Chapter 15

Relationships between Financial Development, Trade Openness, and Economic Growth: Empirical Evidence for Turkey

ABSTRACT

The aim of this chapter is to investigate the cointegration and causal relationship between financial development, trade openness, and economic growth in Turkey for the period of 1980-2012. To analyze the data, the bounds testing and Johansen-Juselius approaches to cointegration and Granger causality test based on vector error-correction model are employed. The cointegration tests suggest that there is a long-run relationship between the variables. The Granger causality test reveals long-run bidirectional causality between trade openness and economic growth. The findings also indicate unidirectional causality running from financial development to trade openness and economic growth in the long run as well as a bi-directional causality between financial development and economic growth in the short run. The results support supply-leading and trade-led growth hypotheses. Therefore, it can be suggested that Turkey can accelerate its economic growth by improving its financial systems and encouraging foreign trade.

INTRODUCTION

In empirical growth literature, degree of financial development (FD) and level of trade openness are amongst the most significant variables which affect growth performance (Barro, 1997; Beck, 2002). Particularly, over the last few decades, the relationship between finance and economic growth has attracted considerable attention in economic development literature. After 2007-2008 global economic crises, policy-makers and researchers have paid more attention to financial systems of the countries (Pan, 2013). Actually, the theoretical foundation of this relationship can be traced back
Relationships between Financial Development, Trade Openness, and Economic Growth

to the work of Schumpeter (1911) defending that financial development encourages new production techniques. Recently, there is growing empirical evidence that FD contributes significantly to economic growth. The leading studies such as those of Goldsmith (1969), McKinnon (1973) and Shaw (1973), along with some recent important works, indicated that well-functioning financial systems can contribute to economic growth in positive ways (see e.g. King & Levine, 1993; Demetriades & Hussein, 1996; Levine, 1997; Rajan & Zingales, 1998; Aghion, Howitt & Mayer-Foulkes, 2005). Some prominent theoretical studies also explain the positive effects through various functions of financial intermediaries (see e.g. Goldsmith, 1969; Patrik, 1966; Levine, Norman & Thorsten, 2000). For instance, according to Levine (1997), financial intermediaries (i) facilitate the trading and pooling of risk, (ii) allocate resources effectively, (iii) monitor managers and exert corporate control, (iv) mobilize savings, and (v) facilitate the exchange of goods and services. On the other hand, Robinson (1952) claims that financial development has no effect on economic growth. Moreover, economic growth may encourage the financial industry to provide better services, and thus economic growth can cause financial development rather than the other way. In addition, the evidences gained from many empirical studies on finance-growth nexus have been mixed and ambiguous depending on the choice of methodology employed and special features of the countries.

As the effect of financial development and trade openness on economic growth varies according to the political systems and economic structures of the countries, studies on individual countries have been gaining more significance in the empirical literature. This study on Turkey, a developing country and a candidate for EU membership, aims at contributing to the current literature in two aspects. Firstly, unlike the other studies on Turkey, the trade openness variable is included in the analyses in addition to the financial development variable. Otherwise, disregarding trade openness and taking only the financial development into account as an independent variable can lead to inaccurate predictions about the degree of the relationship between financial development and economic growth (Wolde-Rufael, 2009; Baltagi, Panicos & Siong, 2009; Beck, 2002). Such an approach as the one adopted in this study allows us to separately examine the effects of financial development and trade openness on economic growth. Moreover, the simultaneous equations system can provide information on how financial development affects trade openness and vice versa (Kim, Shu-Chin & Yu-Bo, 2012). Secondly, following FED’s inclusion of Turkey as the most fragile country among the fragile five (Turkey, Brazil, India, South Africa and Indonesia) in early 2014, concerns about Turkey’s financial markets and economic stability have increased. For this reason, by expanding the current perspective in the literature on Turkish economy and the financial markets, this study is expected to contribute to the policy-makers’ decision making processes.

For the reasons mentioned above, the current study investigates the cointegration and causal relationships between financial development, trade openness and economic growth in Turkey for the period 1980-2012, during which the country experienced fast economic growth and rapid expansion of financial intermediation. We employ the bounds testing and Johansen-Juselius approaches to cointegration and Granger causality test based on vector error-correction model to conduct the analysis. The cointegration tests suggest that there is a long-run relationship between the variables. The Granger causality test reveals a long run bi-directional causality between trade openness and economic growth. The findings also indicate a unidirectional causality running from financial development to trade openness and economic growth in the long run as well as a bi-directional causality between financial development and economic growth in the short run.