

**THE EFFECT OF FINANCIAL LIBERALIZATION ON FOREIGN DIRECT
INVESTMENT IN TURKEY IN BETWEEN 1974-2015**

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INVESTMENT IN TURKEY IN BETWEEN 1974-2015**

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FINAL APPROVAL FOR THESIS

This thesis titled “**The Effect of Financial Liberalization on FDI’in Turkey in Between 1974- 2015**” which has been prepared and submitted by **Ece GÖL** in partial fullfillment of the requirements in “**Anadolu University Directive on Graduate Education and Examination**” for the Master of Arts in **Department of Economics (English)** has been examined and approved on **08/04/2019**.

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Abstract

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The main aim of the study is to investigate the effect of financial liberalization policies on foreign direct investment (FDI) in Turkey. Three indicators which are financial globalization index, capital account openness index (Chinn-Ito index) and trade volume are used in the study to represent financial liberalization. The data are annual and cover period of 1974-2015. In empirical analysis, unit root tests, co-integration tests, VAR model, VECM model and Granger causality test are used. The econometric results prove that there is long term relationship between financial liberalization indicators and FDI in Turkey in between 1974-2015. Whereas financial globalization index and capital account index are Granger cause of FDI, there is not Granger causality between trade volume and FDI.

Key words: Financial Liberalization, Foreign Direct Investment, Turkish Economy

Öz

TÜRKİYE’DE FİNANSAL LİBERALLEŞMENİN DOĞRUDAN YABANCI YATIRIMLARA ETKİSİ: 1974-2015 DÖNEMİ

İktisat Anabilim Dalı

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Danışman: Prof. Dr. Sezgin AÇIKALIN

Bu çalışmanın temel amacı Türkiye’de uygulanan finansal liberalleşme politikalarının doğrudan yabancı yatırımlar üzerindeki etkisini belirlemektir. Çalışmada, finansal liberalleşme göstergesi olarak finansal globalleşme endeksi, sermaye hesabı açıklığı endeksi (Chinn-Ito endeksi) ve ticaret hacmi olmak üzere üç farklı değişken kullanılmıştır. Kullanılan veriler yıllık olup 1974-2015 dönemini kapsamaktadır. Çalışmanın ampirik kısmında birim kök testleri, eşbütünleşme testi, VAR modeli, VECM modeli ve Granger nedensellik testi kullanılmıştır. Ampirik sonuçlar, finansal liberalleşme göstergeleri ile doğrudan yabancı yatırımlar arasında uzun dönemli bir ilişki olduğunu kanıtlamaktadır. Diğer yandan, finansal globalleşme endeksi ile sermaye hesabı açıklığı endeksi doğrudan yabancı yatırımların Granger nedeni iken ticaret hacmi ile doğrudan yabancı yatırımlar arasında herhangi bir nedenselliğe rastlanmamıştır.

Anahtar kelimeler: Finansal liberalleşme, Doğrudan Yabancı Yatırımlar, Türkiye Ekonomisi

Statement of Compliance with Ethical Principles and Rules

I hereby truthfully declare that this thesis is an original work prepared by me; that I have behaved in accordance with the scientific ethical principles and rules throughout the stages of preparation, data collection, analysis and presentation of my work; that I have cited the sources of all the data and information that could be obtained within the scope of this study, and included these sources in the references section; and that this study has been scanned for plagiarism with “scientific plagiarism detection program” used by Anadolu University, and that “it does not have any plagiarism” whatsoever. I also declare that, if a case contrary to my declaration is detected in my work at any time, I hereby express my consent to all the ethical and legal consequences that are involved.

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CONTENTS

	<u>Page</u>
Approval of the Graduate School of Social Science	iii
Abstract	iv
Öz	v
Statement of Compliance With Ethical Principles And Rules	vi
Acknowledgements	vii
CONTENTS	viii
LIST OF TABLES	xi
LIST OF ABBREVIATIONS	xiv
INTRODUCTION	1
CHAPTER I: FINANCIAL LIBERALIZATION AND FINANCIAL.....	3
LIBERALIZATION PERIOD IN TURKEY	3
1.1. Concept of Globalization	3
1.1.1. Globalization and liberalization phase	4
1.2. Financial Liberalization.....	8
1.2.1. Definition	8
1.2.2. Financial liberalization period in developing countries.....	11
1.2.3. Financial liberalization period in Turkey	20
1.3. Capital account liberalization	33
1.3.1. Definition	33
1.3.2. Capital account liberalization in developing countries.....	35
1.3.3. Capital account liberalization period in Turkey	38
1.4. Liberalization of Trade Regime	45
1.4.1. Definition	45
1.4.2. Transformation of trade regime in developing countries	47
1.4.3. Transformation of trade regime in Turkey.....	51
CHAPTER II: CONCEPT OF FDI AND FDI HISTORY OF TURKEY.....	57

2.1. International capital flows and its components.....	57
2.1.1. Phase of investment	57
2.1.2. Phase of Foreign Capital.....	57
2.1.3. Types of Foreign Capital.....	58
2.2. FDI.....	65
2.2.1. Types of FDI.....	65
2.2.2. Theories about FDI.....	67
2.2.2.1. Neoclassical theory.....	67
2.2.2.2. Industrial organization theory.....	67
2.2.2.3. Product cycle theory	68
2.2.2.4. Internalization theory	69
2.2.2.5. OLI Paradigm	70
2.2.3. Main Indicators of FDI	71
2.2.3.1. Financial system.....	72
2.2.3.2. Political and macroeconomic condition	73
2.2.3.3. Market Condition	74
2.2.3.4. Protection of intellectual property rights	74
2.2.3.5. Trade policies	75
2.2.3.6. Privatization	75
2.2.3.7. Taxes and subsidies.....	76
2.2.4. Main impacts of FDI	77
2.2.4.1. Some positive impacts of FDI	78
2.2.4.2. Some negative impacts of FDI	80
2.3. History of FDI in the World and Turkey.....	82
2.3.1. FDI experience in the Developing Countries	82
2.3.2. FDI history of Turkey	90
2.3.2.1. FDI policies in Turkey	90
2.3.2.2. FDI experience in Turkey	92
2.3.2.3. Works to increase FDI in Turkey.....	99
 CHAPTER III: THE EFFECT OF FINANCIAL LIBERALIZATION ON FOREIGN DIRECT INVESTMENT IN TURKEY IN BETWEEN 1974-2015: AN EMPRICAL ANALYSIS	 102

3.1. Literature review.....	102
3.2. Data and Methodology.....	112
3.2.1. Data.....	112
3.2. 2. Methodology.....	113
3.2.2.1. Unit root tests	113
3.2.2.2. Co-integration Test	116
3.2.2.3. Vector Auto-correlation (VAR).....	117
3.2.2.4. Vector Error Correction Model (VECM)	118
3.2.2.5. Granger Causality.....	118
3.3. Empirical Results	119
4. CONCLUSION.....	131
REFERENCES	138

LIST OF TABLES

	<u>Page</u>
Table 1.1 Financial liberalization condition of some selected countries.....	15
Table 1.2 Number of banks in Turkey between 1980-1990.....	25
Table 1.3 Some macroeconomic indicators of pre-post liberalization period	27
Table 1.4 Aggregate net resource flows and net transfers in middle income countries.....	36
Table 1.5 Indicators of financial deepening in Turkey between 1982-1990	41
Table 1.6 World trade in between 2000-2014(\$ million)	50
Table 1.7 Foreign trade values in Turkey between 1980-2017	55
Table 2.1 Net external financing as a share of GNP (%)	93
Table 2.2 FDI components in Turkey Between 1996-2017(billion dollar).....	98
Table 2.3 Sectoral distribution of FDI in Turkey between 2013-2017(million dollar)	99
Table 2.4 Turkey's SWOT analyses.....	100
Table 3.1 Descriptive statistics of variables.....	120
Table 3.2 Covariance and correlation analyses of the variables	120
Table 3.3 Results of Zivot-Andrews Test.....	122
Table 3.4 Results of ADF test.....	123
Table.3.5 Results of PP test.....	123
Table 3.6 Test results for detection of optimum lag length.....	124
Table 3.7 Trace test results for Johansen co-integration test	124
Table 3.8 Maximum Eigenvalue test results for Johansen co-integration test	125
Table 3.9 Results of variance decomposition of FDI	126
Table 3.10 Results of variance decomposition of FGLOB	126
Table 3.11 Results of variance decomposition of KAOPEN	127

Table 3.12 Results of variance decomposition of TVOL.....	127
Table 3.13 Results of estimation of VECM model with OLS	129
Table 3.14 Results of Wald test	129
Table 3.15 VEC Granger Causality/ Block Exogeneity Wald Tests	130
Table 3.16 Short run and long run analysis based on Granger causality test and VECM	130

LIST OF FIGURES

	<u>Page</u>
Figure 1.1. Usage of derivatives between 2000-2016 in the world.....	19
Figure 1.2 Portfolio investment between 1986-2019 (net liability acquisition million\$).....	42
Figure 1.3 Total capital flows to Turkey between 1984-2016 (million \$)	44
Figure 1.4 Import, export and trade volume values in Turkey between 1970-2017	56
Figure 2.1 Types of FDI.....	65
Figure 2.2. Response of domestic firms to foreign entrance	81
Figure 2.3 FDI inflows in developing countries, 1980-2003	87
Figure 2.4 FDI inflows, global and by group of economies, 2005-2016 and projections, 2017-2018(billion of dollar and per cent).....	88
Figure 2.5 Estimated global inward FDI stock by sector 2001, 2007 and 2015(Trillion of dollar)	89
Figure 2.6 Amount of FDI in Turkey between 1980-2000, US\$ billion	95
Figure 2.7 FDI inflow to Turkey (Billion of dollar)	97
Figure 3.1 Time series graph of FDI	120
Figure 3.2 Time series graph of FGLOB	121
Figure 3.3 Time series graph of KAOPEN	121
Figure 3.4 Time series graph of TVOL	121
Figure 3.5 Zivot Andrews Breakpoint test	122
Figure 3.6 Inverse Roots of AR Characteristic Polynomial.....	126

LIST OF ABBREVIATIONS

ADF	: Augmented Dickey Fuller
AIC	: Akaike Information Criteria
AREAR	: Annual Report on Exchange Arrangements and Exchange Restrictions
BIS	: Bank for International Settlements
BIST	: Stock Market İstanbul
HQ	: Hannan-Quinn Information Criteria
DW	: Durbin Watson
FGLOB	: Financial Globalization
FDI	: Foreign Direct Investment
FPI	: Foreign Portfolio Investment
GATT	: General Agreement of Trade and Tariff
GDP	: Gross Domestic Product
GNP	: Gross National Product
IFC	: International Finance Corporation
IMF	: International Money Fund
IPRs	: Intellectual property rights
İMKB	: İstanbul Stock Exchange
KAOPEN	: Capital Account Openness
MNC	: Multinational Companies
M&A	: Mergers and Acquisition
OECD	: Organization for Economic Co-operation and Development
OLS	: Ordinary Least Square
OPEC	: Organization of Petroleum Exporting Countries
PP	: Philips Perron
RTME	: Republic of Turkey Ministry of Economy
TL	: Turkish Lira

TMSF	: Saving Deposit Insurance Fund
TRIPS	: Trade-Related Aspects of Intellectual Property Rights
TVOL	: Trade Volume
UNCTAD	: United Nations Conference on Trade and Development
USA	: United States of America
WEF	: World Economic Forum
VECM	: Vector Error Correction model
VAR	: Vector Autoregressive
YASED	: International Investors Association of Turkey
YOIKK	: Coordination Board for Improving Investment Environment

INTRODUCTION

One of the important problems of developing countries is capital accumulation. The main reason of inadequacy of capital accumulation is less saving rates. Less saving leads less investment rates. These countries need saving of other countries to increase capital accumulation. It means that developing countries try to attract more capital flows as portfolio investments or direct investments. FDI is more attractive because a lot of advantages come with FDI to host country like technology spill over, managerial skills, and know-how. Also, FDI could impact domestic investors efficiently and increase investment and employment rate, impact balance of payment and financial system positively so development and growth of host country is supported.

To attract FDI, some conditions should be provided. Condition of financial system is one of the significant factors for foreign investors. After the oil crisis in 1970s and the collapse of Bretton Woods, Keynesian policies left and liberalization trend started in the world. Developed countries completed liberalization financially in 1970s whereas developing countries started to apply more liberalize policies to deregulate financial system in the beginning of 1980s. For more liberalize financial system, they released interest rates and capital movements, removed all controls on entrance to financial system, paved the way of privatization, made changes about reserve requirements and credits and established supervision mechanism. The financial liberalization period was supported by liberalization of trade regime. GATT and the WTO have encouraged developing countries to liberalize their trade regime. After the regulations, developing countries attracted the attention of foreign investors so capital flows to developing countries have increased.

In this process, Turkey also took important steps towards liberalization. In the 1980, 24 January Decisions is first move to liberalize financial system. The liberalization process started by to release the interest rates. Also, import substitution was abandoned and export oriented policies have applied since 1980. Other policies followed this. However, the most significant step is taken in 1989 by Decision No 32. With this decision, foreign exchange regime got liberalized. The law entered into force in 2003 is also sensitive for foreign investors. With this law, the differences between the rights of foreign investor and domestic investor were eliminated.

In the study, the relationship between financial liberalization and FDI is studied between 1974 and 2015. To represent financial liberalization three different variables are used. First represents the financial globalization level, second represents capital account openness and third one show the trade volume of Turkey. The econometrical results show that there is positive and statistical causality from financial liberalization proxies to FDI.

The study consists of four stages. In the first chapter, financial liberalization is defined and financial liberalization process in Turkey is discussed. In the second chapter, FDI and component of FDI is examined and FDI history of Turkey is reviewed. In the third chapter, firstly, related literature review has taken place and data and methodology are defined. Secondly, the relationship between financial liberalization and FDI is analyzed by econometric methods and results are interpreted. In the fourth chapter, conclusion is presented.

CHAPTER I: FINANCIAL LIBERALIZATION AND FINANCIAL LIBERALIZATION PERIOD IN TURKEY

1.1. Concept of Globalization

Globalization is an important dimension of capitalism and has been enhanced after 1970 with development of telecommunication and technological sectors. Since 1980s, the world has entered the new period. There are two indicators of this period. First is entering the 2000s. Second is end of cold war, hence, leadership of United States of America (USA) in the world. This period is called as ‘new world order’, ‘knowledge era’ or ‘globalization’. The most used one is globalization term. Globalization is economical phenomenon but it has political and socio-cultural dimensions. It can be defined as separation of international trade, increase in mobility of capital and labor, the end of ideological polarization between countries and convergence of countries in terms of economic, politics and socio-cultural. Economic globalization means integration of countries’ economies with world economy by increase in mobility of good, capital and labor. By this way, economic relations between countries intensify and the economies become closer to each other (Afşar and Afşar, 2010, p.46-47). It can be said that globalization takes place in two stages. The first globalization period is result of application of steam engine to transportation and application of electricity to industry. Second period has begun after the last quarter of the twentieth century with application of development in telecommunication and communication technologies to production, trade and financial sectors (Yumuşak et al., 2009, p.64).

In literature, the researchers approach to globalization in a different way. Some of them think that globalization is beneficial process for the world and nations, but some consider globalization is a danger for nation state. According to the advocates of globalization, globalization determines a new form of society. In this society, market is in front of concepts such as politics and nation state. According to antagonists of globalization, the world is not going to be a single and a centre civilization, but on the contrary it is going towards a rapid polarization. The researchers approaching globalization moderately argue that globalization is an irreversible process. According to them, nation state doesn’t lose its importance as advocates of globalization say and nation state doesn’t continue to be important. On the other hand, people who approach

globalization moderately suggest that nation state changes significantly but continues to fulfill its basic tasks (Özel, 2012, p.22).

1.1.1. Globalization and liberalization phase

With globalization, not only the geographical, business culture and business environment differences, but also the dependence between the trading countries and the hard line in the differences in the economic structures get also considerably flexible. One of the countless examples of this flexibility is the process of financial liberalization. One of the main objectives in this process is to open up a closed economy to the world and to bring new trading partners to the big open economies (Mangır, 2006, p.462). The increasing globalization trend exposed the liberalization process. Liberalization means that restriction of the existing some or all controls on some markets like foreign exchange market, financial system, labor market or agricultural product markets (Yılmaz and Tuncay, 2012, p.346). Dağdelen (2004) defined liberalization which is a process of restrictions of all controls on political and supervisory mechanism, trade markets and financial system. Internationalization of these is last part of the liberalization process.

Especially since the 1980s, as information technology has become more prevalent and communication and transportation costs have declined. This has shown its first impact on the context of globalization in financial markets. Accordingly, the first of the changes taking place in the world economy is the increasing globalization of the markets and accordingly the rapid concentration of the competition. In the process of financial liberalization, different factors, usually interacting with each other, have played a role. These factors can be sorted as developments in reel sector and world trade, financial innovations, technological developments, financial liberalization, securitization and external-cyclical reasons (Yumusak et al., 2009, p.70-71).

In 80s and in the beginning 90s, the globalization trend marked economic policies all over the world. Almost all government took steps to increase the share of private sector in the economic activities. In some planned countries, this situation created significant change in the regime. In other countries like in the Latin America, the philosophy and thoughts about to increase economic development transformed seriously. The countries in Europe, the governments regulated the role of the state in the economy. Some conditions in this term support the countries to start liberalization

period. Liberalization requires from the government to abandon production of good. Also, institutions and legal framework is required for the functioning the market freely. Role of the state in the production of goods and services was reduced and renewed in some countries depended on private sector. These conditions caused to increase the rate of public enterprises in market economies and transition economies. The controls on private enterprises in market economies decreased significantly. As a result, it was indicated very good economic policies to ensure that prices are a real reflection of relative scarcity and to release private sector. The all cases changed the role of private enterprises to organize the all economic activities by globalization phase (United Nations Conference on Trade and Development [UNCTAD], 1996, p. 9).

Developing countries had to take important, liberal steps before coming across with all the effects of globalization. They had to open their economies to reduce barriers to trade and capital flows by abandoning the import substitution industrialization model. If the policy shifts didn't exist, globalization would be much less in developing world. It can be said that, liberalization is other side of globalization (Stalling, 2011, p.12). The liberalization policies had different form in the world. For instance, in eastern and south eastern Asian countries, liberalization policies were planned and gradual. The states had prevention when opening the markets to world competition and reduced support to private sector gradually to gain necessary competition power in international area. In other Asian countries, liberalization process was more rapid. While African countries were more doubtful about liberalization, Latin American countries progressed faster. However, the liberalization progress was a reaction for low growth rate and some economic crisis (UNCTAD, 1996, p.10). The liberalization of trade and foreign investments was on the agenda of developing countries after financial liberalization and deregulation policies. In developed countries, free capital flows had seen as very important economic policy since 1970s. Because of that, financial deregulation was accelerated in 1970s. Although financial system wasn't liberalized in those times in developing countries, they adapted this policy quickly. Investment from foreigners to the country was released. Moreover, many developing countries regulated their capital account to support outward investment and residents released to hold foreign currency in their bank accounts (UNCTAD, 1996, p.10). Turkey as one of the developing countries tried to adapt to the liberalization and globalization trend after 1980. The most significant step was January 24 Decisions that were taken to open Turkish economy to

international area. Following the decisions, import substitution policies were abandoned and export-oriented strategy was adapted. The state gradually pulled his hand over private sector. The controls on interest rates released and foreigners were allowed to enter the financial system. In 1989 with Decision No.32, Turkish Lira (TL) became convertible and capital controls were left. This was the turning point for the Turkish economy to complete liberalization and globalization process so 90s were considered more liberal period for Turkish economy. Amount of capital flows and financial transactions increased. Although some external or internal problems disrupted to perform these policies, Turkish economy was liberalized in this term.

In the world, the mentioned process caused some disappointment. As the reason of this, it was shown that policies were not implemented in the appropriate order. Functioning of liberalization process should be followed each other in adaptation period: trade liberalization, financial liberalization and political and supervisory liberalization. Trade liberalization is elimination of all restriction on trade of goods and services and supporting international trade. Financial liberalization goals are elimination the state intervention on banking sector primarily and integration of domestic market with international financial market secondly. Political and supervisory liberalization is a policy that aims to develop the administration policies of central government in favor of private sector and nongovernmental organizations by deregulation, privatization, governance and localization models. It should not be forgotten that these three types of liberalization are related with globalization phenomenon. Liberalization is produced by one of the globalization dynamics. The economic dimension of the new wave of globalization sees the profitability of the capital as the only success indicator and characterizes any social, administrative or cultural constraint in front of the economic profit as irrational (Dağdelen, 2004, p.6-7).

The first step of liberalization is trade liberalization. Countries can control amount of export and import with applying quota and tariffs. Trade liberalization means that elimination of all these controls and accepting free trade. Actually, the origin of free trade comes from mercantilism that accepts merchants as most useful people. Since that time, many views on free trade have been raised. Some views (like David Hume, Adam Smith and David Ricardo) say that free trade is beneficial for all participations of trade. According to them, free trade is always good. On the other hand, some views

(like Karl Marx) say that free trade is imperialism tool of developed countries to establish dominance over undeveloped countries. Before great depression, free trade had importance after the countries foregrounded it to fix external balance. In this period, countries restricted importation by quotas and tariffs so their foreign trade deficits and current account deficits decreased. Other countries reacted this to decrease importation. Therefore, trade volume of the world narrowed. In order to avoid this situation, International Money Fund (IMF) and World Bank which are Bretton Wood twins were established and facilitated in 1947. The main aim of these institutions was to increase trade but import substitution was one of the major policies to avoid balance of payments problem. After the collapse of Bretton Woods system, import substitution was abandoned and trade liberalization was accepted to fix external balance problem (Dağdelen, 2004, p.14-17).

Second phase is financial liberalization that is narrowly defined as the gradual and sequential release of administrative and technical pressures existing in the financial markets of countries within the international economic discipline and the abandonment of financial pressures. The financial liberalization approach, which is the ultimate goal of financial integration, is the inverse of the financial regulation and is used in the literature with the concept of financial deregulation. One of the main objective of financial liberalization is to achieve investment and savings imbalances, to finance high public deficits from the outside, and to close high debt rates by attracting cheap capital from outside in developing countries (Mangır, 2006, p.460-461). Stallings (2001) developed four aspects about the effects of financial globalization for the countries. First, the globalization increases the capital flows to developing countries that depends on their own resources to increase economic growth. By this way, the economic growth is accelerated. However, all kind of financial flows doesn't support economic growth. For instance portfolio investments and other hot money flows have some risks. These flows could create volatility which is very dangerous for economic growth. Second, capital flows can be unequally distributed across countries and regions. Because of that, the growth patterns vary. Also, distinction is made between the winner and loser because foreign investment distributed in geographic regions, sectors, companies and social groups unequally. Third, it is easy for the state to reveal the benefits of capital by minimizing the costs. The sources of most problems is local not global and countries

tend to follow heterodox policies. Fourth, policy changes in global, regional and national areas can support the condition of the world (Stallings, 2011, p.5).

The last phase of liberalization is political and administrative liberalization. Politics and governance mechanisms are first extracted from the control of nation state and then internationalized. Political and administrative liberalization phenomenon means a radical change that includes concepts of decentralization, deregulation, privatization, and governance (Dağdelen, 2004, p.27).

As a result, it can be said that liberalization had created globalization. The four aspects of globalization that are developed by Stalling (2011) encouraged the countries to liberalize. One was that liberalization was the pre condition of membership of General Agreement of Trade and Tariff (GATT) / World Trade Organization (WTO). Also, it is necessary to get loan from IMF or World Bank. It was important to meet demands of local people about import and travel to other countries in the developing world. Finally, leaders of developing countries and international financial institutions and private sector owners agreed. When the Cold War ended, the influence of alternative ideologies diminished and democratic elections brought back leaders, who support such policies (Stallings, 2011, p. 12).

Approach to the liberalization and applications of the liberalization process of politicians who give directions to political and social life is so decisive. Liberalization demand is very low in non-democratic countries. Countries have high democracy level follow foreign expansion policies and central authority adopts deregulation applications. For example, countries taken financial support from IMF follow more liberalist policies because applications of IMF programs force to countries to liberalize their financial system (Döm, 2007, p.96).

1.2. Financial Liberalization

1.2.1. Definition

'Financial Liberalization Theory' is a version of the Neoclassical Theory of Finance that adapts to the developing countries, taking the theoretical basis from the work of McKinnon (1973) and Shaw (1973) from Stanford School's well-known economists. The basic proposal of the theory of financial liberalization, which assumes that the savings will regulate the world scale distribution and equalize the interest rates

between countries, provide the maintenance of financial pressure and the provision of financial deepening, enable efficient resource allocation and accelerate economic development (Williamson and Mahar, 2002, p.8). McKinnon (1973) and Shaw (1973) indicate that financial system is very repressive and it must be free. In their work, six indicators are explained. First is government having control on credit. If credits are determined by market condition, savings could transform investment properly. Second, governments intervene interest rates. This causes problems about capital accumulation. Third, entrance to financial system is under government control and this situation is unfavorable for market condition. Fourth, government responses banking sector directly. For instance, they can decide who will work and how much salary will be paid. Fifth and the worst in the sense of interference to free market, state has financial institution. Last, state decides who will take the debt from abroad and who will lend it. Even if six different dimensions are considered, they accuse the government (Açıklan, 2015, p.47).

McKinnon and Shaw characterize a financially stressed system in which the state determines by whom, at what price, and who can get credit. A state may enforce controls or enforce existing controls by regulating which financial institutions are allowed to perform transactions, holding banks' ownership and controlling international capital flows. On the contrary, liberalization is defined as the process of giving to the market the authority to determine who will be given the lending and who will receive the loan. The price is also determined by market conditions. In addition to this, full liberalization requires that the government allows the companies with certain criteria set by the government to financial sector, gives authorities banking sector to do their own transactions, withdraws from ownership of financing institutions and gives up controls over international capital movements (Williamson and Mahar, 2002, p.15).

In this direction, from the beginning of 1980s to 1990s, developed and developing countries make some reforms to liberalize their financial system. The most important ones are to remove the interest rate ceilings, to decrease or abolish reserve requirements, to open the banking sector to foreigners and residents and liberalize the capital flows with the aim to accelerate economic growth. This happens in two ways. First, saving rates increases because of removing the controls on interest rates and people start to hold their income as financial assets. Increase of financial asset stock

causes to decrease liquidity need and to ease finding necessary funds for investments. Even if increase in interest rate effect negatively investment demand of entrepreneurs, economic growth rises because of increase in loanable funds. However, interest rate on deposit should not be greater than marginal productivity of capital. In such a case, entrepreneurs prefer to interest income rather than investment. Second, to find fund for domestic and foreign credits become easy after financial liberalization process. Even if banking sector transforms only some portion of investable funds to investment, it has a big role in channeling of savings to investments. If financial intermediaries finance investments with high return, banking sector is developed and competitiveness increases. Accordingly, intermediate facilities become more efficient and finance more investments with high return. As a result, average efficiency of investments increases so economic growth is accelerated (Güloğlu and Altunoğlu, 2002, p.3).

According to financial liberalization hypothesis, the main problem is inadequacy of savings not investments. If the problem is low investments, the policies should be created to attract investments. The interest rate that is positive in real sense or positively determined by market forces will cause the idle funds in the economy to shift to the organized financial system. This means that generation of the funds required for investments (Ağır, 2010, p.16). Because of that, the McKinnon-Shaw approach to financial liberalization take attention to saving rate mainly. Financial liberalization increases saving rates and, thereby, investments. However, endogenous financial development and growth theories mentions financial intermediates increases efficiency of investments, not amount of investments. If economy is well developed, the demand of financial intermediates will go up. This causes a rivalry between financial institutions. In addition to this, if financial institutions provide seasonable and precious knowledge to investors, investments get more efficient. Thus, capital formation and economic growth goes up (Ang, 2008, p.542). For this happening, all constraints and limitations should be removed in general economy and financial sector intervention should be minimized. The interest rate policy artificially determined less than inflation outside of market forces causes negative real interest rates; savings are utilized in inefficient ways like real estate, gold or foreign exchange. Higher nominal interest rate than inflation can attract the inert funds to the financial system and the funds to

financial investments can be obtained. As a result, economic growth will be affected from this situation positively (Ağır, 2010, p.1).

Both authors, McKinnon and Shaw, offer that if financial system is not liberalized, self-investment phenomenon is emerged so low productive investments occur. Saving can be transferred to efficient investments in only financially liberalized economies. Savings move to high yielded investment from low yielded investment. Also credit allocation is determined by interest rate in financial sector and became more efficient (Balasa, 1990, p.58). They suggest that demand and supply of saving will be equal thanks to high interest rate after financial liberalization. In addition, savings and financial intermediaries rise besides savings are utilized more efficiently (Balasa, 1990, p.67).

McKinnon and Shaw hypothesis suggests that interest rate ceiling might destroy the structure of economy in varied ways. Firstly, entrepreneurs may be discouraged to invest in risky projects or projects with high return. Moreover, financial intermediaries avoid risk so only some significant depositors can get loan. Last, investments in only capital-intensive projects are preferred by investors who get comparatively cheaper fund. According to McKinnon and Shaw hypothesis, removing the interest rate control and to let interest rate be determined in market condition is good for economy (Ang and McKibbin, 2007, p.219). The hypothesis is against Keynesian and Neoclassic perspectives about interest rate. They suggest economic growth can be accelerated by increasing savings and investments because of financial liberalization. Financial liberalization models are based on loanable fund theories fundamentally. Policy proposal of McKinnon and Shaw model is similar with neoclassical perspective, but there is difference in terms of the relationship between money and capital accumulation. Financial liberalization hypothesis suggests that money and capital accumulation are complementary (Ağır, 2010, p.16).

1.2.2. Financial liberalization period in developing countries

Integration of financial system is the very important dimension of globalization concept that has been very popular. The integration process has begun with portfolio diversification and risk reduction effort of investors since 1980. To do this, investors include foreign stock, bond and bills. The investors borrowed from commercial bank and got fund through credit in 1970s, but they realized it is not very efficient way. This

situation accelerated integration process. Also, resources borrowed from euro-dollar market were limited for all economy and in the crises period, resources demanded pay back. The all cases enforced the economies to liberalize their financial system. They started to establish their stock market and to abandon all restrictions that pretend international economic interaction (Ünal and Açıklın, 2013, p.26). Thus, it can be said that financial liberalization is not only an element of globalization but also an accelerated factor of globalization (Özel, 2012, p.1).

1970s were very hard times for world economy. Gold and dollar based fixed exchange rate regime of Bretton Woods deteriorated because of Vietnam War and Keynesian economic view didn't work for high inflation and recession rate after increase in oil prices. Thatcher from England and Reagan from USA supported that to abandon the Keynesian policies and to give more importance to market mechanism in national and international economics policies to avoid the inflation and recession. To decrease public expenditures, to eliminate welfare state policies, to privatize of state-owned enterprises and easing public control over various sectors were main subject of this view. By this way, both state intervention in macroeconomic policies and state control in individual markets reduced. The reflection of neoliberal economic policies on the international scene, the mitigation of barriers to trade and, more importantly, the reduction of control over international capital movement was provided. However, when Bretton Woods was drafted after the Second World War, it was decided to introduce various restrictions on international capital movements in order to stabilize the world economy. Thus, after the abandonment of dollar based fixed exchange rate regime in 1971, another fundamental element of the Bretton Woods was abandoned (Pamuk, 2015, p.263-264).

The world economy and financial system experienced a rapid transformation in the last quarter of the twentieth century and beginning of twenty first century. The collapse of Bretton Woods system in beginning of the 1970s and globalization of financial markets by abandoning of fixed exchange rate policies encouraged the world markets to integrate so competition in financial markets increased. With significant development of computers and telecommunication technologies, prices and information has become more transparent and capital costs have decreased significantly. Further, capital flows liberalization has followed foreign trade liberalization and free circulation

of capital has been provided by removing restrictions on international capital flows (Yılmaz and Tuncay, 2012, p.346).

The main development in financial liberalization occurred in the mid-1980s and early 1990s. In this period, financial liberalization had spread throughout the world, including Japan and Korea, the most closed countries. International financial institutions (like IMF and World Bank) emphasized liberalization in the financial and real sense in those times so this process was accelerated (Williamson and Mahar, 2002, p.11). Financial liberalization process is faster in Latin American countries. For instance, Chile first removed all controls on interest rates in the late 1970s, privatized national bank, and allowed local banks to gain international qualifications. Foreign banks and non-financial institutions were encouraged to enter the market and capital controls were loosened. In Argentina, directed credits and interest rates were eliminated in the 1970s and capital flows were liberalized. However, both Chile and Argentina put restrictions on capital flows because of crisis in the beginning of 1980s and Chile re-nationalized many banks. Mexico and Peru were two other Latin American countries that were rapidly liberalizing (Williamson and Mahar, 2002, p.32). Argentina, Chile and Uruguay were affected negatively from these implementations because of wrong policies applied. The crises in these countries show that financial liberalization would not provide the expected results unless protective and regulatory legislation are created (Williamson and Mahar, 2002, p.11).

Reforms were more gradual in Eastern Asia. Many countries lifted directed credit policy. For instance, targeted credit programs were narrowed in Indonesia, Malaysia and South Korea in 1980s and 1990s. At the end of the 1970s, Sri Lanka abandoned directed credit programs and started deregulation process in the region by loosening controls on interest rates. Other eastern Asian countries didn't start this process. Israel was another country that applied liberalization policies rapidly. After 1987, the Israel government began to reduce the legal reserve rates, enacted new instruments, loosened access restrictions for smaller banking operations and liberalized international capital flows (Williamson and Mahar, 2002, p.46).

Philippines' financial liberalization experience was same with Latin American countries. On the other hand, financial liberalization process was totally different in South Korea and Malaysia. They faced with some hard conditions, but it could be said

that the process was successful in those countries. Negative financial conditions existed in South Korea, but the country was flexible in the face of problems and adapted to the basic elements of the reform process. When high interest rates put into trouble the real sector following financial reform period, the Central Bank decreased nominal interest rates to the contrary inflationary expectations. In addition, there were tight controls on capital flows so extreme fluctuations that created by capital inflow or outflow were pretended. It's true that South Korea's approach to financial liberalization was cautious and gradual. Precautions were taken against changing macroeconomic indicators. Also, selective credit policy sustained so negative effect of high interest rates on investments decreased. When financial crises occurred in South Korea, the credit distribution process was badly affected, and non-repayable loans reached high dimensions. The crisis was over thanks to the sustained de facto control mechanism on the banking sector. Banks got rid of non-repayable loan burden because of low interest credit of the Central Bank (Eser, 1993, p.92-93).

Malaysia also solved its financial problem easier. The financial liberalization process was narrow in Malaysia. Only interest rates applied to deposits collected by banks were released. On the other hand, capital movements were liberalized but extreme capital inflow or outflow didn't happen because of stability of foreign exchange. Non-repayable loans problems were solved by effective control mechanism on banking sector. The most important factor that decreased negative effect of high interest rates on investment was selective credit policy. Malaysia recovered the economy despite the adverse effects of external shocks because the policy makers approach financial liberalization cautiously and gradually. Before financial liberalization process, Malaysia arranged the economy for competitive conditions unlike Latin American countries (Eser, 1993, p.93).

Table 1.1 shows that financial liberalization conditions of some selected countries between 1973 and 1996. Developed countries like USA, Canada, Japan, England, Germany or Hong Kong, had already liberated their financial system in 1973 while underdeveloped and developing countries had still repressed financial system. Developing counties, like, Argentina, Chile, South Korea or Turkey started liberalization process in the beginning of 1980.

Table 1.1 Financial liberalization condition of some selected countries (Williamson and Mahar, 2002, p.21-22)

		Credit Controls	Interest Rates	Entrance to the Market	Prudential Regulations	Privatization	International Capital Flows
USA	1973 1996	B:L L	LL L	PR LL	L L	L L	LL L
Canada	1973 1996	L L	L L	PR LL	L L	L L	L L
Japan	1973 1996	R LL	PR L	R D:LL;FB:PR	R LL	LL LL	R L
England	1973 1996	LL L	B:LL L	B:LL L	L L	L L	PR L
France	1973 1996	PR LL	R LL	D:PR D:LL	- -	PR LL	R L
Germany	1973 1996	LL L	L L	L L	- -	LL LL	L L
Italy	1973 1996	R L	LL L	PR L	- -	R PR	PR L
Hong Kong	1973 1996	L L	LL L	B:R;NBFI:L L	L L	L L	L L
Korea	1973 1996	R LL	R LL	R B:PR;NBFI:LL	R PR	R LL	R PR
Malaysia	1973 1996	R LL	R L	R B:PR;NBFI:LL	LL LL	LL LL	LL LL
Philippines	1973 1996	R PR	R LL	R LL	PR PR	PR LL	PR LL
Thailand	1973 1996	R LL	R L	R LL	- -	PR LL	R LL
Argentina	1973 1996	R LL	R LL	R L	- -	R PR	R L
Brazil	1973 1996	R PR	R LL	R PR	- -	PR PR	R R
Chile	1973 1996	R LL	R LL	R L	R L	R L	R LL
Colombia	1973 1996	R LL	R LL	R PR	- -	LL LL	R PR
Mexico	1973 1996	R LL	R L	R LL	- -	LL LL	LL LL
Israel	1973 1996	R L	PR L	R PR	LL L	LL PR	R LL
South Africa	1973 1996	R L	R L	R L	- -	L L	LL LL
Turkey	1973 1996	R LL	R L	R L	- -	PR PR	R LL
India	1973 1996	R PR	R PR	R PR	R PR	R PR	R PR
Pakistan	1973 1996	R LL	R LL	R LL	R PR	R PR	R LL

(L: Liberalized, LL: Largely Liberalized, R: Repressed, PR: Partially Repressed, B: Banks, NBFI: Nonbanking Financial Institutions, F:Foreign, D:Domestic.)

The financial liberalization practice is indicated by separating in two parts in the world. 1980-1990 is first period. In this period, a lot of countries eliminated the rules belongs to financial repressive era. In this direction, controls on interest rates were

abolished, reserve requirements decreased, entrance to the financial sector became easy and securities exchanges were constituted. After 1980, developing countries implemented liberalization policies. They did it with the goal to enhance monetary policy via larger confidence on market forces. Some of the policies implemented in the direction of liberalization were removing the constraints on interest rate, decreasing controls on credits, encouraging competition and productivity in financial sectors, improving regulatory of institutions, supporting economic growth and deepening of financial markets. The characteristics of liberalization implementations were similar in developing countries. Especially, policies of practicing credit ceiling and rationing of credit to preferential sectors were seen as obstacles to financial deepening. Hence, it hinders and diminishes economic growth. However, low interest rate policy was implemented by a lot of countries with aim to increase investment and the growth based on Keynesian and Neoclassical theories (Khan and Hassan, 1998, p.581). However, in this period a lot of countries were exposed to serious financial crises. After the crises, financial liberalization practices were criticized negatively. Some economist, even McKinnon, advocated controlled liberalization (Güloğlu and Altunoğlu, 2002, p.4).

Crises in 1980s were main determinants of financial liberalization in developing countries. They strongly believed that liberalization can fix economic growth and instability by increasing savings and efficiency. Especially increase of domestic savings was very essential because of lack of foreign currency. After all, the all expectations from liberalization process came true. In many developed countries, liberalization accelerated financial instability rather than economic growth efficiency. Financial deepening was provided but it didn't affect industrial and commercial sector. After financial deregulation, access to financial intermediaries became easy. Financial institutions were also encouraged to take huge risks. Private sector took large amount of loan with very high interest rate by expecting that economic expansion will be sustained. Also they expected that they could recover extreme interest rate of debt with asset price inflation. However, as time passed they understood that they (both of borrowers and lenders) were overcommitted. And then, borrowers tried to sell their asset to close their debt and banking sector stopped to give credit to fix their balance sheet. At the end of all of these, credit stringency and debt deflation occurred (Akyüz, 1997, p.1). Besides the banking sector, development and creation of stock markets that

is indicator of liberalism gained importance in 1980s but 1990s were very hard times for developing countries. These countries thought that the success of financial liberalization process kept continuing but they ignored or didn't realize some insufficient macroeconomic condition. Also, financial markets were not deep in developing countries for speed financial liberalization process. These conditions caused big crises and bad economic and financial deteriorations in developing countries (Ünal and Açıkalın, 2013, p.27).

Because of globalization and liberalization process, competition increased and price fluctuation occurred. These conditions caused financial risk. VOB (2009) indicates that with the end of the Bretton Woods system in 1972, financial institutions faced serious exchange rate risks due to the continuous changes in exchange rates. In these periods, it is seen that the futures exchanges in Europe have begun to be established and have been developing rapidly until today. The first term contracts on exchange rates were made in 1973. Interest rate fluctuations in international money markets in the same period have raised the issue. Risk management gained importance especially in the 1980s, when the tendency to borrow with fixed interest rates gradually disappeared. Derivatives have emerged as a result of demand for products to eliminate these risks (Nasibov, 2010, p. 39). Derivative markets support financial structure of economies by providing link between cash markets, hedgers and speculators. Derivative markets have grown significantly in emerging markets which abandoned capital controls after 1990. The raising usage of derivative products increased efficient risk management and capital flows to developing countries (Lien and Zhang, 2008, p.39). Construction of modern derivative markets started when information technology was started to be developed and two main stock exchanges was built in Chicago. The World Bank and IBM were first institutions that develop derivative markets. They swapped laons in terms of different currencies. Highly customized interest rates and foreign exchange products developed by leading financial institutions that creates over the counter (OTC) market. Development of new products that was encouraged by minimum regulation and high profit margin in oligopolistic USA markets were accelerated by innovation. Financial derivative markets started in Hong Kong, Japan, Brazil and most of the countries in Western Europe after the end of 1980s and beginning of 1990s. In 1993, Group of Thirty wanted an independent risk audit to trigger legislative initiatives.

In second part, institutional investors followed more standardized products traded in organized and transparent markets like in Chicago, London and Tokyo (Fratzcher, 2006, p. 2).

In 1972, foreign exchange futures markets were established against the exchange rate risk. In 1981, foreign currency swaps and in 1982, foreign exchange options were introduced. Starting from the mid-1970s, oil crisis is one of the most important reasons for price fluctuations in international commodity markets. Because oil prices increased excessively, production costs increased and high unemployment and high inflation were observed in many countries. To prevent high inflation, money supply decreased and the interest rate manipulation as a short-term tool for this purpose gained importance. According to monetarist approach, prices should be determined in market condition so interest should be determined in market condition. To determine interest rate in market condition and to provide stability of money supply, fixed exchange rate policies abandoned. After that, financial risk occurred in financial markets. To avoid this risk, futures markets constructed in 1973, interest rate swap and interest rate options started in 1982, and forward interest rate contracts were first implemented in 1983 (Özel, 2010, 9-10).

The world has experienced a crisis that started in the USA in 2007 and spread almost all over the world in 2008 and its impact began to decline gradually in 2009. This crisis started as a financial crisis, but it turned into an economic crisis and became one of the unprecedented crises. With the 2008 crisis, derivative products became one of the most talked about topics. Davidson et al. (2010) indicated that derivatives have played an important role in the aggravation of the credit crisis and may be the cause of new crises in the future. Derivatives can also cause companies to lose large amounts of losses even though they can use them to hedge risks, because small investments in derivative products can mean large gains or large losses. For example, derivatives played a crucial role in the collapse of American International Group (AIG), one of the largest government-backed organizations in the credit crisis (Uluyol and Kaygusuzoğlu, 2011, p.347).

Along with this crisis, one of the most emphasized issues has been the derivative products. Derivatives derived from the mortgage loan system and sold to investment / financial institutions, these derivative products suddenly lost their value due to the problems in the repayment of mortgage loans and they were considered to be toxic

assets and thus turned into a fire. Derivative products, which are useful in terms of risk management and used since the past, had turned into a crisis that had exploded like a bomb and has a world effect (Uluyol and Kaygusuzoğlu, 2011, p.347). As it is seen in the Figure 1.1, number of derivative products decreased after 2008 global crisis. Another important point, it has decreased since 2014.

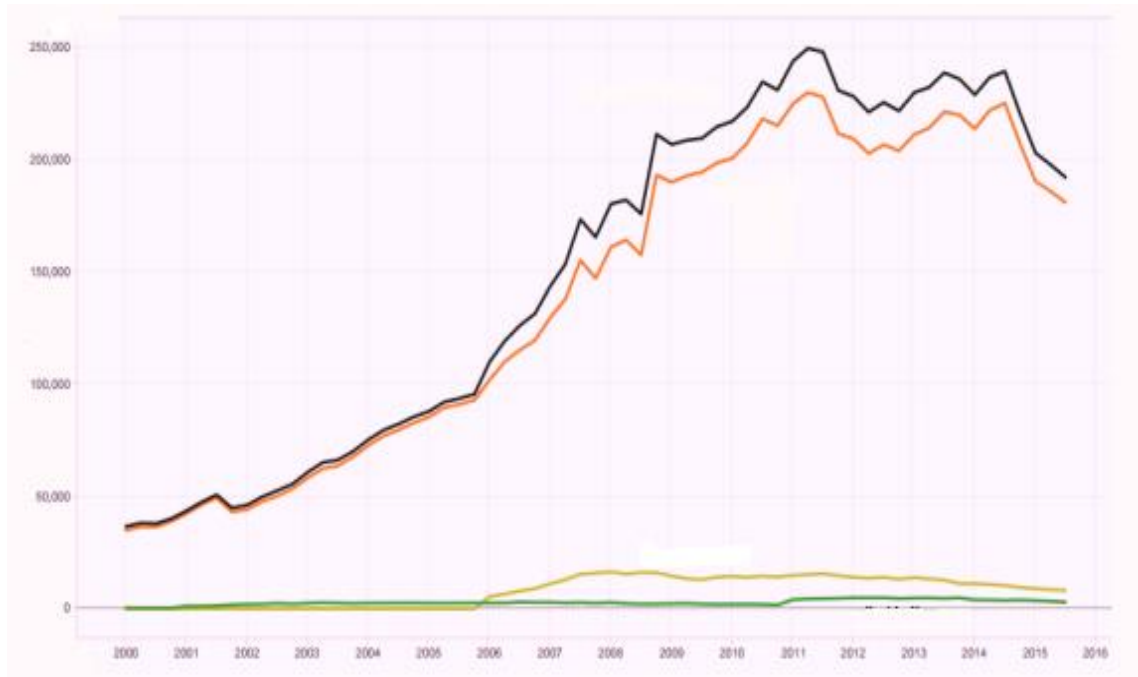


Figure 1.1. Usage of derivatives between 2000-2016 in the world (Tanyel, 2016, p. 5)¹.

The big global crisis in 2008 showed that the impacts of growth rate of credit volume on the countries. Countries, firms, and households borrowed significantly because of the increase in credit volume after financial deregulation. In 2015, ratio of public debt stock to Gross Domestic Product (GDP) was 229,2% in Japan whereas the ratio was 93,5% in euro area. Private sector debt stock also has increased. Especially, mortgage loans have risen significantly because of derivative products and these subprime credits triggered the crisis. As a result, derivative products and funds led to large amounts of borrowing by countries after financial deregulation (Çolak, 2018, p. 216).

¹ Black line represents total derivative products; orange line represents trading volume; yellow line represents credit derivatives; green line represents ultimate user.

1.2.3. Financial liberalization period in Turkey

Financial repression policies were applied in Turkey before 1980. These policies hindered the development of financial system and reduced saving rates. However, there was huge political instability in those times (Güloğlu and Altunoğlu, 2002, p.16). Keynesian development strategies were dominant before 1980 in all over the world. Because of that, internal and external demand problem for growth and development was solved by public expenditure. Because of industrialization programs, intermediate and capital goods were produced in domestic sector. In this period, international trade volume was very narrow in Turkey. There was high tax rate on export to protect domestic production and value of domestic currency was protected artificially by fixed exchange rate policy (Açıkalın, 2015, p.55). Under the influence of Keynesian economic thought, interest rates kept low to increase investment. Especially public banks had significant role in financial sector and efforts to use funds in line with plans were seen. Also, protective and interventionist structure was dominant in financial market because of effects of macroeconomic policies. In this direction, there were a lot of restrictions like credit allowing, selective credit policies, and prohibition of entrance to the sector or determination of interest rates by authorities (Ağır, 2010, p.190). Also, capital movements and foreign trade transactions were subject to many restrictions and fixed exchange rate system was applied in this period (Mangır, 2006, p.463). These repressive policies caused a lot of structural problem. Low nominal interest rate policy was applied under government control and this situation concluded with negative real interest rate in high inflation periods. This was first and important example of repressive system. The government share was very high in banking system and high reserve and liquidity obligations caused high cost for banks. Taxes on financial earnings were very high. Capital market wasn't institutionalized and improved. Entrance to the banking system was under control so there was no competitive environment. Last, public deficit was financed by monetization (Açıkalın, 2015, p.52-53).

Tax revenues of government were very low in those times because the State followed populist policies. On the other hand, structuralist problems and macroeconomic inefficiencies forced the government to reduce tax. Because of that, public deficit was very high, and the government applied high reserve requirement or printed money to decrease this deficit. In the case of problem about financial market, the government had to borrow from external market. There was always intersection

about shifting resources related with reserve or liquidity requirement to the Central Bank or the Government just because reserve and liquidity requirements are also one of the monetary policy tools. In addition, it caused expanding of non-market-based between deposits and credit rates (Özer, 2003, p.2).

Import substitution industrialization view was accepted in Turkey. In those times, authorities were trying to reach industrialization target with conservative and interventionist policies. Financial markets were designed to reach the goals when import substitution policies were applied with development plans (Ağır, 2010, p.190). The import substitution program began to force borders in 1976 when it became difficult to find sources of current debts and to support investments. Political instability had been added to the economic instability that started with the balance of payments problem in 1977-80, and stabilization decisions had to be taken on 24 January 1980 (Mangır, 2006, p.463).

There were lots of problem about banking sector. Before 1980, to put hard restrictions on entrance to the banking sector and to establish new banks provided significant rents to current banks. On the contrary, the banks were obliged to provide high deposit reserves and total liquidity as well as taxation on financial transactions and revenues led to increase in cost of intermediation. They increased their number of branches to benefit more from low-cost deposit but this caused negative effect on operating cost. Commercial and industrial enterprises provided funds by using bank credit excessively rather than exporting stocks and bonds because capital market wasn't developed and interest rate that applied to loans were below inflation rate. Banks established commercial ventures or invested in existing capital as credit user to increase their rent that was shared with industrialists and merchants by applying higher interest rate. The interest rate referred to here is negative in the real sense. Thus, the non-financial subsidiaries of the banks reached significant dimensions. It was hard to make transactions and get assets in terms of foreign exchange because of permanent problems about balance of international payment. The banks' equity couldn't be increased sufficiently, and a system wasn't established to ensure effective supervision and control of banks. Due to lack of supervisory institutions, the capital adequacy of the banks wasn't provided and the asset quality deteriorated. Accordingly, systematic crises didn't appear but some banks had to stop their activities (Çelebican, 1998, p.205-206).

Actually, Turkey could sustain high growth rate until the oil crises because economic conditions were stable and positive. After the oil crises in the beginning of 1970s, all balances were broken and new strategies were needed to improve economic condition. Moreover, allocation mechanism had to be prominent. In 1977 and 1978, some policies initiated but failed. Finally, new reform program was announced in 1980 which changes policy about import substitution includes improvements about trade and support liberalization of financial system (Atiyas and Ersel, 1992, p.1). Financial liberalization process that began in the middle of the 1980s means new strategies which are contrasts the strategies that applied before 1980 (Açıklan, 2015, p.55).

Turkey has entered a new turn with the economic stabilization decisions of January 24 in 1980. These decisions aimed to eliminate fundamental macroeconomic instabilities (like controlling inflation rate and elimination of problems about balance of payment) in the short term while long run aim was to realize basic structural transformation in Turkish economy. Because of that, the import substitution industrialization strategy had been abandoned and export oriented strategy had been implemented. In this framework, some reforms were made related with the government's downsizing, the promotion of the private sector, the elimination of constraints that prevent prices from occurring in free market conditions, and integration of economy with the outside world. The financial sector's reflection on this economic policy option is to allow interest rates to be determined by market forces, to remove restrictions on loan and deposit interest rates and amounts, to allow foreign banks to enter the sector, and to arrange for foreigners to settle accounts in foreign currencies. The financial sector reforms that started with the abolition of any restrictions on the financial markets resulted in the liberalization of the capital account in 1989 and the completed integration with external financial markets (Ağır, 2010, p.191).

Moreover, the exchange rate was devalued to a great extent, public prices had been increased and interest rates increased in this term. The demand for TL was revived and it was tried to be encouraged with time deposits. It was aimed to increase the savings with the free interest rate policy and to reduce the internal demand. It was aimed to transform the idle savings into investment by means of the regulations made in the financial sector and to provide the resources needed for economic growth (Mangır, 2006, p.463).

If history of financial liberalization in Turkey is indicated in vivid detail, it will be correct to start with interest rate. The first step of Turkish financial liberalization policy was removing the control on interest rates and introducing certificates of deposits in July 1980. In those times, tight monetary policy was applied to avoid high inflation. Because of decreasing aggregate demand, earnings were very low. Borrowing from very fragile financial markets damaged their balance sheet so there was a pressure on the market to raise interest rates. Simultaneously, banks that weren't well developed found themselves in hard competition. They financed deposits for non-performing loan. In 1982, interest rate on deposit was 20 percent. Banks, other financial institutions and companies competed each other in unstable and fragile financial system. The state and the Central Bank couldn't control the behavior of banks. The commercial banks signed 'Gentlemen's Agreement' between each other. However, this agreement was violated by some banks and bankers. At the end, a crisis occurred in financial system in 1982 and financial liberalization process became unsuccessful. The Central Bank interfered five commercial banks and their assets and liabilities were transferred to the public banks. In 1983, The Central Bank put ceiling on deposit interest rate again. The period of 1980-1982 was infancy stage of Turkish financial liberalization policy. The authorities failed by thinking that competition in financial sector support financial development (Atiyas and Ersel, 1992, p.3).

Another important step about financial development was new Banking Law in 1985. The main aim of this law was to develop weaknesses of banking sector which emerged in 1982. Also, minimum capital base condition was adjusted for banks. According to it, capital adequacy ratio was 5 percent in 1989 and 8 percent in 1982. It was determined according to Bank for International Settlements (BIS) to control the risk and capital in primary and secondary market (Atiyas and Ersel, 1992, p.3-4).

Liquidity was revised and reserve requirement system changed so credit control of the Central Bank on banking sector reduced after 1980. Interbank money market was established in 1986 to facilitate short term loan. In 1984, the Central Banks started to make open market operations by varied its financial instruments. In 1989, selective credit policy was ended by elimination of rediscount rates. 1990 was important year for the Central Bank because new monetary program was introduced. According to this, the Central Bank started to control its both side of its balance sheet. In other words, it could

control the central bank money. A protocol was assigned between the Central Bank and the Treasury. It included decreasing of public sector borrowing from the Central Bank and finance fiscal deficit (Yeldan, 1997, p.83).

In between 1970-1987, the Central Bank used rediscount rate as selective credit policy. This monetary policy tool was used for financing of development so the Central Bank lost the function of being the last source of liquidity. Credits were provided with long maturity and very low interest rates that was lower than market to primary areas in development. This policy is called as differentiated rediscount rate. Also, reserve requirement rate was also used as selective credit policy for a while. Reserve requirements were not used for arranging money supply until 1982. It was used as resource to directed credits of commercial banks to priority sectors and regions (Şıklar, 2011, p.107).

After 1980, number of permissions related with establishing a new bank and to open branches of foreign bank in Turkey increased. The main aim was to change oligopolistic structure in the market. In between 1923-1980, the Council of Ministers occasionally acted liberal but mostly didn't allow the establishment of a new bank or opening a branch. In this context, the number of new entries in the sector was limited. (Çelebican, 1998, p.207).

Free entrance of foreign banks was very essential factor to accelerate competition in banking sector. On the other hand, authorities didn't give much more importance to improve other financial institutions except for the banks so it can be said that Turkish financial development strategy mainly based on the development and competition of banks. After that, banking sector became dominant in the financial system. They were supported to facilitate in the newly formed financial markets. In this direction, areas of banking sector got broaden so they started to make international transactions. For example, they were enabled to gather deposit, enlarged loans, control mutual funds and create a portfolio for their customers in terms of foreign exchange. The excessive confidence in the banking sector caused banker crisis in 1982. The main reason of the crises was the competition between bankers and banks because of free interest rate. Another reason was that political power of these institutions was so high in those times (Atiyas and Ersel, 1992, p.2). Table 1.2 summarizes that the number of banks in Turkey. The number of total banks increased from 43 to 66. It is the effect of

financial liberalization process that began in 1980. However, another important increase occurred in number of foreign-funded funds. There was a sharp increase. It rose from 4 to 23 in between 1980-1990. It resulted of closing the number of private banks. Another important point was to decrease in number of public banks in this period. In 1980, there were 12 public banks while there were 8 in 1990. The weight of public banks in the banking sector decreased a bit in ten years. It can be said that the financial reform process was successful in terms of attracting foreign capital to banking sector.

Table 1.2 Number of banks in Turkey between 1980-1990 (www.tbb.org, data accessed 17.02.2018)

Number of Banks in Turkey Between 1980-1990			
	1980	1985	1990
Commercial Banks	40	47	56
Public Banks	12	12	8
Private Banks	24	20	25
Foreign Funded Banks	4	15	23
Development and Investment Banks	3	3	10
Total	43	50	66

The Table 1.3 shows the basic macroeconomic indicators belong pre and post liberalization period. It can be measured financial deepening by following ratio of total deposit to GDP. This rate was followed an increasing course through the process. It was 15.8% in 1970 while it reached 20.4% in 1984 and 33.4% in 1997. The important point was that even though real interest rates were high in 1980s, total deposits were relatively lower than 1990s. It shows us total deposits weren't just sensitive to real interest rates. After 1984, residents started to hold foreign currencies and leave TL so total deposit increased again. It can be said that the ratio of total deposit to GDP increased over the time except tight monetary policy period and the period which the TL was overvalued in between 1988-1991 (Mihçi, 2000, p.86).

Another important indicator is real interest rates. Real interest rate was negative until 1980. After 1980, the interest rates became positive, but it sometimes was negative in the following years. The main reason of this was huge inflation rates. Actually, this situation shows that Turkish economy wasn't ready for sudden liberalization process because of one of the main macroeconomic indicators which is inflation rate wasn't stable. Also, credit to private sector is main determinant of financial development. It wasn't change in post liberalization period but increased relatively after 1989 because borrowing from abroad was liberalized. It just decreased in crises time. On the other

hand, credit to public sector reduced after 1980. After 1984, it can be seen that ratio of total public security to GDP increased. Demand of the securities increased because of high rate of return and short maturities. Moreover, demand to public securities from bank also increased after liberalization period. It was 0.1% in 1980s while it was 5% in 1987. In those periods, funds transferred to public increased because public sector borrowing requirement increased (Mıhçı, 2000, p.95-97). It can be said that financial liberalization process depended on government debt securities. Yeldan (2016) mentioned that this situation had three effects on financial market. First, fiscal policy substituted the monetary policy of the Central Bank so credit volume to public increased. Second, this situation created monopolistic power for the Treasury, so credit allocation was deteriorated and expectations for efficiency decreased. Lastly, money multiplier tended to fluctuate because government debt securities were issued at irregular intervals and at large sizes to the market (Yeldan, 2016, p.132).

Table 1.3 Some macroeconomic indicators of pre-post liberalization period (Mihçi, 2000, p.87-88)

	1970	71	72	73	74	75	76	77	78	79	80	81	82	83
Real deposit interest(annual)	0.008	-0.064	-0.041	-0.078	-0.081	-0.089	-0.063	0.148	0.239	0.235	0.383	0.127	0.231	0.104
Inflation Rate	8.130	16.500	13.700	16.000	18.600	19.700	16.300	27.900	47.200	56.800	115.600	33.100	21.900	31.400
Saving/GDP	0.221	0.208	0.214	0.215	0.196	0.196	0.205	0.184	0.170	0.157	0.160	0.183	0.171	0.165
Private Saving/GDP	-	-	-	-	-	-	0.094	0.095	0.121	0.110	0.106	0.095	0.076	0.084
Public Saving/GDP	-	-	-	-	-	-	0.081	0.076	0.062	0.050	0.054	0.091	0.083	0.078
Private Investment/GDP	0.140	0.139	0.159	0.158	0.143	0.146	0.167	0.171	0.161	0.136	0.130	0.107	0.109	0.113
Public Investment/GDP	0.069	0.062	0.063	0.063	0.065	0.079	0.091	0.100	0.084	0.079	0.087	0.090	0.081	0.087
Total Deposit/GDP	0.158	0.167	0.180	0.182	0.167	0.169	0.163	0.180	0.146	0.136	0.121	0.162	0.193	0.187
Public Security(Priv)/GDP	0.037	0.028	0.033	0.036	0.029	0.030	0.035	0.037	0.032	0.031	0.026	0.018	0.015	0.016
Public Security(Bank)/GDP	0.008	0.012	0.014	0.008	0.006	0.006	0.011	0.015	0.013	0.010	0.010	0.013	0.017	0.014
Private security stock/GDP	0.006	0.008	0.009	0.013	0.013	0.013	0.014	0.016	0.013	0.011	0.014	0.014	0.022	0.021
Total public security/GDP	0.045	0.040	0.047	0.045	0.035	0.036	0.046	0.052	0.045	0.041	0.036	0.031	0.032	0.030
Credit to public/GDP	0.026	0.030	0.032	0.037	0.036	0.039	0.039	-	0.027	0.027	0.029	0.020	0.016	0.015
Credit to private/GDP	0.158	0.144	0.160	0.166	0.158	0.176	0.186	0.201	0.158	0.132	0.123	0.145	0.155	0.157
Growth rate of GDP per person	0.023	0.064	0.040	0.018	0.058	0.060	0.065	0.022	0.007	-0.029	-0.028	0.021	0.022	0.012

Table 1.3 Some macroeconomic indicators of pre-post liberalization period(Mihçi, 2000, p.87-88)(continued)

	1984	85	86	87	88	89	90	91	92	93	94	95	96	97
Real deposit interest(annual)	- 0.023	0.070	0.100	0.080	0.059	- 0.028	- 0.006	0.040	0.024	0.052	- 0.002	- 0.007	0.074	0.057
Inflation Rate	48.400	44.900	34.600	38.900	73.700	63.300	60.300	66.000	70.100	66.100	106.300	93.600	80.400	85.700
Saving/GDP	0.165	0.189	0.219	0.239	0.272	0.221	0.220	0.224	0.216	0.219	0.231	0.215	0.200	0.201
Private Saving/GDP	0.096	0.091	0.113	0.156	0.175	0.171	0.191	0.217	0.230	0.245	0.248	0.219	0.219	-
Public Saving/GDP	0.069	0.098	0.106	0.085	0.086	0.063	0.046	0.007	- 0.014	- 0.027	- 0.008	- 0.004	- 0.019	-
Private Investment/GDP	0.113	0.109	0.126	0.146	0.172	0.149	0.156	0.161	0.160	0.191	0.196	0.198	0.199	0.196
Public Investment/GDP	0.080	0.091	0.100	0.099	0.088	0.075	0.069	0.075	0.073	0.072	0.049	0.042	0.051	0.058
Total Deposit/GDP	0.204	0.230	0.246	0.258	0.236	0.213	0.181	0.213	0.215	0.190	0.266	0.282	0.338	0.334
Public Security(Priv)/GDP	0.010	0.007	0.017	0.019	0.015	0.020	0.024	0.023	0.075	0.090	0.102	0.120	0.129	0.142
Public Security(Bank)/GDP	0.031	0.041	0.044	0.053	0.052	0.048	0.040	0.048	0.047	0.046	0.043	0.038	0.070	0.064
Private security stock/GDP	0.020	0.017	0.022	0.028	0.030	0.035	0.041	0.055	0.055	0.056	0.034	0.039	0.031	-
Total public Security/GDP	0.042	0.048	0.061	0.072	0.067	0.068	0.065	0.071	0.123	0.135	0.146	0.158	0.199	0.206
Credit to public/GDP	0.010	0.020	0.031	0.039	0.033	0.025	0.025	0.022	0.015	0.014	0.012	0.008	0.005	0.009
Credit to private/GDP	0.139	0.139	0.166	0.177	0.147	0.135	0.140	0.138	0.153	0.156	0.135	0.168	0.112	0.141
Growth rate of GDP per person	0.031	0.025	0.060	0.051	0.017	- 0.010	0.066	- 0.014	0.028	0.053	- 0.006	0.056	0.052	-

The situation is not very good when ratio of total investment to GDP is considered. Total investment in 1970 was around 22% while it decreased to around 19% in 1980s. Private investment was around 15% and public investment was around 6% before 1980 while private investments reduce to around 13% and public investments

increase 8% in the 1980s. The condition that McKinnon-Shaw hypothesis is not valid for financial liberalization period (Mıhçı, 2000, p.99-101).

Later on, some financial crises occurred because financial market were not enough efficient and deep and the conditions that required for capital movement liberalization didn't exist (Mangır, 2006, p.460). Especially after the failure of fiscal discipline in the public sector, the increasing demand for borrowing was paid off from domestic markets and from 1989 it was paid off from foreign market. The ever-increasing borrowing requirement as a result of constant budget deficits, while raising interest rates, led to increasingly public use of funds in the financial sector. Hence, macroeconomic instabilities in an economy fully integrated with the outside world removed the financial sector from its core functions. As well as the lack of timely, appropriate legal and institutional infrastructure in the framework of liberal policy emerged as a separate problem. The lack of a particularly effective supervision and oversight mechanism was resulted in the transfer of many private banks to the Saving Deposit Insurance Fund (TMSF). Again, populist policies led public banks to increase their duty losses. Further, the result of the crises became heavy (Ağır, 2010, p.191).

Özer (2003) asserted that impact of financial liberalization process in Turkey is complicated. Turkish economy was very defenseless against external and internal shocks though many innovations took place about financial system. Main reasons of this defenseless were macroeconomic instability and structural troubles. Hence, Turkish economy had to face with destructive financial crises in 1994 and 2001 (Özer, 2003, p.3).

After 1990, the main aims of regulations were to provide macroeconomic stability, to establish regulatory and supervisory authorities to prevent asymmetric information problems in credit markets like moral hazard and adverse selection, to create competitiveness in banking sector, to remove the disconnection between domestic and international credit markets and to integrate the domestic stock exchange to international financial market (Güloğlu and Altunoğlu, 2002, p.4).

Liberalization movements accelerated in those years. Some steps were taken about financial market, for instance, repo and reverse repo operations started in 1991 and derivative exchange started in 1999. These steps revived financial markets in this

term. Until 1980, there was no derivative market in Turkey. In 1983, the Central Bank is allowed to perform forward transactions and swap operations between commercial banks and the Central Bank began in 1985. The forward foreign exchange transactions firstly intervened in 1995.

Following the 2001 crisis, the floating exchange rate system was introduced and Derivative Market Incorporated Company (VOBAŞ) was established under İstanbul Stock Exchange (İMKB) in order to prevent this risk in 2001 in İstanbul. Since 2005, VOBAŞ continued its activities under the name of Derivative Exchange Market (VOB) in İzmir. Finally, VOB transferred BIST (Stock Market İstanbul) in 2013 with the name of VİOB (Derivative Exchange Market) in İstanbul. Moreover, in 1995 İstanbul Gold Exchange Market was opened to ease importation and exportation of gold. Likewise, it transferred to BIST in 2013 (www.borsaistanbul.com, data accessed 20.1.2019).

Although some positive steps were taken to enhance liberalization process in 90s, in the beginning of 1994, all the balance in the Turkish economy was bad. Applied monetary and fiscal policies made impossible to fix the failures of the economy. Inflation rates were very high and the authorities thought that the interest rate was responsible for this condition. Government debt securities were cancelled all over again to decrease interest rates. The economic crisis broke out when expectations were not realized. The authorities had to take April 5 decisions in 1994 (Eğilmez and Kumcu, 2016, p.258).

The decisions didn't have only one reason. The boom in demand and inflationary process occurred in 1993 because of internal-external borrowing to finance public deficits and increasing liquidity resulting from the use of the Central Bank advances. Escape from TL started. In this term, foreign trade deficit was \$14 billion and current account deficit was 6.4 billion TL. There was turmoil in the market because rating agencies decreased Turkey's credit note. Central Bank sold \$3.5 billion to balance the economy but it didn't work. Interest rate and exchange rate continued to rise. The effort to reduce interest rates led to transfer financial funds to foreign exchange. In order to stop this chaos, April 5 Stability Program announced in 1994 (Yediyıldız, 2002, p.69). The main goals of these decisions were to reduce inflation quickly, to increase export-decrease import, to limit foreign debts, to increase public revenue to decrease public expenditure, to reform agriculture, social security and privatization. In short term aims were to fix balance of payments and to provide stability

of foreign exchange market while in middle term aims were decrease public deficit and decrease inflation. In long term aims were to encourage export, to accelerate privatization and to make sustainable growth possible (Güloğlu and Altunoğlu, 2002, p.18). It was not possible to achieve the program objectives. Customization targets could not be achieved, tax reform couldn't be realized and no structural measures were taken. Eventually, financial markets were stabilized. The cost of this stabilization was the decline in the demand, the contraction in national income and growth of unemployment (Yediyıldız, 2002p.69).

It was tried to integrate Turkish economy with international financial system by liberalization and privatization practices. Although main aims of these practices were to increase growth and provide stability by channeling savings to efficient investments, financial instability occurred. Short term capital flows couldn't be evaluated for productive investments. Also, dollarization was created. Some existing problems continued such as budget deficits and macroeconomic instabilities. The policies that made in post 1980 period caused a high inflationary developing economy which applies deregulation policies with a lot of problem. After liberalization, attracting capital flows become most important thing for policy makers. These flows caused financial instability because interest rates were kept high and foreign exchange was kept low to attract capital flows. If there is instability in interest rates and foreign exchange, it impacts real sector easily because of strong relationship between financial system and real sector. Turkey experienced these processes after financial liberalization period. Further, fiscal deficit of Turkey was affected negatively in this period because factor revenues decreased. The government couldn't increase saving and it produced new instrument to finance its debts. After that, stock of domestic debt increased dramatically and the interest rate of the new instruments rose (Balkan and Yeldan, 2002, p.10). Hence, it can be said that monetary and fiscal stability is precondition of financial liberalization. Financial crises are pretended if macroeconomic conditions are appropriate (Özer, 2003, p.27).

Turkey entered the millennium with IMF programs. The tight fiscal policy wasn't decisive according to Inflation-Fighting Program accepted in 1999 under supervision of IMF. This policy depended on new doctrine that was improved by IMF. The main aim of this program was to decrease in inflation rate by applying fixed

exchange rate. This policy that was harder than the policy applied in Argentina in the end of 1990. In Argentina, fixed exchange rate was created and The Central Bank of Argentina protected the exchange rate by transforming a currency board. Hence, monetary policy became passive. The policy that was similar with Argentina's was applied during 2000 and contributed 2001 crisis. After that, it was abandoned (Boratav, 2015, p.201). Actually, the experience of Turkish liberalization history shows that selecting exchange rate as an anchor isn't good policy. It causes a lot of problems and financial instability. Because of that reason, public deficit is deteriorated because of capital flows. However, governments could choose these kinds of policies because of popularity. Also, probability of success is very high for these policies in the short term. The main problem is not whether capital flows is useful or not. Government should provide that the capital flows are directed towards effective investments to increase economic growth and development (Balkan and Yeldan, 2002, p.10-11).

Lack of liquidity, increasing structural problems, huge amount of speculative movements and political instability became main problems of Turkish economy from beginning of 2000. These problems were main reason of the big crisis of Turkish economy in 2000. Economic growth rate was -9.5% in 2001. Economy was depressed and the share of budget deficit in GDP reached to 16%. The belief in the applied Inflation-Fighting Program diminished. Moreover, devaluation expectation didn't occur so hot money left the country. On the other hand, role of banking sector was also important to emergence of the crisis (Yazıcıoğlu, 2014, p.265).

Deregulation policies suspended after the crises in the beginning of 2000s. Very strict regulations were applied in the financial sector immediately. It was understood that deregulation policies shouldn't be applied randomly. Also, the crisis began in 2008 in all over the world caused to abandon deregulation policies. Both politics, regulations and deregulations, have useful and harmful aspects. Excessive regulation restricts creativity and decrease production. On the other hand, excessive deregulation makes audits meaningless and causes enterprises that destroy society and environment (Eğilmez, 2017, p.288-289).

Because of financial deregulation process, other countries have borrowed with high amount and Turkey has affected this situation. Public and private sector borrowed seriously. Ratio of household debt to GDP was 7, 5% in 2005 while it approached 55%

in 2016. However, the ratio was under the developed countries. Main reason of this is constraints that banks face in creating derivative products not applied policies (Çolak, 2018, p.216).

1.3. Capital account liberalization

1.3.1. Definition

Akyüz (1997) defined the financial openness as a policy that allows residents can make monetary transactions in foreign exchange and foreigners can make same transactions in domestic market. These transactions are separated as three parts. First is that inward transactions. It means that residents can borrow from abroad or foreigners can invest their money in host countries financial system. Second is outward transaction. Local people can invest their saving in another countries' financial system or foreigner can borrow easily from local financial market. Third one is domestic transactions in foreign currencies. It means that local people can borrow among themselves in terms of foreign currency. In other words, residents can establish debtor-creditor relationship by transferring foreign currency (Akyüz, 1993, p.27).

It is believed that financial openness is beneficial because international savings are pooled and allocated efficiently. Free capital movement allows this situation. The pooled savings are used for most efficient investment. Hence, perfect resource allocation and equalizing profits are proven globally. Because of that, developing countries' expectations from financial openness are these capital inflows if they liberalize financial market and raise interest rates (Akyüz, 1997, p.29).

Use of convenient domestic savings is the important source of acquisition from liberal capital account. The importance of capital flows becomes apparent because of this reason. These profits mainly depend on Foreign Direct Investment (FDI) but it also occurs with other kinds of foreign capital flows. For instance, rivalry between companies in most economic crises after FDI comes, thus local company gets more productive (McLean and Shrestha, 2002, p.6). On the other hand, neo classical theory accepts that foreign savings are important resources for domestic investments and economic growth in the case of absence of domestic savings. Capital flows go to countries that have not enough capital owing to liberalization of capital account (external financial liberalization). In other words, interest rate will rise and savings of

some countries with saving surplus flows to countries that have not capital to enhance investment and growth. This process will go on until interest rate of developing countries equal international interest rate. The more global savings rates are sensitive to the interest rate, the faster this process will work. Before external financial liberalization, some economic regulations must be considered. For example, reforms in prices and financial sector should be completed, macroeconomic stability should be created and tools to compensate autonomy will disappear on monetary policies must be created. Approach which suggests the liberalization of capital flows proposes that public consumption and investment expenditure must decrease, subsidies must end, and public organizations must be privatized. Also, it encourages a tax reform that encourages supply, makes production more competitive, and prevents capital flights (Yentürk, 1997, p.136). For instance, it might be assumed that before external financial liberalization domestic interest rates must be greater than international interest rate. This is the prior situation of capital account openness. After that, domestic borrowers lends from abroad shortly after capital account become open. Thus, domestic currency will be appreciated and damages international trade. Capital will tend to flow non-tradable sector. Tradable sector becomes second choice for investors. This shift of resources is not appropriate because transaction cost occurs in market. Therefore, it is true to say that, trade liberalization should be first. After trade liberalization, capital account openness can be subject. Namely, domestic financial liberalization should be completed before external financial liberalization. External and internal financial liberalization create expertness and domestic banking sector that cope with difficulty of international competitiveness (Balasa, 1990, p.67).

If countries liberalize their financial system and abolish the restriction on capital flows, their stock market will become larger, more liquid and globalized. Liberalization of investment and elimination of limitations causes capital market to more internationally compounded (Levine and Zervos, 1998, p.1181). If countries can borrow internationally, they would consume easily and finance efficient investment. FDI flows, portfolio flows and foreign bank lending increases after liberalization. FDI brings new technologies and administrative know how whereas financial system get deeper because of portfolio flows and foreign lending (McLean and Shrestha, 2002, p.1).

Also, accessible information about the firms of domestic and foreign investors effects stock market development positively. Moreover, countries have appropriate accounting standards and protective rules for investors' supports stock market development (Levine and Zervos, 1998, p.1181). Moreover, liquidity of these markets is high, investments will be more attractive. In this case, savers can sell their equities quickly without any costs if they need money. Also, firms can increase their capital through more liquid stock market. Thanks to more liquid equity markets, investments and capital accumulations become more profitable so economic growth is effected positively (Levine, 2001, p.693).

1.3.2. Capital account liberalization in developing countries

Globalized and integrated financial markets changed the size of international flows beside resources and channels of these flows. The problems grew and became complex because of globalization of international capital flows (Ünal and Açıklan, 2013, p.32).

After 1990s, there was an excessive capital flows to developing countries. It was around \$ 7 billion in 1970 while it increased around \$277 billion in 1998. (Table 1.4) There are many reason of increase in capital flows to developing countries. For instance, many developing countries started to apply macroeconomic stability program that was supported by IMF or World Bank from the middle of 1980. Especially, the main aims of the reform programs were to control inflation and to accelerate economic growth in developing countries after 1990. At the end of the 1980s, many European countries started to change their economic structure to attract more FDI because their economy was expanded and privatized. After 1992, Baltic Countries, Russia and past Soviet countries started structural economic transmission that aimed monetary stabilization and then, this case concluded with high growth rate. Increasing privatization of public enterprises and financial institutions, efforts to increase market capitalization and improvement of financial instruments for local and foreign asset holders were main reforms that made by developing countries in Asia, Latin America and the Middle East in 1990s. In 1960s and 1970s, IMF supported to put restrictions on capital account for developing countries. Despite IMF, the members wanted to abandon the controls liberalization process that was so slow. But in 1990, the situation had changed. IMF imposed to developing countries to ease capital controls with Article III.

After that, developing countries liberalized their capital account after 1990. This situation supports foreign asset holders to make transaction in international financial area because conditions and expectations shifted (Knight, 1998, p.7-8).

Table 1.4 Aggregate net resource flows and net transfers in middle income countries (Global Development Finance, 2005, p.34)

AGGREGATE NET RESOURCE FLOWS AND NET TRANSFERS IN MIDDLE INCOME COUNTRIES (\$ Billion)										
	1970	1980	1990	1997	1998	1999	2000	2001	2002	2003
NET RESOURCE FLOWS	7,546	65,005	68,040	274,663	277,017	230,134	187,718	177,372	151,969	179,128
Net flow of long-term debt	4,758	49,979	31,097	87,073	97,146	35,159	6,872	300	-7,103	10,649
Foreign direct investment (net)	1,536	9,314	20,380	155,564	159,470	169,606	155,761	160,980	139,407	135,648
Portfolio equity flows	-2	0	3,383	19,630	7,174	10,275	9,863	3,181	4,689	16,593
Grants (excluding technical coop.)	920	5,789	13,181	12,396	13,228	15,094	15,222	12,911	14,976	16,238
Memo: technical coop. grants	723	2,640	7,048	9,217	10,315	11,043	9,738	10,525	12,127	13,042
official net resource flows	2,717	19,689	29,938	17,732	28,195	26,067	16,813	16,562	5,658	1,225
private net resource flows	4,829	45,316	38,103	256,931	248,823	204,067	170,905	160,810	146,311	177,903

The increase in international flows to developing countries showed the condition of developed countries that were main source of these flows. Continuing financial innovations in industrial countries encouraged the spreading of risk exposures to developing countries. The condition caused to diversify mutual funds. Developing countries were seen as sources to diversify portfolio by international asset owners. Low interest rates in industrial countries pushed international investors to places with high interest rate and high return (Knight, 1998, p.9)

Another reason was that capital flow was moving autonomously. In other words, excessive capital inflows create arbitrage opportunities in countries where there are no arbitrage opportunities by lowering foreign exchange rates and raising interest rates. The main effect of excessive capital inflows on balance of payment is to increase current account deficit. As it is known, the portion of net capital inflows that does not

go to international reserves is used to finance the current account deficits. That is to say, increase in capital flow causes increase in current account deficit. It is easy to find foreign exchange with excessive capital entry. Also, price of export goods rises because domestic currency is appreciated. Hence, import goods get cheaper (Yentürk, 1997, p.143). The banking sector is underdeveloped or not under regular supervision make hard to cope with problems that created by capital flows. In this case, capital inflows can cause liquidity and foreign exchange crises. Thus, the capital with high mobility could leave an economy with some instability about inflation, exchange rate and banking sector. There are some examples about this issue (Ünal and Açıkalın, 2013, p.33).

Many developing countries didn't follow the right order when liberalizing their economic structure. In Latin American Countries liberalized their financial sector by ignoring trade liberalization. Huge capital flowed to those countries following liberalization. After, exchange rate was appreciated. Argentina and Uruguay liberalized their capital account but trade account was ignored. Chile liberalized open capital account when domestic financial system was disrupted (Balasa, 1990, p.67). These conditions caused big financial crash in Latin America.

After the all crises, it is thought that short term and high volatility portfolio investment is main reason of these crises. After, the countries that had big crises and fixed distortions that come from these crises changed their approach to portfolio flows. Moreover, there are some studies in literature suggesting that portfolio investments impact developed countries positively more than FDIs (Ünal and Açıkalın, 2013, p.34). On the other hand, moral hazard created main reason of Asian Crises after they liberalized their banking sector. Companies borrowed from non-residents in foreign currency and lending in domestic currency. These companies expected that exchange rate remains stable and the government saves them in the case of danger. The lender firms had these expectations but they were not fully informed about the quality of financial system. This caused that investment level exceed optimal level procured in the default of confidential assurance. And then, foreigners halted to lend because government foreign liabilities became more than foreign reserves. This caused big devaluation and firms borrowed from non-residents to bankruptcy. The crises have concluded that capital flows don't support economic growth all the time, on the

contrary, countries can be exposed to financial crises (McLean and Shrestha, 2002, p.8). To avoid this economic crush, before financial liberalization, inflation rate must be under control. Main reason of this, lenders and borrowers are so defenseless because of very high interest rates. Furthermore, state control is very necessary to control risky investment of banks. Particularly, ratio of capital and reserve requirement should be suitable in order to restrict the share of bank portfolios that can be borrowed and supervise the qualification of these portfolios in detail (Balasa, 1990, p.66).

1.3.3. Capital account liberalization period in Turkey

Some external factors caused some problems before 1980 in Turkey. Current account receivables and worker remittances increased after devaluation in 1970 and these receivables couldn't be stabilized. Hence, monetary expansion process started in Turkish economy. An increase in exports started with the incentives given to traditional export products during this period when foreign exchange troubles were not observed. In 1973, the necessary adjustment measures were not taken against three-fold increase in Organization of Petroleum Exporting Countries (OPEC) oil prices. Current account deficits increased gradually. Since the necessary adjustments were not made in exchange rate, state guaranteed convertible TL deposits to attract decreasing workers' remittances, to prevent private sector competition for financing of public deficit and to enable the private sector to borrow from the outside. In 1977, some problems about export and import occurred and growth rate decreased. In 1977-78, economic crises started. Any financial reforms couldn't be made and the efforts to postpone foreign debt did not work. Main reason of this crisis was increases in oil prices and inability to adapt this increase, convertible TL deposits and financing of investments with external debt. In 1978 and 1979, the IMF-driven programs were not implemented due to the weak coalition government. The crisis ended with military intervention at the end of 1979. The decisions of January 24 entered into force (Yediyıldız, 2002, p.66-67).

The most important policies that introduced in 1980s were about liberalization and outsourcing the financial system. Radical changes were made in the foreign exchange regime, some foreign exchange transactions that were previously monopolized by the Central Bank were made possible by commercial banks and banks were able to manage their foreign exchange position. With a practice seen in a small number of countries, to be able to open foreign exchange account in the commercial

banks for residents in Turkey was released. It was aimed to bring the foreign exchange under the pillow to the banking system to a great extent. But in the longer term, individuals and companies were left out of the TL and opened up to foreign exchange. For this reason, inflationary pressures intensified in the following years because it would be difficult to control inflation (Pamuk, 2015, p.267).

In 1984, foreign exchange rate policy was changed with Decision No.30. The first step was taken for transition to free exchange rate policy. To do this, fixed exchange rate policy was abandoned. The Central Bank determined the exchange rate daily and commercial banks could apply a rate below or above this rate. One year later, this practice was abandoned, and foreign exchange rate has determined according to market condition freely (Eğilmez, 2017, p.257-258). After this decision, holding foreign currency, opening foreign exchange deposit account and borrowing from foreigners have become free for residents. Furthermore, to freely use the currencies of banks according to the principles to be determined and to make and sell futures have liberalized. Import of Turkish currency and documents providing payment with Turkish currency have been free. With this arrangement, amount of foreign exchange and transactions in terms of foreign exchange increased sharply. The most important point is that after 1984, dollarization became legal and new money supply definition was formed; M2Y. It is formed by adding foreign exchange deposit account to M2 (Çelebican, 1998, p.209).

In this period, some steps were taken about capital market to fix current condition. In 1982, Capital Market Board was established and started to work in 1983. Capital Market Law of 1981 was strengthened. Thus, The Capital Market Board authorized to organize primary markets for equities and bonds. Also, it authorized to refuse the issues if it decided that this issue can damage the stability or robustness of financial system. Moreover, secondary market was arranged. In this direction, İstanbul Stock Exchange was reopened in 1985 and started to work in 1986 (Atiyas and Ersel, 1992, p.3-4).

With the decision of January 24, it was aimed to determine the prices in the commodity and factor markets and the interest and the exchange rate in the financial market. Import regime was liberalized and programs promoting exports and foreign capital were implemented. The reduction of weight of state economic enterprises and

the state in the economy was aimed. These decisions were indicative of great change in an economy. After election in 1983, economic growth accelerated because of expanding monetary and fiscal policies. On the other hand, inflation and external-internal debts rose rapidly. Real interest rate increased because of increasing inflation and debt. There was devaluation anticipation because of foreign exchange deficit. Lastly, economic recession occurred in between 1988-1989. January 4 Decisions in 1989 were entered into force to avoid this recession and to increase foreign exchange. Foreign capital was encouraged with high interest rate and the convertibility of TL was provided by Decision No. 32. The goal of convertibility was to attract funds without looking into the sources. This uncontrolled capital inflows and outflows provided appropriate environment to money laundering. These speculative capital movements, which disrupted the economic balance, distorted the effectiveness of the instruments of monetary policy (Yediyıldız, 2002, p.68). Although the Turkish economy was skeptical about foreign capital during its establishment, it was stated that foreign capital should be used at times when domestic capital is insufficient. With the influence of the world economic crisis and the Second World War, Turkey turned to protectionist economic policies like many countries and implemented strict controls against foreign capital. Although various regulations were made before 1980 to encourage foreign investors, no steps were taken to liberalize financial markets in this period. Parallel to the liberalization policies implemented since 1980, financial pressure policies have been somewhat reduced. Since 1980, it has been seen that various laws for foreign capital have been taken out and various steps have been taken to create institutional infrastructure. In 1989, financial restrictions were abolished and significant changes were made in the direction of Turkey's economy adapting to the international economy (Kılınç Savrul et al., 2013, p.227-228).

The most important step was that TL became convertible with protection of the value of TL law in 1989; in this way capital movements and exchange rate regime were liberalized. Liberalization in the foreign exchange regime in 1989 strengthened the tendency of Turkish banks to open out. Foreign currency transactions of banks operating in Turkey increased substantially during this period. Banks started to make transactions in terms of foreign exchange. They gave foreign exchange credit and got

asset in terms of TL by using loans that provided from abroad. Thus, open position problem in Turkish banking sector arised (Çelebican, 1998, p.210-211).

In between 1980-1990, Turkish financial sector grew significantly but there was no specific measure to determine the growth level. Financial deepening is usually used for measure financial development level. It is ratio of M1 (currency+demand deposit); M2(M1+time deposit) or M2Y(M2+foreign Exchange rate)to GDP. However, this measure doesn't include the securities market and deposits in terms of foreign exchange. The all financial asset is better indicator of financial development. It includes currency, total deposits and total securities.

Table 1.5 summarizes condition of financial system in Turkey according to these two indicators. The notable indicator here is evolution ratio of total financial asset to GDP. It is seen that it increased continuously during this period (Atiyas and Ersel, 1992, p.6). After 1984, M2Y/Gross National Product (GNP) was introduced because of holding foreign exchange became free and this rate increased continuously. This means that people left TL because of afraid of inflation and tended to hold foreign currency so dollarization occurred in the economy in those times.

Table 1.5 Indicators of financial deepening in Turkey between 1982-1990 (Atiyas and Ersel, 1992, p.32).

Financial Deepening(%of GNP)			
	M1/GDP	M2/GDP	M2Y/GDP
1982	11.6	22.8	-
1983	12.6	23.9	-
1984	9.6	22.4	23.1
1985	8.9	24.1	25.8
1986	9.0	24.5	27.5
1987	9.6	23.0	27.4
1988	8.2	19.7	25.1
1989	7.8	20.3	25.3
1990	8.1	20.3	25.3

The liberalization of capital account was completed with conversion of TL, liberalization of foreign exchange rate regime and eliminating the pressures on international capital flows in the balance of payment transactions. After that, the capital flows became more sensitive to the difference between national and international interest rates. Also, currency depreciation is important factor for these kinds of flows. After 1989, the Central Bank mislaid its control on the interest rate and exchange rate. These two indicators became external for Turkish economy. They were determined by

external factors. High rate of return on domestic asset was required for foreign portfolio flows. After the regulation in 1989 in Turkey, Turkish financial system was appropriate for foreign portfolio investment (FPI). Increasing these kinds of investment and hot money flows caused appreciation of TL (Balkan and Yeldan, 2002, p.7). Actually, the huge amount of short term capital flows or hot money flow increase risk and instability in an economy and could be forerunner a crisis. In fact, this situation happened in Turkey. In 1994, the crises started.

As it seen in the Figure 1.2, there is sharp increase in portfolio inflows in 1994. It was \$4 million in 1993 while it decreased to \$1 million in 1994. It was huge decrease and created a shock in Turkish financial system. The financial crisis blew up in 1994.

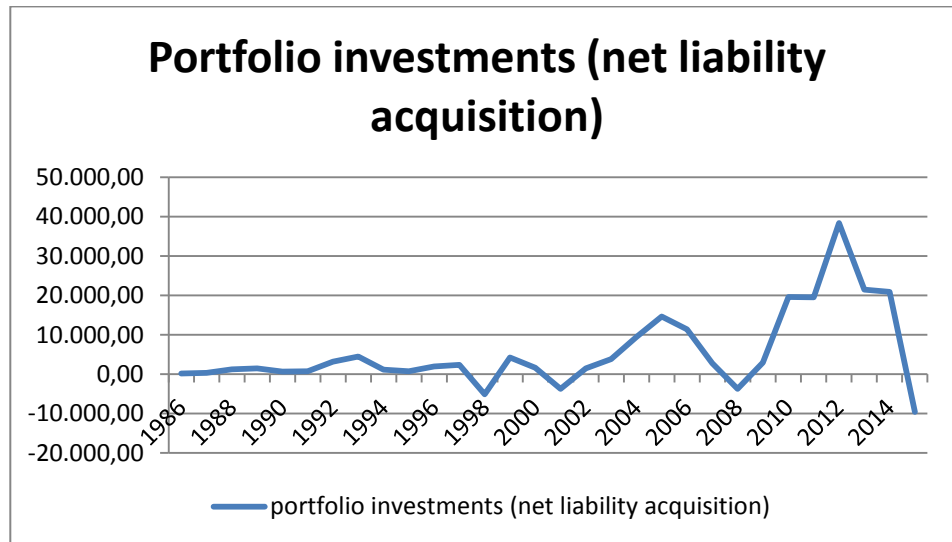


Figure 1.2 Portfolio investment between 1986-2019 (net liability acquisition \$ million)(<https://evds2.tcmb.gov.tr> Data accessed 10.03.2018)

Political instability increased in the period of 1995-1999. The government changed seven times in five years. This instability made economy uncertain and complicated produce long-term policies or apply existing long-term projects. In 1997, economic crises started in Thailand and spread to Southeast Asian countries firstly. After, it impacted Russia and Latin America. Of course, the bad condition of the world economy affected Turkey negatively. The crises affected Turkey after it spread to Russia. Russia declared moratorium because of the Southeast Asia Crises. After that, many countries experienced capital outflows. In 1997, structural problems appeared because the effect of this crisis. The financial market was depressed because of crisis in the international market and tight monetary and fiscal policies were applied in Turkey to

avoid inflation. Because of these two factors, import, export, internal demand and economic growth decreased. In this period, companies gained huge amount of interests but they used this interests to financing public deficit rather than make investment. Also, the banks did same thing, they evaluated government debt securities. Due to the all conditions, financial markets were defenseless to fluctuations (Yazıcıoğlu, 2004, p.263).

Turkey entered 2000s with stability program that was prepared by IMF. This program collapsed half years later and caused big economic crisis. Main aim of neoliberal reconstruction policies was to integrate Turkish financial system to international markets. Two economic crises were added in 2000 and 2001 to most important crisis of Turkey which happened in 1994. However, the relationship with IMF continued after the crises. In the framework with this relationship, maintaining of open economy was considered. Structural transformation accelerated to Turkey's involvement in the international arena. The relationship between IMF didn't change despite two different rulership in the beginning of 2000s (Şiriner and Doğru, 2008, p.174-175). The crisis in 2001 was gotten over with the stability program of IMF. After that, the capital flows to Turkey had increased from between 2002 and 2008. Total capital flows to Turkey reached the highest level in 2007 with \$77 million. The capital flows caused to appreciation of TL and increase in real exchange rate. In between 2001-2007, appreciation of real exchange rate reached 60% between 2000-2007 (Açıkalın and Ünal, 2009, p.43). The global financial crisis in 2008 caused to sharp decrease in the international capital flows (As it is seen in the Figure 1.3). Turkey was impacted this situation. The total amount of foreign capital flows decreased sharply. It was only \$8 million while it was around \$74 million in 2008.

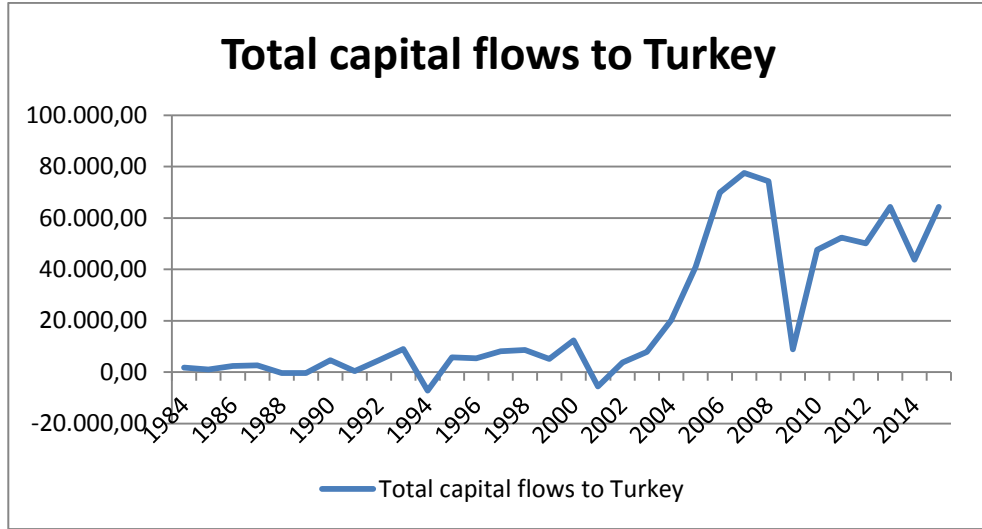


Figure 1.3 Total capital flows to Turkey between 1984-2016 (\$ million) (<https://evds2.tcmb.gov.tr> Data accessed 10.03.2018)

Until 2007, the all financial crises that happened in Turkey depended on internal factors. A lot of countries including Turkey were dragged into crises due to the fact that subprime mortgage crisis in USA in 2008. After 1980, Keynesian ideology was abandoned and new orthodox view of McKinnon (1973) and Shaw (1973) started to rise as it has been discussed and the world entered a new term. After the middle of the 1980s, profit rates of non-financial sector increased with the series of political interventions. The increase in the profits rates was attractive to the real sector so the real sector started to behave like rentier. They started to make financial investment with speculation motive. The profits from financial profits substituted profits from industry. However, the financial bubble encouraged by speculative earnings became instability element (Yeldan, 2009, p.16). The global financial crises impacted macroeconomic condition of Turkey. Financial system was not very fragile. It is compared with previous years and macroeconomic indicators also were stable. Despite these positive conditions Turkish economy was affected negatively. Main reason of this was decrease in foreign demand. Moreover, one of the reasons was inadequacy of savings. Turkey needed the savings of foreigners but resources were exhausted because of financial crises. Hence, Turkey found enough fund to make investment so investment rate stopped. Finally, measures were taken too late and wrong economic policies applied (Özatay, 2016, p.161-162).

After the crisis in 2008, Başçı and Kara (2011) and Kara (2012) indicated that as a result of the monetary expansion policies implemented by central banks in developed

countries, the short-term capital inflows increased the distinction between domestic and external demand. In order to exit from the crisis, the central banks of the developed countries implemented quantitative easing policy has led to a rapid increase of short-term capital flows towards Turkey. While increase in capital flows caused appreciation of TL, it increased usage of domestic loans by facilitating access to credit. Appreciation of TL increased capital account deficit by increasing exportation. On the other hand, credit expansion accelerated domestic demand, so capital account deficit was supported. The rapid deterioration of the current account balance and the increase in the share of short-term capital flows and portfolio investments in financing also raised the fragility of the economy against the sudden changes in the global risk appetite and raised concerns about macroeconomic and financial stability and required an alternative policy approach (Keskin, 2018, p. 169).

1.4. Liberalization of Trade Regime

1.4.1. Definition

Trade liberalization means changing the trade policies of government that restricts trade flows. The policy changes are separated two groups. First group includes price interventions like tariffs, tax, or extra charges. Second group includes nontariff barriers like quotas, license rights, or prohibitions (Xiangming, 2004, p. 560).

Trade openness is achieved by the ratio of exports and imports to national income, which is most commonly known, and generally indicates the degree of integration of the economy to international economies. Trade openness is a concept used to explain the extent to which countries are integrated into other countries with the globalization process. Also, it is concept used to explain which of the countries apply more internally or externally. Globalization of trade means that existing international goods and services flows thoroughly exceed the limits and have increasing trend in the time by liberalization policies by national and transnational actors (Yapar Saçık, 2009b, p. 526-528).

There is consensus about that trade openness is beneficial for economic growth. Increase of imports and exports accelerates growth rate. Exports is main factor to decrease current account deficit whereas transfer of new technology and both physical and human capital are bought by import. Also, purchasing power of consumers

increases thanks to lower price after importation. On the other side, negative effects of international trade on domestic market. Domestic producers could be affected trade openness because of high competition caused by foreign firms. Also, price of raw material goes down because of international trade. The opinions of trade antagonists are confidential whereas opposite views are interesting if the objective is understood. Trade supporters claim that negative effect of international trade on domestic producers can be removed by increasing consumer benefits. Benefits from trade are less noticeable than losses from trade. Moreover, decreasing in price of raw material is a sign of structural change of demand. This change is from agricultural production to manufacturing production, later, from manufacturing production to service sector (Rruka, 2004, p. 5).

Tupy (2005) considered that there are three reasons that explain why voluntary trade is beneficial. First, efficiency in resource allocation in the world is improved by trade. For instance, a glass of water is cheap for people who live near a barrage while it is very expensive for people who live near a desert. The goods and services can be removed to people who give more value to them. Second, trade partners gain from their production which they are specialized to produce it. This is based on comparative advantage. Third, trade is good for consumers because of more efficient production. Wide range of production causes to decrease price of goods and services (Tupy, 2005, p.2).

Kokko et al. (2001) implied that trade regime of the countries affects the characteristics of incoming FDI. Bhagwati (1978) proved that export promoting trade regime increases the amount of FDI inflows while import substituted trade regime discouraged foreign investors to invest. Also with more liberalize trade regime, FDI inflows can be more efficient for growth and domestic market of host country. Under more liberalized trade regime, foreign direct investors tend to invest in sectors that host country has comparative advantages and they acts freely in the market. Because of that investment resources should be used efficiently (Kokko et al., 2001, 125).

In the literature, trade openness is measured by ratio of sum of import and export to GDP. This indicator shows the restrictions on the trade. The effect of trade regime on FDI is based on type of FDI. If the FDI is market seeking, the restrictions can be effect FDI positively. This situation is based on "tariff jumping hypothesis". According to the

hypothesis, foreign investors tend to invest in a country if it is hard to export their product to the country. On the other hand, Multinational Companies (MNCs) that related with exporting prefer to locate in country with more liberalize trade regime. Main reason of this, the transaction costs that related with exporting is high because of protectionist policies (Asiedu, 2002, p. 111). Actually, there is no consensus about positive effect of trade openness on FDI. Import substitution policy can be applied to attract investment to domestic market while export oriented policy that encourages investment for export. Advocates said that trade openness increase FDI because vertical integration of international firms that focused on exporting increase because of decreasing trade costs. Foreign firms prefer to import intermediate goods from a country and to export final goods to another country (Goldar and Banga, 2007, p.9-10). Kumar (2002) said that resources are allocated thanks to the more open market, thus economic welfare goes up. In this line, the efficient economic environment attracts FDI (Zakaria et al., 2014, p. 227).

1.4.2. Transformation of trade regime in developing countries

Adam Smith said that trade creates prosperity. Classical thought continued from the mid- 18th century to mid-19th century. In this period, the theory of absolute advantage that was developed by Adam Smith was the basis of the comparative advantage theory of David Ricardo. Because of that, it is important to examine absolute advantage theory firstly. Smith explains by considering pin production of a firm that division of labor causes specialization so production and efficiency increases. However, he emphasized that the division labor works in larger markets. According to him, if each country manufactures good in the field of expertise, a cross country division of labor takes place. By this way, international trade is beneficial for all countries. Based on this thought, if a country produces a good with less cost rather than other countries, it should be specialized to produce this good to export it. For instance, England sells good X to Argentina and Argentina sells good Y to England according to production cost. If England can produce both good X and Y, trade couldn't be realized. In this case, absolute advantage theory loses its validity (Yapar Saçık, 2009a, s.166). Ricardo realized this weakness of absolute advantage theory, and developed comparative advantage theory. He said that countries can trade even if they haven't absolute advantage. The effect of trade on economic growth is supported by comparative

advantage theory. Thanks to increased specialization and division of labor after trade, export, employment and easy access to technological innovations increase (Kıran and Güriş, 2011, p.70).

Adam Smith indicated that international trade is important factor for growth. However, the theory wasn't very popular in the 20th century because interventionist policies were implemented by nation states. Main aim of developing countries with the interventionist policies was to protect their industry so international trade was restricted for decades. These kinds of policies are known as ‘import substitution industrialization’ strategies. The name of the strategy depends on the study of Raul Prebisch (1950) and Hans Singer (1950). The authors considered two precessors,

- If the industry of the less developed countries couldn't be improved, the gap between less developed and developed countries enlarges. By this way, international price of raw materials and commodities are deteriorated.
- To industrialize, it is necessary to protect newly formed manufacturing industry. It is strongly related with infant industry theory.

Suggestions of Raul Prebisch are accepted by Latin American countries firstly. After that, in 1950s, 1960s and 1970s, a lot of economists suggest protecting their industry and they produced theories about import substitution (Edwards, 1993, p. 1358-1359).

International trade has been carried out for centuries. It reached global dimension after 1870s according to some researchers but some economists think that trade became global after Second World War. After Second World War, GATT was constituted in 1947, global trade increased. GATT determined the rules about industrial products and provided liberalization of trade of these kinds of goods until it transforms WTO. GATT mainly focused on customs tariff. It was decided that the contracting countries would make tariff reductions in industrial products at certain intervals (Yapar Saçık, 2009b, 529).

Trade has been developed since the end of Second World War as mentioned before. However, the bilateral trade agreements covered only industrialized countries until Uruguay Round in 1986. Developing countries have benefited from growth in global trend but they have rarely been involved in bargaining process. This situation

changed in 1994 with transformation of GATT to WTO. After that, some of the developing countries accepted to open their domestic economy to international trade for getting direct entry to industrialized country's market. Other poor developing countries accepted unobtrusive rules monitored by developed countries in time. In 2001, unresolved problems of Uruguay Round were carried out to Doha Round. In this round, the rights of developing countries were given great importance. Because of that, it is known that Doha Development Round. In this round, removing of protectionism on agriculture by industrialized countries was the main subject of discussion so industry and services sector which are more important for developing countries were overshadowed (Caminis, 2007, p. 179).

Following Uruguay round, global tariff on manufactured decreased to 4%. Developing countries reacted by liberalizing their trade regime. Share of manufactured goods in export of developing countries increased sharply in between 1980-2001. However, tariffs on agricultural goods didn't decreased. It was around 40%. The share of agriculture export of developing countries on global trade didn't increase. Protectionism applied by developed countries decreased exportation of developing countries because big part of people lives in rural area. Sometimes, USA, EU, Japan and Canada increased tariffs up to 500% on some goods like vegetables, beef, fruit or tobacco. Despite the fact that Uruguay Round and Doha negotiations, developed countries keep continuing protectionist policies. The bad effects of protectionism on both producers in developing countries and consumers in developed countries were emphasized by world media and some organizations. The protectionist policies negatively affect the poor developing countries first. Adaptation of developed countries to free trade increases world welfare (Tupy, 2005, p.1-3).

The world economy faced big crisis which spreads from financial sector to real sector. The crisis caused to decrease in international trade and FDI. After 2008, economic growth slowed down sharply with decreasing unemployment rate in many countries but it can be said that the most affected are developing countries. Trade and FDIs are important linkages for developing countries to integrate the world so their economies are very sensitive to decrease in international demand. UNCTAD asserted that export of manufacturing goods of developing countries and transition economies

decreased by in the range of 7 to 9% while export of developed countries decreased by around 8% (UNCTAD, 2009c, p. 3).

The Table 1.6 shows that pre and post crises period. The 2008 financial crises didn't cause too much fear in international area as the crisis in 1929-1933. However, import and export decreased in 2009. Export decreased \$16 trillion to \$12.35 trillion whereas import decreased \$16.5 trillion to 12.7 trillion. On the other hand, the growth of trade decreased from 30% to 16% after the financial crisis in 2008. As conclusion, it can be said that wealth from international trade reduced by half after 2008 (Ahmed and Al Gasaymeh, 2017, p. 607).

Table 1.6 World trade in between 2000-2014(\$ million) (Ahmed and Al Gasaymeh, 2017, p. 607)

	Year	Exports	Imports	Trade Balance
Pre Recessionary Crisis Period				
1	2000	6377528.52	6582189.16	-204660.64
2	2001	6128121.85	6357231.91	-229110.06
3	2002	6421953.53	6601585.76	-179632.23
4	2003	7504124.17	7712629.41	-208505.24
5	2004	9117194.55	9436670.00	-319475.45
6	2005	10387032.74	10754351.81	-367319.07
7	2006	12012247.14	12360550.25	-348303.11
8	2007	13880642.57	14269872.04	-389229.47
9	2008	16050749.55	16509170.64	-458421.09
Post Recessionary Crisis Period				
10	2009	12353672.72	12715713.41	-362040.69
11	2010	15104668.61	15449181.71	-344513.10
12	2011	18041680.18	18409549.14	-367868.96
13	2012	18116448.92	18513166.27	-396717.35
14	2013	18479936.87	18730790.02	-250853.15
15	2014	18654397.29	18916181.85	-261784.56

This process after Second World War have aimed to remove the barriers to the mobility of foreign trade and production factors across the world in a way to include all the countries of the world. This process is called as globalization or integration with the world until crisis in 2008 which is second big economic crisis after Great Depression in 1929. In the second process, economic mergers based on geographic proximity, economic, political and security reasons occurred like Latin America Free Trade Agreement (LAFTA), North Atlantic Free Trade Agreement (NAFTA), ASEAN Free Trade Agreement (AFTA), South Asian Free Trade Agreement (SAFTA), Grain and

Free Trade Association (GAFTA). The second process is a process that frees the circulation of goods, services and production factors and in some cases harmonizes economic policies. Free trade area constructed by regional trade agreement which is a part of second process is required to remove custom tax, quota and all other trade blocking factors among the member countries when trading, but they apply independent policy towards non-member countries (Öztürkler, 2010, p. 51).

Developed countries have continued to apply protectionist policies since 2008. Main aim of inter-country cooperation is to enhance mutual benefit as it is also emphasized by WTO and regional trade agreements. Increasing number of regional trade agreement in between 1990-2011 is one of the evidence of this situation. Global Trade Alert (GTA) investigated that amount of protectionist policies have applied by many countries. Moreover, signatories of WTO and regional trade agreements have considered the protectionism. Osabuohien et al. (2014) specified that number of protectionist policies were more than policies aimed trade liberalization. Trade defense instrumentations and measures disrupt international trade was 25% of total measures. Tariff and non tariff barriers are 14% and 13% of these measures in between 2009-2011. Econometric results of the study proved that these protectionist policies effect GDP per capita negatively in 105 countries (Osabuohien et al. 2011, p.21). Protectionist policies were supported by developed countries from 2008 crisis but it didn't become a policy until Donald Trump's presidency. USA has applied the policies because of foreign trade deficits. The country is constantly facing a foreign trade deficit against China. The deficit has increased after participation of China to WTO. The protectionist policies are related with not only governments but also firms, banks and consumers. The policy change impact many indicators such as foreign trade, production costs, and structure of the economy. Because of that, the transformation efforts should be gradually (Çolak, 2018, p. 37).

1.4.3. Transformation of trade regime in Turkey

In Turkey, an industrialization policy based on import substitution was followed until 1980. The strategy based on this policy with planned development accelerated development. Petrol crisis in between 1973-1974 and inflation in Western countries caused disruption of terms of trade and increasing balance of payment deficit. Fixed and adjustable exchange rate policies led to excessive appreciation of TL. In order to

maintain balance, imports were put under pressure and currency controls were tightened. Emphasis on export policies was neglected and Turkey was in a closed economy model against world. Customs reductions, requiring integration with the European Community were deferred, intermediate and investment goods couldn't be imported due to the foreign exchange crisis, production decreased, unemployment increased and scarcities occurred in the country. Along with the decisions of economic stability, all policies pursued were abandoned, and open and liberal policies were implemented instead of import substitution industrialization. Import and foreign exchange controls were terminated by trying to fulfill the requirements of free market economy and export promotion policy came to fore (Karluk, 2007, p. 499).

In the first phase of import substitution industrialization policy, it is planned to produce non-durable consumer goods like food, weaving, clothing within the country. These were accompanied by the production of some intermediate goods like paper, iron-steel, glass and chemistry. It can be said that the first phase of import substitution industrialization policy completed in 1950s. After 1960, it was aimed to produce durable products like refrigerator, washing machine, automobile and other land vehicles. The growth of agricultural sector and opening international market, the change in patterns of urbanization and consumption supported the domestic market to produce durable goods. The production of durable goods would facilitate the overcoming of lack of foreign exchange would increase the possibility of foreign exchange savings, thus reducing the dependence of the economy on foreign markets (Kepenek, 2016, p.392).

The second phase of import substitution industrialization policy was planned development period. For all that, policies weren't economically and technically feasible. The cost of production and the technology used were ignored. Protectionism practiced in Turkey is the absolute protectionism. Absolute protectionism prohibits the importation of the product if the domestic production is enough for domestic demand. In this term, it was emphasized that the protectionism would be temporary. In other words, protectionist policy of Turkey supported infant industry theory. However, USA, IMF and the World Bank didn't support the Turkey's protectionist policy while European Economic Council approached moderately. These policies, which implemented for nearly 20 years, helped to create an industrial foundation but some shortcomings were included. For instance, domestic market was so small. The minimum

production level that makes optimum the average cost of the unit couldn't be achieved. Additionally, each manufacturer comes from a country and there is a main firm in this country. The main firm sends the products which couldn't be produced in Turkey and support technological and production support. This production process was main obstacle to pass third phase of import substitution industrialization process after 1970s (Kepenek, 2016, p.393-394).

In the second half of the 1970s, domestic production of durable goods and intermediate goods reached a certain level. However, the import substitution of investment goods couldn't reach same level. Production of investment good is advanced and strong part of industrialization. Real industrialization is measured by the use of technology, efficiency, cost and performance shown in terms of forward and backward dependence of industrial facilities. The need for external resources of the economy increases in countries where the previous stages are not fully assimilated, the suitable technology for each stage is not used, and the forward and backward link between the sectors is not ensured at the advanced stages of industrialization. This phenomenon had big role in depression in Turkey at the end of 1970s. Increasing oil prices, direct and indirect cost related with Cyprus Peace Operation, internal or external conjunctural factor such as anarchy were also other negative decisive (Şahin, 2012, p. 144-145). Long term absolute protectionism prevents effectiveness and causes monopolies while inefficient production prevents improvements of domestic market. Protectionist policies in 1970s caused a structure which was ineffective in durable goods industry, but which was in monopoly position in the market (Şahin, 2012, p. 145).

In 1980, import substitution industrialization policies were abandoned and growth policies based on exportation was adopted with January 24 Decisions. An exchange policy operated in line with real devaluations; step by step liberalizing import regime; to become a priority for export supported by incentives and subsidies such as expensive foreign exchange, cheap credit and tax refund; the elimination of price controls and subsidies in most of the core goods and policies for narrowing domestic demand are key elements of the January 24 Decisions. In the foreign trade policy, the main direction is towards opening out. Expand trade was understood as entering world markets in industrial products through exchange rate policies that prevented the loss of

very strong export incentives, falling labor costs and the effects of the devaluation in 1980 (Boratav, 2015, p.151-154).

The liberalization of foreign trade regime was maintained at an accelerating pace after 1983, and this trade liberalization process was supported by financial liberalization in 1989. As it is seen in the Table 1.7, ratio of export to GDP tripled in between 1980-1989. Ratio of trade volume to GDP doubled. To increase export, TL was devalued many times in between 1980-1989. By this way, prices of the importation goods decreased. It can be said that main reason of the increasing of export was depreciation of domestic currency. At the same time, price of import good increased so importation of Turkey decreased between these periods. On the other hand, decreasing of formalities about export, decreasing domestic demand and increasing purchasing power of trade partners of Turkey are other significant reasons to increase export. After 1990, foreign trade decelerated. Foreign trade deficit was so high in 1993. As a result of this, credit notes of Turkey decreased and demand to foreign exchange goes up in domestic market. In 1994, big financial crises occurred so purchasing power of people deteriorated. Demand to import goods narrowed seriously. Political problems and continuous structural economic problems effected foreign trade of Turkey in 1990s (Şahin, 2012, p.415).

Table 1.7 Foreign trade values in Turkey between 1980-2017(<http://databank.worldbank.org> Data accessed 19.12.2018)

Years	Export	Import	Trade Volume
1980	5,161932	11,92789	17,08982
1982	11,86405	15,01687	26,88092
1984	15,6066	19,6735	35,28011
1986	13,31244	16,10202	29,41446
1988	18,65397	17,55286	36,20683
1989	16,20292	17,78075	33,98367
1990	13,3651	17,57789	30,943
1992	14,39224	17,34513	31,73737
1994	21,36213	20,38372	41,74585
1995	19,89161	24,35103	44,24263
1996	21,54266	27,82666	49,36931
1998	20,56834	19,70601	40,27435
2000	19,44877	22,55183	42,0006
2002	24,46069	22,99984	47,46054
2004	22,75048	25,3692	48,11968
2006	21,65042	26,50069	48,15111
2007	21,22022	26,06936	47,28959
2008	22,82626	27,08007	49,90632
2009	22,57367	23,3588	45,93247
2011	22,26241	30,40053	52,66294
2013	22,27226	28,07807	50,35032
2015	23,34593	25,95394	49,29987
2017	24,83935	29,3327	54,17205

In international area, there were some important events to integrate trade regime of Turkey to the world. In 1995, Turkey was joined to Uruguay Round that found World Trade Organization. It was aimed that liberalize world trade and improve economic and trade relations of member countries. Other important step was Customs Union Agreement with European Union in 1996. It was shaped trade regime of Turkey in 1990s (Çetin and Savrul, 2016, 512). After 1995, both import and export increase (Table 1.6). The sharp increase in trade volume is seen in Figure 1.4. This is interpreted as effect of Uruguay Round and customs union on trade openness.

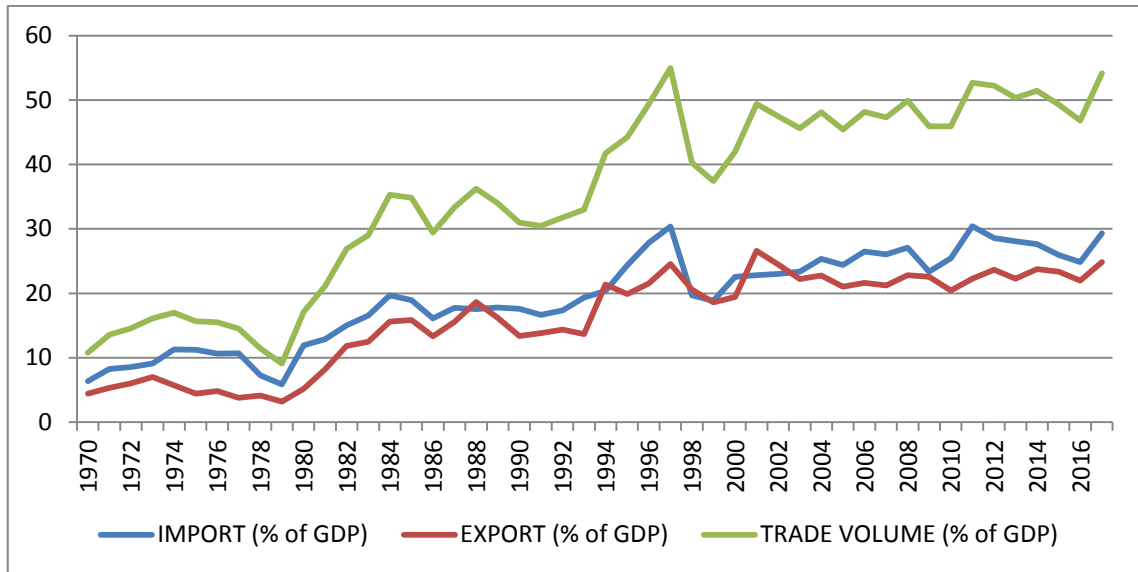


Figure 1.4 Import, export and trade volume values in Turkey between 1970-2017

(<http://databank.worldbank.org> Data accessed 19.12.2018)

Turkey entered millennium with economic crisis which were in November, 2000 and in February, 2001. In 2001, economic growth rate was -9, 5%. In 2002, some steps were taken to remove the negative effects of the crisis. After 2003, Turkey entered into a period of strong growth with the support of global environment.

After 2002, the rapid rise in Turkey's imports and exports, and continued until the last quarter of 2008. Foreign trade figures since October 2008 started to decline. The global crisis, which deepened with the collapse of financial institutions, has also slowed down the economic activities. This negative situation has been reflected in the foreign trade channel. The global crisis has affected the automotive and iron steel sectors, which constitute a significant part of exports, especially in all sectors.

Serin (2001) indicated that the share of agriculture in exports was high before 1980. The structure of foreign trade of Turkey changed because of Economic Decisions of January 24. It is seen that share of agriculture decreased while share of industrial goods in exports increased sharply. In 1990, the share of the agriculture in export was 18.4% whereas it decreased to 7.8% in 2000. In 1990, the share of industrial good was 79% in 1990 while it increased to 91.2% in 2000. Also, Eşiyok (2008) emphasized that important exporter sectors were also importer sectors at the same time. It is important sign the dependence of export on import. Hepaktan (2007) explained the main reason of this with dependence of export goods on intermediate goods import (Özel, 2012, p.87)

CHAPTER II: CONCEPT OF FDI AND FDI HISTORY OF TURKEY

2.1. International capital flows and its components

2.1.1. Phase of investment

Investment means purchasing financial or physical assets. In macroeconomics the meaning of investment is shorter. The investment is the expenditure flows that increase the physical capital stock (Dornbusch and Fischer, 1994, p.331). Investment expenditures include construction of a building or a factory, buying production machines and additions to stocks of companies. However, financial investments are out of this definition. (Yıldırım et al., 2014, p.99).

Investments have two major roles in terms of macroeconomics. First, it is the big part of spending. The huge increase in investment causes big change in aggregate demand. After, output and employment will be impacted from this situation in the short run. Second, investment is important for capital accumulation. Higher investment causes adding to building and equipment. That's why, output of a country increases so economic growth is accelerated (Samuelson and Nordhaus, 1998, p.424).

The term of saving and investment are occasionally complicated. These two terms are indicated carefully by macro economy. For instance, a person buys stock or bond from the capital market of his/her country with their money that he/she doesn't spend. He/she may think that he/she invests but this is saving, not investment. Investment means buying new capital like building or machinery. If a person borrows from a bank and buys an apartment, this is investment rather than consumption. In similar way, a person sells their securities and buys new machinery for his factory, this is also investment. The all cases are example of adding to national investment (Mankiw, 2008, p.563).

2.1.2. Phase of Foreign Capital

Basically, foreign capital means that the economic resources provided by other countries without paying. Phase of "without paying" sometimes means to don't pay the whole (donation) whereas it sometimes means to pay later (capital and investment through external debt) (Şener, 2013, p.7). A part of the foreign capital is financial investments. These include investments in capital markets instruments such as bonds and stocks or investments in short term (money market) instruments such as foreign

treasury bills, foreign exchange, banks, deposit accounts. And the other part includes investments in physical production instruments such as buildings, plants, factories and immovable properties abroad. These types of investments are in the form of production (Seyidoğlu, 2009, p.600).

2.1.3. Types of Foreign Capital

- ***FDI***

It is a direct foreign investment of a company to establish a production facility in other countries or to purchase existing production facilities to spread its production to other regions (Seyidoğlu, 2009, p.600). FDI is defined as a way of international capital flows. It is a mechanism which transfers money from investors to other countries which create high returns. Also, some advanced practices such as technology, know-how, management procedures and some new method about business process are transported by FDI (Zafar et al., 2012, p.678).

In international economics literature, there is no difference between foreign capital investment and FDI. Foreign means that being out of international border of a country. Foreign investment means that a country has current capital stock in other country. Direct means entrance of technology, know-how, management information changing with capital. In Turkish literature, concepts of ‘‘private foreign capital’’, ‘‘foreign capital investment’’, ‘‘direct foreign capital investment’’ or ‘‘direct investment’’ are used instead of concept of ‘‘foreign direct investment’’. In Anglo-Saxon literature, there are some expressions like ‘‘ private investment’’, ‘‘foreign investment’’, ‘‘ direct investment’’, ‘‘direct foreign investment’’ and ‘‘ equity direct foreign investment’’. The term that is accepted by international institutions (like IMF, UNCTAD, Organization for Economic Co-operation and Development [OECD] etc.) is ‘‘ foreign direct investment: FDI’’ (Karluk, 2013, p.755-756).

Some concepts about FDI should be defined (Yaşar, 2013, p.7-8);

- Home country: It refers the origin of foreign investment.
- Host country: It means the country or region investing.
- Foreign direct investor: It is an entity or an institution that is resident in a country and has at least 10% voting power of and company located in another country. Foreign direct investor could be a person, an incorporate or

unincorporated enterprise, a private enterprise or a government unit (OECD, 2008, p.49).

- Net FDI inflow: The difference between FDI flows made to a country and direct foreign investment flows are made by this country to other geographical areas. In short, it is the difference between inward FDI and outward FDI.
- FDI stock: It refers to the cumulative value of net FDI flows made to a country or region over time.
- Direct investment financial transactions: It implies the net inward and outward investment. It shows assets and liabilities according to instruments for any time (OECD, 2008, p.25).
- FDI income: It shows the earnings of foreign investors or of multinational enterprises (OECD, 2008, p.25).

FDIs are made by foreign investors on their own or with local investors. Subject of FDI could be examined by two aspects: host country and foreign investors. Host countries tend to get social and economic benefit from foreign investments. Increasing employment, evaluating natural resources, improving management and information system, decreasing foreign trade deficit or increasing economic growth could be some examples about benefits of FDIs (Karagöz, 2007, p.930). Host countries' other expectations are to create healthy competition in the country, bringing new technologies to the country, to provide political and economic support of developed and exporting countries, promotion, expand the opportunities for entry into foreign markets, bringing know-how, and to improve human resources (Demircioğlu and Çapraz, 2003, p.21).

Traditionally, FDIs are seen as cross border capital investments in balance of payment of The Central Bank. The amount of FDI that is attracted by a developing country is calculated by using balance of payment (Erdoğan, 2016, p.11). FDI is one of the functional subtitles of financial account in the balance of payment. It shows the international investment position. FDI income is sub-title of investment income of the balance of payment (OECD, 2008, p.22).

In recent years, the world has changed rapidly. In this term, the most important element is globalization. Liberalized goods and capital flows in the regional dimension after establishment of three free trade areas in three continents are also main factor of

the globalization. Beside these conditions, developed countries that exported capital and multinational institutions want to save current situation and minimize the risk. Because of the desire to reduce risk, the foreign investors tend to FDI and are very careful to highlight the place that they invest in. The FDI causes to increase the competition between countries with widespread free market economy and decreasing the intervention of the government. Especially, after the changes the regimes of East Europe and Soviet Union and cooperation between Southeast Asian country and America, the FDI has gained much more importance. Increasing alternative to make investment has given multinational investors the opportunity to be selective and search different alternatives (Güneş, 2007, p.13).

Financial markets have become more integrated almost all over the world as a result of liberalization process of exchange controls and market entrances. This situation has caused to increase the competition between economies so new financial instruments have occurred. Also, low transaction costs and broad market access has been provided with the new instruments to attract the investors from other nations. Further, the cross-border investments are supported by advanced technologies, new communication techniques and data processing. FDI has big role in the integrated world. It created direct stable and durable relationship between nations. If correct policies are provided, FDI can support the development of local enterprises and competition environment of both home and host countries (OECD, 2008, p.14). Existence of foreign capital is very important according to neoclassical theory. Today, main goal of developing economies is to accelerate growth and development but they haven't enough capital to do this so they try to attract foreign investment by legal arrangements or liberalization (Afşar, 2007, p.1). Moreover, they have applied special tax policy and different subsidies to attract FDI and FPI (Carkovic and Levine, 2002, p.13).

FDIs have had big share in international capital flows since 1980s. Even though portfolio investments sometimes leave behind the FDI, FDI is most preferred investment type by both developed and developing countries because of staying longer in the host country, contributing economic growth and creating employment (Arıkan, 2006, p.12). In that, capital is limited and necessary factor for all countries especially developing ones so resources have luxury to go to the places with high interest and low risk. At this point, expectations of investor and host country could be different; there is

a possibility of crash of interest. Each side tends to get more interest under bargaining power. For developing countries, FDIs are seen as resources that contribute economic development and welfare. Main reason of this condition is that developing economies don't enough capital accumulation. Therefore, it is expected that foreign investments increases capital accumulation of economy and productivity capacity (Ünal and Açıkalın, 2009, p.1).

One of the important features of FDI is that foreign investors don't only keep the ownership of the company but also control its management at the same time. The subsidiary company can benefit from technology, trade secrets, management information, trade name and other conveniences that are owned by parent company. FDI does not only provide capital transfer but also it provides skills about entrepreneurship and transfer of risk and technology. Thus and so, it isn't considered as financing of establishment and equipment of companies. Because of this role of FDI, it also provides know how and mastery of business, and competition. Moreover, FDI is about industrial sector. It makes easy capital flows between two industries (Karluk, 2013, p.757). FDI has some bad effects although it creates great advantages that increase prestige of the country in the international area besides economic benefits. One of the disadvantages is transfer of any right over the country's capital to the other party through organizations that sell to foreigners through privatizations. The transfer of all rights will cause future generations to have less influence in the strategic decisions to be taken in the country. This could have a negative impact on the country's own security policies (Şener, 2013, p.27). Another negative impact is that FDI can create technology dependence for developing countries. Countries that have become dependent on the technology of other countries transfer their expenditures to these countries. Domestic industrialists who can't produce their own technology lose competitive advantage against MNC in the domestic market. Because of that, they have to close their facilities. Consequently, the economic integrity between the producer and the consumer deteriorates (Şener, 2013, p.28).

The extent to which the FDI affects the economic variables depends on the input of the foreign capital, which sectors it invests in, whether it targets export or external market so it may not respond to all expectations. The effects of FDI vary from the country to the country, from the sector to the sector from the company to the company

and from the period to another period as it is very difficult to accurately measure or estimate the economic impact of FDI. State policies (especially in industrialist countries) has great impact on FDI (Batmaz and Tekeli, 2009, p.1-2).

- ***FPI and differences from FDI***

Portfolio flows take a place in the capital movements in the balance of payments and consist of two main titles: assets and liabilities. Assets part includes securities that are bought and sold by residents. If assets have negative balance, it means buying from abroad is more than selling to foreign market. If assets have positive balance, selling to outward is more than buying from other countries. In liabilities part, there are two subtitles. First is the amount borrowed by banks, public sector and other institutions through bond issuance. Second is to purchase and to sell the securities held by foreigners in the domestic markets (Güneş, 2007, p.16).

The countries which are dependent on foreign portfolio inflows may have to apply and sustain policies that provide trust of foreign investors. Most obvious restrictive effect of portfolio flows is on monetary policies. The most critical factor is monetary policy for developing countries which want to attract portfolio flows. Monetary policies are not important critically in period when portfolio investments are not important and capital flows are depend on donation, credits and direct investments. Foreigners prefer contradictory economic policy because they care about country's risk and exchange rate risk (Esen, 1998, p.62).

FPIs have positive impacts on the economies. Most important benefit of these kind of investments is to transfer of fund from the countries have saving and capital surplus to developing countries that need capital without borrowing (Ünal and Açıkalın, p.16-17). Another benefit is that FPIs can contribute economic growth by increasing liquidity of local stock market. By this way, capital market became more efficient. If a domestic stock market is more liquid, deeper and larger, huge amount of projects can be financed easily. This characteristics of portfolio investments accelerated growth and development (Vita and Kyaw, 2009, p.277). FPIs have great importance in terms of finding financial resources, even if they are temporary (Şener, 2013, p.12).

FPIs have some drawbacks. These investments are able to travel around the world in a very short time. When this situation integrates with limitless developments in

computing and communication technologies, the damage that will cause is sinking. Speculative investments, in combination with frustration, abandon the place of immediate danger because of limitless height in the ability of the financial capital to move. This situation causes an upset economy and a great deal of negativity (Batmaz and Tekeli, 2009, p.9). This is because of mobility of portfolio flows. As the conditions in the country move away from investor expectations, FPIs with other short term mutual funds will soon leave the country. The sudden and large massing of this outflow increases the pressure on the foreign reserves of the host country, causing economic instability to easily turn into financial crises (Seyidoğlu, 2009, p.603).

FDI and FPI are different terms. Indirect investment or FPI means that when a foreign investor are purchasing stocks, investments funds, company bonds and government guaranteed bonds/bills that are traded in stock exchange of a country. In FPI, the investors mainly focus on rate of return of securities. Capital appreciation is another motive for foreign portfolio investors because they want to diversify their portfolio according to condition of local currency, country or industry. Also, FPIs are more liquid if we compare it with FDI. FPIs are based on short term instruments like equities or debts. Bonds and notes are relatively long run instruments. These instruments can be easily translated into another so liquidity of them is high(UNCTAD, 2009a, p.17). That is to say, it can be said that FDI is more permanent if it is compared with FPI or short term capital flows (Agbloyor et al., 2013, p.119).

According to UNCTAD (2009a), there are two important differences between FDI and FPI. First is that a resident of a country invest in another country and the investments in long term and long lasting in FDI. Second is that the foreign investors have great managerial authority and the investors must have 10 percent voting share in FDI. This is the lower limit of voting power of foreign investors (UNCTAD, 2009a, p.35).

Arıkan (2006) suggested that one of the differences between FDI and FPI is structure of capital. Foreign investors bring production technology and managerial knowledge and important innovations that are necessary for developing countries beside physical resources. On the other hand, FPI contributes with capital. Another difference is that foreign direct investors take an active role in management because the investor has at least 10% of shares of the company. Portfolio investors don't take a share in

management even though they have shares of the company. Here, these two investors are different from each other. Foreign direct investors generally invest in companies that produce goods and services while portfolio investors invest in financial companies (Arıkan, 2006, p.12). In other words, foreign direct investors act as manager while portfolio investors couldn't act as a manager (Erdoğan, 2016, p.5).

Goldstein and Razin (2005) indicated differences between FDI and FPI in their study. They construct a model that highlights differences between FDI and FPI. Foreign direct investors have all managerial controls and ownership. On the other hand, foreign portfolio investors have ownership but not managerial control on the firm. They can take part in management but their role is limited. In short, FDI is more efficient than FPI in terms of control in administration of the firm. Because of this reason, foreign investor is more informed than portfolio investors about their projects about the firm so they can operate their projects much more efficient. This condition creates great advantages for foreign direct investors with added value in capital market. On the other hand, this situation creates some costs like asymmetric information problem. If foreign direct investors want to sell their products before maturity, they can get low money. This is because, they are well informed. If potential buyers realize that the foreign investor is well informed, they can be in doubt about the sales arise from wrong information on the prospects of FDI. Then, they don't want to pay too much for the products. This is called liquidity shock. The model shows the tradeoff between managerial efficiency and liquidity shocks.

Differently, according to Afşar (2007), FDI and FPI aren't too much different. There are some significant differences between them. Foreigners invest their capital to securities like shares, stocks, Treasury bills and bond of host country to gain interest. Namely, interest rate is decisive to take FPI. It can be said that FPI is much more complex than FDI.

2.2. FDI

2.2.1. Types of FDI

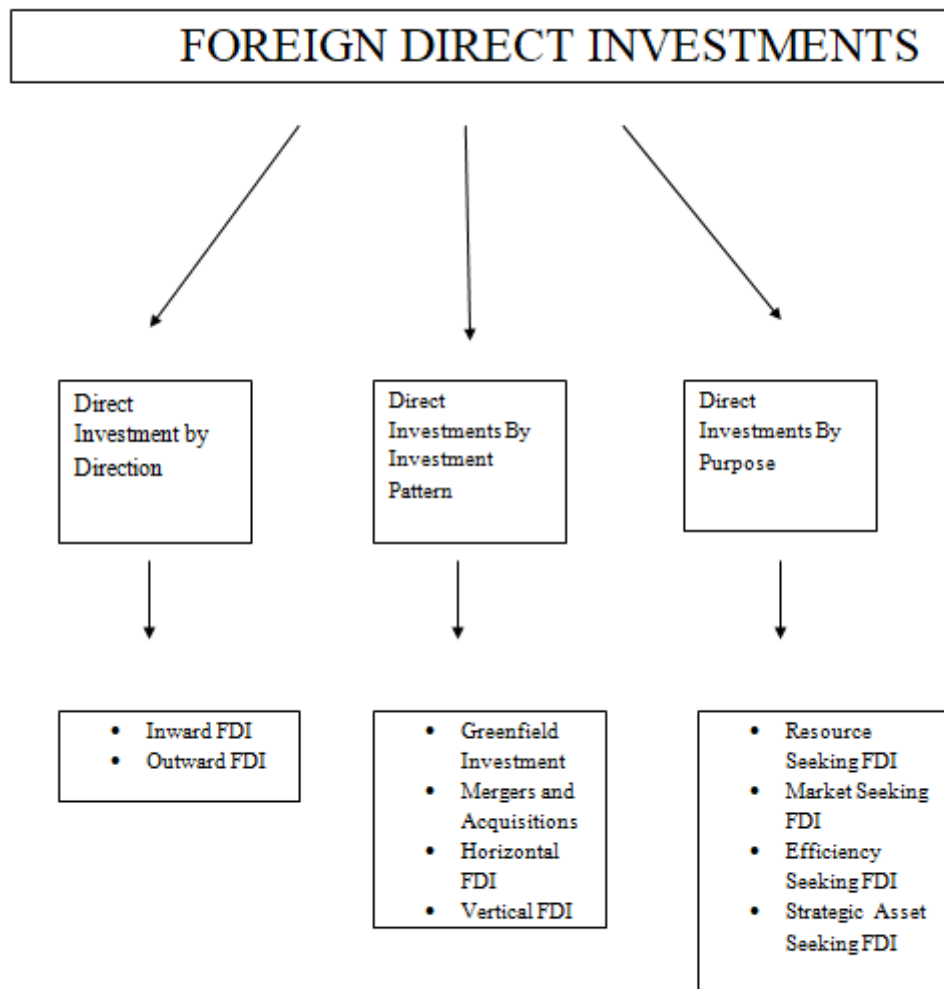


Figure 2.1 Types of FDI (Mucuk, 2011, p.15)

FDIs by direction;

- Inward FDI: It means flow of FDI to a country or region from another countries or regions.
- Outward FDI: It means direct capital flows from a country or region to another geographical areas.

FDI by investment pattern;

- Greenfield investment: It means to establish a new factory or capital facility starting from basic.
- Mergers and acquisitions (M&A investments): It means to take over an existing facility in a country. It happens in the form of mergers and acquisitions. Company mergers are also known as marriages of companies. The two companies merge into a single company. In the acquisition case, a company buys all or most of the shares of another company in the foreign country. M&A investment doesn't increase capital stock while green field investment accelerates it (Seyidoğlu, 2009, p.601).
- Horizontal FDI: It happens when a foreign company makes an investment in the host country to produce same product (Root, 1990, p.622).
- Vertical FDI: It happens when a foreign company makes an investment in a business that has a role as supplier or distributor in the production (www.investopedia.com, Data accessed 7.6.18).

FDIs by purpose (Dunning, 2002, p.231);

- Resource seeking FDI: These kinds of investments bring complementary assets like advanced technology or administrative skills. Accessibility to international areas gets easy and production quality increases.
- Market seeking FDI: These investments bring complementary assets and production quality as resource seeking investments. They develop backward supply linkages and export labor market clusters. They also improve agglomerative economies². Further, expectations of domestic consumer of domestic opponents. Entrepreneurship and domestic competition increases.
- Efficiency seeking FDI: Efficiency seeking investments develop international division of labor. Cross border network is improved. Last, they increase comparative advantages of host countries. Also, availability of foreign markets and source of supply is provided. They develop backward supply linkages and

² Agglomerative economies refer local economies where a large number of companies, services and industries are very close to each other. Because of the situation, costs decrease so efficiency increase.

expert labor market clusters like market seeking investments and production quality raise like resource seeking investments. Structural adjustment is aimed.

- Strategic asset seeking FDI: Financial capital and complementary assets are provided by these investments. Entrepreneurship and domestic competition is accelerated like market seeking investments. International divisions of labor and cross-border network are developed as efficiency seeking investments.

2.2.2. Theories about FDI

2.2.2.1. Neoclassical theory

After Second World War, the FDI gained huge popularity between industrialized countries. In those times, the economists that advocated neoclassical theory approached the foreign investment by considering the arbitrage of capital. It was assumed that there was perfect competition between countries and there wasn't transaction cost. More, transactions were made by independent buyers and sellers and MNCs didn't exist. Under these assumptions, the neoclassical theory defined foreign investment based on differences of interest rates. The place with high profit attracts more foreign capital. In other words, high interest rates are attractive for foreign investors. However, this theory can't define FDI. It is more appropriate for portfolio flows (Karataş, 2005, p.29)

2.2.2.2. Industrial organization theory

In 1960s, the neo classical theory was criticized. The reason of this is that the theory is not appropriate for the FDI. The theory is ignoring MNCs and market imperfections. Stephen Hymer is the first economist that realized that the FDI is different from the FPI. He defined different FDI theory from neo classical theory. He is the first person that takes into account the MNCs when thinking about foreign investment. And then, he developed the industrial organization theory. According to this theory, MNCs are based on market imperfections. Foreign companies face more risks than domestic companies when they invest because of different language, culture, laws and high risk and other foreign conditions. That's why; foreign investors should have some advantages to invest other countries. According to Hymer, these advantages are based on Joe S. Bain's list of barriers to entrance. Economies of scale, advantage of cost and information, differentiation of product, accessing to credit are taking into consideration. MNCs are going to invest abroad thanks to these conditions. Also, they

close markets and increase market power. Actually, FDI is a good way to immortalize monopolistic power of MNCs internationally (Karataş, 2005, p.30).

Industrial organization approach to FDI suggests that foreign investors in manufacturing sector can compete domestic companies easily although domestic firms are well informed. Main reason of this situation is that foreign companies have more productive assets. These are technological know-how, management skills, organized relationship with customers, prestige and export linkage (Aitken and Harrison, 1999, p.607). Also, this theory suggests that foreign companies dominate domestic firms because of monopolistic power. The factors that provide monopoly power are only for the foreign company. Other companies in the market can't benefit from them. This theorem explains foreign investment with the lack of competitive ranks in the foreign markets in which these firms operate. Factors such as vertical integration, horizontal integration, non-transferred information, and utilization of the company's name, model of product life cycle creates monopoly power (Seyidoğlu, 2009, p.608).

2.2.2.3. Product cycle theory

Product cycle theory was developed by Raymond Vernon in 1966 by focusing on manufacturing sector of USA. According to Vernon (1966), the product has three cycles: the new product, the maturing product and the standardized product. In new product cycle, scientific knowledge and access to scientific knowledge is important for entrepreneurs. In this stage, producers can face with some serious and transient problems about new product. Inputs, processing and specification of the new products can be comprehensive so the new product gets unstandardized. In this stage, several locational implications exist. First, the entrepreneur is free about changing the input of product according to price of inputs. Also, the price elasticity of demand is so low by individual companies to the new product. This condition leads product differentiation or monopoly advantage in early stage. Third, rapid and efficient communication is required for producer with customer, supplier and rivals (Vernon, 1966, p.195). After the increase the demand, the product started to become standardized but product differentiation continuous. The rivals avoid price competition. Further, variety emerges because of specialization (Vernon, 1966, p.196). And then, knowledge get free, so individual producers started to produce the highly standardized product (Vernon, 1966, p.202).

In short, life cycle started when a different product enter the market. Initially, this product is special and the producers have monopolistic power. In second stage, the competitors started to imitate this product so the product loses its originality. A few company started to sell this product but the individual producers continues to differentiate this product. In last cycle, a lot of companies enter the market and sell this product; it loses its originality and become standard. At this point, after, brand competition ends, price competition starts (Root, 1990, p.125).

It is known that a new product suddenly appears, mature and disappear. Main theories of international trade and investment accept it. Hume, Ricardo, Marshall, Ohlin, Williams and other international economists took into consideration this situation. The product cycle hypothesis is based on this. According to this theory, companies started to invest in new product in a country by considering monopoly advantage. In the case of lack of the advantage, they endure unwanted costs. Condition of the home country has important role. It encourages the innovating firms in the home market. For this, scientific knowledge and skilled engineers are required. This necessity has tended to eliminate some places in emerging markets and has restricted the choice to some places in the developed countries (Vernon, 1979, p.255-256).

2.2.2.4. *Internalization theory*

In 1976, Buckley and Casson suggested that deficiencies of product cycle theory of Raymon Vernon can be eliminated by internalization. According to this approach, transactions that occur through trade on the market sometimes are very costly because of difficulties in setting prices in the market. In such cases, it is more economical for the firm to internalize these transactions in its own context. It is advantageous in terms of operational costs if the company use resources that can't be exchanged on the market, but which the company has developed in its enlargement process. By creating an internal market through internalization, the firm relieves itself of the adverse effects of stalled competition. It is the most important condition for companies that the benefits of the internalization are greater than its cost. The optimal scale of the firm is realized where the marginal utility and marginal cost of creating more internalization are equal to each other (Batmaz and Tekeli, 2009, p.33).

Internalization theory suggests that if a firm chooses to produce in its own country and export its products to foreign markets, it must choose internalizing distribution service of the market or an agreement based on contract with an independent company or distributor. If a firm chooses production in its own country but rejects to export its products, it has an alternative to sell its advantages to foreign enterprises through licensing or management agreements (Batmaz and Tekeli, 2009, p.34). According to this theory, FDIs are more advantageous than export and licensing in operating foreign resources. Transactions that are occurred by trade are sometimes costly so it is more economic to internalize these costs for companies (Erdoğan, 2016, p.36).

2.2.2.5. OLI Paradigm

Dunning (1981) suggested that only one theory can't explain the FDI. He developed an eclectic paradigm to reconcile the different theories about foreign investments. International production occurs only when ownership, location and internalization advantages are provided. Ownership advantage means that a firm possesses some important factors about production like patents, labor, technology, control on the market, managerial skills etc. These specify the competitive power of this company. Location advantage related with accessibility of inputs. It involves natural resources, raw materials, location, economic and political condition, culture, trade regime, and transportation costs and so on. The internalization advantage related with market imperfections (Blomström et al., 2000, p.4).

Lall (1980) mentioned that the eclectic theory puts forward that the three factors, ownership, location, internalization, determine net FDI position of countries. Ownership specific advantages imply that the enterprises have or obtain assets or rights that foreign investors can't have or not obtain. The assets are very special for the investors which possess them. Additionally, at least one of them can be transferrable in international area (Dunning, 1981, p.30-31). The second advantage, the internalization advantage, is that the enterprises can sell their assets or rights to the firms located in other countries or internalize the use of these assets or rights to provide the best interests. According to last advantage, entrepreneurs can determine where to produce for profitable production outside from their home country. The main estimation of the eclectic paradigm is so simple. If a firm in a country gains more ownership specific advantage than a firm in

another country, this firm have more chance to internalize its use. Also, the more they make efficient production in a foreign areas, the more they are connected international production (Dunning, 1981, p.31).

2.2.3. Main Indicators of FDI

Many conditions can affect FDI inflows in developing countries. Some countries don't have any controls on these flows whereas some countries put restrictions. There are a lot of kinds of these restrictions like making the entrance to the market difficult, complicated confirmation process, tax burden, complicated subsidy policies and restrictions of the share of ownership, sage of land and immigrant worker. The countries have such reasons to put restrictions on foreign capital. These reasons are related with exorbitance foreign affect and loss of national wealth. Willingness to support domestic entrepreneurs and employees and willingness to get transfer of technology and administrative knowledge can be other reasons (International Finance Corporation [IFC], 1997, p.2). However, nowadays, most of developing countries have eliminated the all restrictions. On the contrary, they have changed their policies and regimes totally.

More liberal trade, payment and importation policies lead to foreign investment and production for abroad. Also, excess state intervention is significant decisive factor of FDI. Price controls, request to collect more rents from natural resources, monopolies and existing great amount of government's enterprises. It can be said that privatization incentives are more attractive conditions relatively state controls. It is indirect positive effect on FDI (IFC, 1997, p.3). Moreover, a lot of macroeconomic conditions are necessary FDI like low taxes, appropriate incentives, inflation, quality and cost of labor etc. Developing countries have changed their policies in this direction. However, some of them get considerable amount of FDI like China and India. On the other hand some of them couldn't attract large amount of FDI. There could be a lot of reason of this situation. Hussain and Kimuli (2012) evaluated that market size is the most important condition for FDI. Also, financial integration, labor force, good institutions are determinant of FDI. Location, managerial skills and economies of scale are other important determinants of FDI that is indicated in literature (Busse and Hefeker, 2007, p.397). On the other hand, wage is also important factor for MNCs that especially

produce labor intensive products. Cheap labor is significant for future growth rate of the investment because of cost minimization (Agarwal, 1980, p.762).

Kar and Tatlisöz (2008) separated the factors that affect FDI as pull effects and push effects. Regional trade agreements and diminishing profitability in developed countries are example of push factors. On the other hand, pull effects are based on internal dynamics of host country. Elimination of all control on capital movements and financial liberalization, developments in transportation and telecommunication, undiscovered developing markets, cheap raw materials and labor, tax rate, foreign exchange policies, subsidies, privatization practices, macroeconomic stability, quality of bureaucracy and politic stability. Özcan and Arı (2010) suggested that foreign investors prefer countries with high growth rate because of appropriate market condition and high profitability. Also, appropriate infrastructure (like developed transportation and telecommunication) and inflation rate are significant for FDI.

2.2.3.1. Financial system

Almost all country in the world, particularly emerging markets, makes an effort to attract FDI inflows. It is understood from the liberalization and deregulation process about foreign trade by these countries but the kind of reforms differs from country to country. Competitive capacity of countries about attract FDI is determined by a lot of factors such as economic and politic condition or market infrastructure. Also, condition of financial system is very important when FDI is the topic and its effect to the host country's economic growth. Saving and investment are mobilized, new occasions are created in business sector and trade of new securities can be easy and allocate capital efficiently under favor of financial intermediaries. Financial system is mechanism that raises the inflow of FDI that is useful for countries (Kaur et al., 2013, p.729).

The accessibility and qualification of local financial system might affect foreign capital flows and diffusing of technology in host country. This propagation operation could be more convenient in a country which has well developed financial system. This causes MNCs that invested before increase their investments in host country. More, regional entrepreneurs can be modernized and be encouraged to adopt technologies thanks to financial system development. If a country develops its financial system, risks related with changing technology from old to new will decrease. Foreign companies can

borrow from financial market for their innovative activities if financial system is well developed. By this way, technological exogeneity to regional company may be increased (Ayouni et al., 2014, p.678).

2.2.3.2. Political and macroeconomic condition

Financial development has critical importance for countries but it is not enough. Political stability is important as well as financial development. Political stability can make certain to decrease expropriation risks and government could support reliable financial development. By this way, appropriation of technological innovation could be accelerated and spillovers can be assimilated. Finally, confidence of investors is provided and more FDI is attracted to countries (Dutta and Roy, 2011, p.6). Rapid and steady real economic growth, low interest rates, predictable inflation rate, stable exchange rate and stable fiscal and monetary policy are necessary. The instability of these indicators affects structure of politic and economic condition of the countries negatively so they are not so attractive for foreign capital (Demircioğlu and Çapraz, 2003, p.31).

The political stability becomes very important factor when a foreign investor invests in a developing country. The investment risk includes reflects total of economic, social and political risks. Political problems create an atmosphere of insecurity. Because of this negative condition, foreign capital flights to alternative country that hasn't political problems. High taxes, restrictions on investments rates and transfer restrictions impact foreign investors negatively. Also, political instability covers continuity of state policies. Unstable changes in country policies as a result of frequent changes in government reduce international confidence in the related country (İMKB, 1994, p.50). The first step to provide stability and establish macroeconomic balance is to close financial deficits. First way to close financial deficits is to decrease expenditures and increase income. To do this, it is required to decrease public expenditure, simplify the tax system and establish mechanisms to prevent tax evasions. The dynamics that make the economy more efficient regulate the market and increase exports depend on success in structural changes such as privatization. Not only stability but also structural reforms necessary to integrate the economy into the world and its success will accelerate the development of national economies and participation in world economic integration (İMKB, 1994, p.57).

Affects of FDI and FPI on national interest rate and exchange rate could impact economic policies about growth, productivity and employment positively only if sustainable macroeconomic stability is provided. On the other hand, stable macroeconomic condition and sustainable economic growth is necessary to attract FDI and FPI for long run period. In this framework, economies should provide macroeconomic stability and sustainable growth (Başoğlu, 2000, p.98).

2.2.3.3. Market Condition

The reason for companies to produce in other countries is to seize new markets, to protect and increase existing market volume and to benefit from scale economies. The biggest advantage of the country that wants to attract FDI is having a large market. Market size is measured by GDP per capita of host country. According to generally accepted market size hypothesis, the growth of the market in the host country, and thus the increase in demand, leads to an increase in direct investments. The increase in demand will enable the company to benefit from scale economies which are extremely important in terms of increasing sales and reducing costs. At the same time, having monopoly power in the invested country will enable companies to profit at a high rate when combined with the market size factor. The lack of population and the low purchasing power make the market even smaller. The fact that there is no consumer group that has enough income to buy goods produced in a country has negative impact on FDI inflows (Batmaz and Tekeli, 2009, p.21)

2.2.3.4. Protection of intellectual property rights

Protection of intellectual property right (IPRs) is important for international investment. Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) was introduced by WTO in Uruguay Round in between 1986-1994. It was added international trade system in 1995 as an agreement that arrange IPRs related with trade besides other topics in the WTO. Main aims of the agreement are to decrease obstacles and irregularities in front of international trade and to ensure that the procedures and measures for the implementation of IPR do not constitute an obstacle to trade (www.telifhaklari.gov.tr, Data accessed 7.6.18). Although, TRIPs is introduced, many developing countries are reluctant to improve their legislation about IPRs because they are afraid that losses will be much more than benefits. If protection of IPRs is undeveloped in a country, imitation production will increase. Because of this condition,

host country loses attractiveness for FDI. Also, increasing imitation hurts firms' ownership advantages. Also, host country loses its localization advantages because of underdeveloped IPRs legislations. In other respects, if legislations of protection of IPRs is well-developed, preferences of MNCs can be recorded in that country (Javorcik, 2004, p.39-40).

2.2.3.5. Trade policies

A liberal trade policies and payment system is very important factor for accelerating FDI to the countries. A liberal trade regime lets the companies to produce a lot of goods and services and to export them freely and a liberal payment system let the foreign investors repatriate income. Between 1950 and 1970, import substitution was popular in the world, especially in Latin America so FDI was impacted from this strategy negatively. It was limited because of trade restrictions. This condition created high costs for the host countries and production become inefficient. Also, prices became high and competition in local market decrease because of trade barriers. These cause to decrease in economic welfare. Emerging markets should construct suitable trade regime to let the foreign investors to produce goods and services. After trade liberalization is the good way that investors can find inputs for production at international price (IFC, 1997, p.33-35)

2.2.3.6. Privatization

According to IFC (1997), privatization has large effect of FDI. There are two ways of privatization. First is direct sale of individual enterprises. Second is asset transfer to general public. Foreign investors can interfere directly by direct sale of enterprises. Transferring assets limits the response of foreign investors but it doesn't mean foreign investors are excluded from management. However, foreign investors can be limited in direct sale by some specific arrangements. For instance, sales can be separated for domestic investors, employees or other domestic institutions. On the other hand, some shares can be reserved for foreign investors with other potential owners. Occasionally, the state wants to only a part of the enterprises. In this case, political connection has play role (IFC, 1997, p.44).

2.2.3.7. Taxes and subsidies

Tax rates are an indicator of whether or not to invest. Sometimes, tax level impacts location of foreign investments so the state of developing countries must determine effective tax rate for attracting investment or provide incentives. However, occasionally, foreign investors gain too much rent because of monopoly power or holding nonrenewable energy resources so some governments apply high taxes to control the rent of the foreign investors. This is good way if the investor gain satisfying rate of return (IFC, 1997, p.45). Certain tax incentives for FDI are (Aktan and Vural, 2006, p.44-45);

- Corporate taxes targeting specific economic activities and types of business,
- Investment subsidies,
- Tax holidays (tax exemption or discount for a certain period of time),
- Tax deductions for non-distributed and re-invested profits,
- Low taxation on profit transfer to mainland,
- Discount on real estate tax,
- Discount on tariffs,
- Creation of special economic zones.

Taxes and tax policies have great importance for FDI. Because of restriction of all controls on foreign trade and liberalization policies, impacts of taxes have increased. After globalization process, export has become significant for countries so international differences in taxation are also important. Economic integration enables to provide whole demand of goods and services from single place through removing all obstacles to investment and trade. The incompatibility of tax laws could affect FDI negatively. Actually, main effects of taxes on FDI can be grouped by several titles (Aktan and Vural, 2006, p.40);

- Corporate tax is so important for FDI,
- Taxation of profits can affect location choice of FDI,
- Negative effects of the income tax and social security contribution on FDI based on increase or decrease labor costs,
- Consumption taxes like value added taxes doesn't impact FDI,

- Foreign trade taxes have two influences; first is high tariffs encourages FDI because they increase the cost of export and protects the opponents after the investment takes place. Second, if investment and capital goods are subject to higher taxation, costs will be high and FDI are discouraged.

2.2.4. Main impacts of FDI

With the globalization of capital, capital flows between countries is also accelerated. Entrance to market by FDI has a lot of advantage because importation includes transportation costs. This investment is useful for not only home country but also host country. According to growth and trade theory, capital flows increases GDP per capita in host country. Easy access to technology is the main source of sustainable growth. Further, FDI causes risk sharing between home and host countries. This situation makes FDI more attractive than borrowing. In short, FDI has some advantages like market discipline, technology and managerial expertise transfer and risk sharing (Özcan and Arı, 2010, p.66). After the entrance of MNCs to domestic market, local firms can benefit from them. For instance, domestic workers can have a job in these companies. By this way, valuable information about working may be collected by employees. When the experienced workers leave the work, they can use the knowledge in a domestic company. Therefore, productivity of domestic company will increase. In a similar ways, some company specific information of multinational firms can spillover to local market because local companies are impacted from innovative products, improved products or managing skills. Also, they can take technical support from foreign firms. Moreover, MNCs can be single source of demand for input. This is the upstream benefit for domestic company so they can sell all products to foreigners and maintain the commercial relationship. The all cases are main benefit of MNCs to domestic sector by increasing productivity (Aitken and Harrison, 1999, p.607).

Foreign investment doesn't have same effects on macroeconomic indicators all the time. GDP refers income that is gained by residents and non residents in a country. On the other hand, GNP is income that is gained by citizens living in the country or abroad. For instance, Ford Motor Company open a factory in Mexico, the income that is generated by that factory accrues to people don't stay in Mexico. In short, FDI increases the GDP while the increase in GNP is less than increase in GDP. FDI is significant way to accelerate economic growth. Although, main benefits go to the mainland of the

investments, FDI increases the capital stock, productivity and wages. Moreover, under developed countries learn the state-of-the-art technologies that are developed by developed countries. That's way, a lot of economists support the less developed or underdeveloped countries to attract investment from abroad. This requires abandoning all controls on foreign ownership on local capital. The World Bank is significant organization that encourages the foreign investors to invest in underdeveloped countries. It collects the funds from developed countries and utilized these funds from the poor countries. By this way, poor economies can build new roads, schools or hospitals by these funds. Furthermore, the World Bank informs the less developed countries how to best use the funds. The IMF is another important organization that was established with the World Bank for achieving the same goal (Mankiw, 2008, p.543).

2.2.4.1. Some positive impacts of FDI

- On technology;

In the economic literature, it is emphasized some spillover effects of FDI. FDI leads technology transfer from developed countries to developing countries. Number of new process can be increased, production becomes more efficient and varied market opportunities occur under favor of FDI. Actually, FDI is seen as transmission mechanism of technology (Zenasni and Benhabib, 2013, p.3). Technology is transferred from developed countries to developing ones by FDI which is very strong mechanism. Because of this reason, FDI is seen as a source of industrial development for host countries. It could be said that FDI impact production and competition positively and create new opportunities for labor force in host countries (Ayouni et al., 2014, p.677).

- On financial system;

FDI could stimulate some arrangements about financial markets and lead financial markets to be more transparent and depth. More, if financial markets are well developed, FDI fronts more productive sectors and then creates more profits for investors. Thus, country attracts more FDI (Otchere et al., 2016, p.651).

Many economists suggested foreign capital flows are very important to improve mostly the elite-managed financial system. To stay alive in the competitive financial system including foreign investors, these domestic elites have to support necessary

financial regulations. By this way, domestic financial market is going to be improved. Financial system infrastructure regresses if it totally depends on political intention. The incumbents who have a good position and maintain it create danger for market. They are opposite for financial markets because it is threat for them. Free financial market creates new opportunities and new sources to new investors and markets get more competitive (Samadi et al., 2011, p.445). Despite local governments are suspicious about advantages of foreign capital flow, many economists realize the importance of this issue. The specific benefit of this subject is that money goes to countries which create high return. Unrestricted capital flows make easy to get financial market international. There are lots of methods for capital flow; FDI is one of these ways. FDI promotes globalization and integration process of financial markets (Zafar et al., 2012, p.678).

Moreover, if foreign companies invest in a country, the investors want to use domestic financial market. Most probably, they will have a local bank account and the funds of these accounts will be used by local banks for lending. Because of these bank accounts of investors, huge amount of funds could be available for banking sector. Moreover, these investors will demand higher quality financial services so banking system can improve its services and be compared international area. It can be said that financial system improved by foreign direct investors (Agbloyor et al., 2013, p.120).

- On economic growth;

Foreign capital contributes capital accumulation of host country indirectly (Seyidoğlu, 2009, p.618). It is not rejected that FDI is very important growth enhancing factors for countries especially after recent globalization process. FDI could accelerate growth process of the host country by a lot of ways. For example, market become more competitive, innovations can spread easily and economy can be developed. Moreover, transfer of technology to the host country is provided by FDI under favor of interactive relation between multinational investors and domestic suppliers, clients and mobility of employees. But the developing recent condition might prevent to take advantages of FDI according to recent literature. For this reason, developing economies have to developed technology, labor force and substructure (Al Nasser and Gomez, 2009, p.60-61).

- On balance of payment;

Generally, FDI projects contribute the export of host country or provide substitution of imports of certain products with domestic production so entrance of foreign exchange to the country increase. This condition effects balance of payment positively (Aktan and Vural, 2006, p.62). Foreign capital increases the capital accumulation of the host country because of the initial capital and re-investing their profits. The foreign exchange that comes with foreign capital provides long-term import substitution and export boosting effects. By this way, balance of payment of capital importer country can be improved (İMKB, 1994, p.28).

Less developed or developing countries attract importance for production of foreign companies when they are allowed to invest. Foreign companies have extensive experience about foreign markets and sales and marketing channels in the world. The host country wants to increase its export by utilizing from these characteristic of the foreign firms. Also, the foreign currencies brought by the foreign capital help to improve the balance of payments of the host country by creating import substitution and export enhancing effects in the long run. However, profit transfer made abroad also negatively affect the balance of payment so the host countries generally make restrictive arrangements for profit transfer of MNCs (Seyidoğlu, 2009, p.619).

- On wages;

Foreign-owned firms pay higher wages more than domestic firms because of many reasons. In general, foreign firms are in high wages sector in an economy. They are more sensitive to employ high quality workers with higher education unlike domestic firms and these firms produce capital-intensive products and use intermediate goods intensively in their production. Also, the high wage could have spillover effect on domestic industry. Existing of foreign firms could increase average wage level (Lipsey, 2002, p.57).

2.2.4.2. Some negative impacts of FDI

FDI don't have positive effects all the time to host country. Sometimes production can be reduced because of MNCs, especially, in the short run. Because of the fixed costs of imperfectly competitive firms, MNCs will increase the production

relatively. They have this incentive because they have lower marginal cost. With the entrance of foreign company to the local sector, they can dispose the customers of domestic company. That's why, production of local company decreases. After the decrease of production, the fixed costs of local firms spreads over smaller market so their average cost curve go back up. If decrease in production because of demand effect is huge, net domestic productivity continues to decrease. Positive spillover effects couldn't change this (Aitken and Harrison, 1999, p.607).

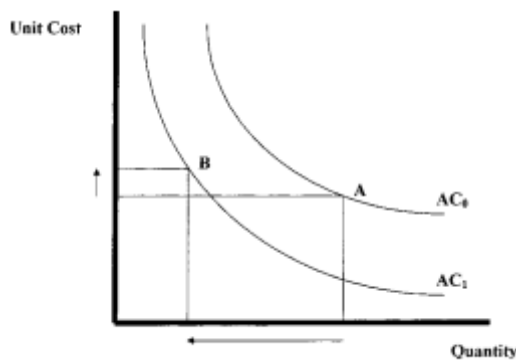


Figure 2.2. Response of domestic firms to foreign entrance (Aitken and Harrison, 1999)

Negative effects of foreign entrance cause to shift AC curve from AC_0 to AC_1 while the positive effects of MNCs cause to shift AC curve shift from AC_1 to AC_0 (Figure 2.2).

FDI causes to increase of foreign control over the economy. FDI, which is accepted without being bound by a plan, can take over the main sectors and control the economy. Huge capital behind foreign companies and their advanced technological knowledge destroy competition in domestic sectors and create monopolistic power for the foreign company. FDI may be able to remove foreign trade barriers that protect the domestic sector of host country. Foreign country gets funds from domestic financial market. This increase in demand causes increase in interest rate. In this condition, domestic companies couldn't get credit because of high interest rates so this creates crowding out effect for domestic companies. Sometimes, foreign investment doesn't tend to export. They provide raw materials from abroad so foreign exchange outflow increases. Foreign companies create foreign exchange rate fluctuations both when entering and leaving (Seyidoğlu, 2009, p.620). Also foreign investors sometimes use their power that they obtained from a management and organization in some sectors

contrary to the interest of the host country. By this way, security of the host country can be destroyed (Şener, 2013, p.4).

Integration to global financial markets has not only advantages but also disadvantage on the national economy. Outsourcing of economies and liberalization in financial markets to benefit from international capital flows could increase instability in the case of existence of macroeconomic instability. Especially, liberalization complicates the control on the economy and commitment to external economies becomes determinant when an economy is opening out. The policies that encourage foreign capital causes budget deficits to continue. By this way, budget deficit is a chronic problem of this country. The governments could borrow easily after entrance of foreign capital so budget deficits increases exponentially. Also, increase in inflation is another conclusion of this situation (İMKB, 1994, p.28).

Further, raising the wages because of foreign companies can affect local companies negatively. Even if this condition is positive for workers, some domestic companies have to quit. Some small companies couldn't adopt the high average wage level. It causes the reorganization of the industry and some bias against multinational firms in domestic markets (Lipsey, 2002, p.58).

2.3. History of FDI in the World and Turkey

2.3.1. FDI experience in the Developing Countries

FDI flows started during the colonial period. FDI have evolved since 1800s. Initially, the investments tended to agricultural resources while nowadays, it has tended to from data processing, nuclear materials to services sector. While foreign investors concentrated on wool, petroleum, mineral, rubber and fruit in between 1800-1890, they concentrated on chemical substances, pharmaceuticals, food and motor vehicles in between 1891-1940. In between 1941-45, transportation and defense industry was popular whereas financial services, communication, machine, hotel and engineering were popular in between 1946-1960. While sectors about electronic stuff, research, tourism, education, health, food and cleaning attracted large amount of FDI in 1960s and 1970s, tourism, data processing, nuclear materials and telecommunications have been sectors that attract FDI recently (Bayraktar, 2003, p.7)

FDI has important role for world economy. In 1910, capital of capitalist countries increased six fold. The great amount of capital that obtained from gold, silver and other resources were in Western banks. This situation changed the role of the banks and they started to make investment into the industry and commerce. Most of them bought industrial or trading company or became partner of these kinds of companies. This strengthening of the capitalism caused to appear monopolistic companies in Europe. Also, interest rates were low because bank vaults were full of the capital. Because of these conditions, Western countries fronted other regions where interest rates were high. Thus, foreign capital started to flows less developed Eastern countries which have cheap land, cheap labor and high interest rates. Industrial goods were exported and states borrowed with high interest rates from west to east. Profitable investments were made in banking, train and port operations, mining and energy fields in East (Şener, 2013, p.1).

Development histories of almost all countries are related with FDI. Persian Gulf oil land, tea fields of India and caoutchouc plants are examples of it. In the beginning of 20th century, the infrastructure of the world economy was constituted by FDI like Brazil's electric power and Spain's telecommunication structure. Companies from Britain invested other countries to produce consumer products from very early times. Chemical firms in Germany and automobile manufacturers invested in abroad before World War I. Companies of Switzerland, Sweden, France, and Japan had constructed foreign affiliates at an early date. Movement of foreign capital had accelerated by technological progress and administrative and organizational techniques. In 1914, the FDI stock of the world was \$15 billion and The United Kingdom had the big part of it. The USA and Germany followed it. In 1938, FDI stock of the world increased to \$66 billion and the UK had followed to keep big share of FDI. However, developing countries, especially countries in Latin America and Asia, had attracted more than half of this amount. Big part of these investments was agricultural and mining but infrastructure had also important share (IFC, 1997, p.11). After World War II, the USA had become the largest foreign investor and investment in manufacturing sector had gained importance. In 1950s and 1960s, many of the emerging markets adopted "inward-oriented" development strategies. It supported development of domestic industry. In this direction, trade barriers were put in front of foreign capital movement.

Export and domestic production was encouraged whereas import was limited. The states had great authority on private sector. In those years, the policy makers thought that the FDI might create adverse effects on economy like economic dependency, political intervention from other countries and bad weakness of local market. Because of this strategy, foreign investors tended to invest in the countries rather than export the products so FDI inflows had increased in the import substitution countries. Moreover, FDI had concentrated in the countries that had natural resources and suitable locations that facilitate export (IFC, 1997, p.12).

In early times, FDI went to developed countries but developing countries started to attract more FDI after end of 1980s. It could be said that market opportunities appeared after collapse of Soviet Union and changing thoughts about reasons and conclusions of FDI by liberalization causes to transfer resources to developing countries by FDI. It is seen that some countries are more successful to get FDI than others because they have more appropriate characteristic investment condition. Also, foreign investors' aims are so determinative about this issue (Karagöz, 2007, p.931). In 1980s, not only advanced capitalist countries but also less developed capitalist countries that apply structural compliance policies imposed by IMF and World Bank privatized some public enterprises to liberalize production. When privatization was symbol of liberalization of production area, release of interest rate was symbol of liberalization of financial markets. To liberalize foreign trade, all restrictions on importation were removed and national markets were opened to international competition and one of the most important solutions of liberalization process is to liberalize international capital flows. The phenomenon of globalization and liberalization in financial markets, especially in the first half of the 1990s, has caused money movements far above world production and commerce. Capital flows to developing countries in this period are multiplying exponentially. These capital flows to developing countries that need to be addressed are concentrated in about twenty countries, which are mainly called emerging markets (İnsel and Sungur, 2003, p.2-3).

There were a lot of events that affect the world. Communism was collapsed, China opened its economy for foreign capital and many countries changed economic and politic regime in South America. Almost all countries had to restrict all control on the trade and allow circulation of foreign capital. In this period, globalization of

production activities accelerated and transportation and communication technologies were developed so companies started to produce internationally. As a result of these developments, world trade volume and capital investment, especially FDI, have increased. Nowadays, FDI is the most important capital for developing countries. The developing countries have liberalized their economy to attract more FDI. For instance, even telecommunication, energy and transportation sectors that are closed for foreign capital in open economies have opened for foreign investors. Many countries have eliminated the all bureaucratic, administrative, legal and institutional barriers to attract more FDI. The competition between developing countries is the most important indicator of consensus that foreign capital is beneficial (Arıkan, 2006, p.1).

Before 1980, the amount of FDI to developing or less developed countries was 15%. After 1980, the rate has been increased but this rate is shared by more than a hundred countries. Namely, countries are in hard competition to attract more investment. They have encouraged foreign investment by preparing some advantaged packages or allowing some opportunities. Some of the incentives are land or building with infrastructure prepared for foreign capital, reduction in paperwork and arbitrary permission in the public offices and removal of private tax exemption. This incentives are given besides other incentives like stable environment, developed financial sector, inflation indexed factors, improved productive mechanisms for the capital and other similar elements. Furthermore, communication of openness and decisiveness to integrate into the world are also important points (Güneş, 2007, p.14).

In 1990s, FDI were seen as ‘‘engine of development’’ and the view about FDI changed totally. It have became the ‘‘good news’’ for all countries. Dunning (2002, p.225) explained the reasons of this change from both nations’ and companies’ perspectives.

From a nation’s perspective;

- Liberalization in international financial market,
- Globalization phase,
- Increasing mobility of prosperous assets,
- ‘‘take off stage’’ of development of many countries,

- The convergence of economic condition among developed countries and recent industrialized nations,
- Altering criteria by which states appreciate FDI,
- Changing thinking of states about costs and benefits of FDI.

From firm's perspective;

- Enhancing need to utilize international markets,
- Competitive pressure to provide raw materials by cheapest ways,
- Willingness to make more efficiency seeking investment because of integration of nations,
- Ease of communication and the cheapness of transportation,
- Increasing oligopolistic competition between prime companies,
- Arising property opportunity of FDI,
- Necessary for foreign technological innovations, management & organization methods and utilize agglomeration economies,
- New incentive for investors to treaty,
- Changing the importance of locational costs and utilities,
- Requirement for preferable balance the advantage of globalization with those of localization.

Because of these reasons, it became focus of attention for many countries. Especially in 1990s, FDI became the largest part of foreign capital for developing countries. The ratio of FDI to total capital flows was 40% in 1997 in developing countries. After the bank credits lost their importance in 1980s, the emerging markets have created new policies to attract FDI. Many countries have offered varied incentives for multinational enterprise like to decrease income tax or subsidy for infrastructure. The countries have strongly believed that these kinds of investments generate great amount of technology transfer (Aitken and Harrison, 1999, p.605).

The increase in foreign capital flows to developing countries in 1990s based on some external conditions. In those times, recession was occurred in industrialized countries. And, interest rates were very low in USA. The economies that attracted too much foreign capital made fiscal and structural reforms (Celasun et al., 1999, s.10). After 1995, a rapid increase was happened in FDI flows in the developing countries as it

is seen in Figure 2.3. The main reason of it was the stock adjustment. It means that private sector took assets from public sector. Foreign investors changed their portfolio after elimination of barriers to FDI. After the sharp increase in FDI inflows, developing countries have continued to liberalize their foreign investment policies. Furthermore, acceleration of globalization phase changed the thoughts about foreign capital and created different opportunities to balance investments (IFC, 1997, p.16).

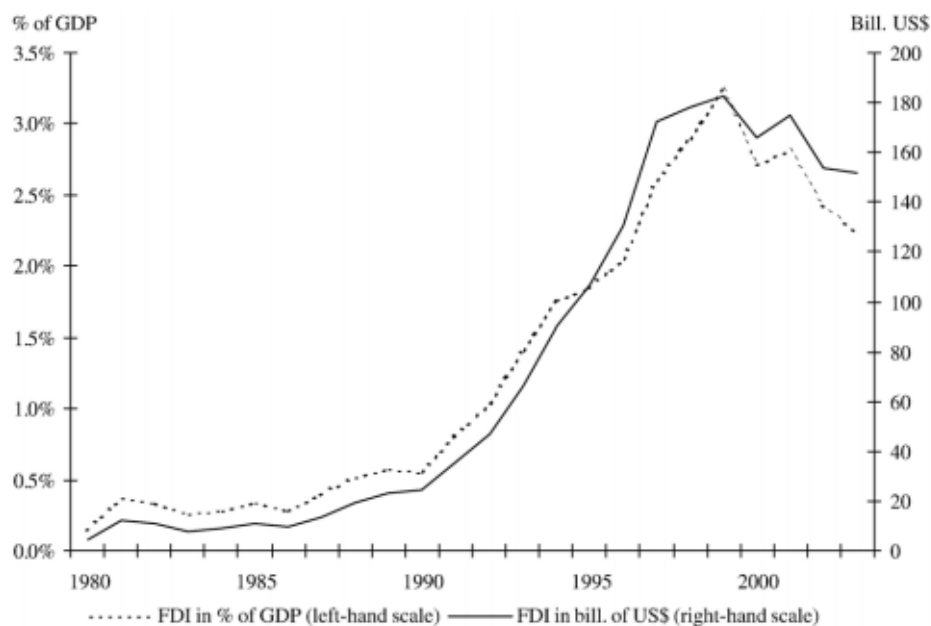


Figure 2.3 FDI inflows in developing countries, 1980-2003(Busse and Hefeker, 2007, p.398)

After 2000s, the most important event is the global crises in 2008. The crises effected amount of FDI in 2008 and in the first part of 2009. In the period of 2003-2007, FDI had rising trend and it reached second highest level in 2007. After that, it started to decrease gradually because of the global crisis. In 2009, FDI flows decreased by 16% in the world because of global financial crises in 2008. Global FDI inflows amounted \$1.114 billion by decreasing 37% whereas out flows amounted \$1.101 billion by decreasing 43%. In 2008, Lehman Brothers that was one of the important financial institutions in USA collapsed and many developed countries had economic recession. Following this, FDI inflows to developed countries decreased. On the other hand, FDI inflows to developing and transition countries rose in the beginning of 2008. However, it decreased at the end of 2008 (UNCTAD, 2010, p.2; UNCTAD, 2009b, p.3-4)

In 2015, amount of FDI in the world increased relatively previous year while it decreased in 2016 by 2 percent to \$ 1.75 trillion as it is shown in the Figure 2.4 In parallel with this, amount of FDI inflows to developing countries from developed countries increased \$ 752 billion to \$ 646 billion in 2016. Main reason of this is economic growth of developed economies and transition economies. Developed economies have attracted the 59% of world FDI (UNCTAD, 2017, p.2-3).

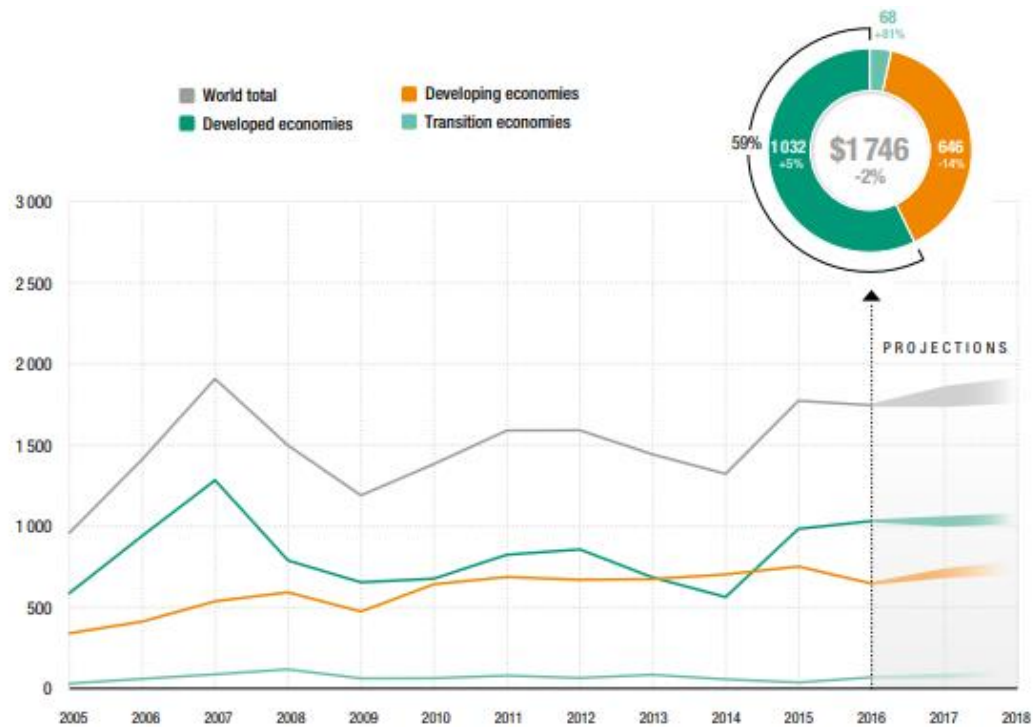


Figure 2.4 FDI inflows, global and by group of economies, 2005-2016 and projections, 2017-2018(billion of dollar and per cent).(UNCTAD, 2017, p.2).

Services sector has continued to have the lion share of FDI in all over the world (Figure 2.5). Investment in services sector like business, finance, health, trade or communication has created two thirds of FDI flows in 2015. The main sub-sectors that attracted 62% of global FDI stock in services are financial sectors and business activities. Manufacturing sector was 26% and primary sector was only 6% of global inward FDI stock. The main sub-sectors that attracted 70 percent of world FDI stock in manufacturing sector are chemical products, food and beverages, electronics, motor vehicles and petroleum products. Actually, FDI have registered in the services sector since the financial crisis in 2008. However, UNCTAD (2017) implies that the big share

of services sector in the global FDI stock shows an exaggerated version of the real significance of the sector (UNCTAD, 2017, p.21-22).

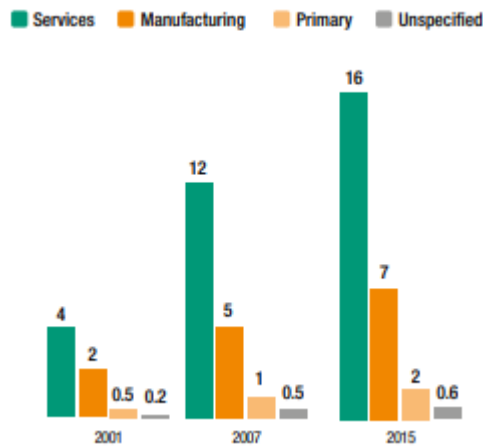


Figure 2.5 Estimated global inward FDI stock by sector 2001, 2007 and 2015(Trillion of dollar)(UNCTAD, 2017, p.21).

During the twenty-odd years from the 1980s to 2008 crisis, there was a consensus between economists that it was better to allow financial capital to move freely over international borders. More recently, the excessive volatility in some financial markets and the damages that is caused by this volatility has stimulated interest in regulating to limit the damage caused by unexpectedly large financial outflows (Gerber, 2017, p.190). Recently, some countries have put restrictions by thinking their national security and interest. For instance, France expanded the coverage of review mechanism for FDI for six sectors. These are energy supply(electricity, gas, hydrocarbons, or other sources of energy), water supply, transport networks and services, electronic communications network and services, operations of buildings and installations for defensive reasons and protection of public health. France applies these strategies by considering national interests. Italy developed new procedures for government to use for investments that is related with defense and national security. This procedure is related with investment review mechanism that was established in 2012. Indonesia decreased the ceiling of foreign ownership. On shore oil production wasn't open for foreign investors. Before, foreigner could own up to 95 per cent. Foreign ownership in data communication services system was also reduced from 95 per cent to 49 percent. The Russian Federation expanded the coverage of review mechanism for FDI on transportation sector and other associated sectors. The review

mechanism also covers investment related with national security and defense (UNCTAD, 2015, p.104). It is easy to understand the conflict between different views. On the one hand, foreign capital inflows are beneficial because they increased investments of host countries in factories, ports and other physical assets. By these way, living standards and income increase. On the other hand, sudden outflow of foreign financial capital causes debt crisis and serious depression in the economy. What is important here is to minimize the risk of capital flight while collecting the fruits of investment growth (Gerber, 2017, p.190).

2.3.2. FDI history of Turkey

2.3.2.1. FDI policies in Turkey

If we compare Turkey with other countries that attract large amount of FDI, it is obvious that Turkey is unsuccessful and late. Until 1980s, Turkish economy was closed and had import substitution industry. Economy was got globalized and liberalized at the end of 1980s and opened for international trade. Openness increased after the relationship between Turkey and European Union revival and Turkey entered custom union. After Turkey has finalized its candidacy for EU, the expectation of attracting more FDI has risen. In Turkey, FDI activities officialized with Foreign Investment Law Decision No.6224 accepted in 1954. This law was supported by some frame decisions after liberalization process started in 1980s and changed totally in 2003 (Karagöz, 2007, p.934).

It is true that Turkey isn't very successful about attracting FDI if we compare it other similar countries like Hungary, Poland, Czechia, Greece or Israel. The foreign investment to Turkey after 1980 is less than foreign investment that is attracted by some countries in a year. This difference is more obvious when the ratio of FDI to GDP is examined, but even so important steps were taken to improve the investment climate. A reform program was started in 2003 to regulate investment climate in light of past experience. The Foreign Direct Investment Law No.4875 which was adopted on June 5, 2003 and published in the Official Gazette on June 17, 2003, opened the way for foreign capital. It is a fairly liberal law. In the same year, Coordination Board for Improving Investment Environment was established and technical committees have been set up to develop strategies to remove certain obstacles. Law enacted to reduce companies' registration from 19 stages to 3 stages and from two and half months to one day by the

law. After these developments, huge amount of foreign capital came to Turkey in 2005 (Arıkan, 2006, p.2).

The main aim of the law Decision No.4875 is to encourage FDI, protect the law of foreign investors, convert the formation of FDI from authorization and approval system to information system and arrange the policies about to increase FDI. According to this law, foreign investment in Turkey is liberalized totally if there is no contravention of international agreement. Also, foreign investors are equal domestic investors in FDI. FDIs aren't be customized unless public benefit is considered. Under the customization condition, payment is paid. The most important point in this law is that net profit, dividend, price of sale, liquidation and compensation, sums to be paid for license, management and similar agreements and foreign loans principal and interest payments can be transferred to abroad by banks and private financial institutions freely. Foreign investor refers citizens of other countries, Turkish citizens living abroad, legal entities established under the laws of foreign countries and international organizations. FDI means cash capital in convertible currency that is traded by the Central Bank, company securities, machinery and equipment and industrial and property rights brought from abroad. Also, it refers opening a new company or branch, purchasing of shares outside the securities exchange, purchasing 10% share or to be a partner in a company with the same voting rights through rights such as profit, proceeds and money used in reinvestment and rights to search for and remove natural resources. This law is accepted June 5, 2003 and published to Official Gazette in June 17, 2003. This law constituted the substructure of FDI. The very liberal law replaced the Law for Encouragement of Foreign Direct Investment (Decision No.6224)³.

There is no doubt that Turkey has needed foreign capital like other developing countries. It is of course possible to increase the performance that remains below the potential by magnification of the target and the measures to be taken. Improving the investment climate, removing obstacles in front of investments and making investment promoting arrangements are important policies to reach the aim. All kinds of support and encouragement must be provided to foreign investors that come to country and to construct new installations. On the other hand, it is more appropriate to make

³Foreign Direct Investment Law, (2003). Turkish Republic Official Gazette, 25141, 17.6.2003.

arrangements for the investor capital which is not for domestic market but for export purposes (Bilgin et al., 2008, p.6).

Main goal of the policies that attract to foreign capital was to enhance growth by decreasing high cost of public debt from the Treasury that was destroyed too much because of financing the government and to meet financial needs. Truly, the significance of foreign capital could be understood considering inefficient domestic financial market and lack of funds that was used by government with high cost won't accelerate growth. It only crowded out the private sector. Turkey regulated the economy to attract foreign capital. Return of assets (especially government debt instruments) denominated TL became high so amount of capital flow increased. After this period, real interest rate started to increase and governments became addicted to foreign capital to finance its expenditures or debts. Increasing dependency on external financing was required to sustain high yield on asset to attract more foreign capital to Turkey. In 1990, the government debt increased too much. The government didn't care it because foreign capital can fix it. Foreign capital was used for financing public debt. In between 1995-1998, huge amount of capital inflow was happened while budget deficit was doubled. Because of increasing external flow, domestic currency appreciated so inflation increased sharply and The Central Bank couldn't control it. The over appreciation caused a crises in 2001 and foreign capital left Turkey sharply (Çimenoglu and Yentürk, 2005, p.95).

2.3.2.2. FDI experience in Turkey

Experiment of Turkey about foreign capital can be separated periods. First is in between 1950-1974. In this period, capital account was comprised of capital transactions that belongs the state. That's why, there wasn't capital flows, either portfolio or direct investment in Turkey. Second term is in between 1974-1989. Actually, this term is relevant with oil crises in 1970s. In those times, Turkey tried to postpone its foreign debt. Until 1980s, Turkey was invisible in international area. After the middle of 1980s, foreign capital started to come to Turkey because some structural reforms were made and financial market and trade were liberalized. Also, prejudice against foreign capital was changed. After 1990, capital account has been liberalized totally to attract capital flows because importance of foreign capital has been realized (Çimenoglu and Yentürk, 2005, p.91). Until 1980, amount of foreign capital was less

than \$250 million. After 1980, it was tried to attract foreign capital with some important steps like ‘‘ Foreign Capital Framework Decree’’.

The Table 2.1 summarizes minimum and maximum amount of ratio of external flow to GNP. In 1994, the rate was minimum rate because of financial crisis. After 1989, portfolio flows and hot money flows to Turkey increased because of very high interest rates. The state wanted to decrease interest rates because government debt was also huge. The policies that were applied by state effected Turkish economy negatively. Speculative capital flows left country and the crises happened in 1994. Crisis of 1994 was the most damaging crisis in Turkish economic history. It can be said that Brazil was more successful. The stability of foreign flows was more stable in Brazil in this period.

The peak level was happened in 1997, net external financing was 7.9%. However, huge volatility existed in the period. For instance, there was foreign inflow about 6.7 percent while there was foreign outflow around 4 percent. However, this volatility isn’t valid for all developing countries. It can be said that Argentina was successful about managing foreign capital. Amount of net external financing was around 6-7 percent until crisis of 2001. This condition is same with other countries in the Table 2.1, except Poland. High capital outflow was happened in Poland in this period. On the other hand, average rate of external financing was shown in the Table 2.1. This rate is so low relatively if we compare Turkey with other developing countries. Actually, main reason of failure of Turkey about managing external financing was about FDI. The share of FDI to GNP has been low. Turkey attracts speculative capital movement generally like portfolio investments, investments in domestic stock market or government securities (Çimenoglu and Yentürk, 2005, p.92).

Table 2.1 Net external financing as a share of GNP (%) (Çimenoglu and Yentürk, 2005, p.92)

Net External Financing as a Share of GNP (%)			
	Min.	Max.	Average(1990-2001)
Turkey	-4.0(1994)	7.9(1997)	3.5
Argentina	-0.8(1990)	7.4(1997)	5.0
Brazil	-0.9(1990)	6.7(1998)	3.5
Mexico	0.9(1996)	9.1(1993)	5.4
Hungary	-1.4(1990)	24.3(1993)	8.7
Israel	0.6(1992)	13.1(1997)	5.0
Poland	0.8(1993)	9.5(2000)	5.7
Russia	-0.4(1999)	21.7(1992)	4.6
Korea	-3.7(1998)	9.2(1996)	2.6
Malaysia	-8.2(1998)	26.0(1993)	6.3
Thailand	-4.6(2000)	17.7(1995)	5.6

In 1990, the State was unsuccessful to manage foreign capital flows. Sustainability of these flows couldn't be proven. By this way, competitiveness in domestic market can be protected and increased but high public deficit didn't allow it. Also, a lot of problems existed in banking sector and some mistakes were made when deregulating domestic financial sector. Manufacturing sector was ignored and any structural step was taken to regulate export. No importance given was to fighting with inflation by not only government but also private sector. The all weaknesses became vulnerable the Turkish economy against foreign capital (Çimenoglu and Yentürk, 2005, p.107).

The FDI stock of Turkey was only \$300 million in 1971. It increased after 1980s. Figure 2.6 summarizes the amount of FDI in Turkey from middle of 1980s. As it is seen in the Figure 2.6, amount of FDI reached \$1 billion in 1990. On the other hand, yearly FDI stock didn't increase after 1990. Global FDI stock increased rapidly while it was stable in Turkey in between 1990-2000. Other important thing in the Figure 2.6 is the difference between realized and approved FDI. Approved investment means that willingness of investor to invest whereas realized investment shows ex-post investment. Actually, there wasn't huge difference between approved and realized FDI in this period except 1995-1997. The main reason of this situation is related with the beginning of the customs union between Turkey and European Union. It was associated with new announcement of manufacturing investment in Turkey. Foreigners' perceptions of the chance supported by investing in Turkey couldn't be realized so many investments were pending. This condition demonstrated that the state was ineffective to make real the inward investments (Loewendhal and Ertugal-Loewendhal, 2001, p.2-3).

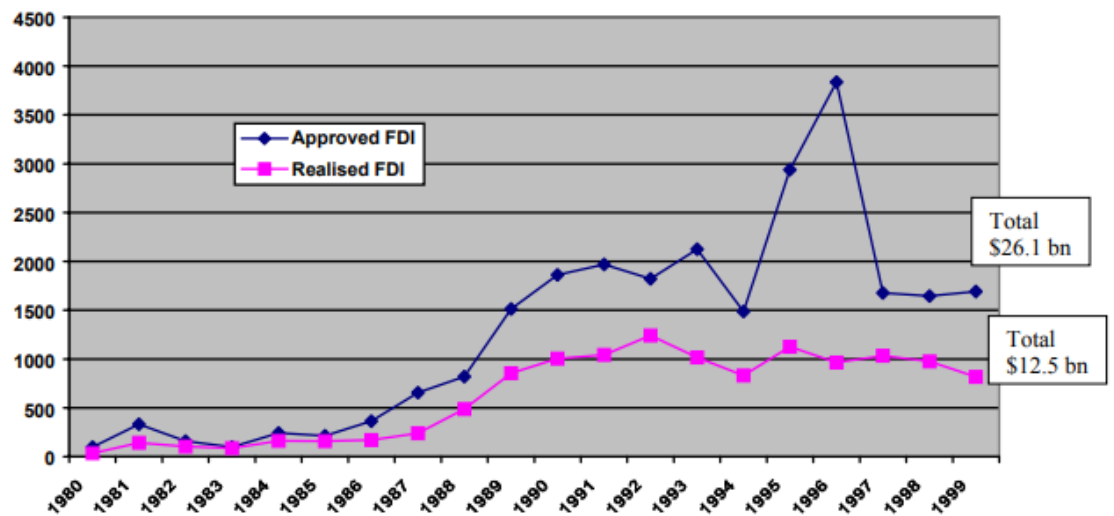


Figure 2.6 Amount of FDI in Turkey between 1980-2000, \$ billion (Loewendhal and Ertugal-Loewendhal, 2001, p.2)

Capital account liberalization problem destroyed macroeconomic balance in Turkey. For instance, fiscal condition and inflation were impacted negatively. Lack of more stable and long lasting foreign capital in Turkey in 1990 shows the importance of domestic and regional factors to attract foreign capital (Celasun et al., 1999, s.10). However, to the contrary unstable macroeconomic conditions, the amount of foreign capital flow to Turkey increased after 1990. The amount of net capital inflow to Turkey was more than four percent the GNP in 1996 and 1997. In this term, the volatility in foreign capital shows the volatility in economic condition. The growth of GNP was more than 6% in each year in 1990s, except 1991 and 1994 (Gulf crisis happened in 1991 son economic growth was also 0.3% and big financial crises was happened in 1994 because of hot money so the economy was narrowed.). In parallel with this, net capital inflows were more than 2% of GNP in 1990s except 1991 and 1994 (Celasun et al., 1999, p.3).

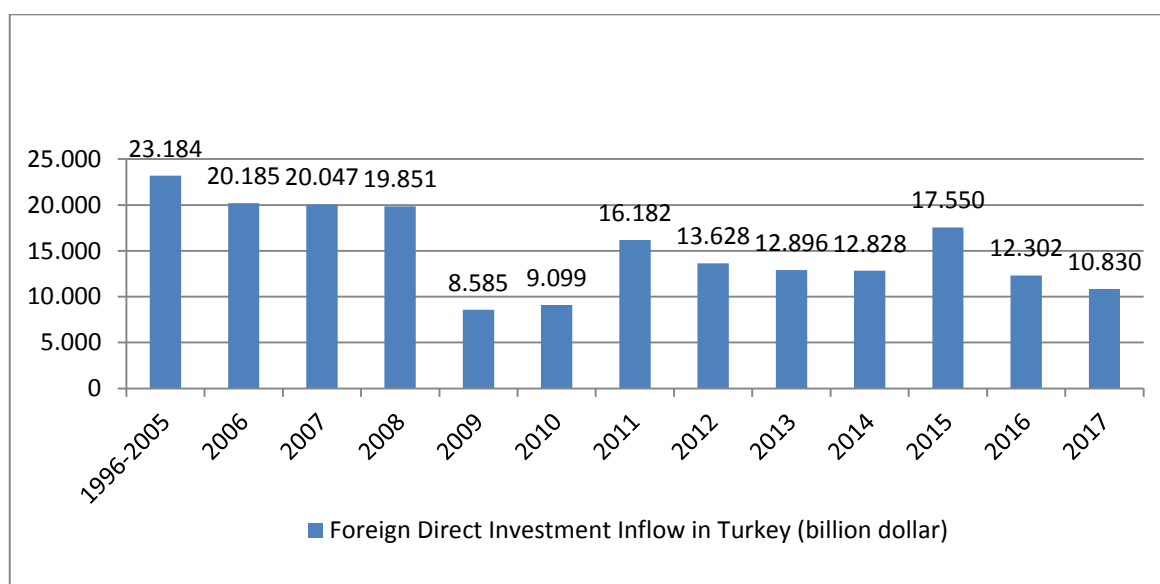
There were some important characteristics of the foreign capital flows to Turkey after 1990. In those times, foreign investments to Turkey were large amount whereas the amount of capital outflows from Turkey was attracted the attention. Before 1994, domestic banks invested in foreign assets too much. The amount of portfolio investments of Turkey was more than one billion dollar in 1996. There wasn't large net capital inflow in Turkey because the ratio of current account balance was less than 2% in 1990s. Second, net FDI in Turkey in 1990s were low. This is interesting situation

because private manufacturing sector were so active and constructed important base for MNCs. There were appropriate conditions for MNCs to make investment in Turkish manufacturing sector but desired results couldn't be achieved in terms of FDI. Third, portfolio flows was less significant than deposits, loans and trade credits. Short term flows were dominant in financial system rather than other securities. Probably, the debt securities were bonds that issued other countries by the Turkish Central Bank and the private sector. Investment in government bond or Treasury bills was not preferred too much. Fourth, Turkey acted as a re-payer to the foreigners in this issue mostly. It is somewhat puzzling condition because Turkey kept large amount of the external debt stock. Fifth, banking sectors held the large amount of foreign debt until 1994. After that, this situation was changed. In 1996 and 1997, foreign debt of non-financial sector was twice as much foreign debt to banking sector but the credits to non-financial sector was guaranteed by banking sector. Last, there was ambiguity about the amount of short term flows. In capital account balance included uncategorized and invisible income, except 'net errors and omissions'. This condition might be explained by 'shuttle trade' before 1996. After that, it was included in capital account balance (Celasun et al., 1999, p.5-6).

2001 was the very important year for Turkish economy. In this year, amount of foreign capital reached the maximum level. It was \$3.2 billion. It increased 225% if it was compared 2000. Amount of foreign capital was \$700 million in 1999 and \$900 million in 2000. In 2001, an Italian company who got GSM license paid second installment. However, amount of foreign capital decreased after 2002 and 2003. It was about 1 billion in 2002 and 500 million in 2003 (Afşar, 2007, p.3).

From the beginning of the 2000s, the amount of international investments in Turkey has risen thanks to the stable and predictable policies and economic growth besides the growing volume of investments in the world economy. In 2005, Turkey's accession negotiations to European Union started. This situation could impact the FDI inflows to Turkey. International FDI inflows, which have increased since 2005 and surpassed \$10 billion, reached \$22 billion in 2007, the highest level in history. However, international capital flows decreased after 2008 because of global financial crisis and Turkey was affected by this crisis. International direct foreign investments increased again in 2010 and amounted to \$16, 2 billion in 2011 while they were realized

in the years 2012, 2013 and 2014, with the cost of \$12-13 billion (Figure 2.7). In 2015, it reached the highest value after the crises with \$17, 6 billion. The total amount of FDI in Turkey during in the period of 1975-2004 was only \$19, 6 billion while it reached \$175, 2 billion by increasing about 9 times in between 2005-2016. The FDI inflow to Turkey that was \$17 billion 550 million in 2015 decreased by 30% and reached \$12.302 billion in 2016. The main reason of this reduction is the coup attempt and adverse developments in the near geographical area in 2016(RTME, 2017, p.10). In 2017, FDI inflow was \$10 billion 830 million. This amount is less than previous year by %19.



*included purchase of foreigners real estate

Figure 2.7 FDI inflow to Turkey (Billion of dollar)(Republic of Turkey Ministry of Economy [RTME], 2017, p.11)

If Figure 2.7 is indicated, it can be seen that FDI flows to Turkey has an increasing and decreasing trend in over time. Turkey is developing country and need to attract FDI to increase capital accumulation. It can be said that, FDI inflows to Turkey between reviewed period is inadequate. On the other hand, when the Table 2.2 is examined, it is realized that FDI on real estate have increasing trend over time although total FDI inflows have inconsistent trend. This situation is not bad but real estate sector is not very efficient because it doesn't create added value for increasing capital accumulation.

Table 2.2 FDI components in Turkey Between 1996-2017(billion dollar)(RTME,2017,p.12)

	1996-2006(cumulative)	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
FDI(net liability formation)	43.369	22.047	19.851	8.585	9.099	16.182	13.628	12.896	12.828	17.550	12.302	10.830
Capital (net)	35.046	18.394	14.713	6.184	6.221	14.145	10.128	9.322	8.370	11.710	6.279	5.568
Inflow(investment)	37.244	19.137	14.748	6.266	6.256	16.136	10.761	9.890	8.631	12.074	6.888	7.437
Outflow	2.198	743	35	82	35	1.991	633	568	261	364	609	1.869
Other capital [*]	1.219	727	2.201	619	384	24	864	525	137	1.684	2.133	619
Real estate(net)	7.104	2.926	2.937	1.782	2.494	2.013	2.636	3.049	4.321	4.156	3.890	4.643

^{*}loans that is borrowed by MNCs from their foreign partner

Which constituted 64% (\$4.753 million) of total capital inflows (\$7.437 million) in 2017 the services sector was the sector with the greatest number of entries. Services sector with 35.6% share followed by the industrial sector (\$2.653 million) (in Table 2.3). Finance and insurance sector was the sub-sector of services sector that attracted the greatest investment with \$1.452 million. Transportation and storage was the second sector by attracting \$1.350 investment with 100% increase over previous year. However, the manufacturing sector decreased by 44% if we compared it with previous year and became third with \$1.261 million investment (International Investors Association of Turkey [YASED], 2018, p.2).

Table 2.3 Sectoral distribution of FDI in Turkey between 2013-2017(million dollar) (YASED, 2018, p.2)

Sectors (\$ million)	2013	2014	2015	2016	2017
Capital Inflow	10.523	8.632	12.077	7.534	7.434
1.Agriculture	47	61	31	38	31
2.Industry	5.390	4.258	5.774	3.067	2.653
Manufacturing	2.843	2.742	4.227	2.241	1.261
Electricity, Gas, Steam	1.794	1.131	1.338	676	943
Mining, Quarrying	717	382	207	148	448
Water and Waste Management	36	3	2	2	1
3.Services	5.086	4.313	6.272	4.429	4.753
Finance and Insurance Facilitates	3.415	1.470	3.516	1.766	1.452
Transportation and Storage	364	594	1.524	635	1.350
Construction	178	232	106	291	627
Information and communication	120	214	150	91	557
Wholesale and retail prod.	379	1.137	599	688	501
Human Health and Social Ser.	106	204	58	274	62
Capital Outflow	587	261	364	621	1.869
Other Capital(net)	578	427	2.133	2.540	619
Real Estate(net)	3.049	4.321	4.156	3.890	4.643
Total	13.563	13.119	18.002	13.343	10.830

2.3.2.3. Works to increase FDI in Turkey

Current condition of Turkey to attract FDI is summarized in Table 2.4. Actually, The SWOT analysis that was constructed in 2008 is still valid. Only, probability of European Union membership can be removed. According to Bilgin et al.(2008), comprehensive and serious tax reforms should be made to attract more FDI in the first frame. Re-auditing of tax exemptions, simplification of legislation, reduction of number of taxes and reduction of tax rates are beneficial for domestic investors as well as foreign investors. Institutions and customs tax should be reduced within the scope of reform. One of the things to do to attract foreign capital is to fight against the informal economy that causes unfair competition. Also, decreasing labor cost is another way. Reducing or facilitating bureaucratic obstacles can be another policy change. These types of changes can affect macroeconomic balance negatively but it is not possible to

attract FDI towards exports without taking comprehensive measures (Bilgin et al., 2008, p.10).

Table 2.4 Turkey's SWOT analyses(Bilgin et al., 2008, p.8)

<u>Strong Sides;</u> Liberal legislation Large domestic market A dynamic and developing economy Geographical location Labor Custom union with EU Government incentives	<u>Weaknesses;</u> Economic instability Heavy duty legal system High labor cost relatively other developing countries Tax burden Some bureaucratic obstacles Informal market
<u>Opportunities;</u> Growth potential Young and dynamic population EU membership possible Privatization policies Location in energy corridor	<u>Risks;</u> Fragile nature of the economy Economy under risk Dependency on foreign markets High political risk Barriers in front of European Union membership Other political problem in the geography

Efforts to improve the investment climate are very important to increase both national and international investments. In Turkey, some policies are made by state. Coordination Board for Improving Investment Environment (YOIKK) was established in the framework with ‘‘The Reform Program for the Improvement of Investment Environment’’ with Council of Minister Leading Decision in 2001. YOIKK has work for avoiding administrative barriers in front of domestic and foreign investment and increasing competition power in the investment climate. The structure of YOIKK that is very successful sample of public-private sector competition is based on Council of Minister Leading Decision that is updating according to increased performance of the economy and changing priorities of private sector. Also the structure of YOIKK became strong after adding ministers have duties and responsibilities about investment. Since 2007, the YOIKK platform has been conducting concrete and result-oriented efforts to reduce obstacles in front of investors by means of action plans that are shaped in line with the priorities of private sector (RTME, 2017, p.61).

Investment Advisory Council was established in 2004 to improve the investment environment in Turkey. The council aims to provide an international perspective to the works that aimed at improving the desired investment climate. To do this, meetings are held with the participation of the world's leading multinational business executives. Also, Turkey experience sharing program was established in 2008 to share the

experience of Turkey about investment, that is gained last 15 years, with demanding countries (RTME, 2017, p.62-64).

According to the World Bank Doing Business Reports of 2018, Turkey has become the 60th country in the 190 countries in doing business. As a result of evaluation made according to 10 difference criteria, 69, 14 is given to Turkey out of 100 point. Turkey was the 69th in the list last year. Average point in Europe and Asia region that includes Turkey is 71.33. Main reasons of the higher score than last year are methodology changes improvement in the regulation of business life with various reforms and revisions in datasets. The greatest improvements in Turkey have occurred in ‘‘credit availability’’ and ‘‘registering property’’ criteria. Score of ‘‘credit availability’’ increased 55 from 45 and Turkey have become seventy seventh according to this criteria. The score of ‘‘registering property’’ have rose 74, 67 by increasing 1, 67 point. Turkey is the forty sixth in the list according to these criteria. The best performance of Turkey is in the ‘‘protection of minority investors’’. It is twentieth in the list according to these criteria among 190 countries. Turkey have lost point in the ‘‘resolving insolvency’’ criteria. Turkey has become 139th in the list according to this criterion. This is because of suspension of bankruptcy decision in the condition of emergency state (www.kobi.org, Data accessed 19.04.2018).

The Global Competitiveness Index is important indicator that measures the performance of competitiveness of almost 140 countries. This index includes quality of institutions, applied economic policies and the productivity level of the countries. According to World Economic Forum (WEF) (2017), in 2017, Turkey has become the 53th among 140 countries while it was 55th in 2016. It has moved up by 2 places compared to the previous year. In addition, Turkey became the 56th country according to Best Countries for Business that is published by Forbes Magazine every year. It was 62th in 2016. Turkey moved up by 6 places compared with previous year (www.forbes.com Data accessed 25.6.2018). These kinds of indexes and lists show the Turkey’s condition for investment. These works that examine the investment climate with different aspects are important factors that affect the decisions of international investors (RTME, 2016, p.66).

CHAPTER III: THE EFFECT OF FINANCIAL LIBERALIZATION ON FOREIGN DIRECT INVESTMENT IN TURKEY IN BETWEEN 1974-2015: AN EMPRICAL ANALYSIS

3.1. Literature review

In the study, the literature is examined according to variables considered to be indicators of liberalization. However, the studies about the relationship between financial development and FDI are mentioned the first place. The relationship between financial development, FDI and economic growth has attracted great attention. Since 1980s, economists have studied about the interaction between the variables by using both empirical and theoretical methods. In the studies examined, it is shown that financial development is important factor for not only FDI inflows but also effect of FDI inflow on economic growth.

Alfaro et al. (2003) examined the effect of FDI on economic development in the framework with financial sector development in 71 countries. An economy that was formed by different agents with varied abilities was identified. These agents could work for multinational firms so they increased their wealth or they could open their own firms and benefit from FDI spillover effect. However, opening a new firm required some costs that should be financed by local financial institutions. The panel data analysis results showed that new entrepreneurs were encouraged thanks to well developed financial system. More, the spill-over effect of FDI increased with the existence of well developed financial market. After that, economic growth was accelerated.

Hermes and Lensink (2003) controlled the influences of financial development level on the relationship between FDI and economic growth for 67 countries in between 1970-1995. Results of panel data estimation showed that financial development indicator had positive and significant influence on growth of GDP per capita whereas ratio of FDI to GDP hadn't positive and significant effect on it. When the interaction term of financial development and FDI was included, the positive and significant relationship was obtained. Consequently, the study showed that financial system had very significant role to increase the positive effect of FDI on economic growth.

Kholody and Sohrabian (2005) focused on the relationship between financial markets, FDI and economic growth in 25 countries in between 1975-2002. Results of

the Granger causality test indicated bi-directional causality between financial development and FDI. Also, the bi-directional causality was valid for financial development and economic growth. Financial development enhanced FDI in countries with high GDP per capita. Felek et al. (2017) tried to find the interaction between financial development, FDI from European Union and economic growth in Turkey in between 2005Q1-2015Q4 by using ARDL bound test. In the study, the authors created a Financial Development Index by Principle Component Method. The results showed that economic growth effect FDI from European Union positively in the presence of well developed financial market.

Alfaro et al. (2009) researched that whether financial development improved the effect of FDI on economic growth through total factor productivity by using OLS cross country analyses in 72 developed-developing and less developed countries in between 1975-1995. The authors concluded that if the countries have more developed financial system, they could benefit from FDI through total factor productivity developments.

Desbordes and Wei (2017) searched the relationship between financial development and FDI in 83 countries (developed and developing) including Turkey between 2003-2006 by considering country-specific financial development and sector specific financial vulnerability. The panel data estimation results proved that financial development had positive and significant effect on green-field investment, mergers and acquisitions, and expansions. Also, financial development increased the accessibility to foreign funds by this way manufacturing sector was developed.

- Studies related relationship between globalization phenomenon and FDI

Financial globalization is main part of financial liberalization in the international area and one of the determinants of FDI in this framework.

Kornecki and Rohades (2007) indicated the role of FDI in stimulating growth process in Central and Eastern European countries in between 1990-2005 by comparing selected variables. The authors concluded that high amount of capital and FDI inflow was important factor for these countries advancing globalization level.

Leitao (2012) aimed to find the relationship between FDI and globalization in Portuguese in between 1990-2008 by using dynamic panel model with the framework of

GMM. The econometric results demonstrated that there was positive statistically significant relationship from globalization phase to FDI in Portuguese in specific period. On the other hand, trade volume and market size were other important factors that impact FDI positively.

Incekara and Savrul (2012) examined the effect of globalization on foreign trade and investment in Eurasian countries in between 1995-2010 theoretically. Capital was insufficient and labor was abundant. On the other hand, economic activities were based on natural resources in those countries. Also, trade was limited. When this was the case, foreign capital was needed. Globalization and integrating with other economies had positive impact on moving the barriers in front of trade and attracting FDI.

Adıgüzel (2013) indicated the effects of globalization on Turkish economy after 1980 by considering financial globalization, globalization of trade and globalization of production/investment theoretically. The author concluded that globalization of production and investment had increased FDI inflows to Turkey especially after 2003. FDI inflows had concentrated services sector while foreign investors had not invest in research and development.

Saibu and Akinbobola (2014) searched the effect of FDI globalization and FDI on economic growth in 12 African countries in between 1986-2004 by using variance decomposition and impulse response functions which based on VAR. The authors concluded that globalization supports economic growth. By this way, capital inflows to the countries increased.

Pekarskiene and Rozina (2015) tried to find the interaction between globalization and FDI in Lithuania for 2005-2014 by comparing selected variables. Results of the analysis proved that globalization level was effected inward FDI more than outward FDI.

Dima (2016) studied the effect of trade openness and globalization on FDI in Romania in between 1990-2014 by using linear regression method. It was concluded that FDI that was affected positively by trade openness stimulated globalization process while the globalization process hindered trade volume in Romania in the specific period.

Doğan and Arslan (2016) considered political globalization and research the effect of globalization on FDI in Turkey for the period of 1970-2012 by using co-integration test. Results of co-integration test proved that there wasn't any relationship from indicators of political globalization to FDI in the short run and long run.

Custorella (2017) examined the determinants of FDI in China in between 1996-2007 by using pooled OLS method. The econometric results proved that the globalization process had been decisive factor to attract FDI in China. Also, there was positive relationship between trade openness and FDI inflows.

Güzel et al. (2017) examined the effect of globalization on FDI in Turkey in between 1970-2013 by using ARDL bound test. The econometric results showed that there was long term relationship between globalization and FDI. However, in the short term, the way of the causality was from the globalization to FDI. This suggested that countries that were integrated with world economies could be successful for attracting FDI.

- Studies related capital account liberalization and FDI

Capital account liberalization is taken another significant part of financial liberalization. In literature, there are many studies indicating effect of capital account on international capital flows in the economics literature. In this part, some of these studies are included.

Asiedu and Lien (2004) focused on how policies related with capital controls impact FDI in 96 developing countries for the period of 1970-2000 by considering Fixed Effect estimation. The authors concluded that capital account openness was one of the determinants of FDI but the effect of capital account openness on FDI was different according to time interval and region.

Gibson et al. (2006) indicated conditions related capital account liberalization in 9 Mediterranean countries for the period of 1980-2002 by using Fixed Effect method. It was understood from the results that foreign investors tended to invest in countries which had liberalized capital account. However, level of FDI some Mediterranean countries was not too high despite in spite of liberalization. According to authors, national and regional policies may support the FDI in flows in those countries.

Noy and Vu (2007) tried to find the effect of capital account policies and FDI for 83 developed and developing countries in the period of 1984-2000 by using OLS and Fixed Effect estimations. The results proved that there was positive relationship between capital account openness and FDI. However, after controlling other macroeconomic variables, only capital account liberalization had increasing effect on FDI. Decreasing political risk and providing better macroeconomic condition were required.

Vadlamannati (2009) explored the effect of FDI inflows to India on four South Asian countries which are Pakistan, Sri Lanka, Bangladesh, and Nepal for in the period of 1975-2006 by using pooled time series cross sectional to fixed effects method. They also included some control variables that effect FDI flows to the countries except Indian FDI variables. Trade openness and capital account openness index are included in the study. The empirical results shows that trade openness with open capital account have a positive and significant effect on FDI inflows.

Hattari and Rajan (2011) studied the differences between FDI, FDI via M&As and FPI flows by including distance factor and capital market integration for 48 home 57 host countries including Turkey in between 2000-2007 period. Results of fixed effect OLS showed that open capital account increased FPI rather than FDI via M&As.

Lartey (2011) examined the relationship between financial openness and real exchange rate appreciation by taking into consideration capital account liberalization. The study covered 109 developing and transition economies for the period of 1990-2003 and GMM estimation was used. The results showed that FDI inflows increased in more financially open economies. As a result of this, real exchange rate was appreciated.

Okada (2013) explored the effects of institutional quality and financial openness on international capital movements in 112 countries including Turkey for period of 1985-2009. The results of system GMM estimator developed for dynamic panel data model evaluated that financial openness had positive impact on FDI inflows in the case of high quality institutions. Also, trade openness and credit to private sector had positive and significant effect of the interaction term of financial openness and institutional quality.

Reinhardt et al. (2013) explored how capital account effects the relation between net capital flows and development in the framework with capital account openness. The study covered 110 countries including Turkey that had populations more than 1 million for 1980-2006 period considering capital account, relative income and financial openness data. As financial openness measures, capital account openness index of Quinn (1997) updated to 2006 and the financial openness index that was constructed by Chin and Ito (2007) were used. After controlling other data about capital account, the results of pooled and fixed effect regression investigate that less developed countries attracted more capital inflows thanks to capital account openness whereas developed countries with open capital account experienced capital outflows. There was no relationship between net capital inflows and economic development in the existence of closed capital account.

Bankole and Ayinde (2014) studied the effects of capital account openness on FDI in Nigeria by using annual data belongs 1980-2011 and considering Bound-Testing Approach. Results implied that capital account openness was harmful for FDI in short run. In the long run, the relationship was based on time but it could be said that FDI was independent from capital account liberalization. Restrictive policies were recommended for Nigeria.

Mouna and Mondher (2014) tried to evaluate the effect of capital account liberalization on FDI including macroeconomic stability, institutions and financial development for 14 Middle East countries in 1985-2009 by using dynamic panel model. The study decided that financial development level and institutions were important factors for the effect of capital account liberalization on FDI.

Munyeka (2014) researched the determinants of FDI in South Africa in between 1970-2011 by using time series data. The results proved that financial openness index was significant factor to attract FDI in South Africa. Byrne and Fiess (2016) examined the nature and factors of international capital flows for 64 emerging markets including Turkey between 1993Q1-2009Q1 by using Panel Analysis of Non-stationary in Idiosyncratic and Common components (PANIC) methodology. The independent variables were financial openness, institutions, human capital, economic growth and real interest rates. The results implied that quality of institution and financial openness was positive and significant effect on international capital flows.

Erdogan and Unver (2015) explored the determinants of FDI in 88 countries including Turkey in between 1985-2011. In the study, static and dynamic panel data analyses were used. The results evaluated that market size, credit to private sector, inflation rate, market capitalization and control of corruption have important factor to attract FDI. Also, level of financial openness that was represented by the Chinn and Ito index had positive and significant effect on FDI inflow.

Gammoudi and Cherif (2015) tried to explore how capital account liberalization effects FDI in 17 MENA countries for the period of 1985-2009 by using GMM estimation. The econometric results showed that the capital account liberalization increased FDI inflow to host country only if political stability was provided.

Bezic et al.(2015) studied the effect of terrorism on FDI in selected 29 European Union and European Economic Area countries by using System GMM for the 2000-2013 and by considering economic institutional conditions. The authors took into consideration capital account openness as institutional variable. The results show that capital account openness that was represented by Chinn-Ito index has positive and significant effect on FDI.

Skabic (2016) investigated the determinant of capital flows to European Union new member states by using panel data Fixed Effect estimation for the period of 2004-2014. The results proved that FDI inward stock and capital account openness affected each other positively.

Makoni (2017) examined the determinants of FDI and FPI in developing African countries including financial sector development by using dynamic General Method of Moments (GMM) methodology for 1980-2014 period. The econometric results showed that low inflation rate, domestic credit to private sector; inflation rate and growth of real GDP were important factors for attracting FDI. On the other hand, market capitalization ratio encouraged FPI while low interest rate discouraged it. Also, open capital account that was represented by Chinn and Ito index increased FPI flows.

Verikios (2018) studied the effect of capital account policies on FDI in China between by using a dynamic computable general equilibrium model of the world economy. The results showed that if capital controls on FDI in China decreased by 50%, FDI inflows to China increased by 6.3%.

- Studies related trade openness and FDI

While analyzing the theory, it was decided that trade openness or trade volume is one of the dimensions of financial liberalization. Because of that, this part includes studies about the relationship between trade openness and FDI relationship.

Aseidu (2002) tried to find the main determinants of FDI in sub-Saharan and non sub-Saharan African countries in between 1988-1997 by using panel OLS estimation. The results supported that liberalized trade regime attracts more FDI in non sub-Saharan countries. FDI inflows to Sub-Saharan countries were less because trade openness wasn't provided in those countries in the period.

Kohpaiboon (2003) tried to find the relationship between trade openness and FDI in Thailand between 1970-2009 by using Engle Granger method and modified OLS estimator proposed by Philip Hansen (1990). The results proved that Bhagwati hypothesis. Export oriented trade regime was better than import substitution trade regime to attract more FDI.

Omran and Bolbol (2003) confirmed the theory suggesting that acceleration of growth by FDI depends on absorptive capacities in Arab countries in between 1975-1999. Financial development was considered as one of these capacities. The financial sector indicators separated as banking sector and stock market. The Granger causality test showed the market based indicators caused FDI. The test showed unidirectional relationship from FDI to bank based indicators in three countries. More, FDI was enhanced in countries with more liberal trade regime. Lastly, econometric results proved that positive impact of FDI on economic growth was based on financial development.

Atique et al. (2004) analyzed the effect of trade regime on the relationship between FDI and economic growth in Pakistan between 1970-2001 by using Engle-Granger (EG) and Hansen methods. The results supported Bhagwati hypothesis that implies positive effect of FDI on growth is high under export promotion trade regime.

Albuquerque et al. (2005) explored the local and global determinants of FDI by using cross country and time series analyses for 94 countries in between 1970-1999. The results showed that global factors had important role to determine FDI inflows to

both industrial and developing countries. On the other hand, some local indicators which were local productivity, trade openness, financial depth, low government burden and stable macroeconomic condition were important factors.

Kandiero and Chitiga (2006) researched the relationship between trade openness and FDI in Africa for four periods which were 1980-1985, 1985-1990, 1990-1995 and 1995-2001 by using fixed effects and GMM model. The results proved that ratio of FDI to GDP was sensitive for trade openness.

Kar and Tatlısöz (2008) studied the determinants of FDI in Turkey in between 1980-2013 by using OLS. Econometric results showed that international net reserves, real exchange rate, GNP, number of labor lost by strikes, trade openness, electric energy production index and subsidy for investment had positive and significant effect on FDI.

Martens (2008) searched the impacts of trade liberalization on FDI for emerging markets by examining 21 related studies between 1997-2007. The author concluded that the trade liberalization and FDI is complements.

Turan Koyuncu (2010) tried to find how effective basic macroeconomics indicators on the FDI in Turkey between 1990-2009 period by using structural VAR analyses. The results proved that FDI in the previous period, GDP, trade openness and change in the net international reserves had positive and significant effect of FDI inflow in Turkey.

Jadhav (2012) tried to find the main determinants of FDI in BRICS countries by taking into account economic, institutional and political factors for 2000-2009 period by using panel unit root tests and multiple regressions. The econometric results showed that the type of FDI inflows to BRICS was market seeking FDI so traditional variables were more important than institutional and political factors. Market size, trade openness and availability of natural resources were positive and significant effect on FDI inflows in BRICS.

Çetin and Seker (2014) searched the effects of trade openness and financial development level on FDI inflows to OECD countries in between 1996-2011 by using system GMM estimator. Empirical results showed that trade openness was decisive

factor of FDI. Financial development level that was represented by ratio of bank credit to GDP is also important factor to attract FDI.

Hunady and Orviska (2014) investigated the main determinants of FDI in 26 European Union countries in between 2004-2011 by taking into account corporate taxes and by using panel data regression model. The empirical results showed that most important factors that influence FDI inflows were labor cost, trade openness, infrastructure and macroeconomic stability while corporate tax had no statistically significant effect on FDI.

Zakaria et al. (2014) tried to find the effects of trade liberalization on FDI in Pakistan by using quarterly data of 1972-2010. The results of GMM estimation proved that, there was positive and significant effect of trade regime on FDI. It implied that abandoning of trade restrictions was important to attract FDI.

Erdogan (2016) examined the relationship between FDI, trade openness and economic growth in Turkey for the period of 1980-2009 by using ARDL bound test. The results showed that there was long-term relationship between these variables. FDI and economic growth caused trade openness in Turkey for the period.

Şahbaz et al. (2016) explored the effect of trade openness and FDI on poverty by using data of Turkey in between 1980-2015. Results of Granger causality test showed that trade openness and FDI decreased poverty in the long term. Also, there was bidirectional relationship between FDI and poverty and one way relationship between from trade openness to poverty. Moreover, there was causality from trade openness to FDI inflow.

Shah and Khan (2016) focused on the relationship between trade liberalization and FDI inflows to developing countries between 1996-2014 in Brazil, China, Mexico, Russian Federation and Turkey. Results of panel estimation proved that more liberalized trade regime and existence of preferential trade agreements encouraged MNCs.

Topallı (2017) studied the relationship between FDI, trade openness and economic growth by using data of Turkey and BRICS countries for 1982-2013 period and by using CADF unit root test and Emirmahmutoglu and Köse (2011) causality test.

The study concluded that there were one way causality from economic growth to FDI; bidirectional relationship between trade openness and economic growth; and bidirectional relationship between FDI and trade openness. However, the results showed that there was no relationship between FDI and trade openness for Turkey.

3.2. Data and Methodology

3.2.1. Data

It is observed that the studies in the literature mostly focus on the relationship between financial development and FDI for both developed and developing countries. The effect of the phenomenon of financial liberalization on FDI is in the background. The main aim of the study is to determine the effect of financial liberalization on net FDI inflows to Turkey by using annual dataset in between 1974-2015. First of all, unit root tests are used to determine degree of stationary of the variables. After that, to identify the long-run relationship between the variables co-integration test, Vector Autoregressive (VAR) model and Vector Error Correction model (VECM) are applied respectively. Finally, to detect the causality, Granger causality is used. The variables are used in the study are;

$$FDI = f(FGLOB, KAOPEN, TVOL)$$

As FDI variable, ratio of net inflow of FDI to GDP is used and provided from World Bank- World Development Indicators. In the studies examined, different variables are used as proxies of both financial development and financial liberalization. There isn't exact indicator that defines these two phases so it is tried to find the variables that impact FDI statistically significant are selected by following the economics literature. In this direction, KAOPEN, FGLOB and TVOL are selected. KAOPEN is index of capital account index that is developed by Chinn and Ito (2006) based on IMF's Annual Report on Exchange Arrangements and Exchange Restrictions (AREAER). It is first principle component of four IMF binary variables which are restrictions on current account, capital account transactions, export proceeds and capital controls (Chinn and Ito, 2005, p. 7). FGLOB is financial globalization index (de jure) provided from KOF Swiss Economic Institute. Actually, the index includes Chinn-Ito index but Chinn-Ito index does not contain information about the prevalence of capital controls and direction or residence of certain types of flows. Because of that, the index

includes another index that is developed by Jahan and Wang (2016). It is also based on AREAR. It contains extensive set of indicators about construction. The last indicator that is included by FGLOB is based on WEF Global Competitiveness Report and taken From Gwartney et al. (2016). It measures the all constriction on investment. Also, it contains measures of the prevalence of foreign ownership and regulations to international capital flows (Gygli et al., 2018). The third variable is TVOL which is ratio of sum of export and import to GDP that is provided from World Bank- World Development Indicators. It shows the total amount of trade of a country with other countries. In the study, *Eviews 10.0* is used for econometric analyses.

3.2. 2. Methodology

3.2.2.1. Unit root tests

In time series analyses, the stability of the series included in the model is very important. The concept of stationary is expressed as the fluctuation of time series around a certain average.

When any time series model is developed, it should be known whether the resulting stochastic process changes over time. If the stochastic process changes over time, in other words if the series are not stationary, it is not possible to express the past and future structure of the series with a simple algebraic model. If the stochastic process is constant over time, a fixed coefficient model of the series can be obtained by using the past values of the series. In short, a stochastic process is called as stationary if its mean and variance are fixed in the time. Also, the value of covariance between two time periods is attached to distance or lag between the periods. And, it is not attached to actual time at which the covariance is figured out. If a time series is stationary, variance, mean and covariance of the series are always constant. If a time series is not stationary, it is called as non-stationary time series. Sometimes, main reason of non stationary can be a shift in the mean (Gujarati, 1995, p.713-714).

Before performing data analysis with time series, it should be checked whether the series are stationary or non-stationary. If the series are not stationary, the value of previous period of the series and the shock that it was exposed in that period remains in the system. The non-stationary time series cause spurious regression. In spurious regressions, R^2 is very high and Durbin-Watson (DW) statistics is very low. It means that time series are strongly auto correlated so the regression is misspecified (Granger

and Newbold, 1974, p.117). Stationary of time series are tested with unit root tests. The most well known unit root tests are Augmented –Dickey Fuller (ADF) test that is constructed by Dickey and Fuller (1979 and 1981) and Philips Perron (PP) test that is constructed by Philips –Perron (1988). If the first differences of a time series are taken and the series is stationary, it can be said that the series is integrated into the first order and shown as I(1).

- Zivot Andrews unit root test

Zivot and Andrews (1992) developed a model in which the breaking point is estimated endogenously. For Zivot-Andrews unit roots test, three models are improved (Zivot and Andrews, 1992, p. 254);

$$y_t = \mu + \beta t + \alpha y_{t-1} + \theta_1 DU(T_b) + \sum_{i=1}^k c_i \Delta y_{t-i} + e_t \quad (\text{Model A}) \quad (3.1)$$

$$y_t = \mu + \beta t + \alpha y_{t-1} + \theta_2 DT(T_b) + \sum_{i=1}^k c_i \Delta y_{t-i} + e_t \quad (\text{Model B}) \quad (3.2.)$$

$$y_t = \mu + \beta t + \alpha y_{t-1} + \theta_2 DT(T_b) + \theta_1 DU(T_b) + \sum_{i=1}^k c_i \Delta y_{t-i} + e_t \quad (\text{Model C}) \quad (3.3)$$

Model A includes structural break with intercept, Model B includes structural break with trend and Model C includes structural break with intercept and trend. In the models, T_b represents time of structural break. It is chosen to minimize one-sided t statistics of $\alpha = 1$. DU is the sustained dummy variable. It takes a shift in the intercept. DT is another dummy variable. It represents break in the trend (Worthington and Pahlavani, 2007, 260). In formally;

$$DU = \begin{cases} 1 & \dots \dots \dots \text{if } t > T_b \\ 0 & \dots \dots \dots \text{otherwise} \end{cases} \text{ and}$$

$$DT = \begin{cases} t - T_b & \dots \dots \dots \text{if } t > T_b \\ 0 & \dots \dots \dots \text{otherwise} \end{cases}$$

The null hypothesis is $\alpha = 0$ for three models. The null hypothesis suggests that the series y_t has unit root with a drift that except any structural break. The alternative hypothesis which is $\alpha < 0$ suggests that y_t is trend stationary process. It includes one-time break that occurs at an unknown time (Waheed et al., 2006, p.6).

- Augmented Dickey-Fuller test

Dickey-Fuller test is one of the methods to test stationary but the test ignore whether the error terms are auto correlated. In this case, the test is inoperative. Because of that, Dickey and Fuller developed (ADF) test. The following equation is used for the ADF unit root test (Gujarati, 1995, p.720);

$$\Delta Y_t = \beta_1 + \beta_2 t + \delta Y_{t-1} + \sum_{i=1}^k a_i \Delta Y_{t-1} + \varepsilon_t \quad (3.4)$$

$$\Delta Y_t = Y_t - Y_{t-1}$$

$$H_0 : \delta = 0 \text{ (} Y_t \text{ is non stationary. } Y_t \text{ has unit root)}$$

$$H_1 : \delta \neq 0 \text{ (} Y_t \text{ is stationary. } Y_t \text{ hasn't unit root)}$$

In the equation (3.4), ΔY_T represents the first difference of the analyzed time series, t represents time or trend variable, ΔY_{t-1} represents lagged difference terms. Lagged difference terms are included to provide that the error term is serially independent. To get reliable result from ADF test, there shouldn't be serially dependent problem. In the equation, k represents the lag length and the lag length is determined according to Akaike or Schwarz Information Criteria. The null hypothesis is $\delta = 0$. If calculated ADF statistic is less than McKinnon critical values, null hypothesis isn't rejected. It means that Y_t has unit root (Gujarati, 1995, p.720; Antonios, 2010, p.3).

- Philips-Perron test

The PP unit root test is modified version of ADF test. In PP test, structure of process of error term is less restricted. Also, PP test try to overcome the problem of autocorrelation by correcting test statistics. The following equation is used for the PP unit root test (Sinha, 1997, p.77);

$$y_t = \check{c}_0 + \check{c}_1 Y_{t-1} + \check{c}_2 \left(t - \frac{T}{2} \right) + v_t \quad (3.5)$$

$$H_0 : \check{c}_1 = 1 \text{ (} y_t \text{ is non stationary. } y_t \text{ has unit root)}$$

$$H_1 : \check{c}_1 \neq 1 \text{ (} y_t \text{ is stationary. } y_t \text{ hasn't unit root)}$$

In the equation (3.5), T represents number of observations while v_t is error term. The null hypothesis that is $\check{c}_1=1$ means y_t has unit root. If PP statistics is less than McKinnon critical values, the null hypothesis is accepted. The PP unit root test is

modified version of ADF test. In PP test, structure of process of error term is less restricted. The serial correlation between error terms and homogeneity of error terms are ignored. Also, PP test try to overcome the problem of autocorrelation by correcting test statistics. The lag length is determined according to Newey-West lag selection.

ADF and PP tests are used as unit root tests in the study.

3.2.2.2. Co-integration Test

Co-integration is the statistical presentation of the long-term relationship between economic variables. The long term relationship between economic variables can be demonstrated by different economic analyzes. This relationship can be analyzed according to structure of the variables. In particular, a study of whether there is a long-term relationship between two or more non-stationary variables depends on the co-integration of the variables. Co-integration means stationary relationship between two or more non-stationary variables. In other words, co-integration is to demonstrate an equilibrium and long term relationship between non-stationary variables. If there isn't long-term relationship between two or more non-stationary variables, the estimated regression will be spurious. In the case of spurious regression, the predicted model generally provides appropriate results. However, it is difficult to interpret the results economically. Since the most of macroeconomic time series are non-stationary, co-integration analyses is used to reveal the relationship between two or more variables (Sevüktekin and Çınar, 2017, p.559).

In the study Johansen Co-integration test will be used.

- Johansen co-integration test

Johansen co-integration test proves that there could be more than one co-integration between variables by improving multi-equation approach. This method is based on the relationship between the matrix rank and characteristic roots. Johansen (1991) improved a time series model as decreased rank regression. Johansen (1991) developed time series as a decreased rank regression in which they calculate maximum likelihood forecast in a multivariate error correction model with Gaussian errors.

The developed model depends on error correction presentation that is showed as;

$$\Delta Z_T = \mu + \sum_{i=1}^{p-1} \Gamma_i \Delta Z_{t-1} + \Pi Z_{t-1} + \varepsilon_t \quad (3.6)$$

In the regression (3.6), Z_T is (n x 1) column vector of p variables while μ is constant term and Δ represent difference indicator. Π shows the long run relationship. ΠZ_{t-1} is error correction factor. It is possible to write Π with two component as $\Pi = \alpha\beta'$. β' represents long term coefficient and α represents setting speed of long-term parameter. It is required to pretesting for the order of integration of each variable. And then, equation (3.6) is estimated. The residuals are used to calculate two likelihood ratio test statistics which are the trace and maximum eigenvalue (λ -max) tests. Finally, if the rank of Π is greater than 1 and Π is less than n, there are more than one co-integrated vectors (Awokuse, 2007, p.39).

3.2.2.3. Vector Auto-correlation (VAR)

VAR models are the system of equation that includes not only lagged value of endogenous variable but also lagged values of other variables in the system. In VAR models, the system includes not only endogenous variables but also exogenous variables. In traditional simultaneous econometric models endogenous-exogenous differentiation is considered but it isn't necessary this kind of differentiation in VAR model. The field of use of VAR models in econometrics is to establish interactions between variables rather than to determine policy, and to make preliminary reports about the future. According to Sims (1980) and Sims, Stock and Watson (1990), the aim of the VAR analysis is not to determine the predictions but to reveal the mutual effect between the variables (Enders, 2004, p.270). VAR model is shown below;

$$Y_t = \alpha_1 + \sum_{i=1}^m \alpha_2 Y_{t-i} + \sum_{j=1}^n \alpha_3 X_{t-j} + \varepsilon_{1t} \quad (3.7)$$

$$X_t = \beta_1 + \sum_{i=1}^p \beta_2 Y_{t-i} + \sum_{j=1}^q \beta_3 X_{t-j} + \varepsilon_{2t} \quad (3.8)$$

- Variance decomposition

An important tool of VAR analysis is variance decomposition. Knowing the characteristics of prediction errors provides important benefits in revealing the interrelationships between the variables in the system. The variance decomposition is defined as the rate of separation of the predictive error variance of each variable to the components that can be loaded into each variable in the system. The variance

decomposition is used to proportionally measure the effects of the shocks on the variables by dividing the predictive error variance of each variable to each of the variables.

3.2.2.4. Vector Error Correction Model (VECM)

If there is a co-integrated vector between variables, according to Granger (1988), at least one-way causality should be found between the variables. In this case, the causality analysis should be performed with VEC model. The advantage of this model, which is used to distinguish between long-term equilibrium and short term dynamics between variables, is to be able to use short and long term data without causing false relationship between dependent and independent variables. The causal link model based on logic of Granger theory including residuals term between X and Y is shown like the VEC model below;

$$\Delta Y_T = \alpha_0 + \sum_{i=1}^n a_{1i} \Delta X_{t-i} + \sum_{i=1}^n \alpha_{2i} \Delta Y_{t-i} + \lambda D_{t-1} + u_{1t} \quad (3.9)$$

$$\Delta X_T = b_0 + \sum_{i=1}^n b_{1i} \Delta X_{t-i} + \sum_{i=1}^n b_{2i} \Delta Y_{t-i} + \delta E_{t-1} + u_{2t} \quad (3.10)$$

In the model, D_{t-1} and E_{t-1} are error correction terms while λ and δ are coefficients that shows long term relationship between ΔY_T and ΔX_T . ΔY_{t-i} and ΔX_{t-i} represents short term dynamics of the system. $a_{1i}, \alpha_{2i}, b_{1i}$ and b_{2i} represent short term parameters that affect dependent variable. Because of that the statistic of the F statistics or the error correction coefficient which expresses the cumulative validity of these parameters is significant. It indicates the existence of causality. Moreover, if the error correction term is statistically significant, there is deviation from equilibrium. In the long term, the speed of approach to equilibrium level depends on error correction term. It is expected that the error correction term should be negative and statistically significant. If the term is positive, there is not significant long term relationship between variables.

3.2.2.5. Granger Causality

One of the most commonly used approaches to investigate the existence of causality between economic variables is the causality test developed by Granger in 1969. The causality tests have been used and developed by different authors over time. These tests can be applied to long-term time series. The time series should be stationary but there is no obligation to be stationary in the same order. The Granger test is affected

by the sample size and annual or seasonal status of the data. Also, the lag order in relationships is important. According to Engle and Granger (1987), it is necessary to investigate whether there is long term equilibrium relationship between variables. For this, properties of time series should be determined with the help of unit root and co-integration test. They suggest that if the series X and Y are stationary at first order and co-integrated, there is at least one-way causality. Finally, Granger causality test should be performed using one of the pairs of equations that are selected according to properties of series.

Granger causality test can be showed as;

$$X_t = \alpha_0 + \sum_{i=1}^m \alpha_i X_{t-i} + \sum_{i=1}^m b_i Y_{t-i} + u_i \quad (3.11)$$

$$Y_t = b_0 + \sum_{i=1}^m b_i Y_{t-i} + \sum_{i=1}^m a_i X_{t-i} + u_i \quad (3.12)$$

In the regression (3.11), α_0 represents the constant term and u_i is error term that is white noise process has distribution of $u_t \sim N(0, \sigma_u^2)$ with zero mean and constant variance. The regression can be identified for each variable. The hypotheses are defined below;

$$H_0: \sum_{i=1}^m b_i = 0 \text{ (There is no causality from Y to X.)}$$

$$H_1: \sum_{i=1}^m b_i \neq 0 \text{ (There is causality from Y to X)}$$

As conclusion of Granger causality test, these conclusions can be come to exist;

- $X \rightarrow Y$ (X is Granger cause of Y.)
- $Y \rightarrow X$ (Y is Granger cause of X.)
- $X \leftrightarrow Y$ (There is bidirectional causality between X and Y.)
- $X \nleftrightarrow Y$ (There is no causality between X and Y.)

In the study, VEC Granger causality test is used to prove causal relationship between variables.

3.3. Empirical Results

Firstly, descriptive statistics, covariance and correlation analyses are defined in the study.

- **Descriptive Statistics**

Table 3.1 Descriptive statistics of variables

	FDI	FGLOB	KAOPEN	TVOL
Mean	0.788567	50.02464	0.241634	36.80427
Median	0.438929	50.31757	0.165809	38.83798
Maximum	3.653480	60.65542	0.448928	54.97032
Minimum	0.019501	31.61000	0.000000	9.099744
Standard deviation	0.897924	7.432986	0.154139	13.03551

- **Covariance and correlation analyses**

Table 3.2 Covariance and correlation analyses of the variables

Covariance analysis				
	FDI	FGLOB	KAOPEN	TVOL
FDI	0.787071	-1.757603	0.050922	7.122522
FGLOB	-1.757603	53.93382	0.585993	-12.21514
KAOPEN	0.218272	2.499696	0.023193	4.559803
TVOL	7.122522	-12.21514	1.065021	165.8788
Correlation analysis				
	FDI	FGLOB	KAOPEN	TVOL
FDI	1.000000	-0.269764	0.376892	0.623349
FGLOB	-0.269764	1.000000	0.523940	-0.129143
KAOPEN	0.377932	0.522852	1.000000	0.543842
TVOL	0.623349	-0.129143	0.542978	1.000000

Correlation analysis shows that there is negative correlation between FDI and FGLOB. On the other hand, there is positive correlation between FDI and KAOPEN and FDI and TVOL.

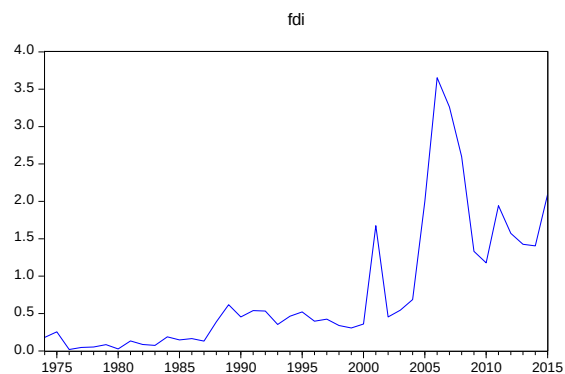


Figure 3.1 Time series graph of FDI

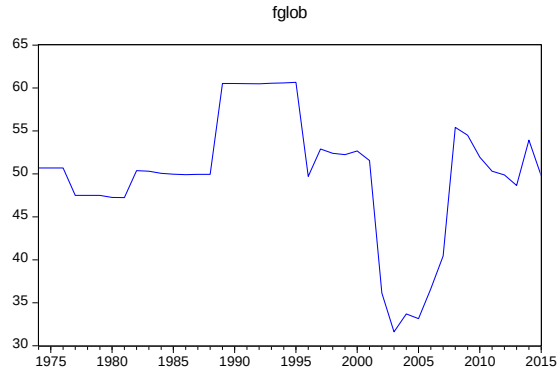


Figure 3.2 Time series graph of FGLOB

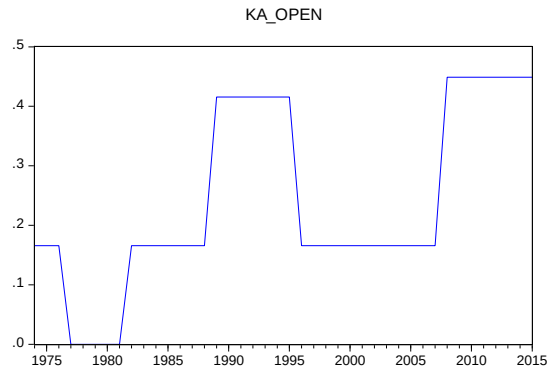


Figure 3.3 Time series graph of KAOPEN

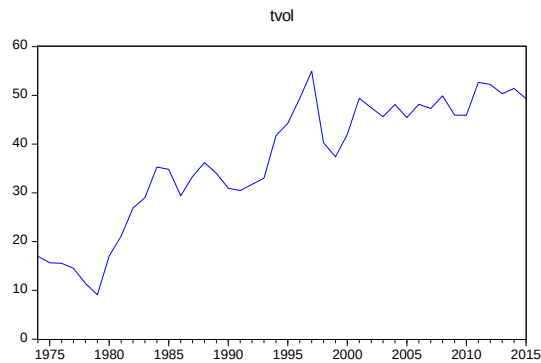


Figure 3.4 Time series graph of TVOL

When the time series graphs of the data are investigated, it is seen that time series of FGLOB and KAOPEN have similar trend in time. The important point is that FGLOB and KAOPEN series increase suddenly at the peak level of FDI in 2007. In those times, FDI inflows to Turkey increased thanks to the stable and predictable policies and economic growth besides the growing volume of investments in the world economy. Furthermore, accession negotiations of Turkey to European Union started in 2005 which is important liberalization and globalization policies. This could affect the investment climate in Turkey. Last, time series of TVOL has an increasing trend over

time. After 1995, TVOL reach the peak level. Customs union agreement and with the European Union and participation to WTO could influence the situation.

- **Results of unit root tests**

Before test the stationary of the series, it is useful to interpret the time series of graphs. It is understood from the Figure 3.1, FDI has trend over time. However, it hasn't intercept because the initial level of the FDI is close to zero. Because of that reason, when the stationary of the FDI is tested, only trend is included. It is not possible to test stationary including only trend with ADF and PP test so Zivot-Andrews test will be used for FDI.

Table 3.3 Results of Zivot-Andrews Test

Variable	Zivot-Andrews Unit Root Test Statistics (Trend)
FDI	-4.044483 (0.297800)

Chooosen break point date is 1997

Chosen lag lenght is 1.

Probabilty is shown in parenthesis.

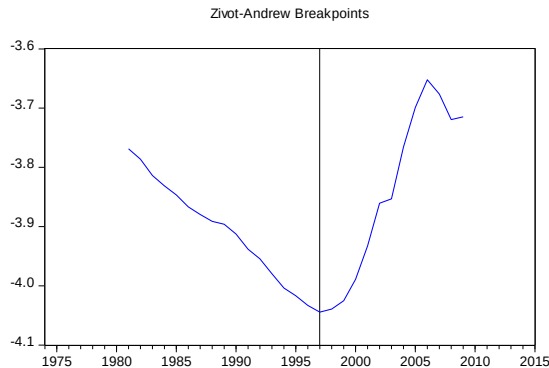


Figure 3.5 Zivot Andrews Breakpoint test

Result of Zivot-Andrews test proves that FDI has a unit root with a structural break in the trend. Probability is greater than 10 percent and the Zivot-Andrews test statistics is less than critical values so the null hypothesis is accepted. As it is seen in the Figure 3.5., the break point date is 1997. It can be said that FDI is not stationary at level.

Before test stationary of other series, time series graphs of series are indicated. When the Figure 3.2 is examined, it is seen that FGLOB has not trend but it has intercept. The initial level is around 50. Only intercept will be included when the

stationary is tested. If Figure 3.3 is examined, there is uncertainty about existence of intercept and trend for KAOPEN so the stationary tested by two stage. In first stage, both trend and intercept will be included while trend and intercept will not be included in second stage. Finally, it is clearly understood that TVOL has both trend and intercept. The initial level is around 15. When the stationary is tested, intercept and trend will be included.

Table 3.4 Results of ADF test

Variables	ADF(level)			ADF(first difference)		
	Intercept	Trend and intercept	None	Intercept	Trend and intercept	None
FGLOB	-1.989745 (0.2900)	-1.992074 (0.5882)	-0.313313 (0.5665)	-5.576624 (0.0000)	-5.497376 (-0.0003)	-5.651042 (0.0000)
KAOPEN	-1.438230 (0.5543)	-2.145567 (0.5060)	-0.297072 (0.5726)	-6.212489 (0.0000)	-6.161175 (0.0000)	-6.244998 (0.0000)
TVOL	-1.413233 (0.5665)	-2.890699 (0.1761)	0.614432 (0.8451)	-5.325959 (0.0001)	-5.336126 (0.0005)	-5.081705 (0.0000)

Probabilities are shown in the parenthesis.

According to ADF unit roots tests, the variables which are TVOL, KAOPEN and FG are non-stationary at level so the null hypothesis is accepted means that the series have unit root. The probabilities are greater than 10% and ADF statistics are less than McKinnon critical values. These three series get stationary when the first differences are taken. It can be said that, TVOL, KAOPEN and FG is I(1).

Table.3.5 Results of PP test

Variables	PP(level)			PP(first difference)		
	Intercept	Trend and intercept	None	Intercept	Trend and intercept	None
FGLOB	-2.123335 (0.2369)	-2.132333 (0.5131)	-0.324708 (0.5623)	-5.574365 (0.0000)	-5.49874 (0.0003)	-5.648988 (0.0000)
KAOPEN	-1.533161 (0.5070)	-2.267687 (0.4413)	-1.305368 (0.5995)	-6.212474 (0.0000)	-6.161156 (0.0000)	-6.244998 (0.0000)
TVOL	-1.255765 (0.6408)	-2.619011 (0.2744)	1.035689 (0.9184)	-6.715494 (0.0000)	-8.215996 (0.0000)	-5.716966 (0.0000)

Probabilities are shown in the parenthesis.

The all three series are non stationary at level according to PP test. The probabilities are greater than 10% and PP test statistics are less than McKinnon critical values. When the first differences are taken, the all get stationary. It can be said that TVOL, KAOPEN and FGLOB are I(1).

- **Results of Johansen co-integration test**

After determining that series are stationary at same level, co-integration test could be run. Johansen's method includes simultaneous estimation of dynamic VAR models (Bahmani-Oskooee and Rhee, 1997, p.106). Because of that appropriate lag length will be highlighted based on VAR model. After that, Johansen co-integration test is applied.

Table 3.6 Test results for detection of optimum lag length

Lag length	AIC	SC	HQ
0	14.90922	15.07984	14.97044
1	10.41213*	11.26524*	10.71822*
2	10.56010	12.09570	11.11106
3	10.52440	10.52440	11.32023

* represents lag length selected by the criterion

In the study, Akaike Information Criteria (AIC), Schwarz Information Criteria (SC), and Hannan Quinn Information Criteria(HQ) are used to determine optimum lag length. These critical values are calculated and optimum lag length is determined by comparing the values. According to Table 3.6, the appropriate lag length is first, because AIC, SC and HQ are at their minimum level. At first lag, there is no serial correlation between residuals.

Table 3.7 Trace test results for Johansen co-integration test

Unrestricted Cointegration Rank Test (Trace)				
Hypothesized No. of CE(s)	Eigenvalue	Trace Statistic	0.05 Critical Value	Prob.**
None *	0.523811	49.14236	47.85613	0.0376
At most 1	0.238686	19.46473	29.79707	0.4599
At most 2	0.183079	8.556344	15.49471	0.4080
At most 3	0.011678	0.467846	3.841466	0.4940
Trace test indicates 1 cointegrating eqn(s) at the 0.05 level				
* denotes rejection of the hypothesis at the 0.05 level				
**MacKinnon-Haug-Michelis (1999) p-values				

Table 3.8 Maximum Eigenvalue test results for Johansen co-integration test

Unrestricted Cointegration Rank Test (Maximum Eigenvalue)				
Hypothesized No. of CE(s)	Eigenvalue	Max-Eigen Statistic	0.05 Critical Value	Prob.**
None *	0.523811	29.67762	27.58434	0.0265
At most 1	0.238686	10.90839	21.13162	0.6565
At most 2	0.183079	8.088498	14.26460	0.3698
At most 3	0.011628	0.467846	3.841466	0.4940
Max-eigenvalue test indicates 1 cointegrating eqn(s) at the 0.05 level				
* denotes rejection of the hypothesis at the 0.05 level				
**MacKinnon-Haug-Michelis (1999) p-values				

There is one co-integration between non-stationary time series according to trace test and maximum eigenvalue test. It is important to get same results from two test statistics for the stability of the model.

- **Results of Vector Auto-correlation(VAR) and Vector Error Correction Model (VECM) Analyses**

The result of VAR in the model is shown like⁴;

$$\begin{aligned}
 FDI = & 0.594820FDI_{t-1} - 0.050908FGLOB_{t-1} + 1.659267KAOPEN_{t-1} + 0.003015TVOL_{t-1} \\
 & (0.11269) \quad (0.01523) \quad (0.85023) \quad (0.00842) \\
 & [5.27842] \quad [-3.34632] \quad [1.95155] \quad [0.35811] \\
 & +2.397668 \quad (3.13) \\
 & (0.79631) \\
 & [3.01097]
 \end{aligned}$$

⁴ $R^2 = 0.891486$

*Standard errors are shown in () while t-statistics are shown in [].

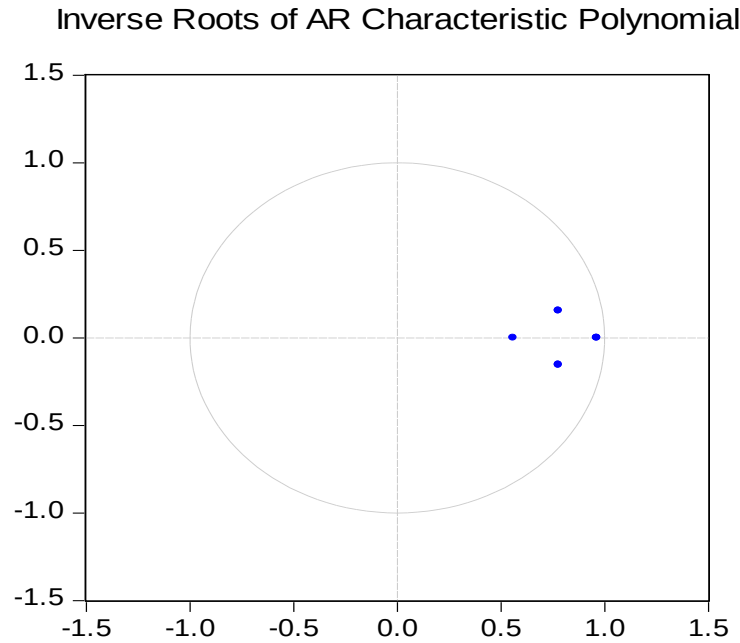


Figure 3.6 Inverse Roots of AR Characteristic Polynomial

If the estimated VAR is stationary, the all roots are shown by blue points should inside the circle. As it is seen in the Figure 3.6, all roots are in the circle so it can be said that the estimated VAR in the study is stationary.

- Results of Variance Decomposition

Table 3.9 Results of variance decomposition of FDI

Period	S.E.	FDI	FGLOB	KAOPEN	TVOL
1	0.458130	100.0000	0.000000	0.000000	0.000000
2	0.539978	91.61287	5.696041	2.633769	0.057318
3	0.595260	78.98920	14.23445	6.243750	0.532596
4	0.644572	67.79898	21.40737	9.083939	1.709708
5	0.687901	59.53337	26.02930	10.87062	3.566714
6	0.724386	53.71225	28.48818	11.88351	5.916060
7	0.754415	49.56935	29.47280	12.42419	8.533663
8	0.779035	46.52334	29.56102	12.69833	11.21731
9	0.799386	44.20144	29.15930	12.82924	13.81001
10	0.816449	42.37612	28.52981	12.88763	16.20644

Table 3.10 Results of variance decomposition of FGLOB

Period	S.E.	FDI	FGLOB	KAOPEN	TVOL
1	4.436005	3.093697	96.90630	0.000000	0.000000
2	5.911716	6.240493	93.32840	1.55E-05	0.431094
3	6.754615	8.761961	89.96364	0.019040	1.255360
4	7.245851	10.57221	87.05332	0.094452	2.280019
5	7.527733	11.76655	84.66578	0.234723	3.332951
6	7.686423	12.48546	82.80912	0.423032	4.282383
7	7.774946	12.87019	81.44841	0.631146	5.050252
8	7.824915	13.04238	80.51368	0.831902	5.612037
9	7.854278	13.09466	79.91481	1.006451	5.984075
10	7.872692	13.08958	79.55910	1.146035	6.205281

Table 3.11 Results of variance decomposition of KAOPEN

Period	S.E.	FDI	FGLOB	KAOPEN	TVOL
1	0.076963	0.052060	53.13239	46.81555	0.000000
2	0.101053	3.645476	53.44327	42.88663	0.024620
3	0.115416	7.517291	50.95651	41.45688	0.069320
4	0.124505	10.51360	47.73641	41.59153	0.158459
5	0.130533	12.50332	44.65791	42.50163	0.337128
6	0.134858	13.64887	42.05483	43.63522	0.661083
7	0.138294	14.17649	39.99141	44.65228	1.179830
8	0.141282	14.29642	38.39677	45.38677	1.920037
9	0.144036	14.17376	37.15037	45.79783	2.878033
10	0.146639	13.92378	36.13503	45.91819	4.023000

Table 3.12 Results of variance decomposition of TVOL

Period	S.E.	FDI	FGLOB	KAOPEN	TVOL
1	4.448218	6.997571	0.068590	0.036401	92.89744
2	5.921185	6.109331	0.078084	0.668885	93.14370
3	6.893668	5.657747	0.106148	1.542349	92.69376
4	7.617229	5.452809	0.142827	2.489686	91.91468
5	8.188735	5.389667	0.176682	3.437000	90.99665
6	8.657157	5.404803	0.199840	4.351299	90.04406
7	9.051135	5.457806	0.209993	5.216979	89.11522
8	9.389021	5.523253	0.209239	6.026002	88.24151
9	9.683312	5.586147	0.201817	6.774074	87.43796
10	9.942866	5.638714	0.192145	7.459269	86.70987

* S: E. means standard error.

In Table 3.9, it is shown that 28,53% of predicted error variance of FDI derives from financial globalization that is represented by FGLOB while 16,19% of predicted error variance of FDI derives from TVOL that is representation of trade volume at the end of the tenth period. On the other hand, only 12.88% of predicted error variance of FDI is explained by KAOPEN that is representation of capital account liberalization at the end of tenth period. Finally, variance decomposition results prove that there is strong relationship between FGLOB and FDI.

- Results of VECM

The result of VECM is shown below⁵;

$$\Delta(FDI) = 0.064213 + 0.213419FDI + 0.059867FGLO - 2.968511 - 0.010017$$

$$(0.06794) \quad (0.213781) \quad (0.02691) \quad (0.30871) \quad (0.01576)$$

$$[0.94514] \quad [1.53984] \quad [2.22397] \quad [-2.25157] \quad [-0.63572]$$

$$\mathbf{-0.600118} \quad (3.14)$$

$$(0.11828)$$

$$[-5.07418]$$

The coefficient of error correction term obtained from the model where the FDI is dependent variable equals -0.600118. There is long run relationship between variables. It is statistically significant and can be interpreted. According to the result, an inequality between dependent and independent variables recovers after 1.66 periods.

To detect which independent variables effect FDI in the short run, the model (3.14) estimated in Ordinary Least Square (OLS).

⁵ $R^2 = 0.477988$

F=statistic = 6.226527

*Standard errors are shown in () while t-statistics are shown in [].

Table 3.13 Results of estimation of VECM model with OLS

$D(FDI) = C(1)*(FDI(-1) + 0.107795264645*FGLOB(-1) - 0.956196026234$ $*KAOPEN(-1) - 0.0141698314139*TVOL(-1) - 6.48440826699) + C(2)$ $*D(FDI(-1)) + C(3)*D(FGLOB(-1)) + C(4)*D(KAOPEN(-1)) + C(5)$ $*D(TVOL(-1)) + C(6)$			
	Coefficient	t-statistics	Probabiliy
C(1)	-0.600187	-5.074184	0.0000
C(2)	0.213419	1.539839	0.1329
C(3)	0.059867	2.223968	0.0329
C(4)	-2.968511	-2.251574	0.0309
C(5)	-0.010017	-0.635717	0.5293
C(6)	0.064213	0.945143	0.3513
R-squared=0.477988 Adjusted R-squared=0.401222 F statistics=6.226527 Prob(F-statistics)= 0.000336 Durbin Watson stat=2.357345			

Table 3.14 Results of Wald test

Variables	Probability of F Statistics	Probability of t statistics	Null hypothesis	
FGLOB	0.0329	0.0329	C(3)=0	Null hypothesis is rejected
KAOPEN	0.0309	0.0309	C(4)=0	Null hypothesis is rejected
TVOL	0.5292	0.5292	C(5)=0	Null hypothesis is accepted.

As it is shown in the Table 3.13., probabilities of coefficient of C(1) which represents error correction term, coefficient of C(3) which represents FGLOB and coefficient of C(4) which represents KAOPEN are statistically significant. It implies that FGLOB and KAOPEN impact FDI in the short run. Moreover, results of the Wald test support the results in the Table 3.14.

- **Results of Granger Causality test**

Table 3.15 VEC Granger Causality/ Block Exogeneity Wald Tests

Dependent Variable: D(FDI)			
Excluded	Chi-sq	df	Prob.
D(FGLOB)	4.946034	1	0.0262
D(KAOPEN)	5.069587	1	0.0243

The results of VEC Granger causality test prove that FLOB and KAOPEN are Granger cause of FDI at 5% significance level. However, there is no causal relationship between TVOL and FDI (Table 3.15.).

Table 3.16 Short run and long run analysis based on Granger causality test and VECM

Short-run analyses					Long-run analyses
Dependent Variables	Independent Variables				
	ΔFDI	$\Delta FGLOB$	$\Delta KAOPEN$	$\Delta TVOL$	VEC_{t-1}
ΔFDI	-	(0.0262*)	(0.0243*)	(0.5251)	-0.600399 [-5.07361]
$\Delta FGLOB$	(0.633)	-	(0.1794)	(0.4201)	-0.013841 [-0.09521]
$\Delta KAOPEN$	(0.6578)	(0.9990)	-	(0.9415)	-0.111209 [-1.13152]
$\Delta TVOL$	(0.9986)	(0.2510)	(0.8794)	-	-0.011984 [-0.65723]

* It indicates that the null hypothesis, which claims that there is no causality relationship at 5% significance level, is rejected.
Probabilities are shown in the ().
t-statistics are shown in the [].

If the short run and long run analysis is studied, it is certain that there is causality from FGLOB and KAOPEN to FDI while there is no causality between TVOL and FDI in the short run. On the other hand, significance of error correction term proves the long run relationship between the variables. When the FDI is independent variable in the model, the error correction term is between 0 and 1 and the t statistics is significant. It means that there is long run relation between endogenous variable and exogenous variables. It is exact that FGLOB and KAOPEN are Granger cause of FDI but the relationship between TVOL and FDI isn't causal in the long run. The dimension of relationship between TVOL and FDI is uncertain. Also, when all variables are considered as dependent variables respectively all error correction terms are found to be negative. However, the t statistics of error correction terms aren't statistically significant.

4. CONCLUSION

The phenomenon of globalization, which started in the 1970s and accelerated in the 1980s, caused the world economy to have a different structure. Amount of international trade, mobility of capital and labor and convergence of countries have increased. By this way, countries are integrated economically. With globalization, differences of business environment and culture and geographical border get flexible. One of the important areas that get flexible after globalization is financial system of countries. Information technology has been advanced whereas transportation and communication costs have decreased because of globalization process. Not only technological developments but also other important improvements like government policies, market structure and geographical changes paved the way for globalization. On the other hand, Bretton Woods regime that provides fixed exchange rate regime based on gold and dollar collapsed after Vietnam War. It is realized that Keynesian theory couldn't create a solution for high inflation and recession that appeared after oil crisis. In order to cope with these negative conditions, governments started to abolish their controls over the economy under the leadership of England and USA. Collapse of Bretton Woods system and abandoning fixed exchange rate regime encouraged the economies to integrate the world.

Developed countries started to transform their economic structure following the development of technology from the beginning of 1970s. After 1980s, developing countries tried to change their financial and economic structure to integrate the new world order. In the direction of financial liberalization process, they removed all constraints on interest rates, reduced controls on reserve requirements and credits, encouraged competition and productivity in financial system, improved quality of institutions and supported development of financial system. The policies that were implemented by developing countries to liberalize their financial system were similar.

Turkey followed the same path with other developing countries when liberalizing the financial system. After the economic stabilization decision of January 24 in 1980, new period began for Turkey. The decisions aimed to decrease state control on the private sector and to let the free market to create price and to integrate the economy with the world. In this context, it was started that interest rates were determined by market force, foreign banks and financial institutions entered the

financial system freely and foreigners' accounts were settled to keep foreign currencies. It can be said that financial liberalization period is completed with the Decision No.32 in 1989. With the decision, capital account of Turkey got liberalized because TL was decided to be convertible. To liberalize trade regime, some important steps were taken. After January 24 Decisions, import substitution policy was abandoned. Furthermore, Turkey participated WTO in 1995 and customs union was started with European Union in 1996. Lastly, in 2003, Foreign Direct Investment Law No.4875 was adopted to liberalize investment climate. With this law, protecting foreign investors has been aimed. These deregulations are significant for Turkey because attention of foreigners has been attracted.

The all regulations and deregulations have an aim. As it is said, the main problem of the developing countries has been capital accumulation. They have tried to attract more capital from other countries since 1980s. Portfolio investments and direct investments are very attractive for the emerging markets to increase economic growth and development. Financial liberalization process that began in 1980s paved the way for developing countries to attract more FDI. After 1980s, capital flows to developing countries increased evidently but the kind of the capital flows was portfolio investment. This condition creates some crisis in some countries that failed to properly implement liberalization. FDI inflows to developing countries increased although not as much as portfolio investment. FDI inflows were more important than FPI because FDI inflows could accelerate capital accumulation. Moreover, entrepreneurship and managerial skills or transfer of advanced technology and know-how are other benefits of FDI. Also, competition in domestic market is stimulated.

It is obvious that developing countries started to attract FDI in 1980s by financial liberalization process. The liberalized, deepened and developed financial system is very significant factor for foreign investors. In the existence of well functioning financial system, foreign investors could find credits in the times of need, existing MNCs can increase their investments and foreign investors tend to more productive sectors.

In literature, most of the studies focus on the relationship between financial development-liberalization-globalization, FDI and economic growth in both developed and developing countries empirically and theoretically. The studies concluded that well

functioning financial market of countries is decisive factor. More developed, liberalized and globalized financial markets increases FDI.

In the study, the effect of financial liberalization on FDI in Turkey in between 1974-2015 is examined. In the first part of the study, financial liberalization phenomenon and financial liberalization history of Turkey are mentioned whereas FDI and FDI history of Turkey are mentioned in the second part. The third part includes empirical analysis.

To represents financial liberalization, three indicators are selected. First one is FGLOB that includes all regulations about international capital flows and controls on capital account, current account, investments, specific types of flows, foreign ownership. The index have constructed by KOF Swiss Institute since 1970. The index measures the financial globalization by ranging between 0 and 100. Financial globalization index of Turkey has been around 50 in the period. It reached the highest level after 1989 with around 60. Decree No. 32 in 1989 could be decisive for this.

The second index is KAOPEN that is developed by Chinn and Ito (2006). It is ranged between 0 and 1. If it is closer one, it refers more open capital account. If it takes zero, it points out closed capital account. It is based on IMF's AREAR. The index is also includes controls on capital accounts, export proceeds and international transactions but it isn't comprehensive as FGLOB. For Turkey, there are four different values in the period of 1974-2015 which are 0, 0,165809, 0,415631, 0,448928. As it is realized that the index of Turkey has never get closer to 1 so it's not true to say that Turkey has open capital account according to Chinn-Ito Index. After 1980, 1989 and partially 2003, the index increased but this increase hasn't been continuous. The crises have impacted the increases negatively. Same condition is valid for financial globalization index.

Third variable is TVOL which equals ratio of sum of export and import on GDP. For Turkey, the index has increasing trend. It reached peak level after 1995 because customs union with European Union started and Turkey joined WTO. Actually trade regime is important for financial system. Because of existence of lasting and reliable reforms, FDI could support financial system or well functioning financial market enhances FDI. However, firstly, it is important to rely on trade policy. It is not easy and

fast to complete liberalization process for countries. According to policy sequencing perspective, liberalizing the trade regime is essential before making reform for capital account. Countries should make their production with efficient resource allocation. By this way, they can channel future capital inflows to specializations based on right comparative advantages. To sum up, reforms should be made for domestic market initially (Omran and Bolbol, 2003, p.247). Because trade policies are important condition for the financial liberalization and FDI, trade volume is included as indicator in the study.

In third part, before test the relationship between variables, stationary of the variables is controlled. For this, Zivot-Andrews unit root test, ADF test and PP test are used. Results of Zivot-Andrews unit root test shows that FDI has unit root at level while ADF and PP tests prove that FGLOB, KAOPEN and TVOL get stationary at first difference. The all variables are used in the study are I (1). This is precondition of co-integration test. After testing relevance of time series, Johansen Co-integration test is applied and 1 co-integrated vector is found between the variables. This means that there is long term relationship between variables. Secondly, VAR and VECM methods are used. Results of VAR and error correction term are statistically significant. The obtained error correction term is around -0.60. The error correction term is significant because it is between -1 and 0. It can be said that the imbalance between the variables can be removed after 1.66 periods. Thirdly, to detect the dimensions of the relationship between the variables, Granger causality test is used. It concludes that FGLOB and KAOPEN are Granger cause of FDI.

According to econometric results, there is statistically significant relationship from variable of capital account liberalization (KAOPEN), variable of financial globalization variable (FGLOB) and sum of import and export (TVOL) to ratio of FDI inflows to GDP (FDI). There is long term relationship from all three independent variables to FDI according to VECM results. Whereas FGLOB and KAOPEN are Granger cause of FDI, there is no causality between TVOL and FDI. It is exact that there is long term relationship between TVOL and FDI but the dimension of the relationship is uncertain.

When the literature is examined, any study that examines the effect of financial globalization and FDI by using KOF financial globalization index can't be found.

However, when the studies that indicate the relationship between globalization and FDI are considered, it is obvious that there is strong relationship between globalization and FDI. If it is accepted that financial globalization is important phase of globalization, it is exact that the econometric results of the study coincides with results of reviewed literature. Güzel et al. (2017) concluded that there is long term relationship between globalization and FDI. The study confirms the study of Güzel et al. (2017) because conclusion and time interval overlap. Also, same situation is valid for some countries like Turkey which are Romania (Dima, 2016) and Lithuania (Pekarskiene and Rozina, 2015). It is concluded that financial globalization paved the way of FDI inflow in developing countries.

The reviewed literature agrees that both capital account liberalization and trade regime have statistically significant relationship with FDI. First, the study concluded that there is causal relationship from proxy of capital account liberalization to FDI in Turkey. Munyeka (2014) concluded with the same results for South Africa between similar time intervals. Byrne and Fiess (2016) found same results for 64 emerging markets including Turkey. Moreover, it is concluded that trade openness with liberalized capital account stimulates FDI in Pakistan, Sri Lanka, Bangladesh and Nepal (Vadlamannati, 2009). Second, it is obvious that most of the studies concluded that there is strong positive relationship between trade openness and FDI. However, it is concluded that there is long term relationship between trade openness and FDI but the dimension of the relationship is uncertain for Turkey in the study. For instance, Kar and Tatlısöz (2008), and Turan Koyuncu (2010) found statistically significant relationship between trade openness and FDI whereas Sahbaz et al. (2016) indicate that trade volume is Granger cause of FDI in Turkey. On the other hand, study of Topallı (2017) proves there isn't relationship between trade openness and FDI in Turkey. However, the results of the study couldn't supply exact results about the relationship between trade volume and FDI while it supply results consistent with literature about relationship between capital account liberalization and FDI.

Liberalization and deregulation of financial market have facilitated that internalization of banking system. A lot of banks can be multinational thanks to lower operational cost after deregulation like being most productive companies multinational. Liberalized, deregulated and multinational banks have some positive effects on both

host country and potential foreign or multinational entrepreneurs. Amount of external fund increase by multinational banks and number of financial instruments go up. More importantly, qualified financial market makes efficient risk diversification and intermediation. Furthermore, transaction costs based on economic activities of non-financial multinational companies decreases if foreign banks exist. This situation accelerates trade by providing financing of trade. Also, FDI will be facilitated because fixed costs and risk of investing other countries decreases (Poelhekke, 2016, p. 22-23). According to result of the econometric results in the study supports this view. After 1980s, national economies have started to integrate each other. Since those times, the world economy has been impacted by macroeconomic conditions and policies of domestic economies. Borders between countries have disappeared remarkably and international trade has increased sharply. On one hand capital transfer has excessive increase on the other hand the knowledge spread all over the world rapidly. FDI has been the leading factor to facilitate globalization period (Chirilia-Donciu, 2013, p.184).

After 1980 with January 24 Decisions, Turkey took the first step to integration with the world. Net FDI inflow to Turkey was \$ 18 billion in 1980 whereas it increased \$ 95 billion in 1981, \$ 113 billion in 1984, \$ 354 billion in 1988. After 1989 with the Decision No. 32, the amount of net inflow to Turkey reached \$ 684 billion. Over time, fluctuations in this trend have been observed. Although, the increase couldn't be permanent all the time, it is exact that liberalization policies have changed the dimension of FDI inflow to Turkey.

To sum up, to remove the controls on the capital and current account, capital movements and export proceeds are significant steps for Turkey in the period of 1974-2015 to attract more FDI inflows. Prevalence of foreign capital and regulations about foreign capital are decisive factors. After the regulations in 1980 and 1989, it is thought to increase FDI inflows in Turkey. Again after 1980, the idea of import substitution was abandoned and open trade approach has been adapted. The 1980s are significant years because important steps were taken for liberalization, efforts to integrate to the world increased and the concept of closed economy abandoned. In this direction, with the lifting of controls on foreign capital, Turkey has attracted the attention of foreign investors to some extent. Finally, importance of FDI inflows for Turkey to increase capital accumulation shouldn't be ignored. In this direction, it is very essential to

produce policies that will enhance globalization and integration on existing liberal policies. However, when the policies are produced, fragility and instability of financial system should be considered and structural reforms should be at the forefront for the financial system.

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