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Financial Liberalization and Investment in Turkey ❖

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Several important aspects of financial liberalization in Turkey in the post-1980 period are discussed. It is argued that the success of financial liberalization, if there is any, is reflected in the increase in productive private capital formation in manufacturing. A simple augmented accelerator model of investment is used to capture the impact of financial liberalization on private investment. The results show that large firms in Turkey have relied on internal sources rather than issuing equity in financing their investment. **JEL: 010, 016**.

Financial liberalization is one of the more controversial aspects of economic liberalization. From a neoclassical point of view, liberalizing financial markets would stimulate savings and hence physical capital formation and would foster economic growth. The structuralist paradigm maintains, however, that deregulation of interest rates, a concomitant part of any financial liberalization package, raises the cost of borrowing and therefore, at least in the short-run, may lower economic growth. Furthermore, according to Grabel (1995:128), financial liberalization in Southern Cone countries has had adverse effects on economic growth because: '… it creates new opportunities for non-productive profit-seeking and causes misallocation of credit toward speculative activities.' This paper first reviews the important aspects of the Turkish economy and its experience with financial liberalization, and then assesses the effects of financial liberalization on investment using a simple model.

The performance of the Turkish economy in the post-1980 period has

been erratic. After the deep recession of the late 1970s, the economy rebounded and grew strongly for the first seven years of the 1980s. The post-1987 period was not equally impressive, however. The downturn in 1987-88 repeated itself almost every other year, culminating in the 1994 recession. The recovery following the 1994 crisis was short-lived, and Turkey has been subject to a wave of external and domestic shocks since 1998. The adverse economic effects of the 1998 Russian crisis, and then of the devastating earthquake in 1999 culminated in a series of financial and banking crises in 1999-2001. Today, at the beginning of year 2002, Turkey is trying to mend its economy with a massive restructuring of its real and financial sectors.

On the inflation front, early post-1980 gains have given way to high and persistent inflation in the last decade. In fact, the 1994 inflation rate reached its 1979 rate. The high and persistent fiscal deficit has kept inflation high. In 2001, after two decades of open war against inflation, it still stands at 65 percent, significantly above the targeted inflation rate. In line with the frequent fluctuations in output, the unemployment rate has varied as well. It rose in the early 1980s in response to strong anti-inflationary policies and then steadily declined until 1990 and then it stabilized around 7 to 7.5 percent in the 1990s.

A primary reason for the inability of the economy to sustain its growth momentum is the authorities' inability or unwillingness to control the public sector debt and deficit as shown in Table 1. What is not shown is that the increasing public debt forced the authorities to rely relatively more on short-term foreign and domestic debt, increasing the public debt burden.

Table 1: Public Sector Deficit- and Debt-GDP Ratio – Selected Years 1982-2000

	Public Deficit/GDP	Public Debt/GDP
1982	4.3	27.9
1985	6.5	47.3
1990	7.5	39.5
1993	12.1	41.8
1995	5.5	46.9

Source: OECD (1997). Economic Surveys: Turkey and IMF (2001). Turkey: Eight Review Under the Stand-By Arrangement.

The performance of the external sector, however, compensated for the seemingly limited success of the aforementioned aspects of the economic liberalization program. A realistic (crawling peg) exchange rate policy has stimulated exports, and the foreign exchange reserves, which were almost depleted in the 1970s. It also provided companies with the much-needed foreign exchange to finance imports of intermediate capital goods and raw materials (Odekon 1988 and 1992). These desirable developments in the external sector continued in the second half of the 1990s, and along with the other liberalization measures contributed to the gradual increase in foreign direct and portfolio investment.

Table 2: Foreign Investment ($ million) - Selected Years 1980-2000

	Direct Investment	Portfolio Investment
1980	18	0
1987	115	307
1989	663	1445
1995	885	703
2000	982	1615

Source: OECD (1997). Economic Surveys: Turkey, 1997 and www.hazine.tr.gov

The inflow of foreign direct investment, however, remained much lower than the authorities' expectations.

The liberalization of financial markets followed a 'stop-and-go' pattern. The deregulation of deposit and lending rates in 1980 was short-lived, and was suspended with the collapse of financial markets in 1983. The well-documented brokerage-house crisis that led to the collapse was the result of the 'uncontrolled' deregulation in effect in the 1980-82 period (Inselbag and Gultekin 1988 and OECD 1987/88:63-84). The lack of an established legal and institutional framework enabled the brokerage firms to offer high interest rates that they could not afford. The Central Bank interfered and supported the banks and successfully contained the crisis from spreading to the entire financial sector.

In 1983, interest rate controls were back along with other restrictions to stabilize the financial markets. In the 1984-88 period, several new financial instruments (such as Income Sharing and Profit and Loss Sharing Certificates) were introduced along with significant institutional reforms to support the banking sector. The latter group includes: '…provisions regarding the capital structure of the banks, the protection of deposits through an insurance plan and deposit insurance fund, the treatment of non-performing loans, and a standardized accounting system' (Inselbag and Gultekin 1988:133).

Real interest rates support the stop-and-go approach to financial liberalization, as mentioned earlier. In the immediate aftermath of the launching of the liberalization program, the real interest rate on savings deposits turned positive. However, by 1988 it was again negative, as it was in 1994 and 1998. The negative interest rates were predominantly due to the high inflation, and limited the resource effects of financial liberalization by not stimulating savings and investment.

In 1986, the Istanbul Stock Exchange (ISE) reopened, albeit with stocks of fewer than 80 companies being traded. By the end of 2000, the number of companies traded on the stock exchange jumped to 287 (www.ise.org). This expansion of the market was partly due to deliberate tax incentives provided to companies and stockholders (OECD 1987/88:83). Consequently, the importance of financial markets in the economy increased. All indicators, the ratio of total financial assets to the GNP, and the number and the value of traded stocks increased in the 1986-2000 period.

Liberalization of financial markets, as expected, diminished the role of the Central Bank in credit creation in the economy. In a similar fashion the financial portfolio in the economy changed significantly. Bank deposits, as well as M1 and M2, steadily decreased. In 1992-93, M2Y grew faster than M2. This phenomenon is an indicator of the currency substitution that took place in the early 1990s, leading to the financial crisis of 1994. Not surprisingly, M2Y increased again after 1998.

Additional measures in the financial liberalization package included a new legislation geared to enhance the competitiveness and efficiency of bank and non-bank financial institutions, significantly reducing the Central Bank's share in the credit

markets as shown above. The legislation also simplified the preferential credit system, and increased the supervisory role of the Capital Market Board created in 1981. In 1987, the Central Bank began to engage in open market operations in a very restrictive manner, and first steps to create a foreign exchange market were taken. It is also worth mentioning that in the early 1980s foreign banks were allowed to open branches, and accordingly the handling of foreign exchange transactions was transferred from the Central Bank to commercial banks.

In addition, again in a stop-and-go fashion, Turkish citizens were allowed to open foreign exchange accounts and to engage in foreign exchange transactions. Liberalization of capital movements facilitated foreign investors and funds to enter Turkish markets and allowed Turkish investors to buy foreign assets up to $5,000. The 1991 Gulf War and elections slowed down the financial reform attempts considerably. The only noteworthy undertaking in this period was the authorization of the Capital Market Board to supervise and regulate financial markets. These reforms were not able to prevent the 1994 and 1999-2000 financial crises. Loss of confidence in financial markets and in economic policies alike, triggered a massive currency substitution, which ultimately led to the collapse of the Turkish Lira. In April 1994, new measures were introduced to contain the financial and economic effects of the crisis and to restore confidence in the system. Public expenditure cuts, tax reforms, resumption of Treasury borrowing in the financial markets, the build-up of foreign reserves, and the 1995 economic upturn helped thwart the crisis. In 1999 and 2000, speculation and arbitrage transactions diverted financial resources away from productive investment, and toward government paper in particular. The distortion this diversion created in the markets led eventually to financial and banking crises by the end of 2000.

The success of economic liberalization programs, and especially that of financial liberalization, depends heavily on how investment responds to market reforms. On one hand, the removal of price and non-price barriers leads to an efficient allocation of resources. On the other hand, the establishment of financial markets and interest rate liberalization stimulates savings. Both of these developments, especially in the long run, contribute to an increase in investment in the economy.

Table 3 distinguishes among total, public and private fixed business investment to GDP ratios. Evidently, privatization has taken its toll on public investment even though in the second half of 1990s the share of public investment in the GDP increased. The private investment-GDP ratio, on the other hand, decreased in 2000 to its 1980 level.

Table 3: Public and Private Fixed Business Investment-GDP Ratios

	1975-79	1980	1996	2000
Total Investment/ GDP	24.3	21.8	25.0	22.5
Public Investment/ GDP	8.6	8.7	5.1	6.9
Private Investment/ GDP	13.1	15.7	19.9	15.6

Source: OECD (1997). Economic Surveys:

Turkey and www.hazine.gov.tr

Financial liberalization increased the number and variety of financial instruments in the Turkish economy. However, the extent to which this has contributed to private capital formation in the manufacturing sector is ambiguous. The literature claims that in the post-liberalization era manufacturing firms, especially large ones, rely more and more on external funding sources for investment expenditures (Economist, November 1995:80, Fazzari et. al. 1988, and Athey and Laumas 1994). This hypothesis is tested below using a simple accelerator model of investment, which measures the effects of internal and external financing sources on investment. The accelerator model of manufacturing investment postulates that investment, I, responds to current and lagged sales, S and S(-1), respectively, and profits, p, as the major internal sources for finance:

$$I = f(S, S(-1), p)$$

A modified version of this model is tested here that incorporates the real interest rate, i, and the stock-market capitalization variable, FIN and incorporates the role of time, T, explicitly:

$$I = f(S, S(-1), p, i, FIN, T)$$

The sales and profit data used in the estimation is for the 500 largest manufacturing firms in Turkey compiled by the Istanbul Chamber of Industry. It covers 10 years, from 1986 to 1996. Interest and stock market capitalization data is from IMF (2001) and Istanbul Stock Exchange respectively. The sample size in the pooled regression analysis is 1923. The results are presented in Table 4.

Table 4: OLS Estimates of Large Firms' Investment Expenditures, 1986- 1996

Constant	-11.20* (-2.51)
ΔS	0.38* (18.95)
ΔS_{-1}	-3.15E-03 (-1.19)
Δp	0.70* (14.76)
T	0.13* (2.58)
i	3.16E-03 (.50)
FIN	-3.12E-06 (-1.39)
R^2	0.40
D.W.	2.11
N	1923

Key: * indicates significant to 5%
Source: Author's compilation.

The message in Table 4 is clear. The large manufacturing firms, in the time period under consideration, relied heavily on internal financing rather than borrowing from external sources. The internal financing variables, S and p, are significant at the 5 percent level in all the models. The statistically significant time-trend captures the strong secular effect of the inclusion of the stock-market variable in the model.

These findings call for a reevaluation of the results of financial liberalization. It seems that, at least in the 1986-96 period, the creation of a stock market in Turkey did not have the expected 'resource' effect, and failed to close the increasing investment-saving gap in the

economy. The substantial increase in the number of shares quoted in the stock market, as well as the sharp rise in the value of trading in the market have failed to affect investment as much as expected.

A possible explanation for this could indeed be that the formation of the stock market siphoned funds away from productive physical capital formation and into speculation. Thus, the 'speculative' effect of financial liberalization has outweighed its 'resource' effect. Measures need to be taken to redirect investment funds from speculative financial activity back to productive investment.

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❖ *The views expressed here are personal to the author and do not necessarily reflect those of the other staff, faculty or students of this or any other institution.*

Book Review:

UNCTAD (2000) – FDI Determinants and TNC Strategies: The Case of Brazil. United Nations: New York and Geneva. PP 180. ISBN 92-1-112469-7.

At the request of the Brazilian government, the United Nations Conference on Trade and Development (UNCTAD) prepared this study on the factors that influence international investment decisions from the perspective of transnational corporations (TNCs). It was hoped that the findings of this report would help Brazil to win more foreign direct investment (FDI) in what is now a very competitive global market.

Published in 2000, the report is divided into 4 chapters: first, an introduction to the current global trends in foreign direct investment, followed by a chapter on the evolution in transnational corporation strategies and the changing role of the State. The third chapter focuses on the current FDI trends in Brazil and concludes with a balanced argument on Brazil's relative attractiveness to international investors. The fourth and final chapter, 'conclusions,' is general (applicable to any host country or territory) and summarises the shift in the global market place for FDI. It describes the approach of TNCs in determining whether or not a host is attractive, then declares that suggestions as to exactly how to attract higher FDI inflows would be, 'beyond the scope of this study.' Thankfully, it proceeds to do just that, albeit in a limited digression and with Brazil-specific recommendations.

The main source of data and authority is a 119-question survey (a sample is published in the appendix of the report) on individual TNCs, their markets, their actual or potential international investments and their perceptions of and investments in Brazil. Only 57 companies from Europe, Japan and the USA responded to the survey, with 11 of them choosing to remain unnamed - the fact that the report was being prepared at the request of the Brazilian government was seemingly sufficient to prompt such action.

By its own admission, the report claims to represent only formal TNC views and not those TNC objectives that may be expressed during informal discussions. However, this is not expected to mean that the findings are less useful, as TNC investment decisions are presented to the public based on these formal objectives.

From the data collected, investors in Brazil are split in two groups: those optimistic about post-reform Brazil, and those who remain concerned about long term sustainability. Opinions on FDI in Brazil were naturally diverse between these groups, but remarkably TNCs often reacted very differently to the same information. Again variations could be justified by determining what group the particular TNC came from or even more interestingly, by an expansion of what the TNC corporate strategy at the time was.

One concept that is repeated consistently throughout the chapters, is the need to address 'psychic' distance as a major factor in TNC views of Brazil, and indeed anywhere. Psychic distance refers to perceptions held by decision makers

that have little or no knowledge about local conditions, typically represented by TNCs with little or no investment in the host country. The study explains that this psychic distance can remain very significant even where decision makers are briefed and updated on the profile of the host country; it would be more effective to physically take the decision makers to the country.

A notable effort is made to globalise the conclusions drawn in the report, and one question, however unfair, that may hover on the reader's mind is: "is this all still relevant given the significant developments in the international relations post third quarter 2001?" The answer will probably depend on the individual reader (or TNC being considered), but this reviewer feels that attempts at generalising findings of a 1995 study published in 2000, are not only desirable, but in this case, successful. By staying away from the specifics of local and regional politics and focusing instead on the general desires of TNCs the report does encourage the confidence required for it to stand the test of time. Furthermore, by resisting the temptation to list specific policies that may have been perceived to be prohibitive to future FDI (from a TNC perspective), this report manages to remain fresh, years after publication.
The usual high quality of UNCTAD tables and figures also add to utility. The publication manages to deliver Brazil-specific data and still maintain general discussion throughout the text.

The approach and conclusions drawn are specific enough to be of assistance to the policy maker seeking further ideas about exactly what to do next, yet general enough to be applied in a non-Brazil, non South American setting. However, for academics familiar with the dynamics of FDI, little is new, and the main attraction may lie in the collection of Brazil-specific facts and figures that will compliment prior knowledge. For practitioners the key takeaway is that to maximise the potential contributions to domestic development governments must be ready to be flexible and to act with the speed necessary to secure the best TNC partners. Home strengths must be re-evaluated, and assessed against the needs of the individual TNC seeking to invest. Domestic strengths, such as a big potential market (as in Brazil), are attractive but on their own will not secure the 'right' corporate partnerships that will endure the test of time. How well governments can tackle this, and the fact that everybody is watching, is the challenge resulting from shifts in the global marketplace in recent history.

This report's findings and its UNCTAD complement of useful data means that it will be of interest to a wide group of readers.

Yemi Babington-Ashaye

Forthcoming Conferences:

August 27-29, 2002: International Association of Official Statisticians on *Official Statistics and the New Economy* to be held in London, UK. Themes: What is meant by the new economy? Policy implications and their statistical needs? Business transformations and their need for statistics? Structural implications? For more information please refer to http://www.statistics.gov.uk/ioaslondon2002/

September 9-13, 2002: 13th World Congress of the International Economic Association to be held in Lisbon, Portugal. Parallel sessions of contributed papers and invited papers will be presented. For more information please refer to http://www.iea-world.org

Recently published papers:

- The March 2002 issue of the Economic Journal has a Special Session on *Income Mobility and Telecom Auctions*. Of particular note is the paper by K. Binmore and P. Klemperer on *The Biggest Auction Ever: The Sale of the British 3G Telecom Licences.* Other papers in this issue include A. Castello and R. Domenech's paper entitled *Human Capital Inequality and Economic Growth: Some New Evidence*.
- The March 2002 issue of the Journal of Economic Literature includes papers by D. Acemoglu on *Technical Change, Inequality and the Labor Market*; and J. Sobel's *Can We Trust Social Capital?*

Appreciation:

A large number of colleagues on an ongoing basis commit time and energy to the formal review of papers received for publication consideration. Others are consulted more informally on publication themes for future issues. In particular, and within the context of the themes considered for publication over the last year or so, I wish to offer sincere thanks to the following:

Mak Arvin, Fabian Biancardi, Roger Clarke, Ivan Cohen, Wolfgang Deckers, Jean Drèze, Chris Ellis,Brian Grogan, Hamid Kashani, Geeta Gandhi Kingdon, Ben Knight, Walter McCann, Seyed Mehdian, Jessica Melton, Maurice Milne, Tefvik Nas, Josephine Ndunge, Michael Piette, Camille O'Reilly, Ismail Shariff, Sabine Spangenberg and Chris Scott.

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Jean Drèze: 'Dealing with Famines'.

Amitrajeet A. Batabyal: 'What's New in Trade and the Environment'.

Andrew Henley: 'The Consumer Spending Roller-Coaster'.

Alexandre Barros: 'New Growth Theory'.

Hans Singer: 'The Bretton Woods Institutions and the UN'.

Ian Byatt: 'Economic Regulation of the Water Industry in England and Wales'.

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Brian Grogan: 'The New Great Depression'.

Greg Hill: 'Positional Goods and the Macroeconomy'.

Theodore Pelagidis: 'Social Cohesion as a Competitive Advantage'.

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✓**Andrew Henley**: 'What is the Role of Business Ethics in a Competitive Economy?'

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✓**Yasuji Otsuka and Bradley M. Braun** : 'The regulation of cable TV: a review of the 1985-95 U.S. experience'.

✓**Sabine Spangenberg**: 'The Political Economy of a British Stakeholder Society'.

✓**David Steele and Julian Wright**: 'The Forward Premium Bias under different Monetary Policy environments'.

✓**Amitrajeet A. Batabyal:** 'The Economics of Land Use, Wilderness Designation, and Resource Regulation in the American West'.

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✓**Najma R. Sharif:** 'The Seclusion Ethic and the Educational Attainment and well-being of Adolescent Girls'.

Book reviews published since November 1999. Most of these are available on the BNE web-site:

***Roberts, M.J. and Tybout, J.R**. (eds.) Industrial Evolution in Developing Countries: Micro Patterns of Turnover, Productivity and Market Structure. Published for the World Bank by Oxford University Press, 1996. Reviewed by **Parviz Dabir-Alai**.*

***Ishikawa, K.** Nation Building and Development Assistance in Africa: Different but Equal. Published by*

St.Martins Press, 1999. Reviewed by ***Mak Arvin.***

Krugman, P. *The Accidental Theorist - And Other Dispatches from the Dismal Science. Published by Penguin Books 1999. Reviewed by* ***Parviz Dabir-Alai****.*

Gowan, P. *The Global Gamble - Washington's Faustian Bid for World Dominance. Published by Verso 1999. Reviewed by* ***Brian Grogan****.*

Shiller, R.J*. Irrational Exuberance. Published by Princeton University Press 2000. Reviewed by* ***Ivan K. Cohen****.*

The World Bank *- Greening Industry: New Roles for Communities, Markets, and Governments - A World Bank Policy Research Report. Published by Oxford University Press 1999. Reviewed by* ***Sabine Spangenberg.***

Bauer, P. *From Subsistence to Exchange and other essays, with an Introduction by Amartya Sen. Published by Princeton University Press 2000. Reviewed by* ***Walter Elkan****.*

Schmidt-Hebbel, K. and L. Servén*, editors. The Economics of Saving and Growth: Theory, Evidence, and Implications for Policy. Published by Cambridge University Press for the World Bank 1999. Reviewed by* ***Mak Arvin****.*

Deepa Narayan, Raj Patel, Kai Schafft, Anne Rademacher and Sarah Koch-Schulte*. Voices of the Poor: Can Anyone Hear Us? Published by Oxford University Press for the World Bank 2000. Reviewed by* ***U. Muge Dolun****.*

UNCTAD – World Investment Report 2000*: Cross-border Mergers and Acquisitions and Development. United Nations: New York & Geneva, 2000. Reviewed by* ***Parviz Dabir-Alai****.*

UNCTAD – World Investment Report 2001*: Promoting Linkages. United Nations: New York & Geneva, 2001. Reviewed by* ***Parviz Dabir-Alai****.*

Useful web-sites:

www.statistics.gov.uk/rpi for useful information on the UK's latest spending habits.

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