The Economic Impact of Financial Liberalization in Turkey: Channels of Banking Sector and Foreign Direct Investment

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Candidate Name : EMRE ALTINOVA

I certify that the dissertation entitled:
The Economic Impact of Financial Liberalization in Turkey: Channels of Banking Sector and Foreign Direct Investment
submitted for the degree of: ***MSc Accounting & Finance Management***
is the result of my own work and that where reference is made to the work of others, due acknowledgment is given.

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List of Abbreviations

BDDK – Banking Regulation and Supervision Agency

OECD – Organisation for Economic Co-operation and Development

EU – European Union

FDI – Foreign Direct Investment

GDDS – General Data Dissemination Standard

GDP – Gross Domestic Product

IMF – International Monetary Fund

NPL – Non Performing Loan

TBB – The Banks Association of Turkey

TCMB – Central Bank of The Republic of Turkey

TFP – Total Factor Productivity

YOIKK – Council for the Improvement of the Investment Environment

ABSTRACT

It is obvious that liberalization affects countries either negatively or positively. In order to receive benefits from it, it should be controlled efficiently. Therefore, this research examines economic impact of financial liberalization in Turkey through the channels of Banking sector and FDI. As, Turkey liberalized at 1980, the economy enhanced compared to the earlier years. However, there were some financial shocks due to inadequate extraversion and financial fragility that is investigated in this research. Banks is the driving factor of the economy according to the study due to positive interest rates led them the strongest link in the financial sector. FDI affects economy positively with providing employment, know-how and technology. In the last decade, Turkey received huge inflows but the economic growth could not be directly correlated with it. Overall, findings suggests that, there is a positive correlation with liberalization and economic growth if liberalization controlled effectively.

1. Introduction

In the last three decades, financial liberalization was recognized in several developed and developing countries in their financial system to enable markets in facilitating and sustaining economic growth. In line with the liberalization, eased or lifted bank interest rate ceilings, market determined economy, lowered entry requirements, reduced government intervention, privatization had occurred to encourage the entry of foreign financial money flow and enhance domestic market. According to McKinnon and Shaw(1973), financial repression gives low and usually negative real interest rates, decrease private financial savings, therefore reducing the resources available to finance capital accumulation by forcing financial institutions. From this perspective, emergent countries can stimulate domestic savings and growth, and decrease excessive dependence on foreign capital flows through financial liberalization.

According to many empirical studies, the relationship between financial liberalization and economic growth are positively correlated in their future growth rates of GDP that suggests financial growth in long run effect(Levine et al. 1996). However, there are also negative arguments about liberalization, some researchers found that benefits of growth were different than expected. Liberalization causes some problems to the countries while enhancing the country externally but causes financial fragility especially in developing countries due to weak financial system. In Turkey, liberalization started at 1980; particularly, banking sector in Turkey was hit by number of problems that led boom and bust cycles, systemic crises which was discussed in this research. Therefore, both positive and negative affect of financial liberalization discussed in this research.

In recent years, Turkish economy have been developing so entrepreneurs and foreign companies are looking for opportunities in Turkish market. Harrison (2004) identifies that policy makers in emerging markets have eased restrictions about foreign direct investment that enable incentives for multinational firms. I have chosen banking system as Beckaert et. al.(2001) and Levine (1996) described increasing stock market liquidity in line with efficiency of the banking system eliminate the restrictions and speeds up growth because almost all companies borrow from local banks. My primary objective of the research is to determine factors behind economic growth to understand it in banking sector in line with financial liberalization. Turkish financial system is weighted on banking sector which relies on supply and demand change in the market. In addition to financial tools that they provided, information

technology, product and financial services to increase their margins in Turkey. Providing Dynamic and efficient solutions can stimulate economic growth. Especially after 2001 crises, new regulations, new foreign capital banks, re-capitalization handovers and mergers improved the density in the finance sector around 88%(Coskun & The Banks Association of Turkey 2012). Therefore, first channel of economic growth in my research is banking sector as it is the primary driver of Turkish economy.

Foreign direct investment (FDI) is the key factor in international economic integration by creating direct, stable and long-lasting links between economies(OECD Online). Transfer of know-how and technology between countries, encourage Turkey to stimulate its products more broadly in international markets. Under the right policy, being an additional source of funding for investment by providing liquidity to the government. Therefore, it can be an important vehicle for development(OECD Online). Especially, from 1980 to 1990 and after 2003, FDI inflows were high in Turkey. Therefore, second channel of economic growth in the research is FDI which enable different channels to economic growth.

Below questions can be asked in order to understand the research;

- How did the changes of the regulations in Turkey in line with financial liberalization affect economic growth?
- How did banking sector regulations affect economic growth both before financial liberalization and after financial liberalization?
- What was the outcome of foreign direct investment and how did it affect the economic growth in line with the financial liberalization?

In order to answer above questions, I have divided the research into four parts. In Section 1, economy in Turkey in general has been examined with the regulations and policies since establishment of the Turkish Republic- 1923. Also, I believe four different financial liberalization arguments are related with Turkey and data has given about this arguments. In addition to that, FDI and Banking sector has been explained separately with their laws and regulations before and after financial liberalization. In Section 2, framework for the economic growth has shown in the conceptual framework. In Section 3, I have identified the research methodology and give details about how I prepare this dissertation. In Section 4, I have discussed my findings and tried to explain basically how these channels affected economic growth. Finally, conclusion summarize the dissertation and give some recommendations for

economic growth in emergent countries as well as in Turkey. If you have any further questions, please do not hesitate to contact me.

2. Literature of Review

2.1 Turkey Before Financial Liberalization (1923 – 1980)

2.1.1 Turkish Economy

After Turkish republic was established in 1923, Turkish economy was a closed economy and government intervention was sovereign(Demirci 2005), industrialization strategy was more domestically and all the actions were supervised by government. In the first fifteen years, reconstruction of war, new regime, reforms and adoption of secular principles in the political life led economic difficulty with huge external debts and dismantling capitulations of Ottoman empire(Rodrik & Celasun 1989) which limited domestic initiatives effectively.

In mid-thirties, statism assigned a leading role to public sector in technological development and industrial improvement till Financial Liberalization. Import substituting industrialization was quite successful in resource mobilization which generated growth. Many investment projects were implemented in this period(Rodrik & Celasun 1989) due to bank interest rates had ceilings which are lower than market interest rates which was set by government. Low rates can result a surplus demand for investment and gave an opportunity to borrow from regulated rate.

In 1940s, economic destruction was spared for Turkey due to stayed neutral against Second World War. However, economy was stagnated during these years because of increased military expenditure with Marshall Plan which was based on defense considerations that shift economic priorities(Rodrik & Celasun 1989) and foreign trade was reduced due to the war(Macovei & Directorate-General for Economic and Financial Affairs 2009).

Economy was enhanced rapidly at 1950s in line with agricultural output. However, huge crop failure in 1954 reduced growth. External debt management and domestic policy was temporary with increased reliance of short term borrowings and trade arrears. Central Bank tried to stabilize economy by financing public enterprise deficits and agricultural purchases which caused high inflation that led IMF stabilization program.

In 1961, five year planning program was established with specific incentives that led an increase in domestic savings performance in line with government development programs. However, programs discriminated against exports with quotas, licences, import deposits and tariffs which increased import substitution pattern in the economy and caused overvalued exchange rate. These strains in external balance was at the top at 1969. Devaluation has

occurred after it which led favourable to export and GDP expansion from 1971 to 1973(Rodrik & Celasun 1989).

These actions was prevented growth of Turkish economy, especially, import side of view. Government policy was to produce basic goods and export the other needs from outside. Economic growth was under pressure of external markets, it expanded in line with export which had continued till the end of 1970s that caused import substitution industrialization. Fixed investment of public sector has started to decrease and private sector made the economy more dynamic. This process caused financial strains because public sector required large budget and economy was rely more on banking sector as seen below table which shows Turkish economy based on assets at Central Bank and deposit banks 1970, 1975 and 1980.

	1970	1975	1980
A. Total assets of financial institutions (% of GNP)	76.7	80.1	66.6
B. Distribution of assets			
1. Monetary system (Central bank and deposit banks)	68.4	73.3	84.7
2. Investment banks	12.4	11.5	6.3
3. Social insurance institutions	14.4	11.8	6.4
4. Other institutions	4.8	3.4	2.6
Total	100.0	100.0	100.0
C. Net issues of domestic nonfinancial (real sectors)			
1. Total (% of GNP)	59.7	57.8	47.8
2. By sector (%)			
a. Public sector	48.2	42.9	55.1
Administration	27.3	23.6	31.8
Enterprises	20.9	19.3	23.3
b. Private firms	37.3	47.6	37.3
c. Households and others[a]	14.5	9.5	7.6
Total	100.0	100.0	100.0
3. By type (%)			
a. Equities	8.9	11.2	6.9
b. Debt issue			
Bonds	11.3	8.6	8.6
Nonbonds[b]	79.8	80.2	86.6
Total	100.0	100.0	100.0
4. Held by (%)			
a. Financial system	87.1	83.9	85.8
b. Monetary system	57.0	59.7	71.1

Source: Akyuz and Ersel (1984, annex 2) for financial assets; Akyuz (1984, tables 4.1 and 4.4) for other data.

[a] Includes agricultural producers and nonprofit organizations.

[b] Credits, advances, etc.

Table 1: Turkey's Financial System 1970 - 1980

Additionally, raised inflation caused increased negative interest rates which increased in public expenditure(Agir 2010) that caused macroeconomic instability at the beginning of 1970s. There were three reasons. Firstly, petroleum price increased in 1973 and Cyprus Operation in 1977 had raised financial burden, which prevented TCMB(Central Bank of Republic of Turkey) to achieve and maintain price stability(TCMB online), that caused financial crisis. Secondly, even financial crisis in external markets, government continued its financial policy expansion(Agir 2010) which enabled inflation and currency problem. Lastly, the nature of export expansion policy improved the need of foreign currency that caused

exchange rate problem and Turkish Lira increased its value. Therefore, Turkey tried to stabilize economy with the help of external debts that led increased debts in line with payment difficulties due to the current deficit. Finally in 1978 – 1979 IMF support had applied to finance the debts and to relief the budget aimed to increase savings. However, it caused negative real interest rates therefore financial repression (Agir 2010). Financial system was based on only banks, only responsibility of public and private banks was to complete basic functions like giving credit and taking bank deposit. Due to government intervention, there was not a foreign bank in the market to reach efficiency (Toprak 1993, Binay&Kunter 1999).

Selective credit policies was in order which made credit interest rates below market average (Agir 2010) and high inflation rate, poor interest policies, external debts tried to be met by TCMB(CBRT). Private sector support was limited due to banks huge public sector support. Turkey's response to external shocks and postponed internal financial adjustments with short term borrowings, external debt strategy etc. caused stagnation of exports, payment crisis and bank reserve reduction which enable foreign exchange crisis with the worsening balance of payments in 1978. In order to shape financial stability, financial constraints was reduced with an agreement at the beginning of 1980 (Akalin 2006, Kilic 2012) and financial liberalism was started.

2.1.2 Historical Analysis of Banking Sector in Turkey Before Financial Liberalization

Banking structure in Turkey was changed after republic was established by Mustafa Kemal Ataturk. From that date, Turkish Economy, government and external markets affected from the structure. The terms was classified in 2 different headings before financial liberalization in this research.

- Republic and Statism Term (1923 – 1944)
- New Statism and Planned Term(1944 – 1980)

2.1.2.1 Republic and Statism Term (1923 – 1944)

Turkish economy was weighted on agricultural economy, national bank system was established in order to enhance monetary system in Izmir Economic Congress at February 1923(Coskun & The Banks Association of Turkey 2012) and first bank was established as private bank at 1924 named Turkiye Is Bankasi served to real estate trade, give credit to companies. Sanayi and Maadin Bank was established at 1925 as first government bank to support capital and mine markets, did partnerships with private sector and managed capital

intense firms belong to government then privatize. However, it was unsuccessful. In order to support agriculture sector Ziraat Bank has been established at 1924 to give credits and present all banking facilities. At 1926, Emlak and Eytam Bank was established to suppot construction sector and care orphan rights. The most important action in this term is Central Bank has been established at 1930. The basic purpose was to support and foster Turkish economy. Therefore, the duty of the bank was to determine discount rate, regulate money market and money circulation, carry out treasure trasactions, preserve value of Turkish Lira (TCMB online).

First ten years private sector tried to encourage to be capital intense. However, capital savings were not enough to improve. Due to great depression at 1929 and competitiveness, many banks were closed and huge capital banks branches that allow government intervention had increased as they decided to take necessary actions on investment structures. Therefore, bank sector was depend on government and capital savings was done primarily by public banks. Government formed 5 year plan for industrialization between 1934 and 1938. Sumerbank was established to perform and manage the investments, provide source to economic growth, enhance national industry. Another improvement was in energy sector, all costs were financed specifically in one bank which was set up at 1935 as Etibank. Denizbank was set up at 1938 to support small and medium enterprises in the industry.

To sum up, World War I and Independence War devastated economy in this term. Turkey was trying to be industrialized with the help of the bank establishments in different sectors. However, finance sector was not efficient. Therefore, government support and strict economy made the investments not been done by private sector. Almost all investments was financed and budgeted by public sector.

2.1.2.2 New Statism and Planned Term (1945 – 1960)

The most important activity in this term was to incentivise private sector rather than public sector to enhance economic growth. Investments, national income improvement especially industrial sector and increased population enabled immigration from rural area to cities so the need for money and credit was increased. The return of investments to the bank has increased which allow private banking more important. Interest rates and commissions of banks was determined and activities based on foreign currency was given permission to Central bank by government. This led a raised competition between banks on receiving deposits which increased the branches of Banks and decreased the number of distinctness(Coskun & The Banks Association of Turkey 2012).

Small liberalization was seen in this term, capital import has started and inflation rate and capital deficit problem has occurred that led economic crises in 1958. At 1960, new regulations determined liquidation fond was established for banks which sourced from banks 0.001% of total commercial deposit and savings. Moreover, in order to support banking sector and improve its competitiveness, The Banks Association of Turkey was established(TBB online).

Between 1960 and 1980, planned term for capital utilization has started to reach economic stability. Negative real interest rate policy had followed, then Turkish Lira was overvalued and monetary sector was under control of government. The basic action of the banks was determined as financing the investments in development plan(Keskin et al. 2008). In this term, there were enough commercial bank in the sector and government had forbidden to establish new commercial bank and five development bank and two investment bank has set up in this term. On the other hand, holding banking supported to incentivise private sector then private commercial banks were transformed to holding banking(Coskun & The Banks Association of Turkey 2012).

To sum up, before 1980 government was ruling banking sector. Source and income distribution was controlled by Central Bank and government. Oligopolistic structure was dominant in the sector because of cost, efficient point of view. Moreover, entry barrier enabled branching rather than opening a new one. In 1970s, holding banking had increased in line with holdings.

2.1.3 FDI Analysis in Turkey Before Financial Liberalization (1954 – 1980)

The first law about FDI was accepted to utilize Turkey economically at 1954. In line with the new law, income transfer restraint was lifted, financial easiness was provided by department of finance. There was not a discrimination between foreign employees and local employees. Moreover, work permit, custom exemption and income transfer for foreign employees was provided(Ercakar & Karagol 2011). In line with government planned term, a regulation was done in 1963 and a foreign currency amount was set as a base for investment and also currency operations for the institutions was liberalized. However, liberalization term and incentives was not enough for FDI, at the end of 1980 total FDI was $281 million. Some important points; At 1974 and 1979, investors left the country, currency problem at 1977 led government to restrict income transfer which caused a decrease in investment. $197 million

was invested at 1973. Therefore, incentives, potential on economy, geographic and strategic location was not enough to attract investors to choose Turkey before 1980.

Years	Annually		Years	Annually	
	Million $	Million TL		Million $	Million TL
before 1954	2.8	7.9	1967	9	80.3
1954	2.2	6.1	1968	13.9	107.7
1955	1.2	3.3	1969	13.2	109.6
1956	3.4	9.4	1970	9	89.4
1957	1.3	3.6	1971	11.7	150.7
1958	1.1	4.5	1972	12.8	173.2
1959	3.4	20.5	1973	67.3	918.7
1960	1.9	16.3	1974	-7.7	-106.7
1961	1.2	10.9	1975	15.1	215
1962	4.2	37.4	1976	8.9	140.3
1963	4.5	40	1977	9.2	162.6
1964	11.9	103.9	1978	11.7	275
1965	11.6	88.8	1979	-6.4	237.8
1966	9.7	86.9	1980	53	-

Table 2: FDI before Financial Liberalization(Annually)

Above table presents FDI amount in yearly base. As seen from the table, there was a huge increase in 1980 in line with domestic policy stabilization and when we compared with the other years, there was a huge difference in the amounts. Therefore, financial liberalization, economic reforms increased the trust on Turkish economy which changed foreign direct investment trend.

2.2 Financial Liberalization Arguments

There are different approaches of Financial Liberalization, Turkey's liberalization process is more based on Neo-Classical Approach. However, assumptions of this approach is lacking. Therefore, new approaches have discussed over time. In the research four different type of arguments have discussed;

- McKinnon- Shaw Hypothesis on Financial Liberalization(Neo-Classical Approach)
- Structural Approach on Financial Liberalization
- New Keynesian Approach
- Post Keynesian Approach

2.2.1 McKinnon-Shaw Hypothesis (Neo-Classical Approach)

The hypothesis is based on various contexts. Initially, it focused on "Financial Repression" which is real interest rates on savings and investment levels in emergent countries. Over thirty years, it was classified in three different generation(Struthers et al. 2004). First generation model identifies the financial crises literature (Krugman 1979) which are the rapid changes in international capital flows that effect international investment conditions. Krugman (1979) identified flow reversals affect account adjustments therefore currency and banking crises. Additionally, currency crises was occurred by the weak fundamentals that led foreign direct investment to pull the resources. Second Generation Model (Obstfeld 1996) discussed currency crises as countries government expectations changed speculative attacks and the loss arising from maintaining the regime and inconsistent policy making and change in market sentiments. Third Generation Models (Krugman 1999) was come out after Asian currency crises because first and second generation model did not fully explain the phenomena. Domestic banks in emerging countries was unsustainable due to huge entry of short term capital that enables asset price bubble therefore reverse the capital inflows. Additionally, fragile financial institutions can not response sudden change in market which caused insolvency then currency crises (Struthers et al. 2004).

McKinnon(1973) and Shaw(1973) analysed to eliminate financial repression on the domestic financial system in emergent countries. The hypothesis is based on domestic savings and growth, they identified how interest rates rise gave positive effect on growth rates. Artificial ceilings on interest rates in strict economies liberalized and interest rates was market determined(Demirgüç-Kunt et al. 1998). These artificial ceilings decreased savings, discourage well diversified portfolio and capital accumulation (Struthers et al. 2004). Government strict policy led financial repression by giving negative or low interest rates that effects economic growth negatively for three reasons. Firstly "dualism" which firms demand to choose capital intensive technologies that enhances company whereas they do not have enough capabilities to implement high yield projects. Additionally, government excessive intervention in money and credit markets in emergent countries can cause "credit rationing" effect that definite real interest rates allows non market forms and inhibit adjusting the clear market. Bank takes risk and gives extra credit to customers with same interest rates. Quantity of saving amounts was low, quality of activity was poor which compound each other. Finally, low interest rates increases consumption because individuals tend to keep it in personal wealth due to protect themselves against inflation and poor, inefficient financial sector. Therefore, there are not

enough savings and investment funds. In addition to that, high inflation rates led to slow economic growth(Kilic 2012). Finally, “adverse selection” was one of the reasons of not homogenous economy. Lenders tend not to lend money to high risk projects but they sometimes can not distinguish borrowers of high risk projects due to lack of knowledge.

Early hypothesis assumed that higher interest rates occurred that foster savings when control on them was lifted. In line with liberalization, higher saving enables higher investment therefore economic growth is higher. There are some developments to this hypothesis, Campbell and Mankiw(1987) identified liquidity constraints because McKinnon and Shaw hypothesis was based on homogenous household set. If there is a relaxation on liquidity, savings will be declined. Additionally, Ostry&Reinhart (1992) confirm the findings and only wealthier countries do some savings in line with increase in real interest rates, Reinhart&Tokatlidis(2001) identifies that liberalization brought financial deepening as measured in credit and money aggregate, higher level interest rates can lower investment but not lower growth due to a higher level foreign direct investment as identified previous Turkey economic growth part. Bandiera (2000) studied on liberalization and saving in eight different components and many different countries between 1970 and 1994 and found that liberalization short run effect is negative in all countries but positive effect in long run at Turkey as 13% rise in saving rate with the liberalization.

To sum up, financial liberalization increases competitiveness and efficiency in financial sector which enables product differentiate, quality of service and technological improvement. However, Neo-classical approach assumptions, full employment, efficient financial sector, precise and asymmetric information, are different practically than theory. As a result, new theories has occurred to explain financial liberalization effects.

2.2.2 Structural Approach

Taylor (1983) and Van Wijnbergen (1983) focussed on economic, social and institutional structure in emergent countries. Inflation rate increase is affected from supply and demand imbalance and in order to solve it growth is a need. According to the author, tax and expenditure reforms, deregulation in labour and capital market, eliminate monopoly, privatization and foreign capital deregulation can lead growth. In addition to that, government intervention is needed in emergent countries but it should be flexible and not strict (Ozer 2006).

Structural approach concept identifies that financial liberalization slows down economic growth in 1980s for three reasons. First, credit interests increased as a result of

financial liberalization. High rates increase the cost of debt in line with production cost then price of the product. Price increase decreased the demand that cause stagflation. Secondly, being successful in Neo-classical approach depend on bank deposits because savings are not productive, investors do not want to take risks on their investments. Finally, non-institutional financial sector is more efficient that assumption is; increased real rates allow to choose institutional credit market active rather than non-institutional.

To sum up, structural approach does not support Neo-classical approach and identified that economic growth does not depend on real interest rates.

2.2.3 New-Keynesian Approach

This approach support that financial liberalization policies can result a decrease in investments and savings therefore slow down economic growth.

New Keynesians support their approach criticizing Neo-classical approach's two assumptions. Neo-classical approach criticized, economy is not in full employment. Real interest rate theory described that investment and savings amount increased with removed interest rate ceilings in line with liberalization. However, in unemployment circumstance, saving or investment are not available.

In addition to that, financial sector in emergent markets is not efficient and not developed for asymmetric information. Interest rates is increased after financial liberalization and bank has a lack of data while giving credits and take the risks. In order not to give wrong decision with lack of data, credit rationing has occurred (Ozer 2006).

To sum up, New Keynesians argued employment deficit and asymmetric information in Neo-classical hypothesis and discussed that investment and savings has reduced as an effect of financial liberalization.

2.2.4 Post Keynesian Approach

This approach is different than New Keynesian approach. Unforeseeable future of projects affects investment decisions. High Net present valued projects and risky projects can be chosen due to the effect of expectations and competitive environment (Esen 1998). This approach focussed on undefined domestic and international macroeconomic coordination leads low quality, instable high return investments. Therefore, financial structure of the market will be weak against crises.

2.3 Turkey After Financial Liberalization(1980 - ..)

2.3.1 Turkish Economy After Financial Liberalization

In order to solve financial problems, first target was to solve liquidity problems, reduce inflation then enhance economic growth meanwhile lowering government intervention to minimum with the help of private sector. In order to increase the role of private sector, discussions has done liberalize foreign direct investments and enhance savings, privatization, tax reforms and freeing international trade by decreasing tariffs. Market determined system was put in practice. As a result, not only reaching financial stability but also economic growth was targeted (Şenses 1984, Yıldızoğlu&Marguies 1988, Öniş 1991, Ertuğul&Selçuk 2001).

Neo-classical Liberalization model was more based on for Turkey and expanded step by step (Kilic 2012). Therefore, bank interest rates were more variable and ceilings was lifted. Additionally, entry barriers, government intervention in credit allocation was lowered (Demirgüç-Kunt et al. 1998). Domestic savings(McKinnon 1973; Shaw 1973) and import based industrialization growth strategy was followed.

As we look first 10 years of liberalization, there was a success in inflation rate as it was decreased hugely as seen Appendix between 1980 and 1985. In line with the liberalization, the capacity has increased, devaluation of Turkish Lira was around 32.9 which helped the policy of externalisation (Agir 2010). FDI volume has increased and government debts has decreased at the same time which enables to decrease current deficit. In line with foreign direct investments, competition between banks has increased and forced them gentleman agreements between them which covers interest rates. However, Banker crises has occurred, as they were given higher interest rates than banks, they could not meet requirements of investors. So, TCMB(CBRT) intervened the market interest rates at the beginning of 1983 till 1987. Deposit certificates could not be sold by bankers(money brokers) and some institutions which caused banker bankruptcy and bank closures (Binay&Kunter, 1999). This was discussed more on the Banking system section. On the other hand, privatization was successful at the beginning and total income was $183 million between 1985 and 1989. Export volume was increased in line with the liberalization, devaluation, tax advantages, tariffs and not fully freeing import policy had decreased the foreign trade coverage ratio in first 10 years.

After 1989, movement of capital was fully liberalized, domestic institutions could buy and sell government bonds and even transfer security profits to overseas. Therefore, we can

say that Turkey was more bound to export markets financially which made government to control financial markets harder that caused financial crises in 1994. Macroeconomic instability decreased import and increased the value of Turkish Lira which made higher labour cost. Insecure market made foreign direct investment to leave Turkish Economy. Between 1994 and 1998. However, the crisis in Russia at 1998 had affected economic growth negatively. The annual report of TCMB- CBRT(1998) showed that reduced domestic demand and international markets decreased pace of the Turkish economy. Additionally, the earthquakes at 1999 caused negative economic growth and increased unemployment rate.

Political system at 1990s, choices of government led economy in Turkey weaker. Supervision was bad, weak controls of budget and expenditure caused macroeconomic instability (Alper & Öniş 2001). Both import and export had decreased but current deficit was lower in these years. Due to weak controls and auditing, corruption was seen in these years.

At 2000s, inflation rate, income and expenditures was aimed to control. Interest rates, exchange rates was determined by the market. Wages and prices in public sector was changed in line with inflation rate. Privatization and foreign direct investment has been increased to foster economic growth. Financial crises in 2001 caused serious banking bankruptcy problems, In order to finance the debts, macroeconomic stability and economic growth, government started a program under IMF control (TCMB 2001).

2.3.2 Banking Sector in Turkey After Financial Liberalization

Banking structural in Turkey was changed with new policies and regulations liberalization as Turkey was tracking more extraverted policy in line with the liberalization. The terms were classified in 3 different headings in this research;

- Liberalization and Extraverted Policy Term(1980 – 2000)
- Re-structured Term(2001 – 2010)
- Present Banking (since 2011)

2.3.2.1 Liberalization and Extraverted Policy Term(1980 – 2000)

As discussed in Turkish economy part, economic recession in 1978 – 1979 pushed government to change its policy. Industrialization process, foreign currency saving was not resulted as expected. In July 1980, real interest rates was decided to market determined, rates had increased gradually. Deposit certificate permission to banks was given. Negative real rates was over, positive interest was given to deposit. However, banks and banker crises made

government to intervene interest rates between 1983 and 1987. In this term, government gave permission to foreign banks to go in market and also Turkish banks extraverted to foreign markets(Coskun & The Banks Association of Turkey 2012)(Keskin et al. 2008; Kilic 2012).

Regulations done to improve competitiveness in line with financial liberalization, strengthen market conditions and banking efficiency, support savers and improve auditing. Financial liberalization gave banks to raise interest rates around 3 times in line with deposits in the system. Total deposits had increased 6.6 times, GDP had increased 85% between 1980 and 2000. Financial system enhanced with foreign source, foreign currency saving possibility, currency transactions and liberalized interest rates. However, current deficit had raised significantly and government decided to take credit domestically. Raised interest rates and high inflation rate led increased bank costs which reduced growth rate of branches and personnel in banks in Turkey until 1995. Especially, private capital national banks and foreign capital banks had increased significantly whereas public banks had decreased slightly.

Additionally, Istanbul Stock Exchange started to operate at 1985 whose name has changed to Borsa Istanbul at 2013.to contribute to finance economic growth in Turkey(Borsa Istanbul online) and support banking system with new financial instruments(Keskin et al. 2008), 80 companies' stocks were traded. In order to encourage participation to stock market, tax incentives were provided to stockholders and companies(Gezici 2007). Moreover, money union between banks with the support of Central bank established for flexibility on sources, efficient usage of liquidity surplus. There were positive developments in banking sector at this term but reverting long term investments weakened and banks prioritize to finance government and consumers. Credit/Deposit ratio was decreased from 84% to 49.9% from 1990 to 2000(Coskun & The Banks Association of Turkey 2012).

Economic crises had occurred between 1989 and 1994 due to extreme liberalization. Interest rates raised, government debts liquidated from Central Bank reserves, currency deficit increased to a record amount around $14 billion that led to overvalue Turkish Lira. Even, intervention to exchange rate did not manage macroeconomic instability. Banking crises had occurred, some banks closed due to financial incapability, unfair competitiveness and moral hazard(Coskun & The Banks Association of Turkey 2012).

2.3.2.2 Re-structured Term(2001 – 2010)

High inflation rate, not be able to managing current deficit led government to perform economic program. BDDK (Banking Regulation and Supervision Agency) was established to

regulate and supervise banking sector(BDDK online) at 2000 under one governmental body with reduced political effect. Regulation problems on public banks, political uncertainties, cautious on international capital investments in developing countries and decreased amount of foreign direct investment in second term of 2000 which led liquidity depression. Policy of government, debts of some banks, stock exchange market value decrease made foreign investors leave the country. Financial crises at 2001 causes more problems to banking sector. Banks prevented to give new credit opportunities for real sector and encounter payments of credits. Currency deficit was more than $45 billion so currency bank has established to control over it. In line with crises at 2001, increased public debt, depreciation of lira and inadequate recapitalization of banks led GDP portion of banks increased from 38.2% at 2000 to 74.1% at the end of 2001. However, recapitalization made banks more reliable financially that is discussed in findings & discussions part. Banking crises affected 81 banks and caused a loss to the budget around 30% of GDP, from February to October, Turkish lira depreciated around 60% against US dollar(Macovei & Directorate-General for Economic and Financial Affairs 2009).

Government demanded to increase bank capital structure then regulations were done to BDDK set up re-structure program for re-structuring public banks financially and operationally, analysis of banks in Savings Deposit Insurance Fund(TMSF), support private banks and made them more strength, increase efficiency in the sector in line with enhanced supervision.

Basic regulations in banking system;

- Entry to sector, supervision and observation is done by BDDK.
- Bank owners must be reliable, their past must be clear
- Equity and reserves of the bank must be enough according to the law
- If the bank reserves is not enough and BDDK gave incentives to improve the position of the bank and still have not changed anything, BDDK will have a right to lift bank's activity certificate.
- BDDK set up regulations and restrictions, banks must fit them

2.3.2.3 Present Banking (since 2011)

Even, banking sector significance has been reducing over the years, it is still the most important element in financial sector around 88% of total equity of financial sector. After

financial crises at 2001, banks enhanced their structure and become more strongly financially. Number of banks has decreased however, there are a huge increase in bank's branches, ATM, credit cards and credit card machines. Capital Adequacy Ratio of Basel 8%, BDDK set this ratio to Turkish Banking sector at 12%(Coskun & The Banks Association of Turkey 2012) and the ratios of the banks are higher than this ratio which enabled the banks get over the crises with smaller effects at 2008. There has been a huge decrease in asset quality after 2008 crises, whereas quality of capital is strong and the ratio of equity to total assets compared to other emergent countries are higher and liquidity is growing as seen in below table. Central Bank is expected to remain the development of indebtedness and contribute financial stability. According to financial strength index(TCMB 2013), Turkey is financially strength which is still above 100%(TCMB 2013).

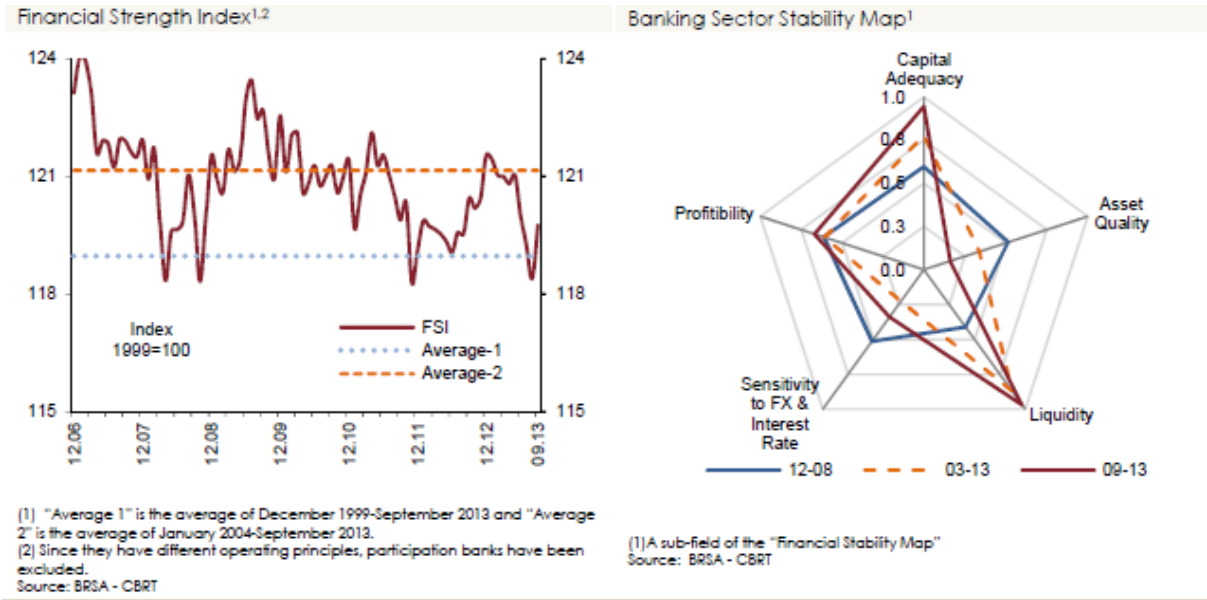


Figure 1: Financial Strength Index and Banking Sector Stability Map

Banking sector has been growing strongly, total assets to GDP growth is shown as below. Financial stability report(TCMB 2013) identifies various emerging economies including Japan, Brazil, India, Colombia, Poland, Indonesia etc., the ratio has raised higher in Turkey after Brazil since 2009.

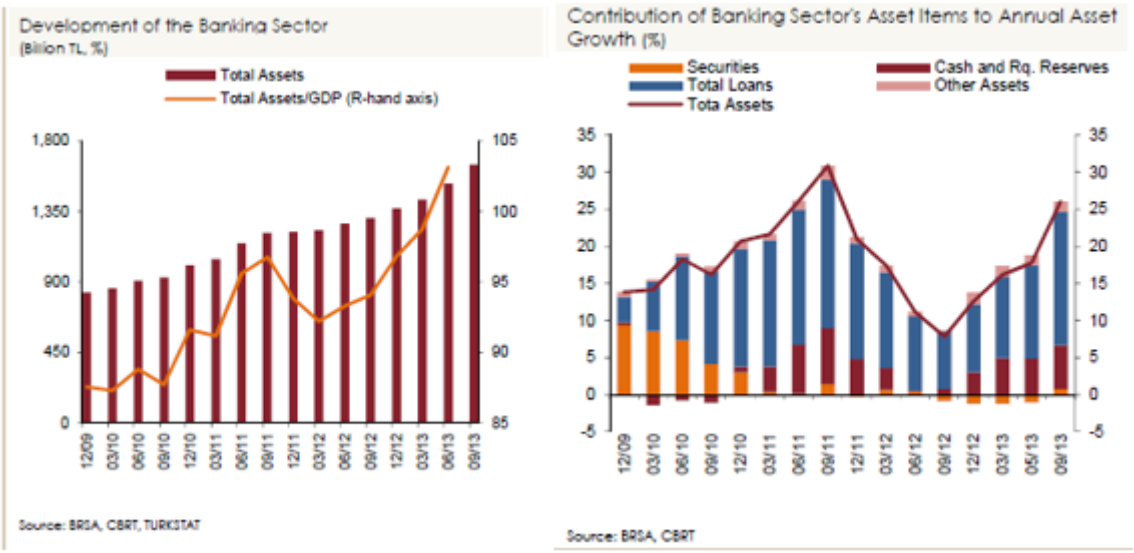


Figure 2: Development of the Banking Sector, Contribution of Banking Sector Asset Items to Annual Asset Growth(%) 2009-2013

Also, loan growth is higher than other emergent economies especially it has strengthened since the second half of 2012 which was upgraded Turkey's credit rating to investment level with the support of the liquidity policies by CBRT(TCMB) at 2013. Especially, privatization and public infrastructure investments, construction sector enhanced loan growth. On the other hand, non-performing loan(NPL) ratio of the system remained less, NPL sales has declined which is the fastest compared to other countries in the report even with no asset write-offs in banking sector structure on NPL ratio(TCMB 2013).

The second largest item on assets side is the securities portfolio, it has been fluctuated over time due to General Data Dissemination Standard(GDDS) by IMF, interest rates were decreased and transaction volumes increased which led resident banks met the GDDS demand of non-residents. Increased expectations of liquidity decrease in global markets made the banking sector purchase GDDS outflows from non-residents' portfolios. Loan growth has been increasing in the last two decades.

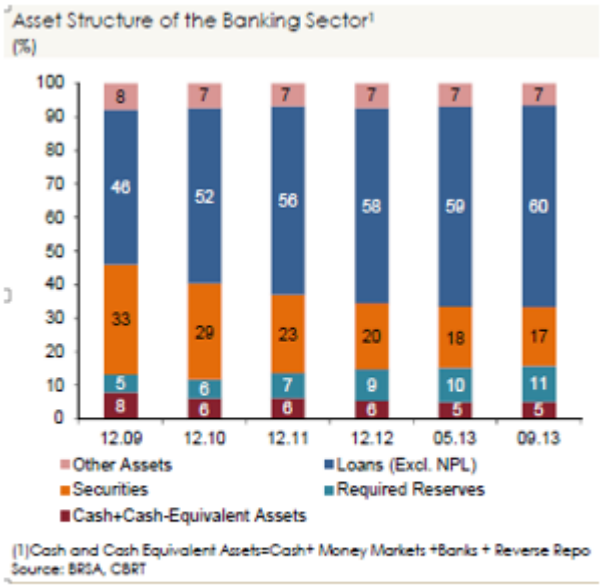


Figure 3: Asset Structure of the Banking Sector (%)

Liquid assets has been decreasing because banks have gradually reduced their security portfolios with the support of interest rate rise that they have a larger share in their balance sheets among other countries. However, total adequacy ratio is still higher than required legal limit.

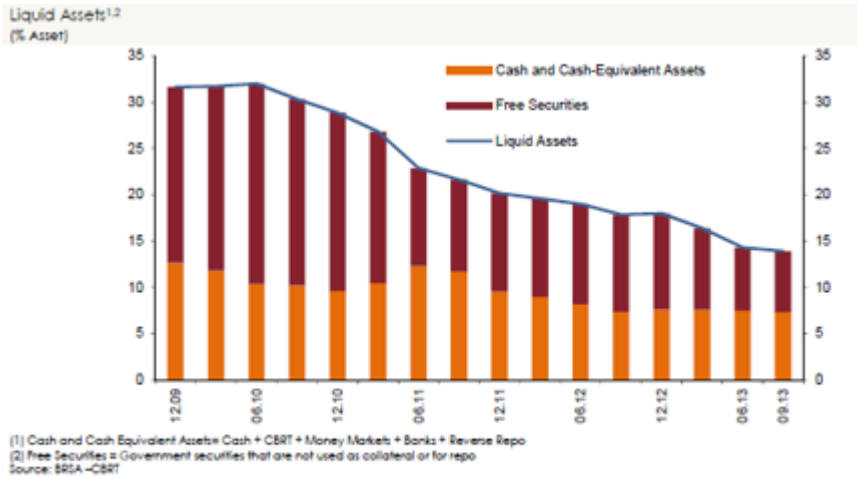


Figure 4: Liquid Assets (% Asset)

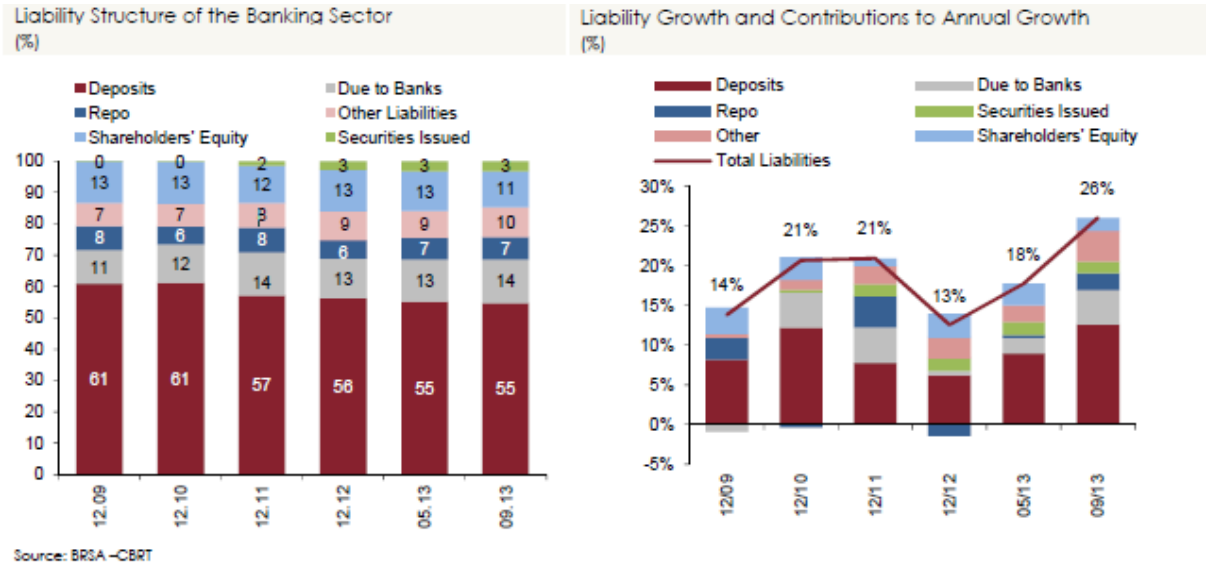


Figure 5: Liability Structure of the Banking Sector, its growth and contributions to Annual Growth (2009-2013)

When we looked to the liability structure of the banking sector, deposits have the largest share. As analysis of the banking, the contribution of repo funding to the liablility has turned positive due to improve in reserve requirement liabilities since the beginning of 2013. Turkey had the most increase among other countries in loan/deposit ratio from 2009 to 2013.

Banks do not have any difficulty in taking external funds even tighten times of global liquidity. It has been increasing with slowed pace. From September 2012 to September 2013, total foreign liabilities of banking sector had increased 29,1%. Whereas, securitization loans average maturity that constitute the loans with foreign liabilities longest maturity remained stable around last 6 years.

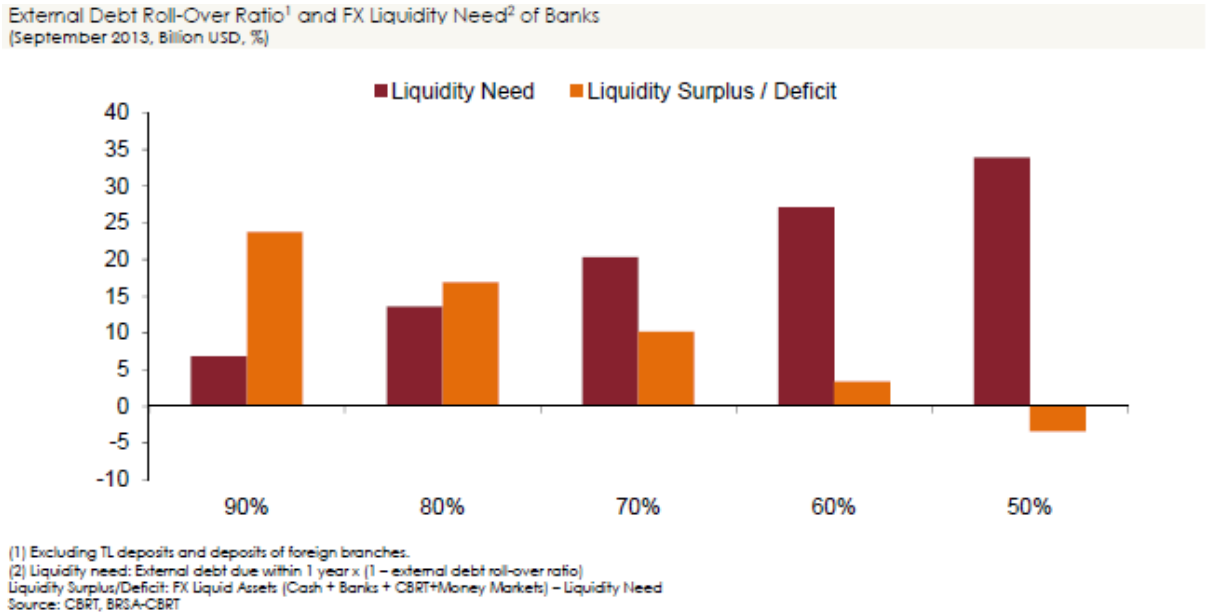


Figure 6: External Debt Roll-over Ratio and Foreign Currency Liquidity Need of Banks

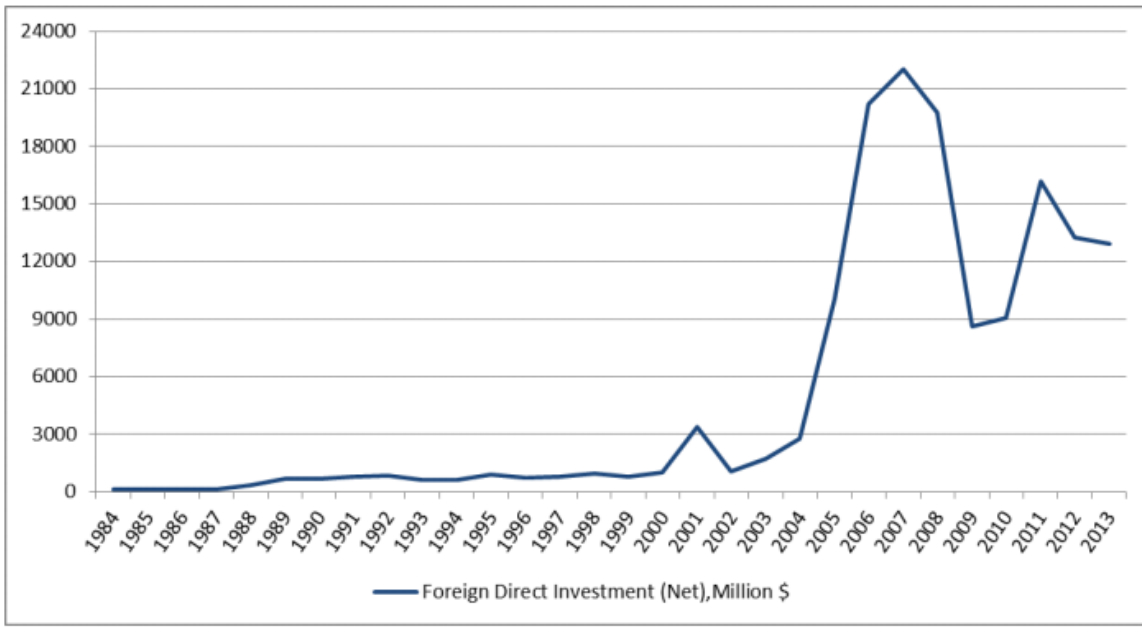
Banks can meet their short term external debt suitably with the liquid assets on hand, almost half of the external short term debt was covered by foreign exchange liquid assets which was high enough. It has been a rapid increase since 2011 due to surplus liquidity in global markets. The first bond issue was realized in the scope of the Global Medium Term Note in April 2013(TCMB 2013) that is a new program that gives a flexibility of borrowing with a certain portion from abroad for Turkish banking sector. Net interest margin has been reducing since the middle of 2012 but the sector remains profitability while return on assets and return on equity was stable.

2.4 FDI Analysis in Turkey After Financial Liberalization

. As discussed before, there was a huge increase in 1980 in line with domestic policy stabilization, financial liberalization, economic reforms increased the trust on Turkish economy which changed foreign direct investment trend. Almost all foreign companies had increased their capital and total capital increase was $338 million as government gave permission. The upward trend continued and reached around $800 million till 1990. However, FDI was stable between 1990 and 2000. Even Czech Republic, Poland and Hungary was liberalized after than Turkey, they attract $1.3, $5 billion and $2 billion FDI in order at 1997. Political and economic inability, expansion of China and far-east market, capital tendency (Brady Plan) in Latin

American countries were seen as reasons of lower FDI. Moreover, investment returns of developed economies with their advanced technology were higher than emergent countries In order to support FDI, government bodies was established to give recommendations, research study areas to search further improvements.

FDI amount has risen steadily due to new law at 2003. In new reform, investors do not need to get permission from government for direct investment and base currency amount for investors abolished. Above graph presented the difference between FDI amounts in line with the new law. Ercakar and Karagol (2011) defends that external sources like FDI is needed for emergent economies to overcome capital deficit, structural problems in economic growth. Alternative sources do not reveal debt burden and less volatile. Not only capital but also incoming know-how and technology with FDI can enhance economy. Privatization has increased after 2003 and FDI was covered around 5% of GDP in Turkey at 2006 and reach expected amount in following years. Due to global crises at 2009, amount was decreased but cumulative foreign capital investment was $79 billion which was 27th in the world.



Source: CBRT

Figure 7: FDI Inflows(1984 – 2013)

Investments has done various different sectors as shown in following graph.as accelerated the capital flow and investment growth mainly in manufacturing sector and services.In 1990s, FDI was covered around 0.5% of GDP in Turkey. Lower than other

emergent economies. Political effects, corruption, high inflation, government permissions for investors, economic instability and incapable infrastructure were the most important reasons for this which is discussed in the following section of the dissertation. FDI inflows were the second highest at 2006 in the last decade and coverage of GDP ratio was highest; 3.8%. This ratio was decreased to 2.05% at the end of 2011(Trading Economics Online).

Sector	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Total
Manufacturing	347	206	865	1,701	4,131	3,971	1,642	923	3,573	4,392	**21,751**
Construction	8	2	81	215	287	337	209	314	301	1,453	**3,207**
Financial Intermediation	54	127	3,856	6,954	11,717	6,136	817	1,620	5,882	1,443	**38,606**
Electricity, Gas and Water Supply	87	63	2	1,164	567	1,055	2,153	1,823	4,244	924	**12,082**
Health and Social Work	3	0	26	71	176	147	105	112	231	545	**1,416**
Administrative and Support Service Activities	0	0	17	30	2	25	6	0	47	242	**369**
Wholesale and Retail Trade	177	36	78	456	234	2,088	390	435	709	219	**4,822**
Mining and Quarrying	13	74	41	123	336	145	89	135	146	214	**1,316**
Real Estate, Renting and Business Activities	0	1	216	79	448	453	210	241	300	179	**2,127**
Transportation and Storage	0	6	21	453	679	96	230	182	223	131	**2,021**
Telecommunication	2	670	3,263	6,353	472	97	173	36	36	114	**11,216**
Total	**696**	**1,190**	**8,535**	**17,639**	**19,137**	**14,747**	**6,252**	**6,238**	**16,055**	**10,136**	**100,625**

Source: CBRT

Table 3: Sectoral Distribution of FDI Inflows, (2003 – 2012) (USD Million)

3. Conceptual Framework

This research primarily based upon economic growth of Turkey after financial liberalization. Before 1980, Turkish economy was a closed economy, using import substitution growth policy with strict regulations. After financial liberalization, transactions in the market was changed, investments and savings has increased and foreign investors could go into the market easily.

Due to the liberalization, many authors believe that it led economic growth with its yield. However, it depends on countries financial system and market drivers. The author believes that foreign direct investment (FDI) and banking sector is the primary driving input of Turkish economy. Therefore, the scheme of the dissertation is shown as below.

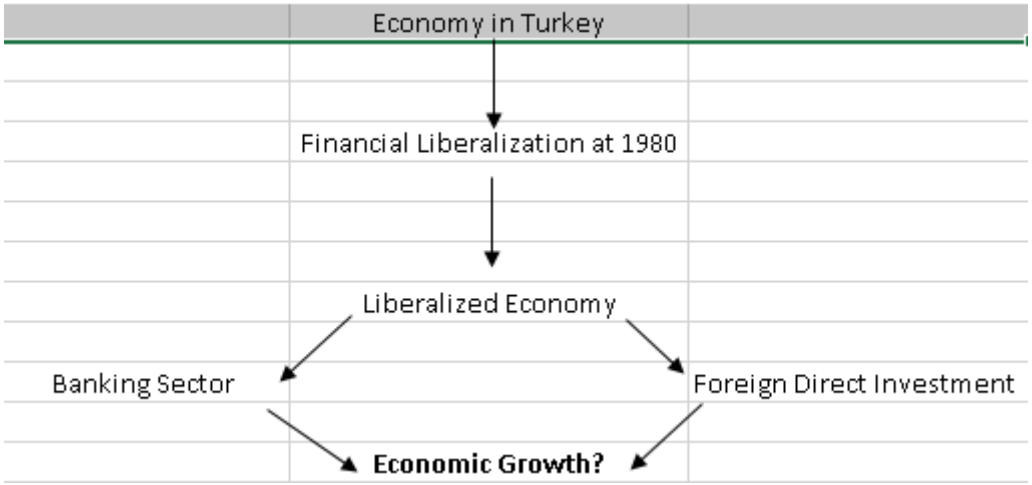


Figure 8: Conceptual Framework of the Dissertation

Banking sector has been the strongest sector in Turkey under financial institutions since the republic established at 1923. On the other hand, FDI brings not only foreign capital but also technology, employment that gives positive effect. However, markets response can be different in different countries due to various reasons made economists to argue two different hypothesis. These hypothesis discussed under four different liberalization approaches which are Neo-classical approach (McKinnon & Shaw 1973), Structural approach, New Keynesian approach and Post Keynesian approach in this dissertation.

Hypothesis 1	Liberalization fosters economic growth by freeing up market which increases savings and investments
Hypothesis 2	Liberalization led boom bust cycles due to fragile economy

4. Research Methodology and Methods

This research is a subjective research, almost all the findings based on the authors' perspective to economic growth of Turkey with methodical and rigorous research. Therefore, interpretevism describes the research philosophy(Collis & Hussey 2003) in some way. The author influenced from the research of articles and conducted interviews then interpreted from gathered data. However, positivistic approach is also connected to my topic in many ways. Being gathered data from various articles with different views, focussed on different theories and construct hypothesis to predict the phenomena (Collis & Hussey 2003). Theories are based on hypothesis in the articles and they have been discussed statistically by authors. In addition to that, the author tried support official further views by interviews with the individuals in governmental body which are Central Bank of the Republic of Turkey(CBRT-TCMB), Ministry of Economy, Banking Regulation and Supervision Agency(BDDK), Coordination Council for the Improvement of the Investment Environment(YOIKK) and Investment Support and Promotion Agency. Sometimes, interviewees gave their researches about the subject and the author used them in the research.

Qualitative research has used either to understand the government support, banking sector and FDI effect towards economic growth after financial liberalization. The author conducted case study on Turkey to judge the effect of financial liberalization which is consistent with interpretivist paradigm. As mentioned earlier, one to one interviews conducted with individuals in governmental body and also with some economists and asked the ideas about financial liberalism, banking sector and FDI. Questions was not specific, based on the conversations and dissertation process.

Two different hypothesis developed based on the articles about financial liberalization, then the effect was researched on Turkey by analysing different variables in the economy, interest rate, savings, investments, inflation rate etc. Turkey liberalized at 1980, study variables and subject lies over a long period of time. Therefore, this is a longitudinal study as being analysed and examined dynamics and processes economically more than 30 years(Collis & Hussey 2003). Secondary data is crucial, published articles from government, World Bank, IMF and OECD supported the research to study on various social and economic factors.

The case is economic growth in the research under financial liberalization, this certain phenomena explored and put it in a particular context with multiple methods. Both qualitative and quantitative data. Therefore, this is an exploratory case study in order to understand and

explain the theory of financial liberalization effect in Turkey. At first, economic history of Turkey and financial liberalization knowledge enhanced and it has written in the literature of review part. Being supported from some lecturers from Baskent University and my Supervisor Alan Lynch, the dissertation template was established. The author's previous lecturers at the University, interviewees and government's websites helped data collection for documentary analysis, interviews and observations(Collis & Hussey 2003). Then, enhanced knowledge and experienced interviewees helped case analysis, led various descriptions of events, opinions and phenomena. In addition, the author did cross-case analysis in a small part of dissertation to compare and contrast the effect of being an EU member at findings and discussions part.

Financial Liberalization effect of economy has various hypothesis based on the effects amongst different countries but the author dwell upon two of them as shown at conceptual framework part. Data collection from relevant to the hypothesis has done and used to generate an analytic frameworks. Therefore, the research is both quantitative and qualitative. As, it is based on one on one interviews and articles about the Turkish economy and the market growth, also the discussions of various authors so qualitative research was driven. Also quantitative due to statistical and econometric analysis of the articles and being explained the hypothesis with mathematical expression of quantitative relationships.

5. Findings Discussions

5.1 Banking Sector and Boom Bust Cycles

Kaminsky and Schmukler(2003) identified short and long run effects of financial liberalization in 28 countries since 1973. Three measures discussed; first one capital account liberalization(capital mobility) –reversals in emergent markets where restrictions and capital controls are at times reintroduced. Pattern of emergent economy was domestic financial sector liberalization. Turkey followed extraverted policy in banking sector in its industrialization process after 1980. Currently, there are 50 banks and 17 of them was established in the first ten years of liberalization. Two of them was private capital, one of them was public bank and 15 of them was foreign investment to the financial system. This shows that liberalization would encourage and enable investments which caused bigger and efficient capital allocation as suggested in McKinnon-Shaw hypothesis (McKinnon 1973; Shaw 1973).

Second, domestic financial liberalization where interest rates, allocation of credit and foreign currency deposits are regulated. Domestic liberalization causes financial booms and busts in the short run but have not intensified through long run. Evidence shows; larger booms and immediate crashes in developing markets after liberalization. Inadequate macroeconomic policies and weak institutional regulatory environment made recurrent crises in Turkish economy. Money broker(banker) crises at 1982, financial crisis at 1994 and crisis in Russia at 1998 effected economic growth and finally economic crises at 2001 led a breakdown in US dollar, a sharp depreciation in Turkish Lira and 5.7% reduction in GDP(Macovei & Directorate-General for Economic and Financial Affairs 2009). Below table, presents the percentage shares of national investment and national savings in GDP as dramatic fluctuation cycles of Turkish economy.

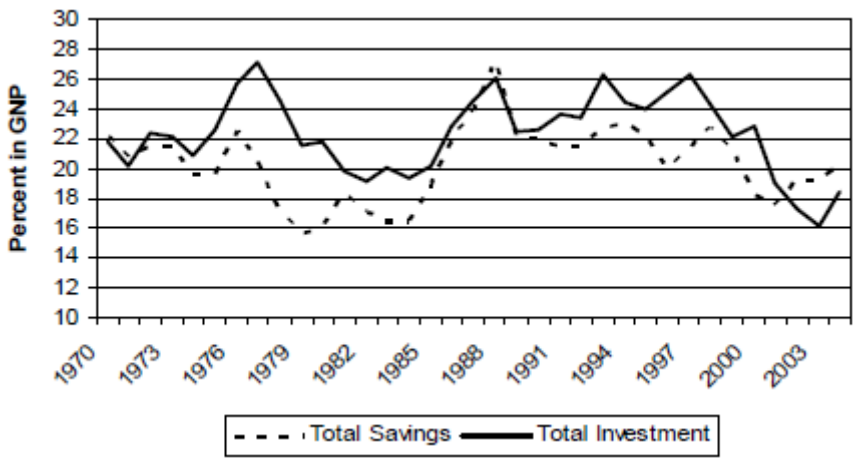
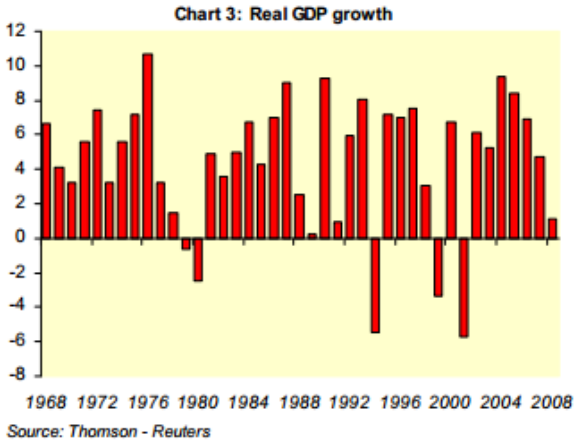


Figure 9: Patterns of Total Investment and Savings (1970 – 2003)

Unlike McKinnon(1973) and Shaw(1973) hypothesis, savings were increased until 1982 in line with the liberalization then decreased in time. This was a result of credit rationing as New Keynesian approach defended, investors tried to do savings with bankers because they gave more returns to savers where high rates increased banks cost of debt in line with liberalization and non-institutional became more efficient as discussed Structural approach of financial liberalization. However, there was a downward trend in total investment side until 1986 which was a boom year of both total investment and total savings. As discussed earlier in Section I, inflation rates had decreased gradually between 1980 and 1985 in line with financial liberalization. Extraverted policy, market determined interest rates made overvalued Turkish Lira devaluated against foreign currency which attracted investors to invest in Turkey. Finally, risk taking behaviour of the banks affected boom bust cycles. Bank gave credits easier at economic boom which decreased the quality of the credits in line with the competition of the market. Credit have used in different sectors rather than enhancing total factor productivity.

Thirdly, stock market liberalization which is an evolution of regulations by foreigners on the acquisition of domestic stock market shares and repatriation of interest, capital and dividends. The data collected from institutions and laws governing on financial system which clarified if the quality of institutions enhanced, financial cycles will become less noticed(Struthers et al. 2004). Devaluation of Turkish Lira, programs to reduce domestic demand for foreign goods, made continue of public debt burden. Below table shows the change of real GDP growth and inflation & exchange rate to give an idea about volatile and macroeconomic stability which was suffered by weak currency and high inflation.



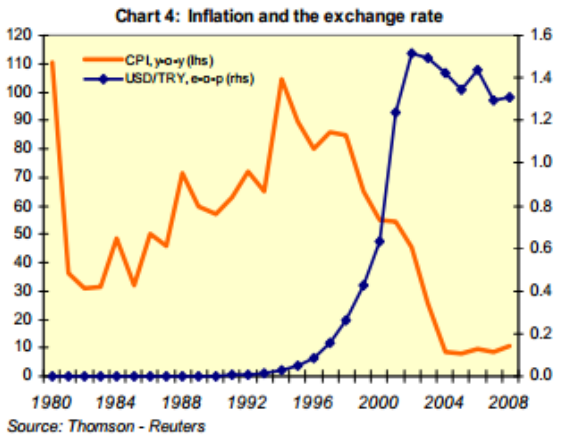


Figure 10: Real GDP Growth, Inflation and the Exchange Rate

Liberalization process were not supported by efficient macroeconomic policies and reforms which led economic crises in 1990s. High reliance on banking sector, boosted inflation due to current deficits which led public debt burden that effects negatively Turkey's economic growth. Several insolvent private banks operated under government support whereas public banks had big loss due to growing lending (Macovei & Directorate-General for Economic and Financial Affairs 2009). Demirguc-Kunt, Asli(1998) identified that banking crises are more likely occur in line with financial liberalization. In Turkey, weak institutional environment, inefficient bureaucracy, weak rule of law foster crises as liberalization process was not cautiously approached. The first result they concluded about financial fragility were macroeconomic developments with bad policies and vulnerability to balance of payments crises. As, Current deficit and debt burden had increased and Central bank reserves met with liquidity requirements. However, financial system was relied on banks. Many banks were closed due to the bank crisis at 1994, then crises at Russia and earthquake devastation at 1999 triggered liquidity problems of Turkey. Government needed to apply IMF at 1999. Also, Turkey tried to stabilize economy with new insufficient policies. However, inadequate financial sector and inefficient institutional environment led adverse effects of liberalization.

To sum up, these boom bust cycles appeared due to inefficient activities of the banks. Credit ratios of the banks has increased gradually after financial liberalization and credits taken from investors were used it in new sectors which does not affect Total Factor Productivity(TFP) which identifies economic growth with labour, capital and technology, see for example (Altug et al. 2006). Banking sector margin had increased significantly after financial liberalization. Due to liberalized markets, banks were using foreign currency arbitrage by buying bonds from

cheap euro market and used it as consumer loan. Moreover, constraints are more binding on developing economies than developed countries. Focussing on micro approach was insufficient and prevented focussing on indicators of financial strength which results severe banking crises. However, financial liberalization enabled banks to enhance its assets share in GDP and also the density of the sector had increased. Therefore, economy became more reliable on banking sector. Finally, macro-prudential approach which is a financial system wide approach of regulatory and supervisory frameworks to clarify financial deepening of the system. Turkey focussed on that approach after 2008 financial crises which made Turkish economy more durable and sustainable. This policy was discussed in the section 5.2.

5.2 Foreign Direct Investment

Harrison et. al (2004) discuss different types of foreign direct investment. Firstly, a domestic company receives equity injection from foreign company called joint venture. Secondly, subsidiary is limiting loan exposure to local subsidiary, so subsidiary need to borrow from parent to invest. After financial liberalization, foreign direct investments in emergent countries will be increased due to ease the restrictions and regulations. However, Hermes and Lensink (2000) concluded that with the contribution of financial development have supported foreign direct investments and allowed positive impact on economic growth. World Bank report(2013) compares foreign direct investment in India and China. China started liberalization in 1979 with export oriented policies while India started 1990s and trail import oriented policies. India began to catch up China as a foreign direct investment share of gross domestic product (GDP). Therefore, there is a positive correlation between foreign direct investment and economic growth (Harrison et al 2004) (World Bank 2013).

Common problem of emergent economies in economic growth is capital incapability. As McKinnon and Shaw (1973) discussed savings are the source of investment. However, current deficit, interest on debts was financed by savings from insufficient sources. Therefore, investments and economic growth were low at 1990s. FDI was very important as Ercakar & Karagol (2011) identified in four different reasons; finance power, technology yield, managing efficiency and foreign market opportunity. There are different arguments about the correlation between FDI and economic growth. However, even if it does not affect economic growth in positive way, it will give employment opportunity, technology intake, improved labour force than can enhance economy. The following table shows, FDI, economic growth and Inflation

rate of Turkey. When the other variables are stable, we can say there is no correlation between FDI, economic growth and inflation rate.

Years	FDI(Million $)	Growth(%)	Inflation(%)
1990	684	9.4	7.6
1991	907	0.3	6.6
1992	911	6.4	8.4
1993	746	8.1	8.9
1994	636	-6.1	8.5
1995	934	8	7.6
1996	914	7.1	6.6
1997	852	8.3	6.8
1998	953	3.9	6.9
1999	813	-3.4	7.6
2000	1707	6.8	6.5
2001	3288	-5.7	8.3
2002	1042	6.2	10.3
2003	1693	5.3	10.6
2004	2779	9.4	10.2
2005	10010	8.4	10.2
2006	20223	6.9	11
2007	22023	4.7	14
2008	18148	0.7	12
2009	7610	-4.7	9.8
2010	8411	9.2	9.5
2011	9038	8.5	9.8
2012	15904	2.2	9.2
2013	12387	4	9.7

Table 4: FDI inflows, Economic Growth Rate and Inflation Rate

Between 1990 and 2000, other emergent countries had passed Turkey when attracting FDI because of unforeseeable future projects, especially at 1994 and 2001 huge amount of FDI outflows and economy has been reliant on short term capital flows for growth purposes as following table shows a probable causality between two variables. As Krugman(1979) identified international capital flow reversals had occurred, China and Latin American countries FDI inflows exceeded Turkey. Moreover, government permissions against FDI was make it harder to invest.

Especially after 2002, inflation rate has decreased dramatically and economic growth was more stable, political effects were decreased by giving permission to one governmental

body BDDK. Nominal debt was decreased from 74% to 45.5% in line with increased FDI. The reason is to make economy of Turkey more strong; the reforms were more convenient after new government and FDI is higher than the countries in this area. Reform at 2003 gave right to investors no need to get permission from government or base currency amount for investors abolished that attracted investors to invest in Turkey. Moreover, Turkey's strategic location; bridge between Asia and Europe, nearly located to growing Arabic continent and large domestic market are another strength that enabled Turkey to become 17th largest economy in the world in terms of GDP at 2013 with 820,207 millions of USD(World Bank online). Finally, Turkey is increasing its business all over the world which will become as one of the biggest FDI attraction countries if macroeconomic stability continues. During the last decade, stable and predictable policies of the government have been carried out which fostered FDI inflows and between 2003 and 2012 it reached from USD 15 billion to USD 122.8 billion(Republic of Turkey Ministry of Economy 2013). FDI can give boost to economies in the world with its technology yield, know-how and liquidity. However, when we analyse unemployment rates of Turkey (appendix) especially after 2001 crisis, the rate has increased and did not turn back the previous ratio even huge investment inflows after 2003 crisis. Especially, the rate is higher for young professionals which changes between 15% and 25%. We can say that there is a lack of harmony in the correlation growth amounts. Therefore, FDI contribution to economic growth was not clear in Turkey.

Finally, European Union (EU) has opened a new chapter for Turkey. Being a membership of European Union talks has officially started at the end of 2013. EU commissioner identifies that Turkey is an important partner for the EU(Hurriyet Daily News 2013). Moreover, German Chancellor Angela Merkel, who has great effects of decisions in Europe, reacts positively towards new chapter. Being a member of European Union will enhance market size which affect positively on FDI. Also, EU membership enables to reduce travel and accommodation costs of the businessmen while they are in acquisitions in Turkey. As the expectations of being a member of EU has increased, it can enhance FDI and therefore Turkish economy. Peppercorn tariffs and quotas in customs, lifted visa requirements and double tax agreements between European Union countries make investors to invest in Turkey easier than before. Also, transaction costs, plane ticket prices, communication costs will be decreased in line with the EU membership. For instance, both Czech Republic and Hungary joined EU at 2004, and when we check FDI amounts, there was a big jump at 2005 which could

be a conclusion of the membership as you can see below tables of FDI amounts of both countries(Trading Economics Online).

Figure 11: Foreign Direct Investment of Hungary (2004 – 2014)

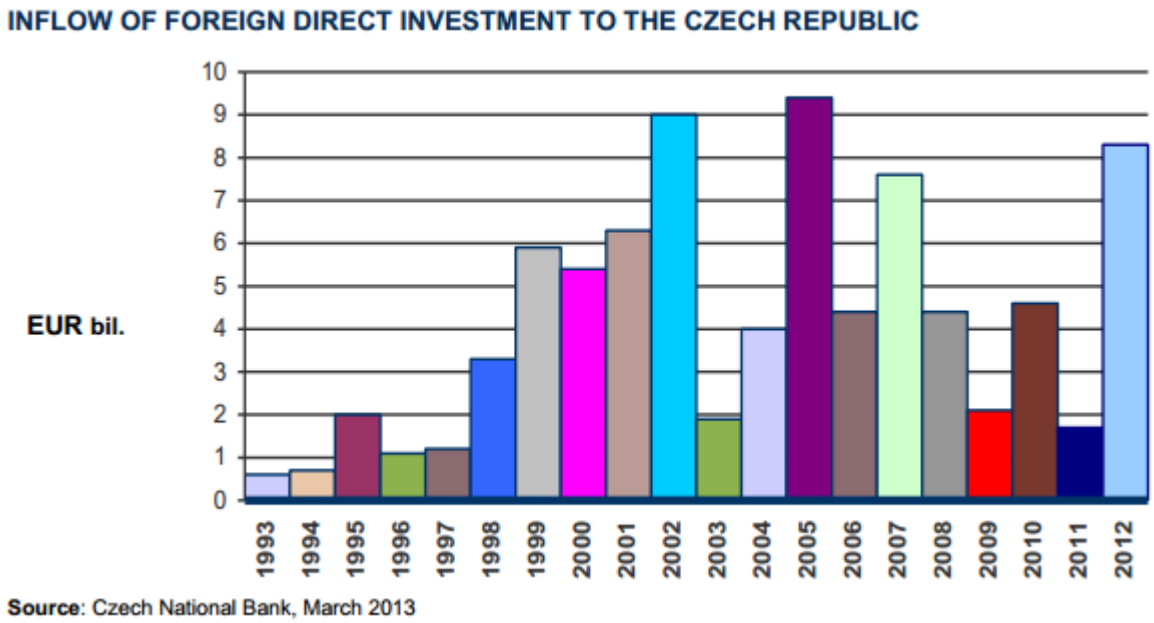


Figure 12: Foreign Direct Investment of Czech Republic

To sum up, financial liberalization fostered FDI in the first ten years. However, the amounts was lower than expected. The regulation at 2003 attracted investors because the policies were more convenient with the new government and some excessive regulations were lifted. Therefore, there was a positive correlation between financial liberalization and FDI

amount of Turkey. However, it was not at the expected degree compared with the other liberalized countries at that time when we compared FDI coverage of the GDP.

5.3 How can Turkey Manage Economic Growth

Economic liberalization proceeded good progress over removing price controls, market determined interest rates, freeing foreign trade, relaxing capital controls, growing private sector encouraging FDI which resulted a huge inflow especially after 2003. From 2002 to 2007, inflation was decreased from 45% to 8,8% and government expenditure to national income ratio was decreased from 12.7 times to 0.2 times (TUIK 2009). Export had increased more than import. Economic growth was in order from 2002 to 2007 which are 7.9%, 6%, 9.9%, 6.7%, 6.9%, 4.6% and depend more on foreign direct investment as current deficit was increased from 7.283 TL to 46.705TL (TUIK2009). It has been growing since government tried to finance debts with foreign direct investment and privatization. However, Turkey could not close the huge economic gap with the developed countries due to strict state interventionist and inward oriented economic policies. Two reasons could explain low economic growth that Turkey had just after financial liberalization which are total factor productivity and cyclical macro-prudential policies.

Altug, Filiztekin and Pamuk (2006) identified the importance of TFP (total factor productivity) growth as many other studies explained output growth based on it. Labour force participation has declined and lower growth on TFP due to substitution of agricultural products, high tax rates on labour which led a shift of resources from agricultural sector. Also, Turkey's output growth was based more on capital growth. However, growth of Turkey was lower than other emergent countries in the period between 1980 and 2005 which was 0.4% which suggested slow process of structural transformation, inability of economy to achieve a sustained increase which may link to lower FDI, lower savings amongst other developed countries(Altug et al. 2006). TFP of developed countries were around 2% whereas Turkey had very low percentage which was 0.8%. In addition to that, bank loans has been increasing over

	Capital	Labor	Total Factor Productivity
1950-1980	2.13	2.26	0.58
1980-2005	1.52	1.39	1.14
1950-2005	1.88	1.92	0.83

Source: Altug, Filiztekin and Pamuk(2006) - 2 sector model

Table 5: TFP of Turkey 1950-2005

time but TFP level was not high as expected. Below table presented that investment ratio was higher than savings ratio before 2001 crises. However, investments was not efficient because TFP was not improved because research and development was low. When we checked the numbers from 1980 to 2000, investment expenditures/total expenditures ratio was decreased from 17.24% to 5.15%. External debt interest payments/total expenditures was raised from 2.04% to 46.65%(Ardic 2004). Decrease in investments affected economic growth negatively in line with high inflation, unemployment and current deficit led up to economic crises. These ratios show that consumption had done without creating wealth in Turkey which does not affect TFP growth hence economic growth.

Table 3.1: Main Economic Indicators 1980-2003

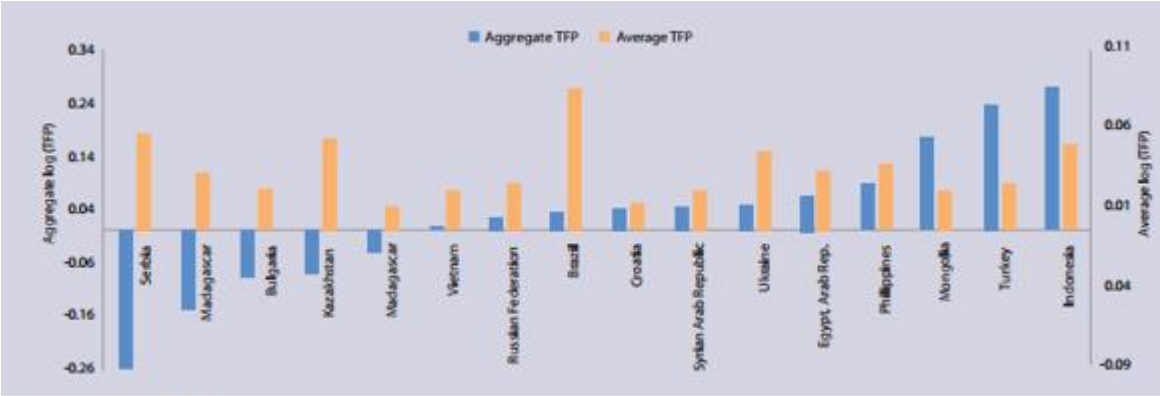
	1980	1985	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
GNP growth (%)	-2.8	4.3	9.4	0.3	6.4	8.1	-6.1	8.0	7.1	8.3	3.9	-6.1	6.3	-9.5	7.9	5.9
Savings (% of GNP)	16.0	18.9	22.0	21.4	21.6	22.7	23.1	22.1	19.9	21.3	22.7	21.2	18.2	17.5	19.2	19.3
Investment (% of GNP)	21.8	20.1	22.6	23.7	23.4	26.3	24.5	24.0	25.1	26.3	24.3	22.1	22.8	19.0	17.3	16.1
Current Acc Balance (% of GNP)	4.9	1.5	-1.7	0.2	-0.6	-3.5	2.0	-1.4	-1.3	-1.4	1.0	-0.7	-4.9	2.3	-0.8	-3.4
Stock of Foreign Debt (% of GNP)	--	37.4	32.2	33.2	34.6	37.0	49.6	43.1	43.2	43.8	46.7	55.6	59.3	78.0	72.0	60.8
PSBR (% of GNP)	8.8	3.6	7.3	10.1	10.5	10.2	6.2	5.0	8.6	7.7	9.4	15.6	11.8	16.4	12.7	9.4
Inflation (% change in WPI)	107	43.2	52.3	55.3	62.1	58.4	121	86.0	75.9	81.8	71.8	53.1	51.4	61.6	50.1	25.6
Real Interest on govern' bonds [b]	--	--	-4.0	5.3	13.9	9.9	28.6	18.1	31.1	22.1	29.5	36.8	4.5	31.8	13.0	17.0
Real Exchange Rate Index [c]	--	83.2	94.5	91.4	87.4	86.6	66.7	75.9	74.4	74.0	74.9	71.2	71.5	59.4	71.1	84.0

Source: The "Economic and Social Indicators, 1950-2004" published by the State Planning Organization (SPO) of Turkey.
Notes:
b: Average annual compounded interest rates on domestic borrowing, adjusted for the average maturity of securities issued in a year.
c: Index = 100 in January1982. The weights in the currency basket are 0.75 for US$ and 0.25 for euro. In relative price calculations, producer prices for the USA, producer prices for the Euro area and wholesale prices for Turkey are used (source: ifs, sis)

Table 6: Main Economic Indicators of Turkey 1980-2003

Savings are the most important input for economic growth to finance investments as Neo-Classical theory discussed. In order to enhance growth rate, reduce external debt Turkey tried to attract FDI. Growth usually fosters with technology and increase in TFP and FDI brought technology(usually capital intense) , increase competitiveness in the market. Therefore, improve efficiency in the market. Especially, increased FDI after 2003 affected TFP

growth of Turkey. Below figure shows estimated TFP figures of different countries. Amongst other countries, Indonesia had the highest aggregate productivity and Turkey had the second highest one(Saliola & Seker 2011) across developing world which showed that Turkey had efficient policies especially after 2001 financial crises and FDI was the driving factor of it.



Source: Enterprise Surveys.

Figure 13: Aggregate and Average Productivity of countries in 2008 – 2009

Aftermath of the global financial crisis, authorities met a challenging environment by widening current account deficits, solid short-term capital inflows and gradual credit growth which makes Central Bank of the Republic of Turkey(TCMB- CBRT) adopt a delayed "policy mix" called Macro-prudential policies(International Monetary Fund 2012). The policies enable to supervise all the financial system and regulate with strict policies to understand financial deepening of the sector and to remove financial fragility(International Monetary Fund & Monetary and Capital Markets Department 2011). Policies have constituted under one regulatory authority which is Central Bank to understand potential, systemic risks, to regulate financial institutions in order not to meet moral hazard or to reach enough liquidity, capital requirements (too big to fail)(Coskun & The Banks Association of Turkey 2012).

Table 3.3: Indicators of Financial Deepening

	1980	1985	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
DEPOSITS/GNP	14.1	24.8	21.5	24.4	24.3	21.2	28.4	28.1	36.2	37.1	38.3	51.2	44.6	28.0	48.5	42.1
TL Deposits/GNP	14.1	22.6	16.6	16.7	15.6	12.6	14.5	14.2	18.7	18.4	20.4	27.7	24.4	11.9	21.2	22.0
FX Deposits/GNP	--	2.2	5.0	7.6	8.7	8.6	13.9	13.9	17.5	18.7	17.9	23.5	20.2	16.1	27.3	20.0
SECURITIES/GNP	4.9	6.5	10.4	12.5	17.7	19.2	18.0	19.1	22.0	23.9	25.6	34.6	34.8	35.6	60.0	60.0
Public Securities/GNP	3.6	4.7	6.4	7.0	12.2	13.6	15.4	15.3	19.0	20.7	22.0	29.8	29.3	32.8	55.2	55.0
Private Securities/GNP	1.3	1.7	4.0	5.4	5.5	5.6	3.4	3.8	2.9	3.2	3.5	4.8	5.5	2.8	4.8	5.0
FINANCIAL ASSETS/GNP[a]	19.0	31.3	32.0	36.9	42.0	40.3	46.4	47.2	58.2	61.0	63.9	85.9	79.4	63.4	109	102
BANK CREDIT/GNP[b]	--	20.3	16.4	15.9	16.8	17.1	14.8	17.1	20.7	24.5	20.8	20.2	21.5	17.3	11.9	14
M2/GNP	17.4	24.2	18.0	18.5	17.3	14.1	16.2	16.0	2.0	19.2	21.3	28.1	26.0	26.2	22.6	23.2
M2Y/GNP	17.4	26.3	23.5	26.5	26.6	23.7	30.7	30.7	35.9	36.3	37.8	51.3	43.8	58.0	48.9	42.3

Source: The "Economic and Social Indicators, 1950-2004" published by the State Planning Organization (SPO) of Turkey.
Notes: All figures are expressed as percent of GNP
[a]: The sum of Deposits and Securities [b]: Bank Credit includes credit to public by depository institution.

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Table 7: Indicators of Financial Deepening in Turkey

After financial crisis, net financial assets had increased 11% of GDP between 2003 and 2007, mainly came from recapitalization and increased efficiency with competition of banks which eliminated of problematic and weak banks, merge small and medium banks, condensation of large scale banks. 26% decrease in government debts and 10% increase in households leverage ratio. Developed capital structure of banking sector, deposit based fond structure, low foreign currency risk enabled to overcome financial shocks(Coskun & The Banks Association of Turkey 2012). Zero risk public stocks, bonds and decrease in policy interest rates raised bank profits because there have been enough funds with negative or zero interest rates in the external markets thanks for the liberalized economies. At 2010, banking sector in Turkey had the highest equity, asset and net interest rates profits amongst all European Union countries. Coskun (2012) researched condensation index of the banks under structural approach of financial liberalization and identified that credits rate increase is less than asset and deposit increase of the banks especially after 2000. Banking sector is like a monopoly in Turkey in finance sector and there is a competence between banks especially after transition to

strong economy program after 1999, see for example TCMB (CBRT) working paper (http://www.tcmb.gov.tr/yeni/duyuru/eko_program/str_econ.pdf).

To sum up, CBRT continued to strengthen capital flows by relied on foreign currency purchasing until the middle of 2011. Macroprudential tools that were in the domain of the financial supervisor had been underutilized. In response to the global financial crisis, financial supervisor safeguard the domestic financial sector by curtailing dividend payouts to bolster bank retained earnings and capital in 2008 and renew it every year. At June 2009, foreign currency lending prohibited and at December 2010, real estate loans was limited which was the biggest expenditure in market. Finally, the authorities convince a target of 25% increase on banks' annual loan growth for 2011 that become binding for some banks at the mid-2011. Especially, credit growth was the biggest issue in Turkey's economic growth, consumption without wealth was the biggest problem in the banking sector. Slowing down credit growth helped Turkey more sustainable against financial crises in the future.

6. Conclusion

In this research, I examine the economic growth with the channels of banking sector and FDI. Both have various impacts to stimulate the economy. Laws and regulations has been effective since Turkish Republic establishment. Government intervention was strict in the economy. In line with the financial liberalization, government's strict regulations has been changed to market determined strategy and import substitution strategy was no longer followed. Extraverted policy term turned interest rates positive from negative. Banking sector has been dominant especially after it. Due to negative interest rates before financial liberalization, banks continued to operate with the support of the government. As mentioned in Neo-classical theory, freeing up interest rates increased savings and investments but banks were using this interest rates for foreign currency arbitrage by buying bonds from cheap euro market and used it as consumer loan. Bank credits has increased significantly in line with the liberalization which enabled increased foreign currency in the domestic market. Moreover, expenditures have done different sectors, research and development was low which did not improve TFP, therefore economic growth. In order to affect growth, research and developments have to be done excessively and investments have to done towards driving industries. On the other hand, financial liberalization enabled FDI increase in Turkey in the first ten years. Economic growth and unemployment rate was stable. However, the amount was low at 1990s due to weak policies and fragile and instable economy.

Boom bust cycles has occurred in banking sector due to fragile financial sector and instable until 2000. In order to be more stable, government has given regulation and supervision in banking sector to BDDK (Banking Regulation and Supervision Agency – BRSA) to reduce political effect and uncertainties. After this term, weak and problematic banks were eliminated from financial system. Due to inadequate recapitalization enhance GDP portion of bank and strengthen their financial position led them most important element in the sector and economic growth is positively correlated with the banking sector. Especially, loan growth has increased in line with increased FDI. Investors use the banks to invest various opportunities. FDI affect was perceived especially after 2003 in line with the new more liberalized policies and huge inflation rate decrease, FDI coverage of GDP has increased compared to 1990s. As, the perception of FDI has many positive effects towards economic growth, unemployment rate has increased even with huge FDI inflows, whereas, there was a sustained economic growth after 2003 except 2008. Therefore, I could not find a substantial data that FDI fosters economic

growth but we can say that there is a positive correlation between financial liberalization and FDI.

Especially, when we looked to economic growth rate of Turkey, there was huge fluctuations after financial liberalization annually. After liberalization, growth fluctuations shows that the potential of Turkey economy was high in earlier years. The potential of the economy was not evaluated and utilized due to poor policies and weak government controls. Economy was bound more on foreign markets after financial liberalization. Total foreign liability of banking sector has been decreasing due to improved liquidity of banking sector (see in Figure 1: Financial Strength Index and Banking Sector stability Map). However, loan rates has increased significantly in line with interest rate improvement so liquid assets of the banks has decreased. Loan – deposit ratio has improved significantly from 2009 to 2013, it shows that banks are earning as much as they could be.

To sum up, I believe that Turkey still has not catch its potential, growth is still based more on debt and external factors. For instance, the world economy grew 2.3 percent in 2012(World Bank 2013) and Turkey's growth rate was around 2.2. Banks are still using arbitrage to increase their margin and customer loans are still increasing. Generally financial liberalization affect Turkish economy positively in the long term. However, liberalization also caused boom bust cycles due to fragile financial system and weak controls. From my perspective, growth seems sustainable but it is bound on external markets because Turkey still has one of the highest interest rates in the world.

Appendix

	Economic Growth	Inflation Rate	Unemployment Rate
1969	4.3	6.5	
1970	4.4	8.1	
1971	7	16.3	
1972	9.2	12.9	
1973	4.9	16.6	
1974	3.3	18.7	
1975	6.1	20.1	
1976	9	15.3	
1977	3	28.3	
1978	1.2	49.6	
1979	-0.6	56.5	
1980	-2.4	116.6	7.2
1981	4.8	36.8	7.2
1982	3.1	27	7.6
1983	4.2	30.5	7.5
1984	7.1	48.5	7.4
1985	4.3	50.4	6.9
1986	6.8	37	7.7
1987	9.8	39.6	8.1
1988	1.5	71.7	8.7
1989	1.6	63.7	8.5
1990	9.4	62.2	7.6
1991	0.3	68.7	6.6
1992	6.4	77.1	8.4
1993	8.1	68	8.9
1994	-6.1	149.6	8.5
1995	8	88	7.6
1996	7.1	80.7	6.6
1997	8.3	88.3	6.8
1998	3.9	85.4	6.9
1999	-3.4	68.2	7.6
2000	6.8	56.3	6.5
2001	-5.7	54.3	8.3
2002	6.2	43.1	10.3
2003	5.3	18.4	10.6
2004	9.4	9.3	10.2
2005	8.4	7.7	10.2
2006	6.9	9.7	11
2007	4.7	8.4	14
2008	0.7	10.1	12
2009	-4.7	6.5	9.8
2010	9.2	6.4	9.5
2011	8.5	10.5	9.8
2012	2.2	6.2	9.2
2013	4	7.4	9.7

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