

Investment expenditure and capital accumulation in an inflationary environment: The case of Turkey

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Abstract

The empirical results of the paper show that the private fixed capital accumulation in Turkey is constrained by the demand constraint and the availability of financial resources. The significance of the liquidity variable clearly points out that credit policy and accommodating monetary policy with the lower rates of interests must be the essential elements of economic policies that revive investment in Turkey. It seems from the empirical results that the cost of capital has a significant but discouraging effect on investment expenditure. With this empirical finding it also becomes evident that fiscal stimuli would work in stimulating private investment, they must be the essential components of an investment programme in Turkey. In regard with the purpose of this paper, the variable, namely the willingness-to-invest, that is expected to capture the perception of investors on investment climate, also appears to be significant factors for the overall sample period. Interestingly, the speed of adjustment of private investment from disequilibrium is fairly slow. This is because there may be some frictions (such as heavy tax burden) and/or some structural constraints (e.g. insufficient infrastructure and inadequate legislative structure) in the economy causing this slow down. In reviving private investment, especially in the long run, one must pay attention to the importance of these factors, and appropriate government actions have to be taken.

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1. Introduction

There have been various proxies numerically to observe instability that would influence economic decisions. The market based-price variables such as inflation, exchange rate and interest rate have generally used to measure instability. These macroeconomic variables however are all related with the political stand and stability. It has today become evident from the experience of two successive single party governments in power in Turkey that political disputes and uncertainties had been the main source of economic instabilities which would considered as the reason for infertile business environment before 2001. In particular the weak government formations of the past can then be considered to be the key detrimental factor for poor macroeconomic performance without any doubt. Besides, volatility of economic growth and key price variables has become the key factor deteriorating business climate and hence discouraging entrepreneurs.

Good macroeconomic conduct is expected to improve business climate and increases the willingness of the entrepreneur to invest, and eventually generate economic growth. Private investment in this regard can be considered as the pre-condition for having sustainable economic growth rates for a substantially long period of time. Among others, it is also the most volatile component of gross domestic expenditure and is extremely responsive to instability and uncertainty about the future condition of an economy largely because of its irreversible nature.¹ Therefore private fixed capital investment is a good candidate to observe the likely impact of instable business environment. However measuring instability and uncertainty in the economy is another challenging issue.

Research in literature has extensively employed statistical methods which are based on the probability theory (see Driver & Merton, 1992). This conventional measure of the stochastic uncertainty deals with whether or not a certain event will occur, and the probability of the occurrence of this event is based on the random frequency of the occurrences of this event data in the past. This statistical process to evaluate uncertainty is an attempt to approximate human behaviour by a certain decision rules by using rigorous mathematical models. However there are two reasons for not following this path of modelling uncertainty and instability. First, the use of the statistical methods is often limited by the availability of the sufficiently long high frequency data on the past values of the event, which is required for statistically reliable modelling uncertainty. This is mostly the case to overcome in the empirical studies in emerging market economies. Second, the definition of a particular event is very often made on the basis of the subjective perception by economic agents, rather than its randomness, which brings about *vagueness* on the definition of this particular event. For example, the phrase “*high inflation*” can be interpreted in different ways depending on circumstances. In Turkey where inflation rates once used to surge above 50%, a low inflation rate could be considered as any rate below 10–20%, and more importantly disinflating the economy towards these rates can be regarded as comforting economic development by investors. However in developed market economics such as the US and the EU countries, inflation can be

¹ Instability and uncertainty play a key role in investment decisions because of their three important characteristics (Dixit & Pindyck, 1994; Pindyck, 1991). First, investment expenditures are largely irreversible in the sense that once put into place, the reallocation of capital involves an additional cost. Second, the economic environment where investment decisions are taken is uncertain and all information about the feasibility of investment projects arrive gradually, which reveals extra costs of acquiring this information. Third, investment expenditure can be delayed in time. Given these features of capital investment, increased uncertainty leads to firms to spend more money and time on acquiring precise information about the feasibility of investment projects before committing their financial resources. Especially in a highly volatile economic environment they opt to wait and postpone their investment expenditure until the future becomes clearer.

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