Chapter 21

Foreign Direct Investment, Financial Development and Economic Growth: The Case of Turkey

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ABSTRACT

This chapter discusses the effects of financial development on relationships between FDI and economic growth within the framework of the relevant literature, and researches empirically the current situation in Turkey. To that end, analysis is conducted through the use of Johansen et al. (2000) cointegration method, based on the quarterly data for the period between 1989 and 2011. To the authors’ knowledge, there are no studies assessing the complementary relationship between FDI and financial development in the relevant literature in Turkey. According to the results, financial development and FDI affect economic growth positively, and financial system makes important contributions to the positive effect of FDI on economic growth.

INTRODUCTION

The impact of Foreign Direct Investments (FDI) on economic development is intensely researched in the literature. The relevant literature has proven many times that FDI promotes economic growth in the host country by providing transfer of new knowledge and technologies. In this direction, FDI is particularly important for underdeveloped and developing countries as they do not have sufficient capital accumulation for industrialization. A developing country is required to meet certain conditions in order to be able to attract FDI and benefit to the maximum extent from the positive impacts of the attracted FDI on economic growth. A recent literature has emerged, which examines whether the spillover effect to be created by FDI depends on the level of financial development of...
the host country. It is a general consensus in this literature that a well-developed financial system increases the spillover effect to be provided by FDI. According to the literature, the opportunities presented by the financial system in the host country are quite influential on the capability of foreign investors to maintain their activities and make new investment decisions. Besides, in the provision of funds needed by domestic producers to transfer the new knowledge and technologies to be provided by FDI, the level of financial development of the host country is a significant determinant of access to external financing. The newly emerging literature provides evidence showing that the positive externalities to be provided by foreign direct investments will be limited in the case that the level of financial development of the host country is insufficient (Alfaro, 2003; Hermes & Lensink, 2003; Omran & Bolbol, 2003).

Results of cross-country studies indicate that countries with a more developed financial system tend to benefit more from FDI. However, Ang (2009) states that the cross-country studies show that the existence of relationships between the variables, but he also states that the results may not be generalized and the relationships between such variables are determined by the institutional structure of the relevant country and the policies it follows. Ang (2009) emphasizes the need for country-specific studies in order to develop policy proposals for a country. In fact, cross-country analyses may not be appropriate for testing the presence of such a relationship due to historical, political and social differences between countries not included in the model.

In this context, the present study aims to research the current situation in Turkey, which is one of the emerging economies. In parallel with globalization policies adopted generally all over the world in the 1980s, Turkey started to implement economic liberalization policies after the decisions taken in 1980 which came to be known as “Decisions of 24th January”. Adopting inward-oriented and import substitution growth model before 1980, Turkey started to carry out free trade policies by adopting an outward-oriented growth model following these decisions. As a result of these new policies, while there was an upward trend in FDI in Turkey for the 1980-1992 period, a downward trend in FDI was observed for the 1993-1999 period. In order to attract more FDI to Turkey in the 2000s, new arrangements were introduced to decrease bureaucratic procedures and costs. As a result of these new arrangements and macroeconomic developments in this period, FDI, with a sharp increase, showed an upward trend again but was behind the expectations. Considering the low savings rate of Turkey, FDI becomes particularly important for the industrialization process. Moreover, the contribution to be made by FDI to Turkey, where plans are made to adopt a production process based on innovative and advanced technologies as well as production of goods and services with high added value, is of great importance.

The objective of this chapter is to discuss the potential relationships between FDI, financial development and economic growth within the framework of the relevant literature and research empirically the current situation in Turkey. To that end, analysis will be conducted through the use of Johansen et al. (2000) cointegration method, based on the quarterly data for the period between 1989 and 2011. The reason behind choosing this method is the anticipation that in a developing country like Turkey which has a relatively fragile economy, economic crises may emerge in the form of structural differences/breaks within the relationships addressed. Current literature mainly examines the relationship between FDI and economic growth within the scope of causality tests. However, cointegration analysis was necessarily used in the study since causality tests are disadvantageous to parameterize long term relationships in particular. Furthermore, it is necessary that structural breaks likely to occur in time series are present.
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