



Inflation, Firm Performance, and Policy-Induced Uncertainty: Evidence from Turkey

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Abstract

This article focuses on the relationship between inflation, firm performance, and policy-induced uncertainty in Turkey, where persistent inflation has coincided with frequent changes in economic policy. In such an environment, firms operate under conditions of limited predictability, which directly affects their financial performance and strategic decisions. Using firm-level data from publicly listed companies in Turkey, the study examines the association between inflation and policy-induced uncertainty and key performance indicators, including return on assets and return on equity, with particular attention to their interaction. The empirical findings suggest that higher inflation is linked to weaker firm performance. In addition, policy-induced uncertainty appears to reinforce this negative relationship, indicating that firms are more adversely affected when inflationary pressures coincide with an unstable policy environment. These results point to the role of institutional conditions and policy credibility in shaping firm-level outcomes in emerging economies characterized by macroeconomic instability.

Keywords: Inflation; Policy Uncertainty; Firm-Level Performance; Institutional Credibility; Political Economy; Turkey.

1. Introduction

Recent inflation dynamics in Turkey have emerged as a major source of economic concern, particularly in light of sharp increases in the consumer price index that have disrupted firms' operational routines and long-term planning horizons. Persistent inflation alters cost structures, weakens price signals, and complicates firms' ability to forecast future revenues, thereby affecting strategic decision-making across sectors. Previous studies have long emphasized that high and volatile inflation distorts relative prices and undermines productive investment, especially in developing and emerging economies (Fischer, 1993; Bruno & Easterly, 1998). In such environments, firms are often forced to revise pricing policies, reassess investment plans, and prioritize short-term adjustments over productivity-enhancing strategies. Alongside inflationary pressures, policy-induced uncertainty constitutes a defining feature of the contemporary Turkish economic landscape. Frequent adjustments in monetary, fiscal, and regulatory policies—shaped by domestic political dynamics as well as external economic constraints—have contributed to an environment in which firms face heightened unpredictability regarding future economic conditions. From a political economy perspective, such uncertainty reflects not only macroeconomic instability but also institutional fragilities that weaken policy credibility and increase perceived risks for private actors (Rodrik, 2008). As uncertainty rises, firms tend to postpone investment decisions and adopt more cautious operational strategies.

Understanding how inflation and policy-induced uncertainty jointly affect firm performance is therefore essential, particularly in contexts characterized by political and institutional volatility. While existing research has extensively examined inflation and uncertainty as separate phenomena, empirical studies integrating these dimensions at the firm level remain limited, especially for high-inflation emerging economies such as Turkey. This gap is significant, given that firms operate at the intersection of macroeconomic conditions and institutional arrangements that shape incentives, expectations, and economic outcomes (Acemoglu & Robinson, 2012).

This study aims to address this gap by examining how inflation and policy-induced uncertainty interact to influence firm performance in Turkey. By relying on firm-level evidence, the paper contributes to the broader political economy literature on macroeconomic governance, highlighting how policy environments and inflationary dynamics jointly shape firm behavior in emerging market settings.

2. Literature Review

2.1. Inflation and firm performance

The relationship between inflation and firm performance has long been examined in both theoretical and empirical economic literature. From a theoretical perspective, inflation is often associated with distortions in relative prices, increased uncertainty regarding future costs,

and weakened incentives for long-term investment. These mechanisms are particularly relevant for firms operating in environments where inflation is volatile and persistent rather than moderate and predictable (Fischer, 1993; Bruno & Easterly, 1998).

Empirical studies generally suggest that high inflation adversely affects firm profitability and investment decisions by increasing operational costs and complicating financial planning. Evidence from both developed and emerging economies indicates that inflation constrains firms' ability to allocate resources efficiently and reduces overall productivity (Nas & Perry, 2000; Apergis et al., 2021). In emerging markets, where institutional frameworks may be less robust, these effects tend to be more pronounced.

2.2. Policy-induced uncertainty and economic outcomes

Policy-induced uncertainty refers to fluctuations and unpredictability in economic policies that affect firms' expectations regarding future regulatory and macroeconomic conditions. Such uncertainty has been shown to influence firm behavior by encouraging postponement of investment decisions and adoption of more risk-averse strategies (Bloom, 2009; Baker, Bloom, & Davis, 2016).

Existing research highlights that uncertainty surrounding fiscal, monetary, and regulatory policies can negatively affect economic performance by weakening firms' confidence and reducing capital accumulation. Empirical evidence suggests that in environments characterized by frequent policy shifts, firms are less willing to engage in long-term planning, which ultimately constrains growth and employment (Gan et al., 2019; Ekinci & Genç, 2018). These dynamics are particularly relevant in politically volatile economies, where policy credibility may be limited.

2.3. Inflation, uncertainty, and firm-level outcomes

While inflation and policy-induced uncertainty have been widely studied as separate phenomena, fewer studies examine their joint effects on firm-level outcomes. The interaction between persistent inflation and unstable policy environments can generate compounded risks for firms, intensifying uncertainty and amplifying performance losses. From a political economy perspective, these interactions reflect broader institutional conditions that shape economic governance and market expectations (North, 1990; Rodrik, 2008). By integrating insights from the inflation and uncertainty literatures, this study adopts a firm-level perspective to examine how these macroeconomic forces operate simultaneously. This approach allows for a more nuanced understanding of how firms respond to economic instability in emerging economies, particularly in contexts where inflationary pressures and policy uncertainty coexist.

Recent post-pandemic evidence highlights that elevated policy uncertainty and persistent inflation have jointly constrained firm-level investment and performance in emerging and advanced economies, reinforcing the relevance of institutional credibility and policy predictability in shaping firms' expectations and resilience (e.g., Bloom et al., 2022; Bekaert, Engstrom & Xu, 2022; Altig et al., 2023).

3. Methods

3.1. Data

The analysis draws on firm-level data from publicly listed companies in Turkey over multiple years, allowing the examination of both cross-sectional and temporal variation in firm performance. Firm-level financial information includes standard performance indicators such as return on assets (ROA) and return on equity (ROE), while macroeconomic variables capture broader economic conditions faced by firms.

In addition to firm-level indicators, the dataset incorporates macroeconomic measures such as inflation rates and indicators of policy-induced uncertainty, enabling a comprehensive assessment of how macroeconomic instability translates into firm-level outcomes. The use of publicly listed firms ensures data consistency and comparability over time, which is particularly important in empirical analyses focusing on macroeconomic volatility and firm performance (Demir, 2009).

3.2. Variables

The dependent variables in this study consist of commonly used measures of firm performance, including return on assets (ROA), return on equity (ROE), and sales growth rates. These indicators capture different dimensions of firm performance, ranging from profitability to growth dynamics, and are widely employed in the empirical literature on firm behavior under macroeconomic uncertainty.

The key independent variables include inflation rates and a proxy for policy-induced uncertainty. Inflation captures the general price environment faced by firms, while policy-induced uncertainty reflects fluctuations in economic and regulatory policies that shape firms' expectations and decision-making processes. To account for firm-specific heterogeneity, the empirical models include a set of control variables such as firm size, industry classification, and market share, which are standard controls in firm-level panel analyses (Bloom, 2009; Baker et al., 2016).

3.2.1. Policy-induced uncertainty measure

To capture policy-induced uncertainty in Turkey, this study employs the Economic Country-Specific Uncertainty (ECSU) index developed by Kılıç and Ballı, constructed in line with the methodology of Baker et al. (2016). The ECSU index is based on the frequency of joint appearances of economy- and uncertainty-related terms in leading Turkish newspapers, reflecting time-varying policy-related uncertainty perceived by economic agents. The original monthly ECSU series is aggregated to annual averages to ensure consistency with the annual macroeconomic indicators used in the empirical analysis. This approach provides a transparent and context-specific proxy for policy-related uncertainty in Turkey.

3.3. Empirical strategy

The empirical strategy draws on firm-level data with both cross-sectional and time-series variation. This structure allows for accounting for unobserved firm-specific characteristics and for capturing intertemporal variation in firm performance. Baseline specifications assess the associations between inflation, policy-induced uncertainty, and firm performance indicators.

To examine whether inflation amplifies the impact of policy-induced uncertainty, interaction terms between inflation and uncertainty measures are incorporated into the model specifications. This enables an assessment of their joint associations with firm-level outcomes. In addition, alternative performance measures and model specifications are considered to assess the stability and robustness of the main patterns discussed in the analysis, in line with standard practices in the empirical firm-level literature (Wooldridge, 2010). The baseline specifications account for time-invariant unobserved heterogeneity across firms and common macroeconomic shocks over time. Standard errors are reported using heteroskedasticity-robust estimators. Routine diagnostic checks are used to assess potential multicollinearity and serial correlation.

Potential endogeneity concerns are partially mitigated by accounting for firm-specific and time-specific factors. The analysis is not intended to establish strict causal relationships; rather, the specifications are designed to limit bias arising from unobserved firm attributes. Routine diagnostics do not indicate severe multicollinearity or residual serial correlation that would materially affect the reliability of the baseline patterns discussed in the text. For brevity, detailed regression tables are not reported in the current version.

This study relies exclusively on secondary, publicly available firm-level and macroeconomic data and does not involve human or animal subjects.

4. Results

4.1. Baseline results

The baseline estimations indicate that inflation is associated with a statistically significant decline in firm performance, as reflected in key indicators such as return on assets (ROA) and return on equity (ROE). Higher inflation appears to increase operational costs and complicate firms' pricing and planning decisions, thereby exerting downward pressure on profitability. These findings are consistent with theoretical expectations emphasizing the distortive effects of inflation on resource allocation and firm-level efficiency.

4.2. The role of policy-induced uncertainty

The results further show that policy-induced uncertainty has a negative and statistically significant effect on firm performance. Firms operating under heightened uncertainty tend to exhibit weaker performance outcomes, suggesting a more cautious approach to investment and operational decisions. Importantly, the interaction terms between inflation and policy-induced uncertainty reveal that the adverse effects of inflation intensify in periods of elevated uncertainty. When both factors coexist, firm performance deteriorates more markedly than in environments characterized by relative price stability and predictable policy frameworks, highlighting the compounded nature of macroeconomic instability.

Complementary exploratory evidence based on annual data indicates a positive co-movement between policy-induced uncertainty (ECSU) and inflation in Turkey, suggesting that periods of heightened uncertainty tend to coincide with stronger inflationary pressures.

Beyond statistical significance, the magnitude of the estimated coefficients suggests economically meaningful effects. In particular, increases in inflation and policy-induced uncertainty are associated with non-trivial declines in firm performance indicators, implying that even moderate deteriorations in the macroeconomic and policy environment can translate into sizable firm-level performance losses. This highlights that the effects are not only statistically relevant but also economically important for firms' operational and investment decisions.

4.3. Robustness analysis

To assess the stability of the baseline findings, several robustness checks are conducted using alternative specifications of performance indicators. The results remain qualitatively unchanged when different proxies for inflation and policy-induced uncertainty are employed. These additional estimations reinforce the baseline conclusions, confirming that inflation and policy-induced uncertainty consistently exert a negative influence on firm performance across model specifications.

5. Discussion

The findings of this study can be interpreted through a political economy perspective that emphasizes the role of institutions, policy credibility, and state-market relations in shaping firm behavior. In politically and economically volatile environments, firms do not respond to inflation and uncertainty in isolation; rather, their responses are mediated by institutional arrangements, policy consistency, and expectations regarding future government actions. From this perspective, inflation is not merely a macroeconomic outcome but also reflects deeper governance and coordination challenges that influence firm-level decision-making.

The results indicate that policy-induced uncertainty amplifies the adverse effects of inflation on firm performance, suggesting that instability in economic governance compounds price-level distortions. This interaction highlights the importance of policy credibility and predictability, which are central themes in political economy analyses of economic performance. When policy signals are inconsistent or frequently revised, firms may delay investment, reduce productive capacity, or prioritize short-term survival strategies over long-term growth, thereby weakening overall economic performance.

In the Turkish context, these dynamics appear particularly pronounced due to the coexistence of persistent inflationary pressures and frequent shifts in economic policy frameworks. The empirical evidence aligns with broader arguments emphasizing the role of institutions and governance in shaping macroeconomic outcomes. Rather than inflation or uncertainty acting independently, their combined presence creates an environment in which firms face heightened constraints, limiting their capacity to adapt and perform efficiently.

Overall, the findings suggest that efforts to improve firm performance in high-inflation environments cannot be separated from broader institutional considerations. Policies aimed at stabilizing prices may yield limited results if they are not accompanied by measures that enhance policy credibility, transparency, and institutional coherence. From a political economy standpoint, addressing firm-level performance thus requires not only technical economic adjustments but also sustained institutional commitment to predictable and credible economic governance.

6. Conclusion

This study demonstrates that inflation and policy-induced uncertainty are associated with weaker firm performance in the Turkish economy. The empirical findings indicate that persistent inflationary pressures, when combined with an uncertain policy environment, constrain firms' profitability and strategic decision-making. These results contribute to the firm-level literature by highlighting how macroeconomic instability and governance-related factors jointly shape economic outcomes in an emerging market context.

From a policy perspective, the findings suggest that efforts to improve firm performance in high-inflation environments are closely linked to broader institutional conditions. Policy frameworks characterized by predictability, transparency, and credibility appear to play an important role in shaping firms' expectations and investment behavior. In this regard, institutional stability may be as relevant as conventional macroeconomic tools in supporting sustainable economic activity.

Several limitations of this study should be acknowledged. The analysis focuses on publicly listed firms, which may not fully capture the experiences of small and micro enterprises operating outside capital markets. In addition, firm-level responses may vary across regions and sectors in ways that are not fully addressed in this framework. Future research could extend the analysis by incorporating a wider range of firm types and exploring regional heterogeneity to provide a more comprehensive understanding of the interaction between inflation, policy uncertainty, and firm performance.

Taken together, these findings underscore the importance of credible and predictable economic governance. Practical steps include strengthening the independence of the central bank, improving the clarity and transparency of monetary and fiscal policy communication, and limiting regulatory volatility through stable, rule-based frameworks. Better coordination between monetary and fiscal authorities can help reduce uncertainty, anchor firms' expectations, and support firm performance in high-inflation environments.

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