvement during the period 2000–04, as the International Monetary Fund (IMF)-supported program of fiscal and structural reforms started to bear fruit. The central government's primary budget balance (ignoring debt repayments) increased from around 1.5% of GDP in 1999 to 6.5% by 2004.

During 2002, the real output growth was around 11%, and in line with the central bank's targets. A growing confidence in the Lira was demonstrated by a gradual drop in the share of foreign currency deposits in the country's banking system. Turkey's economic performance continued to improve during 2003, and maintained a decent run during 2005 as well, reaching a growth rate of 7.3%. Inflation rate touched 6.2% in the same year.

Turkey has been exposed to the forces of financial globalization with largely negative consequences during the course of the 1990s. The Turkish economy was not adequately prepared for full scale capital account liberalization in 1989, given the depth of domestic macroeconomic and political imbalances and the under-regulated nature of the financial system. The outcome was a highly fragile and lop-sided pattern of economic growth fuelled by short-term and speculative capital inflows. This environment was quite conducive to financial crises and, indeed, Turkey has experienced three consecutive financial crises with costly ramifications within a period of less than a decade.

4.2.1. 2001 Crisis

Starting from the 1990's Turkey faced a series of short-term cycles of instability crisis and entered a period of severe economic political crisis in November 2000 and profoundly again in February 2001.

The economic crisis of February 2001 was a major setback for the Turkish economy. A major collapse of output was accompanied by a dramatic increase in unemployment. The crisis differed from the earlier crises that the Turkish economy had encountered in the sense that the burden of the crisis fell not only on unskilled labor or wage earners. All sections of society rich and poor, educated and uneducated have been affected by the crises in varying degrees. In spite of these negative ramifications, a positive side-effect of the crisis has been to help to break down resistance to reform and to improve the hand of key external actors such as the IMF and the EU in accelerating the momentum of the reform process.

This crisis had heavy costs particularly in terms of its economic consequences. From a long-term aspect, however, the depth of the crisis constituted an advantage in the sense that it helped to change the balance of power in Turkey's political economy quite radically in favor of the "pro-reform coalition". This shift in the balance of power was particularly evident in the IMF's relations with the on-going coalition government, which up to the point of the crisis, had been a reluctant partner in the reform process. The coalition government whose two dominant members were the left of center and the right of center was quite nationalistic in outlook. Given that their base of electoral support was primarily derived from poorer segments of society, they were reluctant to endorse key elements of the IMF-inspired reform package, the massive cuts in agricultural subsidies being a good example.

Subsequent to the crisis of February 2001, the resistance of the coalition government to key components of the reform package was effectively broken and the IMF gained the upper hand. This shift in the underlying balance of power in the policy-making process was also, in part, a consequence of the fact that the IMF was willing to allocate substantial financial resources to help Turkey's recovery process. Geo-political considerations came to the picture in the sense that Turkey was a key ally of the United States in the Middle East which is a region of critical interest from a US foreign policy perspective. (Argentina which experienced a similar crisis in the same year of Turkey, for example, was not equally fortunate in eliciting similar magnitudes of IMF support.)

The increase in the power of the IMF to push the reform process was evident in a number of different areas and notably in the banking sector. A new agency, The Bank Regulatory and Supervisory Agency, the BRSA, had been established in June 1999 following the ratification of the IMF sponsored Banks Act No. 4389 (IMF, 1999). It took responsibility for banking supervision and regulation from the Treasury and the Central Bank and became operational in September 2000. BRSA also incorporated Sworn Bank Auditors and Savings Deposit Insurance Fund (SDIF) in 2001. Further, the regulation and supervision of non-bank financial institutions have been transferred from the Treasury to the BRSA in 2005.

However, in the pre-crisis period, there was no natural constituency pressuring for the establishment of an agency like the BRSA and there was lack of political and bureaucratic will as well as fierce resistance from powerful banking lobbies. As a result, the BRSA was unable to perform a proper regulatory role in such a way as to prevent the twin crises which essentially stemmed from the malfunctioning and under-regulation of both the private and the public components of the banking system. Following the February crisis, however, the BRSA was able to obtain, with IMF support in the background, the partial autonomy from politicians and interest groups involved to press ahead with tough regulatory measures with some domestic support. There is no doubt that effective measures have been taken in the direction of stronger financial regulation in Turkey after the 2001 crisis. Turkey is on the way to establishing a regulatory state.

4.2.2. The 2001-2004 Era

The “Strong Economy Program”, which was put into practice in the aftermath of the 2001 crisis, has continued to be implemented in an uninterrupted fashion during the early years of the period’s government. The outcome judged by the principal macroeconomic indicators has been rather impressive. Turkey has been able to accomplish tight fiscal discipline. Inflation, for the first time over a period of three decades, has been stabilized at single digit levels. The dramatic fall in inflation rates has been accompanied by a strong surge in economic growth. Indeed, Turkey has managed to achieve a record growth rate in real GNP of 9.9 percent in 2004.

The combination of falling inflation and high rates of economic growth suggests that the prospects of achieving sustained growth as opposed to temporary spurts are higher than at any time in the course of the post-1980 neo-liberal era. Admittedly, inflation had come down from a peak of 100 percent to 35 percent in the early years of the 1980s. However, Turkey had failed to achieve complete fiscal stabilization during that period and macroeconomic instability increased steadily during the second half of the 1980s.

Another striking improvement concerns the reduction in the country’s debt burden. The debt-GNP ratio has been falling steadily from the record level that it reached during the crisis period due to a combination of sharp fiscal adjustment and high rates of economic growth. Central Bank reserves have been increasing which suggests that the balance of payments situation is in a comparatively healthy situation. Interest rates have been falling steadily which is a clear sign that market actors find government policies much more credible compared to the pre-crises era. Falling interest rates is a sign of rising trust and investor confidence. The reports of key multilateral institutions as well as private financial actors clearly endorse this optimistic picture and point towards a durable improvement in Turkey’s economic performance.

The government’s commitment to the IMF stabilization plan produced positive results as single digit inflation, reduced real interest rates, economic growth, declining PSBR, confidence in Turkish Lira (reversed currency substitution), and commercial banks’ increasing engagement in productive lending but the major economic challenges include failure to reduce the unemployment rate and worsening of the current account deficit due to heavy import dependence and appreciation of the Turkish lira.

4.2.3. 2008-2009 Crisis

The Global Financial Crisis has been called by leading economists the worst financial crisis since the one related to the Great Depression of the 1930s.[63] It contributed to the failure of key businesses, declines in consumer wealth estimated in the trillions of U.S. dollars, substantial financial commitments incurred by governments, and a significant decline in economic activity.[64] Many causes have been proposed, with varying weight assigned by experts. Both market-based and regulatory solutions have been implemented or are under consideration, while significant risks remain for the world economy.

The collapse of a global housing bubble, which peaked in the U.S. in 2006, caused the values of securities tied to housing prices to plummet thereafter, damaging financial institutions globally. Questions regarding bank solvency, declines in credit availability, and damaged investor confidence had an impact on global stock markets, which suffered large losses during 2008. Economies worldwide slowed in late 2008 and early 2009 as credit tightened and international trade declined. Critics argued that credit rating agencies and investors failed to accurately price the risk involved with mortgage-related financial products, and that governments did not adjust their regulatory practices to address 21st century financial markets. Governments and central banks responded with unprecedented fiscal stimulus, monetary policy expansion, and institutional bailouts.

The immediate cause or trigger of the crisis was the bursting of the United States housing bubble which peaked in approximately 2005–2006. High default rates on "subprime" and adjustable rate mortgages (ARM) began to increase quickly thereafter. An increase in loan incentives such as easy initial terms and a long-term trend of rising housing prices had encouraged borrowers to assume difficult mortgages in the belief they would be able to quickly refinance at more favorable terms. However, once interest rates began to rise and housing prices started to drop moderately in 2006–2007 in many parts of the U.S., refinancing became more difficult. Defaults and foreclosure activity

[63] **http://www.reuters.com/article/idUS193520+27-Feb-2009+BW20090227**
[64] Martin Neil Baily and Douglas J. Elliott, **The US Financial and Economic Crisis: Where Does It Stand and Where Do We Go From Here?**, The Brookings Institution, www. brookings.edu, June 2009

increased dramatically as easy initial terms expired, home prices failed to go up as anticipated, and ARM interest rates reset higher.

In the years leading up to the start of the crisis in 2007, significant amounts of foreign money flowed into the U.S. from fast-growing economies in Asia and oil-producing countries. This inflow of funds made it easier for the Federal Reserve to keep interest rates in the United States too low (by the Taylor rule) from 2002–2006 which contributed to easy credit conditions, leading to the United States housing bubble. Loans of various types (e.g., mortgage, credit card, and auto) were easy to obtain and consumers assumed an unprecedented debt load. As part of the housing and credit booms, the amount of financial agreements called mortgage-backed securities (MBS) and collateralized debt obligations (CDO), which derived their value from mortgage payments and housing prices, greatly increased.

Such financial innovation enabled institutions and investors around the world to invest in the U.S. housing market. As housing prices declined, major global financial institutions that had borrowed and invested heavily in subprime MBS reported significant losses. Falling prices also resulted in homes worth less than the mortgage loan, providing a financial incentive to enter foreclosure. The ongoing foreclosure epidemic that began in late 2006 in the U.S. continues to drain wealth from consumers and erodes the financial strength of banking institutions. Defaults and losses on other loan types also increased significantly as the crisis expanded from the housing market to other parts of the economy. Total losses are estimated in the trillions of U.S. dollars globally.

While the housing and credit bubbles built, a series of factors caused the financial system to both expand and become increasingly fragile. Policymakers did not recognize the increasingly important role played by financial institutions such as investment banks and hedge funds, also known as the shadow banking system. Some experts believe these institutions had become as important as commercial (depository) banks in providing credit to the U.S. economy, but they were not subject to the same regulations. These institutions as well as certain regulated banks had also assumed significant debt burdens while providing the loans described above and did not have a financial cushion sufficient to absorb large loan defaults or MBS losses. These losses impacted the ability of financial institutions to lend, slowing economic activity. Concerns regarding the stability of key financial institutions drove central banks to provide funds to encourage lending and restore faith in the commercial paper markets, which are integral to funding business operations. Governments also bailed out key financial institutions and implemented economic stimulus programs, assuming significant additional financial commitments.

2009 crisis major impacts have shown itself on financial institutions. The International Monetary Fund estimated that large U.S. and European banks lost more than $1 trillion on toxic assets and from bad loans from January 2007 to September 2009. These losses are expected to top $2.8 trillion from 2007-10. U.S. banks losses were forecast to hit $1 trillion and European bank losses will reach $1.6 trillion. The IMF estimated that U.S. banks were about 60 percent through their losses, but British and eurozone banks only 40 percent.[65]

One of the first victims was Northern Rock, a medium-sized British bank. HM Treasury, Bank of England and Financial Services Authority (September 14, 2007)[66]. The highly leveraged nature of its business led the bank to request security from the Bank of England. This in turn led to investor panic and a bank run in mid-September 2007. Calls by Liberal Democrat Shadow Chancellor Vince Cable to nationalize the institution were initially ignored; in February 2008, however, the British government (having failed to find a private sector buyer) relented, and the bank was taken into public hands. Northern Rock's problems proved to be an early indication of the troubles that would soon befall other banks and financial institutions.

Initially the companies affected were those directly involved in home construction and mortgage lending such as Northern Rock and Countrywide Financial, as they could no longer obtain financing through the credit markets. Over 100 mortgage lenders went bankrupt during 2007 and 2008. Concerns that investment bank Bear Stearns would collapse in March 2008 resulted in its fire-sale to JP Morgan Chase. The

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[65] **http://www.reuters.com/article/idCNL554155620091105?rpc=44**
[66] **http://www.bankofengland.co.uk/publications/news/2007/090.htm**

crisis hit its peak in September and October 2008. Several major institutions failed, were acquired under duress, or were subject to government takeover. These included Lehman Brothers, Merrill Lynch, Fannie Mae, Freddie Mac, Washington Mutual, Wachovia, and AIG.[67]

During September 2008, the crisis hits its most critical stage. There was the equivalent of a bank run on the money market mutual funds, which frequently invest in commercial paper issued by corporations to fund their operations and payrolls. Withdrawals from money markets were $144.5 billion during one week, versus $7.1 billion the week prior. This interrupted the ability of corporations to rollover (replace) their short-term debt. The U.S. government responded by extending insurance for money market accounts analogous to bank deposit insurance via a temporary guarantee and with Federal Reserve programs to purchase commercial paper.[68] The TED spread (The TED spread is the difference between the interest rates on interbank loans and short-term U.S. government debt ("T-bills"). TED is an acronym formed from T-Bill and ED, the ticker symbol for the Eurodollar futures contract.), an indicator of perceived credit risk in the general economy, spiked up in July 2007, remained volatile for a year, then spiked even higher in September 2008, reaching a record 4.65% on October 10, 2008.

In a dramatic meeting on September 18, 2008 Treasury Secretary Henry Paulson and Fed Chairman Ben Bernanke met with key legislators to propose a $700 billion emergency bailout. Bernanke reportedly tells them: "If we don't do this, we may not have an economy on Monday."[69] The Emergency Economic Stabilization Act also called the Troubled Asset Relief Program (TARP) is signed into law on October 3, 2008.

Without the ability to obtain investor funds in exchange for most types of mortgage-backed securities or asset-backed commercial paper, investment banks and other entities in the shadow banking system could not provide funds to mortgage firms and other corporations.

[67] **http://www.foreignaffairs.com/articles/63714/roger-c-altman/the-great-crash-2008**
[68] **http://online.wsj.com/article/SB122186683086958875.html?mod=article-outset-box**
[69] **http://www.nytimes.com/2008/10/02/business/02crisis.html?_r=1**

This meant that nearly one-third of the U.S. lending mechanism was frozen and continued to be frozen into June 2009. According to the Brookings Institution, the traditional banking system does not have the capital to close this gap as of June 2009: "It would take a number of years of strong profits to generate sufficient capital to support that additional lending volume." The authors also indicate that some forms of securitization are "likely to vanish forever, having been an artifact of excessively loose credit conditions." While traditional banks have raised their lending standards, it was the collapse of the shadow banking system that is the primary cause of the reduction in funds available for borrowing.

Crisis effects on wealth have figured out dramatically. There is a direct relationship between declines in wealth, and declines in consumption and business investment, which along with government spending represent the economic engine. Between June 2007 and November 2008, Americans lost an estimated average of more than a quarter of their collective net worth. By early November 2008, a broad U.S. stock index the S&P 500, was down 45 percent from its 2007 high. Housing prices had dropped 20% from their 2006 peak, with futures markets signaling a 30-35% potential drop. Total home equity in the United States, which was valued at $13 trillion at its peak in 2006, had dropped to $8.8 trillion by mid-2008 and was still falling in late 2008. Total retirement assets, Americans' second-largest household asset, dropped by 22 percent, from $10.3 trillion in 2006 to $8 trillion in mid-2008. During the same period, savings and investment assets (apart from retirement savings) lost $1.2 trillion and pension assets lost $1.3 trillion. Taken together, these losses total a staggering $8.3 trillion.[70]**.** Since peaking in the second quarter of 2007, household wealth is down $14 trillion.[71]

Further, U.S. homeowners had extracted significant equity in their homes in the years leading up to the crisis, which they could no longer do once housing prices collapsed. Free cash used by consumers from home equity extraction doubled from $627 billion in 2001 to $1,428 billion in 2005 as the housing bubble built, a total of

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[70] **http://www.foreignaffairs.org/20090101faessay88101/roger-c-altman/the-great-crash-2008.html**
[71]**http://money.cnn.com/2009/06/11/news/economy/Americans_wealth_drops/?postversion=2009061113**

nearly $5 trillion over the period. U.S. home mortgage debt relative to GDP increased from an average of 46% during the 1990s to 73% during 2008, reaching $10.5 trillion. To offset this decline in consumption and lending capacity, the U.S. government and U.S. Federal Reserve have committed $13.9 trillion, of which $6.8 trillion has been invested or spent, as of June 2009. In effect, the Fed has gone from being the "lender of last resort" to the "lender of only resort" for a significant portion of the economy. In some cases the Fed can now be considered the "buyer of last resort."

At the heart of the portfolios of many of these institutions were investments whose assets had been derived from bundled home mortgages. Exposure to these mortgage-backed securities, or to the credit derivatives used to insure them against failure, caused the collapse or takeover of several key firms such as Lehman Brothers, AIG, Merrill Lynch, and HBOS.

The crisis rapidly developed and spread into a global economic shock, resulting in a number of European bank failures, declines in various stock indexes, and large reductions in the market value of equities and commodities.

Both MBS (Mortgage Backed Securities) and CDO (Collateralized Debt Obligations) were purchased by corporate and institutional investors globally. Derivatives such as credit default swaps also increased the linkage between large financial institutions. Moreover, the de-leveraging of financial institutions, as assets were sold to pay back obligations that could not be refinanced in frozen credit markets, further accelerated the liquidity crisis and caused a decrease in international trade.

World political leaders, national ministers of finance and central bank directors coordinated their efforts to reduce fears, but the crisis continued. At the end of October 2008 a currency crisis developed, with investors transferring vast capital resources into stronger currencies such as the yen, the dollar and the Swiss franc, leading many emergent economies to seek aid from the International Monetary Fund.[72]

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[72] **http://www.nytimes.com/2008/10/24/business/worldbusiness/24won.html**

Global impact of the crisis became visible also in emerging markets. A number of commentators have suggested that if the liquidity crisis continues, there could be an extended recession or worse. The continuing development of the crisis prompted fears of a global economic collapse. The financial crisis is likely to yield the biggest banking shakeout since the savings-and-loan meltdown. Investment bank UBS stated on October 6 that 2008 would see a clear global recession, with recovery unlikely for at least two years. Three days later UBS economists announced that the "beginning of the end" of the crisis had begun, with the world starting to make the necessary actions to fix the crisis: capital injection by governments; injection made systemically; interest rate cuts to help borrowers.

The United Kingdom had started systemic injection, and the world's central banks were now cutting interest rates. UBS emphasized the United States needed to implement systemic injection. UBS further emphasized that this fixes only the financial crisis, but that in economic terms "the worst is still to come". UBS quantified their expected recession durations on October 16: the Eurozone's would last two quarters, the United States' would last three quarters, and the United Kingdom's would last four quarters. The economic crisis in Iceland involved all three of the country's major banks. Relative to the size of its economy, Iceland's banking collapse is the largest suffered by any country in economic history.[73] At the end of October UBS revised its outlook downwards: the forthcoming recession would be the worst since the Reagan recession of 1981 and 1982 with negative 2009 growth for the U.S., Eurozone, UK and Canada; very limited recovery in 2010; but not as bad as the Great Depression.

The Brookings Institution reported in June 2009 that U.S. consumption accounted for more than a third of the growth in global consumption between 2000 and 2007. "The US economy has been spending too much and borrowing too much for years and the rest of the world depended on the U.S. consumer as a source of global demand." With a recession in the U.S. and the increased savings rate of U.S. consumers, declines in growth elsewhere have been dramatic. For the first quarter of 2009, the annualized

[73] **http://www.economist.com/world/europe/displaystory.cfm?story_id=12762027**

rate of decline in GDP was 14.4% in Germany, 15.2% in Japan, 7.4% in the UK, 18% in Latvia, 9.8% in the Euro area and 21.5% for Mexico.

In May 2009, the United Nations reported a drop in foreign investment in Middle-Eastern economies due to a slower rise in demand for oil. In June 2009, the World Bank predicted a tough year for Arab states. In September 2009, Arab banks reported losses of nearly $4 billion since the global financial crisis onset.

Real gross domestic product — the output of goods and services produced by labor and property located in the United States — decreased at an annual rate of approximately 6 percent in the fourth quarter of 2008 and first quarter of 2009, versus activity in the year-ago periods. The U.S. unemployment rate increased to 10.2% by October 2009, the highest rate since 1983 and roughly twice the pre-crisis rate. The average hours per work week declined to 33, the lowest level since the government began collecting the data in 1964.

There are about a dozen emerging economies that are on the verge of a potential financial crisis in 2009 including Turkey, New York University Professor Nouriel Roubini, one of the first to warn about the U.S. housing bust, said in an interview with Financial Times. The year 2009 will be an economic stagnation and recession year for most of the global economy with deflationary pressures and a likely severe global recession, Roubini told FT adding that the return to positive economic growth would not be seen before 2010.[74]

As forecasted, like many economies, the Turkish economy has been affected by the global financial crisis with its Finance Ministry reporting that Turkey's budget deficit swelled to 23.2 billion Turkish liras ($15 billion) in the first half of 2009, 13 times higher than a year earlier.

Gross Domestic Product shrank by a record 13.8% in the first quarter between January 1 and March 31, 2009 (Q1 GDP 2009); which The Economist described as

[74] **http://www.hurriyet.com.tr/english/finance/10629542.asp**

"putting Turkey among the economies worst hit by the global recession."[75] Between October 2008 and July 2009, an estimated 40,000 Turkish workers lost their jobs.[76]

The International Monetary Fund expects the Turkish economy to contract by 5.1% in 2009, compared to the Turkish government estimate of 3.6%.[77] However, The Economist also points out that: Yet in many ways Turkey has weathered the credit crunch better than other emerging economies. Partly thanks to tough regulation, not a single Turkish bank has gone under. That is also because, unlike many Western banks, they have few toxic assets and limited mortgage exposure. So the government has not had to divert public money into rescuing banks.

In 2009, the Turkish Government introduced various economic stimulus measures to reduce the impact of the financial crisis such as temporary tax cuts on automobiles, home appliances and housing. This resulted in the production of durable consumer goods increasing by 7.2% but automotive production still fell.

Turkey, facing a large financing shortfall in 2009 after the global crisis battered its markets and caused a sharp economic slowdown, had third-quarter economic expansion of 0.5 percent - below a median forecast of 0.75 percent - down from the revised growth of 2.3 percent in the second quarter. The country is expected to sign a stand-by or a precautionary stand-by deal with the International Monetary Fund, whose support helped it recover from a financial crisis in 2001 to record economic growth around 7 percent, before slowing sharply in recent quarters.[78]

To see the big picture, it is better to examine the data comprising ten-year periods while analyzing the affects of these crises on Turkey's economy. Yearly balance sheets are sensitive to incidental, inevitable and uncontrollable external shocks. Yearly analysis also do not provide an enough time period to obtain the outcomes of the policies developed and if required to fix these outcomes as well. That's why assessing the longer periods - the decades - is much more important in aspect of observing

[75] **http://www.economist.com/world/europe/displayStory.cfm?story_id=14041662**
[76] **http://news.xinhuanet.com/english/2009-08/27/content_11949806.htm**
[77] **http://news.xinhuanet.com/english/2009-06/28/content_11612750.htm**
[78] **http://www.hurriyet.com.tr/english/finance/10629542.asp**

countries' historical courses and trends. In spite of the negative growth rate at the beginning and the recent periods of 2000's, this decade seems to come up with fine results for Turkey. Table 3 gives a brief summary about Turkey's periodical growth rates.[79]

Table 3

Turkey: Ten-Year Economic Growth Rates

Years	10-Year Growth Rate (%)	Yearly Average Growth (%)
80's	47,82	3,99
90's	44,86	3,78
2000's	41,56	3,54

Source: TÜİK (2009 growth rate assumed as -6%)

4.3. SUMMARY OF TURKISH POLITICAL HISTORY

Since its transition from authoritarian one-party regime to competitive politics in the late 1940s, Turkey has experiences both democratic and military-authoritarian rules. Between 1950 and 1988, Turkey had elected civilian governments for nearly thirty-two years and experienced either direct or indirect military rule for about six years. While the tenure of elected governments in office have been periodically cut short by coups, military interventions in postwar Turkish politics (1960, 1971 and 1980) have all been followed by the journey back to democracy and revitalization of electoral politics. As a result, the dominant feature of the Turkish political system during the last four decades has been the absence of either a fully consolidated democracy or an institutionalized authoritarian regime. The pendulum like swings between elected governments and military rule – followed by attempts to restructure political institutions and reformulate the rules of the democratic game under military aegis – underscore the failure of the contemporary Turkish political system to develop a durable solution to the critical problem of political legitimacy.

The interruption of relatively extended periods of populist or semi-populist democratic governance (1950-60, 1961-71, and 1973-80) by military coups have

[79]**http://www.radikal.com.tr/Default.aspx?aType=RadikalYazarYazisi&ArticleID=972523&Yazar=UĞUR%20GÜRSES&Date=04.01.2010&CategoryID=101**

typically occurred during a political crisis. The nature and intensity of these crises have varied considerably. For example, the military's decision to seize power in 1960 was prompted primarily by growing polarization between the government and the opposition. This intense intra-elite conflict, which was accompanied by the governing party's efforts to coerce the opposition led by the Republican People's party into submission, undermined the legitimacy of democratic politics and paved the way for the modern Turkish Republic's first experience with a military coup in 1960.

The circumstances surrounding the breakdown of the Turkish democracy in 1971 were quite different. The late 1960s witnessed an upsurge of student political violence between the militans of the extreme left and right. In comparison with these earlier crises, the one that Turkey experienced in the late 1970s had a far stronger destabilizing effect on Turkish society and politics. For much of the 1970s, and particularly toward the end of the decade, Turkey displayed the familiar signs of an embattled democracy on the brink of breakdown. They included increasing ideological polarization in the party system; rapid escalation of violence by organized terrorist groups.

The problem of political instability was heightened by the simultaneous rise of a severe economic and financial crisis resulting from rampant inflation, declining terms of trade, economic stagnation, and Turkey's deepening debt to international governmental organizations and foreign banks. In addition to these domestic political and economic problems, developments in Turkey's external environment – the victory of Islamic fundamentalism in neighboring Iran and the Soviet invasion of Afghanistan – also contributed to the crisis atmosphere that seized Turkey in the late 1970s. By 1980, the possibility of another military takeover had become a matter of public discussion as many Turks, including some segments of the civilian political elites, began to express their open or tacit support for military solution to the escalating crisis.

The extent of the Turkish military's efforts at political engineering following each intervention since 1960 has varied with the nature and intensity of the crisis preceding its seizure of power. For example, in the case of the 1960 takeover, the officers saw the roots of the crisis primarily in the leadership strategies of electoral politics. Consequently, the military government of 1960-61 limited its political engineering to prosecuting its leadership, rewriting the constitution, and introducing a new electoral system. In 1971, the officers perceived the activities of the urban guerillas and the militant left as the principal threat to political stability and the institutional unity of the armed forces. Hence, the intervention was followed by a massive crackdown on the Marxist terrorist groups, their real or imaginary supporters among the left-wing political forces, and a large-scale purge in the military.

Since the crisis that seized Turkish society and politics in the late 1970s was much more serious than its predecessors, the military's response in 1980 also proved to be far greater and repressive in its scope and objectives than in 1960s or 1971. Not only did the military stay in power longer than in earlier interventions, but it also engaged in an ambitious attempt to transform the major institutional pillars of Turkish politics. An important aspect of this political project concerned the military regime's efforts to restructure the traditional party system.

In addition to politics, the 1980 coup also had a greater impact on economic policy-making in Turkey than it had been the case in earlier military interventions. In January 1980, a few months before the military's seizure of power, government launched a major economic stabilization program with the active support and the cooperation of the IMF. The stabilization initiative was designed to normalize an economy that had sprung out of control and had begun to show the signs of a general crisis – triple digit annual inflation rate, ex-acerbation of the unemployment problem due to industrial slow down, widespread shortages of even the most basic consumer goods, and a rising trade imbalance that created additional constraints on the country's dwindling foreign exchange reserves.

The generals who came to power following the coup in September 1980 faced two pressing problems. One concerned restoring political order and suppressing the terrorist organizations of the extreme left far right separatism. Following a large scale antiterrorist campaign, which involved mass arrests and extensive use of marital law powers, the military brought terrorism under control within a fairly short time. The other presiding problem on the military government's agenda was the state of the

Turkish economy. Prior to the coup, the military had given its tacit support to the government's stabilization program. After the coup, it continued its support. This plan rejected the economic growth strategy pursued by the populist governments of the 1960s and the 1970s, which was based on import-substituting industrialization, extreme protection with high tariff walls, dramatic wage increases, and low public sector prices.

Between 1983 and 1987, Turkish politics moved from military authoritarian rule toward gradual political opening accompanied by the strengthening of civil society. This intermediary phase between authoritarianism and re-democratization was characterized by political liberalization – a period when the military permitted the revitalization of electoral politics within narrowly drawn limits and removed some of the restrictions on civil liberties. Although the initial phase of the political liberalization process took place under the generals' supervision, it nevertheless proved to be an important step toward the civilization of Turkish political life.[80]

The year 1987 marked the beginning of the third phase in Turkey's transition from authoritarian rule to democratic politics. Political developments in the four years following the semi-competitive 1983 elections dramatically highlighted the pitfalls in the military regime's political project concerning the transition process. This was particularly true with the traditional parties and to revamp the party system. Beginning with the local elections of 1984, the pre-coup political parties reemerged on the Turkish political landscape. Operating under new names, they nevertheless retained much of their organizational links with the past.[81]

The causes of the previous breakdowns of the democratic political system run much deeper than the failure of parties and their leaders – as many people think, including the military leaders of 1980-83, like to think – to manage social and economic change within a democratic framework. Nevertheless, the prospects for the continuity of the competitive party-oriented democratic regime in the 1990s look good.

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[80] Tevfik F. Nas, and Mehmet Odekon, **Economics and Politics of Turkish Liberalization**, Associated University Press, NJ USA, 1992, p.33–34
[81] Nas and Odekon, p.37

Under the multi-party system Turkey has had high levels of economic growth since 1945, with economic growth slowing down during periods of military rule. The only exception to this is the period following the OPEC crisis of 1974 when economic growth rates started to decline under various coalition governments.

Political parties in the post-1946 multi party era, for the first time in history, have provided an opportunity for the common man out in the periphery to be heard and counted. The emerge of political parties has done much to curb the authoritarianism of the military-bureaucratic centre under one-party governments.

In general, political parties have been successful in ushering participatory democracy into Turkey. Elections, political participation, and electoral legitimation of governments have become indispensable aspects of Turkish political life. Much ground has been gained on this count since 1950.

Military interventions have not produced long-term solutions to political terrorism, and the crisis of political participation thus reduced the legitimacy (or the widespread acceptance) of military interventions. During the early 1990s, and especially under the incumbent coalition, important gains have been made in demonstrating the viability of coalition governments in Turkey. This coalition government has survived the stresses and strains of a new wave of ethnic terrorism, economic crisis and changes of leadership in both coalition parties.

The number and the vitality of voluntary associations appear to be on the rise, indicating the emerge of a social and political consciousness which in turn is expected to act as a further cushion for democratic political institutions.[82]

Coming to 2000's, Turkey had a transition to one-party government period, starting from the 2002 elections. This process continued also in the 2007 elections gaining majority of the votes and resulting in one-party government.

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[82] Çiğdem Balım, **Turkey: Political, Social and Economic Challenges in the 1990s**, E.J. Brill, Leiden, The Netherlands, 1995, p.61-62

5. RESEARCH ON ELECTION EFFECTS: EVIDENCE FROM ISE

In Turkish financial literature, most of the studies examine the impacts of political risks and general elections on macroeconomic factors, such as interest rates, inflation rates, exchange rates, GDP, real money supply and real expenditure etc. But there are few studies that examine effects of political risks and elections on stock markets.

Among these studies Mandacı (2003)[83] is considerable. Mandacı examined whether election times are the periods along which abnormal stock returns in the ISE can be secured or not. She used daily index returns and examined the effects of elections by employing 'event study methodology' measuring if the security prices fully reflect all publicly available information or in other words, measuring the semi-strong-form efficiency of the market. She tested the abnormal returns fifteen days before and after the general elections and their statistical significance and also calculated the cumulative average abnormal returns for the different event windows before - after the elections and found out that especially for the post election event windows the cumulative average abnormal returns are statistically significant (except for the 1991 elections).

Parallel to Mandacı's point of view, this study additionally investigates local elections of 1994, 2004, 2009 and general elections held through the years 1991 - 2007 as well. In spite of using daily returns as she did, this study is based on daily closing index values of ISE-100 in order to interpret and evaluate the index fluctuations. Five general elections and three local elections are covered. The first general election took place on October 20, 1991; the second was held on December 24, 1995; the third was on April 18, 1999; the fourth and fifth elections were on November 3, 2002 and July 22, 2007 respectively. And the dates of the local elections are March 27, 1994; March 28, 2004 and March 29, 2009 respectively.

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[83] Pınar Evrim Mandacı, **Abnormal Return Fluctuations in the ISE (Istanbul Stock Excchange) Before and After the General Elections in Turkey**, The ISE Review Vol:7 No:27, September 2003

5.1. DATA AND METHODOLOGY

The election dates since the establishment of ISE, which I used in the research were obtained from the web page of the "Turkish Grand National Assembly (TGNA)", www.tbmm.com internet address.

Also, the daily index values in TL terms are derived from ISE, by using the National Stock Market's official web site; www.imkb.gov.tr. The daily index values in the study are the daily closing prices of ISE 100. Although ISE designs different types of 43 indices, ISE 100 index which measures the price change caused by the variation in the market, is known as the best indicator that reflects the main trend of the market.

Therefore, "Event Study" method is preferred to conduct the analysis in order to see the behavior of the stock prices during the election periods. Thus, the impact of the elections in the country over the ISE 100 index can be observed. Event study is a statistical method to assess the impact of an event on the value. On this scope, every general and local election period is examined in a line graph. This method assumes that the expected index values do not deviate much more from the historical indexes, in other words, the expected index in the near future will be equal to mean returns in the recent past.

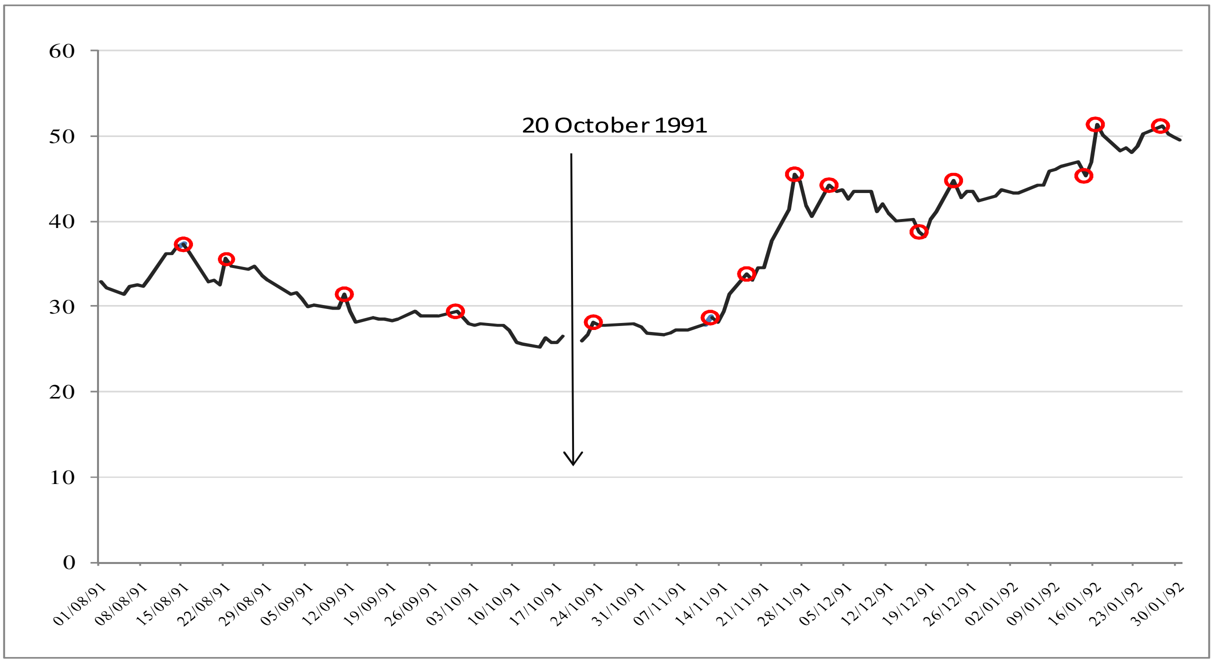
5.2. FINDINGS OF THE EVENT STUDY

The graphs below display the fluctuations of ISE 100 Index values 60 days before and after the election dates. The peak and deep points are marked with signs in order to figure out the election effect on the index.

I have taken 120-day periods (-60 to +60 days) as Mandacı (2003) did, because the price changes are more effective during these 120 days. As the election date approaches, information inflow and market activity increases. Especially subsequent to the election date, as the uncertainty resolves, this market trend gains acceleration. Hence, I've used an extensive time period of 120 days to determine exactly when the effects of elections become significant on ISE.

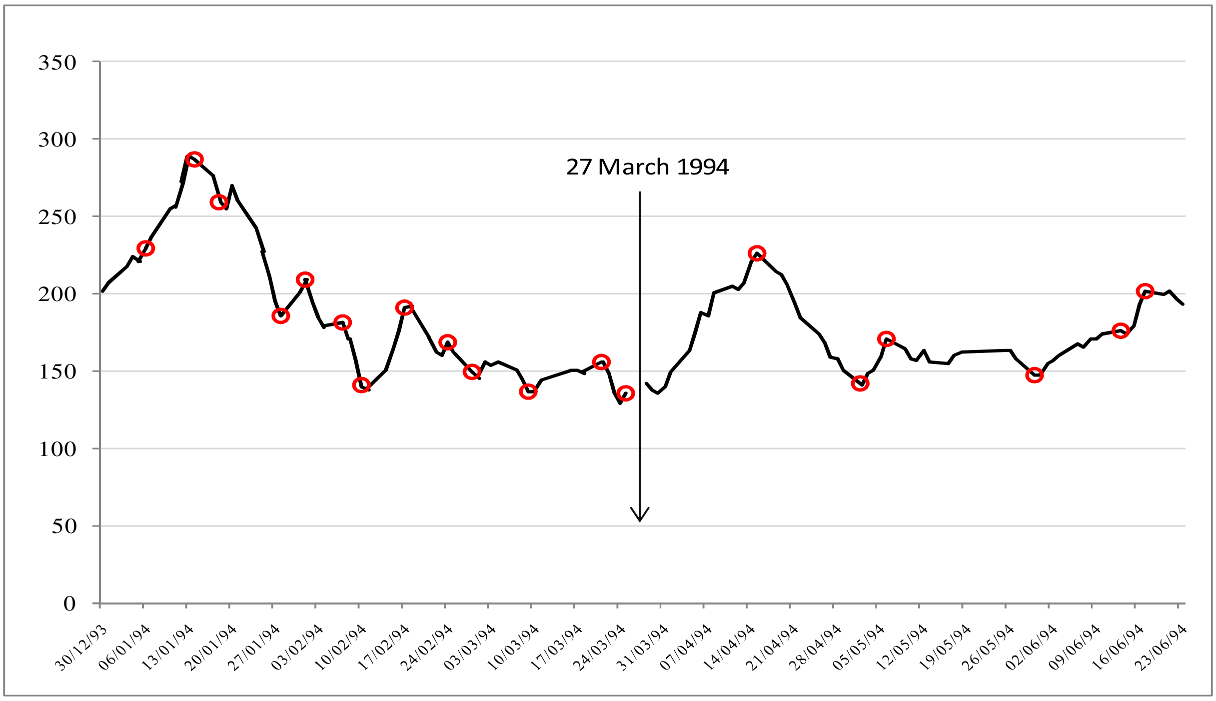
Graph 1

ISE 100 Values 60 Days Before & After the General Election of Oct. 20th, 1991



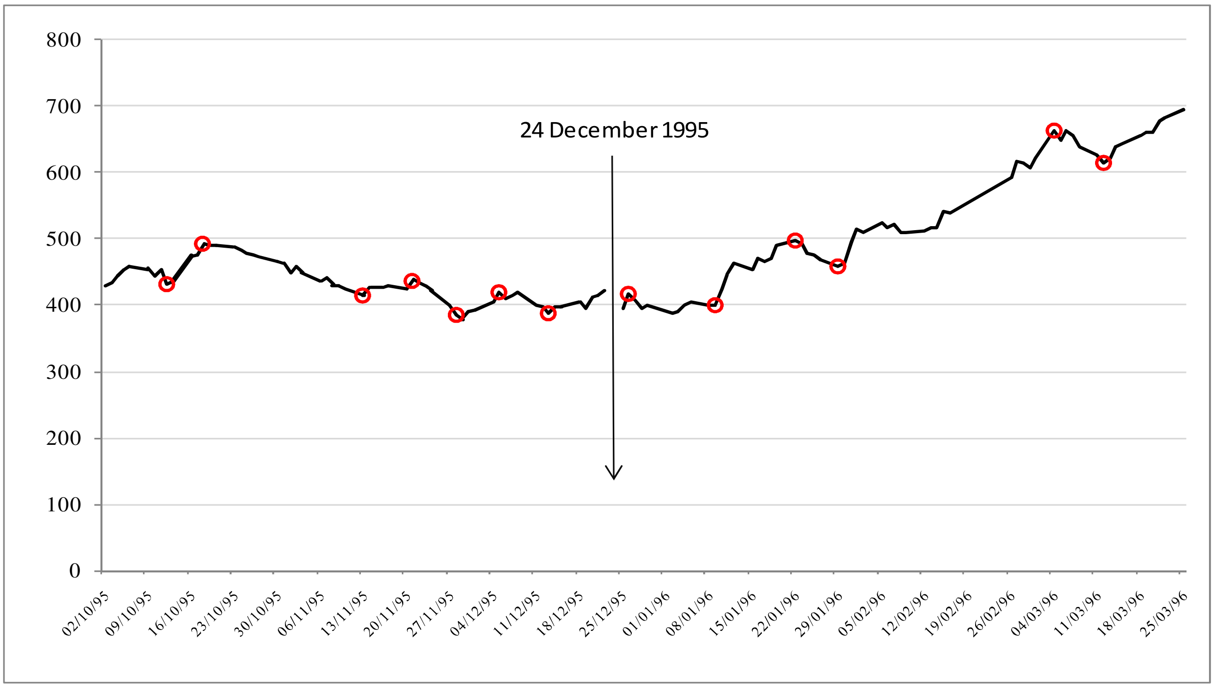
Graph 2

ISE 100 Values 60 Days Before & After the Local Election of March 27th,1994



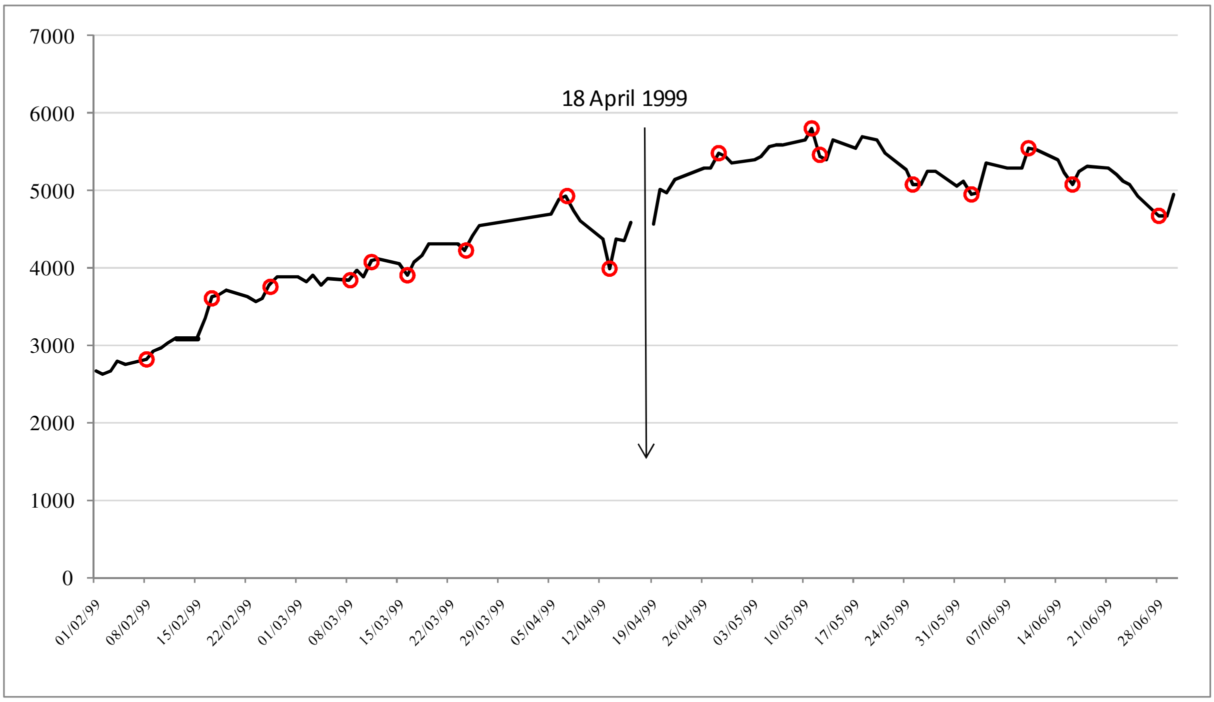
Graph 3

ISE 100 Values 60 Days Before & After the General Election of Dec. 24th, 1995



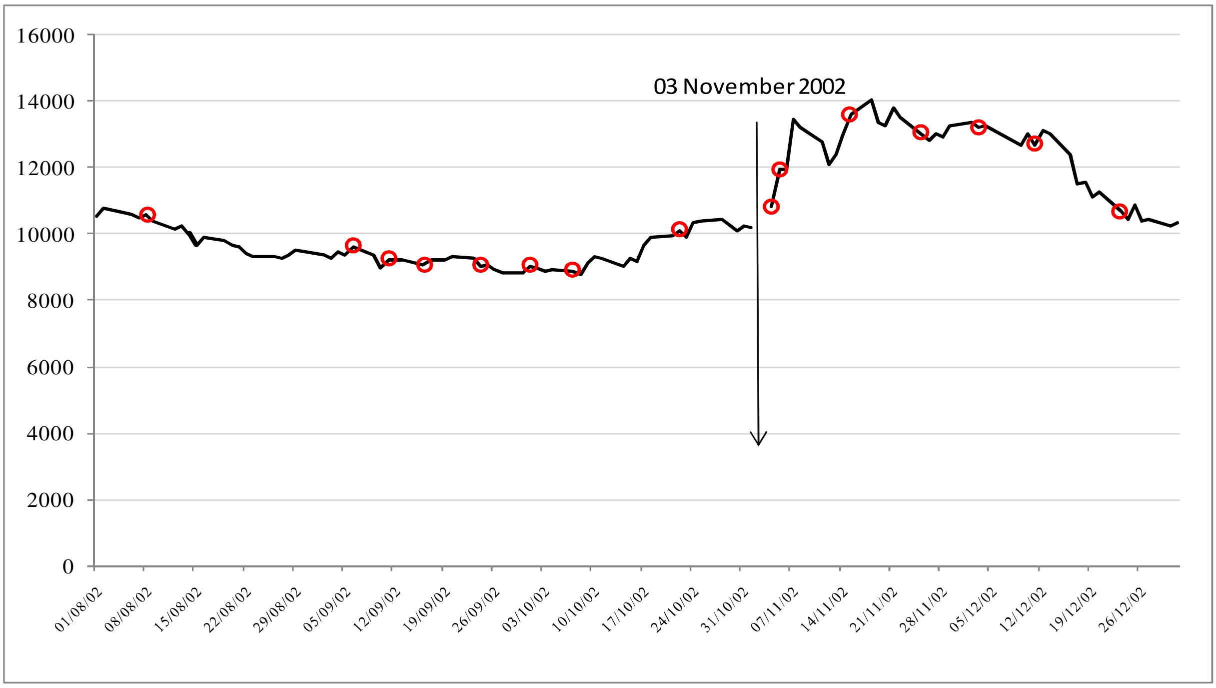
Graph 4

ISE 100 Values 60 Days Before & After the General Election of April 18th, 1999



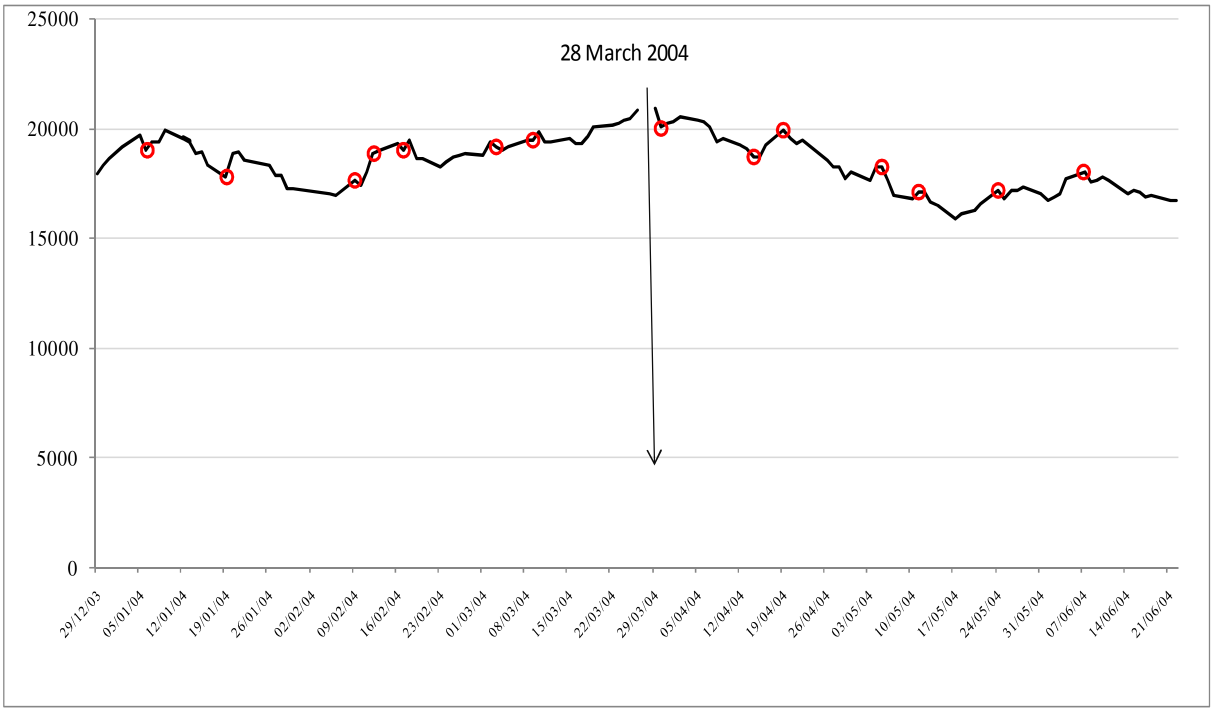
Graph 5

ISE 100 Values 60 Days Before & After the General Election of Nov. 3rd, 2002



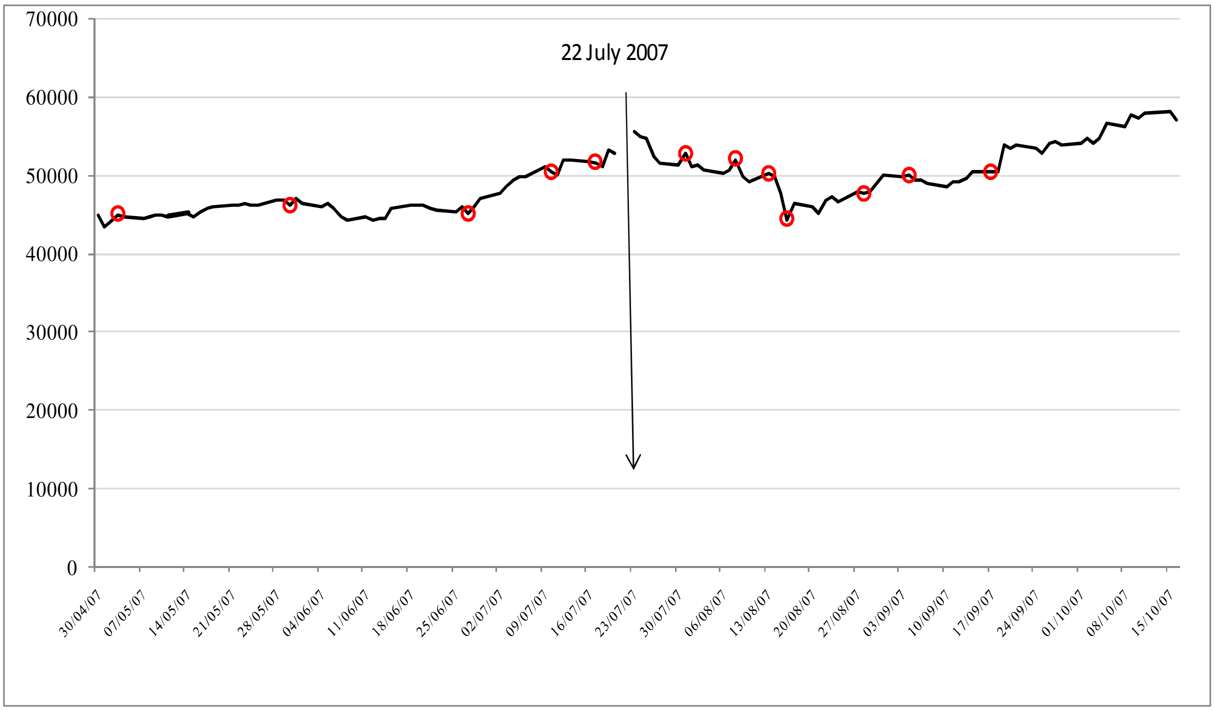
Graph 6

ISE 100 Values 60 Days Before & After the Local Election of Mar. 28th, 2004



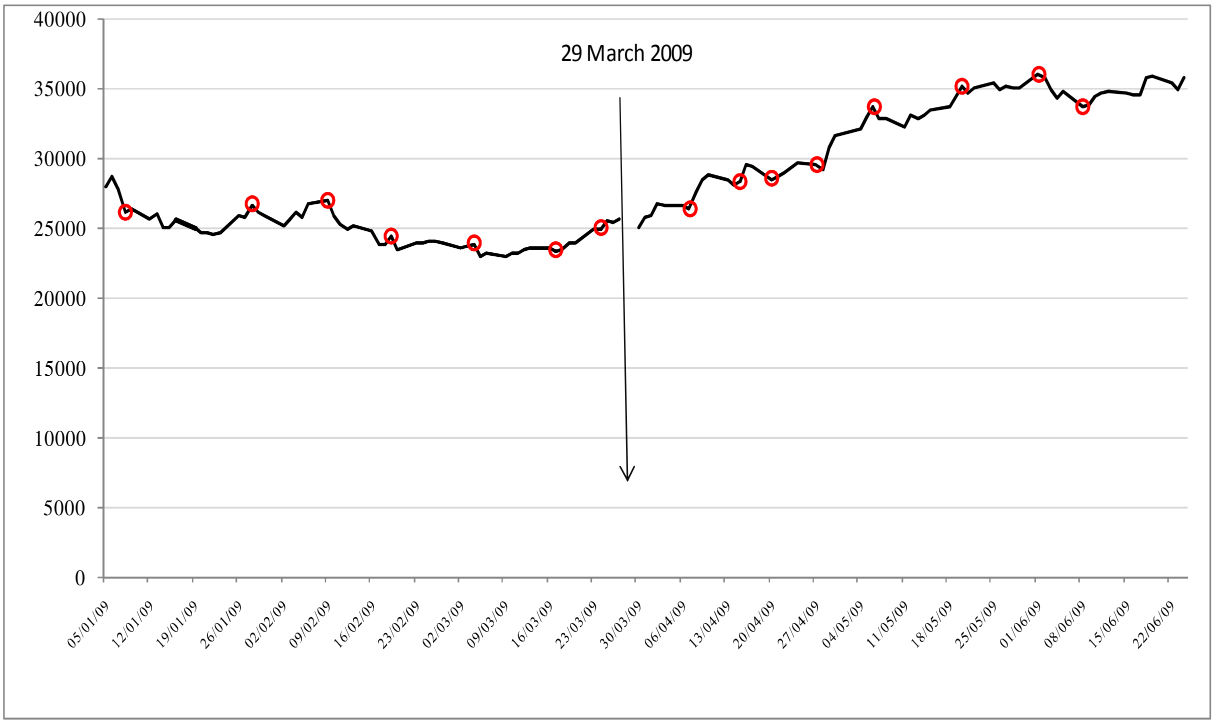
Graph 7

ISE 100 Values 60 Days Before & After the General Election of Jul. 22nd, 2007



Graph 8

ISE 100 Values 60 Days Before & After the Local Election of Mar. 29th, 2009



The graphs present the reactions of ISE 100 to the elections. To explain briefly, in 1991 and 1995 elections we observe withdrawals from ISE 100, prior to the election date. In contrary, upward trend can be seen in the days following the election. In 2002, index remained stable on the eve of the election due to the uncertainties that investors expect to resolve. Index tends to rise just after the results of 2002 elections are declared. 2007 election also showed similarities with 2002. ISE 100 has considerably increased, especially in the first three days following the election. The previous week has also presented a rising trend just before 2007 election in the same way with 2002, while the day before stayed stable. Compared to general elections, local elections seem to have less significant effects on ISE 100.

The event study methodology is firstly used in Ball and Brown's studies in order to analyze the value of companies' annual earnings announcements. Fama, Fisher, Jensen and Roll (1969) used the event study method for testing efficient market hypothesis.[84] The event study method determines whether there is an "abnormal" stock price effect associated with an unanticipated event. There are mainly three assumptions of the method: Markets are efficient which means stock reflects all relevant information, event is unanticipated which means abnormal values are result of reaction and there is no confounding effects which means eliminating other factors.

The event study methodology has been widely used to examine security price behavior around events such as accounting rule changes, earnings announcements, and changes in the severity of regulation and money supply announcements. The event study methodology has, in fact, become the standard method of measuring security price reaction to some announcement or event.

To conduct the event study, first of all, event and the relevant event period have to be identified. Then, expected impact is determined and values impacted by the event are identified. After eliminating or adjusting sample, cumulative abnormal values (CAI) are computed. The advantages of the method can be listed as: Powerful and easy

[84] Eugene F. Fama, Lawrence Fisher, Michael C. Jensen and Richard Roll, **The Adjustment of Stock Prices to New Information,** Blackwell Publishing, International Economic Review, Vol. 10, No. 1, Feb., 1969, pp. 1-21

design, ability to detect abnormal performance, also can be used in less than perfect conditions, easy to interpret and share.

In event study method, "event window" is chosen in order to see deviations before and after the event date. In this study, the event window is 15 days before and after the election date. It is assumed that elections have short term effects on stock markets. Both general elections and local elections are examined under the study. By taking the event date (election date) as a base, this method is used to examine whether there are high deviations from the average index values in the common stock market recent before and after the event date.

In order to calculate abnormal index values, below equation is used to measure which shows deviations from the mean index values in the model.

$$AI_t = I_t - \overline{I_i}$$

AI denotes abnormal index values and It denotes index values at time t. Where i represents general and local elections, $\overline{I_i}$ denotes average index values of the pre-election period which is 15 to 360 days before (-15,-360) the election dates. The calculated abnormal index values are standardized by standard deviations with below formula.

$$AI_t = (I_t - \overline{I_i})/\sigma(I_i)$$

After calculating the AI values for 15 days before and after the elections, z-test is utilized to test the statistical significance of the values.

Z-test is used to examine whether samples come form same distribution when the number of observations (n) is greater than 30. There are some limitations in order to conduct z-test. First of all, observations have to distribute independently. The distributions should be normal distributions, however if n is greater than 30, the data does not have to be normally distributed. All individuals/observations must be selected randomly from the distribution and all of them must have equal chance of being selected. Z-test does not require degree of freedom, because Z distribution is not sensitive to sample size. The calculated z-test values are compared with z-table result at a significance level which is %5 for this research. Z-table critical value is 1,96 for %5 significance level.

Z-test formula:

$$Z = \frac{(M - \mu)}{SE_m}$$

Where M is the mean sample to be standardized, μ is the population mean and SE is standard error of the mean.

Standard error formula:

$$SE_m = \frac{\sigma}{\sqrt{n}}$$

Where σ is standard deviation and n is sample size.

Variance formula:

$$\sigma = \sqrt{\frac{1}{N}\sum_{i}^{N}(x_i - m)^2}$$

N shows sample size and m is mean of the sample. X_i denotes the observations.

For a 95% confidence interval, if the Z is greater than 1,96 or less than -1,96, it means that p (tolerance or error rate) is less than 0,05 and the difference is statistically significant.

H_0: Sample comes from the same distribution.

H_a: The sample is different from the population.

T-test is used when the sample size is less than 30. For the t-test degree of freedom is calculated because the t distribution is sensitive to sample size. Calculated t score is compared with T-table critical value. If the calculated value of t statistic is greater than critical value, then the null hypothesis is rejected.

Table 4 and Table 5 present five general and three local election results. For each election date, 30 days are tested by z-test at the %5 significance level. Z critical value is 1,96 and if the calculated Z value is higher than the critical value it means that the deviation is statistically significant. For 1991 general election, only 10^{th} day is obtained as an abnormal index value.

However for Mar. 27^{th}, 1994 election most of the days (through the 6th to 15th days) after the election date are obtained as abnormal index values. 5^{th} day before the election date is also obtained as abnormal index value. This year was actually when the currency crisis occurred in Turkey. Subsequent days to the election date in which abnormal index values observed are coinciding with the crises Turkey had faced in April 1994. Within this extreme period, ISE witnessed repeatedly enormous losses day by day. (The Turkish Lira depreciated by almost 70 percent against the US dollar in the first quarter of 1994. The Central Bank heavily intervened in the foreign exchange market, and as a result, lost more than half of its international reserves. Overnight interest rates jumped to unprecedented levels, such as 700 percent, from a stable pre-crisis level around 70 percent. Economic growth declined by 6 percent. A stabilization program, later supported by an IMF Stand-By was launched on Apr. 5^{th}, 1994). Therefore, we can't present exact relation between the 1994 local election and those abnormal index values because of the currency crisis occurred at the same period.

Table 4 displays the statistical results of pre-election and post-election results through 1991 - 1999. The 10^{th} day of pre-election in 1991, the abnormal index value is statistically significant. For 1994 local election, the 5^{th} day before the election an abnormal index value is observed. After the election, 6^{th} to 15^{th} days have abnormal values which are statistically significant in connection with the currency crisis Turkey faced within the same days. The 11^{th}, 5^{th} and 2^{nd} days before and also the 1^{st}, 9^{th} and 12^{th} days following the general election of 1995, abnormal values observed which are statistically significant. The 8^{th} and 7^{th} days before the 1999 general election have abnormal values as well as 7^{th} day after the election has abnormal value.

Table 4

ISE-100 Index for Pre-election and Post-election Periods (-15, +15)

	1991 Election		**1994 Local Election**		**1995 Election**		**1999 Election**	
Day	**AI**	**Z test**	**AI**	**Z test**	**AI**	**Z test**	**AI**	**Z test**
-15	-1.5424	0.4012	0.8181	0.1345	0.4199	1.0254	1.6065	-0.2554
-14	-1.6324	0.4482	0.8481	0.4567	0.5559	-1.2368	1.6048	-0.6589
-13	-1.7576	-1.2352	0.7657	-1.0254	0.4600	-1.3658	1.4671	0.2547
-12	-1.7772	-1.4814	0.6704	-1.3546	0.5064	0.2548	1.7506	0.3698
-11	-1.7572	-1.5600	0.5394	0.5624	0.5523	**1.9867**	1.9513	1.5647
-10	-1.7669	**-1.8978**	0.5436	0.2314	0.3746	0.2534	2.1718	0.3259
-9	-1.7726	-1.4549	0.6712	-0.9874	0.3559	0.2546	2.4481	1.5487
-8	-1.8486	-1.0568	0.7720	-0.2354	0.2615	-0.5879	2.4920	**-1.9784**
-7	-2.0519	0.8945	0.7725	-0.2548	0.3439	-0.9987	2.2178	**-1.9800**
-6	-2.0972	0.7201	0.7381	1.0024	0.3479	-0.3658	2.0280	-0.9856
-5	-2.1367	0.5689	0.8472	**1.9985**	0.4246	**1.9968**	1.6925	-0.4578
-4	-1.9749	1.6920	0.7248	0.2354	0.3374	0.2546	1.1275	-1.5362
-3	-2.0475	0.9987	0.5331	0.1475	0.4840	0.2235	1.7012	-0.2547
-2	-2.0541	0.7894	0.4208	0.0010	0.5043	**1.9547**	1.6566	-0.3659
-1	-1.9429	0.5699	0.5117	0.3658	0.5889	0.2356	1.9920	-0.4578
1	-2.0251	0.2345	0.6226	0.7845	0.3304	**-2.0258**	1.9637	-2.0356
2	-1.9187	-1.5648	0.5617	-0.3653	0.5278	-1.2354	2.6251	-1.3584
3	-1.7238	-1.3652	0.5302	-1.1024	0.4467	-1.0025	2.5705	0.2548
4	-1.7793	-1.6895	0.6018	-1.0255	0.3340	0.3254	2.8216	-3.0020
5	-1.7623	0.9997	0.7558	-1.6589	0.3813	0.3587	3.0405	0.2457
6	-1.7507	0.5302	0.9732	**-1.9874**	0.2644	-0.9874	3.0267	0.2356
7	-1.8128	0.4001	1.1604	**-1.9974**	0.2815	-0.7845	3.2994	**-1.9985**
8	-1.9046	0.6585	1.3827	**-2.0358**	0.3639	-0.3568	3.2365	0.2356
9	-1.9245	1.0001	1.3420	**-2.0024**	0.4134	**1.9254**	3.1114	0.1478
10	-1.9150	-0.3658	1.5750	**1.9658**	0.3645	1.0356	3.1691	-0.2563
11	-1.8504	-0.5864	1.6498	**2.7894**	0.3789	1.0024	3.2533	0.1245
12	-1.8541	-0.3256	1.6184	**2.4870**	0.6135	**-1.9475**	3.4396	0.6895
13	-1.8541	0.1458	1.6936	**-1.9874**	0.8015	0.2354	3.4546	0.2457
14	-1.7514	0.3654	1.9136	**-1.9647**	0.9721	0.6587	3.4775	-1.4578
15	-1.6381	0.3568	1.9933	**1.9587**	0.8706	0.9966	3.5676	-1.2356

Table 5

ISE-100 Index for Pre-election and Post-election Periods (-15, +15)

	2002 Election		**2004 Local Election**		**2007 Election**		**2009 Local Election**	
Day	**AI**	**Z test**	**AI**	**Z test**	**AI**	**Z test**	**AI**	**Z test**
-15	-0.8693	1.9925	2.2067	**1.9905**	1.7371	1.3254	-0.4127	1.8554
-14	-1.0558	**2.0060**	2.2045	0.1160	1.9813	**2.2399**	-0.4061	-1.7589
-13	-0.8800	1.5234	2.3065	**2.5054**	2.1860	**2.3955**	-0.4069	0.9654
-12	-0.9481	-1.7845	2.1693	**-3.7045**	2.2822	0.2549	-0.4004	1.3798
-11	-0.6058	**1.9874**	2.1637	**3.9074**	2.2938	**1.9598**	-0.3984	1.5747
-10	-0.4681	0.1245	2.2170	1.9045	2.6504	0.2534	-0.3983	-1.9859
-9	-0.4051	0.0253	2.1496	1.1055	2.4641	0.2549	-0.4026	1.5487
-8	-0.3111	-0.4578	2.1407	-1.4570	2.3350	-1.5589	-0.4014	**-1.9784**
-7	-0.4413	0.1457	2.2448	**1.9657**	2.8365	**-1.9958**	-0.3894	**-1.9800**
-6	-0.1452	0.3580	2.3805	1.5500	2.8573	**-2.3955**	-0.3876	**-1.9827**
-5	-0.1267	**-2.0350**	2.4276	-0.1550	2.7770	**1.9995**	-0.3652	-1.2578
-4	-0.1091	0.3215	2.4337	1.5095	2.7435	1.2549	-0.3631	-1.5378
-3	-0.3103	0.0898	2.4870	1.1097	2.6067	-1.2235	-0.3495	-1.8247
-2	-0.2341	0.3658	2.5280	**1.9650**	3.1759	**1.9548**	-0.3527	**-2.3759**
-1	-0.2575	0.3578	2.6476	1.5570	3.0757	**3.2359**	-0.3454	-1.4578
1	0.1642	**-3.2564**	2.6643	**-2.0564**	3.7674	**-2.3255**	-0.3595	-0.1357
2	0.9055	**1.9785**	2.3828	**1.9705**	3.5887	0.2354	-0.3437	-1.3584
3	0.9231	1.4512	2.4354	**2.4590**	3.5633	0.3325	-0.3391	1.2548
4	1.9306	1.3652	2.4786	**3.5650**	2.9668	1.3254	-0.3180	**2.1180**
5	1.7622	**2.5874**	2.5321	0.5074	2.7224	1.2558	-0.3216	1.8457
6	1.4611	**2.0358**	2.4815	0.1550	2.6960	**-1.9584**	-0.3211	-1.2257
7	1.0065	0.9998	2.4624	**1.9990**	3.0472	**-2.8545**	-0.3281	**-1.9985**
8	1.2214	0.2354	2.3858	1.0554	2.6549	-0.9595	-0.2955	1.8357
9	1.5937	**2.6985**	2.1819	0.6905	2.6791	**1.9254**	-0.2728	1.1478
10	2.0148	**-1.9671**	2.2100	-0.9679	2.5050	1.3359	-0.2654	**-1.9573**
11	2.3246	**-1.9652**	2.1292	**-1.9650**	2.4313	1.3324	-0.2753	1.1845
12	1.8739	0.9685	2.0782	**1.9605**	2.5028	**2.9485**	-0.2826	**2.7895**
13	1.8094	-0.7845	1.9381	-1.7045	2.8532	1.2354	-0.2785	1.8457
14	2.1584	**2.9685**	1.9411	0.9605	2.3142	**-1.9558**	-0.2479	1.4578
15	1.9502	0.1245	2.1325	**1.9745**	2.1115	0.9996	-0.2499	-1.8357

Table 5 displays the statistical results of pre-election and post-election data through 2002 - 2009. Before the 2002 election, there are 3 abnormal values which are statistically significant. The 14^{th}, 11^{th}, and 5^{th} days are abnormal values before the election. After the election, the 1^{st}, 2^{nd}, 5^{th}, 6^{th}, 9^{th}, 10^{th}, 11^{th}, and 14^{th} days' values are observed statistically significant. For 2004 local election, before the event date there are six abnormal values which are statistically significant. In addition, eight different days following the local election of 2004 have abnormal index values. It is found that index values for a total of fourteen days are statistically significant for 2007 general election. Before and after the election positive index values are observed. Right before the 2009 local election there are four days in which abnormal values determined. Also, 4^{th}, 7^{th}, 10^{th} and 12^{th} days following the local election of 2009, present abnormal index values.

Index values are cumulated from data -15 to day +15 from the cumulative average abnormal index values:

$$CAAI = 1/N\left[\sum_{t=-15}^{t=+15}(AI_t)\right]$$

Table 6 and Table 7 show the results of the t-test statistics which is used to test the cumulative values.

Table 6

Cumulative Average Index Values (CAAI) Measures (-15, +15)

Event Window	1991 Election		1994 Local Election		1995 Election		1999 Election	
	CAAI	T test	CAAI	T test	CAAI	T test	CAAI	T test
-15 to +15	-1.85417	**2.5867**	0.951701	0.3524	0.462066	-1.0245	2.465501	0.6784
-15 to 0	-0.93868	0.2354	0.339231	0.1457	0.217251	0.3547	0.930258	1.0245
-10 to 0	-0.65645	-0.3562	0.217838	0.2354	0.134102	-0.3658	0.650919	0.1478
-5 to 0	-0.33854	0.7845	0.101254	0.2478	0.077974	1.1024	0.272328	0.3265
0 to +5	-0.30697	1.247	0.102406	1.247	0.067339	1.3002	0.434051	**1.8524**
0 to +10	-0.61722	**-1.542**	0.31685	0.124	0.123597	0.7841	0.962155	**1.5687**
0 to +15	-0.91549	**1.4058**	0.61247	**1.3997**	0.244816	0.2585	1.535243	**1.9658**

Table 7

Cumulative Average Index Values (CAAI) Measures (-15, +15)

Event Window	2002 Election		2004 Local Election		2007 Election		2009 Local Election	
	CAAI	T test	CAAI	T test	CAAI	T test	CAAI	T test
-15 to +15	0.531066	0.7845	2.304698	0.7841	2.680212	**-0.16987**	-0.34262	0.5689
-15 to 0	-0.23892	**1.3562**	1.156907	-0.5689	1.266751	0.3587	-0.19265	-1.0457
-10 to 0	-0.09362	0.2356	0.788552	**1.8954**	0.917405	**1.9874**	-0.12517	**1.8978**
-5 to 0	-0.03459	0.1457	0.417466	0.8974	0.479292	0.5689	-0.0592	0.0258
0 to +5	0.189518	1.9874	0.416438	1.0214	0.553623	0.1475	-0.05606	1.0358
0 to +10	0.432768	0.2354	0.807156	**1.3785**	1.00636	**-1.6589**	-0.10549	0.1478
0 to +15	0.769988	**1.5689**	1.147791	0.2356	1.413461	**-2.354**	-0.14997	-0.7458

In Table 6 and Table 7, the cumulative average abnormal values and t statistics are presented. In Table 6, some of the cumulative average values are statistically significant during the post event periods, yet none of them (except 1991 -15 to +15 period) is statistically significant during the pre-event periods. This result shows that investors wait for the uncertainty to be resolved before the election. However there are some statistically significant values during the pre-event periods in Table 7.

In Table 6, 1991 general election, the cumulative average abnormal values of the (-15 to +15) event window is statistically significant at 5% and the cumulative average abnormal values of the (0 to +10) and (0 to +15) are also statistically significant at 5% level. For 1994 local election, the cumulative average value of (0 to +15) is statistically significant at 5%. There are no abnormal values obtained for the election of 1995. For 1999 general election, the cumulative average abnormal values of (0 to +5), (0 to +10), (0 to +15) event windows are statistically significant.

In Table 7, for 2002 election, a pre-election cumulative average abnormal value of (-15 to 0) is statistically significant. The cumulative average abnormal value of (0 to +15) event window is also statistically significant at 5% level in 2002 election. For both 2004 local election, 2007 general election, and 2009 local election the cumulative average abnormal value of (-10 to 0) is statistically significant. The cumulative average abnormal values of (-15 to +15), (0 to +10) and (0 to +15) event windows are also significant for 2007 general election.

5.3. CONCLUSION

In this study, the effects of general and local elections on ISE 100 index are examined by utilizing event study method, since the establishment of ISE. Daily index values are used to examine the fluctuations. In order to measure if abnormal index values are obtained in a single period around election times (fifteen days before and after the general and local elections) the z-test methodology is used. Abnormal values are observed both before and after the elections but mostly after the elections. According to z-test results, we can conclude that; except 1991 general elections, abnormal index values are determined in the ISE 100.

Line graphs also point out an important occasion that in the day before the 1991, 1995 and 1999 general elections ISE 100 presented an upward trend, whereas in the following day index witnessed a decrease. However, both 2002 and 2007 elections showed opposite situations. ISE 100 decreased in the previous day and than sharply increased in the subsequent day to the election. Investors' confidence in one-party government is the main reason for that distinction. Coalition governments of 1991, 1995 and 1999 elections created an unreliable image in the minds of investors. 2002 and 2007 elections resulted in one-party government causing a favorable effect on investors' behavioral patterns. Investors' positive expectations from a strong one-party government shaped the market in an upward trend.

The results of t-test, cumulative average values analyses supported that the values are statistically significant especially after the elections. Generally, cumulative average abnormal index values of the event windows subsequent to the elections are proved to have statistical significance.

As a result, investors face abnormal index values before and after the short term that elections are held. The influence of some general elections on ISE 100 turns to be in positive direction after the elections. Before the 2002 elections, effects appear to be insignificant in (-15 to +15) event window, as a result of ongoing uncertainties following the election results. (As the formation of the coalitions take time and uncertainty stays for a while, although the election results are declared.) After 2002 elections, a new era began for Turkey extending to the present; one-party government. This new era bang sense into investors that one-party governments are better than previous fragile coalitions which cause instability and uncertainty in stock markets. In fact, the effects of elections on ISE 100 are not isolated from other political and economic events as crisis, international agreements, international rating grades, etc. All of these factors and information inflow play important role in the environment that vital economic events occur. Regardless of the actions taken on other topics by the governments, this research only relates the elections and ISE 100 performance, not the success or failure of any government.

This study presents similar results with Mandacı (2003) for 1991, 1995, 1999 and 2002 elections. Mandacı found that in 1991 elections, cumulative average abnormal returns are statistically significant in (0 to +15) days event window. Parallel to this result, in my study cumulative abnormal index values are also statistically significant in (0 to +10) and (0 to +15) days event windows. Likewise, in 1995 elections, there are no statistically significant CAAI. Also in the election of 1999, CAAI respond in the same pattern that; (0 to +5), (0 to +10), (0 to +15) days event windows are statistically significant. The election of 2002 demonstrates that; the CAAI of (0 to +15) days event window is statistically significant at 5% level, whereas Mandacı found (0 to +10), (0 to +15) days event windows are statistically significant at 10% level. Results for the 2007 general election and the local elections are interpreted in the previous paragraphs.

Finally, as the statistical results supported, it is proved that ISE 100 index values tend to fluctuate with upcoming elections and results of the elections as well, with familiar responses parallel to other nations' stock markets. Investors do react to both general and local elections with positioning themselves to the possible effects of the outcomes on stock market and face abnormal index values prior to and after the elections since the establishment of ISE. This effect seems to be more significant in the 2002 and 2007 general elections as a result of the investors' confidence in one-party government, rather than unstable and incompatible coalitions. The positive atmosphere in the political arena encourages investors in an optimistic manner, providing the market gain dynamism.

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