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# Development & Growth

Economic Impacts of Globalization

Global Studies Vol.3



**Editors**

**Farhang Morady, Hakan Kapucu, Ömer Yalçinkaya**

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(Edited by: Farhang Morady, Hakan Kapucu, Ömer Yalçınkaya)

# **DEVELOPMENT & GROWTH**

## **Economic Impacts of Globalization**

*Global Studies Vol.3*

*Edited By*

Farhang Morady

Hakan Kapucu

Ömer Yalçınkaya

**Development & Growth: Economic Impacts of Globalization**  
*Edited By: Farhang Morady, Hakan Kapucu, Ömer Yalçınkaya*



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## Introduction

# Development & Growth: Economic Impacts of Globalization

*Farhang MORADY*

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*Ömer YALÇINKAYA*

The growth paradigm or the economic growth generally been presented as a positive, limitless and good for social problems. The term was hardly touched in pre-capitalism by any academic research. With the rise of capitalism and industrial revolution it became an important tool to measure production quantitatively and qualitatively.

Industrialisation also encouraged the expansion of trade and gradual breakdown of the pre-capitalist order in 18th century in Britain. The spread of market had facilitated the specialisation, encouraging division of labour. Whilst for The Classical Political Economists; Adam Smith, David Ricardo and Thomas Malthus; economic growth is self-reinforcing. Marx pointed out importance of forces and relations of production and significance of social classes within it (Marx, 1863).

Smith, Ricardo and Malthus were writing at a time when capitalist development was expanding fast and growth was a central in the process. The gradual impact of the West on the rest of world became part of a wider process of change in the World Economy. European capital increased its domination of the world trade through expansionist commercial policies (Wallerstein, 1979). The economic growth encouraged commerce. The necessity to export, and other technological changes formed part of the reason for the decline of feudalism. This transition from feudalism to capitalism began in the West and soon made an impact on the rest of the World.

In 1932 Simon Kuznets, the US economist identified Gross Domestic Product (GDP) to measure the national output of a country within a period. It has continued to be an important indicator to measure economic growth, but it has also been under considerable criticisms. For example; GDP treats resources as income without excluding depletion or depression of the resources. Moreover, GDP has been criticised for disregarding income distribution. Despite all the criticism, GDP has been the most significant indicator of growth and development.

With the Post War-II reconstruction of devastated countries and in order to kick-start the World Economy, the state in both developed and developing countries became the important agency to facilitate economic growth. The establishment of the Bretton Woods institutions, the Keynesian model of government intervention and the US implementation of “New Deal” facilitated growth. This was deliberate strategy to reconstruct and create networks of international cooperation. This was pointed out by President Truman in 1949:

*A program of development based on the concepts of democratic fair-dealing. All countries, including our own, will greatly benefit from a constructive program for the better use of the World's human and natural resources (Truman, 1949).*

This meant the reinforcement and need to distribute the 'Benefits' of capitalist form of development, more widely, against the planned economy sustained by the Soviet Union.

The economist such as Joseph Schumpeter pointed to the possibility that capitalist growth, if it is sustained, could abolish poverty (Schumpeter, 1954, pp66-68).

Whilst development meant rapid industrialisation, GDP became a key policy objective for the policy makers and governments around the world, not just in the Soviet Union but the Western Capitalist World, to set targets for their Growth Rate.

The end of the Cold War in the 1980s, for some, meant triumph of Neoliberal Capitalism. The others talked of trade liberalization; free movement of capital and the development of information technology, facilitating the relocation of businesses across the world. (Ohmae, 1995). Friedman suggested that globalization is the Inevitable;

*Integration of markets, nation-states and technologies ... enabling individuals, corporations and nation-states, to reach around the world farther, faster, deeper and cheaper than ever before (Friedman, 1999).*

Francis Fukuyama (1992) suggested the new era as ‘The End of History’ through which the ‘Liberal Idea’ triumphed, leading to a new global hegemony. For Fukuyama the only route to modernity, growth and development is the Neo-liberal Democratic path under Global Capitalism.

This optimism was not shared by all academics, as Globalization produced poor growth and polarization of wealth: what Collier terms the ‘Bottom one Billion’ (2008). As a result, there has been major criticism of the World Bank and the International Monetary Funds in the second half of the 1990s, especially with the Asian financial and economic crises. The response from these institutions has been vigorous. They continued to believe that liberalization, deregulation, and privatization represent the best way forward for growth and development.

With 2008 world recession the World Economy has faced a new challenge. The emergence of powerful economies such as; China, India and Brazil; helped the world economy to grow, at least for now. However, the unevenness of the world economy continues to cause difficulties especially the US as they feeling the threat of their competitors such as China, Germany and even India.

The victory of Donald Trump as the S President has represented an ideological shift from free trade advocator of global capitalism to a mixture of right-wing populism. Before and after the presidential election, he called for the revival of the American economy, which has been under considerable pressure since 2008 World Recession. In order to prove growth rate Trump has a huge challenge ahead, not least to deal with the competition from South East Asian economies, especially China. It remains to be seen whether the new US administration will continue with their populist rhetoric

In this book, “Economic Impacts of Globalization: Growth & Development”, several academicians provide different analysis of economic growth and economic development. The scientific ethics and responsibility of the works in the book belong to the authors / writers.

The book comprises of 15 chapters focusing on economic growth and economic development in the era of globalisation. By taking different angles, they demonstrate different problems and solutions.

In the first chapter entitled “The Effects of The Global Scale Economic and Political Uncertainty on Economic Growth: The Example of Selected Emerging Market Economies (1992-2015)”. Ömer YALÇINKAYA and Halil İbrahim AYDIN analyze

the effects of the global scale economic uncertainties based upon the developments in USA on the economic growth performances of the rapidly developing emerging market economies such as; Brazil, China, India, Indonesia, Mexico, Russia, South Africa and Turkey (EME-8); within the scope of the new generation panel data analysis methodology econometrically for the period 1992-2015. From this aspect, it is purposed in this study to empirically examine that whether global scale economic and political uncertainties have an effect as predicted in the theoretical framework on the economic growth performances of the emerging market economies in the group of EME-8. Determined at the end of the study that all the effects of the economic and political uncertainties based upon the developments in the USA are avoidant (negative) and statistically meaningful on throughout of EME-8 group panel and all cross section units that generate this panel.

The Second Chapter Farhang Morady will analyzes the implementations of neoliberalism and its implications in post-revolutionary Iran. It will argue that neoliberalism is not a 'one size fits all' doctrine, especially in relation to oil producing countries, notably the case of Iran. This is because of the abundant energy resources held by Iran, which has cemented its geopolitical position within the region. Iran has gone through different phases of neoliberalism but this has not diminished the role of the state within Iran. Despite privatization, including significant deregulation, an end to subsidies for specific industries and commodities, the Iranian state continues to be instrument in the political economy.

The "The Impact of Regional Economic Cooperation: Case of South Caucasus" was prepared by Giorgi BENASHVILI. The article considered and discusses about the possibilities of economic cooperation in the South Caucasus, within the framework of the economic partnership between Azerbaijan, Georgian, Armenia and Turkey, in particular of transportation, energy routes and regional trade. The South Caucasus region is a geopolitically important region at the crossroads of Europe and Asia, with strategic energy and transport routes. This geopolitical location increase opportunities to extend economical activities. Twenty years after break-up of the Soviet Union, three states of the South Caucasus Armenia, Azerbaijan and Georgia are facing considerable challenges in creating sustainable and inclusive economic growth. The transformation to democratic systems and market economies was very durable process and requires further reforms. From the 1990s period, all those states trying to introduce new foreign markets for goods and services. Economic factors, historical links, cultural ties and social factors are stimulating and necessitating economic cooperation between the

countries in the South Caucasus. The motivation to study economic development and cooperation in the South Caucasus is the step to introduce more possibilities, partnerships and developing of this significant region.

The “The Relationship between Economic Globalization and Financial Freedoms in Eastern European Countries: A Panel Data Analysis” was prepared by Dilek ŞAHİN. The objective of this study is to look through the relationship between economic globalization and financial freedoms in Eastern European countries. Within the context of this objective, the relationship is analysed by panel data analysis using annual data between 1998 and 2013. The results of the analysis indicate that there is a relationship of both co-integration and causality between economic globalization and financial freedoms. Moreover, there is a positive relationship between economic globalization and financial freedoms. In other words, the level of economic globalizations understood to accelerate the level of financial freedoms.

The “The Effects of Globalization on Financial (Money and Capital) Markets” was prepared by Ayşe ERGİN. The boundless development of transportation and communication technologies has led to a different dimension for commercial relations among countries. This new world order, characterized as globalization in economic terms, has three different field effects in a broader perspective. These are international trade, international production and finally the liberalization of international financial flows. At this point, perhaps the most influential field of globalization is likely to be the financial markets. This influence, assessed as financial globalization, is the result of “the breakdown of the boundaries among national financial markets, the maintenance of international competition by eliminating various controls and limitations on the financial markets, the convertibility of markets, the fluctuation of exchange rates, the rise in international capital flows and, the prominence of new institutional investments such as mutual funds and investment trusts in financial markets”.

The “Monetary Policies and Economic Growth/Development Relationships within the Context of Globalization” was prepared by Ayberk Nuri BERKMAN. This study aims to make a statement on the relationship between monetary policies and economic growth/development within the scope of the concept called globalization by formulating several definitions for the globalization process. It is believed that globalization, perceived as the free movement of capital, on the world scale, without the restriction of national boundaries, is favourable to all economies and will increase the prosperity and happiness of the wholesale world economy. However, the frequent

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recessions and the subsequent economic and financial crises imply that globalization must be managed. For this reason, it is currently waiting for an effective international structure for global economic system governance. This study first examines the effects of globalization on monetary policy after explaining definitions of globalization, then compares the growth of world economies. The conclusion introduces the proposal that the literature suggests at the point of eliminating the drawbacks of the global economy.

The “The Rising Eco-Power in Global World: An Analysis over The Economic Growth Model of PRC” was prepared by Fulya KÖKSOY. The rising of the People’s Republic of China (PRC) that is stated as a rising eco-power in global world emerges in the axis of its economic growth model that has been continued successfully for many years. PRC starts to prioritized economic growth with the period of Deng Xiaoping. In this frame, the economic profile of PRC rises on the axis of reform and the outward opening policy. In addition to the rising economic profile, the emergence of a growing PRC in the framework of proactive policies exhibited outside of Asia-Pacific geography has highlighted other important factors. In this context, the economic growth model of PRC plays an important role for the transformation of Chinese economy. With regard to this, the aim of this study is to analyze the economic growth model of PRC with its economy politics and to problematize the impact of the economic growth of PRC.

The “Economic Threat of Globalization: Crisis Generation Mechanism” was prepared by Halim TATLI and Mahmut ERDEM. The Great Depression and the economic and social destruction that followed the Second World War, showed how much the countries were affected by each other and how much they needed each other. In addition, the economies that have completed the industrialization process have sought to get every type of opportunities out of domestic markets for taking advantages. Thus, a new economic order that deals with the world as a whole is becoming a prevailing in the economic field as well as being a political area through international organizations. Today, some positive and negative effects of this order are evaluated in the context of the concept of globalization. This study examines the risks that globalization has for countries in the sense of the economic crisis, a process in which new relations are developed on the earth. Analysing 1997 East Asian Crisis, the link between economic globalization and financial liberalization will be explained according to economic indicators.

The “The Impacts of Banking Sector on Economic Growth within the Context of Globalization” was prepared Filiz YETİZ. In parallel with the growth of commercial

life in the world, banks have played the most active roles in financial markets in finding funds efficiently and uninterruptedly. Along with the globalization, there have been significant changes and developments in the financial sector, especially in the banking sector. This process has led to the creation of new products in the banking sector and the expansion of banking activities. In the globalization process, bank mergers and acquisitions have become widespread. The banking sector has been opened to international competition, and the entry of foreign capital banks into the market has become easier within the sector. The strength of the banking system would ensure the strength of the country's economy. Along with the growth and development of banking, the growth and development of the country's economy will increase in proportion to the same direction. For this reason, banks have a very important place in the finance sector. This study aims to reveal the developments experienced in the banking sector within the globalization process and their reflections on economic growth from a theoretical point of view.

The "Get Up, Stand Up and Do Not Give up the Fight: Making a Terrorist Homo Socio-Economics" was prepared by Haktan SEVİNÇ and Merter AKINCI. Fighting against the global terrorism has become one of the most important objectives in the world's agenda since 9/11. On the one hand, the dominant strategy to make war on terrorism is shaped by the endeavours to eradicate terrorist activities. On the other hand, the main question of whether socio-economic tools can be used to fight against terrorism has still been debated. In order to answer the question, this paper investigates the socio-economic roots of terrorism in MENAP countries. Following the traditional regression estimation methods, the spatial disparities in the linkages are investigated using Geographically Weighted Regression analysis. The results of the analysis show that the wider the socio-economic benefits are, the lower the possibility to involve in a terrorist activity is. In other words, the empirical findings indicate that an increase in the level of income, investments, consumption, openness, institutions, education, freedom, happiness, and democracy decreases the average terrorist activities, while a rise in the level of unemployment, poverty, inequality, resident instability, and ethnic and religious heterogeneity widens it.

The "The Rise of Theo-Politics in the Context of Globalization: Impacts on Global Political Economy" was prepared by Murat SİLİNİR. In the pre-modern period, the position of religion was pivotal, in the economic and political system. In this system, the church was a crucial political and economic actor. With the appearance of "Modern World", that historical background reaching the 15.Century, religion has almost been

pushed out of economic-political sphere. Domination of Nation-State understanding on the global system has progressed parallel to this process. Towards the end of the twentieth century, impact of globalization increased and religiosity has returned to political and economic realm. In this process, rapid technological transformations play an important role. The main purpose of this study is to analyse rise of Theo-Politics in the context of globalization and its impacts on the global political economy. In this general context, firstly, the rise of Theo-politics will be examined in the context of modernity and globalization.

The “Interaction between Domestic/Foreign Savings and Investments in The Context of Globalization” was prepared by Merve TUNCAY. Financial liberalization is expected to contribute to the economic welfare of nations by directing savings into productive investments as also supported by the separate studies of Shaw (1973) and McKinnon (1973). On the other hand, different cases that have been experienced by the countries since the 1980s caused this process to be questioned by both the academic literature and the market participants. This study examines the financial liberalization process in the context of savings and investments from a theoretical perspective and the experiences of Turkey in liberalization process.

”The Relation of Foreign Trade and Globalization: A Practice in Turkey” was prepared by İbrahim ÇÜTCÜ. The foreign trade potential of a country is known as an important element of global competition for development and growth in international economy. In the study, it is planned to analyse the relationship between globalization and foreign trade for the years 1970-2016 depending on the availability of data for Turkey. While the globalization index variable planned to be used as an independent variable in the analysis is addressed in three dimensions; economic, social and political, the foreign trade variable to be used as a dependent variable consists of import and export data. In the study in which the co-integration analysis and the causality test will be implemented with the data obtained from the Swiss Economic Research Institute and Turkish Statistical Institute. A time series analysis will be conducted as a method and it is aimed to reveal the results of the relationship between globalization and foreign trade.

”Geographical Location Analysis of Sectoral Concentration in The TR63 Region” was prepared by Fatma Betül URHAN and Ersin Kaya SANDAL. This study analyzed the sectors becoming prominent in the manufacturing and service sectors in the provinces of Hatay, Kahramanmaraş, Osmaniye and the İBBS Level 2 TR63 region constituted by these provinces, using the method of Location Quotient (LQ). TÜİK 2002 General

Industry and Workplace Census data were utilized in calculating location quotients by provinces, while 2009-2013 TÜİK Annual Manufacturing Industry statistics were used to calculate location quotients by regions. Sectoral location quotients were analyzed and the sectors that are becoming prominent in the location dynamics in the region were presented. The sectoral concentration on the level of provinces and regions was analyzed in the context of economic geography.

The “Defense Expenditures and Turkey” was prepared by Hamza ŞİMŞEK. Turkey is obliged to preserve its defence power due to its geographical position. Many countries around the world want to increase their defences for this purpose. The world defence costs constitute 2.6% of the Gross National Product of the world. The USA is the spearheading of this trend by its enormous expensing budget. Countries need to increase their national income in order to compensate their defence spending. Turkey takes the 17th place by 15.2 billion dollars of military expenditure and 18th in the world in national income. In respect to this, the subject needs to be discussed must be the addressing level of the needs of defence from the domestic resources rather than the size of defence expenditures. It is seen that the countries which have a voice in today's global diplomacy and powerful armed forces meet their military requirements from the domestic resources.

The “Inflation, Interest Rates, and Output Level in Terms of Globalising Monetary Policies” was prepared by Canan SANCAR. Globalisation affected the capability of monetary policy makers in providing prices and output stability through expectations and through the effects of globalisation on the monetary policy transfer mechanisms. According to a recent opinion put forward by the academic and political community, globalisation has become a central driving force in determining the domestic tendencies of inflation and starting from mid 1990s, they have moved together with inflation levels at international level. Globalisation led to high-level convergence and the synchronisation of interest rates (both in the short and long term). Thanks to globalisation, interest rates were started to be determined by fixed-rated regions rather than individual countries and the operations of the monetary policy efficiency of any country got weaker. Developments in the global market, rather than the domestic factors, play an important role in the fact that long term interest rates show an equal level to each other in the 2000s. Therefore, long term interest rates are more affected by the international conditions than the decision of the monetary authority. The increasing economic and financial market integration among countries increased the homogeneity in the monetary policies of countries' central banks. As a result of the

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developments that emerge with globalisation, the bound among domestic inflation and domestic source use as well as consumption got loose.

We hope different research provided in this book would help the reader with analysis of both the risks and opportunities brought by the globalization process. In addition to this, we believe that the detailed contents will contribute to the body of knowledge, in the area of economic growth and development literature. Finally, we would like to thank all the authors whose paper published on this book whose ideas may inspire academicians and students around the world.

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# 1 | The Effects of the Global Scale Economic and Political Uncertainty on Economic Growth: The Example of Selected Emerging Market Economies (1992-2015)

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## Abstract

*It is analyzed in this study that, the effects of the global scale economic uncertainties based upon the developments in USA on the economic growth performances of the rapidly developing emerging market economies such as Brazil, China, India, Indonesia, Mexico, Russia, South Africa and Turkey (EME-8) within the scope of the new generation panel data analysis methodology econometrically for the period 1992-2015. From this aspect, it is purposed in this study to empirically examine that whether global scale economic and political uncertainties have an effect as predicted in the theoretical framework on the economic growth performances of the emerging market economies in the group of EME-8. Determined at the end of the study that all the effects of the economic and political uncertainties based upon the developments in the USA are avoidant (negative) and statistically meaningful on throughout of EME-8 group panel and all cross section units that generate this panel also. These results reveal that the increments in the economic and political uncertainties based upon the developments in the USA manipulate the economic growth*

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*across the panel and in all cross section units that generate the panel as negative and statistically meaningful as being predicted at a theoretical-empirical level in the period of study.*

**Keywords:** *Sustainable Economic Growth, Global Scale Economic-Political Uncertainties, Selected Emerging Market Economies, The New Generation Panel Data Analysis.*

**Jel Codes:** C50, E27, FO2, F63.

## Introduction

During the recent years, the unmasterable and time-deepening economic recessions since the depression of 2008 constitute the major topics of the agenda relating to the future of the global economy. As a matter of fact, a balanced and sustainable economic growth trend has not been achieved for many developing countries notably the developed ones since the depression of 2008 and the weak growth environment gradually becomes evident (Wongi, 2016: 1-2). Some particular political and economic uncertainties such as ineffectiveness of monetary expansion policies, increasing of the indebtedness of public-private sector, increasing the volatility in financial markets, gradually reducing the global demand, multiplying the protectionism precautions, declining the increasing of total factor productivity, increasing the available geopolitical risks and political uncertainties further by the decision of scission of the United Kingdom from EU (Brexit) are shown as the possible reasons of this circumstance (TCKB, 2016: 3).

This kind of economic developments that create uncertainties at global scale enhance the fluctuations in markets reverse the capital flows, restrict the access opportunities to the external financing and limit the decisions of consumption-investment by diminishing the appetites of economic actors for risk-taking (TMB, 2016: 3). In this context, the contractionary pressures of the high-level economic and political uncertainties actualized via different channels that feed each other like consumption, investment, employment and the risk premium. Due to retaking or arranging the decisions of consumption, investment and employment necessitate the extra costs; the economic-political uncertainties carry the economic agendas to postpone or cancel their decisions till being dissolved the uncertainty away or found more information. On the

other hand, since the economic-political uncertainties increase the risk premium, the necessity of a higher financial cost and lower asset prices become the current issue (Balta et al., 2013: 7). All of these enhance the downward pressures on the global economic growth rates at the slow tempo, retard the expansion of shrinking economies and bring the problematic of failure of thriving a structural dimension.

On that sense, the reason for continuing the economic constrictions in developing countries notably the developed ones based on the depression of 2008 and not to catching the desired recoveries in no way are mainly attributed to economic and political uncertainties at global scale (Ermişoğlu and Kanık, 2013: 2; Wongi, 2016: 1-2). Besides, uniting the global scaled economic and political uncertainties mostly based on the developments in the USA with shrinking liquidity and low product prices increase the pressures on economic growth outlooks of developing countries (TMB, 2016: 4-6). In this connection, it is aimed in this study to analyze the effects/reflections of the global scaled economic and political uncertainties based upon the developments in the USA on the economic growth performances of selected emerging market economies such as Brazil, China, India, Indonesia, Mexico, Russia, South Africa and Turkey. Together with this general purpose, it is also planned to examine econometrically if the global scaled economic and political uncertainties have an effect on the economic growth as being predicted in the theoretical frame or not.

Within this scope, the literature on the subject is summarized in general terms in the second part following the introduction and the status of the study in literature is explained. In the third part, the methodology of the survey is shortly described by the data set and the long termed effects of economic and political uncertainty on the economic growth as econometrically. Finally, the study is finished by the fourth part include the overall evaluations.

### **Summary of the Literature**

It is observed when the related literature is reviewed that the economic and political uncertainties Index (EPU) of Baker et al., (2013) is used to determine the effects of the economic and political uncertainties on the economic growth. The index of EPU is created by a combination of three sub-indexes called index of the frequency of news on economic and political uncertainties in newspapers, index of tax regulations about to expire and distribution index of inflation and public expenditure expectations. The

EPU index that was created only for the USA, in the beginning, is being also calculated at present for developing and developed countries notably the EU countries 1 (Baker et al., 2015: 1-72). It is seen when analyzing the empirical literature that starts to occur after the studies of Baker et al., (2013) that there are the limited number of researches to investigate the effects of economic and political uncertainties on the economic growth via EPU index. At the same time, the avoidant effect of economic and political uncertainties on the economic growth most of the time is specified in the studies which are actualized by using the EPU index of USA or the relevant country (Baker et al., (2013-United States), Bhagat et al., (2013-India), Stockhammar and Österholm (2014-Sweden), Baker et al., (2015-United States), Stockhammar and Österholm (2016)). In this study, as in the researches of Stockhammar and Österholm (2014-2016), it is aimed to review the reflection effects of global scaled economic and political uncertainties in the other countries. By the way, it is thought that the findings of this study about selected emerging market economies will contribute the improvement of related literature.

### **The Data, Methodology and The Findings of The Research**

In this part of the study, the effects of the global scaled economic and political uncertainties based upon the developments in USA on the fast-growing selected emerging market economies (Brazil, Russia, India, China, South Africa, Mexico, Turkey and Indonesia-EME-8) on the annual basis for the period of 1992-2015 and econometrically are analyzed. The sources and variables that are used in the model will be predicted to examine the effects of the index of economic and political uncertainties of USA on the economic growth performances (per capita real Gross Domestic Product-GDP) of countries in the EME-8 group are shown in Table 1.<sup>1</sup>

In this study, the effects of the global scaled economic and political uncertainties on the economic growth are examined by the panel data analyses due to being used the time-series data of different countries and it is aimed to determine the size/direction of the long termed relations between the variables. The econometric model which will be predicted for cross section units that generate the panel one by one and the real fixed

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<sup>1</sup>The variable of RGFCF is used in terms of capitation values by being proportioned to the total population from the same database.

capital investments control variable to review the effects of the global scaled economic and political uncertainties in EME-8 group on the economic growth are shown in equation 1.<sup>2</sup>

**Table 1. The Variables And Sources In The Model**

Inspection Period: 1992-2015		
The abridgment of the Variable	The Definition of the Variable	Data Sources
PCRGDP	Per Capita Reel GDP 2010 (USD)	World Bank (WB) (World Development Indicators).
RGFCF	Reel Fixed Capital Investments 2010 (USD)	
EPU	Economic and Policy Uncertainty Index (ABD)	www.PolicyUncertainty.com.
Note:	The defined variables, PCRGDP, RGFCF are used with the logarithmic values in relevant period and the EPU variable as an index is used in analysis with the level values.	

$$\text{Model: } PCRGDP_{it} = \alpha_{it} + \beta_1 RGFCF_{it} + \beta_2 EPU_{it} + u_{it} \quad (1)$$

The symbols of ( $\alpha$ ), ( $\beta$ ), ( $u$ ) in model respectively represent the constant parameter, the slope parameter, the error term. The (i) subscript represents the countries, and the (t) subscript represents the year. The model described in the equation to analyze the long termed effects of the global scaled economic and political uncertainties in EME-8 group on the economic growth is investigated in this study by 4 phases respectively within the scope of the new generation panel data analysis.

### The Test Results of Cross Section Independence

The steady state of the series in panel data methodology is crucial. There could be experienced the spurious regression case, the biased test statistics of t, F and the values of  $R^2$  when analyzing by the nonstationary series. Consequently, it is firstly required to analyze the steady state of the series for obtaining consistent results in the studies of

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<sup>2</sup>The packaged softwares of Stata 14.00 and Gauss 10.0 are used to predict the model defined in the study.

panel data (Tatoğlu, 2013:199). The unit root tests which will be used for specifying the steady state of the panel data split in half as first and second generation according to whether cross section dependence (CSD) is existed in units create the panel. It is assumed that the cross section units that produce the series in panel unit root tests of the first generation are independent of each other and all units are affected at an equal rate from a shock happens just in one section of the series. According to the second generation unit root tests based on the assumption what asserts the cross section units are interdependent, it is accepted that each unit is affected differently from a shock happens just in one section that creates the panel. The panel unit root tests of the first generation do not produce consistent results in the case of the existence status of cross section dependence between the units create the panel (Hadri 2000; Levin et al., 2002; Im et al., 2003; Breitung 2005, etc.). In this case, the second generation panel unit root tests that allow the cross-section dependency between the units that create the panel could be used (Taylor and Sarno 1998; Breuer et al., 2002; Pesaran 2007; Hadri and Kurozumi, 2012, etc.). Thus, it needs to investigate the CSD in series and cointegration equation in panel data studies before being started to analysis and specify the unit root, cointegration and other tests which will be used in the analysis. Otherwise, the tests used can be biased and give inconsistent results as well.

It is required to be considered the time and section dimensions of the series together while being reviewed the cross section independence in panel data. Breusch and Pagan (1980) CD-LM1 test is used in case of being time dimension of the panel bigger than the section dimension ( $T > N$ ); Pesaran (2004) CD-LM2 test is used in case of being the time dimension equal to the section dimension ( $T = N$ ) or the time dimension smaller than the section dimension ( $T < N$ ). In the meantime, Breusch and Pagan (1980) CD-LM1 and Pesaran (2004) CD-LM2 tests can produce inconsistent results in a case of being the unit average different than zero. So, the CD-LM1 and CD-LM2 tests which can produce biased results in the case of being the ensemble average different from zero and the unit average were developed by Pesaran et al., in 2008 as the Figure 2.

$$LM_{adj} = NLM^{**} = \sqrt{\frac{2T}{N(N-1)}} \left( \sum_{i=j}^{n-1} \sum_{j=i+1}^n \frac{(T-K)\tilde{\rho}_{ij}^2 - \mu_{Tij}}{u_{Tij}} \right) \quad (2)$$

Pesaran et al., (2008) added the average of cross sections and its variance to the test statistics and mentioned that it gives more consistent results than CD-LM1 and CD-LM2 tests in case of being the individual average different from zero (Pesaran et al., 2008:105-127). The primary hypothesis is described as ‘there is no cross section dependence in series and model’ in this test that is called adjusted CD-LM test (CD-LM<sub>adj</sub>). There is reached the end of the existence of CSD in the series and model in the case of being denied the primary hypothesis in the test has the characteristics of the asymptotically standard normal distribution. In our study, the existence of the cross section dependence in the cointegration equation and the variables in defined models for the EME-8 group is analyzed via CD-LM<sub>adj</sub> test; the results are shown in Table 2.

It is observed when the test results in Table 2 are analyzed that all variables in the defined model for the EME-8 group and the probability values belong to the cointegration equation are smaller than 0.01. For this reason, the main hypothesizes (there is no cross section dependence) in EME-8 group based on CD-LM<sub>adj</sub> tests for variables and the cointegration equation must be denied while the alternative hypothesizes must be accepted. These results show the existence of the cross section dependence for the variables in the defined model between the cross section units and the cointegration equation. In addition to this, results indicate that the new generation panel data test techniques which consider the CSD should be used in next stages of the analysis.

**Table 2. Results of Cross Section Independence Test**

EME-8		
Variables	CD-LM <sub>adj</sub> Statistics	L
PCRGP	40.12* [0.000]	5
RGFCF	41.71* [0.000]	3
EPU	13.75* [0.000]	2
Model	32.47* [0.000]	4

**Note:** The mark of (\*) before the CD-LM<sub>adj</sub> test statistics that are obtained from the form of Constant+Trend shows the existence of cross section dependence for 1% significance level in a relevant variable and cointegration equation of defined model. The L column in the table shows the optimal delay lengths which are determined based on the Schwarz information criteria for the variables and cointegration equation. The values in the mark of ‘[ ]’ shows the possibility values belong to the test statistics.

### The Results of Panel Unit Root Test

The steady state in defined models for two country groups is examined by the second generation CADF (Cross-sectional Augmented Dickey-Fuller) panel unit root test by Pesaran (2007) that considers the CSD. In this test, firstly the CADF test statistics values for all units in the panel are calculated, then the CIPS (Cross-Sectionally Augmented IPS) statistics for panel-wide by calculating the arithmetic mean. CADF test statistics which can also produce meaningful results in conditions such as  $N > T$  and  $N < T$  are computed as follows:

$$t(N, T) = \frac{\Delta y_i' \bar{M}_i y_{i-1}}{\bar{\sigma}^2 \left( \Delta y_{i-1}' \bar{M}_i y_{i-1} \right)^{1/2}} \quad (3)$$

After being calculated the CADF test as indicated in Equation 3, the CIPS statistics values are obtained by calculating the arithmetic mean of these values like below:

$$CIPS = N^{-1} \sum_{i=1}^n t(N, T) \quad (4)$$

**Tablo 3: The Results Of CADF-CIPS Panel Unit Root Test**

Level		CADF					
Variables		PCRGDP	L	RGFCF	L	EPU	L
EME-8	Brazil	-0.97	4	-1.45	1	-0.35	2
	China	1.41	4	0.77	2	-0.35	2
	India	-2.40	1	-0.99	1	-0.35	2
	Indonesia	-1.97	1	-2.28	1	-0.35	2
	Mexico	-1.17	5	-1.80	1	-0.35	2
	Russia	-2.88	3	-2.98	1	-0.35	2
	South Africa	-2.94	3	-2.30	3	-0.35	2
	Turkey	-2.14	4	-1.39	1	-0.35	2
		CIPS					
Panel		-1.63	5	-1.58	3	-0.35	2
1st Difference		CADF					
Variables		$\Delta$ PCRGDP	L	$\Delta$ RGFCF	L	$\Delta$ EPU	L
EME-8	Brazil	-0.74	3	-1.28	1	-2.84	2
	China	-3.18***	1	-1.87	1	-2.84	2
	India	-3.44**	2	-4.41*	1	-2.84	2
	Indonesia	-2.53	3	-2.79	2	-2.84	2
	Mexico	-2.08	5	-3.01***	3	-2.84	2
	Russia	-3.98**	4	-3.17***	1	-2.84	2
	South Africa	-2.16	4	-2.48	1	-2.84	2
	Turkey	-4.60*	3	-2.43	1	-2.84	2
		CIPS					
Panel		-2.84*	5	-2.62*	3	-2.84*	2
Critical Values		CADF			CIPS		
		% 1	% 5	% 10	% 1	% 5	% 10
		-4.35	-3.43	-3.00	-2.60	-2.34	-2.21

**Note:** The marks of (\*), (\*\*) and (\*\*\*) before the CADF and CIPS test statistics indicate that the related variables are respectively stationary at 1%, 5%, and 10% significance level. The 'L' column in the table shows the optimal delay lengths based on the Schwarz information criteria. The critical table values of CADF and CIPS statistics are obtained from the study of Pesaran (2007) based on the condition of T and N. The mark of ' $\Delta$ ' is the different operator and shows that the first difference of variables is taken. The constancy model is used as the test model for the panel-wide and all the cross section units that create the panel.

## Results of Panel Co-Integration Test

The process of getting difference can eliminate the possible long termed relations between series which are stationary and the effects of temporary shocks of these series from the past. Under this circumstance, a steady combination of these series could be found even the series belong to the economic variables are not stable, and this combination could be specified by the co-integration analysis (Tari, 2010: 415). The panel co-integration tests give consistent results in the models (Johansen 1988; Kao 1999; Pedroni 1999, etc.) which have not CSD while these tests provide unbiased results in the case of being lack the cross section dependence in the cointegration equation. In such a case, the panel co-integration tests that allow (Westerlund and Edgerton 2007, Westerlund 2008, etc.) for the cross section dependence between the variables should be used.

In the Panel Co-Integration test of Westerlund (2008) Durbin-Hausman that was used in this research, the long termed cointegration relations are reviewed one by one in the dimension of panel and group. It is accepted that the autoregressive parameter is the same for all sections in DH panel ( $DH_p$ ) test, on the other hand, this autoregressive parameter differentiates between the cross sections in DH group ( $DH_g$ ) test. With this aspect, the existence of cointegration relation for all sections create the panel is accepted when the  $H_0$  main hypothesis in DH panel test is denied; while the  $H_0$  primary hypothesis is denied in DH group test, the existence of cointegration relation is accepted at least in some sections create the panel. Otherwise, it is decided on accepting or denying the  $H_0$  main hypothesis in both DH panel test and DH group test by being compared the test statistics with the critical values of normal distribution table.  $H_0$  main theory is denied at 5% significance level in case of being the test statistics values for  $DH_p$  and  $DH_g$  tests bigger than normal distribution critical table value (1.645); then the existence of cointegration relation in some sections create the panel and all sections create the panel is accepted (Westerlund, 2008: 196-199). In the study, the existence of the long termed Integration test of Durbin-Hausman and Table 4 shows the results.

**Table 4.** Results of Durbin-Hausman Panel Co-Integration Test

EME-8			
Test Statistics	DH <sub>g</sub>	DH <sub>p</sub>	$\tilde{\Delta}_{adj}$
Model	2.193* [0.000]	3.35* [0.000]	0.091* [0.464]

**Note:** The probability values were reported for the tests of DH<sub>p</sub> and DH<sub>g</sub>. These values are obtained from 10.000 repetitive bootstrap distribution; the test statistics are derived from the constancy form. The mark of ‘\*’ shows the existence of the cointegration relation between the series at 1% significance level. The mark of “\*” before the  $\tilde{\Delta}_{adj}$  test statistics indicate that the slope coefficients belong to the cointegration equations in models are homogeneous based on 1% significance level. The numbers in the square brackets show the probability values belong to the test statistics.

It is seen by evaluating Durbin-Hausman test results in Table 4 that, the main hypothesizes (there is no cointegration relation between the series in some sections create the panel and all sections create the panel) for the defined model in the EME-8 group are denied at 1% significance level and the H1 alternative hypothesis is accepted at the same time. This condition means that there is a long termed cointegration relation between the series in all cross section units create the panel and the panel-wide in the EME-8 group as well. After being determined the long termed relationships in defined models, the homogeneity status of the slope coefficients in co-integration equation is examined by the Slope Homogeneity Tests. In this test, the condition of ‘whether the slope coefficients differ based on the cross section units in co-integration equation’ is analyzed by the alternative hypothesis called ‘the slope coefficients are not homogeneous’ against the primary hypothesis called ‘the slope coefficients are homogeneous.’ The central hypothesis is accepted at 1% significance level in case of the ( $\tilde{\Delta}_{adj}$ ) test statistics probability values bigger than 0.01; and it is decided that the coefficients of co-integration are homogeneous between the cross sections (Pesaran and Yamagata, 2008: 50-93). In the study, the homogeneity of the slope coefficients in co-integration equation of defined model fort the EME-8 group is analyzed by the ( $\tilde{\Delta}_{adj}$ ) test and the results are shown in Table 4. It is observed by looking at the results of homogeneity test results that the probability value for ( $\tilde{\Delta}_{adj}$ ) test statistics is bigger than 0.01. These results reveal that the constant term and slope coefficients in co-integration equation of defined model for the EME-8 group are homogeneous and all the co-integration assessments for panel-wide are valid and reliable.

### **Prediction of Coefficients of Long-Term Co-Integration**

After the co-integration tests determine the long termed relations between the variables in the defined model, the problem of how the long-term coefficients belong to the independent variables will be predicted shows itself. Due to the cross section dependence is determined in the defined model for EME-8 group, the size of the long termed effects of independent variables in the model on dependent variables should be predicted by the estimators who consider the CSD. Within this context, the estimator of Panel AMG (Augmented Mean Group) by Bond and Eberhardt (2009) is used for obtaining the long termed coefficients for cross section units create the panel and the panel-wide in the EME-8 group. The long termed cointegration coefficients for the panel-wide in the estimator of Panel AMG are calculated by being weighted the arithmetic means of long termed cointegration coefficients belong to the cross sections. The estimator of Panel AMG considers the common factors and dynamic effects in variables and also produces powerful results in the event of an internality problem (Eberhardt and Bond, 2009: 1-3). In the study, the model that was established to review the long termed effects of global scaled economic and political uncertainty in EME-8 group on the economic growth is predicted by the method of Panel AMG, and Table 5 shows the results.

It has resulted when the data in Table 5 is analyzed that the coefficient of RGFCF explanatory variable is positively in line with expectations and significant at 1% importance level in all cross section units create the panel and the panel-wide. These results reveal in all cross section units generate the panel and the panel-wide that the increments/developments in real fixed capital investments affect the economic growth positively and statistically significant. At the same time, we can see when the results are analyzed as one by one for cross section units create the panel that the sizes of positive effects of the variable of RGFCF on the economic growth respectively are China, Indonesia, Russia, Brazil, Turkey, South Africa, Mexico, and India. These results show that the real fixed capital investments have an intensifier effect on the economic growth in all cross section units create the panel and the panel-wide. On the other side, it could be said that the size of this effect is the largest in China and the least in India.

**Table 5.** The Coefficients of Long Termed Co-Integration: Results of Panel AMG

Dependent Variable: PCRGDP						
EME-8	RGFCF		EPU		Constant Term (C)	
Countries	Coefficient	SE.	Coefficient	SE.	Coefficient	SE.
Brazil	0.2934*	0.0244 [0.000]	-0.0035*	0.0002 [0.000]	7.5849*	0.1988 [0.000]
China	0.4503*	0.0610 [0.000]	-0.0117*	0.0021 [0.000]	6.6811*	0.6288 [0.000]
India	0.2233*	0.0703 [0.001]	-0.0106*	0.0017 [0.000]	7.8773*	0.5568 [0.000]
Indonesia	0.3791*	0.0165 [0.000]	-0.0054*	0.0002 [0.000]	6.8837*	0.1264 [0.000]
Mexico	0.2446*	0.0326 [0.000]	-0.0018*	0.0003 [0.000]	7.9586*	0.0481 [0.000]
Russia	0.3644*	0.0295 [0.000]	-0.0059*	0.0005 [0.000]	7.7003*	0.2483 [0.000]
South Africa	0.2685*	0.0322 [0.000]	-0.0011*	0.0004 [0.000]	7.5221*	0.2658 [0.000]
Turkey	0.2758*	0.0164 [0.000]	-0.0050*	0.0002 [0.000]	8.0570*	0.1401 [0.000]
Panel	0.3124*	0.0275 [0.000]	-0.0056*	0.0014 [0.000]	7.5331*	0.1768 [0.000]

Note: The (\*) mark before the coefficients that are calculated for the variables in cross section units and the panel-wide shows that the t-statistics belong to the coefficients are significantly based on 1% importance level. The term of SE in Table indicates the standard errors belong to the coefficients and the values in square brackets show the probability values belong to the coefficients.

On the contrary, it is seen when the results in Table 5 are analyzed concerning the variable of EPU that the coefficient of the EPU explanatory variable is avoidant and significant at 1% importance level in all cross section units create the panel and panel-wide as expected. These results introduce that the increments in economic and political uncertainties based upon the developments in USA effect the economic growth negative and statistically significant as predicted at the theoretical-empirical level in all cross section units create the panel and panel-wide. Besides, it is seen when the results are analyzed as one by one for cross section units generate the panel that the size of avoidant and significant effects of EPU variable on the economic growth could be respectively

ranged as China, India, Russia, Indonesia, Turkey, Brazil, Mexico and South Africa. These results indicate in the inspection period that the economic and political uncertainties based upon the developments in the USA have a reducing effect on the economic growth in all cross section units create the panel and the panel-wide, on the other hand, it could be said that the size of this effect is the largest in China and the least in South Africa. Moreover, the results show the size of adverse effects of the economic and political uncertainties based upon the developments in the USA on the economic growth is bigger more than ten times in China in comparison with South Africa.

## Conclusion

In this research, the effects of the economic and political uncertainties based upon the developments in the USA on the economic growth performances of selected emerging market economies (Brazil, Russia, India, China, South Africa, Mexico, Turkey, and Indonesia-EME-8) are analyzed as econometrically for the period of 1992-2015. From this aspect, it is purposed in this study to empirically examine that whether global scaled economic and political uncertainties have an effect as predicted in the theoretical framework on the performances of the emerging market economies in the group of EME-8. In the study, the model that is established with the control variable of real fixed capital investments to analyze the long termed effects of the global scaled economic and political uncertainties in EME-8 group on the economic growth is predicted one by one within the scope of new generation panel data methodology for the cross section units create the panel and the panel-wide. At the end of the study, it is possible to express the results which are compatible with the theoretical and empirical literature in the following way:

Determined that the effects of the economic and political uncertainties based upon the developments in the USA on the economic growth are avoidant and statistically significant in all cross section units create the panel and the panel-wide of the EME-8 group. These results reveal that the increments in the economic and political uncertainties based upon the developments in the USA manipulate the economic growth across the panel and in all cross section units that generate the panel as negative and statistically meaningful as being predicted at the theoretical-empirical level in a period of study. Besides, it has resulted that the size of avoidant and significant effects

of the economic and political uncertainties based upon the developments in the USA could be respectively ranged as China, India, Russia, Indonesia, Turkey, Brazil, Mexico and South Africa. These results indicate that the reflections of the economic and political uncertainties based upon the developments in the USA on the economic growth performances of selected emerging market economies are negative. On the other hand, it could be said that the size of these adverse effects is the largest in China and the least in South Africa.

All these results from the study show that the global economic and political uncertainties based on the USA play a major role in continuing the economic shrinkages in selected emerging market economies that occurred by the depression of 2008, while the other circumstances are accepted as stable. Furthermore, the results make us think that the global economic and political uncertainties are the important factors that avoid reaching the long termed and sustainable economic growth rates in selected emerging market economies in the group of EME-8. In addition to all these, being involved a greater number of countries for the next empirical studies to analyze the effects of global scaled economic and political uncertainties on the economic growth will contribute to the improvement of the literature that has just begun to emerge.

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# 2 | Neoliberalism and Market in God's Kingdom: Energy, and Development in Iran

*Farhang Morady*

## **Abstract**

*Neoliberalism is a general theory that explains changes in different phases of capitalism. It is essentially a shift from state-led development to increasing the use of the market-based solutions and rolling back the frontiers of the state. This paper is an attempt to analyze the implementations of neoliberalism and its implications in post-revolutionary Iran. It will argue that neoliberalism is not a 'one size fits all' doctrine, especially in relation to oil producing countries, notably the case of Iran. This is because of the abundant energy resources held by Iran, which has cemented its geopolitical position within the region. Iran has gone through different phases of neoliberalism but this has not diminished the role of the state within Iran. Despite privatization, including significant deregulation, an end to subsidies for specific industries and commodities, the Iranian state continues to be instrument in the political economy.*

## **Keywords:**

*Neoliberalism, Energy, State, Development, Islamic Republic of Iran, Market Liberalization and Subsidies.*

## **Introduction**

Neoliberalism is essentially set of ideas and practices claims to liberate the entrepreneur spirit through the extension of free market, free trade and robust property right (Harvey, 2005). This has become an all-encompassing term for differing economic and political projects. The state should be minimal, as the competition of the market will bring economic efficiency and choices. The crisis of capitalism in late 1970s, and 1980s has opened the gap for neoliberal ideas to have resonant as a solution to global capitalism. Despites, their political, historical, geographical, and economic differences nearly every country in the world, especially in the global south has implement neoliberal policies in some form. The policies have become an increasing a real alternative to over-come the predicament of the World Economy.

Whilst neoliberalism operates in supra-nationally and it has dominant in the world it also involves the nation-state; the degree of this involvement depends on variants of how neoliberalism is applied in countries with different economic, political and geopolitical characters. Indeed, neoliberalism needs to be presented as the complex set of economic and political processes. (Larner, 2000). This paper is an attempt to show the implementation of neoliberalism in Iran since 1979 revolution, especially in the last two decades; during Mahmoud Ahmadinejad and Hassan Rouhani's presidency. By focusing on Islamic Republic, it will demonstrate (a) Regardless of ideology of the regime the global economic forces has given very little leverage for the Islamic Republic to act independently from global capitalism; (b) The energy continues to be vital for Iran's economy and development since 1979 and (c) Hence the state monopoly of the energy resource and this has been fundamental in both the process of economic liberalisation and development. In doing this, I will argue that neoliberalism is not one size, fit for every countries in the world. The process of development in Iran demonstrate that the role of the state, the social forces, and geo-political position of a country is vital in the implementation and implications of the neoliberal strategy. This article will be in two parts, it will first provide analysis of neoliberalism and then apply this to Islamic Republic's different governments, attempting to implement neoliberal strategy since 1979 and its consequences.

## **Nexus of Neoliberalism: Energy, State and Market**

There are ambiguities exactly what neoliberalism is. It may be defined as a way of running and managing capitalist development. This may alter with change in government policy, emphasising on privatisation and free market. In a sense Neoliberalism is revitalization of the orthodox 'Laissez Fair' economic ideology that existed until the Great Depression of 1870s. The idea that free market economies is capable of generating more wealth in an efficient manner against 'Un-natural Monopolies'. It is claimed that the state intervention distorts the economic development and must be confined to protect private property and national defence. This, however, is not new as it was practiced until beginning of the 20th century; the free market gave way to monopoly capitalism. In the post WWII, the state intervention became vital to provide the necessary infrastructure for capitalist development not just in the Eastern Block including the Soviet Union but also the Western countries such as the US, Britain, France, German and Italy. This led to the transformation to economy and renewed profitability and accumulation. Based on John Maynard Keynes idea, it was believed that restrictions and regulations would assist the process of accumulation of capital at the time. (Campbell, 2001: 189).

Keynesian model became accepted policy by both government and corporations in the world. The state was able to stimulate the crisis driven global economy which was damaged by two wars and a huge recession of late 1920s. Keynesian model came under a huge test in mid 1970s with world economic crisis. The state intervention began to be presented as a problem. Different scholars, notably monetarist economist Milton Freedman, accused government's interference in the free market as a cause of the economic crisis. He argues that the government was unable to control money supply. Others such as von Hayek and Robert Lucas were vociferous against the state intervention, being inefficient, incapable and generate waste (Garrison, 1992). They all claimed that the economy can solve its problem and achieve higher economic growth through free market and free trade. Hence, national monopolies were seen as distorting prices and natural rate for unemployment and wages. Inability of the state to solve the crisis of the economy allowed neoliberalism to gradually succeed to fill the ideological gap.

It was during the late 1980s and 1990s that Neoliberalism and its associate term globalisation become a buzz word in many academic debates. Especially, amongst those,

who use the concept to describe the spread of global capitalism, market, declining role of the state and globalisation of civil society. (Harvey, 2005; Saad-Filho and Johnston, 2005). In short Harvey defines neoliberalism as:

*“... A theory of political economic practices that proposes that human well-being can best be advanced by liberating individual entrepreneurial freedoms and skills within an institutional framework characterized by strong private property rights, free markets and free trade. The role of the state is to create and preserve an institutional framework appropriate to such practices. The state has to guarantee, for example, the quality and integrity of money. It must also set up those military, defence, police and legal structures and functions required to secure private property rights and to guarantee, by force if need be, the proper functioning of markets. Furthermore, if markets do not exist (in areas such as land, water, education, health care, social security, or environmental pollution) then they must be created, by state action if necessary.” (Harvey 2005:2).*

Harvey claims that before 1970s capitalist development was expanding because of class compromise between ‘capital and labour’. Through intervention the state was able to focus on:

*“... Full employment, economic growth and the welfare of its citizen, and that state power should be freely deployed alongside of, or if necessary, intervening in or substituting for market processes to achieve these ends.” (Harvey, 2005:11).*

This ended with the crisis of over accumulation in 1970s, as the system broken down. A Neoliberal approach was adopted because the capitalist class was determined to restore their profitability and power (Harvey, 2005:16). Whilst Harvey correctly points out that Neoliberalism is a theory of political and economic practices rather than a complete political ideology. His argument is not convincing that China can be characterised as a free marketer because the Communist party with a huge regulatory strategy still dominant in its economy. Indeed, as Nonini (2008) points out, China has not taken totally neoliberal approach in its development in which the state has played an important role in intervening and navigating the economy. The new emerging capitalist classes are still subservient to the direction of political elites in the communist party. Others such as Pollin (2005) points out that Russia under Yeltsin undertook a neoliberal approach, which had disastrous results. This was different in the case of Russia under Putin, relying heavily on energy sector to support the development

process. Indeed, the hydrocarbons now contributes around 25 percent of GDP, 50 per cent of the federal budget income and 65 per cent of export earnings.<sup>1</sup>

To lump China and the other countries together in an attempt to explain their capitalist development is as much wrong as if we include the oil producing countries such as Iran, Venezuela or Qatar in the same categories. This does not mean that these countries have not adopted neoliberal capitalist development. It is basically how this process is taken place. Indeed, the retreat of the state is not necessary the case, not just in the emerging countries such as China, Russia, Brazil, Turkey and India or in the case of the oil producing countries. Perhaps the area, that neoliberal practices has been in place, is the poor countries, where the International Monetary Fund (IMF) and World Bank's (WB) measure forced them to accept to become a junior partners to capitals operating from the advanced countries.

Since the rise of populist right wing political figures in the West, especially the victory of Donald Trump as a president in the US, has turned the attention to whether neoliberalism is coming to its end. Whilst it is too mature to predict this at this stage, there are enough evidence to suggest that Trump's administration are using nationalist language and strategy to navigate the US ailing economy. In order to protect the US interest and have an advantage over its competitors such as Japan, China and Germany Trump's administration putting forward protectionist approach in its trade relations. For example Trump's policy of withdrawal from the US from Trans Pacific Partnership (TPP), a trade deal with 11 other Asian Pacific countries.<sup>2</sup>

As with the implementation of neoliberalism in the oil producing countries there have been rigidity regarding how to deliver this without contradictions. Although multinational companies (MNCs) continue to play an important role, the state owned companies such as Russian Oil Company (Rosneft), Iranian oil company (NIOC), and Saudi Oil Company (Aeamco) are also vital as well, secondly, the centre of biggest oil and gas industry is Organisation of Petroleum Exporting Countries (OPEC), which control 30 per cent of global oil production and huge amount of oil reserve. By definition this is a cartel, it is not about free market, it is a complicated market structure.

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<sup>1</sup> Key World Energy Statistics 2011, accessed March 12, 2012, [http://www.iea.org/textbase/nppdf/free/2011/key\\_world\\_energy\\_stats.pdf](http://www.iea.org/textbase/nppdf/free/2011/key_world_energy_stats.pdf).

<sup>2</sup> See [www.whitehouse.gov/inaugural-address](http://www.whitehouse.gov/inaugural-address).

Furthermore, the price of oil is not determined just by fluctuation of supply and demand. History of oil and gas is about managing supply and surplus and keeping the commodity off the market through collusion. Although oil and gas producing countries correspond to capitalism, it is dominant to its functioning of the system, it does not precisely adapt to the working of the market. Many of oil producing states may have been subject to what Harvey describe to neoliberal free market, free trade, structural adjustment programme, which is precisely about the process. What appears however evident that they don't necessarily fit into the type of neoliberal states. Because they lie on a huge highly centralised bureaucracy, with small countries as subsidiaries as well as operate as a joint venture with MNCs. But the state remain central as they earn 2/3 of whatever it is earned and sometimes this can reach up to 80 per cent depending on what the price is. Of course the oil and gas sector is more than just state own industry. It includes the other industries i.e. refineries, chemical industries, engineering, services and the banking sector that finance these industries. The military apparatus that it has support the industry.

### **Oil Dependency and Development**

With the growing international importance of oil, especially since early 1970s, the governments of oil-producing countries accrued windfall income, which could be used to manage their economic and political affairs. These states, including Iran, embarked on capitalist development in the 1960s and 1970s with near-total dependence on a single resource. In a very short period revenue from energy had transformed the economy and society. This rapid development within oil-producing countries, particularly those in the Persian Gulf, attracted the attention of academics and analysts, who sought to define the nature of such states. Conceptualization of the state of the oil producing countries varied from using the term, 'Reinter State' (Mahdavi, 1970), authoritarianism (Ross, 2001, 2009) and some have claimed that these states are hindrance to democracy (Friedman, 2006). Most analyses were focused on internal cultural characteristics and the prevailing operation of the economy and politics, thus ignoring the wider historical and geographical context and the role of great powers – factors, that are equally important in the formation and operation of such states. Oil has provided the state with huge income and authority to dominate the political economy, but contending domestic social forces are themselves constantly attempting to gain a share of 'Unearned' external rents from oil income. On the other hand international companies and forces are competing to secure greater reserves of this finite resource for themselves.

Historically, one of the key characteristics of capitalist development in general, but specifically in Iran, has been its uneven distribution both in the economy and the political sphere. There are persistent differences in both the degree and the rate of economic development between economic sectors and geographical regions. By 1979, capitalist development in Iran was totally dependent on the global economy, hence it was impossible for the Islamic Republic to choose any other corridor for its survival retaining a degree of continuity within the country. Given is the inextricable link with the global economy and the state's revolutionary ideals (which pulled Iran in opposite directions), the question of how to manage the domestic political economy was a complex one.

The state earns between 60-80% of the income from oil on a regular basis and this windfall oil revenue is 'Unearned' income. It provided the state with immeasurable economic and political power and it turns the ruling elite into 'Guardians of the Status Quo' (Meissner, 2010). The state became one of patronage, with the citizens as clients - depending on how close the citizens were to the ruling elites to get the benefit accordingly. With the establishment of the Islamic Republic the situation has taken a new twist; the clerical rulers claim legitimacy from God and have a huge income with which to enforce this mandate. This has generated further debates especially amongst commentators who emphasized the correlation between high-energy income and lack of development and progress in countries like Iran.

The 'Rentier State Theory' and the 'Oil Hinders Development and Democracy' both hypothesis are subordinate to a greater discussion about whether natural resource abundance is a 'Curse' or a 'Blessing' for development. The 'Resource Curse' argument, based on an over-reliance on natural resources (in this case oil extraction) points to it being detrimental to economic, political and social wellbeing (Moss, 2011). Hence, poor macro-economic performance, authoritarianism, and negative development outcomes including poverty and conflict are all blamed for possessing energy. (Collier and Hoeffler, 2000).

However, any two of these events can be mutually reinforcing. The pivotal relationship between oil wealth and authoritarianism has been challenged by a number of scholars. They asserted the reverse causality and highlighted the importance of institutional quality. They argue that in a country with good governance, oil-abundance can be a 'Blessing' rather than a 'Curse' on democratization. (Herb, 2005; Dunning, 2008;

Haber and Menaldo, 2011). In fact, naturally oil-abundant countries, such as; Botswana and Chile; demonstrated successful development and democratization (Stevens, 2015: 11).

Whilst there is some evidence that oil wealth is an important factor in the persistence of authoritarianism and lack of development in rentier states. This is not the only reason because there are other factors that also contributes to this situation. However, literature that supports the rentier state theory is both apolitical and ahistorical. They merely analyze state-society relations in isolation from both the global political economy and the historical context in which internal and external forces have aggravated or eroded the persistence of authoritarianism. Thus, it is important to consider the effect of dynamic interplay between local and global politics on the shape of regimes, together with the revenue available to them.

As it is important to analyse the state and energy relations through global political economy, similarly, the implementation of Neoliberalism has not been the same within a country or between different countries. There are different variants of neoliberalism and how particular governments have actually implemented 'neoliberal' policies. For example; in Chile, Venezuela and Iran all have employed neoliberal policies, but not using a similar strategy. It would be better to highlight the complexity and contradictions in any analysis of neoliberalism, in the context of the condition that global capitalism is in rather accepting monolithic definitions and accounts of the supposed 'Neoliberal Project'. This does not reject the view as Harvey points out:

*"If Neoliberalism has been a vehicle for the restoration of class power, then we should be able to identify the class forces behind it and those who have benefited from it."* (Harvey, 2005: 31).

The centre of accumulation, however, remains in day-to-day exploitation of the social forces that are affected through process neoliberal policies. This process is very inconsistent which can throw up all sort of political complications, as there have been resistance and fight back in different parts for world.

### **Islamising Capitalist Development?**

In 1979, the mass movement that uprooted the monarchy and replaced it with Islamic Republic was full of promises including changing structure of Iran's economy, offering

free electricity, telephone, gas and water for all.<sup>3</sup> Islamic Republic appeared to be one of the most virulent anti-imperialist nations, influenced by revolutionary zeal. The political movement leading up to the ideological character of the revolution stated its aims as being against ‘Westernization’ – viewed as the main enemy and the principle source of social and economic deprivation.

In order for Islamic Republic to reaffirm itself, it claimed to present an alternate to both western capitalism and the socialism of the ex-socialist countries.<sup>4</sup> Rejecting capitalism and socialism, Khomeini, advocated new economic conditions based on Islam, which would enable prosperity to help the majority:

*“Under an Islamic government, economic conditions will change, we will offer a healthy economy ... our concern is real restructuring of the economy which helps the majority, the needy and the poor.”* (Khomeini, 1985: 100-125).

Khomeini claimed that Iran will be a ‘Self-sufficient Country’ (Khomeini, 1985: 49). He accused the previous regime of squandering the country’s resources, most importantly oil, and allowing the western countries to take it away in return for very little:

*“... Our oil is being plundered; and our country is being turned into a market for expensive unnecessary goods... A number of foreign states carry off our oil... and the negligible sum they pay to the regime they have installed returns to their pockets... [And] God only knows what it is spent on.”* (Khomeini, 1981: 115).

Not surprising, under pressure from competing political forces and well aware of the anti-imperialist camp, his view was in general critique of the Third World’s dependency on advanced capitalist countries. With this ideological vision, including economic self-sufficiency, export of the revolution, increasing non-oil exports and breaking links with the west, the new regime began to organize the political economy.

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<sup>3</sup> For Iranian revolution of 1979 see Abrahamian, 2009.

<sup>4</sup> There are various literatures discussing Shia Islamic models for economic development see For details of the Shia-Islamic Economy see, Sadr, 1971 and 1978, Talaqani, N.d. and Bani Sadr, 1979

Despite different revolutionary leaders including Khomeini echoing their opposition to market oriented capitalism before and during the revolution, it was only matter of time before the regime could popularise the market reforms and embrace neoliberalism. Indeed, Iran's economy at the eve of the revolution was relatively modernized and integrated to global capitalism, already strongly linked to the international division of labor as an oil producer, and importer of capital, intermediate and consumer goods from the rest of the world. The question was how to manage the political economy, through the state, the market or both.

Under these circumstances, to continue the old relations with the west was not politically wise, since the regime had come to power by voicing the people's resentment at this. Bringing in foreign capital and much-needed expertise was also not expedient – in fact, entrepreneurs and management were leaving the country, taking with them some of the capital, and leaving the banking system in turmoil: many institutions could not meet the demand for money by depositors. The flight of capital from the country in 1978-79 had already pushed up the price of foreign currencies against the Rial on the black market, and left many factories lacking finance. Foreign technocrats and advisors either fled or had been deported; consequently many industrial projects such as steel-mills, petro-chemical plants were half-completed and lying idle.

The state was already playing a large role in Iranian economy, industry such as oil, gas, petrochemical, steel, copper, and aluminum already came under state control, and this was extended to over 560 other companies through the nationalization program.<sup>5</sup> The government promised that it would compensate its foreign partners for this nationalization. By 1980, nearly 80 per cent of the private industries came under the control of the state.

The government decided to nationalize foreign trade in order to control prices and the transfer of hard currencies to the rest of the world. The state had to use credit from the public sector to pay for imports. This was not simple matter, however, as the bazaar had strong support amongst some of the clergy.

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<sup>5</sup> Foreign companies affected by the nationalization were mostly the government's partners in industries such as lubricating-oil refineries (partly owned by Exxon and Shell), General Motors and France's Renault (partners in local assembly plants), British Leyland's truck and bus plants, West Germany's Bosch and Mahle and the US John Deere, involved in tractor-assembly.

Just as oil was a vital economic and political factor for the previous regime, it became vital for the new ruling authorities too. Oil was a political issue both nationally and internationally. Indeed, one of the main slogans of the revolutionary movement had been criticism of the role of imperialism and its relation to oil. The income continued to have the same economic and political impact as before, giving the state some room to maneuver, both economically and politically. The state continued to receive a large amount of external rent and, like the previous regime, plan a large expenditure program without relying on heavy taxation or overseas borrowing. The oil revenue thus allowed the Islamic Republic some immunity from socio-economic pressure. This also helped the state by not impose heavy taxation on a population whose expectations of economic reward had increased. However, nationalization of industries and the establishment of new state institutions required finance, which could only be provided by the state, through oil rent.

This policy was, however, contradictory in the light of the new regime's stated attitude towards the west. The post-revolutionary regime argued for decline in oil production, diversity of exports, and delinking with the west. But it was impossible to break Iran's economic links with the world market. The Iranian economy still needed to import necessary supplies for the operation of its industries, the army and to provide food for the population, and some of its needs were not produced in Iran (Central Bank of Iran, 1981: 161).

Iran continued to trade with the west because it was impossible to avoid, the structural change in Iran's economic relations would have caused further intensification of her economic and political crisis. Iran also required continued western expertise to run its food, textile, wood processing, petro-chemical, power, manufacturing and electronic industries, which already employed thousands of foreign engineers and technicians.<sup>6</sup> A complete break with the west would merely have compounded the problems of unemployment and the shortage of basic supplies in the economy, including food. Iran continued to import a large percentage of the staple foodstuffs required for the growing population. The new regime's policy after the revolution was to keep oil production at a low level.

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<sup>6</sup> The oil industry by 1984 employed some 1,000 Italian, Japanese, British and German expatriates. See Fesharaki, 1985.

This was successfully achieved only because Iran possessed adequate foreign reserve to manage its economy. As soon as this ran out the economic need for oil revenue became more pressing and this altered the regime's oil policy. Oil production began to increase and it was even sold at cost-price during the Iran/Iraq war.<sup>7</sup> It became clear for the revolutionary government that Iran cannot come out of dependency on oil, which accounted for over 80 percent of all government foreign exchanges. Prime Minister Rajaie, in 1980, admitted that 'oil is the life blood of the revolution'.<sup>8</sup> Khomeini went further when gave a warning that ten years of austerity lay ahead before the country could become productive enough to fulfill its needs. In one of his speeches, pointed out: '... What is clear for us is firstly Islam which has everything. We did not have a revolution for our stomach. We revolted for Islam.' (Khomeini 1986: 163). Although, Iran's production dropped from 5.6m b/d to under 2m b/d, this was compensated by the price rise from about \$18.5 per barrel in 1979 to \$35 in 1981. (Morady, 1994)

### Iran's Oil Production (1950-2015)



Source: *Energy Information Administration*

<sup>7</sup> During the Iran/Iraq war the regime was faced with an extreme need to finance the war and, due to the glut of oil in the world market, offered oil at cut price. See Chubin and Tripp, 1988 and Luciani, 1989.

<sup>8</sup> On the debate over the economic and politics of oil see Ettelat-e Ekhtesadi va Siasi no 6. 19/Mehr/1365, Razaqi, 1988, Bakhsh, 1981 and Renner, 1988.

## Implementing Neoliberalism

Following the end of Iran/Iraq war of 1980-88 and the death of Khomeini in 1988, Ali Khamenei Islamic Republic's the discussions emerged in what ways reconstruction and development should take shape. Despite the perception of western commentators, Islamist interpretations held within Iran are rarely homogeneous (Morady, 1994). Overall, differences in approach must be viewed as reflections of the social forces which led to the formation of each group. Whilst both so called the Conservative and Pragmatists advocate an open economy with a role for the private sector, plus provision of support for the traditional middle class and "Bazaari", their differences are in their approach to the foreign policy. The conservative advocate an anti-US stance and closer collaboration with North Korea, China, India, Russia, Syria, Hamas in Palestine and Hezbollah in Lebanon (Moslem, 2002).

The pro-market and pragmatist, Ali Akbar Hashemi Rafsanjani won the presidential election in August of that year, with 94 per cent of the vote. He along with the growing number of professionals and technocrats who had been given influential positions within the political system, took on the challenge of sorting out Iran's ailing economy. Rafsanjani's faction became known as Kargozaran-e Sazandegi. The 'Executives of Reconstruction', bestowed with the superlative title of Sardar-e Sazandegi – the 'Generalissimo of Reconstruction'.

Rafsanjani's administration adopted a market reform strategy accepting IMF's 'Structural Adjustment Program' in 1989. The post Iran-Iraq war reconstruction had a reformist (*eslahat*) hue and was aimed at bringing Iran closer to international capitalism by reducing state subsidies to industry, promoting free trade and re-privatization, and stimulating the stock exchange. Khamenei – who had replaced Khomeini as Supreme Leader - had in the past denounced western liberalism but he was in agreement with Rafsanjani over the need to balance the budget and end rationing and price controls, with the aim of both reducing the level of inflation and reining in the defense budget.

Rafsanjani's second term in office did not attract the same support as his first: witness the fact that 13 million voters (50 per cent of the electorate) did not even turn out to vote in 1993. The rapid privatization of many key industries and removing many import subsidies led to closing down of some local manufacturing was driven into the ground and many plants closed as imported goods came flowing in. The value of the

Rial dropped as the regime removed foreign exchange controls in response to dictates from the IMF. His economic liberalization policies had led to a rise in the rate of unemployment, and low incomes were further impacted by cuts in food subsidies. By the mid-1990s, Rafsanjani's government faced huge economic difficulties as unemployment reached 30 per cent and food prices rocketed, especially for the important staples of sugar, meat, butter and rice. The young particularly bore the brunt of the country's socio-economic problems and their discontent turned to resentment against government restrictions on their civil liberties and freedom of speech. The problem was so severe that it resulted in a series of riots in April-May 1992, August 1994 and April 1995 (Bayat, 1994:10).

Reformist politician Mohamed Khatami's candidacy for presidency generated much enthusiasm, especially amongst the younger generation. He won successive elections in 1997 and 2001, promising on the eve of his presidency to improve economic, political and social conditions at home. Like Rafsanjani, he attempted to bring gradual liberalization and opening up of the economy to the outside world.

By the time of the July 2005 election, a large section of the population felt let-down by the failure of Khatami to deliver on his promised economic and political reforms. Despite years of a 'Reformist' presidency, Iranians were experiencing continuing unemployment, inflation, limited political freedom, restrictions on the press and the imprisonment of journalists and student leaders<sup>9</sup>.

### **Towards a Populist Approach to the Market?**

During Mahmoud Ahmadinejad's presidency (2005-2013) the populist approach of the early days of the Islamic Republic was revived. Mixing religious slogans with nationalism the market reforms were continued with even more vigor. His populist gestures included payment of cash for the removal of subsidies for basic food such as bread, meat and eggs. Initially the cash payment was of some help to the poor and especially those below the poverty line, with the high inflation rates this became less assistance to those hoping to acquire their basic necessities.

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<sup>9</sup> The most well-known person imprisoned was Akbar Ganji, a journalist and writer who (at the time of writing) has been in prison since 2000 after taking part in a political conference held in Berlin. He recently went on hunger strike for over a month.

Ahmadinejad was committed to accommodating the interests of an emergent bourgeois class, fueled by revenues from skyrocketing oil prices which reached more than \$100 per barrel in early 2008.

Ahmadinejad employed a different strategy to implement his neoliberal strategy. For example he introduced a 'Justice Share' of stock for the needy in privatized state companies and he moved to transfer shares from state-owned companies to the poor helps to boost the cooperative sector. However, he ensured that the management of these cooperation are appointed by the state, effectively his protégée. In September, Etemad-e Mobin, an investment company linked to the Islamic Revolutionary Guard Corps (IRGC), bought a 51 per cent share of the national telecommunications sector after it was privatized (Erdbrink, 2010).

Ahmadinejad's market strategy was different from Rafsanjani and Khatami; he was on line with the others to ensure the republic's survival at any cost including brutally suppressing strikes, students and women's protests, and nationalist movements in Kurdistan and Azerbaijan. In 2005, one year into his presidency, the bus workers' union organized a popular strike of its 17,000 members in Tehran in protest against poor working conditions. The result was the arrest and detention without charge of their leader, Mansour Osanlu. (International Campaign for Human Rights in Iran, 2010).

Politically, however, the alliance between Ahmadinejad, Khamenei and the IRGC represented a move away from the less republican, secular and democratic elements within Iranian politics. Their power rested on the two pillars of the security forces and the oil industry, which between them provided security for the regime. However, without a good income from oil this alliance could not be sustained, and income was dependent on production levels and the price in the world market.

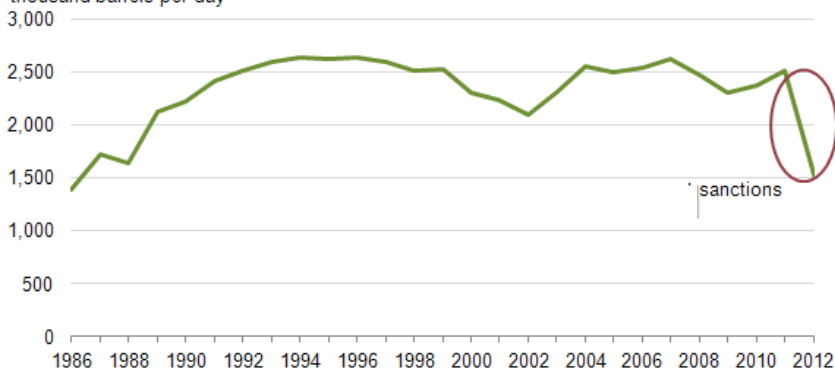
With the restrictive sanctions imposed by western governments in order to stop Iran to enrich its nuclear program put the country under considerable pressure. This was mainly targeted Iran's energy sector and its access to the international financial system, causing great difficulties forcing the republic to re-examine its foreign policy. Sanctions imposed by the US during Ahmadinejad's administration, did not at first dramatically affect Iran's economy. The game-changer was when sanctions were no longer imposed unilaterally by western countries, but took the form of internationally cohesive

sanctions agreed by United Nations resolution, effectively involving countries and organizations around the globe.

Consequently, Iran faced huge difficulties as oil exports reduced from over 2 million barrels a day to less than 1.5 million. Decreasing oil production and Iran's inability to earn necessary foreign capital after 2012, was reminiscent of both the crisis following the nationalization of the oil industry in 1950 and the situation during the Iran-Iraq war in the 1980s. The Islamic Republic was facing enormous domestic economic difficulties, creating a split within the ruling establishment.

**Iran's exports of crude oil and condensate (1986-2012)**

thousand barrels per day



Source: Energy Information Administration, <https://www.eia.gov/todayinenergy/detail.php?id=11011>

By 2012 the Islamic Republic's oil export revenue had declined to \$69 billion from \$95 billion in 2011. At this time oil exports accounted for 80 per cent of Iran's total export revenue and 50-60 per cent of the government's income. Sanctions also curtailed much-needed investment in the oil industry as foreign companies cancelled many different projects.

According to an IMF report published in April 2014, the economic sanctions constricted Iran's economy, with real GDP declining by nearly 6 per cent a year in 2012-13. Between June 2012 and February 2014, Iran experienced negative GDP growth for seven consecutive quarters.

## **“Hope” and “Despair” in the Iranian ‘Islamic’ Republic**

Hassan Rouhani’s coming to power was a in many ways a return to Rafsanjani and Khatami’s strategy of integrating Iran to global capitalism through Western guidance. Rouhani’s model for development has not been different to those of Rafsanjani and Khatami, this is clearly expressed in his book, *“National Security and Economic System of Iran, 2010”*. His cabinet included long-standing technocrats such as Mohammad Bagher Nobakhet, government spokesperson; Mohammad Nahavandian, the president’s chief of staff, and Akbar Torkan, his political adviser. Collectively, this group has drawn up the neoliberal open market model for development, which is described in his book (Rouhani, 2012). On numerous occasions since 2013 Rouhani has called for a change in Iran’s labor markets: to remove the minimum wage, provide flexibility to employers to take on and lay-off workers, and to reduce the power of unions.

Additionally, since becoming president, Rouhani travelled with his foreign minister Mohammad Javad Zarif and Energy minister Hamid Zanganeh, to the World Economic Forum in Davos, Switzerland in 2014, and later to Italy and France to encourage and attract foreign investors. His biggest challenge so far has been to privatize state-owned industries and discontinuing projects such as Maskane Mehr, an affordable social-housing scheme launched by Ahmadinejad. With all its limitations, Ahmadinejad’s sponsored housing project was one of the successes of his government, enabling 4.4 million low-income families with the opportunity to become homeowners.

Rouhani’s government’s attempt to speed up neoliberal reform through greater integration of Iran’s economy with the world market has had its risks. The foreign investors have been very cautious to invest partly because of their anxiety over sanction and factional differences inside the regime. Continuing conflict and lack of clarity and cohesion amongst the elites has not encourage investors to consider Iran as a good long term proposition. In addition, depending on the sectors and regions in which foreign investors are involved, they may have to work with existing highly conservative organizations such as the IRGC, which currently retains its former political affiliations. Rouhani have tried to convince IRGC to support his government in his reforms through promoting the benefits that could accrue to them.

Rouhani’s solutions for Iran’s ailing economy have been contingent upon forming faster relations with the global community. To this end, and following intense government

negotiations, Iran and the great powers reached a framework agreement on 13 July 2015. Consequently, there was a resurgence of optimism that Iran's economy would start growing by attracting necessary foreign investment. However, it has so far proved to be a slow process to remove restrictions on financial transactions and to release Iran's billions of dollars of frozen assets. Despite the successful outcomes of the negotiations, the US clearing banks in Europe, Asia and the Middle East have moved with extreme caution and continue to closely monitor the operation of firms trading with Iran through US-based dollar accounts. It may take some years before Iran can return to the era before comprehensive global sanctions were imposed. It should be noted that the US policy towards Iran is one of expedience, based on an imperialistic agenda that consists of a series of demands and expectations. It continues to prioritize its own geopolitical interests in the region in continuance of the agenda it has pursued since the 1950s.

Although relief from sanctions has helped Iran's economy but it has not meant to end all troubles Iran is facing. With continuing to give free rein to the market with very little state intervention, some of the indigenous small and medium producers, who were unable to compete with imported goods, ended up closing down. Ironically, Iran's industrial base was more diversified and able to grow during and before the sanctions, than now when those restrictions have eased. Home-grown industries had previously proved themselves quite capable of producing advanced technological end products such as military hardware.

A further problem is that Rouhani's government has been facing a world economy that has been going through crisis since 2008 leading to a dramatic oil price drop which is unlikely to return to pre-sanction levels. The crude oil price which was at \$100.75 per barrel in August 2014, had halved to \$45.46 per barrel by August 2015. However, according to government figures, this drop has been offset by an increase in oil production which is now approaching 3.7 million barrels a day. Whilst this improvement is welcomed, it is still not enough for the country to meet its peoples' basic demands. In order to better balance the budget, Rouhani's government's response has been to cut welfare, thus attacking the livelihood of the poorest population in the country. A report by the Statistical Centre of Iran for the period 2014-15, shows that economic inequality has increased, and that the standard of living for the poorer sections of the community is worsening (Statistics of Iran, 2016). All the evidence suggests that the government of 'Hope' from the 2013 election, is now turning into one of 'Despair'. Although the IMF's recent report of 24<sup>th</sup> of February 2017 suggests

following nuclear agreement between 4+1 Iran's recoveries has been good. It also warns that any changes the government approach, could risk a recession<sup>10</sup>. Trump's administration threatening to impose new sanctions has already deterred foreign investment and trade and hence retrieval. Despite this based on the official figures unemployment is 12.7% but for those who are under 25 years old is 29.2%. The concern with Iran's economy was even raised by Khamenei in one his speeches recently, "If all crucial tasks with regard to the Economy of Resistance had been carried out, Iran would have been able to see a tangible difference in the country's economy and people's lives."<sup>11</sup>

Khamenei's concern is reflection of young Iranian who was interviewed by Financial Times Journalist when expressed his life has been very tough under Rouhani, he couldn't even afford to buy clothes for his children for the Persian New Year Festival, "My income, this year has been just enough to stop begging in the street."<sup>12</sup>

As the presidential election looming, it is the vote of the young Iranian that would be crucial for whoever is going to stand.

The solution for Iran's ailing economy may not therefore lie in the neoliberal approach advocated by Rouhani and Rafsanjani, which has resulted in Iran being flooded with foreign goods and direct investment. For a government to succeed in raising Iran out of its economic difficulties, it needs to have a policy that includes the sustainable, equitable and transparent use of oil revenues; diversification of the economy; investment in national manufacturing industries, and effective corporate control through an appropriate taxation system.

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<sup>10</sup> See Bloomberg, available in [www.bloombergquint.com/business/2017/02/28/iran-s-impressive-recovery-clouded-by-uncertainty-imf-says](http://www.bloombergquint.com/business/2017/02/28/iran-s-impressive-recovery-clouded-by-uncertainty-imf-says).

<sup>11</sup> See Financial Time, available <https://www.ft.com/content/2728d67e-097d-11e7-97d1-5e720a26771b>

<sup>12</sup> See Al-Monitor, available in <http://al-monitor.com/pulse/originals/2017/03/iran-rouhani-first-term-economic-management-goals.html>

## **Conclusion**

Neoliberalism essentially is an ideology that advocates free market and wholesale privatisation. It postulates that the market mechanism facilitate the growth provides prosperity for everyone. It claims that the state sponsored intervention in economic affairs leads to waste and inefficacy and hence it causes more problems than a solution for development. The experiencing of many developing countries implementing neoliberal policies of structural adjustment programme, encouraged and sometimes imposed by World Bank and International Monetary Fund have been in many ways counterproductive for the poor. The implementation of neoliberalism in developing countries have not taken the same shape due to their internal economic structure, resources and geopolitical situation. Nearly all have implemented market reform. The oil producing countries such as Iran because of the state's receiving a huge income from energy has taken a different route, the state playing a leading role to bring market reform. Different governments attempted to manage Iran's economy within the frame of global capitalism through market liberalisation or combination and the state led development. Much of the evidence so far demonstrates that neither have solved the real problem that vast majority of Iranian people faces. Iran's economy remains in a difficult condition, largely because the Western economic sanction continues to impact even though Iran and the international community signed nuclear deal with P5+ 1 (the UK, US, France, China, Russia and Germany). However, the crippling economic sanction on Iran has not been completely lifted as the US continues to put pressure on different companies to who may wish to work with Iran. The domestic political back biting and regional political crisis in Yemen, Iraq and Syria has complicated the situation as well.

Under such circumstances both the so called conservative and pragmatists factions are fighting for power and the best possible path for development. Regardless of their differences they are staunch defender of capitalism and neoliberal market policy. Islamic Republic, 38 years after the revolution, has continued to work within the confines of global capitalism not outside of it.

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# 3 | The Impact of Regional Economic Cooperation: Case of South Caucasus

Giorgi BENASHVILI

## Abstract

*The article considered and discusses about the possibilities of economic cooperation in the South Caucasus, within the framework of the economic partnership between Azerbaijan, Georgian, Armenia and Turkey, in particular of transportation, energy routes and regional trade. The South Caucasus region is a geopolitically important region at the crossroads of Europe and Asia, with strategic energy and transport routes. This geopolitical location increase opportunities to extend economical activities. Twenty years after break-up of the Soviet Union, three states of the South Caucasus Armenia, Azerbaijan and Georgia are facing considerable challenges in creating sustainable and inclusive economic growth. The transformation to democratic systems and market economies was very durable process and requires further reforms. From the 1990s period, all those states trying to introduce new foreign markets for goods and services. Economic factors, historical links, cultural ties and social factors are stimulating and necessitating economic cooperation between the countries in the South Caucasus. The motivation to study economic development and cooperation in the South Caucasus is the step to introduce more possibilities, partnerships and developing of this significant region.*

**Keywords:** *Regional Economic Cooperation, Energy Routes and Regional Trade, South Caucasus.*

**JEL Codes:** *F63, O10, O18.*

## Introduction

The South Caucasus comprises the three states of Armenia, Azerbaijan and Georgia. It's a geopolitically important region at the crossroads of Europe and Asia with strategic energy and transport routes. Twenty years after the break-up of the Soviet Union, the Republics of Armenia, Azerbaijan and Georgia are still facing considerable challenges in creating sustainable and inclusive economic growth and in building democratic states and pluralistic societies. Yet the all of three countries have significant human capital, a rich cultural heritage and the economic potential to create a prosperous future.

The three countries of the South Caucasus, and former members of the Soviet Union, are in the midst of a challenging transition.

Since 2008, the importance of the South Caucasus has been increased, after the EU Eastern Partnership policy was launched<sup>1</sup>. The EU is committed to building strong and mutually beneficial relations with this region, irrespective of their individual level of ambition in their relations with the EU. The Association Agreements/Deep and Comprehensive Free Trade Areas (AA/DCFTAs), concluded in 2014, have brought the relations between the EU and Georgia to a new level. These agreements aim at strengthened political association and economic integration and create new opportunities in the region as increasing economic development. (Benashvili, Asanidze, 2016)

## Political Landscape of the South Caucasus

The South Caucasus is situated at the meeting point of the Russian Federation, Iran, Turkey, Europe and Central Asia. The oil and gas reserves in the Caspian Sea and Central Asia and the pipelines to Europe through the South Caucasus East-West energy

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<sup>1</sup> The Eastern Partnership (EaP) is a joint initiative involving the EU, its member states and 6 eastern European partners: Armenia, Azerbaijan, Belarus, Georgia, Moldova and Ukraine.

corridor emphasize the geopolitical importance of the region. The region is faced with the strategic Southern Gas Corridor. After completion, it will deliver Caspian-basin natural gas (first from Azerbaijan, and later perhaps from Turkmenistan, northern Iraq or other regional producers) via Azerbaijan, Georgia and Turkey, to European markets in the Balkans and Italy. (Gurbanov, 2016)

The transition from the Soviet system to pluralistic democratic societies and functioning market economies have been going through with political and social disruption, governance deficits, wars, occupation and conflicts in different regions. For the last two decades the three South Caucasus countries has experienced very deeply social distress, severe armed conflicts and territorial disputes, namely with regard to Nagorno-Karabakh, Abkhazia and South Ossetia/Tskinvali Region and war against Russian Federation. Today there are still around 1.2 million internally displaced persons (IDPs) and refugees in the three countries. Despite international mediation, the conflicts are still frozen. During the last decade, they remain largely unresolved and continue to hamper regional economic development and political stability. (Benashvili, Asanidze, 2016)

Armenia remains completely isolated mainly because its borders with Azerbaijan and Turkey are closed. The country has friendly relations with Iran and after joining to the Eurasian Economic Union,<sup>2</sup> continues to depend economically and politically on the Russian Federation. Due to regulatory reforms, an improved business environment and higher exports of commodities, Armenia's economy is slowly recovering. According to World Bank GDP (2015) is 10.561 \$billion. However, poverty and unemployment remain high, particularly in rural areas, and have further increased over the last few years. Remittances from working migrants and the Armenian diaspora play an important role for family income support and investments in the country. Subsistence agriculture remains the major employment sector, accounting for 45% of the working population. Market liberalization has placed large constraints on the once heavily subsidized agricultural sector and colluding interests pose threats to fair competition. The political climate remains difficult: According to Freedom House Armenia is rated

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<sup>2</sup> In 2013, President of Armenia Serzh Sargsyan announced in Moscow that Armenia will join the Customs Union of Belarus, Kazakhstan, and Russia.

as 'partly free' and its media as 'not free'. The parliamentary elections in May 2012 were characterized by a competitive, vibrant and largely peaceful campaign. (OSCE, 2012)

Azerbaijan mainly derives its revenues from oil and gas exports. Its considerable economic growth in the mid-2000s slowed down after 2006, partially due to reduced oil production. This reflects the high dependence of Azerbaijan's economy on natural resources. Pressure to diversify its economy is increasing. The non-oil sector, in particular construction, telecommunications and banking services, is steadily growing, however it is mainly supported by oil-financed, unsustainable government spending. The agricultural sector employs 40% of the population but contributes only 5.2% to the gross domestic product (GDP). Azerbaijan was declared as the world's top regulatory reformer in the World Bank's 2009 Doing Business Report, but competition is still hampered. While Azerbaijan is compliant with the Extractive Industries Transparency Initiative (EITI) and has introduced some formal anti-corruption measures, it continues to suffer from high perceived levels of corruption. The general Azerbaijani population is benefiting to some degree from the large revenues derived from natural resources. This positive development is reflected in the country's decreasing poverty rate, from 43.7% in 2003 to 7.6% in 2011. IDP's and refugees constitute the poorest and most vulnerable segment of the population. The human rights situation in Azerbaijan is viewed critically and the country has consistently been ranked as "non-free" by Freedom House since 2003.

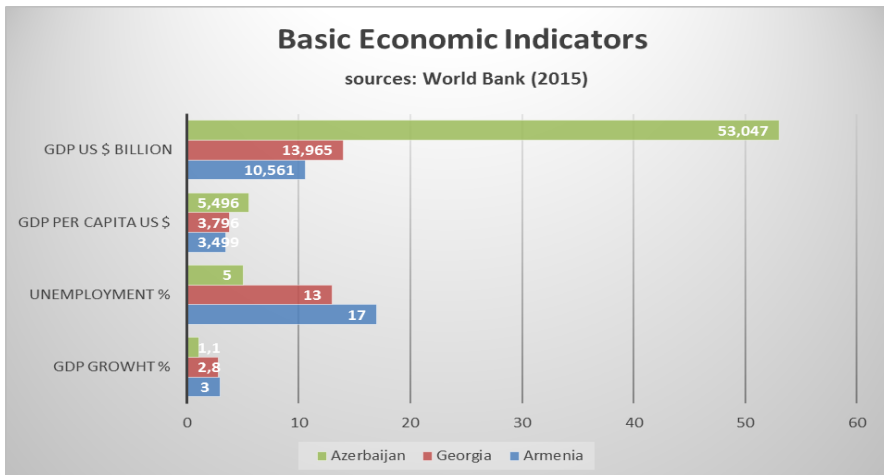
After destruction of Soviet Union and since announced the state independence, Georgia has been going through very damaged and difficult stage of development. During the yearly period, it was involved two ethno-conflicts, into the different part of state, which was encouraged by Russia. Georgia was faced to necessity of launched new trade connections and find new partners. From that period Georgia set up and has experienced pro-western foreign policy. Today, Georgia is strongly striving towards Euro-Atlantic integration. Apart the other neighbors, it has the deepest relations with EU.

Yet, in 2012 Freedom House qualified Georgia as only 'partly free'. The lack of independence of the judiciary remains a major concern. The armed hostilities with the Russian Federation in 2008 and the economic crisis at that time pushed the country into a deep recession. However, in the past few years the Georgian economy has slowly recovered with a growth rate of above 5%. According to World Bank, GDP is 13.965 \$ billion (2015). Major reforms are being carried out following a neo-liberal approach,

including in social services. Agriculture remains one of the sectors with the biggest growth potential, employing almost half of the total working population. Rural poverty will remain a significant challenge in Georgia in the coming years. Income disparity is widening, and the country has the highest Gini index (4.160) for the region (2015). Although the living conditions of IDPs are steadily improving, in many cases they still cannot fully exercise their social and economic rights and are suffering from a lack of employment opportunities. IDPs still belong to the most vulnerable segment of the Georgian population. The parliamentary elections in October 2012 marked the first democratic transfer of power in Georgia's post-Soviet history and led to co-governed (named a cohabitation) between the president and the prime minister. The new coalition government has declared its intention to focus on Euro-Atlantic integration, rural development and improve economic relations with the Russian Federation. (Benashvili, 2015) After signing Association Agreements/Deep and Comprehensive Free Trade with EU, Georgia remains to get visa free regime with Schengen area.

### Regional Snapshot of Economy

Table 1. Basic Economic Indicators



Following the breaking up of the Soviet Union, the South Caucasus experienced a full economic fragmentation. The cooperation chains of enterprises and states dramatically

decreased between the different parts of the former Soviet Union. On the other hand, some trade partnerships were used for political pressure. Former Soviet States were faced to necessity of launched new trade connections and agreements. Additionally, the political elites were vigorously engaged in building ethnically-defined nation states, whereas the strenuous battle to getting power. They also struggle for domination over the economic resources of the newly independent states (Jijavadze, 2016) In the South Caucasus, these processes were exaggerated by nationalistic rhetoric and policies that led to violent conflicts.

One of those conflicts has been over the Nagorno-Karabakh region between Armenia and Azerbaijan.<sup>3</sup> Turkey closed the rail and air connections with Armenia and halted the transit of humanitarian aid through its territory to Armenia in 1993. Today, Armenia has two “gates” to the world – Georgia to the north and Iran to the south. These “gates” are largely inappropriate for the establishment of regional economic cooperation and the implementation of transnational projects. (Muradyan, 2016) Out of the 1,500 kilometers of land border that Armenia shares with its four neighbors, only about 250 kilometers are open for transnational economic relations. Armenia has well-established relations with Georgia and their current economic ties are crucially important for Armenia, as Georgia is the main transit country for Armenia. Iran and Armenia have developed energy and trade cooperation even though Armenia’s major trade and economic partners for either state or private business actors is Russia. With an active flow of remittances and investments from Russia, its role in Armenia’s economy is major. Recently Armenia deepened its economic integration with Russia within the framework of the EAEU along with Belarus, Kazakhstan, and Kyrgyzstan. In this context, Armenia could potentially benefit from new opportunities gaining access to the EAEU markets. On the other hand, Armenian businesses have almost one-sided economic relations with their Turkish counterparts. Goods from Turkey enter Armenia, but no major trade flows are going from Armenia to Turkey. Georgia plays an important role in the socio-economic relations of the South Caucasus since it is the transit country for regional transport and energy projects. Currently, Georgia has substantial socio-economic cooperation with all neighboring countries.

There are various motivations for economic cooperation between countries in South Caucasus. Economic factors, historical links, cultural ties and social factors are stimulating and necessitating economic cooperation between countries. In addition to

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<sup>3</sup> As a consequence of which the borders between the countries were sealed off in the early 1990s.

this, the geographical proximity and unity of the countries in the region is a conducive and encouraging factor for the formation of economic co-operation agreements.

**Table 2. Merchandise Export and Import**



Although, there are no economic or diplomatic relations between Azerbaijan and Armenia. It means that Armenia doesn't participate in any regional or transitional projects. It has resulted during the formation of a new East-West Silk Road through Georgia to Europe via Turkey. As a network of major present transportation corridors, Azerbaijan and Georgia are becoming vital transit links between East and West.

The economic cooperation between Azerbaijan, Turkey and Georgia has been developed through mega projects in energy transportation. There are free trade agreement between Turkey and Georgia now, but it hasn't reached yet between Azerbaijan and Turkey. As well, Georgia and Turkey get visa free regime for their citizens. All of this three country are trying to get benefit from the recent regional connectivity initiatives to boost trade, increase foreign direct investments and growth its economy.

Azerbaijan has borders with Kazakhstan and Turkmenistan via the Caspian Sea and it has land borders with Georgia, Russia, Iran, Armenia, and Turkey. Azerbaijan's cooperation with Georgia and Turkey is focused on natural resources and excludes Armenia due to the Nagorno-Karabakh conflict. Azerbaijan has the richest oil and gas reserves in the region and therefore plays an important role in major energy projects. Access to these resources explains the Azerbaijani regime's claim for a leading role in the South Caucasus and its attempts to influence the policies of the big neighbors, particularly those of Turkey and Georgia.

In particular, Azerbaijan is one of the sponsors of the East-West and North-South transport corridors. This effort will require improvements in infrastructure and logistics performance for trans-border trade. The rich oil and gas reserves of Azerbaijan and purposeful policy have created opportunities for doing huge amount of works in the energy sphere as well. If we look through the energy security issue, it is clearly seen that Azerbaijan already plays an important role in the energy security of Europe. Azerbaijan has large gas reserves, and in September 2014 BP began construction of the Southern Gas Corridor to supply Europe directly by 2019, bypassing Russia. From this standpoint, starting the implementation of the "Southern gas corridor"<sup>4</sup> project has been a historic event. Caspian oil is now flowing through a pipeline running from Baku through Georgia to the Turkish port of Ceyhan, providing western countries with ready access to a vast new source of supply.

The development of transport infrastructure is also one of the main priority of Azerbaijan. Today it is restoring the historical Silk Way with the application of modern technologies and the participation of neighboring countries. At present, the Baku-Tbilisi-Kars railway – running from Azerbaijan through Georgia and into Turkey - is under construction and will for the first time connect Azerbaijan with Europe by train.

### **Baku-Tbilisi-Kars Railway**

The Baku- Tbilisi- Kars Railway is a new corridor that will connect Azerbaijan, Georgian and Turkish railways. The project implementation began in 2007 and construction began in 2008 and it foresees the rehabilitation and reconstruction of 178

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<sup>4</sup> The Southern Gas Corridor (SGC) is a term used to describe planned infrastructure projects aimed at improving the security and diversity of the EU's energy supply by bringing natural gas from the Caspian region to Europe.

km-long railway between Marabda and Akhalkalaki and construction of a new railway from Akhalkalaki to the Turkish border.

The Kars-Akhalkalaki route is expected to fully replace the inactive Kars-Gyumri-Tbilisi line, which was the only rail route the USSR used to reach Turkey. Istanbul unilaterally halted traffic on this route after Armenian-Turkish relations deteriorated due to the Armenian-Azerbaijani war in Karabakh.

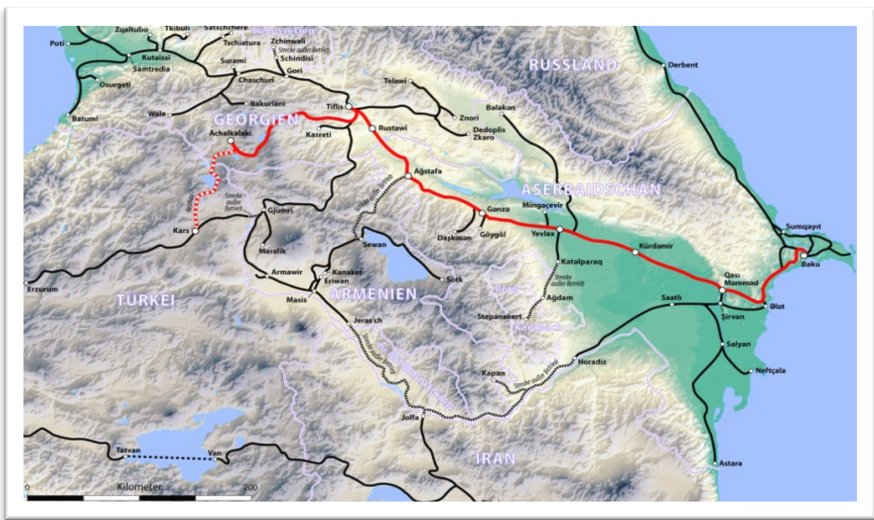


Figure 1

This project will effectively open a new rail-only corridor from the Caspian Sea to Europe via Turkey, eventually excluding the need for sea transportation once the planned rail tunnel under the Bosphorus Strait in Istanbul is complete. Once the railway was fully operational, all three countries will mutually benefit from improved trade and economic relations and gain additional Foreign Direct Investments (FDI) through the new railway connecting Europe and Asia.

According to the international interest of Georgia, the Baku- Tbilisi- Kars Railway is expected to enhance Georgia's status as a transit country, and developing a strategic alliance with Turkey and Azerbaijan. The Kars-Akhalkalaki-Baku railway line promises other benefits for Georgia. As well, railway line is the direct ground route between Baku and Istanbul. According to analysts, the railway has the potential to attract freight, including oil, from Central Asia to Turkey by offering a further outlet to the sea. Caspian traders have a possibility to deliver its oil by rail directly to European purchasers. They will obviously save money and time if skip tanker routes by The Black Sea. Georgia could offer two different oil transit routes to Europe, by sea and by land. It's making the country an important part of the transport corridor linking Asia, the Caucasus, and Europe. (Anjaparidze, 2005)

The Baku-Tbilisi-Kars project, which facilitates the transport of passengers and goods between Azerbaijan, Georgia and Turkey, will be fully commissioned at the beginning of 2017.

### **Southern Gas Corridor**

The Southern Gas Corridor (SGC) is a term used to describe planned infrastructure projects aimed at improving the security and diversity of the EU's energy supply by bringing natural gas from the Caspian region to Europe. Due to stretching over 3, 500 kilometers, the Southern Gas Corridor is one of the most complex gas value chains ever developed in the world. It is comprised of several separate energy projects, which representing a total investment of approximately 45 US\$ billion. This Corridor includes 3 pipeline projects from Shah Deniz Stage 2: **South Caucasus Pipeline (SCP)** – Azerbaijan, Georgia; **Trans Anatolian Pipeline (TANAP)** – Turkey; and **Trans Adriatic Pipeline (TAP)** – Greece, Albania and Italy. Also, it has Possibilities for further connection to gas networks in South Eastern, Central and Western Europe.

The South Caucasus Pipeline (SCP) was built to export Shah Deniz gas from Azerbaijan to Georgia and Turkey. The pipeline starts from the Sangachal terminal near Baku. It follows the route of the Baku-Tbilisi-Ceyhan (BTC) crude oil pipeline through Azerbaijan and Georgia to Turkey, where it is linked to the Turkish gas distribution system. The pipeline has been operational since late 2006 transporting gas to Azerbaijan and Georgia, and starting from July 2007 to Turkey from Shah Deniz Stage 1. The length of the pipeline is 691km, with 443 km in Azerbaijan and 248 km in Georgia. The diameter is a 42-inch . According to BP Azerbaijan, in the first half of 2016, SCP

spent about \$13 million in operating expenditure and around \$498 million in capital expenditure. SCP's daily average throughput was about 20.1 million cubic metres of gas per day in the first half of 2016.



**Figure 2. (BP Azerbaijan)**

The Second project is the “Trans-Anatolian gas pipeline” (TANAP). According to this project signed by Azerbaijan and Turkey in 2012, the gas pipeline will extend from Turkey-Georgia border till Turkey-Greece border. The fourth project is the “Trans-Adriatic pipeline” (TAP). The pipeline will extend from Greece to Albania and coming to Italy beneath the Adriatic Sea. All these 3 projects are the parts of the “Southern gas corridor”. Azerbaijan is an important shareholder in these 3 projects and the major shareholder in the TANAP project. As a result of the implementation of the “Southern gas corridor”, a number of countries will gain access to the Azerbaijani gas as an alternative gas reserve. Georgia, Turkey, Greece, Bulgaria, Albania and Italy are among the participants of the “Southern gas corridor” project. So Azerbaijan and Georgia

become a very important and reliable partner for providing the energy security policy of Europe.

### **Iran's perspective in the South Caucasus**

The South Caucasus region was one of the primary influenced regions by such a sharp turn in the history of Iran. (Mamadov, 2016) Iran's interests in the region and ties with three Caucasus states (Armenia, Azerbaijan, Georgia) date back to the early 19th century when the region was a part of the Persian Empire. One of the main reasons of increased interests of Iran towards the South Caucasian region was related with the fact, that Caucasus was historically known to be a crossroads of trade from the Mediterranean to China and from the Baltic Sea to the Arabic world. (Chitadze, 2012) Because of its strategic importance, Russia fought with Iran in order to conquer the region. The fights usually brought high costs to the local people.

Turning back to the recent history of Iran's foreign policy towards the South Caucasus, it can be seen that Tehran was in unpleasant situation and unprepared to build up effective connections with the countries. Compared to other regional and global powers, Iran was following a defensive policy by offsetting external threats in the region. The Western powers (mainly the US-Turkey-Israel) were presenting a major source of threat to Iran in Georgia and Azerbaijan, where they could allocate their resources and isolate Tehran to participate into the regional energy projects. During the last two decades, Iran did not have sufficient economic and political resources to play a key role in the South Caucasus. (Benashvili, Asanidze, 2016)

After January 16, 2016 since the senior diplomats in Vienna formally announced the lifting of sanctions against the country, following confirmations from the UN that Tehran had fulfilled its obligations under the last year's nuclear accord, Iran will again have a chance to engage in the regional political and economic processes with its significant geographic location and landmass positioning in the east-west route. Iran will have enough capacity and potential to play an important role in geopolitical process of the South Caucasus due to the growing economy, increasing foreign investment and reestablished friendly relations with Western powers.

The Iranian Nuclear Agreement it is not only about preventing Iran from developing nuclear weapons but about huge economic projects and diversification of the European gas supplies as well. It should be accentuated that, especially after the Crimean crisis,

the US and EU countries openly impose the sanctions and embargos on Russia. They attempt to find a political solution for better relations with Iran in order to eliminate the Russian oil and natural gas monopoly in Europe. Iran holds the world's fourth-largest proved crude oil reserves and the world's second largest natural gas reserves. Which means that Iran has the potential to replace Russian gas in Europe and become a serious player in the European energy security. Furthermore, Iranians are also interested in getting into the European gas market, which could bring billions of dollars to the country's economy. But in order to bring its gas to Europe Iran needs access to the South Caucasus first. Either through Armenia to Georgia and then from the Black Sea to the European continent or by working together with Azerbaijan using the TANAP pipeline (Trans-Anatolian Natural Gas Pipeline is a natural gas pipeline from Azerbaijan through Georgia and Turkey to Europe). It may sound easy for Iran to choose one or the other route, but it will definitely have to take into consideration of the Russian influence in the region because till now Russia is the main influential and aggressive actor in the region.

Iran seems to once again integrate in the world affairs and global economy. This integration will have consequences for the South Caucasus as well. The region lies at the cross roads between the East and the West and has a considerable geostrategic importance. On the other hand, there are very strong grounds for closer cooperation perspective between the South Caucasian countries and Iran. As well Georgia has visa free regime Iran, it started new negotiations in 2015 to import Iranian gas. (Gurbanov, 2016)

## **Conclusion**

In this paper we discussed about the current situation in the South Caucasus, as well as the prospects for regional cooperation and integration. The article diversified some strategic directions, which would have significant mean for future development of this region, meanwhile it depends on European Security policy and also global trade routes.

Considering the recent economic developments and attempts towards economic integration between Azerbaijan, Turkey and Georgia and other mega projects from Central Asia to Europe making the South Caucasus a transit region, showed that this transportation corridor is a new strategic and significant one for Western and European countries in energy security policy.

Convinced that regional economic cooperation could be an important step towards conflict transformation in the South Caucasus, this paper suggests that the prospects of such integration be considered.

South Caucasus which has function as a bridge between Europe and Central Asia, has been improved its strategic importance through mega pipeline projects, which are transporting crude oil and natural gas from Central Asia, Caspian and Iran to Europe.

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# 4

## The Relationship Between Economic Globalization and Financial Freedoms in Eastern European Countries: A Panel Data Analysis

*Dilek ŞAHİN*

### Abstract

*The objective of this study is to look through the relationship between economic globalization and financial freedoms in Eastern European countries. Within the context of this objective, the relationship is analyzed by panel data analysis using annual data between 1998 and 2013. The results of the analysis indicate that there is a relationship of both cointegration and causality between economic globalization and financial freedoms. Moreover, there is a positive relationship between economic globalization and financial freedoms. In other words, the level of economic globalization is understood to accelerate the level of financial freedoms.*

**Keywords:** *Economic Globalization, Financial Freedoms, Eastern European Countries, Panel Data Analysis.*

**Jel Codes:** *F02, F60, F65, C33.*

## Introduction

As a concept, globalization denotes the transnational integration of economic, political and socio-cultural spheres, with some common values exceeding local and national borders (Adıgüzel, 2013: 1). It has been seen that the mobility of people, goods, capital, information and technology between borders increase with the globalization process. There are different opinions as to when globalization first began. The main reason of this is the fact that the phenomenon of globalization has a multilateral structure that is used in many different fields such as social, cultural, political, economic and governance. Some approaches and some events are taken as the basis of the beginning of the globalization process. While some argue that globalization has existed since the dawn of history, some suggest that globalization is the same age as modernization and capitalism. Some views defend that globalization has been united in the context of the ideas that are concerned with the dissolution of the industrial society and the capitalist order.

The concept of globalization classified under three headings: economic globalization, social globalization and political globalization. The economic globalization that makes up the scope of the study refers exactly to the integration in the world economy as a result of rapid spread of technology, international capital flows and the increase of cross-border trade of goods and services (Shangquan, 2000, 1). In other words, economic globalization is the achievement of the integration of countries thanks to a decrease in customs walls, tariffs, quotas and capital constraints that separate the economies from one another and make goods, services, labor and capital travel faster and easier between countries (Adıgüzel, 2013: 3). There are three determining factors in the rapid increase of economic globalization. These elements can be enumerated as the change in the production structure with the internationalization of production, the expansion of trade of international goods and services and the increase of international capital movements (Mrak, 2000, 3).

It is possible to classify economic globalization into two different areas, which are the globalization of production and financial activities. The globalization of production is the spreading of the production activities of companies operating on a country basis to other countries and continents. Production activities are carried to international arena through global companies. Targeting the whole world as a production activity, these

companies are looking for ways to shift their production activities to countries that will provide cost advantages and they are shifting their activities to countries where they think raw material cost, intermediate cost and labor cost are lower.

Another innovation that economic globalization offers to the world economy is financial liberalization. The globalization of financial activities is the shift towards cross-border areas without being subject to any restrictions so as to ensure that the capital is not within any geographical boundaries and that there is lower risk and higher earnings. Financial liberalization is both an element of globalization and a factor that accelerates it.

On the one hand, the control and restrictions on the financial markets disappear, and on the other hand, financial markets are opening up to international competition thanks to financial globalization. The globalization of financial activities has developed rapidly, especially after the 1980s. Financial markets, which quickly integrated into one another, have led to changes in the origins, channels and volume of international capital movements.

At the core of these developments lie the deregulation policies implemented by developing countries to attract international financial activities to their countries, the adoption of a flexible exchange rate regime, and the rapid increase in the types of financial instruments. This transformation experienced in the financial markets has made it possible to easily transfer fund surpluses from an economy to the economies which have a funding deficit. With the financial freedom and liberalization provided in this process, while the foreign direct investments, portfolio investments and other capital flows have been carried on the international platform, the financial transaction volume of the individual investors has increased. Individual investors seeking to generate more returns in the globalized economic system have accelerated the capital accumulation process by transferring their savings to internationally liberalized financial markets and have shifted to the markets where the highest profits on a global scale will be achieved thanks to the financial restructuring of all obstacles on capital. The capital costs have decreased, the volume of investment has increased and the amount of production has increased due to the fact that the accumulation of capital is directed towards the countries where financial freedoms are provided.

Economic freedoms are defined as the absence of state restrictions on the production, distribution and consumption of goods and services (Ceatano and Calerio, 2009: 65). According to another definition, economic freedoms are the realization of the economic activities of the individuals living in the society without being intervened by the state and other individuals, and they also refer to the rights and freedoms which allow individuals to own property (Tunçsiper and Biçen, 2014: 28). Economic freedom consists of a combination of the phenomena of personal preference, private property, and liberal events of exchange. The measurement of economic freedoms has become possible with the publication of indices of some basic components of economic freedom and economic freedom published by some institutions.

Two indices are used to measure economic freedoms. The first is the Index for Economic Freedom (IEF) published by the Heritage Foundation in the US and the other is the Economic Freedom of the World (EFW) prepared by the French Institute in Canada (Pearson et al., 2012: 2). The economic freedoms in the index prepared by the French Institute consist of five subheadings in which public size, legal structure and security of property rights, strong currency access, international trade freedom, business, credit and labor regulations are included (Ajide, 2014: 152). These five sub-chapters have 23 components. Many of these components are composed of subcomponents. Each component and sub-component is distributed over a scale with a range of 0-10. The score of the components is calculated by taking the average of the subcomponents. 0 expresses maximum prohibition, while 10 expresses the minimum restriction on freedoms. Scoring in five different areas is used to generate the general index for each country.

The economic freedoms published by the Heritage Foundation consist of 10 subcategories. While some of these economic freedoms measure the investment and trade openness of the economy, some are concerned with economic freedom at the individual level and the measurement of individual freedoms for the use of workforce and financial resources. Economic freedoms consist of freedom of business, commercial freedom, financial freedom, public expenditures, monetary freedom, investment freedom, financial freedom, property rights, exemption from corruption and workforce freedom (Beheshtitabar and Irgaliyev, 2008: 6). The financial freedoms that constitute the economic freedom index and the bulk of this study are aimed at measuring the effectiveness of the countries' banking system and showing that the financial sector is

independent of governments' controls and interventions. While calculating the financial freedoms index, the scope of government regulations in financial services, the intervention of the government to banks and other financial institutions through direct or indirect ownership, the size of financial markets and capital markets, the effect of the government on credit distribution, foreign trade openness parameters are taken into consideration and the level of financial freedom in the economy as a whole is determined.

According to the Heritage Foundation, the economic freedom index indicates the relationship between economic opportunities and economic prosperity by analyzing economic policies in countries. 100 represents the maximum value on the index and the scores of countries range between 0-100. High scores indicate a high level of freedom. If the index value is between 80-100, it is valued as free; 70-79.9 is valued as largely free; 60-69.9 is valued as partially free, 50-59.9 is valued as not free to a great extent; 0-49.9 means repressed.

The study consists of four parts. In the second part following the introduction, the related studies in the literature are mentioned. The third part consists of model, data set and methodology, and the fourth part consists of empirical analysis and findings. There is a general evaluation in the conclusion part in which the relationship between economic globalization and financial freedoms in 20 Eastern European countries is analyzed between 1998-2013 through panel data analysis technique. In order to analyze the relationship mentioned in this study, financial freedoms were used as dependent variables and economic globalization variables were used as independent variables. In the study, whether each variable was stationary or not was analyzed by panel unit root tests. Following this, cointegration analysis and panel DOLS and FMOLS analysis were made. Panel Granger causality test was used to determine whether there was a short- and long-term causality relation between the variables. Finally, a model was presupposed to determine the relationships between the variables handled in the model.

## **Literature Review**

Despite the fact that there are many studies in the literature that take into account globalization movements that have gained momentum in the 1980s, it is seen that the qualitative aspect of globalization is taken into account in most of these studies, but the quantitative aspect is ignored. Moreover, it is overtly seen that economic globalization

is mainly limited to economic freedoms, and in particular to the relationship with financial liberalization. It is possible to summarize some of these studies as follows: Obstfeld (2004) stated that high-income countries could benefit more from opportunities brought forth by financial freedoms increasing along with the globalization process than emerging market economies. Besides, the study emphasized that fixed or floating exchange rate systems are not applied efficiently due to the limited effect of globalization on financial freedom in these countries and that the market fluctuation is also high due to this. In another study, Schmukler (2004) stated that financial globalization has positive and negative effects on financial markets. Therefore, the financial system develops thanks to financial globalization. On the one hand financial globalization increases the amount of available funds on financial markets, and on the other hand it enhances financial infrastructure. Thus, the adverse selection of credit and the problem of moral hazard are reduced. On the other hand, it has been maintained that financial globalization causes financial crises by increasing fragilities in financial markets. Quinn and Toyoda (2007) examined the change in globalization and international capital account arrangements for 82 countries between 1995-1999. In the analysis made, the Generalized Moments Method was used. The results showed that liberalization in capital movements increased with the process of globalization. It is also seen that countries which are geographically close to one another have similarities in the capital account policies and that these similarities have taken place towards libertarian tendencies. In another study Köse et al. (2009) pointed out that financial globalization has increased financial freedoms. It is stated that this situation is especially more prevalent in developing countries. The main reason for this is the increasing financial sector development and commercial openness due to financial freedoms. The authors also stated that there are risks and uncertainties that financial liberalization will bring about. Saiah et al. (2012) emphasized in their studies that financial market integration, which develops due to the globalization process, will reduce unemployment rates by increasing investments and productivity, accelerate economic growth rates and ensure a stable structure for domestic financial institutions. Besides, they stressed that the financial system could cause financial crises by causing a sudden movement of short-term capital, that national funds might be directed to foreign markets, that national independence in money and finance policies might disappear and that the country's risk might rise in economic terms. Garcia (2012) stressed that in transition economies, financial globalization has affected the financial system positively.

## Model, Data Set and Methodology

In this study in which the relationship between economic globalization and financial freedoms is analyzed, whether there is a relationship between economic globalization and financial freedoms and whether this relationship is positive or negative has been analyzed in 20 Eastern Europe countries (Albania, Azerbaijan, Belarus, Bulgaria, Czech Republic, Armenia, Georgia, Croatia, Hungary, Moldova, Poland, Romania, Slovakia, Slovenia, Turkey, Ukraine, Greece, Cyprus, Bosnia Herzegovina, Kazakhstan) for the period between 1998-2013 using panel data analysis.

The index of economic globalization and financial freedoms used in the analysis was obtained from the KOF Index of Globalization and Heritage Foundation's official website. The globalization index is measured with a scale ranging from 0-100. According to this scale, as it is approached towards the zero index value, the level of globalization decreases and as the value of 100 index score is approached, the level of globalization increases. The Financial Freedom Index prepared by the Heritage Foundation is assessed with a scale ranging from 0-100 and it is emphasized that as the scale approaches zero, the financial freedoms decrease and as the value of the financial freedoms approaches 100 index value, financial freedoms increase. The model used in the study is shown in the equation (1):

$$FF_{it} = \alpha_{it} + \beta_1 EG_{it} + \mu_{it} \quad (1)$$

The explanations of the variables and variables in Equation (1) are as follows: FF refers to financial freedoms, EG refers to show economic globalization and  $\mu_i$  is the error term. In this study, the panel unit root analysis will be made by investigating firstly the time series properties of each variable in predicting the model in equation (1). Panel cointegration tests will then be performed on the variables containing the unit root to obtain cointegration parameters. Then, the causality relationship between the panel causality tests and the variables will be investigated. Finally, the model will be estimated. Figure 1 shows the series of variables used in the analysis.

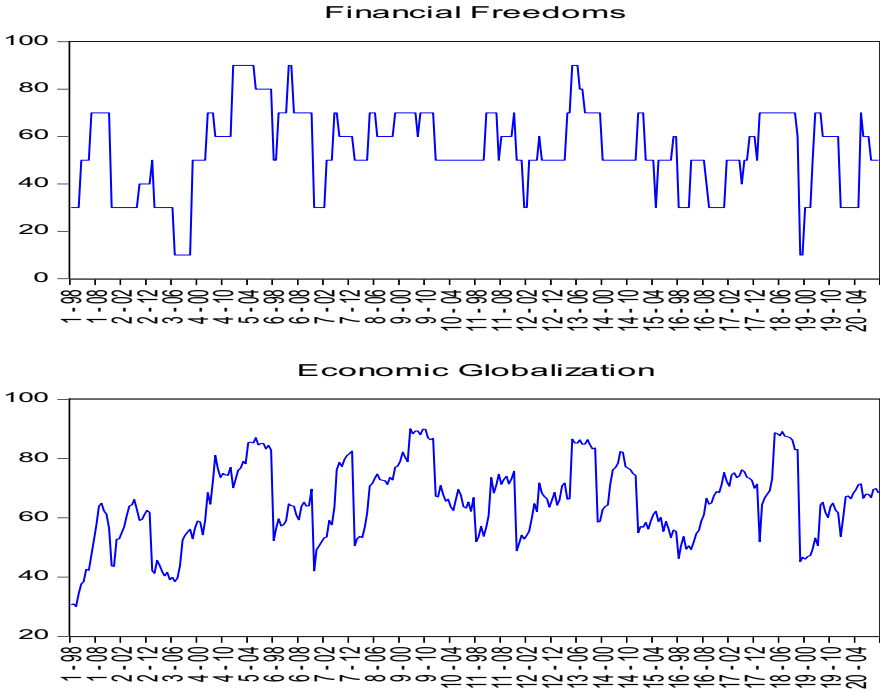


Figure 1. Graphical Representation of Variables Used in Analysis

## Methodology

Under this heading the methodology in the study is mentioned. In this context; firstly, information is given about panel unit root test, panel cointegration test and panel Granger causality test.

### Panel Unit Root Test

It is possible to enumerate unit root tests which are frequently used in panel data analysis as Levin, Li and Chu test, Fisher ADF and Fisher PP. The tests and the models used in these tests can be explained as follows: Levin, Lin and Chu (2002) test are tests that

take into account individual constants and time trends. Levin, Lin and Chu (2002) founded the test they developed on three different models.

$$\text{Model 1: } \Delta y_{it} = \delta y_{it-1} + \mu_{it} \quad (2)$$

$$\text{Model 2: } \Delta y_{it} = \alpha_{0i} + \delta y_{it-1} + \mu_{it} \quad (3)$$

$$\text{Model 3: } \Delta y_{it} = \alpha_{0i} + \alpha_{1i}t + \delta y_{it-1} + \mu_{it} \quad (4)$$

These three models represent a stable, fixed and fixed trending model, respectively. The error process shown here through  $\mu_{it}$  follows the stationary translational ARMA process and is correlated across the units.

$$\mu_{it} = \sum_{j=1}^{\infty} \theta_{ij} \mu_{it-j} + \varepsilon_{it} \quad i = 1, \dots, N \text{ and } t = 1, \dots, T \quad (5)$$

If the main hypothesis is generalized taking into consideration the model (2) in the Levin, Lin and Chu (2002) panel unit root test;

$$\Delta y_{it} = \delta y_{it-1} + \sum_{L=1}^{P_L} \theta_{iL} \Delta y_{it-L} + \alpha_{mi} d_{mt} + \varepsilon_{it} \quad m = 1, 2, 3. \quad (6)$$

While the vector of deterministic variables is determined through  $d_m$ ,  $\alpha_m$  indicates the parameters of these. In this equation, L is optimal delay length and it is determined by using any information criteria.

$$H_0 = \delta_i = \delta = 1 \quad (\text{There is a general unit root in the series})$$

$$H_1 = \delta_i = \delta < 1 \quad (\text{There is not a general unit root in the series})$$

In Levin, Lin, and Chu (2002) panel unit root test, standard deviation is calculated by proportioning long term standard deviation to the short term deviation in the horizontal section. The calculated standard deviations are used to calculate the corrected t-statistics. The formula for the corrected t-statistic is shown in the following equation.

$$t_{\delta}^* = \frac{t_{\delta} - N\hat{S}_N\hat{\sigma}_{\bar{E}}^{-2}STD(\hat{\delta})\mu_{m\bar{T}}^*}{\sigma_{m\bar{T}}^*} \quad (7)$$

Here, mean correction  $\mu_{m\bar{T}}^*$  and standard deviation  $\sigma_{m\bar{T}}^*$  values are included in the table of average and standard deviation correction tables included in the study. It is decided whether or not the hypothesis  $h_0$  is accepted or rejected, in other words, whether the examined series contain unit roots by comparing the table critical values with the t test statistics obtained from here.

In the Fisher type tests (Fisher ADF and Fisher PP) the null hypothesis for individual unit root existence is tested. In Fisher tests, firstly unit root test is performed for each unit, then the  $\rho$  values obtained from these tests are used to produce the whole test. The Fisher ADF test applies classic ADF test for time series; The Fisher Philips and Peron tests apply the classic Philips and Perron tests for each unit for time series. In the Fisher ADF and Fisher Philips and Perron panel unit root tests, the test statistics are respectively thus:

$$\lambda = -2 \sum_{i=1}^N \ln(p_i) \rightarrow X^2_{2N} \quad \text{and} \quad (8)$$

$$Z = \frac{1}{2\sqrt{N}} \sum_{i=1}^N (-2\ln(\rho_i - 2)) \rightarrow N(0,1) \quad (9)$$

Here  $\rho_i$  is the probability value of the unit root test for the horizontal section i.

## Panel Cointegration Test

Panel cointegration tests are used to analyze the long-term relationship between non-stationary panel data variables. Among panel cointegration tests, Pedroni panel cointegration test developed by Pedroni is the widely used one.

The Pedroni panel cointegration regression is shown thus:

$$GSYH_{it} = \mu_i + \delta_i t + \beta_{1i} \Delta EH_{1it} + \beta_{2i} \Delta EH_{2it} + \dots + \beta_{Mi} \Delta EH_{Mit} + \mu_{it} \quad (10)$$

Pedroni (1999, 2000, 2001) panel cointegration tests consist of seven items including four panel tests and three group statistics. These statistics can be reached with the aid of the average of the following Philips and Ouliaris statistics (1990):

$$Z_p = N \sum_{i=1} \frac{T_{t=1} \mu_{it-1} \Delta \mu_{it} - \lambda_i}{T_{t=1} \mu_{it-1}^2} \quad (11)$$

Table 1 shows the group statistics and panel statistics of the cointegration test developed by Pedroni.

Table 1. Pedroni Cointegration Tests

	Group Statistics	Panel Statistics
1. $\rho$ statistics	$TN^{-1/2}Z_pN, T^{-1} \equiv TN^{-1/2} \frac{1}{N} \sum_{i=1}^N \frac{T_i}{T_i}$	$T\bar{N}Z_{pNT-1} \equiv TN \frac{N_{i=1}T_{t=1}L^{-2}}{N_{i=1}T_{t=1}}$
2. $t$ statistics (non-parametric)	$N^{-1/2}Z_tN, T \equiv N^{-1/2} \frac{1}{N} \sum_{i=1}^N \frac{T_{t=1}\mu_{it}}{\sigma_i^2 T_t}$	$Z_{tNT} \equiv \frac{N_{i=1}T_{t=1}L^{-2} \mu_{it-1} \Delta \mu_{it}}{\sigma_{NT} N_{t=1} T_{t=1} L^{-2} \mu^2}$
3. $t$ statistics (parametric)	$N^{-1/2}Z_t^*N, T \equiv N^{-1/2} \frac{1}{N} \sum_{i=1}^N \frac{T_{t=1}\mu}{T_{t=1}S_i}$	$Z_{tNT}^* \equiv \frac{N_{i=1}T_{t=1}L^{-2} \mu^*_{it-1} \Delta \mu}{S_{NT}^* N_{t=1} T_{t=1} L^{-2} \mu}$
4. $\mathcal{V}$ statistics		$T^2 N^3 Z_{eNT} \equiv T^2 N^{\frac{3}{2}} \frac{1}{N_{i=1} T_{t=1}}$

In group statistics,  $\sigma_i^2$  and  $S_i^2$  respectively has the equality of individual long-term variance of residual  $\varepsilon_{it}$   $\varepsilon_{it} = \mu_{it} - \gamma \mu_{it-1}$  and synchronous variances of the residual

$\lambda i = \frac{1}{2} \sigma_i^2 - S_i^2$ .  $S_i^*$  is the standard synchronous variance of the residue obtained

from the ADF regression.  $S_{NT}^{*2}$ ,  $S_{NT}^{*2} \equiv \frac{1}{N} N_{i=1} S_i^{*2}$  is the synchronous panel

variance estimator. In panel statistics,  $\Omega_i$  is a consistent long-term predictor of the variance covariance matrix for the vector of unit-rooted series whose differentiations have been taken. It is defined as the sub-triangular Cholesky decomposition of  $\Omega_i = \lim_{t \rightarrow \infty} T^{-1} T_{t=1} \Delta Z_{it} T_{t=1} \Delta Z_{it}' Li, \Omega_i$ .

Therefore,  $L_{11i}^2 = \Omega_{11i} - \Omega_{21i} \Omega_{22i}^{-1} \Omega_{21i}'$ . Moreover, there is the equation of

$$\sigma_{NT}^2 = N_{i=1} \frac{\sigma^2 i}{L_{11i}^2}.$$

After reaching the result that there is cointegration between variables, cointegration parameters need to be predicted. Co-integration parameters are obtained by the group-average panel FMOLS (Fully Modified Ordinary Least Squares) and DOLS (Dynamic Ordinary Least Squares) developed by Pedroni (2000, 2001). Panel FMOLS predictor is shown thus:

$$\hat{\beta}_{GFM}^* = N^{-1} \sum_{i=1}^N \beta_{FMI}^* \quad (12)$$

Panel DOLS predictor is shown thus:

$$\ln Y_{it} = \beta_{0i} + \beta_{1i} \ln K_{it} + \beta_{2i} \ln X_{it} + \sum_{k=-K_{it}}^{K_{it}} \alpha_{ik} \Delta K_{it} + \sum_{k=-K_{it}}^{K_{it}} \lambda_{ik} \Delta \ln X_{it} + \varepsilon_{it} \quad (13)$$

Ki here and ki are predecessors and delays. Panel DOLS predictor is written thus:

$$\hat{\beta}_{GD}^* = N^{-1} \sum_{i=1}^N \beta_{Di}^* \quad (14)$$

### Panel/Vector Error Correction Model (VECM)

The cointegration relation implies that there is at least one way causality relation between variables. In co-integrated panels, panel error correction model needs to be estimated in order to be able to perform panel causality tests. A panel VECM model can be expressed thus:

$$\Delta \log Y_{it} = \delta_{1i} + \sum_{p=1}^k \delta_{11ip} \Delta \log Y_{it-p} + \sum_{p=1}^k \delta_{12ip} \Delta \log K_{it-p} + \sum_{p=1}^k \delta_{13ip} \Delta \log X_{it-p} + \theta_{1i} \hat{\varepsilon}_{it-1} + \mu_{1it} \quad (15)$$

$$\Delta \log K_{it} = \delta_{2i} + \sum_{p=1}^k \delta_{21ip} \Delta \log K_{it-p} + \sum_{p=1}^k \delta_{22ip} \Delta \log Y_{it-p} + \sum_{p=1}^k \delta_{23ip} \Delta \log X_{it-p} + \theta_{2i} \hat{\varepsilon}_{it-1} + \mu_{2it} \quad (16)$$

$$\Delta \log X_{it} = \delta_{3i} + \sum_{p=1}^k \delta_{31ip} \Delta \log X_{it-p} + \sum_{p=1}^k \delta_{32ip} \Delta \log Y_{it-p} + \sum_{p=1}^k \delta_{33ip} \Delta \log K_{it-p} + \theta_{3i} \hat{\varepsilon}_{it-1} + \mu_{3it} \quad (17)$$

The k in equations represents optimal delays and  $\hat{\varepsilon}_{it}$  represents the error terms of the panel FMOLS estimate. By means of these equations short- and long-term causality between variables can be shown. A short term causality can be found out through Wald test, which is applied to the lagged values of variables. Long-term causality is determined according to the  $\varphi$  t statistics of the coefficients of error terms. Accordingly, statistically significant error correction coefficients are an indicator of long-term causality. According to this, statistically significant error correction coefficients are a sign of long-term causality.

## Empirical Analysis and Findings

In panel data models, as in time series analyzes, it is necessary to determine whether the variables have unit root in order to avoid the fake regression problem. The unit test results used to determine to what extent the variables which are the first stage of cointegration analyses are stationary are shown in table 1. In these tests, the null hypothesis suggests that the variables have unit roots, while the alternative hypothesis suggests that the variables are stationary. The results obtained from different unit root tests show that the variables are not stationary at the level values and they become stationary when their first differences are taken. That is, all variables are I (1).

**Table 2. Panel Unit Root Tests**

Variables	ADF Test Statistics	Probability	PP Fisher Test	Probability	Levin, Lin, and Chu	Probability
<b>At Level Values</b>						
EG	7.09565	1.0000	4.03628	1.0000	3.02087	0.9987
FF	19.4173	0.9308	19.3579	0.9322	-0.27137	0.3931
<b>First Differences</b>						
$\Delta$ EG	231.179	0.0000*	255.724	0.0000*	-13.8590	0.0000*
$\Delta$ FF	-11.8583	0.0000*	162.377	0.0000*	-11.8583	0.0000*

Note: \* represents meaningfulness at the 5% level.

In the first differences of the variables with unit root in the level values, when the unit root problem disappear, the cointegration tests are applied in the analysis of the long term relationship. In Table 3, panel cointegration tests developed by Pedroni (1999) were used in analyzing the long-term relationship between variables. Pedroni has proposed seven test statistics, four of which are evaluated as in-group statistics and three of which are evaluated as cointegration statistics between the groups. The null hypothesis to be tested in the model implies that there is no cointegration relationship between variables. Panel cointegration test results are given in Table 3. As a result, it seems that there is a long-term co-integration among the variables.

**Table 3. Panel Cointegration Test Result**

Test Type	Statistics	Statistical Value
<b>Pedroni</b>	Panel V	1.757930*
	Panel RHO	-2.568317*
	Panel PP	-3.796672*
	Panel ADF	-4.125744*
	Group RHO	0.569152
	Group PP	-4.240766*
	Group ADF	-4.569531*

Note: \* represents meaningfulness at the 5% level.

After determining the cointegration relationship between the variables, the panel cointegration parameters need to be determined. Pedroni (2000 and 2001) developed panel DOLS and panel FMOLS methods for long-term coefficient estimation. The cointegration parameters obtained from Panel DOLS and Panel FMOLS are shown in Table 4. According to these results, the coefficients of the variables in the model are statistically significant and the sign of the coefficients is positive. There is therefore a positive relationship between financial freedoms and economic globalization.

**Table 4.** Panel Cointegration Parameters

FF	EG
Panel DOLS	0.802276 (0.0000)*
Panel FMOLS	0.811530 (0.0000)*

The results of the analysis show that there is a long-term relationship between the variables involved. In this context, at least one one-way causality relation is expected between the related variables. When Panel Granger causality test results are evaluated in Table 5, it is seen that there is no causality relation from financial globalization towards financial freedom in the short term, whereas causality relation from financial freedom towards economic globalization is observed. When we look at the long-term causality relationship, it is seen that there is a bi-directional causality relation between economic globalization and financial freedoms.

**Table 5.** Panel Granger Causality Test

Variables	Short Term Causality		Long Term Causality
	$\Delta FF$	$\Delta EG$	$\mathcal{E}_{t-1}$
$\Delta FF$	-	0.537089 [0.7645]	-0.063962 (-1.985574)*
$\Delta EG$	5.370449 [0.0682]**	-	-0.066631 (-3.517283)*

**Note:** \* refers to meaningfulness at 5% level and\*\* refers to meaningfulness at 10 %. Values in brackets indicate p-values, while values in parentheses indicate t-statistics .

After the causality analysis, fixed and random effect models were estimated to determine the relationship between variables. The Hausman test was conducted to test which model was more effective and the fixed effect model was found out to yield more consistent results. For this reason, only the findings of the fixed effect model are interpreted here. As seen in Table 6, there appears to be a positive relationship between economic globalization and financial freedom as a result of the fixed effect model. One unit increase in the level of economic globalization has increased financial freedoms by 0.39 units. Moreover, the fact that the coefficient of the error correction mechanism in the model is negative and statistically meaningful indicates that macroeconomic imbalances that may occur in the short term can be corrected in the long run.

**Table 6.** Model Estimation Result regarding Panel Data Variable

Fixed Effect Model			Random Effect Model		
Variable	Coefficient	t-statistics	Variable	Coefficient t	t-statistics
C	0.129287*	0.331368	C	0.196043*	0.503681
EG	0.3948855*	3.540169	EG	0.309008*	2.848064
EC(-1)	-0.294923*	-7.520017	EC(-1)	-0.122759*	0.503681
Statistics Regarding the Model	R <sup>2</sup> =0.209 F=3.517311 F(prob)=0.000 DW=2.085197		Statistics Regarding the Model	R <sup>2</sup> =0.07159 F=11.45205 F(prob)=0.000 DW=2.094028 Hausman Test=36.731249(0.000)	

**Note:** Since a cointegrated relationship is obtained between the variables, the error correction parameter is added to the models and is called EC (-1). \* represents meaningfulness at 5% level.

## Conclusion

The concept of economic globalization is a process in which the flows of international goods and services and international capital movements accelerate with liberalization and deregulation measures. Moreover, the cross-border fluidity of the workforce increases and national economies integrate with global markets. Financial globalization is defined as the elimination of obstacles to the integration of the financial system with international financial markets. Especially after the 1980s, with the accelerating trend

of globalization, countries have abolished the limits they have exerted in the field of production and trade and liberalized their financial markets.

This study investigates whether there is a relationship between economic globalization and financial freedoms between the years 1998-2013 in 20 East European countries and whether the relationship is positive or negative using panel data analysis. Within the scope of panel data analysis, stationarity analyzes were performed through various unit root tests. The Pedroni cointegration test was then conducted to reveal the existence of a long-term relationship between variables. After the cointegration test, Panel Granger causality analysis was performed to determine the causality relation between the variables. The unit root test results showed that the variables became stationary when the first differences were taken. As a result of the Pedroni cointegration test, the existence of a cointegrated relationship between the related variables has been established and it has been found that there is a long-term relationship between these variables. After determining the cointegration between the variables, the panel cointegration parameters were determined by Panel DOLS and Panel FMOLS, and as a result, a positive and statistically significant relationship was found between the two variables. The existence of a long term relationship between panel data variables showsthat there is a causality relationship between the variables, even if the relationship is one-way. As a result of the causality analysis, it is seen that there is no causality relationship from economic globalization towards financial freedoms in the short term; it is also seen that there is a causal relationship from financial freedoms towards economic globalization. When we look at the long-term causality relationship, it is seen that there is a two-way causality relationship between economic globalization and financial freedoms. In the context of the analysis, fixed and random effect models were applied to determine the magnitude of the effects and fixed effects model showed more consistent results in the framework of the Hausman test. The findings showed thatthe level of economic globalization accelerated financial freedoms.

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# 5 | The Effects of Globalization on Financial (Money & Capital) Markets

Ayşe ERGİN

## Abstract

*The boundless development of transportation and communication technologies has led to a different dimension for commercial relations among countries. This new world order, characterized as globalization in economic terms, has three different field effects in a broader perspective. These are international trade, international production and finally the liberalization of international financial flows. At this point, perhaps the most influential field of globalization is likely to be the financial markets. This influence, assessed as financial globalization, is the result of “the breakdown of the boundaries among national financial markets, the maintenance of international competition by eliminating various controls and limitations on the financial markets, the convertibility of markets, the fluctuation of exchange rates, the rise in international capital flows and, the prominence of new institutional investments such as mutual funds and investment trusts in financial markets”. On the other hand, the emergence of highly liquid derivatives markets has facilitated basic financial transactions and contributed to the development of global financial markets. However, the use of derivative instruments in the marketplace for speculative purposes has increased the diversity of risks and, in this context, the deepened financial markets have allowed banks, non-bank financial institutions, institutional investors, and companies to control the risks they face better by implementing complex risk avoidance strategies.*

**Keywords:** *Financial Markets, Financial Economy, Economic Effect of Globalization.*

**JEL Codes:** *O16, P34, F65.*

### ***Introduction***

The concept of globalization was first coined in an article on the distribution and use of resources by the British economist W. Foter in 1833, later on, it was also mentioned on April 4, 1959, in *The Economist* magazine. The effectiveness of contemporary globalization is based on Garrett Hardin's research study on the allocation and utilization of resources written in 1968 (Karabıçak, 2002, p. 116). Globalization, which is historically more recent phenomenon, had been accompanied by a series of changes and transformations since the 1980s. The disintegration of the Soviet Union, the ending of the Cold War, the technological progress in communication and data processing, and the demands and regulations brought about by the outsourcing due to the increasing capital accumulation have all accelerated the globalization. The world economy has been undergoing a restructuring phase throughout the 1980s, along with the globalization process. The developed countries have begun to implement policies that would liberalize financial markets in order to create more profitable investment areas, while the developing countries have done the same to save the funds they needed to finance their growth.

With the introduction of policies aiming at financial liberalization, the circulation of financial capital around the world had gained momentum, and it is observed that such capital flows tend to be directed to developing country markets. Also, the liberalization of the financial markets has also increased the fragility of the countries, while facilitating the spread of any economic problem in the countries. Especially in the post-financial liberalization period, financial crises have been observed in many countries, accompanied by "expansion-contraction cycles," especially due to greater freedom of capital inflows and outflows. Due to the liberalization practices, the incidence of twin crises, in which money and banking crises coexist, has increased. In this context, financial liberalization has become one of the reasons for the use of different financial instruments (such as derivatives) which have changed the structure of both money and capital markets.

This descriptive study aims to explicate the effects of globalization on the financial (money and capital) markets by taking advantage of country and case examples. In the

first part of the study consisting of three parts, the concept of globalization and economic effects are discussed, and the process analysis is tried to be performed. The second part mainly focuses on financial liberalization as the cornerstone of globalization and discusses financial market structures. In the last part entitled “The Transition Process of Money and Capital Markets within the Context of Financial Globalization,” the effects of financial liberalization on the markets are examined with respect to country examples and historical periods.

### **Concept of Globalization, Its Dimensions, and Economic Effects**

Globalization is described along with a process that advances in both directions in the local-universal spectrum, pointing out to a highly dynamic and variable conception, far from a static structure. Globalization continues to infuse different areas of the world as time elapses and continuously adapts its current structure with the inclusion of new initiatives and movements to its scope (Bayar, 2008, p. 25). Although it is not easy to assert a clear definition of globalization, it can be expressed as the advancement of interaction and interdependence among the communities and governments in different regions of the world within the process of mutual cross-border economic integration and the integration of national economies into world markets as a result of progressive mobility of goods, services and capital.

The globalization phenomenon does not contain merely a single dimension, nor does the whole globe is affected in the same fashion. The globalization concept is comprised of three interconnected elements; such as the expansion of markets, the change of governmental and institutional structures, and the emergence of new social and political trends. These are not theoretical approaches that substitute each other, but each represents a different aspect of globalization. Globalization is, in essence, linked to issues such as multinational corporations/investments, international trade, regionalism, global finance, national decision-making, global non-governmental organizations and international institutions, as well as having an interdependent framework of governments and societies (Toprak, 2001, p. 9).

Globalization with such a wide range of impacts is thought to provide the countries with new opportunities and new risks (or hazards) as indicated by the concept of globalization paradox. In other words, the phenomenon of globalization leads to a paradox by bringing out two different dynamics, one in favor of globalization and the

other opposed to it. Economic growth, the revival of foreign trade, provision of competition, and finally the further strengthening of multinational corporations are the views in the best interests of globalization. On the other hand, according to Giddens; globalization is a process that can be as destructive as it is constructive. For this reason, underdeveloped countries may be exposed to its adverse effects from time to time. It may lead an economy to monopolization, or it may render it defenseless. Economic globalization is to be described simply as neither good nor bad. Globalization is a highly complex phenomenon for a simple depiction. No economy other than the emerging global market economies has ever been successful as of yet. There has not been a single country that could survive outside the global economy.

The World Bank data of the World Development Indicators can also be seen as the hallmark of globalization: GDP per capita in the world increased by an average annual rate of 2% over the 1980-2005 period; when considered regarding regions, there seems to be a rapid growth in East and South Asia, slow growth in Latin America and stagnation in Africa. While there has been a significant drop in infant mortality rates in the regions, it is understood that the world average fell from 6.45 % to 3.75%. There has been a significant increase in life expectancies in all regions except for the transition economies and Africa. It is also understood that the duration of education has increased in almost every region and the world average has increased to 6 years from 4.4 years between the years 1980-1999. In terms of democracy, except for China and the Middle East, the world has taken important steps towards democratization (Yay, 2009, p. 3; Shleifer, 2009).

## **Financial Globalization and Financial Market Structure**

Financial Globalization is the integration of international markets into an international market by removing barriers to the entry and exit of foreign capital into the financial markets by removing the direct controls on the financial markets and ensuring that market conditions are met in domestic markets of the countries. Basic phenomena emerging throughout this process can be summarized as the removal of controls on interest rates, the removal of boundaries separating national financial markets, the elimination or substantial reduction of controls and restrictions on the banking and financial systems, the realization of financial markets convertibility, the acceleration of international capital flows by letting exchange rates to fluctuate. Generally speaking; there are two basic stages through which the objectives of directing capital flows towards the regions with higher productivity rather than the regions with lower productivity,

and increasing global capital productivity would be accomplished. These are originally initiated with policies towards the liberalization of domestic financial markets and are followed up by the policies towards the realization of foreign financial liberalization with or without the policy on liberalization of capital flows.

Full financial liberalization is realized after these two phases are completed sequentially (Berkman, 2011). The main features of the financial liberalization approach can be summarized as follows (Ağır, 2010, p. 17);

- Determination of bank deposit rate and loan ceilings and abolishment of loan issuance to priority sectors,
- Free access to the banking sector or financial services industry in a broader sense,
- Private ownership and bank autonomy for banks,
- Removal of restrictive applications on payments in foreign currency,
- Opening domestic financial markets to competition.

**Table 1.** Assignment of Regulation Methods in Financial System

Period	International Financial Structure	Financial System	Regulation Style in Banking System
1980-1980	Integration limited to World economy	Financial Stress	Regulation; Supervision of risk by public authorities
1980-1990	Globalization in Economic and Financial System	Financial Liberalization	Deregulation; Removal of measures to regulate the market
From 1990's to present	The Rise of Global Financial Crises	Resolution sought for Post-Financial Liberalization problems	Reregulation; Establishment of auto-control systems and integration of international organizations into regulation function

Source: Tuncel, 2012, s. 6.

Technological developments are catalysts for the success of these efforts in the short-term. Historically, the capital itself had been re-created by trade, production, and

speculative capital movements. Therefore, it would be more appropriate to associate the basis of globalization in financial terms with the past accumulation of capital relations and the results of these relationships (Selen, 2004, p. 22). In this context, developments that have led to globalization in financial markets are usually initiated by the demolition of the Bretton Woods system in the early 1970s. As the fixed exchange rate system has been torn down and the flexible exchange rate system has been introduced, the exchange rate among the currencies has made it possible to earn money. As a result of the rapidly increasing foreign exchange transactions, an immense foreign exchange market has emerged. In this world's largest market which is operative 24 hours a day, it is possible to convert from currency to another along with improvements in the computer technology. Thus, international capital movements have increased rapidly, interdependence and integration among the national financial markets have grown, and the national markets have become branches of a single global market (Ganiev, 2014, p. 119). Although there is a market structure that functions as a single branch, it has been differentiated in different periods by different government policies. In the following table, the financial policies of the countries and the precautions taken are shown in historical periods.

Pertaining to this large amount of capital that has been formed in the world, the entries to and the exits from the countries' economies in order to obtain short-term profits and rents would cause massive economic fluctuations. Another phenomenon that the world economy recognizes as a result of globalization is the financial crisis resulting from the immediate short-term capital inflows and outflows. Upon examining the world economy, it is seen that there has been a crisis every nineteen months on average. In this context, perhaps the most important reflections of globalization are thought to be towards financial markets. The adverse effects of globalization on capital movements can be summarized as follows (İnandım and Özlale, 2005, pp. 12-13):

- Capital movements are short-term, more volatile and mobile; since they are often carried out in the form of speculative monetary movements, mostly seeking arbitrage gains.
- Along with the free distribution of capital movements across countries at the global level, countries have begun borrowing from international markets instead of direct debts through the official channels. Thus, the linkage of capital movements to macroeconomic imbalances of national economies has

weakened, and it has become easier for developing countries to compete in international markets.

- Servicing of the capital movements in order to obtain arbitrage revenues has led these funds to move towards new financial markets in emerging markets. National currencies of the countries with speculative capital inflows have been overvalued and have provided significant accumulation of foreign exchange reserves.

In parallel with transaction volumes and economic savings with 24-hour business that are increased as a result of the economic liberalization, the production capacities of the country are also increasing. In the meantime, the structural change of the countries is also accelerating in an effort to adapt to changing conditions. However, as a consequence of the financial globalization, the increasing international capital flows can weaken the developments in the national finance sector by deteriorating the mutual price balances and then inflate asset base prices. Adverse macroeconomic outcomes accompanied with inflows and outflows may occur with the possibility of depositing and withdrawing large amounts of funds rapidly. These capital flows, along with informal activities, weaken the control power of the domestic monetary authorities and can disrupt macroeconomic stability (Bulut, 2009; Allen, 1999). Also, financial globalization has brought out many difficulties regarding monetary policy: Firstly, financial and economic conditions have become much more complex. Secondly, the determination of asset prices and interest rates has become much more dependent on world conditions. The effect of exchange rates on monetary policy has increased even more. It becomes apparent in the last crises that globalization of financial markets with extreme freedom, policy mistakes would be reflected in the global markets as well whenever they are made anywhere in the world, and even the countries that have not made any policy mistakes would also have to pay for the costs of the crises that emerge in global markets (Yay, 2009, p. 34).

### **The Transition Process of Money and Capital Markets within the Context of Financial Globalization**

The fact that the policies of outsourcing are seen in the world economies in every field has changed the capital markets in the direction of globalization. Today, the daily trading volume in the world financial markets equals to the annual volume of the world trade. This development has emphasized the globalization of financial markets.

Globalization appears to have been gathered at three major centers in the financial markets, such as the European Union, the North American Free Trade Agreement between the US and Canada and the Asia-Pacific Economic Cooperation between Japan and other Far Eastern countries where Internationalization, integration, and integration are experienced (Yigit, 2015, p. 75).

One of the most important anticipations stemming from the financial liberalization movement is the development/deepening of financial markets in the countries. It is accepted that the public interference and the public pressure on prices and quantities in financial markets are detrimental to the development of these markets. It is also argued that the market economy would become operative in the financial markets with the dissolution of government interventions this would constitute a source of investments by increasing domestic savings so that economic growth would accelerate. One of the main propositions of the views underlying financial liberalization is that domestic savings will increase as a result of liberalization and the funds raised in financial markets will contribute to higher investment and eventually to economic growth by expanding credit volume (Oktayer, 2009, p. 75).

Since the 1970s, major changes have been realized within the international banking events. As OPEC countries increased their oil prices in 1973, supranational banks involved in major capital flows at unprecedented rates. With the increase in oil prices, there has been a surplus in the oil-exporting countries, while the oil-importing countries have become more dependent on banking funds. As a result, the assets of international banks grew by 95% between the years 1976 and 1980.

From the 1980s through 1990s, the developed and the developing countries have been implementing a series of reforms to liberalize their financial systems. The most important of these are the abolishment of credit ceilings due to the liberalization of interest rates, the reduction or elimination of the reserve requirement ratios that banks are obliged to keep in the Central Bank, and the liberalization of capital movements by making the banking sector available to both foreign and domestic banks. Such policies are referred to as financial liberalization policies. The main objective of financial liberalization policies is to speed up economic growth.

**Table 2. Liberalization Dates**

	Official Liberalization	First ADR	First Country Fund	Intensity of Liberalization	IMF Capital Account Openness	Quinn Capital Account Openness Average
Argentina	1989	1991	1991	0.505	1993-	0.361
Brazil	1991	1992	1992	0.315		0.382
Chile	1992	1990	1989	0.195		0.382
Colombia	1991	1992	1992	0.306		0.403
Greece	1987	1988	1988	0.502	1996-	0.674
India	1992	1992	1986	0.079		0.278
Indonesia	1989	1991	1989	0.228	1980- 1995	0.632
Israel	1993	1987	1992	0.000	1996-	0.438
Malaysia	1988	1992	1987	0.432	1980- 1995	0.597
Mexico	1989	1989	1981	0.462	1980- 1981	0.479
N. Zealand	1987	1983		0.611	1983-	0.826
Pakistan	1991	1994	1991	0.206		0.319
Philippines	1991	1991	1987	0.292		0.278
Portugal	1986	1990	1987	0.519	1993	0.646
S. Africa	1996	1994	1994	0.333		0.354
Spain	1985	1988		0.722	1994-	0.681
Thailand	1987	1997	1985	0.180		0.378
Turkey	1989	1990	1989	0.675		0.333

Source: Bekaert, Harvey and Lundblad, 2005.

Again in the 1990s, there was a serious real production surplus and “over-competition” situation. In such an environment, where the financial capital promised more profits, real capital has become biased to financial investments which tended to increase directly with some in-house funds in accordance with the profitability of real production. For instance, in Southeast Asian countries, the sum of foreign loans to four Asian Tigers and the Philippines in 1990 was \$ 150 billion, but it rose to \$ 390 billion in 1997.

Nonetheless, a significant portion of this money entering was short-term, and in general, these short-term debts have risen to 60 % of total debts (Balkan, 2002, p. 18). The history and methods of liberalization of capital markets in different countries differentiate from each other with the exception of related examples. The following Table 2 above indicates this situation (Türsoy, 2008, p. 24).

In Table 2 above, official capital market liberalization is shown as one of the important indicators. This indicator is based on the chronologically prepared data set of important financial, economic and political events in many developing countries, set forth by Bekaert and Harvey (2002). As a result of financial liberalization, consumer loans spread rapidly. This puts consumption ahead of income by eliminating the income constraint on consumption expenditures largely, at least for the sake of certain income groups. Thus, the international capital flows tend to fuel consumption by being directed into consumer loans in the banking system (Uzunoğlu *et al.*, 1995, p. 64). In addition, the development of financial centers has affected the international circulation of capital, the rapid growth of emerging economies and the existence of markets offering high profits in the short-run. These main developments, which can be expressed as securitization at the same time, can be categorized as follows (Acar and Yavuz, 2011, p. 270);

- **Liberation;** Government interventions are related to the reduction of regulations and regulatory regimes, and the transactions to be performed in accordance with liberal politics in the direction of the latest developments in the world consist of the liberalization of monetary inflows/outflows, the abandonment of interventions for exchange rates and interest rates, and the removal of obstacles on lending/obligations.
- **Internationalization;** Increased savings within the country have created the need for instruments for the assessment of savings, and the availability of safe and profitable markets has led fund demanders and fund suppliers to move towards these markets outside the borders of their country. Thus, international financial markets have started to be used more actively. In this context, the funds have the possibility of mobility in international markets contingent upon the saving owners' preferences. As a result of the internationalization of financial markets, international variables, as well as local variables, affect national markets. As long as the interaction between local and international markets continues to be an important source of changes in

the local financial system in many countries, the increase in international financial interaction also increases the change in local financial markets (Kaplan, 1999, p. 9).

- ***Science and technology;*** The emergence of derivative instruments and the technological infrastructure with which they can be used have led to the development of financial markets.

Financial markets, which have the function of facilitating risk transfer and sharing among economic units, are producing new financial instruments by keeping up with the developments. The commencement of new pursuits along with the inadequacy of the spot markets against the fluctuations created by the supply and demand imbalances accounts for the formation of derivatives and many similar complex derivative instruments including futures, futures, options, swaps, and synthetic securities (Karatepe, 2000, p. 2). Other reasons for this pursuit are the international financial movements to international dimensions and encountered risks.

Besides its contributions to the economies of countries, the shortcomings of financial liberalization are also among disputable matters. In developing countries with inadequate financial regulations, the economics of uncontrolled financial liberalization policies become more fragile. According to this view, the capital markets tend to invest more in these countries, since they have the chance to earn higher revenues in the liberalized developing countries. In this respect, financial liberalization policies cause the short-term capital flows to developing countries. The rise in the short-term foreign capital mobility makes the financial structure of developing countries more fragile. Large amounts of capital outflows due to economic instability, especially in emerging economies where the financial structure is not well established, would pave the way for financial crises in these countries (Korkmaz *et al.*, 2010, p. 2822).

## **Conclusion**

The financial globalization, constituting another pillar of the economic dimension of the global economy which is of great importance and has a multifaceted effect as the continuation of the transformation that took place in the international system throughout the 1980s, would be described as “delimitation of the national financial markets, maintenance of international competition, increase of international capital

flows and the role of new institutional investments such as mutual funds and investment partnerships within the financial markets". Financial liberalization applications aim at the direction of funds from low-return and high-risk locations to high-yield and low-risk locations, utilization the world's funds more efficiently and transfer of savings to productive investments. On the other hand, emerging financial crises after liberalization since the 1980s led to the reexamination of this concept and the extent to which the academic world achieved the intended results.

Especially developed countries have recently achieved intensive financial improvements and even have succeeded in their transition to economic integration. It is obvious that financial globalization overstrains the economic management, in other words, the market, and policy-makers, even though some countries are rescued from financial crises by utilization of various financial instruments via efficient money and capital markets. In this context, it is not possible for financial globalization to affect money and capital markets. The credit ratios of commercial banks in the money markets and the mobility of interbank transactions revealed it, while the international fund flows in capital markets and the derivatives used were supporting this argument. The hazardous effects of financial globalization would be minimized if market makers and investors trading in the financial markets can follow the financial globalization-related developments and use alternative financial instruments and policies at the right moment in any case of financial issue.

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# 6

## Monetary Policies and Economic Growth / Development Relationships within the Context of Globalization

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### Abstract

*This study aims to make a statement on the relationship between monetary policies and economic growth/development within the scope of the concept called globalization by formulating several definitions for the globalization process. The world economy has been in a continuous transformation for the last 35 years called globalization which has many drawbacks. There are two main developments that prepare the formation of globalization: the first is that the Bretton Woods system, which has been experiencing unprecedented growth and development in stability since its inception, has become unable to function because of the oil crisis that began in the early 1970s. The other is that the Cold War, which started just after the Second World War and lasted for a long time, began to be solved at the end of the 1970s and was finalized and officially completed in 1991. Following these successive developments, international economic, political and cultural relations have changed. The communication and information network that has grown in parallel with the increasing technological development has increased the volume and fluidity of foreign trade and capital movements. It is believed that globalization, perceived as the free movement of capital, on the world scale, without the restriction of national boundaries, is favorable to all economies and will increase the prosperity and happiness of the wholesale world economy. However, the frequent recessions and the subsequent economic and financial crises imply that globalization*

*must be managed. For this reason, it is currently waiting for an effective international structure for global economic system governance. This study first examines the effects of globalization on monetary policy after explaining definitions of globalization, then compares the growth of world economies. The conclusion introduces the proposal that the literature suggests at the point of eliminating the drawbacks of the global economy.*

**Keywords:** *Monetary Policies, Globalization, Economic Growth, Economic Development.*

**JEL Codes:** *E44, E51, E52, O40, O47.*

## Introduction

In the course of last thirty-five years, very serious transformations have been in the world economy. Some aspects of these transformations are well-known; as the role of markets has increased, the role of the public has diminished, the economic transactions among the countries have increased greatly, and national/international financial transactions have grown rapidly. In short, the outlook of these transformations has been shaped by the rise of neoliberalism, globalization, and financialization (Epstein, 2005, p. 3).

The determinants of financial globalization on macroeconomic policies would be considered as the increase in economic integration in the world economy, the growth of world trade commensurate with the world's GNP, and in particular, the incredible growth in the international trade of financial assets. Another important element behind the macroeconomic effect is that progress in communication and information technology being a crucial catalyst for the process, allowing both the goods and the financial assets to make international transactions quickly and easily. The enormous global integration process has been realized in the last century alone for, at least, capital markets with an unprecedented level of dynamicity. In this sense, the most fundamental difference between financial globalization and all other periods would be that the international capital tends to move toward the poorer countries from the richer ones for financing almost entirely long-term investments to maintain the financial development (Obstfeld and Taylor, 2003).

In general, financial globalization has diminished the efficiency and the control power of macroeconomic policies as to national policy-makers and administrators. Especially,

the increase in the mobility of international financial capital has put pressure on exchange rates and interest rates. The fiscal policy, which is another important aspect of macroeconomic policies that partially lacks efficiency due to the increased openness of the economies, also encounters certain problems. Increasing capital mobility is considered as a consequence of the financial integration when the constraints on macroeconomic policy autonomy and the risks in which they involved are taken into account. Thus, it is accepted that financial globalization increases the fiscal discipline regarding macroeconomic policies that are carried out. The underlying rationale for this acceptance is that the potential costs of inferior macroeconomic policies tend to be much higher. The sudden stop of international capital inflows due to the weakening of financial discipline may turn into a disintegration for the emerging economies. Thus, the size of the financial globalization for the country can be said to be equivalent to the existence of better macroeconomic policies (Bertolini and Drazen, 1997).

In fact, according to Siglitz (2002), the provision of fiscal discipline is of the utmost importance among the skeptical benefits of financial globalization and integration. Another systematic review of international capital mobility that supposedly disciplines the national macroeconomic policies is conducted by Tytell and Wei (2004). They found that, as the dimensions of financial globalization increased, better monetary policy results (practices) are revealed. However, they somewhat failed to present any systematic evidence that better financial policies would be implemented with the increase of financial globalization. According to Tytell and Wei (2004), for instance, when inflation-reducing policies and fiscal deficit-reducing policies are compared, it is assumed that the ruling elite groups had higher political costs due to resistance for reducing fiscal deficits, and consequently fiscal policy could have produced much better results along with the financial globalization (Köse *et al.*, 2005).

That is to say, while the financial globalization reduces the effectiveness of the country's macroeconomic policies, on the one hand, it also leads to changes in macroeconomic policies to mitigate the adverse impacts of capital flows and to foster beneficial effects for the country. Macroeconomic policies are becoming more and more vulnerable to open economies because of the timing and implementation mistakes that countries make in the liberalization of their financial markets and because of the inherent instability tendencies of liberalization. For example, suppression of interest rates may have an impact on foreign exchange demand. While trying to offset this demand with the capital inflows, all foreign and domestic balances can be ruined by the pressure on

foreign currency exchange. For this reason, instability may be transformed into crisis (Öztürk, 2001, p. 7).

The surge in capital mobility over the last thirty-five years has created both new opportunities and new challenges in the macroeconomic policies/practices of the nation states. However, contrary to what might have been thought, the increase in capital mobility did not increase the need for coordination of monetary and fiscal policies. The reason for this is that increased capital mobility leads many economies to greater exchange rate flexibility. This situation naturally reduces the need for cooperation in the monetary field (İskenderoğlu *et al.*, 2008).

Another new situation regarding macroeconomic policies is the pressure created by the financial globalization for inducing countries to move to a more flexible exchange rate regime accompanied with increasing capital mobility rather than fixed exchange rates. In other words, the increase in the level of integration of financial markets forces countries to move away from constant exchange rate practices. On the other hand, there is a consensus among economists as to the increase in capital mobility being decisive on the existence of fixed exchange rate regimes. In particular, the increase in capital mobility has made the fixed exchange rate regime less vulnerable to fragile and speculative fluctuations. Moreover, the increase in the movement of capital may exacerbate the contagious effects of economic crises, and yet a new area of struggle is taken on by the national macroeconomic policies, even though it has not been revealed by local dynamics (Qauwe and Polan, 2000, pp. 6-18).

Given the current wave of the financial globalization, the increased competition, especially among the developing and the emerging market economies, appears to provide certain benefits within the framework of macroeconomic policies. This competition concept forces the governments to implement greater fiscal discipline and to perform practices within the institutional and political context. On the other hand, financial globalization has created some problems in terms of macroeconomic policies. Especially two important problems are deepening. In the first place, the financial globalization not only increases national income inequality but also contributes to a growing difference between advanced industrialized countries and developing countries regarding their living standards. The second problem involves the increase in financial volatility as the main area of struggle regarding macroeconomic policies due to financial globalization. Nevertheless, the degree of openness of economies towards international

capital flows and the international integration of financial markets may also encounter a variety of major problems that would arise should the countries relinquish rapid capital movements (Wayier and Berger, 2003, p. 2).

When the increasing capital inflows towards developing countries as a result of financial globalization are graded in terms of the constraints placed on policy autonomy and the risks in which they are involved, it is seen that portfolio investments restrict the autonomy of the economic policies the most, while the investors are mostly restricted by foreign direct investments. Regarding potential risk, the riskiest capital inflows are short-term portfolio investments. Since portfolio investments require a high liquidity feature, they can lead to financial crises because they facilitate the capital outflows. The reversal of portfolio investments involves a high risk. Since the liquidity of foreign direct investments is also low, then the probability of a sudden return is weak. In a sense, financial globalization is seen as a means of putting pressure on all governments to transform their policies and institutions towards particular outcomes. The liberalization of trade policy, the abolition of capital controls, the opening of financial markets to foreign investors, and the reduction of the role of the state in the economy are common imperatives for global economic participation. Abandonment of the understanding of welfare state in developed countries and liberalization of economies in developing countries are new situations for which globalization is responsible (Öztürk, 2001, pp. 74-75).

The type of capital movements is also important in determining the extent of the adverse effects that financial globalization may cause in capital movements. Short-term capital movements and “hot money” flows are more volatile than long-term capital movements since they have high sensitivity to macroeconomic drawbacks, which may lead to more serious crises and may require deeper adaptations (İnandım and Özlale, 2005, p. 30). In order to put forth the transformation of macroeconomic policies caused by financial globalization for consideration more clearly, the impacts of financial globalization on the monetary policy, the fiscal policy, the exchange rate policy, and the economic growth would be explicated separately. In this context, the monetary policy, which is the most influenced by financial globalization, is to be evaluated in the aspects of inflation, central bank independence, and transfer mechanisms (Kandır *et al.*, 2007).

## **Financial Globalization and Monetary Policy**

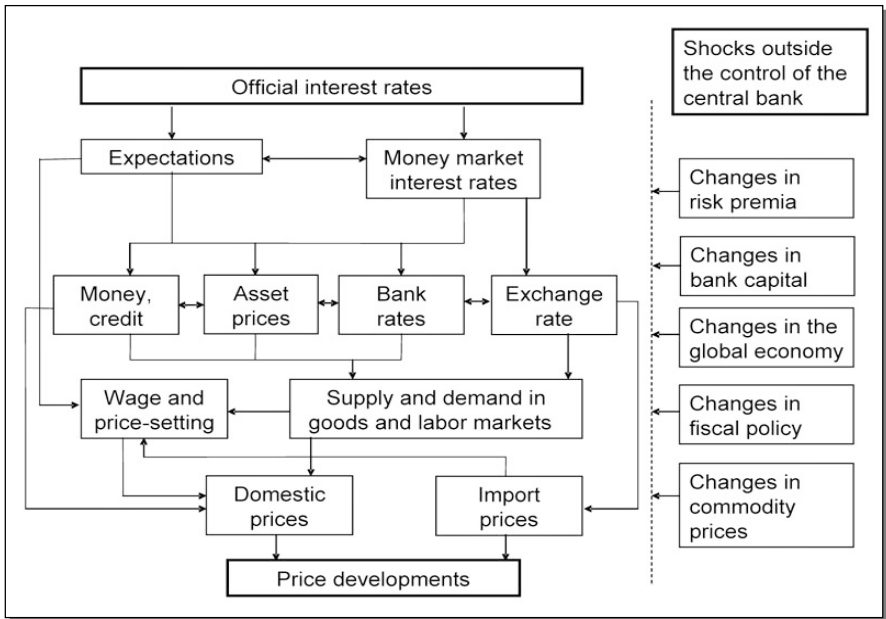
Firstly, it is necessary to consider the general characteristics of applied monetary policies for explaining the effect of financial globalization on monetary policy. Following the first globalization movement between the years 1870 and 1914, the main function of monetary policies between the years 1914 and 1945 was to finance budget deficits in the wake of local political interests during the World Wars. As pointed out by Obstfeld and Taylor (2002), a very effective control of capital movements has been achieved throughout that period to prevent possible monetary crises and to preserve the value of gold. For the period from the Cold War era to the year 1971 5 until 1971, the controls on international capital movements had continued, notwithstanding, not as intensively as before. The applied fixed exchange rate regimes have rendered monetary policy dependent on exchange rate movements, and although monetary policies have more activist feature compared to previous periods, they have not been independently implemented.

The technological breakthrough that began in the 1970s, especially innovation/progress in telecommunication made it possible for capital to be transmitted into costly but more lucrative lands along with lowered costs and risks. At that point, financial globalization has created a financial environment that could not be compared with the former one in terms of monetary policy (Buetow and Johnson, 2001, pp. 177-178). This environment, in itself, required reconsideration of monetary policy practices and strategies. The first example of application that stands out at this point is the abandonment of fixed exchange rate system in favor of a more flexible regime. Improvement of technology has also caused the emergence of appropriate financial innovations for the financial environment. It is seen that the monetary policies that developed countries unexpectedly relaxed following the global financial crisis could not be sufficiently successful in terms of approximating inflation targets and fulfilling full employment and could lead to potential problems in the functioning of the financial system. In this respect, the performance of recent global monetary policies and the alternative applications that can be used in the future are evaluated on the basis of four main questions below:

## Does the Transmission Mechanism Work?

Central banks are aiming to stimulate economic activity while lowering interest rates to near zero or negative levels and increasing liquidity by bond purchase programs. As summarized by Hannoun (2015), this effect is expected to be processed through several different channels, which can be called loans, asset prices, mitigation of deflation and exchange rates.

The most important of these channels is undoubtedly the “credit” channel. In an environment with low-interest rates, it is aimed to decrease the funding costs of the banks and to decrease the interest rates of the borrowers and to direct the economic units to consumption through borrowing.



Source: European Central Bank. <https://www.ecb.europa.eu>

**Figure 1.** Transmission Mechanism of Monetary Policy

On the other hand, it is unlikely to say that this channel worked well in the last period. In the post-crisis period, the decline in job security or low real interest rates may result in a decrease in the expected benefits of existing savings, which may result in consumers not being willing to spend. Moreover, as Krugman (2013) and OECD (2016) emphasized, the deterioration in income distribution is also seen as an important factor that limits consumption demand. From the investment perspective, according to Stiglitz (2016), capacity utilization is already low due to global demand weakness, and therefore, interest rates are insufficient to trigger new investments. Additionally, the fact that the banks have not had the opportunity to repair their crisis-stricken balances is causing them to tighten credit conditions (Turan, 2011, p. 56). Moreover, the fact that the decline in short-term interest rates is not fully reflected on the deposit interest rates, which are the main financing source of loans, is also shown as one of the factors limiting the decline in loan interest rates. For the other channels mentioned above, it is possible to mention the weaker and one-time effects or difficulties in implementation (Alper, 2016, p. 98).

In short, the gained experiences suggest that non-traditional monetary policy is not a precisely desired result due to disruptions in the mechanism of monetary transmission and the structural problems. However, it is not a correct finding to assert that policies are completely ineffective. Many studies in the academic literature argue that even if these policies are not implemented, the outlook for growth and inflation would be much worse than it is today (Peersman, 2011; Santor and Suchanek, 2016; Borio and Gambacorta, 2017).

### **Would a Monetary Policy Be Used Effectively if a New Danger of Economic Contraction Arises?**

This question can be answered through two basic issues. The first one involves the transmission mechanism mentioned above. The second one is related to very low levels of the current interest rates. These issues point out the fact that it may be useful to support other policies in order to increase the effectiveness or functionality of the monetary policy. If the policy rates are low at the dawn of a new economic contraction, it may be difficult to further loosen the policy. In this case, the central banks should either put in non-interest methods like bond purchases, or they should push interest rates even further below zero. However, there are some risks involving the fact that such policies have been used for a long time. The main problem here is that banks cannot

reflect these policies on deposit interest. In the case of negative interest rates being introduced on deposits, there is a risk of escaping from the bank accounts to subordinated savings. This is because holding cash means zero interest, which means that its yield is higher than in deposits (Goodfriend and King, 2016).

Nevertheless, such a tax is questionable regarding the reaction of the society and its applicability. These non-traditional policy-related problems seem to weaken the monetary policy against a new contraction cycle that can prevail in a low-interest environment.

### **Do Large-Scale Bond Purchases with Near Zero or Negative Interest Rates Generate Risks?**

As mentioned before, one of the purposes of low interest is to encourage borrowing. However, the prolongation of this period and the excessive accumulation of debts may be a risk factor. Periods in which borrowing is too easy can lead to an inexorable increase in both public and private sector borrowing. If the borrowing is not used efficiently, it will lead to new financial crises in the future. It may also render critical concepts such as easy borrowing, debt management, and risk analysis inconspicuous in terms of financial stability.

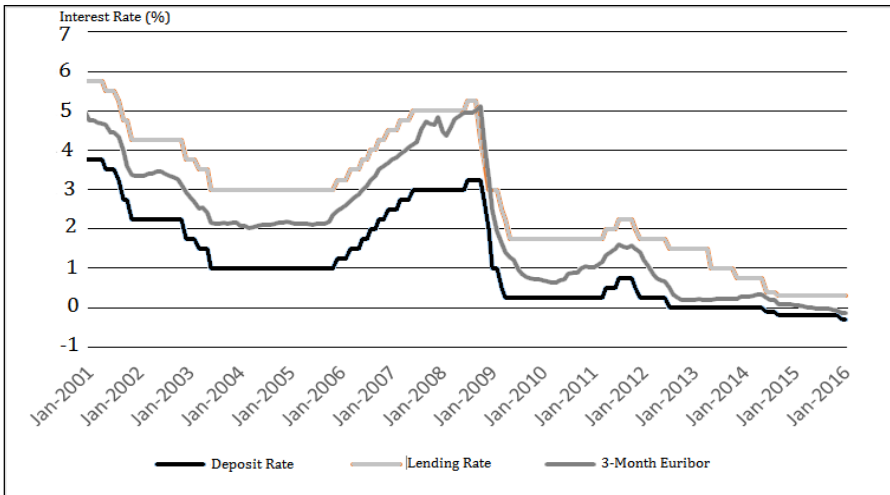
The return on financial assets is directly proportional to the risks involved. In other words, it is natural that there is a difference between Germany and Italy. With low or negative interest rates becoming permanent, traders tend to prefer risky assets over risk-neutral assets, and the difference mentioned above diminishes. This situation increases the risk assumed by the investors and damages the functioning of financial markets. Large-scale asset purchases can also disrupt this behavior by affecting the relative prices of assets on the market.

Possible asset price bubbles can also be a significant risk factor. Asset prices tend to rise along with falling interest rates. However, it may be possible that the prices of certain assets suddenly decrease as the interest rates return to their normal levels in the future or there are expectations in this regard. Investors who allocate a large portion of their assets to these assets may be adversely affected by such sudden price changes, which can even lead to a financial risk (Kimball and Kimball, 2016).

## What Would Be the Alternative?

The Central Banks face two options. The first one is to resume bond purchases and application of negative interest rates; the second one is to overcome the issue of low or negative interest rates by figuring out a way to increase the policy rate faster.

For an economy with declining resources or a low inflation rate, the traditional recipe for the monetary policy is to be reduce the interest rate. The central banks in the world are stubborn as to react to weak economies, so that in many countries they reduced the overnight interest rate to zero. Nevertheless, when the task was not completed, the Bank of Japan made a decision to go negative by attracting .1% interest on the reserve for excess reserves. In this step, Japan entered the Euro system, same as Switzerland, Denmark, and Sweden, which have been applying negative interest policies of the constraints of using this policy to stimulate the economy.



Source: European Central Bank.\* Average interest rate over the month on 3-month interbank loans and end-of-month values for ECB deposit rate and lending rate, January 2001 to January 2016.

Graph 1. Negative Interest Rates\*

How negative interest rates can work can be explained by taking the European Central Bank (ECB) as an example. Traditionally, the ECB would set two interest rates: a deposit interest rate that the ECB pays to banks on excess reserves held overnight in the banks' accounts with the ECB and a marginal lending rate at which banks could borrow overnight from The ECB. The deposit rate would usually be a lower bound on the interest rate at which banks would offer to lend to each other. The lending rate also sets a ceiling. Graph 1 below indicates how this system functioned historically, along with interest rates on 3-month interbank loans moving within the corridor determined by the ECB.

The ECB brought its deposit rates down to zero as of July 2012. Then, in June of 2014, as if that was not enough, the rate (that seemed to be corresponding to an annual rate of .1%) went down to -.1% in June of 2014. As of December 2015, the ECB lowered the deposit rate to -.3%. Assuming that the first option is not preferred regarding the risks it creates, there are alternative policies that can support normalization in interest rates. One of the proposals in this direction suggests that central banks set a higher inflation target. Such a target is said to be able to increase the efficiency of the monetary policy again by raising nominal interest rates. Nonetheless, it is necessary to take into account that a movement in this direction may be detrimental to the credibility of central banks, which has been established for many years, and the relative price effects of a higher inflation rate.

Structural reforms aiming to boost productivity following the crisis are among the proposals that can help interest rates to rise again by supporting economic growth. Nonetheless, it is anticipated that such policies could adversely affect growth, especially in the short-term due to costs (Summers, 2015). Also, Vogel (2014) mentioned that these costs might increase even if the interest rates are close to zero. The policy approach targeting long-term interest rates that the Central Bank of Japan has recently begun to implement can be seen as an alternative. However, evaluating the effects of this policy over time may be healthier. Krugmann (2012) also noted that successful implementation of long-term interest targets was related to credibility same as exchange rate targets.

The most widely accepted recommendation for raising interest rates back to normal levels appears to be support for growth with fiscal policy. Recently, the European Commission has also called for the implementation of the fiscal policy in the Eurozone.

Two basic criteria stand out in terms of the efficiency of fiscal policy. The first of these is the low-growth environment. Empirical studies indicate that fiscal policy is more effective in a low-growth environment. In this regard, the current situation seems favorable regarding fiscal policy. The second important element is the financial position, meaning, how much space is available in the fiscal policy. Unless the country's financial position is strong, there is a risk that the expansionary fiscal policy may adversely affect the economy, as opposed to what is intended through expectations.

### **New Monetary Policies and Interest Rate Corridors during the Post-Global Economic Crisis Period**

The use of monetary and fiscal policies is recommended during periods of crisis, depending on its extent. The increase in tax rates, the reduction of public expenditures and the collapse of liquidity constitute several policies that are the most fundamental of these measures. However, most of these measures (such as increasing interest rates, allowing exchange rates to fluctuate, maintenance of convertibility, etc.) taken without examining the probable effects of the reasons for the emergence of the crisis, rather than being a solution to the crisis, further deepen the crisis (Şimsek and Altay, 2009, p. 12). Especially in the last quarter of the year 2008, monetary policy decisions in all the central banks in the world have come into the frequent application. During this period, many governments have announced rescue packages, and financial institutions in difficult situations have been supported with medium- and long-term loan options. When financial situations which could not be rescued with financial support are encountered, the method for nationalization of the institutions has been chosen. Nevertheless, during the period of struggling the financial crisis, interest rate policy has become the most important instrument used by the central banks. Thus, the central banks tried to keep the money market under control by switching the interest rates (Sarpkaya, 2009, p. 86).

Upon examination of the interest corridor system, it is seen to have a triple interest system; lending interest rate, policy interest rate, and borrowing interest rate. When the interest rate corridor is mentioned, the central bank's overnight lending and borrowing interest rates are expressed, while the policy interest rate is usually the middle point of this corridor. With the interest rate corridor policy, same as other monetary policies, it is aimed at removing the uncertainties in the economy. Thus; while the central banks provide liquidity to the market, they have the opportunity to respond quickly to

changing conditions and to attain flexibility for the interest rates they implement. Along with the corridor system, the change in the policy can be intervened in the market by only switching the corridor without using any open market operation. Thus, instead of directly intervening in the policy rate, the central banks try to control the exchange rates and the credit channel in the markets by narrowing and widening interest rate corridor (Vural, 2013, pp. 30-31).

This policy instrument, which is used to reduce interest rate volatility and to manage market expectations by Canada, the UK, Japan, the European Central Bank (ECB), Norway, Australia, Sweden, and New Zealand before the global financial crisis and it is implemented by Indonesia, Poland, Romania, Hungary, and Iceland during the post-crisis period. However, these countries and the ECB used different types of interest corridor systems (İskenderoğlu *et al.*, 2011).

## **Conclusion**

According to the Traditional View on the effectiveness of the monetary policies acknowledged until the 1980s, asymmetric information between the Central Banks and the public is needed to be increased. Thus, the Central Banks would have to make shocking interventions that would surprise the public by keeping their applications as secrets to achieve their goals. In this way, the Traditional Approach assigned a passive role to the economic units within the monetary policy strategies. However, it can be seen from the 1990s onwards that information and communication technologies have increased the activities of economic units, thus gaining a central role in policy strategies. Accordingly, the orientation of economic units in the framework of the Modern Approach has become an important element in monetary policy implementations. On the other hand, it is determined that the expectations of the public opinion can be directed at the rate of increase in the credibility of the policies. Political trust requires that the practices of the Central Bank be clear and transparent. Thus, unlike the Traditional Approach, a strategy should be adopted to reduce asymmetric information between the Central Bank and the public, so that monetary policies can be effective. Accordingly, to reduce the information deficiencies that create asymmetric information, it is necessary for the Central Banks to regularly inform the public about the aims of policies, transfer mechanisms, and all data sets that emerge during the developing process.

Crises can affect countries and economies from different channels depending on the cause and reason. Countries' crises can be affected by the positive or negative economic processes that can be spreading rapidly from country to country due to increasing globalization, with the different economic conditions of each country, for different reasons such as development process. As a result of the global economic crisis experienced recently and, the countries are affected more or less by the crisis regardless of being developed or developing countries. As well known, there is a variety of monetary and fiscal policies that can be applied differently depending on the causes and effects of each crisis. Countries and economic policy-makers affected by the crises have set about to generate and implement "way-out" policies (Ergin and Aydın, 2017, p. 63). Therefore, as a result of developing world conditions, economic policies and conjuncture instruments expanding in kind and effect; different economic policies have been implemented in the world during the crisis. The interest rate corridors that started to be applied by the European Central Bank (ECB) in the 1990s has been added to the solution prescriptions nowadays and used by the countries as an effective monetary policy instrument during and after the crises. With the application of the interest corridors, the central banks would have the advantage of intervening faster than in the case of the classical monetary policies. Thus, in a sudden and unexpected economic period, the central banks can intervene in the markets quickly and effectively via interest corridor policies, without hampering the economy and without influencing other variables. Therefore, the effectiveness of the interest corridors policy may be felt even more during the upcoming crises.

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# 7 | The Rising Eco-Power in Global World: An Analysis Over the Economic Growth Model of PRC

Fulya KÖKSOY

## Abstract

*The rising of the People's Republic of China (PRC) that is stated as a rising eco-power in global world emerges in the axis of its economic growth model that has been continued successfully for many years. PRC starts to prioritized economic growth with the period of Deng Xiaoping. In this frame, the economic profile of PRC rises on the axis of reform and the outward opening policy. In addition to the rising economic profile, the emergence of a growing PRC in the framework of proactive policies exhibited outside of Asia-Pacific geography has highlighted other important factors. Within this point, the impact of PRC is perceived over both world politics and world economy. Especially, after its accession into World Trade Organization, Chinese growth rate and economic integration into the global economy gained momentum. In fact, if economic data are analyzed, it is seen that PRC is the second largest economy after United States of America (USA). In this context, the economic growth model of PRC plays an important role for the transformation of Chinese economy. With regard to this, the aim of this study is to analyze the economic growth model of PRC with its economy politics and to problematize the impact of the economic growth of PRC.*

**Keywords:** *Economic Growth, The Economic Growth Model of PRC, The Sources of Chinese Economic Growth, Outward Opening Policy.*

**Jel Code:** *F43, N1, O5, P2, P21.*

## Introduction

There have been two main phases for the economic structure of PRC. The first of these is the period of Mao Zedong until 1978 and the second is the period of Deng Xiaoping that is the reform period from 1978 to onwards. In this context, it is said that the rising of PRC was emerged by the economic reforms that has been practiced since 1978. In other words, economic growth model that has been developed by economic reforms has a substantial impact on the rising of China and the transformation of socialist economic system to socialist free market economy.

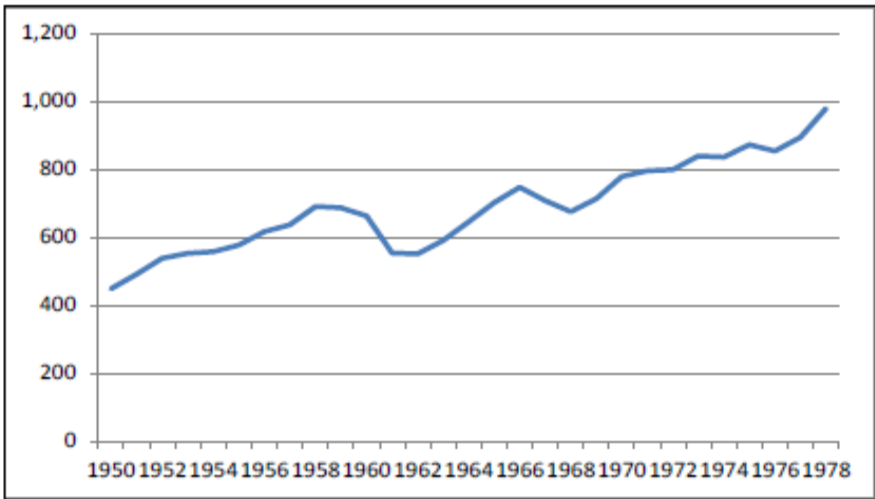
The membership of China into WTO in 2001, on the axis of the economic growth model, played an important role for the growth of China. In addition to the high growth rate, China started to transform into the attraction center for foreign direct investments.

In this study, economic growth model of China under the sources of economic growth is addressed with the help of the notable progression of the Chinese economy during the recent years. In fact, the story of China's rising as a significant economic power is a remarkable issue in the international platform. In this context, the aim of this study is to analyze the transformation of Chinese economy especially from 1978 to nowadays. The economic structure in the period of Mao Zedong is also analyzed.

## PRC's Economy in the Period of Mao Zedong (1949-1976)

Inward and closed economic policies were the most prominent economic feature of PRC in the period of Mao Zedong (Chow, 2004:131). In this context, China's economy was masterminded and monitored by the state and the main target of the state was to manage a self-sustained Chinese economy. There were not market mechanisms, there was little fosterage for companies, employees and farmers because of the state's control over the economy (Morrison, 2015).

Lots of economic plans has been observed in the period of Mao Zedong in order to provide economic stability, high rate of economic growth and industrialization. Within this context, a first five-year development plan was implemented between 1953 and 1957. Despite the high growth rate and industrialization achievement, the second five year development plan that was named as Great Leap Forward was started between 1958 and 1963 for more economic growth. In addition to this, the Cultural Revolution was begun in 1966 because of some political reasons and the failure of Great Leap Forward. But, the economic output of this revolution was also negative (The History Learning Site, 2016).



Source: (Marrison, 2015).

**Figure 1.** Chinese Per Capita GDP:1950-1978 (\$ billions, PPP Basis).

As seen in the figure 1 and table 1, gross domestic product (GDP) and the table 1 shows that the total factor productivity (TFP) expanded swiftly after the period of Great Leap Forward. Although there were more deranged growth in GDP and outrageous reduction in TFP growth after the period of the Cultural Revolution, capital growth was more striking level in terms of the 1963-1965 period.

**Table 1.** Accounting for the Economic Growth of PRC (1963-1978)

<i>Period</i>	<i>GDP Growth</i>	<i>Capital Growth</i>	<i>Labor Force Growth</i>	<i>TFP Growth</i>
1963-5 (Recovery I)	14%	1%	2%	12%
1966-76 (Cultural Revolution)	5%	6%	3%	1%

**Source:** (Flores et.al, 2003:10).

Consequently, sufficient economic success could not be achieved in the period of Mao Zedong. After his death in 1976, economic transformation could be applied by economic reforms of Deng Xiaoping that will be analyzed in more detail in the next section. Moreover, there were some reasons for these economic reforms. In this context, Xiaoping wanted to restore the negativity created by Cultural Revolution. Also, the weakness of central planning economic system and the powerfulness of marked-oriented economic systems of neighboring countries were realized (Chow, 2004:128-129). In brief, economic reform period was started thanks to all of these reasons.

**PRC’s Economic Reform Period and Economic Growth (1978-...)**

After the death of Mao Zedong in 1976, Deng Xiaoping took over the government. Thanks to Xiaoping’s policies, reform and opening period started in China and it joined the global capital world. In this context, China passed from a closed market economy to market-oriented economy (Er-Rafia, 2016). Chinese economy is very destitute, inactive, centralized and segregated from the global economy previous to inception of economic reforms. China has been among the fastest growing economies in the world since passing to market-oriented economy in 1978 (Morrison, 2015). In fact, this period can be described by the motto of Xiaoping : “ it doesn’t matter if a cat is black or white, as long as it catches mice, it’s a good cat” . In other words, the “Cat Theory” is the theoretical assumption for the economic growth of China (Di, 2016).

Economic reforms were made primarily in agriculture and rural areas and they were enlarged to the whole economy specially urban economy in 1984 (Tisdell,2008:7). In this point, PRC’s economy transformed from an agrarian economy in the 1980s to manufacturing economy (Zhao and Wang, 2009:179). In addition to this, these

reforms were expanded into other areas. This was known as the third period of economic reforms after the transformation from agrarian to manufacturing economy. Private sector was strengthened. Moreover, the regulatory reforms for the banking system, the tax system were carried into effect (Ding and Knight, t.y.:4-5). Also, these reforms and economic growth have been continued by Jiang Zemin, Hu Jintao and Xi Jinping.

**Table 2.** Accounting for the Economic Growth of PRC (1977-1999)

Period	GDP Growth	Capital Growth	Labor Force Growth	TFP Growth
1977-1978 (Recovery II)	8%	7%	2%	4%
1979-1984 (Agricultural Reform)	9%	7%	2%	5%
1985-1989 (Urban Reform)	9%	10%	2%	5%
1990-1992 (Retrenchment)	9%	8%	2%	5%
1993-1999 (Deng's Reform)	10%	12%	1%	5%

Source: (Flores et.al, 2003:10).

As seen in table 2, there were major changes in China's economy. Although there was a little decrease in GDP growth according to the period of 1963-1965, China has accomplished to grow by around %9 between 1977 and 1999. Also, there was a high degree of capital growth, but the main reason of improvement was better use of resources and crucial and stabilized growth of TPF (Maddison, 2007:19). In addition to, the rate of economic growth has varied from period to period. This situation is seen in table 3 together with the reasons.

**Table 3.** Reasons of China's Periods of Growth (1978-2007)

PERIOD	GROWTH	CAUSES
1978–1979	Fast	Post-Mao investment surge; price reform; war with Vietnam
1980–1982	Slow	Government budget and investment cuts to fight inflation
1983–1985	Fast	Familand tenure reform; rapid money supply growth; negative real bank deposit rates; enterprise investment surge
1985–1986	Slow	Government credit tightening to fight overheating; interest rates rose above inflation; banks' net new lending declined
1987–1988	Fast	Overstimulation to restore growth; rapid money expansion; price reforms; inflation; interest rates set below inflation
1988–1990	Slow	Anti-inflation credit tightening started in 1988; money supply decline in early 1989; social unrest; credit tightening hardened by 1990
1991–1996	Fast	1989–1990 anti-inflation period officially ended; 1991 credit expansion; 1991 investment real growth jumped to 15 percent; 1991–1992 food price increases; ration coupons ended; 1994–1996 rural boom overpowered urban anti-inflation tightening
1997–2000	Slow	Absolute declines in rural consumption overpowered urban safety net gains; increasingly severe government credit tightening after 1993 finally took hold; high interest rates and low or negative inflation; inventory declines; banks re-capitalized to cut corporate debt and bad loans
2001–2003	Fast	Lower interest rates; 2001 bank lending surge; 2001 inventory jump; WTO accession stimulated investment in 2002; 2003 anti-SARS investment stimulus caused overheating; real investment growth rate up from 5 percent in 2000 to 17 percent in 2003
2004–2005	Pause	Government cooling-off policies cut 2005 domestic real demand growth from 10 to 8 percent; investment growth rate fell from 17 to 9 percent; grain price adjustments boosted rural consumption growth
2006–2007	Fast	Inflation initially controlled; domestic demand real growth recovered to 10 percent; trade surplus contributed 2.6 percentage points to 11.9 percent total GDP growth; interior provinces, many with little trade, all had double-digit growth; inflation threat appeared in 2007

Source: (Keidel, 2008:3).

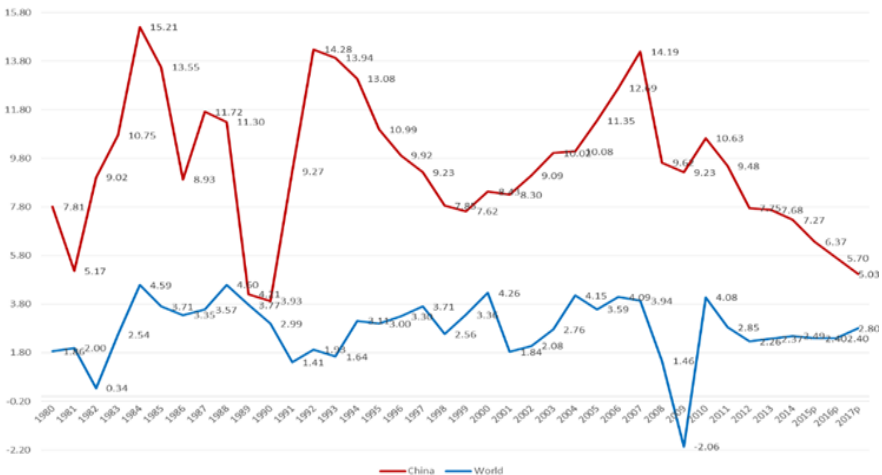
Consequently, market institutions and incentives that did not find in socialist planned economy were created by economic reforms. Also, the balanced allocative efficiency and dynamic factor accumulation were fostered by these reforms (Ding and Knight, t.y.:5).

### The Sources of Economic Growth in PRC: GDP and GDP Per Capita

Gross domestic product and gross domestic product per capita are one of the major indicator for economic growth. As seen from figure 2, annual GDP growth (%) of

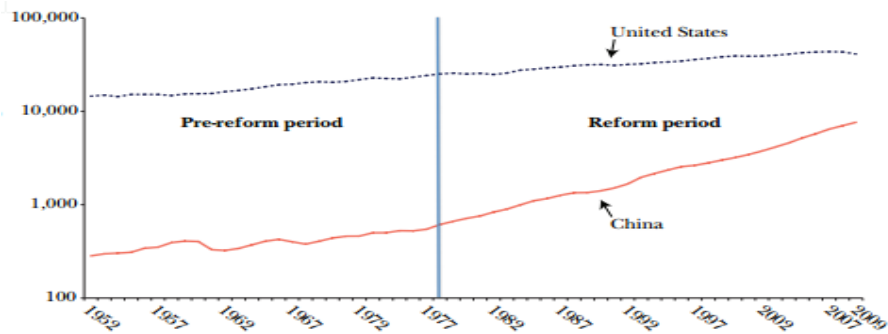
China from 1980 to 2017 is %9.45 on average. This ratio is higher than the annual GDP growth of world. In fact, China sustained %9.23 economic growth even after the 2008 economic crises. The impact of the economic crises on China was smaller than on the Japan, Germany, United Kingdom and USA that are the main industrialized economies. Within this context, while these large industrialized economies experienced negative growth, China continued to grow rapidly (Yao and Chen, 2009). Also, as seen from figure 3, GDP per capita of China has shown an increase especially since 1978. Besides, China is the second largest economy by looking at both GDP size and GDP per capita after the United States by the end of 2012.

As seen from figure 2, there were three peaks for annual GDP growth of China, in 1984-1985, 1992-1993 and 2006-2007. These upheavals reflected the intense effect of newly reforms period. In other words, the green light was given to open-door policy. Moreover, as seen from table 2, there was a big recession between 1989 and 1990 thanks to the surge of inflation, social unrest and international ostracism because of political reasons (Ding and Knight, t.y.:5). It can be said that it is seen as a reflection of political problems in international platform on the economy.



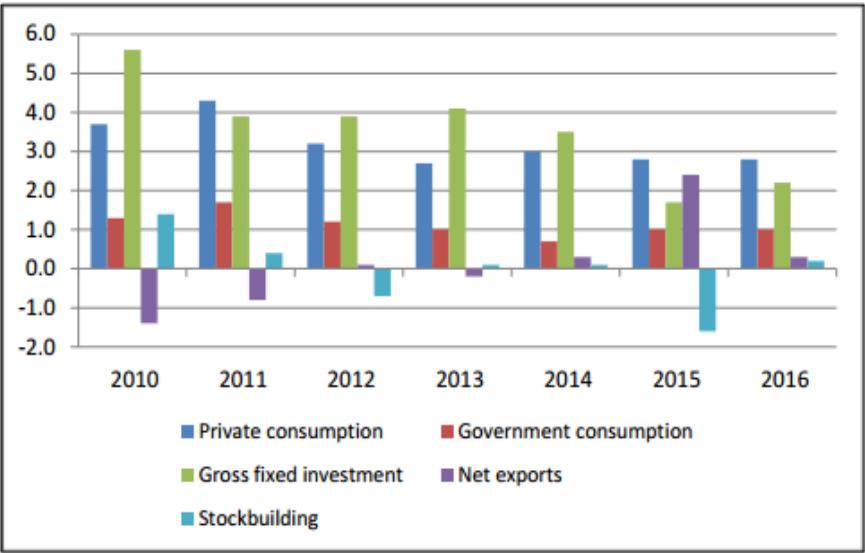
Source: World Bank Data.

Figure 2. China vs. World: Annual GDP Growth in % (1980-2017)



Source: (Zhu, 2012:15).

Figure 3. GDP Per Capita of China and USA (1952-2009)



Source: (Morrison, 2015:32).

Figure 4. Sources of GDP Growth

In addition to these analyzes, as seen from figure 4, there are the sources of GDP growth that have an impact on Chinese economic growth. In this context, it is seen that the gross fixed investment increased GDP growth highly in general. Also, private consumption was the largest factor to GDP growth in 2015 and 2016.

### **High Savings, Investments, Industrialization and Cheap Labor**

Investment (Capital Accumulation) has a significant role in economic growth of PRC. The national savings like heavy industry and infrastructure and large-scaled capital investments that is financed by foreign investments are also crucial factor in economic growth (Angresano, 2009: 337). In this context, arise in output has been caused by new machinery, better technology and more investment in infrastructure (Hu and Khan, 1997).

As mentioned above, one of the major determinant of economic growth is the level of savings. In this context, China's rapid growth is also encouraged by the high savings. The ratio of savings to GDP increased during the process of industrialization. In fact, as seen in table 2, China has a very high savings rate when it is compared to other countries. In addition to this, the savings rate is higher than investment rate in general during the reform period. China's trade surplus and a vast amount of holdings of foreign assets are constituted by this situation (Yang, t.y.:13-14).

China has one of the highest capital formation rates in the world. The increasing rate of capital formation is resulted by high savings and huge capital inflow (Wang et.al, t.y.:3). The average rate of capital formation increased from %36.4 of GDP in 1980s to 41.12 in 2000-2010. Also, this ratio is explained as %45.67 in 2015.

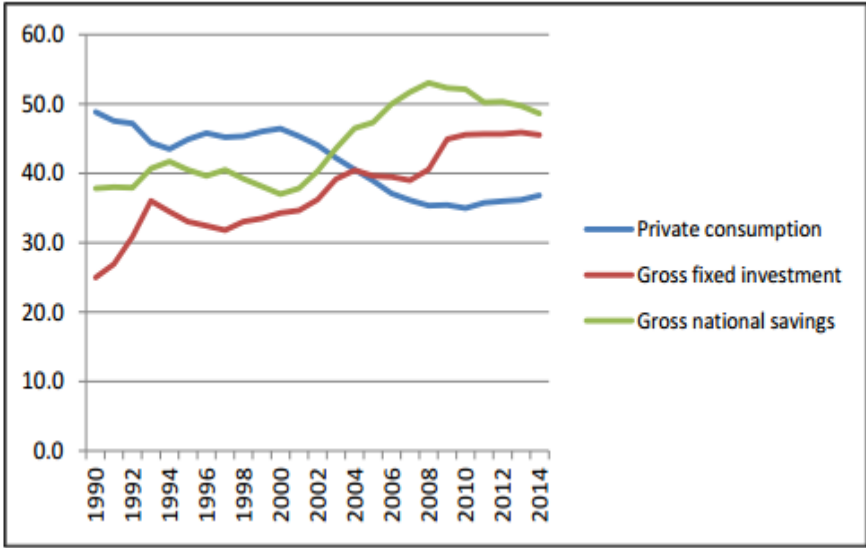
**Table 2.** International Comparison: Rate of Savings to GDP (%)

Country/Year	1960-69	1970-79	1980-89	1990-99	2000-2011
China		30.5	34.7	40.9	47.4
United States	19.9	19.6	17.8	17	14
Japan	35.3	35.6	31.8	30.7	25.4
Korea	8.7	22.3	26.5	35.1	31.5
Singapore	-4	28.6	41.7	48.2	43.9
Malaysia	21.9	27.1	30.2	40.7	35.5
Thailand	18.7	22.3	31	35.3	29.6
India	12.5	17.9	20.5	23.6	31.6
Egypt				22.6	19.9
South Africa	23.5	25.5	25	16.7	15.4
Brazil	16.8	19.35	19.8	16.8	16.6
Argentina		26.5		14.9	24.4
United Kingdom		20	17.6	15.7	14.4
Germany		23.8	20.6	21.4	22.6
France		24.1	18.9	19.8	19.6
East-Asia		27.8	31.6	36.4	29.5
European Union	12.9	24.8	24.1	22.6	20.2
High income	25.6	25.5	23.1	22.8	19.6
Middle income		25.3	25.7	25.3	28.5
Low income	11.3	17.3	19.6	20.7	22.6
World	24.5	25.3	23.4	23.1	21

Source: (Yang, t.y.:13)

As seen from figure 5, Chinese gross savings and gross fixed investment increased prominently although private consumption as a percent of GDP decreased rapidly. In

this context, gross savings and especially gross fixed investment were the main engine for the economic growth of China from 2000 to 2014.



Source: (Morrison, 2015:31).

**Figure 5.** Chinese Gross Savings, Gross Fixed Investment and Private Consumption as a Percent of GDP (1990-2014)

On the one hand industrial production, the establishment of highways, harbours and telecommunication settings are also crucial factors for the economic growth of PRC. In fact, economic growth is affected positively by the production of steel, oil and chemical substances (Angresano, 2009:337-338; Dai, 2006:7). On the other hand, the cheap labor and strongly productivity growth are other factors for economic growth (Overholt, 2010:23-24). In this context, PRC is a crucial leader making production at low cost thanks to cheap labor, advanced technology and foreign direct investments (Palley, 2005).

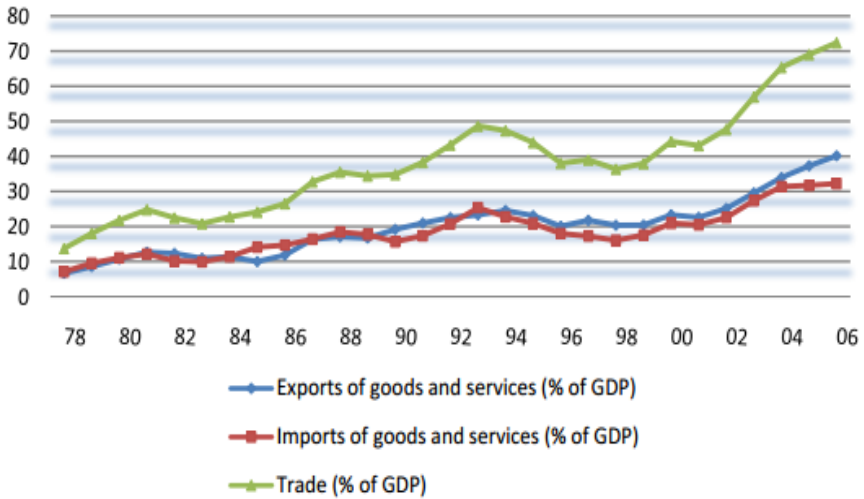
## **Accession into World Trade Organization (WTO)**

The accession of PRC into the WTO in 2001 is a milestone for the economic growth of it. In other words, the economic transformation of China is fueled by its membership into the WTO. PRC's GDP increased from 1.33 trillion \$ to 10.86 trillion \$ between 2001 and 2015 (Corre and Pollack, 2016:7). Investment climate has been changed, the rate of import, export and foreign direct investment have been growth by the accession into WTO and the crucial reforms (Zhao and Wang, 2009:179;).

Going-Out Strategy begun in the late 1990s under the President Jiang Zemin, it was accelerated by Hu Jintao, following the entrance of PRC into the WTO. In this context, a two-sided strategy is developed: comprehensive purchases and investments in resource-rich areas, and a splendid progress in the export of Chinese consumer goods (Corre and Pollack, 2016:7).

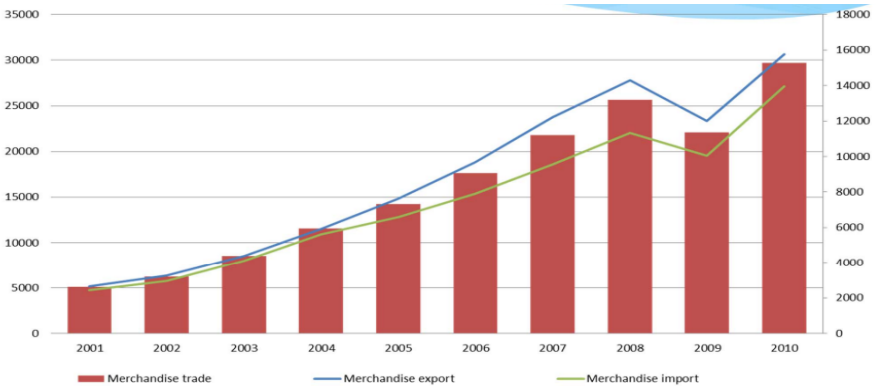
According to WTO, China is now:

- the second largest economy in the world according to GDP terms ( after USA)
- the largest merchandise exporter
- the third largest merchandise importer (The EU is the second)
- the fourth largest commercial services exporter
- the third greatest commercial services importer
- the first destination for inward foreign direct investment (FDI) among the developing economies (seen in figure 8). The greatest source for outward FDI among the developing economies (seen in figure 8) (WTO, t.y.).



Source: World Bank Development Indicators.

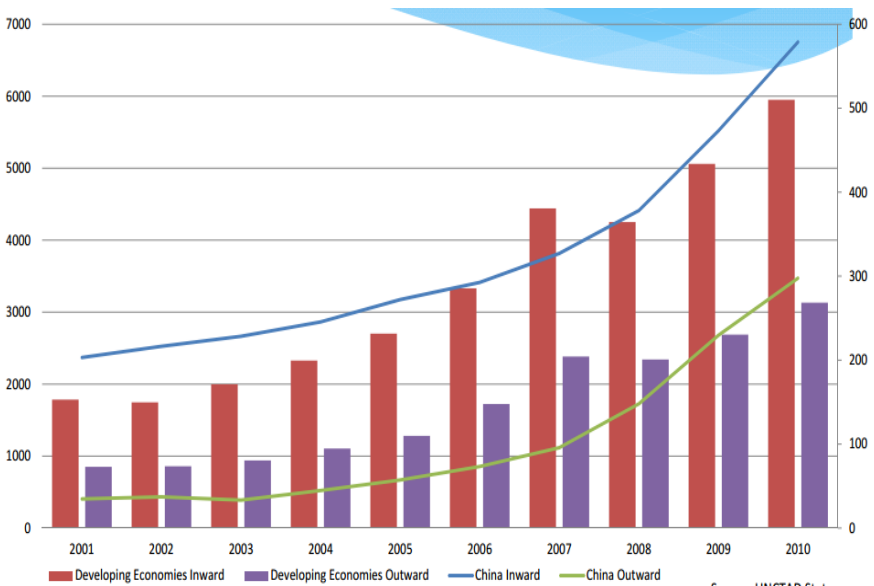
Figure 6. Trade Volume of China



Source: (WTO, t.y.).

Figure 7. PRC's Merchandise Trade during 2001-2010 (in billion USD)

Figure 6 and 7 shows the China's trade volume outputs. In this context, we can see the trade volume of China before the accession of WTO and after the beginning of reforms period in figure 6, and after the membership of China into WTO in figure 7. In 1978, as seen from figure 6, total trade of China was over 10% because of the trade liberalization beginning and it was over %40 after the accession of WTO in 2001. In fact, this ratio reached the highest level, over %70, in 2006.

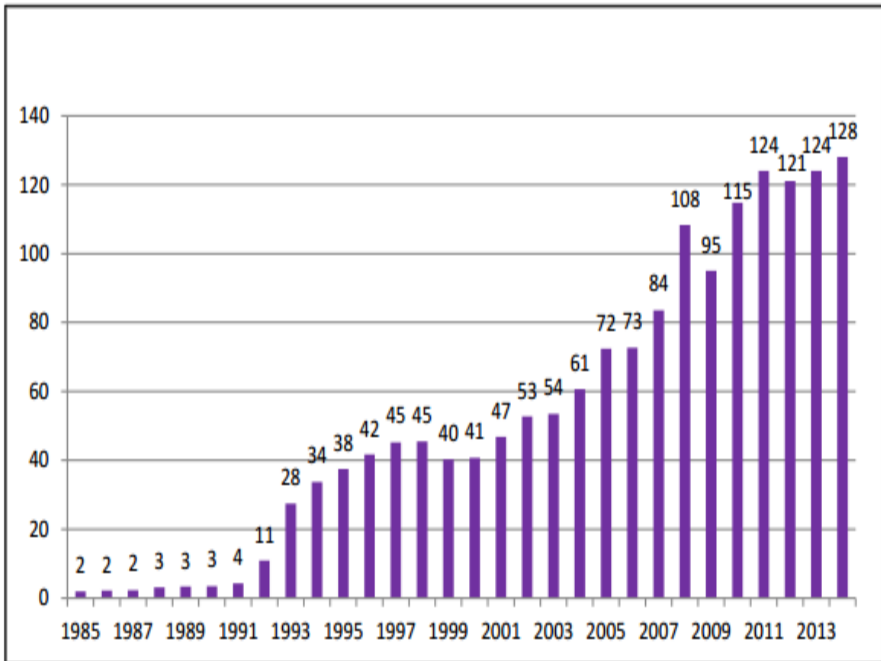


Source: (WTO, t.y.).

**Figure 8.** PRC's Inward and Outward FDI Stock during 2001-2010

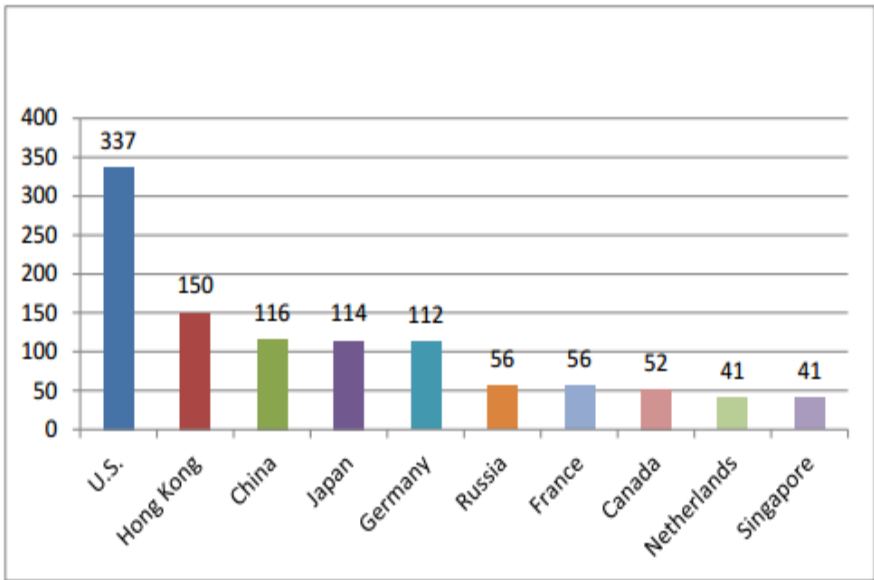
Foreign direct investment has been expanded sharply in China since its economic reforms in the early 1990s (Yue, 2008:439-440; Morrison, 2015:12). While the annual inflow of foreign direct investment was 3.5 billion \$, this ratio rose to 60 billion \$ in 2005. Also, the total inflow was more than 620 billion \$ between 1978 and 2005 (Maddison, 2007:19). Moreover, this ratio was 1.630 billion \$ between 1985 and 2014, as seen from figure 9. The expansion of Chinese exports is also fuelled by foreign direct

investment. In this context, PRC's FDI policy has been advertently exercised towards export-oriented FDI. Consequently, FDI firms have become a main exporting group (Chen, 2011:16) and FDI is one of the major contribution for the economic growth of China. Moreover, as can be seen in figure 10, China is the largest source for outward FDI. In fact it was the third largest source for outward FDI just after USA and Hong Kong in 2014.



Source: (Morrison, 2015:14).

**Figure 9.** Chinese Data on Annual FDI Inflows to China:1985-2014 (\$billions)



Source: (Morrison, 2015:19).

**Figure 10.** Major Sources of Global FDI Outflows in 2014 - \$ billions

**Conclusion**

PRC that was founded in 1949 gained economic independence thanks to the state policies and five-year compulsory development plan that has been implemented since 1953. On the other hand, the pace of the economic growth was not improved because of the famine in the period of Great Leap Forward (1958-1961) and politic, economic and cultural problems in the period of Cultural Revolution (1966-1976). PRC has started to perform economic growth model that is termed as free market economy in order to compensate the destructive economic and social effects of the Cultural Revolution and to achieve rapid growth and prosperity. Reform period started with the strategic decision that was taken in the period of Deng Xiaoping. This reform movement caused a significant effect over the growth of China.

Annual GDP and GDP per capita growth, high savings, investments, cheap labor, high net exports of goods and services and high foreign direct investments create a crucial impact over the Chinese economic growth. In this context, not only the growth model of China that has been developed by economic reforms and but also the accession of China into the WTO in 2001 played an important role to transfer Chinese economy into the global market.

Consequently, China has achieved an enormous economic growth owing to the market-oriented economic reforms and opening-up strategy for over the past 35 years. When economic data are analyzed, it is witnessed that China has achieved to be second largest economy in time by GDP size subsequent to USA. It is the largest merchandise exporter, the first destination for inward FDI and the greatest source for outward FDI thanks to opening-up strategy. In brief, all these phenomena demonstrate the rise of China as a significant eco (economic)-power and the success story of Chinese economy in global world. In this context, the economic transformation of China has continued to affect not only China, but also the world states.

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# 8 | Economic Threat of Globalization: Crisis Generation Mechanism

*Halim TATLI*  
*Mahmut ERDEM*

## **Abstract**

*The Great Depression and the economic and social destruction that followed the Second World War, showed how much the countries were affected by each other and how much they needed each other. In addition, the economies that have completed the industrialization process have sought to get every type of opportunities out of domestic markets for taking advantages. Thus, a new economic order that deals with the world as a whole is becoming a prevailing in the economic field as well as being a political area through international organizations. Today, some positive and negative effects of this order are evaluated in the context of the concept of globalization. This study examines the risks that globalization has for countries in the sense of the economic crisis, a process in which new relations are developed on the earth. Analyzing 1997 East Asian Crisis, the link between economic globalization and financial liberalization will be explained according to economic indicators.*

**Key Words:** *Globalization, Globalization and Crisis, Globalization and East Asian Crisis, East Asian Crisis.*

**Jel Codes:** *F00, F60, O10.*

## **Introduction**

**I**s globalization a threat at the same time? This phenomenon, which has been intensively on the agenda since 90's, needs to be questioned with this dimension. Because globalization, which can be identified with neo-liberal philosophy, has brought political and social as well as economic interaction. It will not be wrong to state that this integration brings also along with many advantages and opportunities that they will be at risk and cost in uncertain proportions and amounts. Hence, in order to understand the effects that this phenomeon has created and will have, it is necessary to treat the phenomeon as a process based on mutual interaction.

After the Second World War, the ecomonic policies implemented by the new institutions that resulted in the regulation of the world economic system and the post-1980 globalization and liberalization of the capital movements gave a new dimension to the crises in the world economy (Topçu, 2015). In particular, the crises that ocurred in the 1990's are contemporaneous with globalization, in today's sense and recently these concepts have been discussed together. The influence of globalization on crisis transmission and spreading has become a debated topic, but the mechanisim of the crisis creation by the parameters of the globalization has become open to debate.

The globalization is a phenomoen handled by different branches of science. Therefore, a common defination of this phenomeon is not reached. However, it became possible to evaluate the causes of birth over the phenomenoa it carries and effects it creates. After this introductory section which will shed light on the subject of the study, it will be explained what the globalization is and how it is perceived. In the next section, the measure of globalizaition and globalization indices will be briefly discussed without going beyond the scope of this topic. In the economy- politics section of globalization, with the aim of bringing a different point to view it will be explained what globalization will bring about as a process, and who will gain more benefit from this situation and who will be the victims of those. In the last part, the relation of the parameters carried by the East Asian Crisis (EAC) to globalization will be explained and a general evaluation will be made in the conclusion section.

## **Globalization**

Interaction and division of labor between individuals has been a necessity since the existence of human kind. As a matter of the fact, according to Ibn- Khaldun whose sociology is considered to be supreme place, the human being who needs to be fed and able to produce within it; it is not always possible to do all these thing on their own, even if they have the ability to carry out these process, but sometimes they need to spend a lot of time and effort, and for this reason people have to come together and joint activities. As a matter of the fact, according to Ibn Khaldun whose sociology is considered to be basis of sociology by social synthtesis that he had done in early period, human beings should be fed and procude in order to sustain their life; it is not always possible for them to do all these things on their own and if they have an ability to do all these things alone, but sometimes it takes a lot of time and effort, so people have to come together and participate the joint activities (Khaldun, 2004). How individuals are engaged in common activities to meet their needs, such as nutritution and housing in a more rational way, and if they engage in interaction, socities can also interact and come together around common interests, primarily tribes, modernly called states. The interaction of socities or masses on a plane can be consireded as a first step in understanding the phenomeon of globalizaition.

As we have said before, evaluations regarding with globalization which is being a multidimensional and comprehensive phenomeon is quiteily various; it is possible to evaluate casuses of birth, the events it carries and effects it creates. Undoubtedly, the globalization as origion is based on more ancient times, widespreadly on the basis of the bipolar world. Prior to this period, the concept of nation-state, liberalizations in the foreign trade and financial sector intensively despite to protectionist model of economy, with the multinational corporations insreasing their regional economic cooperations and influence, this process becomes the main indicator of globalization in today's sense and at the same time it distinguishes this period from other periods in the terms of the concept of globalization (Şenses, 2009). Naturally, it is necessary to evaluate this period in the name of understanding what globalization means in the present sense than to see it as the birth or beginning of globalization. Namely, with the collapse of the Soviet Socialist Republics (USSR) in 1991, the confidence in this model decreased. At the same time, this leads to increased confidence in the predictions of the neoliberal movement. This situation has led to a consicious liberalization. By means of capital and

increasing technology, the low-cost commodities now have opportunities outside the domestic markets, which have almost reached the point of exhaustion.

Different definitions have been made for the different spheres of science and for the globalization that is of interest to people. Giddens (2013), a modern society- scientist while defining the globalization; local developments are as a network of connections and a concentrations process between social contexts or regions shaped by developments around the world, on the other hand Journalist and writer Friedmasn (2000) argues that we should not regard it as a globalized phenomeon or a transient orientation, but an inclusive international system that shapes the internal and external relations of almost every country today.

Another scientist like Vujakovic (2010), Samimi (2011) sees the globalization as a process of increasing interaction and interdependence between economies, socities and international distances and according to him, the globalization is comlex process that affects different aspects of our lives such as economic, social, enviromental and political areas and includes reducing cross- border flows of goods and services, international flows of capital, tariffs and trade barriers, migration and cultural transformation and spreading of technology and knowledge beyond borders. On the other hand, Nallari (2009) , who is now a manager at the World Bank, says that it has been increasingly free flow of ideas, people, goods, services and capital, while the global system is “a financial system’ managed by a creditor” in the terms of developing countries.

Based on these definitions and explanations, we can say that the process of interaction is based on mutual interest at the state level and at the individual level, moving away from the nation state model and liftingf the economics borders the by the way of transactional corporations.

## **Measurement of Globalization**

Regarding how globalization affects us, it is necessary to measure not only understand its effects, but also to manage it (Samimi, 2011). In addition, various indices have begun to be developed in order to shed light on this issue, which has frequently been discussed by its supporters and their opponents, the postive and negative impacts and make it clear by comparing macroeconomic indicators.

Not only because of mutual cultural, political and social interconnections of nations, but also because of the increased economic interactions, this complex structure of globalization, which is a process that develops the network of direct and indirect relations among individuals makes difficult to measure the globalization as country-based (Arribas et al., 2009). A Standard method has not been developed on the indicators to be used in the measurement of globalization involving these multidimensional and complex processes (Samimi, 2011) and therefore many different indices have been developed as shown in Table 1.

**Table 1.** Measuring Globalization Indices And Comparing Them

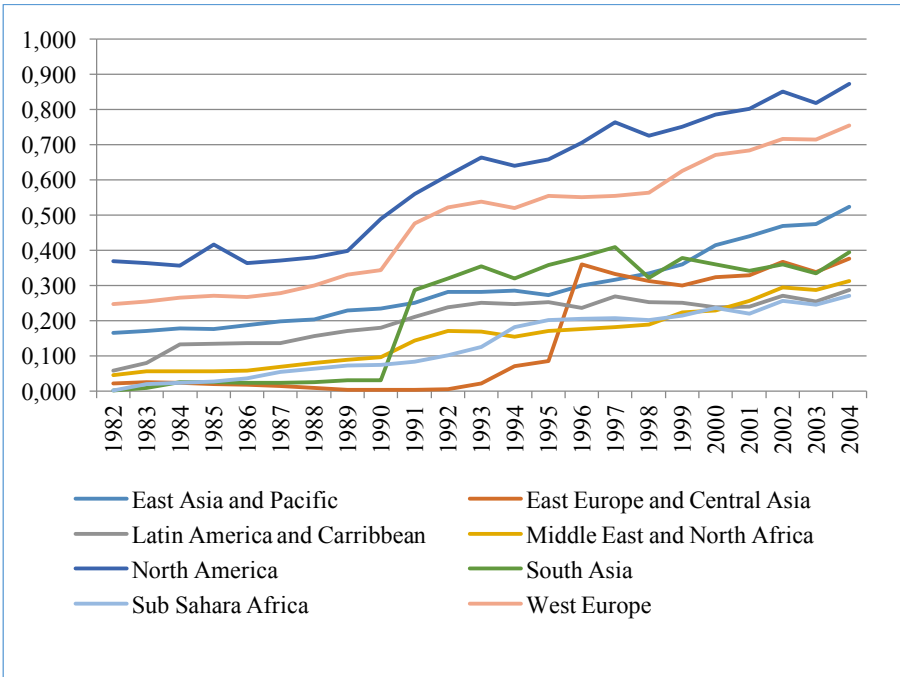
Index	Years	Number of Countries	Number of Indicators	Economic Globalization					Social Globalization			Political Globalization		
				Portfolio Investments	Foreign Direct Investment	Outward Openness	Tariff and Capital Restrictions	Geographical Distance	Cultural Structure	Information Communication	Environment	Membership in International	Participation in the United Nations Mission	Consulates in the Countries
KFP	1971-2007	72	12	-	+	+	-	-	-	+	-	+	+	-
KOF	1970-2011	207	23	+	+	+	+	-	+	+	-	+	+	+
CSGR	1982-2004	62	16	+	+	+	-	+	-	+	-	+	+	-
MGI	2000-2012	117	11	+	+	+	-	+	-	+	+	-	-	-
NGI	1995-2005	70	21	+	+	+	-	+	+	+	-	+	+	+

\* KFP, KOF, CSGR, MGI, NGI, respectively; Kearney/Foreign Policy, KOF = Swiss Economic Research Institute, Centre for the Study of Globalisation and Regionalisation, Maastricht Globalization Index, New Globalization Index.

**Source:** It was obtained from Hayaloğlu P., et al. (2015)'s work.

Table 1 focuses on different indices and some indicators at the country level compared over the years. As shown Table 1 for the understanding and comparison of indicators contained in the indices, criteria and indicators differ from each other. In order not to go out of this subject, even though the indexes are not mentioned individually in this

study, the CSGR index data will be used to see the global level of globalization in the worldwide. Claimed by (Samimi, 2011) CSGR index same with KFP to be index creation prodecure and to be complementary to the KFP, measures the economic, social and political dimensions of globalization for 62 countries annually using 16 variables developed by the center for Globalization and Regionalization of the University of Warwick in the period 1982-2004. Using the data of this index in Table 1, the globalization level of 8 different locally sperated regions of the world are shown.



Source: It was prepared by the authors using the data obtained from study The CSGR Globalisation Index: an Introductory Guide, Centre for the Study of Globalisation and Regionalisation Working Paper 155/04 of persons Lockwood, B. and Redoano, M. (2005).

**Figure 1.** According to CSGR index, annual globalization levels of world regions between 1982-2004

Considering the commence year 1982 of the date of the index according to Figure 1, there is an increase in the level of globalization in general as of years, as the regions carry

globalization parameters. Due to this increase same effort all regions, and that the globalization is a driving factor with reciprocal interactions reinforcing each other. In addition, the short-term downward break in 1997 in East Asia and Pacific region, we can say that it is a reaction to the East Asian crisis that took place in the same year.

### **The Economy- Politics of Globalization**

As the globalization becomes a product of a direction, with a growing network of industrialization and technology and also science that entering into service of capitalism, it lives a self-sustaining process. The globalization within self-sustaining Neo-liberal policies and institutions, has weakened the immune system of underdeveloped and developing countries with its interaction, has reduced resistance and has increased its fragility. Namely, it is the economy-politics of globalization that sees low-developed and developing countries as direct market with low production level and high costs at the same time those are the advanced economies and companies, which have completed industrialization process, have high technological possibilities and are leading the world economy.

The globalization is becoming an opportunity for capital. For the capital that it is seeking to find new possibilities outside of the exhausted domestic markets, the underdeveloped and developing countries are treated as field that will serve to industrial law. The profit-intentional capital is trying to produce first and then market. The products produced with the high technology and low cost and tried to be entered into these markets are entering at lower prices than products sold at higher prices due to higher costs in these markets and naturally this excludes out of the play the true owner of this market. Competition in these areas is no longer among their own producers, but among multinational corporations. The most crucial of this situation is that the producers of these countries are left out their market without opening out and in those markets, industrialization and technology remain at low levels.

With a simple example, in the mercantilism school, it is assumed that superiority or power of two states are based on their precious metal and the mineral resources in the country available that are also limited. According to this fact, these countries, in order to be superior to each other, they will want to add their own treasure valuable resources of each other and they will do it through foreign trade. One of the two countries will sell their goods cheaper than to other and will buy precious metal from it

At this point, such a trade would be extremely reasonable for everyone. This will be reciprocal transfer by the reason of commodities coming from outside at a cheaper price and the consumption will be prosperous. However, the country reaches the precious metal depletion point, the trade situation of exporter from the country side will be removed and the exporter will head to other markets. Now it is reached to crucial point. Demands for domestic goods have decreased as goods coming from abroad are demanded more and production mechanism have been getting weaker and the production has naturally come to standstill. Now the goods do not come cheap from outside as like old one and precious metal stock are getting on decrease. Individuals who have had welfare for some time come to the point of no consumption. It is inevitable that local industries that are not accustomed to compete the world and are affected negatively by the introduction of higher quality and cheaper foreign products into market (Acar, 2002). Such like a trade is a zero –sum game. In other words, there will be a winner, but other must lose for his win. This phenomenon which can call neo-liberal globalization in today's sense, seems to be no different in practice. The main objective of the neo- liberal philosophy that defends the free market economy by reducing the state's role in the economy is the high profitability of private sector. The capitals that make a move to direct or indirect investments that make high profits, are quickly withdrawn from these regions, and even if it is not an indicator that could create a crisis behind them, they will face these countries in a possible crisis environment. Moreover, the capital in a such environment where the economic and financial infrastructure is not sufficiently sound, will often increase the vulnerability of these countries' economies to profit from speculative gains, without converting the capital to permanent or added value deposits.

The defenses of those who refuse to accept this claim, or those who think otherwise, has been observed to gain benefit from the globalization and achieved high growth rate. It is necessary to state that there is no wrong point in their defense or in their defence of this opinion. Indeed, Stiglitz (2009); Explaining the effects of globalization on the economy alone; explains the positive effects of globalization by saying that the demand for goods of a country is not limited only its own markets, that the investments of a country are not limited to their own. However, looking the philosophy of this process it is obvious that those who play main role want to see underdeveloped and developing countries constantly in the same position. The immigrant problem, which has been on the agenda lately, is shedding light on this issue. Namely; A majority of developed and developing countries are concerned about immigration attitudes, human rights, etc. These things are left aside, When handling the issue from the economic point of view,

the globalization will be seen to be unique only to capital and corporations. One of the economic production factors, the labor force which is the counterpart in practice as human being does not find a place in the so called-global world as a machine, a robot, or a few pieces of paper. While the conditions for free circulation of the capital on the earth are exceptionally ready, for labor that can be described as unskilled, except for highly equipped labor, even when it comes to life struggle, the point of view does not change. So it would be wrong to think away from the interest of the relations established in the international arena both economically and politically. Indeed, it is not possible for this assistance to be regarded entirely as a goodwill-gesture, considering that the unsold goods in the hands of Marshall Plan in 1947 and monetary aid sent for reconstruction are only aimed at the developments of regions to which they are sent without their own interests. On the one side there is a war-torn and almost exhausted continental Europe and some neighbors that are in the same position, on the other side there is America which has industrialized, producing and growing economy but can not sell it, while others are fighting. Of course, for the question "How is an opportunity best assessed?". The Marshall Plan is a good example for long-term investments that can lead an example for the whole world.

### **East Asian Crisis**

Today's globalization means a process that is rising on the basis of multi-faceted world project and is shaping that neo-liberal theory directly or indirectly reforms of all economic structures (Kılıç, 2008). Although it is a natural ending to the reduction technology and transportation costs, nowadays globalization is driven by a number of free market-oriented policies by breaking down its form and reducing its share in the economy. Increasingly differentiated financial liberalization and globalization in the years after 1980; bring to the fore a short-run, speculative model of dividing away from real investment behaviour, it deprives from ability to produce solutions on an understanding based on technical analysis, away from real problems like unemployment, investment, growth, exports by indexing national economies to the artificial ups and downs of stock of exchanges and transforming them into "casino capitalism" (Yeldan, 2013). Negative internal and external financial regulations and practices such as move of interest controls, reduction of the compulsory reserves, the facilitation of market for both domestic and foreign banks, and the liberalization of capital movements have significantly increased the interest, Exchange rate, liquidity and solvency risks of banking system (Karabulut, 2002). Increasing interest to attract capital from most

developing countries to the flow of capital among the countries brings the economy of the country fragile in speculative capital outflows for those countries in the future (Topçu, 2015). An environment in which the capital is so globalized but labor is not globalized undoubtedly represents the globalization of capitalism and the globalization of capitalism has spread the crisis-making mechanism inherent in the market system to the whole world (Eğilmez, 2016). In the post- 1980, the economies have constantly faced with financial crises as a result of change in the capital movements that are accelerating with globalization, weak macroeconomic indicators, defective economic policies, inadequate financial infrastructure and insufficient control, moral hazard, asymmetric information inaccurate predictions of market actors (Kibritçioglu, 2001). Especially in 1990s, International financial system has started to suffer a lot of financial crises; Europe Monetary Crisis (1992-93), Latin America "Tequila Crisis" (1994-95), Turkey Crisis (1994), East Asian Crisis (1997-98), Russia Crisis (1998), Brazil Crisis (1999), Turkey Crisis (2001), Argentina Crisis (2002). Kaminsky ve Reinhart (1999), Although there were more crises in 1970s than 1990s, it has been told that the number of banking crises experienced in 1990s was about three to four that of 1970s banking crises and they showed that in 1990s there were more complex and unqualified financial market than 1970s. Fixed or linked Exchange rate systems, intensive capital inflows and outflows, and macroeconomic indicators of uncertainty play role in all other crises except for the European Monetary Crisis, as well as the peculiarities of each of these crises of the 1990s (Delice, 2003). The following discussed the DAC which is discussed in the terms of its causes and consequences, and which has been sourced from many many different causes and in which neoliberal globalization has been seriously tested.

EAC is one of the controversial crises that is a financial crisis in nature. Regarding with this crisis there are many different claims and it is possible to find supporting these claims. Because the indicators are different from each other and it is easy to put forth the arguments after the crisis. Therefore, opinions on the origin of different causes can be often supported by the data. However, in this section will be focused on one of the controversial aspects of the EAC, whether the crisis is caused by the structural problems of countries or external problems. The analyzed made the data presented will be addressed through the countries most affected by the crisis calling as ASEAN-5 (Indonesia, Malaysia, Thailand, Philippines and Republic of Korea) (Chang ve Velasco, 1998).

The crises that lived in 1990s are the result of speculators' speculative attacks, even though there is no imbalance in the economy, the authorities are not in the necessary

precautions about foreign exchange and they are in the class of crisis called as "Second Generation Crisis" in the literature (İlhan, 1997). As a matter of fact, if we look at the development of the EAC, it is seen that it is originated from a more speculative environment. Internal and External speculators stated that from the beginning of 1997, Thai Baht was overvalued, and the anticipation that the country would lower Bath's value in order to increase would begin to become a ruler (Turan, 2011). This speculation exception was a sign that the conditions for currency speculation have begun to mature. This exception which is a guide, brought a wave of speculation for Thai Baht in the same period. The Central Bank of Thailand has for a time resisted the use of foreign exchanges reserves to protect the value of domestic money. However, the fact that these efforts did not work together with the decrease in the amount of foreign currency brought about the end of this struggle and the Baht released on July 2, 1997, devalued the high rates and brought the crisis. The crisis in Thailand has quickly spreaded to other regions, with financial transactions being integrated and the capital being globalized.

EAC has been a crisis, unpredictable by any person or organization before the crisis. Krugman (1999) reported that only the "marginal productivity of Asian countries" would fall and that they might be able to achieve growth rate like those of former counterparts, because EAC was a crisis that no one including himself could predict (Krugman; 1994). Nevertheless, he did not consider the possibility of a crisis. Because, before the crisis, there was no macroeconomic disorder that could point to the crisis. For this reason, different indicators that lead to the development of the crisis need to be examined.

The problems and weakening in the financial system, which play a key role in the Asian Crisis has increased the fragility of the financial system, thus making the financial system weak and leading to international panic, and it became more vulnerable to the adverse effects of these panic attacks (Samur, 2010). If this situation is disclosed; Countries need resources to invest in production and investment. While underdeveloped and developing countries do this, their resources are often inadequate. One of the most effective policies for removing this inadequacy of capital accumulation is external financial sources. In this context, they are able to benefit from the financial instrument of underdeveloped and developing international financial market (Biniş, 2010). The international financial sector is a system that compares funders and fund claimers, and is a major driver of the economy. However, Mishkin (1999) debates that

one of the parties to the financial contract does not have the same information as other party, causing moral hazard and negative selection problems and under these conditions, financial markets are no longer able to channel funds to those with the most efficient investment opportunities in a good way. Also; inadequate financial infrastructure and absence of a mechanism to ensure the security of foreign investment has led to short-term lending as an easy way out for investors (Rajan ve Zingales, 1998). Therefore, we can accept that short-term rather than long-term debt originated from the inadequate infrastructure of the financial (Poret, 1998). Table-2 shows the share of short-term debts in total foreign debt of ASEAN-5 countries. Accordingly, the share of short-term debts has been steadily increasing between 1991 and 1996, and this ratio has reached very high levels in Korea and Thailand.

**Table 2.** Ratio of short-term debt to total foreign debt of ASEAN-5 countries (%)

Country	1991	1992	1993	1994	1995	1996
Indonesia	18.0	20.5	20.2	18.0	20.9	25.0
Thailand	33.1	35.2	42.9	44.5	44.1	42.3
Malaysia	12.1	18.2	26.6	20.4	21.2	27.9
Korea, Rep.	28.2	27.0	26.0	25.5	51.6	50.2
Philippines	15.2	15.8	13.9	14.2	13.4	18.1

**Source:** It was taken from the Worldbank database and prepared by the authors.

There has been an intensive capital flow to ASEAN-5 countries in the years immediately before the crisis, which foreign investors find attractive with higher interest rather than many other countries, due to high growth rate and investment opportunities. However, these intensive capital flows are short-term due to the insufficient financial infrastructure and lack of mechanism by which these funds can secure themselves, this intensive flow of capital brings about a situation that could further increase financial fragility. At the same time, in the event of financial panic, the system will be further damaged by the capital move. In EAC has been showed the adverse impact of short-term foreign sources and also investment channels for itself flow. Short-term debts borrowed with foreign currency were transferred to domestic long-term investments in domestic currency. With Devaluation effect and short-term financing escaping from the crisis environment, this debt became unpaid and large-scale bankruptcies occurred in the country. The problem caused by the flow of capital is irresponsible due to lack of infrastructure and welfare. The unlimited incentives of these countries, shown with finger bound to their performance brought an air to act them irresponsible. Foreign financing, which taken out of control from the outside, was likewise transferred to insufficient sources. Banks

and Firms ignored negative indicators, perhaps thinking that the government will continue its macroeconomic performance and protect themselves. Table-3 given the ratios of ASEAN-5 capital flows to Gross Domestic Product (GDP).

**Table 3. Ratio of Capital Flow to GDP in ASEAN-5 Countries (%)**

	1994	1995	1996	1997
<b>Korea</b>				
Direct Investments	-0.3	-0.4	-0.4	-0.2
Net Portfolio Investments	1.8	1.9	2.3	-0.3
Other Net Investments	1.7	2.5	3.0	3.4
<b>Indonesia</b>				
Direct Investments	1.4	2.3	2.8	2.0
Net Portfolio Investments	0.6	0.7	0.8	-0.4
Other Net Investments	1.9	3.1	2.7	0.1
<b>Thailand</b>				
Direct Investments	0.7	0.7	0.9	1.3
Net Portfolio Investments	0.9	1.9	0.6	0.4
Other Net Investments	7.0	10.0	7.7	-12.6
<b>Malaysia</b>				
Direct Investments	5.7	4.8	5.1	5.3
Net Portfolio Investments	-	-	-	-
Other Net Investments	-4.1	4.1	4.5	-0.6
<b>Philippines</b>				
Direct Investments	2	1.8	1.6	1.4
Net Portfolio Investments	0.4	0.3	-0.2	-5.3
Other Net Investments	2.5	2.4	8.5	4.5

**Source:** It was taken from the following work: Duman (2014):Finansal Krizlere Karşı Politika Tercihleri

Foreign capitals are undoubtedly a source of financing to make economic moves by paying a price and it should be a condition. However, when looked above ration, it is obvious that the foreign capital has a tendency for speculative purpose rather than for investment purpose.

Those who tied the great contraction to the chronic structures of Asian countries, Radelet and Sachs (2000); argued that EAC arises from deficits against some of the weakness in the economies (especially short-term and debt –growth) and financial

paninc stemming from a series of panic- triggered policy mistakes. Radelet and Sachs (2000), who describes the crisis as a self-improving international panic experiment, developed a concept that creates liquidity and panic in financial system. Accordingly, when the share of short- term loans in the international funds entering the financial system increases, While the level of international reserves (shortly Central Bank) of financial sysyem is data, the system's international liquidity and deficiency through financial panic increases (Samur, 2010). If the ratio developed by Radelet and Sachs (2000) reaches level 1, this alone can not create the crisis, butit can create financial panic atmosphere and it can emerge as an element to trigger the crisis. Table-4 presents the short- term debt/reseve ratios of ASEAN-5 countries.

**Table 4.** Short-term debt/reserves ratios of ASEAN-5 countries.

<b>Country</b>	<b>June 1994</b>	<b>June 1997</b>
<b>Indonesia</b>	1.724	1.704
<b>Thailand</b>	0.992	1.453
<b>Malaysia</b>	0.252	0.612
<b>Korea, Rep.</b>	1.623	2.060
<b>Philippines</b>	0.405	0.848

**Source:** It was taken from the following work: Radelet ve Sachs (2000); The Onset of the East Asian Financial Crisis

Rates, according to 1994 data, Malasia and Philippines are at a relatively low rate, but they tend to be quite high in other countries as well as in almost most other countries after crisis. It would be wrong to say that for these ratios a crisis should ocur in the ASEAN -5 countries or that this is the reason of crisis. But it may be consisnet to show that it creates a panic atmosphere arising from the lack of international liquidity and that it will encourage a possibbe financial crisis. Samur (2010)cited that the thershold is as one of the for the unprecidtability of the crisis, it can be taken as 0.5 inseed of 1. In addition we can say that these ratios are hihgand that uptrend can increase vulnerability of financial system.

One of the controversial indicators of this crisis has been institutional goverance. Mitton (2002), in the empirical study of ASEAN-5 countries at the level of firms said that corporate goverance, an important factor in the development of financial markets, is not a factor in the crisis alone, but based on findings that a weak institutional goverance could leave countries vulnerable to the crisis. Companies aming philosophically profitable, can realize these goals in may ways (public offering,

partnership etc.) It is therefore necessary to be transparent and accountable to companies, their shareholders and other groups in the face of danger and crisis. In EAC, the boards and managements committees of bank shall play a good role and develop healthy relations with shareholders (Bonte et al, 1999). In addition, Johnson et al. (1999); in the study they conducted, found that firms based in Asean -5 countries were mostly organized in the style of family business and that individual relations with the politicians were strong, as well as many illegal allegations made by many companies during the crisis and stated that institutional governance measures, particularly the protection of minority shareholders, market value losses and stock market decline better than macroeconomic measures.

No international organization has predicted this crisis and market indicators such as interest rate changes and credit ratings were clearly ineffective in forecasting the Asian Financial Crisis (Bonte et al, 1999). The ratings given by rating agencies became high until the (See: Table- 5). The reports of national and international audit institutions showed that there were negative indicators and they did not perform their adequate level of duties in sufficient measure and level. Rahman (1998); Said that the lack of transparent, reliable and comparable financial information would not alone cause financial crunch in East Asia, but that the existence of reliable descriptive accounting knowledge would either inform the crisis or prevent the crisis from deepening. In addition, The IMF, an institution that is often discussed with gesture policies, has not warned even before the crisis, although it often expresses its pre-crisis growth figures with globalization and liberalization (Chang ve Velasco, 1998). Therefore, the failure of international institutions can be seen as a reason.

**Table 5.** Credit notes given by Standard & Poor's for the some Asean 5 countries before and after the crisis

Country	July 1, 1997	November 30, 1998
Indonesia	BBB	CCC+
South Korea	AA-	BB+
Malaysia	A+	BBB-
Thailand	A	BBB-

**Source:** It was taken from the following work: Kräussl (2000): Sovereign Credit Ratings and Their Impact on Recent Financial Crises

Looking at the Table-5, Standard & Poor organization maintains credit ratings of these four countries that have experienced the crisis just before the crisis. From this point of the view, we can see that these economies do not have any negativity. There are different reasons for this reasons; Either this organization has failed to make successful analyzes or may have originated because these countries did not have a structural problem and the crisis could not be taken as a direct indicator of the negative effects of globalization brought by globalization and did not reflect the future risks. We can not say that these institutions are very reliable, but second option seems more realistic. In addition, during the six-month period of following the outbreak of the crisis, the rating institutions have decreased the credit note Thailand's 4, Indonesia's approximately 5, South Korea's 9 place have a negative impact and supported current crises in these countries (Öztürk, 2003). Thus, contrary to this unpredictability prevailing the crisis, such harsh reactions after the crisis has led to the questioning of the impartiality and reliability of these institutions and failure of international institutions.

If, as a result of these evaluations, the development of EAC is summarized, it can be said that the crisis consists of following parameters:

- International organization failure and insufficient accounting standards and audit
- Weakness of institutional governance in companies.
- Inadequate financial market infrastructure
- Flow of Foreign Capital
- Failure of Policy (As short-term borrowings are directed towards long-term).

The causes of crisis are closely related with to economic globalization. For these reasons it would be wrong to say that the crisis is caused by the structural problems of countries. We would probably not be discussing this crisis if these problems were not caused by interaction and financial liberalization of the economic globalization. However, it is still necessary to make it clear that there is no innocent person in this crisis. Because the practices of growth and win-win in the process of liberalization have been made with insufficient infrastructure and away from institutionalism. The absence of an external mechanism to shift the capital to right investment areas transforms them into a burden. It was understood that a big economic crisis erupted that view that everything went to well for that day was an error.

## Conclusion

It has always been a matter of debate whether the benefits of globalization or harms of globalization which lift the borders between societies and economies, allow mutual interaction. It seems that this debate will continue for a long time. Since the globalization itself is a multi-dimensional phenomenon, it keeps different mechanisms together. However, the level of globalization in the terms of good and evil in the world scale is generally in a rising trend due to interdependence.

Globalization is not a worst and crisis causing phenomenon, but it carries many different parameters with risk factors for countries. These parameters which are of particular relevance to underdeveloped and developing countries, can serve consequences for them if not analyzed correctly. Although globalization offers some opportunities to underdeveloped and developing countries, it is in the benefit of more developed countries. In a situation, where the globalization is ignored and all of other countries are beginning to follow inward policies, the most negative result will be undoubtedly developed countries. Therefore, countries or economies behaving vigilantly about globalization and rationalizing their relations can prevent a bad outcome. As a matter of fact, Turkey, experiencing many crises in succession from 1990s to 2001 has experienced a deeply resilient life in the 2001 crisis, along with the regulations on banking and finance and structural reforms after 2001 crisis. Therefore, if the right policies and preferences are applied, these risks will be minimized, but the share of the added value created by globalization will be the most accurate.

The following example can be used to make the subject more clear and understanding: Building a new building on an empty plot can be less costly and more rational than upgrading an old and obsolete building or rebuilding it. You may experience unexpected results while you build this new building, you make a mistake by making wrong choices, borrowing constantly, considering the glory of the building and making an unreasonable decision. Some East Asian countries, too, did the financial liberalization which gave new life to the congested economy with its existing structure, without basing it, without questioning about the course of the economic performance. And, as a result, the base of the rotten new building was demolished in spite of its splendor.

The emergence and result of EAC, in which neo liberal globalization policies have been tested, remain a subject that other countries should consider. As a result support for local economic actors, emphasis on structural reforms, emphasis on microeconomic policy emerge as important policies in order to mitigate the effect of global crises or not to be affected by global crises.

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# 9 | The Impacts of Banking Sector on Economic Growth within the Context of Globalization

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## Abstract

*In parallel with the growth of commercial life in the world, banks have played the most active roles in financial markets in finding funds efficiently and uninterruptedly. Along with the globalization, there have been significant changes and developments in the financial sector, especially in the banking sector. This process has led to the creation of new products in the banking sector and the expansion of banking activities. In the globalization process, bank mergers and acquisitions have become widespread. The banking sector has been opened to international competition, and the entry of foreign capital banks into the market has become easier within the sector. The strength of the banking system would ensure the strength of the country's economy. Along with the growth and development of banking, the growth and development of the country's economy will increase in proportion to the same direction. For this reason, banks have a very important place in the finance sector. The general belief stems from the studies on the relationship between the banking sector, and economic growth is that with the increase in financial instruments and institutions throughout the globalization process, financial development would increase by giving support to economic growth. This study aims to reveal the developments experienced in the banking sector within the globalization process and their reflections on economic growth from a theoretical point of view.*

**Keywords:** *Globalization, Banking Sector, Economic Growth*

**JEL Codes:** *F43, G21, O16*

## **Introduction**

Banks operate as the foundations of the financial markets, and they perform many functions that affect economic growth. Banks play important roles in the growth process by increasing domestic savings and by attracting foreign capital into the country. Financial globalization has led to the creation of new services and products in the banking sector and the expansion of banking activities. Especially bank mergers and acquisitions have become widespread throughout the process of change. As a result of this situation, entry of foreign capital banks to the market in the banking sector has become easier, and competition environment has increased. The banking sector has been exposed to the international competition. This dramatic change is also reflected in the employment conditions of the financial sectors. These developments in the financial sectors have affected the economic growth process.

The aim of this study is to investigate the impact of the economic transformation called globalization on the banking sector and economic growth and to investigate its implications on the Turkish banking sector. In the first two chapters of the study, a general definition of banking is made, and the effects of globalization on financial system and banking are examined under crucial headings. In the third part, information about globalization and economic growth relation in the banking sector is given. In the last part of the study, the general view of the Turkish banking sector is examined, then conclusions and suggestions are given.

## **An Overview of Banking**

In simple terms, banks collect deposits from their customers and utilize the collected deposits most efficiently in various credit transactions. Banks are also referred as the financial institutions which make and regulate all kinds of transactions that involve money, credit, and capital. Today, banks are operating in many areas. They collect deposits; provide cash credits; make payments; maintain buys/sells and brokerage services for financial instruments; carry out domestic and international money transfers, foreign exchange and foreign trade financing transactions (Takan, 2010, p. 2).

## **The Effects of Globalization on Financial System and Banking**

Globalization is a development that enables international capital to move globally, markets to open to each other, trade to be liberalized, and international companies to be transformed into global companies (Erdoğan, 1999, p. 2). Globalization refers to transformations or changes that are experienced especially in every part of the world. Thus, it would be more appropriate to consider globalization as a type of process. Sometimes globalization transforms certain institutions, rules or facts; and sometimes it creates new ones. In the light of all these evaluations, the process of globalization can be embodied in a few examples of instant sharing of information, the excessive free mobility of financial movements, and internationalization of the firms (Düren, 2002, p. 52).

In the 1980s, outward-looking economic policies began to be implemented in many countries. In parallel to these developments, the process of modernization and restructuring of the financial sector has been initiated. The concept of financial developments includes financial innovations, namely the development of new financial instruments, the development of market structures and institutions as well as the issuance of new securities in inventories, money and capital markets. These developments lead to the intertwining of national and international systems, in turn, causing globalization. Among the important elements of the financial system are the rapid developments in computer technology and communication. With globalization, the costs in the banking sector tend to decrease, and the financial products and services become highly diversified. Also, technological developments have accelerated the payment transactions and the international transfer of securities. The two other important factors regarding the financial system, especially the banking sector, are globalization trends and innovation & liberalization in the markets. These three basic factors have led to the rapid development of the markets, the increase of globalization, the competition in the markets, and hence the increase of the types of transactions and instruments. These developments, not only helped to expand and deepen the national financial systems but also increased the integration among different financial markets (Günel, 2007, pp. 136-137). With globalization, it became easier for banks to borrow loans from banks abroad, to obtain equity from international markets, and to eliminate the restrictions on cash flows in foreign currency (Ribon and Yosha, 1999, p. 5). The changes resulting from the liberalization of the banking sector are as follows (Yağcılar, 2011, p. 56):

- The restrictions on the selection of investments and activities of the banks have been lifted. Moreover, the legal separation among different credit institutions has been canceled in order to ensure fair competition.
- The direct interventions towards the competitive behavior of banks, in terms of the control of loan and deposit interest rates, service charges and branching arrangements have been eliminated.
- The liberalization of local markets is accompanied by the loosening of the external constraints on investors and the international activities of banks. As a result of the liberalization process, effective government conservation and entry restriction practices have been abandoned.
- With the globalization, many changes and developments in the finance sector, especially in banking, have emerged. Rapid increases in cross-border financial transactions as a result of the rapid transitions have accompanied the expansion of international banking. The most important of these transitions and developments can be expressed under six headings;
  1. Bank Mergers and Acquisitions
  2. Foreign Bank Entries
  3. Competition Strategies of Domestic and Foreign Banks
  4. Financial Innovation
  5. Employment Conditions
  6. Intensifying Competition and Marketing

### ***Bank Mergers and Acquisitions***

In the 1990s, bank mergers and acquisitions became widespread and gained momentum. According to the United Nations Conference on Trade and Development (UNCTAD), the value of global mergers and acquisitions has increased dramatically in this period, with an annual average rate of 42%. The banking sector is also influenced by these developments. The number and value of mergers and acquisitions have increased significantly, especially at the end of the 1990s. Between 1997 and 2000, 1325 mergers and acquisitions have been experienced annually, with an increase of 52%

compared to the period between the years 1990-1996 (Yavuz and Akgeyik, 2010, p. 25).

Nevertheless, the scale and volume of recent mergers and acquisitions are increasingly attracting the attentions of researchers and policy makers all over the world. Recent mergers and acquisitions among major banking institutions (such as Bank of America-NationsBank, Bank One-First Chicago, and Norwest-Wells Fargo) have been nominated as the largest operations of the US history regarding their financial size (Berger *et al.*, 2002, p. 23).

### ***Foreign Bank Entries***

Foreign banks can operate in various methods by settling in host countries. These methods include; the establishment of a foreign bank after having establishment permits, correspondent banking activities, opening of a representative offices/branches/agents, affiliates/subsidiaries, bank consortiums, off-shore banking and acquisitions (Turan and Kaya, 2014, p. 40).

It is argued that foreign banks' entry into the host country firstly increase direct foreign capital inflows to the related countries as well as productivity, financial service diversity, and quality in the sector. However, there are opinions that foreign banks use advanced credit evaluation and intelligence methods, and that they provide the country with benefits by utilizing technology at the highest level. On the other hand, there are also some hypotheses suggesting that foreign financial groups and banks can prevent the loss of prestige with their support provided to partners and affiliative institutions throughout the crisis process while helping the outflow of domestic savings. Foreign banks, which are thought to have developed more regarding risk management and corporate governance and have more experience and equipment, play an important role as an example for local banking in these areas. However, the opinions of encouraging banks in the host country to reduce costs by fostering competition and inducing them to improve quality to maintain market share can be considered as other advantages of foreign banks in the local banking system (Duramaz, 2016, p. 33).

### ***Competition Strategies of Domestic and Foreign Banks***

Foreign bank entries are realized by opening branches or acquiring an existing one: Banks such as JP Morgan Chase and Deutsche Bank are thriving in a new market by opening branches. Commerzbank, HSBC, and Banco Stander are on their way to acquire existing institutions. Both growth strategies have their pros and cons. Growth by opening new branches takes time and involves risks of being foreign to local market conditions. Acquiring minority or majority shares of an existing institution requires internal restructuring and transfer of personnel/activity processes (Pomerleano and Vojta, 2001, p. 50). Also, the banking sector consolidation in Latin America is largely driven by the larger foreign institutions' acquisition of domestic banks. This process, highlighted by the financial distress phenomenon, is partly related to the less fragility of foreign banks in the face of financial shocks (Yeyati and Micco, 2007, p. 1634). The data regarding foreign bank participation and private sector borrowing supports the hypothesis in favor of foreign banks' stabilizing effects (Clarke *et al.*, 2003, p. 27).

Strategies followed by domestic banks are realized as the reflection of the local advantages in the commercial, retail and SME sectors and the competitive pressure imposed by foreign banks. The entry of foreign banks brings out technology and process transfer to the local markets. Their assets drive domestic banks to improve their banking services and encourage banking customers to demand better products and services. Domestic banks are increasingly aligning their products, services, lines of credit, reserve requirements and management methods with those of foreign banks (Yağcılar, 2011, p. 65). Services such as exchange activities, derivative business activities, cross-border securities intermediation, mergers and acquisitions, trade financing, foreign exchange, cash management provide competitive advantages to foreign banks, while domestic banks cannot be offered with the same success. Local banks, on the other hand, generally have a competitive advantage in products such as funding and know-how, which require local skills (Pomerleano and Vojta, 2001: 51).

### ***Financial Innovation***

Since the financial innovation responds to the needs with maximum competence and, at the same time reduces the costs, it appears as a decisive factor during the competition process. There are three main sources of financial innovation. Financial liberalization, public policies for credit markets and wider technological change. While interest restrictions in banking markets before liberalization had limited the ability of banks to

attract deposits and thus issue loans, the effect of restrictions on the number of branches had also narrowed the markets they served and the chances of influencing to areas in which the costs could have been reduced through scale economies. With the abolishment of these restrictions, emerging banking networks have made the fixed costs possible to be shared in the expanding market the product innovation. Thus marketing of new products has become more lucrative (Yağcılar, 2011, p. 77).

Along with technological innovations, costs have been reduced at the point of collecting, processing, distributing financial information of individuals and businesses. Nevertheless, banks are known to have developed sophisticated techniques for selecting and assessing better borrowers under the name of “credit technology,” while at the same time managing risks in general. The rapid expansion of securitization and the use of credit derivatives are also among the elements of this trend. Also, the progress of compiling large databases for borrowers within information technologies has allowed banks to measure credibility with new methods and to provide new credit products (Hardy and Tieman, 2008, p. 188).

### *Employment Conditions*

The most important problem that economies of the world countries face is unemployment. Today, there is a rapid change in the country’s economies from the industrial society towards the information society and the economic and social transformation is taking place by leaving the labor intensive workplace to information intensive production. The rapid development of production in the globalization process has played a major role in the development of information and communication technologies. Technology increases efficiency in productivity and employment relations and reduces labor demand at a certain level of production. In particular, new technological improvements lead to higher demand for high-skilled employees and greatly reduce the demand for low-skilled employees (Erdoğan, 1999, p. 5).

Globalization is seriously changing the employment conditions in financial sectors. While the transition period creates a suitable environment for the qualified staff, it threatens job security and also causes intense stress, lack of motivation/organizational loyalty. Especially in recent years, customer-centric banking concept has led to intense call center operations in the sector. Call centers further deepen the rapid change in working methods and conditions. As a result, efforts to improve the level of wages and

working conditions in the sector have become more evident in recent years. In the UK, for example, The Alliance for Finance has called for a reduction of stressful working conditions at call centers and a reduction in the labor force as a co-operative layer of workers in the sector. A similar development has occurred in the UK again. In Turkey, the Banking, Insurance, and Finance Union (BIFU) has noted that there is heavy pressure on employees and supervisors to achieve the targets and it has shown that the working environment on which the performance-based remuneration system is based is created (Yavuz and Akgeyik, 2010, s. 10).

### *Intensifying Competition and Marketing Approach*

Competition in the banking sector has led to the emergence of high levels of concentration in many member countries. Concentration rates are high in many countries, particularly in the banking sectors of small EU member countries (the largest five establishments in Belgium, the Netherlands, and Finland have around 84% of total assets). Concentration rate, however, remained relatively lower than in Germany, Italy, Luxembourg and the UK. In recent years, it has been evaluated that the concentrated market structure negatively affects the competitive market conditions. If a market is characterized as a monopoly or oligopoly, this situation raises concerns that the market power is being exploited. As a matter of fact, the banking market is observed as a monopoly structure in many EU countries (Erdönmez, 2005, p. 55).

The new expansion of the world banking sector is formed by a strong wave of mergers and acquisitions. Regulatory changes in the European Union banking directives introduced in Europe since the early 1990s, especially the monetary union launched in 1999 along with the ongoing financial innovation, would reshape of the banking sector. The main objective of financial integration within the European Union framework is to promote competition in the banking sector in the long-term. The prevailing opinion is that competition would eliminate many restrictive practices, reduce the interest differential between lending and borrowing, and thus increase the performance of the banking sector (Koskela and Stenbacka, 2000, p. 18).

Available evidence suggests that market concentrations in both the US and Europe allow banks to attain market power. Banks in concentrated markets tend to make higher profits, higher interest rates on loans and lower interest rates on deposits. Even so, a very small proportion of the overall profit differentials for the US banks can be explained by market concentration. Moreover, some studies using more up-to-date data

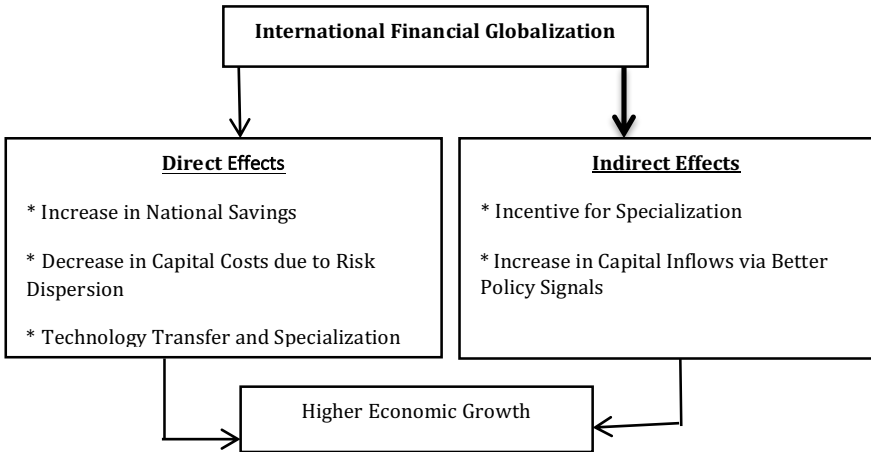
indicate that the impacts of concentration and market power on prices are weakening. The results have shown that banking markets are becoming more competitive or “contestable” depending on liberalization and technological progress (Canoy *et al.*, 2001, p. 21).

### **The Relationship between Globalization and Economic Growth within the Banking Sector**

Financial integration, defined as the integration of countries through the mediation of their international financial markets, requires liberal economic policies. In the context of the integration of financial markets, financial liberalizations are categorized into money and capital market liberalizations. Liberalization policies in capital markets are explained as the liberalization of the capital account, removal of obstacles in capital inflows and outflows, abolishment of restrictions on financial pressure policies and foreign investors which are obstructing the effective allocation of savings and savings and weakening financial intermediation. The liberalization of the money markets is expressed as the deregulation practices which prevent the attempts to adversely affect the competition conditions besides the maintenance of transparency conditions based on information flow between the financial markets, the liberalization of interest rates, the elimination of the restrictions on the banking system, and the development of interbank competition (Sever *et al.*, 2010, p. 47).

They argue that financial liberalization would be beneficial both for borrowers and lenders. In many conducted studies pioneered by McKinnon (1973) and Shaw (1973), it is emphasized that the abolition of financial constraints would make a positive contribution to economic growth. Higher interest rates in competitive market conditions would allow resources to be used in more efficient areas. Also, the reduction of reserve requirements will increase the effectiveness of intermediary services by reducing the funding costs (Berkman, 2011, pp. 260-261). Furthermore, financial globalization would create pressure on the national financial sector in the context of its ability to allow national firms to find foreign funds with easier and more convenient conditions (Galindo, Micco and Ordoñez, 2002, p. 4). Banks in the financial system play an important role in the growth process of the country's economy along with the functions they perform. With the integration of financial markets due to globalization, banks can change their growth performance directly and indirectly in economies. The direct contributions to growth are in the form of increasing domestic savings, spreading

risks, lowering the cost of capital, transferring technology and developing the financial sector, while indirect contributions consist of promoting specialization, providing better policies and signaling.



Source: Prasad *et al.*, 2004, p. 36

**Figure 1.** Channels through which Globalization Raises Economic Growth

- **Increase in National Savings:** Domestic savings are considered to be one of the key elements of economic growth, along with increased productivity and technological progress, provided that being oriented towards investing. Globalization in the banking sector can also lead to faster growth by allowing foreign savings to be used for investments.
- **Technology Transfer and Specialization in Management:** Significant increases in the share of foreign direct investment in financially integrated economies. This allows technology to potentially spread in the banking sector and provides assistance for better management practices. Hence, both productivity and economic growth increase (Prasad *et al.*, 2005, p. 25).
- **Development of Financial Sector:** The increase in foreign ownership of domestic banks can provide many benefits. With their experience, foreign

banks are able to finance their projects with international resources. In addition, foreign banks can diversify their funds through their branch networks and portfolios in many countries around the world. Foreign banks play an important role as a capital resource for the local banking systems throughout the post-crisis recapitalization period (Turan and Kaya, 2014, p. 44).

- **The incentive for Specialization:** Specialization in production process supports productivity and growth. Globalization increases the distribution of international risks and risk dispersion, and also encourages specialization (Prasad *et al.*, 2004, p. 15). Specialization would lead to increased quality and fast-paced financial transactions in the banking sector.
- **Increase in Capital Inflows through Better Policy Signals:** The willingness of an economy towards financial globalization can be a sign that would indicate more friendly policies towards foreign investors in the future. Elimination of restrictions on capital outflows is perceived as a signal, and capital inflows may also increase (Sever *et al.*, 2010, p. 49). As a result, the use of banking products with new technology would become more widespread, and the efficiency of the financial sector would increase.

### Globalization and Developments in the Turkish Banking Sector

Along with the liberal policies that started to be implemented in Turkey after 1980, the restrictions to prevent foreign capital flows are abandoned, and at the same time, the gates of the domestic financial sector are opened to the outside world. As a matter of fact, the importance of banking in the Turkish economy has increased in line with the decisions made after 1980, and foreign banks have gained momentum along with the incentives provided to the Turkish banking sector for foreign capital (Duramaz, 2016, p. 36).

Accompanied by the emergence of new financial institutions and instruments following the 1980s and early 1990s, the rapid development of financial markets in the world have also affected the Turkish banking sector. In that sense, in general, “liberal trends in global financial markets, globalization, the abolition of exchange rate controls, the liberation of capital movements, the rapid increase in the world trade, and the

improvement in communication technologies” can also be seen among the other developments that led to increase in the number of foreign banks in Turkey (Akgüç, 2007, p. 12).

As a result of the decisions made after 1980 in Turkey, the importance of banking has increased, and the foreign bank entry rate has accelerated along with the incentives provided by foreign capital to the Turkish banking sector (Koyuncu and Şahan, 2011, p. 259).

The increase in the number of foreign banks in Turkey has also been realized through acquisitions as well as through the opening of new branches in general. During the post-1980 period, the foreign banks’ desire of having shares in the capitals of the domestic banks coincided with the domestic banks’ pursuit of foreign partnerships. Factors such as the fact that most of the foreign capital companies in Turkey are internationally funded; the foreign banks wanting to financially support these institutions; and the foreign trade potential of Turkey in the coming years are other reasons why foreign banks wanted to take place in Turkey after 1980 (Soyluoğlu, 2008, p. 31).

The number of banks operating in Turkey in October-December 2016 period is 52. The numbers of deposit banks, development & investment banks and participation banks are 34, 13, and 5, respectively.

**Table 1.** Number of Banks in the Turkish Banking Sector

Number of Banks	Dec. 2015	Sept. 2016	Dec. 2016
Deposit Banks	34	34	34
Banks with Public Capital	3	3	3
Banks with Private Capital	9	9	9
Banks Transferred to the Fund*	1	1	1
Banks with Foreign Capital	21	21	21
Development and Investment Banks	13	13	13
Participation Banks	5	5	5
Total	52	52	52

**Source:** TBB (2016). \*Banks that are transferred to the Savings Deposit Insurance Fund (SDIF)

**Table 2. Banks with Foreign Capital**

Banks with Foreign Capital	Number of	Number of
	Branches*	Employees
	2,905	59,804
Alternatifbank A.Ş.	53	928
Arap Türk Bankası A.Ş.	7	288
Bank Mellat	3	50
Bank of Tokyo-Mitsubishi UFJ Turkey A.Ş.	1	70
Burgan Bank A.Ş.	49	994
Citibank A.Ş.	8	468
Denizbank A.Ş.	694	12,938
Deutsche Bank A.Ş.	1	121
Finansbank A.Ş.	630	12,451
Habib Bank Limited	1	16
HSBC Bank A.Ş.	90	3,188
ICBC Turkey Bank A.Ş.	44	809
ING Bank A.Ş.	268	5,284
Intesa Sanpaolo S.p.A.	1	29
JPMorgan Chase Bank N.A.	1	56
Odea Bank A.Ş.	50	1,681
Rabobank A.Ş.	1	34
Société Générale (SA)	1	65
The Royal Bank of Scotland Plc.	1	37
Turkland Bank A.Ş.	33	608
Türkiye Garanti Bankası A.Ş.	968	19,689

Source: TBB (2016).

Following the crises of 2000 and 2001, a decline and a steady course in the inflation and interest rates in the country with the Transition to the Strong Economy Program (TSEP) in the Turkish economy have led to an increase in the interest of foreign capital banks towards the Turkish banking sector as well as other foreign investors. After the subsequent period is realized following the 2001 crisis, the first acquisition (Demirbank) is made by HSBC with foreign capital in the sector. Five banks, including Egebank, Yurtbank, Yaşarbank, Bank Kapital and Ulusalbank which are transferred to

the SDIF after the 2001 crisis, are merged under Sümerbank that is later acquired by Oyakbank. Apart from this, three banks including Esbank, Etibank, and Interbank are merged into Etibank A.Ş., and these merged banks are transferred to Bayındırbank.

Another development in the process was the merging of Pamukbank with Halkbank. Sitebank, also transferred to the SDIF, is acquired by Novabank in 2002 and its name is renewed as Bank Europa at first and then later as Millenium Bank. Turkish Foreign Trade Bank, another bank in the sector, is acquired by Fortis Bank in 2005. Finansbank A.Ş., a privately funded bank, is acquired by the National Bank of Greece in 2006, although it is not transferred to the SDIF (Duramaz, 2016, pp. 39-40). In 2007, Tekfen Bank was acquired by Eurobank EFG. In June 2007, ING Bank based in the Netherlands that operates in different countries of the world had acquired Oyakbank which is later transferred to the SDIF.

Bank Turanalem JSC acquired Şekerbank in December 2006. MNG Bank is acquired by Arap Bank plc and Bank Med partnership in January 2007. MNG Bank's new shareholders changed its name to Turkland Bank (Işıl, 2012, p. 453). The number of foreign-owned banks in Turkey is 21 as of 2016. Fifteen of them are foreign-owned banks established in Turkey, while six are foreign-owned banks that opened new branches in Turkey.

**Table 3. Numbers of Branches and Employees**

<b>Numbers of Branches and Employees (December 2016)</b>	<b>Number of Branches</b>	<b>Number of Employees</b>
<b>Deposit banks</b>	<b>10,740</b>	<b>191,363</b>
<b>Banks with public capital</b>	3,702	57,586
<b>Banks with private capital</b>	4,132	73,742
<b>Banks transferred to the Fund**</b>	1	231
<b>Banks with foreign capital</b>	2,905	59,804
<b>Development and investment banks</b>	41	5,336
<b>Total</b>	<b>10,781</b>	<b>196,699</b>

**Source:** TBB (2016). **\*\* Banks that are transferred to the Savings Deposit Insurance Fund (SDIF)**

The number of deposit banks in Turkey and the total number of branches of development and investment banks has reached to 10,781. In that context, the banking

sector also provides a substantial contribution to employment markets by labor force it provides. There is a total of 196,699 employees as of the year 2016 (TBB, 2016, p. 2).

Nearly half of the workforce in the banking sector which has a great significance in terms of employment in Turkey is employed in privately funded deposit banks, while this ratio is closely followed by public banks and foreign capital banks. The number of banks with public capital is 3, and the number of banks with private capital is 9.

**Table 4. Banks with Public and Private Banks**

<b>Banks with Public and Private Capital</b>	<b>Number of Branches</b>	<b>Number of Employees</b>
<b>Banks with Public Capital</b>	<b>3,702</b>	<b>57,586</b>
Türkiye Cumhuriyeti Ziraat Bankası	1,814	25,015
Türkiye Halk Bankası A.Ş.	964	16,956
Türkiye Vakıflar Bankası T.A.O.	924	15,615
<b>Banks with Private Capital</b>	<b>4,132</b>	<b>73,742</b>
Adabank A.Ş.	1	29
Akbank T.A.Ş.	841	13,843
Anadolubank A.Ş.	106	1,784
Fibabanka A.Ş.	73	1,488
Şekerbank T.A.Ş.	273	3,611
Turkish Bank A.Ş.	13	225
Türk Ekonomi Bankası A.Ş.	515	9,640
Türkiye İş Bankası A.Ş.	1,374	24,756
Yapı ve Kredi Bankası A.Ş.	936	18,366

Source: TBB (2016).

## **Conclusion**

Banks are important institutions also for the financial markets since they channel the savings of the depositors into the most productive lucrative business areas. The limited availability of alternative financial institutions, especially in developing countries, increases the share and importance of banks within the financial system. Therefore, all affirmative and adverse developments in the banking sector would be reflected in the country's economy. Nowadays, the globalizing world economy has important impacts

on the banking sector as well as on the other sectors. The competitive environment in the banking sector has reached its climax in the process of globalization. Foreign bank entries and mergers have increased commensurate with the competitive environment, while new products and services besides the traditional banking features, technological innovations, and new employment opportunities have been developed. In the banking sector, which has been developed by globalization, the funds to be used in investments would be an important contribution to growth in case of an abundant variety of financial instruments, and low intermediation/investment costs.

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# 10 | Get Up, Stand Up and Do Not Give Up The Fight: Making a Terrorist Homo Socio-Economicus

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## **Abstract**

*Fighting against the global terrorism has become one of the most important objectives in the world's agenda since 9/11. On the one hand, the dominant strategy to make war on terrorism is shaped by the endeavours to eradicate terrorist activities. On the other hand, the main question of whether socio-economic tools can be used to fight against terrorism has still been debated. In order to answer the question, this paper investigates the socio-economic roots of terrorism in MENAP countries. Following the traditional regression estimation methods, the spatial disparities in the linkages are investigated using Geographically Weighted Regression analysis. The results of the analysis show that the wider the socio-economic benefits are, the lower the possibility to involve in a terrorist activity is. In other words, the empirical findings indicate that an increase in the level of income, investments, consumption, openness, institutions, education, freedom, happiness, and democracy decreases the average terrorist activities, while a rise in the level of unemployment, poverty, inequality, resident instability, and ethnic and religious heterogeneity widens it. In addition, the findings point out that the spatial effects of socio-economic factors are more prominent in the countries located in the Eastern, South Eastern and Southern regions compared to those of in the Western and Northern regions.*

**Keywords:** *Terrorism, Socio-Economic Determinants, Geographically Weighted Regression Analysis, MENAP Countries.*

**JEL Codes:** *C31, F51, O53, O55, P16.*

## Introduction

In today's world, the terror and terrorist activities contain some concepts and definitions, which are not clear from politic and international aspects. In this context, the terrorist activities in a country might not be defined as terrorism by another country or an international organization, while the local activities, which can be considered as attack on the national security, in certain countries might be accepted as international terrorist activity. For this reason, it is very difficult to make a global definition of terror or terrorism, and it couldn't be made yet.

Although the concepts of terror and terrorist have been used for describing the violence implemented by the government on individuals during the French Revolution in year 1789, the terror in its wider and generally accepted meaning represents any sort of political way aiming to destruct the order and legal, administrative, and sociological structures of the states. Moreover, the definitions relating the concept of terror to the concepts such as violence, political objective, power, crime, fear, threat, victim, objective, and war method considers terror as a new method of war as a result of the local, regional and global threats on the world in recent years (Muş et al., 2015: 5-6). Thus, the terrorist activities, which have initially emerged in form of local and regional events, have started to gain a global character especially through the religion-based terrorist activities (such as 9/11 attack). After that period, the terror and terrorist activities have become important problems in terms of national and international security, and started to be investigated by the politicians and economists as an important obstacle that the socioeconomic growth faces with.

On the other hand, despite they are kept together in the same pool with negative words such as crime, cruelty, threat, and fear, the words "terror" and "terrorism" might be subjected to certain positive discriminations by certain countries or international organizations depending on the political objectives. The most prominent one among these definitions is the definitions aiming to legalize the terrorism by naming themselves "freedom warriors", "holy warriors", and "revolutionists" and to legalize the terrorism

and keep the purely negative thought away. Despite these definitions, the most important common part of these events, which are named terror and terrorist activities and occur in any part of the world, is to address the civil population on purpose (Wilkinson, 2006: 1). Moreover, the terrorism is also defined as the intentional acts of violence by imposing pressure on the groups that are important to the society in order to obtain the personal, social, economic and political gains, and thus, direct action-based warning of the target group (Shahbaz and Shabbir, 2011: 2).

Within the scope of all these definitions, the terrorism and terrorism activities can be affected in four different ways based on the global economy. First of all, the humanity and physical capital are diminishing because of the terrorist attacks. Secondly, the fear and confusion as a result of terrorist attacks cause high level of uncertainties. The high uncertainty has significant effects on the level of investment in emerging economies. Thirdly, the expenditures made to prevent or reduce the terrorist activities increase the military expenditures of those countries. Therefore, the increase might cause the transfer of the resources of a country from the more efficient sectors to the less efficient security and defence sectors. Finally, it might affect the growth by directly influencing sectors such as the tourism sector that is considered to be an important component or a growth driver for some countries (Ağırman et al., 2014: 100; Enders and Sandler, 1996: 331).

In this study, it is aimed to examine the MENAP countries, which consist of 22 Middle East and North African countries and Afghanistan and Pakistan, in order to determine which factors determine the terror and terrorist activities by employing Geographical-Weighed Regression Model (GWR) on the data of year 2015. For this purpose, this work starts with the first section, where the definitions of terror and terrorist activities are provided. In second section, the theories aiming to explain the terror and terrorist activities from socioeconomic aspect and the studies that have been developed within the scope of these theories are discussed. In third section, it is presented what the socioeconomic variables of this study are and which characteristics they have. In fourth section, the econometric method and analysis results of this study are presented. And then, this study ends with the general results and conclusions.

### **Theories regarding the Terror and Terrorism**

As mentioned in introduction section, the terror and terrorist activities, which might be an important problem for economic growth of countries and have socioeconomic

effects on the economy, might load significant costs on the economy. Furthermore, the terror and terrorist activities' costs pass beyond the borders of countries and become an international problem. But, since their effects on the economy have not been sufficiently studies in literature, it has become a point of interest from the aspect of literature of economics. From this aspect, because it is a new topic for the literature of economics and it draws significant interest, different theories have been introduced in order to explain the grounds of terrorism. For this purpose, Krueger and Maleckova (2003) discuss the terror and terrorist activities on the socioeconomic basis and from the perspective of demand- and supply-side factors. The supply-side factors indicate that the well-educated individuals possessing the power of privilege might tend to support the terror activities because of their desire to have seat in politic area. The demand-side factors are based on the idea that the terrorist organisations would prefer well-educated persons in order to achieve success more easily.

The Gurr's (1968) Theory of Economic Deprivation suggests that the bad conditions and the inequality of opportunity would support the terrorism, the political factors would also contribute to this process, and the terrorist activities would settle. Moreover, the idea of economic deprivation indicates that the deficiencies in economic system would cause poverty and income inequalities and might construct the social structures such as tension, violence, crime, and hatred. The theory of economic deprivation that suggests that the economic opportunity costs would be high for individuals in an environment, where the levels of poverty and income inequality are high, also suggests that the foudns for terrorist activities would emerge as a result of this. The authors such as Li (2005), Golgstein (2005), Crain and Crain (2006), Kurrild-Klitgaard et al. (2006) and Krieger and Meierriecks (2016) have also reached at the results in parallel with this conclusion.

In a theory introduced by Olson (1963) and named immiserating modernisation, it is suggested that, as a result of the deterioration of income balance in the favour of a social segment due to the growth process, the other social segment would have nothing in the hand but the hatred and violence sensations. According to this theory relating the terror and terrorist activities with an unbalanced social mechanism, the mentioned mechanism would change in long run and develop through the improvement. This theory emphasizes that the demographic borders of the society will change together with the dynamism of economic growth, and the social basis of thought will completely change as the communication and living conditions gain new forms. Such a perspective

considers that the terrorist activities' scope might enlarge in cases that the individuals losing their confidence to the social equality mechanism would be enabled to join in the terrorist organisations.

Differently from these ideas, another perspective regarding the emergence of terror and terrorist activities is the theory of clash of civilizations introduced by Huntington (1996). The idea of clash of civilizations suggests that, depending on the social development process, the groups having different identities embitter the conflicts of interests of the groups with the groups in or outside the country and support the terrorist activities. The opponent identity groups easing for the terrorist organisations to find supporter lay the ground for transformation of identity-based ideologies into acts of violence. The manifesto, which is brought by the difference between the philosophies and is defined to be real-politics, enable the different identity groups to follow different politic movements. The forms of socioeconomic and politic relations between different subgroups generally support seeking for interest and, as emphasized by Daniel, Arce, and Sandler (2003), it generally results in the conflict of interest to achieve the dimension of hatred. The terrorist actions of subgroups benefiting from the hatred are not used as a tool for solely declaration of the philosophy but also for transferring the financial wealth. Thus, the actions deteriorating the moral values and reinforcing the commitment to the organization would allow the terrorism to be considered an action organization having lower costs and higher efficiency. Moreover, the studies carried out by the authors such as Russett et al. (2000), Chiozza (2002), Fox (2002), Inglehart and Norris (2002), Tuscisny (2004), and Neumayer and Plümpner (2009) have achieved conclusions that do not completely overlap with the ideas of Huntington, as well as they didn't completely ignore them. Those studies are against that Huntington considered the current and future conflicts between western civilizations and Islamic civilization to be the source of terrorism.

Furthermore, another significant theory explaining the causes of terror and terrorist activities is the theory of Contagion Effect. Introduced by Midlarsky et al. (1980), this theory is based on the self-energizing natural structure of terror and terrorist activities from time and space aspects. It suggests that the terror and terrorist activities firstly emerged due to the contagion effect and the prior terrorist activities would be the precursors of the actual and future terrorist activities. Besides that, it is also stated that the terror shows contagion effect through the media and communication tools. Because of the high levels of income that can be gained from terror and terrorist activities, the

establishment of a terrorist organization can be interpreted as transition to an upper benefit level for a terrorist group. Moreover, this thought system states that the terrorist activities in a country would in future spread over its neighbours in the course of time. Thus, it is emphasized that the terror and terrorist activities might have started in a tactical process in neighbour countries. In conclusion, the terrorist organizations having enlarging scope might both benefit from this process and minimize the total costs by merging with the terrorist organizations in neighbour countries. Accordingly, the temporary and spatial contagion effect of terrorism directly affects the cost/benefit composition and might provide the world with international terrorism by enlarging the scope of threat. The studies carried out by Drakos and Kutan (2003), Hon et al. (2004), Howie (2006), and Nacos (2009) concluded in parallel with this theory.

### **Dataset and Variables**

In this study, the socioeconomic determinants of terror are examined using Geographical Weighed Regression (GWR) model for 22 Middle Eastern and North African countries and Afghanistan and Pakistan (MENAP) as of the year of 2015. The main reason for taking this period into consideration is the ability to access the data. The data constituting the horizontal section system were obtained from the official websites of Vision of Humanity, The Economist Intelligence Unit, World Database of Happiness, Freedom House, International Monetary Fund (IMF), and World Bank.

The main feature of this study, which makes it superior than all other studies in literature, is the determination of terrorism's determinants on the basis of MENAP countries, where the highest intensity of terrorist activities on the earth are seen, and the inclusion of each of the countries into modelling the terrorism-related socioeconomic deprivation severity. This deprivation is considered from both economic and social aspects. This process contributes to the actuality of study via the execution of GWR, which is considered as a new in econometric methodology, and a wide dataset. Moreover, the socioeconomic policies that should be implemented in order to accomplish the effective struggle with the terrorism are discussed in this study, as well as a wide perspective is provided when compared to other applied analyses in the literature. Beside determining the determinants of terrorism, also it is discussed in this study if there is a quadratic (nonlinear) relationship between the terrorism and income and democracy levels. Since the study covers a wide area of interest, the mentioned analyses aim to directly contribute to the literature. Table 1 prepared for the analyses,

which consist of 21 1 dependent variable and 9 economic and 12 social independent variables (totally 21 independent variables), represents the fundamental information related with the variables discussed in this study.

**Table 2.** Main Information about the Variables

Indicator	Abbreviation	Definition of Indicator	Unit	Database
<i>Dependent Variable</i>				
Level of Terrorism	Terror	A country's global terrorism score based on the average level of the sum of incidents, fatalities, injuries and properties	Index	Vision of Humanity
<i>Independent Variables: Macroeconomic Indicators</i>				
Income Level	Income (+/-)	GDP in PPP dollars per person	PPP International Dollar	IMF
Income Level	Income <sup>2</sup> (-)	Square level of GDP in PPP dollars per person	PPP International Dollar	IMF
Unemployment Rate	Unemployment (+)	The ratio of unemployed labours to total labour force	%	World Bank
Level of Foreign Trade	Openness (+/-)	The ratio of the sum of exports and imports of goods and services to GDP	%	World Bank
Inflation Rate	Inflation (+)	Annual percentages of average consumer prices are year-on-year changes.	%	IMF
Level of Poverty	Poverty (+)	The ratio of the population living on less than \$1.90 to the total population	%	World Bank
Distribution of Income	Inequality (+)	Gini index	Index	World Bank
Level of Consumption	Consumption (-)	Household final consumption expenditure as a percent of GDP	%	World Bank
Total Investment	Investment (-)	The ratio of total investment to GDP	%	IMF
<i>Independent Variables: Social Indicators</i>				
Institutional Development	Institution (+)	Institutional framework of nations is measured as the average level of the	Index	Freedom House

		civil liberties and political freedoms		
<b>Level of Happiness</b>	Happiness (-)	The level of happiness is used as a subjective enjoyment of one's own life as a whole. In other words, the level of happiness is referred as subjective well-being or life satisfaction.	Index	World Database of Happiness
<b>Level of Freedom</b>	Freedom (-)	Economic freedom level of the countries	Index	Heritage Foundation
<b>Level of Population</b>	Population (+)	Number of residents of the country	Number of Person	IMF
<b>Level of Education</b>	Education (+/-)	Government expenditure on education as a percent of GDP	%	World Bank
<b>Level of Democracy</b>	Democracy (+/-)	The democracy index is a <u>weighted average</u> based on the answers of 60 questions, each one with either two or three permitted alternative answers.	Index	EIU
<b>Level of Democracy</b>	Democracy <sup>2</sup> (-)	Square level of democracy index	Index	EIU
<b>Ethnic Heterogeneity</b>	Ethnic (+)	The level of ethnic fractionalization in a country	Index	Fearon (2003)
<b>Linguistic Heterogeneity</b>	Linguistic (+)	The level of linguistic fractionalization in a country	Index	Alesina et al. (2003)
<b>Religious Heterogeneity</b>	Religion (+)	The level of religious fractionalization in a country	Index	Alesina et al. (2003)
<b>Cultural Diversity</b>	Culture (+/-)	The level of cultural diversity in a country	Index	Alesina et al. (2003)
<b>Residential Instability</b>	Resident (+)	Migration of residents from one country to another	Index	Own Calculations

**Note:** The symbols of the parentheses show the expected sign of the variable.

Before introducing the econometric methodology used in analyses, it is very important to make explanation about some of the variables. The data related with terrorism, which is the Global Terrorism Index published by Vision of Humanity, is a database translating the dimensions of terrorist actions in various countries on the earth to a quantitative level. In this dataset quantified between 0 and 10, the terrorism value of a country approximating to the score of "0" indicates that the terrorism level of that country is very low, while the values approximating to 10 indicate the increasing level of terrorist actions. Furthermore, in order to determine if the resident instability (in

other words, the continuous migration wave within the country) cause terrorist actions in that country, the measurement method developed by Akyüz and Armstrong (2011) was employed, and the province-level resident instability was calculated using Equation (1):

$$\text{Resident Instability} = \left( \frac{\text{Net Migration of Country}}{\text{Total population of Country}} \right) \times 100 \quad (1)$$

The *Income*<sup>2</sup> and *Democracy*<sup>2</sup> variables to be used in the analyses were utilized in order to determine if there is a quadratic (nonlinear) relationship between the terrorism and income and democracy, respectively. The main reason for including these variables into regression models was that they have been used in international literature, and it was aimed to determine if the similar case applies to socioeconomic structure of MENAP countries.

Democracy index measured by The Economist Intelligence Unit by using 60 indicators is based on a scale between 0 and 10, and indicates the democracy scores of countries. Accordingly, as the democracy score of a country approximates to 0, it indicates that they country has an authoritarian administration perspective, while the scores approximating to 10 indicate democratic governance. In addition, the level of happiness aiming to determine the life satisfaction level is measured via a scale prepared using the answers to the questions, which are about the happiness, quality of life, and satisfaction and which were asked during face-to-face interviews. The scores vary between 0 and 10, and the scores approximating to 0 indicate decreasing level of life satisfaction, while those approximating to 10 indicate increasing life satisfaction. On the other hand, following the study of Scully (1988), the level of institutional development has been expressed as the mean value of civil and politic freedoms. The civil and politic freedoms index measured by Freedom House is calculated using a scale with scores between 1 and 7. The score approximating to 1 indicates increasing level of institutional development, while those approximating to 7 indicate the decrease in institutional development. The level of ethnic diversities and the linguistic, religious, and cultural diversities were calculated by utilizing the studies of Fearon et al. (2003) and Alesina et al. (2003). The index has values between 0 and 1. The scores approximating to 0 indicate decreasing diversity, while the scores approximating to 1 indicate increasing diversity.

The measure of economic freedom is based on 10 quantitative and qualitative factors that are gathered in four categories as rule of law, limited government, regulatory efficiency and open markets. Each of the ten economic freedom indicators within these categories is marked on a scale of 0 to 100. The overall economic freedom score of a country is calculated by averaging the ten economic freedom indicators. If a country's score comes closer to 100, it is said that the economic freedom level of the country gets higher and *vice versa*.

### **Econometric Methodology and Model**

Since the terrorist activities in the MENAP countries are mainly observed in countries on eastern and southern regions, the economic losses caused from terrorist actions reach at much higher levels in those countries. For this reason, while investigating the socioeconomic determinants of terrorism, the analyses assuming that all of the MENAP countries have similar structural characteristics might cause relatively misleading results. Thus, it is very important to examine the terrorist actions, which condense in different ways in different countries, by locally differentiating parameters. GWR is one of the main techniques based on the econometric estimation of locally differentiating parameters. In this study, in order to determine the socioeconomic determinants of terrorism in MENAP countries, the methodology developed by Öcal and Yıldırım (2010) was utilized.

GWR analysis, which includes a nonparametric spatial model process, uses subsampling data and is based on the local linear regression tests in order to produce the estimation process for each point in the space. This approach considers the distance-based weighing and enables parameter estimations for every parameter and geographical regions. Within this context, the GWR analysis enables obtaining local parameters for every province in dataset, and such an analysis is considered to be a superior method when compared to other methods discussing the entire dataset without any discrimination between the cities. In GWR analysis, the individual regression of each province is weighed according to their spatial proxy levels. Thus, the spatial change in the parameters is smoothed according to the spatial weights, and the wide range of regional differences in the parameters is eliminated (Öcal and Yıldırım, 2010: 483).

The GWR analysis is an extended model of the Least Squares (OLS) method, which is the weighting of observation values in the form of a function of distance between

coefficient estimates of a region and other regions. Thus, the parameter estimations become specific for space  $i$  as emphasized by Fotheringham, Charlton and Brunsdon (1997). In general, GWR model is expressed as follows;

$$Y_i = \alpha_{i0} + \sum_{k=1}^p \alpha_{ik} X_{ik} + \varepsilon_i \quad (2)$$

$Y$  taking place in regression equation (2) as dependent variable consists of the combination of  $X_k$  independent variables ranging up to  $k = 1, \dots, p$ .  $\varepsilon_i$  takes place in the equation as “white noise error coefficient” having mean value of 0 and constant variance.  $\alpha_{ik}$  represents regression coefficients for every location  $i$  and variable  $k$ .  $\alpha_{i0}$  represents the constant variable of the model. The local estimations to be obtained using regression equation (2) are determined by utilizing the weighed regression model’s solution to be established by weighing the observations, which are the function of distance of location  $i$  to other locations. The parameter vectors in location  $i$  are obtained,

$$\hat{\alpha}_i = \left( X^T W_i X \right)^{-1} X^T W_i Y, \quad i = 1, \dots, n \quad (3)$$

$W_i$  in regression equation (3) represents the local spatial weight matrix for every observation. The main component in parameter estimation process of GWR analysis is to prepare the weight matrix representing the importance of every observation between the locations. In spatial analysis, it is generally accepted that the location  $i$  will affect a closer location more. Thus, while estimating the parameters in location  $i$ , it is necessary to assign more importance to the locations closer to location  $i$ . From this aspect, a natural way of determining weighing matrix is to execute the 1/d process called reverse distance criterion.  $d$  in this process represents the weight between locations  $i$  and  $j$ .

The weighing matrix for location  $i$  is generally created by excluding the observations of farther locations when compared to a specific distance. In case that the distance from  $i$  to  $j$  is longer than distance parameter having the threshold of  $d$ , the weight of 0 should be assigned to the observation  $j$ : (Öcal and Yıldırım, 2010: 484)

$$\text{For every } i, j = 1, \dots, n \begin{cases} W_{ij} = 1 & \text{if } d_{ij} \leq d_c \\ W_{ij} = 0 & \text{if } d_{ij} > d_c \end{cases}$$

After obtaining the weighing matrix, the GWR parameters can be achieved by using different  $\alpha$  coefficients to be selected according to the values minimizing the sum of residuals' squares:

$$\sum_{i=1}^n [Y_i - Y_i^*(\alpha)]^2 \quad (4)$$

$Y_i^*(\alpha)$  in equation (4) represents the harmonized values of  $Y_i$  in location  $i$ . Since the harmonized values of  $Y_i^*$  are the linear combinations of  $Y_i^*$ 's  $X_i$  and  $\hat{\alpha}_{ik}$  parameters, it is based on estimation of every  $\alpha_{ik}$  location (Öcal and Yildirim, 2010: 484).

In order to determine the socioeconomic determinants of terrorism in MENAP countries, the economic and social determinants should be separately considered; equation (5) is used for economic determinants and equation (6) for social determinants:

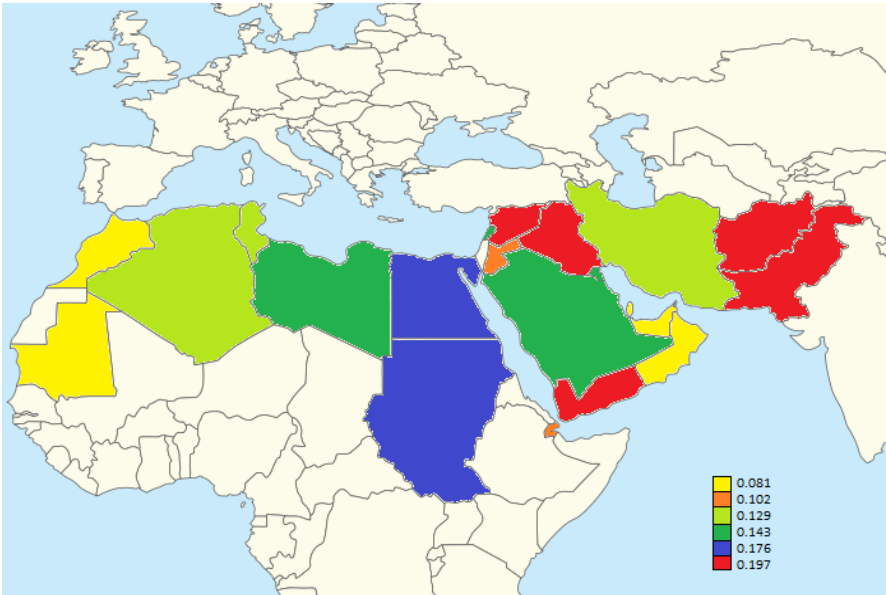
$$\begin{aligned} \text{Error}_i = & \alpha_0 + \alpha_1 \text{Income}_i W_i + \alpha_2 \text{Income}_i^2 W_i + \alpha_3 \text{Unemployment}_i W_i + \alpha_4 \text{Openness}_i W_i \\ & + \alpha_5 \text{Inflation}_i W_i + \alpha_6 \text{Poverty}_i W_i + \alpha_7 \text{Inequality}_i W_i + \alpha_8 \text{Consumption}_i W_i \\ & + \alpha_9 \text{Investment}_i W_i + \varepsilon_i \end{aligned} \quad (5)$$

$$\begin{aligned} \text{Error}_i = & \beta_0 + \beta_1 \text{Institution}_i W_i + \beta_2 \text{Happiness}_i W_i + \beta_3 \text{Freedom}_i W_i + \beta_4 \text{Population}_i W_i \\ & + \beta_5 \text{Education}_i W_i + \beta_6 \text{Democracy}_i W_i + \beta_7 \text{Democracy}_i^2 W_i + \beta_8 \text{Ethnic}_i W_i \\ & + \beta_9 \text{Linguistic}_i W_i + \beta_{10} \text{Religion}_i W_i + \beta_{11} \text{Culture}_i W_i + \beta_{12} \text{Resident}_i W_i + \varepsilon_i \end{aligned} \quad (6)$$

$\alpha_0$  and  $\beta_0$  constants in Equations (5) and (6) represent the gradient parameters of  $\alpha$  and  $\beta$ , while  $W_i$  represents the geographical weighing of location  $i$  and  $\varepsilon_i$  represents the white noise error term.

### Implementation Results

GWR analysis was utilized in order to determine the socioeconomic determinants of terrorism in MENAP countries. In parallel with this objective, Table 3 represents the analysis results regarding the macroeconomic and social determinants of terrorism and Figure 1 represents the spatial distribution of *Terror* variable's coefficient. In order to enable the comparison, the analysis results show both OLS (global coefficients) and GWR (local coefficients) model estimation results.



**Figure 1.** Spatial Distribution of Beginning Period Terror Coefficients

**Table 3. OLS and GWR Results of the Socioeconomic Determinants of Terrorism**

Results of the Macroeconomic Determinants						
Variables	Minimum	Lower Quartile	GWR	OLS	Upper Quartile	Maximum
Constant (C)	8.273	8.338	8.495*** (0.000)	8.376*** (0.000)	9.073	9.882
Income	0.002	0.003	0.006** (0.013)	0.004** (0.035)	0.009	0.013
Income <sup>2</sup>	-0.011	-0.009	-0.008** (0.026)	-0.005* (0.061)	-0.004	0.001
Unemployment	0.073	0.084	0.112* (0.063)	0.062 (0.466)	0.212	0.353
Openness	-0.063	-0.021	-0.019*** (0.000)	-0.014*** (0.002)	-0.010	0.011
Inflation	0.057	0.060	0.020 (0.868)	0.048 (0.259)	0.166	0.371
Poverty	0.014	0.040	0.059** (0.041)	0.315 (0.407)	0.130	0.230
Inequality	0.053	0.065	0.078* (0.074)	0.034 (0.532)	0.128	0.198
Consumption	-0.025	-0.004	-0.002** (0.037)	0.064 (0.246)	0.007	0.021
Investment	-0.175	-0.151	-0.134** (0.041)	-0.115* (0.055)	-0.093	0.106
R <sup>2</sup>			0.613	0.473		
F-Stat			7.310***	5.077**		
Prob (F)			0.000	0.035		
DW			2.037	2.118		
AIC			4.352	5.099		
Results of the Social Determinants						
Variables	Minimum	Lower Quartile	GWR	OLS	Upper Quartile	Maximum
Constant (C)	4.336	5.447	6.190** (0.014)	2.292 (0.546)	8.912	12.727
Institution	0.347	0.375	0.448* (0.073)	0.275 (0.497)	0.714	1.368
Happiness	-3.110	-2.778	-2.558*** (0.002)	-2.124*** (0.007)	-1.575	-1.113
Freedom	-0.316	-0.274	-0.241*** (0.000)	-0.197*** (0.002)	-0.151	-0.020
Population	0.001	0.028	0.048*** (0.008)	0.032** (0.049)	0.068	0.095

<b>Education</b>	-0.087	-0.072	-0.064* (0.086)	-0.103 (0.855)	-0.056	-0.029
<b>Democracy</b>	-0.016	-0.012	-0.008* (0.094)	-0.458 (0.465)	-0.002	0.036
<b>Democracy<sup>2</sup></b>	-0.028	-0.014	-0.030 (0.550)	-0.037 (0.647)	0.028	0.111
<b>Ethnic Diversity</b>	0.251	0.457	1.020** (0.037)	-2.217 (0.503)	3.085	5.980
<b>Linguistic Diversity</b>	1.472	1.793	1.338 (0.441)	-2.048 (0.482)	2.826	4.828
<b>Religious Diversity</b>	0.005	0.010	0.015* (0.068)	0.004 (0.579)	0.032	0.057
<b>Cultural Diversity</b>	1.341	1.765	1.150 (0.552)	-2.062 (0.557)	3.407	6.570
<b>Resident Instability</b>	0.021	0.098	0.176* (0.051)	0.113* (0.055)	0.376	0.589
<b>R<sup>2</sup></b>			0.561	0.450		
<b>F-Stat</b>			5.273***	2.116*		
<b>Prob (F)</b>			0.001	0.061		
<b>DW</b>			1.982	2.113		
<b>AIC</b>			3.241	4.356		

**Note:** \*\*\*, \*\* and \* indicate significance at 1%, 5% and 10%, respectively. Probabilities are given in parentheses.

Figure 1, where the effects of previous values of “*Terror*” variable on the terrorist activities in current period are shown, indicates that the values of terrorism in previous periods ranged between 0.081 and 0.197. Figure 1 is an important indicator, because it represents the severity of terrorist activities in MENAP countries in western, northern, eastern, south eastern, and southern locations. Spatial distribution of previous values of terror variable indicates that, when compared to MENAP countries in western and northern locations, the positive effects of previous values of terrorist actions in countries in eastern, south eastern, and southern locations on the current values are more dominant. When combined with the macroeconomic and social variables in Table 3, higher levels of unemployment, weak commercial structure, relatively lower level of funds transferred from national income to the investments, and the unpreventable poverty and income inequality in countries in eastern, south eastern, and southern regions supports this process, as well as the insufficiency of consumptions, weakness of democratic tendencies, high increase in population, exploitative character of institutional structure, low educational level, ethnic and religious discrimination, and rapid migration.

Table 3, where the results of GWR results regarding the socioeconomic determinants of terrorism are presented, indicate that all of the variables showed statistical significance, except for the inflation, and linguistic and cultural discrimination, while OLS analysis couldn't exhibit such strong linkages. GWR analysis coefficients within 25-75% quartile intervals indicate that the variables have high level of statistical significance. From this aspect, when compared to OLS analysis, the GWR analysis provides results having higher significance levels, and it proves the robustness of estimations obtained. GWR analysis results, which met the expectations in terms of coefficient signs, indicate that terrorism might deepen in parallel with the increase in level of income but, depending on achieving a certain threshold level of income, the terrorist actions might enter into a trend of decrease. On the other hand, the fact that the coefficient of *democracy* variable is negative and the coefficient of *democracy*<sup>2</sup> variable is insignificant enables us to state that there are no parabolic tendencies in terms of democratization process, that this country group has no upper limit in terms of democracy, and that the terrorism might decrease as the democratic tendencies strengthen. The analysis findings indicating that the rising unemployment, poverty and income inequality triggered terrorist activities revealed that, besides the high income growth increases, the increasing commercial tendencies and investment and consequent increase in the consumption expenditures might decrease the severity of terrorist attacks. It was shown in analysis results that the terrorist actions brought to the agenda by the increased population pressure, exacerbated ethnic and religious discriminations, and the migration movements could be eliminated only via the increasing level of institutional development, social well-being, establishing the freedoms, improving the educational, attaining a democratic society structure, and removing all kinds of discrimination leading to stratification of social.

## Conclusion

Leading to economic and social deformation as well as the loss of life and property, the terrorism has been further discussed throughout the world especially after the attacks on 9/11. The terrorist actions affecting the societies not only in economic aspect but also at social level might enlarge their area of impact especially via the distribution channel. Besides that, many applied studies, where it has been assumed that all of the countries affected from terrorism had similar structural properties, might miss that the societies may have non-homogenous characteristics. Such studies that do not take the heterogeneity phenomena into consideration and are based on global estimation

techniques may fall away from the reality in observing the real situation. In this study, which starts from the heterogeneity axis, the socioeconomic determinants of terrorism are discussed via GWR analysis by taking the MENAP countries. As well as determining the determinants of terrorism, it was also discussed if there is a quadratic (nonlinear) relationship between the terrorism and the income and democracy levels.

When compared to OLS analysis, the analysis results indicating that GWR analysis offer more consistent and meaningful results show that, in parallel with the increase in the level of income, the terrorism becomes more severe but, when the specific threshold for income level is achieved, the terrorist actions enter into a decreasing tendency. Moreover, the analysis results show that there is no threshold value for the democratic process, and consequently the terrorism might be regressed depending on the strengthening democratic tendencies. The analysis findings indicating that the phenomena such as unemployment, poverty, and immiserating modernisation theories also apply to the MENAP countries. The structure, in which the growth period cannot prevent the unemployment in MENAP countries, in other words where the growth along with the unemployment occurs, might cause deterioration of social peace by combining with the poverty and inflation bedimming the future. Due to the unsolved problems in the fair sharing regarding the increasing income, MENAP countries face with brutal growth phenomena, and they are expected to take rapid steps in order to overcome with the income inequality. Within this context, it can be emphasized that the expansion of trade tendencies and the increases that may occur in investment and consequently consumption expenditures should be given priority. In addition to that, the establishment of a prosperous social structure by raising the level of education, the creation of non-exploitative institutions, the acceleration of democratization tendencies, the establishment of a libertarian social structure, and the elimination of all forms of discrimination that cause social stratification constitute the dominant factors to be taken in the struggle with the terrorism.

While it can be specify that taking bigger steps in the path to economic growth and democratization as a whole is an important factor for eliminating the terrorism, it can also be said that the policies to be applied on the distributing the income and the policy measures required for breaking the vicious cycle of poverty will be paid vital importance. Therefore, the macroeconomic policy practices that would reinforce the foundations of sociocultural structure must be the pioneer in the fight against terrorism in MENAP countries. The beginning and ending points of this process can be established by means

of institutional structures of educational institutions having uninterrupted and robust infrastructure. Given the fact that the upbringing of future generations is only possible in a socioeconomic structure provided by a fair and peaceful environment, the solution of the problem of ethnic and religious discrimination that will inflict the indivisible unity of the nation is also very important. Otherwise, the social order that might be broken due to the terrorism will take another step towards the social chaos led by the terror problem.

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# 11 | The Rise of Theo-Politics in the Context of Globalization: Impacts on Global Political Economy

Murat SİLİNİR

## Abstract

*In the pre-modern period, the position of religion was pivotal, in the economic and political system. In this system, the church was a crucial political and economic actor. With the appearance of “Modern World”, that historical background reaching the 15. Century, religion has almost been pushed out of economic-political sphere. Domination of Nation-State understanding on the global system has progressed parallel to this process. Towards the end of the twentieth century, impact of globalization increased and religiosity has returned to political and economic realm. In this process, rapid technological transformations play an important role. The main purpose of this study is to analyze rise of Theo-Politics in the context of globalization and its impacts on the global political economy. In this general context, firstly, The rise of theo-politics will be examined in the context of modernity and globalization. Secondly, the concept of post-secularism will be discussed, in the context theo-politics. In the last part of study, the economic and political reflections of the theo politics will be examined.*

**Key Words:** Globalization, Theo-Politics, Political-Economy.

**Jel Codes:** F59, F60, F69.

## **Introduction**

The world is facing a process in which the term of globalization remains incapable of understanding and explaining the global developments. These rapid transformations reveal new paradigms and social practicals and many uncertainties above all (Blosfeld, Millsand, and Bernardi, 2006, 3). The allegations about the nation-state which is regarded as the main actor of the global system (Goldstein, 2001, 11) lost its traditional influence by the effect of globalization, gradual increase of mutual interdependence day by day (Giddens, 2016, 69), expanding the impact area of technological improvements and similar developments brought together the adaptation problem to the impetus of change in socio-politic and economic areas. The fact of globalization progresses goes parallel with the fact of modernization. There is a symbiotic relation between these two facts as well. Some thinkers such as Giddens accept the globalization as the basic result of the modernity, in particular, international relations and political approaches of global economy conduct the inception point (benchmark) of globalization to the start time of the modernity, namely to the geographical discoveries (Martell, 2010, 28).

In pre-modern period, the religion was at the center of the social, political, economical and even the military area (Machiavelli, 2010, 46-47). The concepts such as freedom, equality, ownership, free thought, cultural autonomy were under the domination of religious institutions (Winfield, 2016, 39). The political power did not have central position. Therefore, a system existed that was composed of multinational imperial structures have a weak central authority and many small states were under the umbrella of these structures. In that period, it could be underlined a religious dominance rather than the national sovereignty. The nationality was not the issue also in economic area. Especially the mercantilism that was brought to Europe by the flow of goods and valuables after the geographical discoveries corroded and transformed the traditional economy political structure. The boundaries of the political organizations were changeable and ambiguous. The developments as the disintegration of the religious and political and economic structure, the rise of nation-state on the historical stage, replacing the multinational flexible military structures by the national military approach incarcerated the religion to a highly ineffective place. Within this scope, the modernity symbolizes a war against religion and religious institutions in a sense. Almost everything that is traditional was exposed to a revolutionize by the geographical explorations by the discovery of 'new world' by the Europe representing the old world. The Reform

and the Renaissance processes also played a crucial role. The modernity, so the globalization worked to diminish the centrality or power of this religiosity.

Anything that the modernity accepted as finished had not finished indeed. The legend of death of religion was an illusion that modernity always tried to underline. Whereas it has existed since the beginning of human history and this misperception is over (Friedman, 2015, 324). Especially, the factors such as reverberating the approach of Clash of Civilizations of Huntington in academic and political decision makers, September 11 terrorist attacks, ‘radicalization of the modernity’ (Giddens, 2016, 171), growing uncertainty as a output of the radical transformations started to make the admitted as religious visible. Emerging of the religion as a modifying and transforming factor seems indisputable and increase of religiosity on political structure reflects new and exciting reality. (Huntington, 2004, 233). The religiosity started to become visible with the globalization process took effect gradually late in the Cold War. Anthony Giddens did not accept this condition precisely as much as Huntington, but yet he underlined the hegemony of a set of unchangeabilities (religious) in the context of ‘tradition’ in some parts of the vital area (Giddens, 2016, 171). Thus, the ‘institutionalized of the modern doubt’ (Giddens, 2016, 171) positioned against the ‘religious dogmas’ will give it’s place to post-modern or new religious certainties and principles. The global economic and political uncertainty will take a step to a teo-political clarity. The main purpose of this study is to analyze rise of Theo-Politics in the context of globalization and its impacts on the global political economy. In this general context, firstly, The rise of theo-politics will be examined in the context of modernity and globalization. Secondly, the concept of psot-secularism will be discussed, in the context theo-politics. In the last part of study, the economic and political reflections of the theo politics will be examined.

### **The Rise of the Teo-Politics**

It is a historical issue that what kind role must be taken in a social and political area by the religion. According to Durkheim who is known by many as the founding father of the modern sociology, almost all the significant social institutions arose from the religion. According to this, the human intellectuality reflects a religious spirit (Dunn, 2009, 4). The modernity suggested an argument opposite of this claim. The religion is placed on a special status apart from the economic and political area in the modern period. The ‘away’ position of the religion from the secular area took a step to a new

age in the millennial process. Within this extent, the concept of Teo-Politics is one of the multidimensional concepts which will be effective in the 21st century. While the religion had a status in the center of socio-economic and socio-politic order in the periods before the modernity, now it has a new and expanding circle by mainly the effect of the globalization. In the modern times, that is derivative of the Age of Enlightenment, the ideology built in a stable form took the place of sacred books which were effective means of the pre-modern periods (especially in the West). The clergymen were at the forefront in previous period while the intellectuality comes into prominence in the modern period (Friedman, 2015, 101).

At present, the social anger for the radical jihadist organizations especially after the September 11 terrorist attacks is accepted as a critical issue by the politicians. In a period of 2016 Presidential Elections of US, the anti-Islamic teo-political discourses of the Republican President Trump fueled the arguments of 'effect of the religion' more in the decision-making process in American policy. Even though America is a country has the secular political system, the closeness of the relations between religion and politics is not a new fact. The view of founding fathers of America to the politics and society does not reflect an autonomy different from the religion. Bible is one of the key factors in this process, and there is somebody who argue that this key role of the Bible still continues (Dunn, 2009). Some of these persons such as Coen associates this to the security approach:

*While September 11 attacks did appear to produce an increase in securitization and more negative depictions of Islam in Senate rhetoric, the study finds enduring themes across both periods of analysis. Prior to 9/11, securitized phrases like Islamic Fundamentalism, Radicalism, and Islamic Extremism were already in use among senators. The analysis suggests apparent shift in Senate discourse –for example, initially, linking Islam with anxiety – inducing narratives regarding Iran, the Palestinians, or the Clash of Civilizations, then subsequently with post-9/11 concerns about jihadist terrorism- ultimately reflect an enduring securitization of the religion in evolving context. Following this pattern, rhetoric among policy makers depicting Muslim refugees and immigrants as Trojan Horse for ISIS attackers may be understood as one of the latest manifestations of an enduring securitization of Islam in U.S. political discourse. (Coen, 201).*

In addition to Coen, Giddens states that the religion has a cosmological effect. Accordingly, the religious cosmology provides a security area for the theist (Giddens,

2016, 104). This security approach and feeling also reverberate to the social practical. In this sense, the individual surrenders to the divine reality. This devotion provides both confidence and an explicit identity. The religious officials gain importance in terms of inner trust and being supportive in a system where the reliability of the religion is not discussed. According to Giddens, 'the religious beliefs inject confidence into the experiences of case and situations and present a frame provides to explain and respond of these' (Giddens, 2016, 104). Within this general context, following points should be emphasized for the teo-politics:

### **The Prominent Dimensions of Teo-politics:**

1. The rise of teo-politics at the global level is a conjunctural growth. There is the effect of the transition period when lived after the Cold War is not over yet. One of the unavoidable of socio-economic and socio-political transition times is appearing the cyclical reactions as a traditional form.
2. The reactiveness of this rise was underlined, but this reactiveness is an answer of the clarity seeking against to the uncertainty generated by the modernity. In premodern period, one of the significant functions of the religion was to present absolute information about social, economical and political issues. The modernity places the 'doubt' on the seat of honor and makes it a prior condition of the rationalization in fact (Pandemic Uncertainty vs. Religious Certainty).
3. The doubt created interrogator approaches for the solution of the problems by the query function. Within the scope of rising the teo-politics, abandoning the skepticism and replacing this by the blessed 'certainty' can play a prohibitory role against being focused on the structural problems of the global system.
4. The dizzier circumstances resulting from the multidimensional rooted transformations do not reflect a convenience that will be explained by only the term of teo-politics. There is the need for multi-dimensional concepts to interpret, explain and describe the connections between the facts in the process where multidimensionality is the master. The term of teo-politics deprived of this capacity.

5. The effect of the religion on the individuals is not a new fact. The new one is being increased the visibility of this effect by the media for a specific political goal. This produces an illusion on the perceptual platform. In this sense, the media serves a particular mission. The respondents of this mission are the Muslims on the foreign political level.
6. The concept of 'war against the terror' is developed in the new security approach after the Cold War. The religion and terror are started to be discussed within the same context by this battle and the concept of 'war against the terror'. Unfortunately, the terrifying attacks of terrorist groups such as DAESH started to occupy the world agenda after September 11 attacks and 'Arab Spring' reinforced this image.
7. It needs to be considered, the relation between populism rises in the world and teo-politics. For instance, the discourse and the political practices of Donald Trump's took a teo-political form while these discourses and the applications were in a populist way in emerging process. Concordantly, being selected Trump as the President is not a surprise. The discourse and practices of Trump have expanded effects for the Teo-Political area. It must be emphasized that this trend is a temporary political development.
8. The paradigm of the Clash of Civilizations includes the speculativeness and practicability as teo-political in itself. The paradigm of Clash of Civilizations that was firstly discussed by Huntington to cope with the paradigmatic deadlock still protects it's actuality on the global economy and political platform disputatiously. Accordingly, the ideologies one of the first identifiers of the modern times petered out. The religion replaced by the ideologies in this new and complicated period. It is seen as illusive to allege that the foreign policy decision-makers of America develop entirely independent policies and strategies from this battle-oriented concept.
9. It could not also be alleged that there is not a correlation between technological development and the teo-political rise. The discussions and events happened through the internet, social media and the visual media represent a possibility of the existence of a relation between technological development and teo-political rise.

10. The teo-political dimensions of the term of 'Radicalization of Modernity' of Anthony Giddens could be referred. The concept of radicalization of the globalization could also be derived from this term. Even though this general radicalization tendency is tried to be explained by the facts of modernity and globalization, the religious radicalization appears like the prominent issue of the teo-politic area (Giddens, 2016, 171),
11. The securitization is one of the teo-political means used by the military and politic actors (especially at present). This teo-political choice has a relation with the new security concept built on the global platform. Above all, U.S. and NATO developed a new security concept on the global level. Within the frame of this theory, the Islam is subjected to securitization after being coded as a threat under the approach of 'War on Terror.' This circumstance is one of the structural factors scales the Teo-Politics trend up.
12. There is also the teo-political reflection of the structural economic crisis. Political actors can pursue irrational policies in economic and political chaotic times.

### **Towards 'Post-secular' Process?**

Experiencing the rooted transformations in terms of political, social and cultural dimensions reveal the new structures. In this general transition process, the principle of separation of powers which is one of the key features of the political approach declined; the new, complex and almost hybrid national identities reproduced by being exposed the national identities to be eroded. To a certain extent, this associate with the level of globalization and modernity reached. The religion made a comeback to the historical and economy political area with the post-modern form. This return provided both the religious politicization and being instrumentalized the religion with the purpose of manipulating the masses within the frame of new politicization process of the religion. The modernity tried to incarcerate the religion into a special place by depolitization. Religion is exposed to a new politization (Robbins, 2011, 78) in the post-secular process and this condition creates a teo-political form as well. This form also evokes the post-secularism. The post-secularism does not express the rise of the spirituality or increasing visibility in the social life. The post-secularism involves the paradigmatic changing on the mental platform. The belief has a major role in this progress and changes the secular

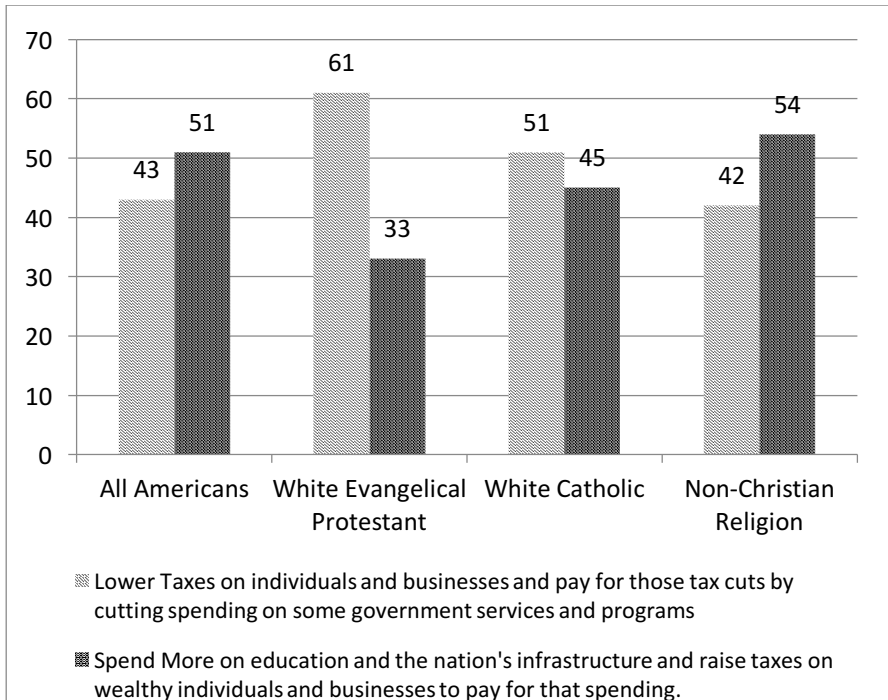
state understanding. The perspective of politic decision-makers on the religion changes within this frame. This change effects the politic apprehensions of politic decision makers naturally. The changes in American policy (especially after 11 September) remarked in this direction. The signing of Republican President Trump on a law draft by January 2017 prevents the entrance of 7 Muslim countries (Iran, Iraq, Syria, Somali, Yemen, Afghanistan, Libya and Sudan) to the US created a teo-political tension. This decision had repercussions in both American public and global agenda. Much as this ruling is estopped by the federal court due to being unconstitutional, this order of the US president could be commented as a post-secular judgment. This decision bears post-secular traces in terms of symbolizing the factionalism for Islam and the Muslims. Coen interpreted this situation based on his research as the securitization of Islam and the Muslims. The reference object of securitization is the American Society and American system. This securitization process also reflects the discourse of American politic decision-makers. The words such as war, death, blood, conflict, terror, murder, attack, horror, etc., are associated with Islam and the Muslims (Coen, 2017). There are also political economic dimensions of these situation.

### **Economic and Political Effects of Teo-politics**

Analyzing the relations and interactions between the religion and the societies is not a new and daily issue. According to the approaches accepted as modern, the religiosity started to die away by the modernity. The activation of laic or secular approaches in social, political and economic areas reduced the impact level of religious institution and understandings. Max Weber symbolizes the difference from the line of this vision. The famous emphasis on the relation between Protestant identity and the capitalism of Weber indicates to the continuance of religiosity in another form. Weber argued that skepticism revealed by being abandoned the loyalties to the religious and traditional authorities does not completely destroy the religiosity (Weber, 2003, 35-36). With regard to Weber, the Protestant ethics is one of the factors affects the development of capitalism. In modern times, the rise of powers of countries such as UK, Germany, and Holland as a pivotal quality is related to the Protestant religious identity differently from Catholic countries such as France, Spain and Italy which have the Catholic identity. Weber stated in his work called Protestant Ethic and the Spirit of Capitalism that the Protestantism provides a better substructure than Catholicism for economic growth (Friedman, 2015, 253). Some of the Catholic and Jew economists are uncomfortable with handling the Protestant belief and economy discipline as integrated by Weber (Nelson, 2001, 42). With Weber, views of Adams Smith are also very

important. Does Adam Smith have a teo-politics perspective? There are very few information and document about the details of religious belief of Adam Smith (Hanley, 2016, 305). Despite this, it is possible to deduce that Adam Smith thought that the classical religiosity is a serious obstacle to economic development due to some status of him such as 'invisible hand principle,' free market approach effected by the natural balance of nature, displaying a less religionist life as opposed to his dad.

**Table 1:**



(Deckman, 2017)

The current research results of religious perception involve interesting consequences. The research results which are indicated by Deckman are significant in terms of expressing the economic-political reflections of spiritual opinions. According to a survey conducted in America, 53% of the respondents answered that the taxes as a

means of the social state system could be increased for education and infrastructure works (especially for the taxes of rich people). 43% of them mentioned that the US citizens should pay fewer taxes and the fiscal activities need to be reduced as well. The answers for this question submit a different table and meaning range based on the religious distributions. For example, while 61% of white Evangelicals and 51% of the white Catholics mentioning that less tax should be paid; 54% of unchristian indicated that more taxes must be taken from especially the rich people for education and national substructures (see Table 1).

### **Conclusion:**

The religion that the modernity tries to incarcerate into a special place takes to the stage again in a teo-political form by also the effect of globalization. The rise of teo-politics is crucial trend within this context. This is both responsive and conjectural trend. The new security system led by the US and September 11 terrorist attacks plays a critical role in this process. Due to this period still continues, it is too difficult to share certain information about the results of this process. But it still could be stated that this process is a derivative of economic and political crisis, and the analytic steps in economy-politic areas will be able to stop this rising.

The effect of the religion on the individuals is not a new fact. The new one is being increased the visibility of this effect by the media for a specific political goal. This produces an illusion on the perceptual platform. In this sense, the media serves a particular mission. The respondents of this mission are the Muslims on the foreign political level.

It could not also be alleged that there is not a correlation between technological development and the teo-political rise. The discussions and events happened through the internet, social media and the visual media represent a possibility of the existence of a relation between technological development and teo-political rise.

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# 12 | Interaction between Domestic/Foreign Savings and Investments in The Context of Globalization

Merve TUNCAY

## Abstract

*Financial liberalization is expected to contribute to the economic welfare of nations by directing savings into productive investments as also supported by the separate studies of Shaw (1973) and McKinnon (1973). On the other hand, different cases that have been experienced by the countries since the 1980s caused this process to be questioned by both the academic literature and the market participants. This study examines the financial liberalization process in the context of savings and investments from a theoretical perspective and the experiences of Turkey in liberalization process.*

**Keywords:** *Financial liberalization, globalization, savings, investments, Turkey.*

**JEL Codes:** *F02, F43, G10, G15, O16.*

## Introduction

Reflection of the globalization on finance shows up under financial liberalization practices. The issue of whether the financial liberalization which was hoped to contribute to aggregate economic welfare, increase growth and risk

diversification has literally met the expectations is in debate not only among the developing but also developed countries. Does this complete independence door opened by financial liberalization really provide economic welfare by effectively canalizing savings towards investment opportunities with maximum return or cause many other countries to pay together the increasing cost of a crisis arose in a country by integrating the economies as one single market? Countries have been liberalizing their financial markets after Bretton Woods failed in the 1970s through conducting this process in money and capital markets. During this process which has been led by IMF and the World Bank, it is seen that the importance of short-term capital flows increased dramatically and therefore substituted foreign aids and loans to compensate balance of payments deficit. The process which takes theoretical basics from the separate works of Shaw (1973) and McKinnon (1973) is mainly the elimination of all practices preventing capital from flowing across countries freely. Hence it is expected savings to be utilized in productive investment areas more and positively affect the economy. However Neo-Keynesian view argues that it has the potential to increase instability in the financial system and do not always increase savings and investments and fasten growth as expected.

This study is handled within the scope of financial liberalization and its effects on capital flows and hence investment and savings from a theoretical perspective and through the proof from previous researches. Also, the study aims to contribute this issue in the light of financial liberalization experience of Turkey.

## **Globalization of Capital**

The argument of the economics theory that the free capital flows provide more efficient use of resources, new opportunities towards risk diversification and support for financial growth has led both the developed and developing countries to liberalize their financial markets for more than 30 years (Edison, Klein, Ricci, and Sløk, 2004:220-221). Especially, increasing economic performance of open economies compared to closed economies beginning in the 1960 and 1970s has become the main reason of adopting open economy based growth strategies by the developed countries in the 1980s (Emsen, Değer, and Karaköy, 2006: 3). On the other hand, it is seen that the main factor behind financial liberalization process is the collapse of Bretton-Woods system in the early 1970s (Tükel, 2007:32). The other reasons can be considered for financial liberalization are also increase in savings and investments and the impact of institutions such as International Monetary Fund (IMF), World Bank and World Trade Organization

(Özdemir and Sever, 2004:37). Accordingly, the expected benefits from financial liberalization and integration have generally been the competitive advantage, elasticity, and efficiency in resource allocation (Cicioğlu, 2009:71).

The growth period lead by Japan and the Western countries from the beginning of the 1960s, brought out the concept of “developing countries” and caused local financial markets to be insufficient as a result of the increasing financing needs. Thereupon they started to demand funds from foreign markets and the capital started to gain momentum at the international level (Ünal, 1990: 3-4). Moreover, we see that the financial liberalization policies for free capital flows in the modern sense started to be structured right after this period (Gündem and Tunç, 2010:1326). Financial liberalization process started first in the USA in 1974 and followed by England and Japan in 1979 and 1980 and Germany in 1981 (Tükel, 2007:32). During this process we see that many financial innovations emerged as a result of financial liberalization process arising from the factors can be summarized as below (Tükel, 2007:33):

- Emergence of floating rate debt instruments and derivatives markets due to the fluctuations in inflation and interest rates, options markets due to the option transactions based on debt instruments,
- Efforts made by financial institutions to avoid legal regulations,
- Technological developments.

Despite financial liberalization policies are thought to transform savings into investments and thus positively affect economic growth, there are also criticisms because of its role in the economic and financial crises triggered before (Hermes and Lensink, 2005:1). As a matter of fact, it is seen that these financial crises have frequently shown up since the late 1980s that the financial liberalization process was expanding. According to a study, 18 out of 26 banking crises in the world took place within the next five years after financial liberalization. It is also seen that these speculative funds flowing up to the "low-exchange rate - high-interest rate policy" were not being used in investments neither by the private nor the public sector but instead used in covering public sector deficits (Kara, 2001:36). Within this process, short-term and high liquid fund inflows towards and outflows from developing countries cause price movements in foreign exchange and capital markets and other parts of the economy thus leading first to financial crises and then real sector crises (Cicioğlu, 2009:73). Even, increasing level of private capital flows in the 1990s was being seen as the main reason for 1997

Asian crisis (Gürkan, 2008:33). Kara (2001: 38) states that the hot money flow towards a developing country as a result of capital flow liberalization causes an upward pressure and thus instabilities on the exchange rates (Kara, 2001:38). According to a view, the fact behind the pressure from developed countries to developing countries for the adoption of financial liberalization and market economy is that the desire of international financial institutions which are connected to these developed countries to benefit from foreign markets, find new sources of funding or access to profitable investment opportunities (Apak and Demirel, 2013: 34).

Financial liberalization has an effect on economic growth, economic policies, income distribution, exchange rates, balance of payments, interest rates and savings, investment, and consumption. It is also discussed in the literature that the liberalization of capital movements has abolished the independence of the monetary and fiscal policies of the governments to a large extent. The increase in short-term capital movements is considered as a risk factor because these inflows can be turned into sudden outflows and causes doubts about the current account deficit (Cicioğlu, 2009: 43-51). This is because hot money movements that break their ties with the real economy weaken the investment tendency in the countries they have entered and can make the macroeconomic policy instruments rapidly ineffective (Kara, 2001: 37).

### **Concept and Theories of Financial Liberalization**

Financial liberalization is defined as the measures implemented in order to loosen or remove regulatory controls on institutional structures, instruments, and intermediation in different segments of the financial sector (Ghosh, 2005: 2). In practice, financial liberalization is defined as the removal of factors preventing movement of capital freely across nations (Mangır, 2006:462). This term is generally expressed as the process of opening up the economies to international capital flows and shown as the result of deregulation implications by removing or reducing restrictions on banking and finance system in order to attract capital flows (Gündem, 2008:5). As a result, it is expected average returns and efficiency of investments to increase, growth in economy and savings to increase as entrepreneurs give up low return investments. Efficient use of increased savings due to financial liberalization will positively affect the increase in the amount and quality of investment and hence the economic growth (Ağır, 2010:16).

The process of financial liberalization has two nested stages. The first stage starts with the introduction of policies to liberalize domestic financial markets and after this stage,

policies aiming liberalization of capital markets in other words foreign financial liberalization are implemented. Absolute financial liberty will have been realized only after these two stages are completed (Gürbüz, 2006:12). Financial liberalization is implemented in capital and money markets separately. Liberalization implications in the capital markets take place by opening up capital account and removal of financial pressure policies and restrictions against foreign ownership (Galindo, Micco and Ordonez, 2002:2). Liberalization of money markets, on the other hand, is realized by the deregulation implications where government restrictions on banking system are removed, competition among banks is increased, price competition is provided by deregulating interest rates and service pricing, diversification is encouraged instead of specialization, expansion of branch network is provided both at national and international level and transparency conditions are satisfied among financial markets (Onur, 2005:129-130). Liberalization of national financial markets can be realized in three ways (Mangir, 2006:462):

- Enabling citizens to borrow from international markets and foreigners to invest in the domestic markets,
- Enabling citizens to transfer capital abroad and holding foreign assets in foreign markets and also foreigners to borrow from and issue assets in domestic markets,
- Enabling citizens to set debt-investment relations such as opening foreign exchange deposits or using foreign currency loans.

Besides these implications, there are also views supporting financial liberalization process led by Ronald Ian McKinnon and Edward Stone Shaw and views criticizing led by Lance Jerome Taylor. The analyses conducted by the economists like McKinnon and Shaw indicate that financial controls in the developing countries cause macroeconomic instabilities and negatively affect economic growth thus financial liberalization is needed (Basoglu, Ceylan, and Parasiz, 2009: 525). The McKinnon and Shaw approach, known in the literature as “Financial Repression”, forms the basis of financial liberalization policies implemented with the support of the IMF and the World Bank. According to this view, it is possible to increase the savings rate in the economy thus more resources can be transferred to productive investments resulting in a stable growth through these policies (Yıldırım and Altun, 1995: 78). McKinnon suggests that interest rates are mainly used in policies applied to the liberalization of the financial system in the financial liberalization hypothesis, with interest rates affecting

economic growth either through the level of savings or investments. Accordingly, increase in real interest rates leads to increase in savings, thus increase in current deposits in the banking sector will have a positive effect on investments and economic growth (Hepsağ, 2009:64-66). The Shaw-McKinnon approach suggests that the first step of financial liberalization is the implication of interest rate liberalization. The function of interest rate in this framework is summarized as follows (Yıldırım ve Altun, 1995: 78):

- There is a positive relationship between savings rate and real interest rate.
- The liberalization of interest rates will allow the rational use of capital through an efficient financial system. Thus, the increase in real interest rates will increase the propensity to save and direct the units with fund surplus to the banking system.
- Based on the assumption that financial markets operate efficiently, the amount of funds transferred to productive areas will increase.

The neo-keynesian approach, which is one of the opinions strongly criticizing neoclassical approaches of McKinnon and Shaw that ignore distribution and class-related problems and associate growth with savings or credit volume, considers effective demand as a determinant of growth and incorporates classes and distribution problems into their analysis as well (Gürkan, 2008:11). According to this approach, an increase in the interest rates has a deterrent impact on the investments, thus affecting the effective demand and slowing down the growth rate by causing financial disruption (Yetiz, 2008: 48). The Neo-Keynesian approach criticizes the policies of financial liberalization due to the potential of causing instability in the financial system and the lack of capital markets development in developing countries leading firms to meet their financing needs from the relatively more developed banking sector (Gürkan, 2008: 11). This approach argues that financial liberalization does not always have an accelerating and inflation-reducing effect on growth by increasing savings and investments (Tükel, 2007: 26).

Depending on the financial liberalization policies implemented, another view criticizing financial liberalization from a macroeconomic point of view as a result of various experiences, especially in developing countries, has been the neostructuralist approach (Gürbüz, 2006: 26). This approach advocates that that financial liberalization increases inflation by causing interest rates to rise (Tükel, 2007: 25). This view also argues that the interest rate ceiling, namely, the financial repression should not be abandoned

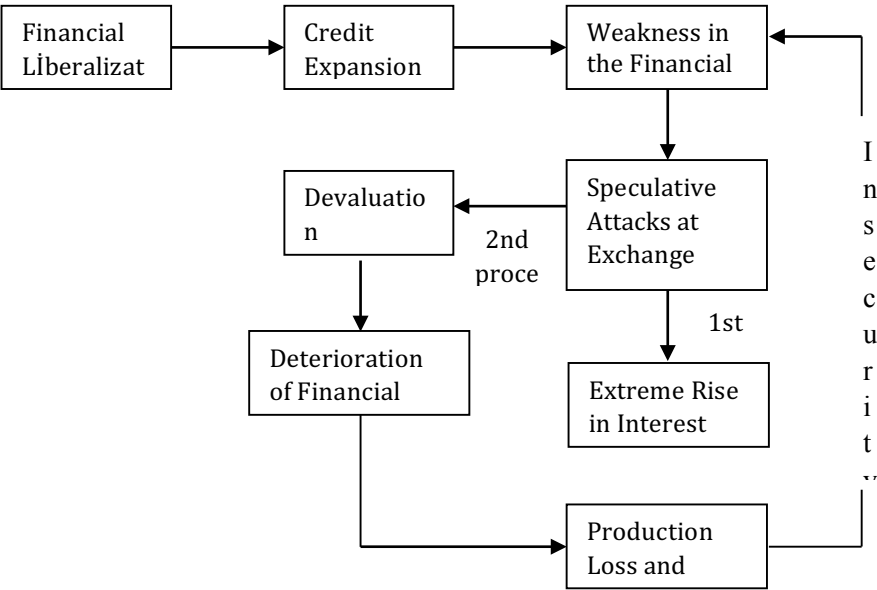
(Gürkan, 2008: 15). According to structuralist view payments for labor and raw material are financed by short-term debts and thus interest rates should be considered as a variable cost during the production process. Potential rise in interest rates as a result of financial liberalization therefore causes working capital costs and price levels increase and/or production level decrease compared to that of fixed interest rate implications which are when also accompanied by exchange rate liberalization eventually lead to short-term national income losses (Basoglu, Ceylan, and Parasiz, 2009: 529-530).

### **Financial Liberalization and Capital Flows**

The financial system implements a number of functions in an economy that essentially provides the flow of financial resources, facilitates risk management, distributes resources to the most efficient projects, monitors the efficiency of financial resources usage, and ensures the effectiveness of business transactions between economic participants. Within this close relationship, the role financial liberalization takes in the relationship between finance and growth becomes prominent (Hermes and Lensink, 2005: 2). After Bretton Woods system failed and many countries left their currency to fluctuate in 1973, March, liberalization in capital flows and the financial system began. During this new period liberal policies and deregulation implications rather than Keynesian policies were adopted and competition and privatization based practices came to the forefront (Örnek, 2005:200).

It is seen that along with the realization of foreign financial liberalization in almost all of the developing countries, capital inflows towards developing countries seem to gain speed while the structure of capital flows gains a more short-term nature and the capital seeking for speculative return becomes prominent especially in the early 1990s. (Gürbüz, 2006: 45). Despite this short-term capital inflow is a highly profitable resource transfer from an individual perspective, it also had a serious cost to the economy by causing high-cost borrowing and economic recession, making money, fiscal and even income policies of the government nonfunctional and ultimately having impact on economic crises (Kara, 2001:32). The capital flows arising from financial liberalization process increased especially the fragility of developing countries and dragged world economies into repeated crises. In this context, the Mexican Crisis in 1994, the Asian Crisis starting as a regional crisis first in 1997, the Russian and Brazilian Crises in 1997 and 1998, and the Turkish Crisis that broke out in 2001 are examples of serious crises caused by short-term capital movements (Örnek, 2005: 201). Basoglu

et al. (2009) also argue that these financial crises almost always turn into a systemic crisis later in every developing country which cause a vicious circle as shown in Figure 1:

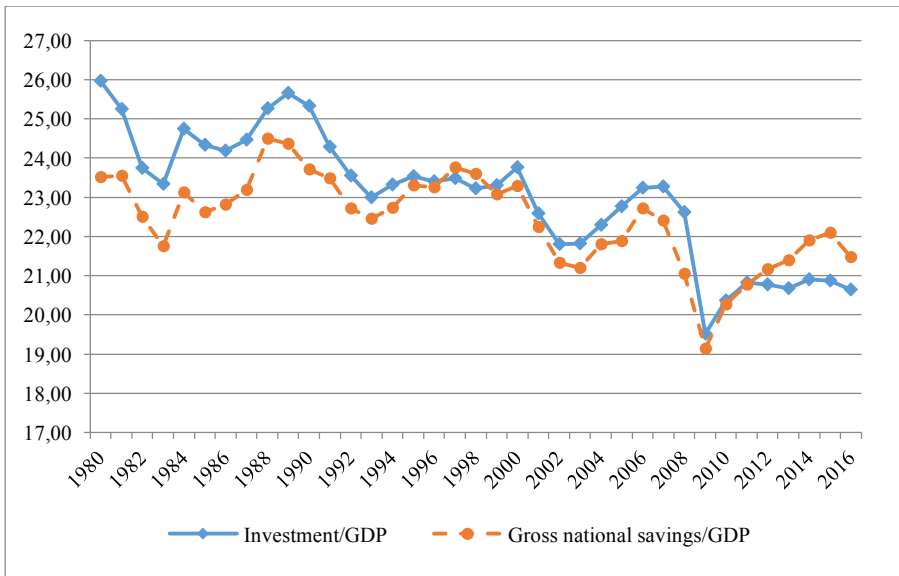


Source: Basoglu, Ceylan and Parasiz, 2009: 547.

**Figure 1.** Financial Liberalization and the Systemic Crisis

One of the most important impact of financial liberalization and thus financial integration is that the enormous growth in the volume of capital flows from industrialized northern countries to such countries and developing southern countries as well. Examining capital flows by variety, it is seen that the largest increase is in the foreign direct investment (FDI) and foreign portfolio investment (FPI) while there is a significant decrease in bank credits (Gürkan, 2008: 27). It is possible to observe these increases in the capital flows arising from financial liberalization in the balance of payments as it is theoretically the basic table reflecting the economic relations of a country with the outer world (Gündem, 2008:44). Figure 2 and Figure 3 represent the

savings and investments in the advanced and developing countries between 1980 and 2016 respectively. As it is seen both share of total investments and gross national in GDP have a declining trend in the period of 1980-2016 in the advanced economies as whole. Furthermore despite the declining trend, the share of investments is higher than the savings till 2011. On the other hand, despite having a volatile view, both share of investments and savings in GDP have a declining trend till 2000. As of 2000 savings and investments increase rapidly and savings increase faster than the investments which contributes to current account balance in a positive way.

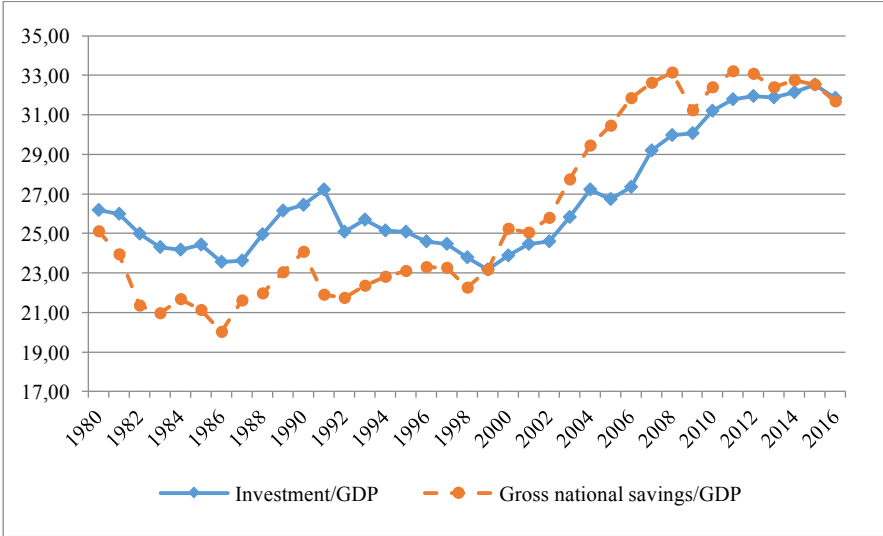


Source: IMF, World Economic Outlook Database, <https://www.imf.org/external/pubs/ft/weo/2016/02/weodata/index.aspx>, Accessed: 15.03.2017.

**Figure 2.** Investments and Savings in the Advanced Economies (1980-2016)

Capital flows, which are called as the “hot money” used extensively in the financing of public deficits mobilizes depending on the low exchange rates and high real interest rates (Kara, 2001: 31). The countries are able to finance their spending through borrowing without taking taxes, while the abundance of resources in the country is

widening the credit volume and reducing the domestic savings rate. This leads to a short-term growth and welfare increase in the economy (Cicioğlu, 2009: 43-51).



Source: IMF, World World Economic Outlook Database,  
<https://www.imf.org/external/pubs/ft/weo/2016/02/weodata/index.aspx>, Accessed: 15.03.2017.

**Figure 3.** Investments and Savings in the Developing Economies (1980-2016)

### Effect of Capital Flows on Investment and Savings

Today, we can say that the development level of financial systems is measured by how liberalized the financial markets of a country are (Ağır, 2010: 110). Because in the developing countries, control of the financial sector and accordingly the distortions in the interest rates before the implementation of the financial liberalization policies caused financial system being not able to provide the necessary funds, besides, due to the lack of adequate borrowable funds, the desired increase in investments could not be achieved and this situation adversely affected economic development (Hepsağ, 2009:64). It is, therefore, important to clear whether financial liberalization can lead savings to the productive investment areas as expected.

On the other hand, it is also known that capital inflows prevent domestic savings and potentially create inflationary pressures, distorting the exchange rate imbalance and causing macroeconomic instabilities (Örnek, 2005:201). Thus, it is also important to investigate the causality regarding the impact of increased capital movements on savings and investments among countries that are financially liberalized. The financial system affects capital accumulation either by increasing savings rates (level effect) or by improving the distribution of savings among potential investors (redistribution effect). The availability of funds can also support economic growth through the financing of technological innovations (Achy, 2005: 70). With the liberalization of financial markets, domestic investments have begun to move independently of domestic savings. Therefore, in an open economy, external sources, that is, free capital circulating around the world, have become another means of financing investments besides domestic savings (Cicioğlu, 2009: 138).

The issue of causality is at the center of debates regarding the relationship between savings and investments. This situation can be followed in the national income accounts. GDP in terms of expenditure that the rationale behind means the use of all goods and services produced in practices can be defined as follows (Palley, 1996: 3):

$$Y = C + I + G + X - M \quad (1)$$

Here;

*Y*: nominal GDP,

*C*: nominal consumption expenditure,

*I*: nominal investment expenditure,

*G*: nominal government purchases,

*X*: exports, and

*M*: imports.

Production, which generates total revenue, has to be used by its owners. Assuming that the private sector is composed of households and firms, and accepting that income is distributed between consumption, savings and tax payments by definition, national income can be expressed as follows (Palley, 1996: 3):

$$\mathbb{Y} = C + S_H + S_F + T_H + T_F \quad (2)$$

Here;

$S_H$ : household savings,

$S_F$ : firm savings (undistributed profits),

$T_H$ : household tax payments, and

$T_F$ : tax payments of firms.

When we combine equation (1) and (2), we get a new equation as below (Palley, 1996: 3-4):

$$S_H + S_F + D = I + NX \quad (3)$$

Here;

$NX = X - M$ , i.e. net export,

$D = T_H + T_F - G$ , i.e. state savings (surplus if positive, deficit if negative)

The left side of the equation (3) shows the national savings composing of private sector savings and state savings. By definition, the right side is the sum of investment and net exports. That is, unconsumed part of the national income is kept as savings and used as investment or export (Palley, 1996: 4). The equilibrium of savings-investment in this equation is the main component of current account balance. In other words, when domestic investments are not supported by domestic savings and public expenditures exceed tax incomes, the current account gives account deficit (Cicioğlu, 2009: 138).

Some of the studies examining the effects of capital flows on domestic savings have pointed out that the first impact of foreign capital inflow will be in the negative direction but through the subsequent capacity expansion, the impact will result in the positive way. On the other hand, some of the studies argue that there is no significant correlation between the two variables or a small effect along with a meaningful correlation (Gürkan, 2008: 62). Nevertheless, it is clear that developing economies open to international capital flows are influenced by capital flows (Gürbüz, 2006: 50). While investments in a closed economy can be said to increase as savings increase, in an open economy capital flows make difference between domestic savings and investments.

Accordingly, domestic savings can also be evaluated abroad. In an environment where capital movements are unobstructed, ideally, savings of each country tend towards wherever will provide the highest return. As a result, increased domestic savings rate will provide a lower current account deficit, while not contributing to domestic investments and growth (Gürkan, 2008: 65).

### **Interaction of Investments and Savings Under Financial Liberalization: Story of Turkey on Its Way to Financial Liberalization (1980-2000)**

The process of international expansion in Turkey started through the deregulation movements experienced in foreign trade first with the decisions of January 24, 1980, and later followed by the liberalization of capital movements by bringing convertibility to Turkish Lira through regulation no. 32. in 1989. Gürbüz (2006: 77) and Ağır (2010: 49) state that these movements were triggered by the balance of payments problems, foreign exchange bottlenecks and the debt crisis that emerged at the end of the 1970s. Another important step in financial liberalization is moving from the fixed exchange rate system into the flexible exchange rate system which is determined according to market conditions, removing exchange controls, ensuring the convertibility of domestic currency, and deregulating capital movements. Within this framework, the financial liberalization movements in Turkey were realized on the deposit interest rates, foreign trade and capital movements respectively (Çokgezen, 2010: 19-20).

Through the liberalization practices carried out in the 1980s, it was expected that the Turkish economy would have been put into market economy system as well as to other developing countries, a stable growth in the economy would have been realized and more resources would have been transferred to the productive investments (Yıldırım and Altun, 1995: 77-78). However, despite the expectations regarding liberalization process to the contrary, Turkey has entered a period of expenditure and consumption that cannot be financed by its own resources in the course of the ongoing financial deterioration period since the middle of the 1980s. Thus, the competitiveness of the economy has decreased, the potential for winning foreign exchange has fallen, the dependence on the hot money has gradually increased, and capital movements has had an unstable tendency during this process (Kara, 2001: 34; Mangır 2006: 464). Especially after the 1990s, the "twin crises", that is finance (banking) and balance of payments crises (currency) crises, have intensely and severely influenced the Turkish economy (Emsen et al., 2006: 3). It is possible to list the common points of the crises

that started in the finance market and then the real sector in the developing countries besides Turkey during the 1990s and 2000s as follows (Mangır, 2006: 464):

- Non-sustainable budget deficits,
- High external debts,
- Negative interest rates along with the increase in the inflation rates,
- Decrease in the production,
- Increase in unemployment along with wage declines,
- Rapid fund flows through globalization,
- Increasing short positions in the banking system.

One of the most important objectives of financial liberalization and financial restructuring practices in Turkey has been the creation of competition conditions in order to increase the amount of resources intermediated by the financial sector (Saygılı, 2001: 167). Until the liberalization of capital movements in 1989, we can summarize the liberalization process in Turkey as follows (Mangır, 2006: 463-464):

- 1980: Price controls on the stock market were removed.
- 1980: Restrictions on interest rates were lifted.
- 1981: Import substituting period ended.
- 1982: The capital market was established.
- 1984: Exchange rate transactions were allowed.
- 1985: Banking law were put into force.
- 1986: Interbank currency board opened.
- 1987: Open market operations started.
- 1988: Effective foreign exchange market was established.
- 1989: The gold market was established.
- 1989: Restrictions on capital movements were lifted.

Along with the removal of these limitations in the financial markets after 1989, the government's authority to direct economy by its macroeconomic policies has weakened. Moreover, the legal and institutional regulations required for an open and free economy in Turkey were not at a sufficient level. This situation seriously threatened the stability of the Turkish economy against speculative movements in foreign capital inflows and outflows (Ağır, 2010: 61).

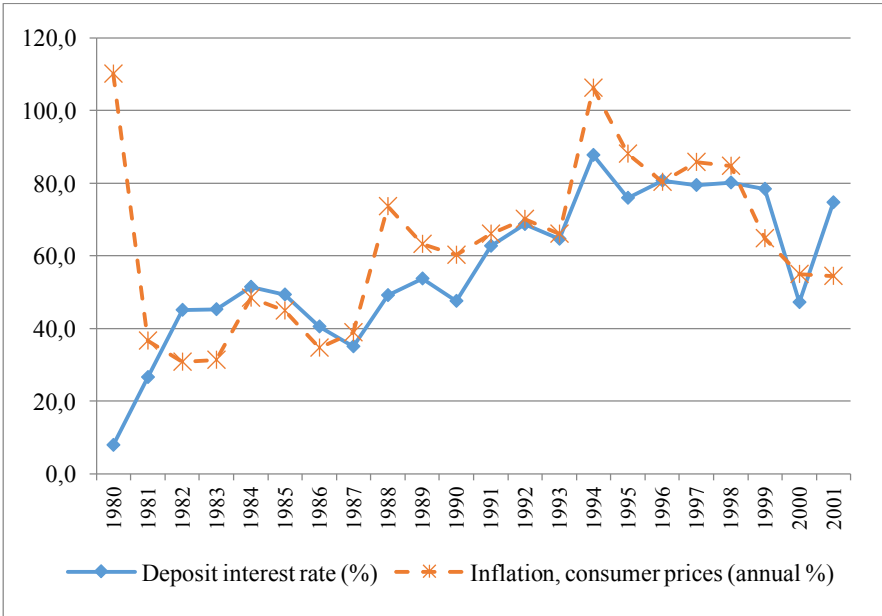
The most prominent feature of these movements, which determine the 1980's of the country; is that the process of financial liberalization was carried out by the control of the public. Lack of the relevant institutional infrastructure in the markets prevented the process from taking place spontaneously in the markets (Sak, 1995: 59). The financial markets could not have any real progress in Turkey, which continued its economic activities in a closed system until the 1980s. Up until this period, the fundamental and dominating institutions in the financial markets were the commercial banks and the only financial instruments offered to savings holders were the deposits (Bolak, 1998: 21). Beginning from this period, especially the banking sector in Turkey continued to develop in the shadow of global capital and economic crises (Akgeyik and Yavuz, 2009: 31-33). Özgen (1995: 1) notes that these practices did not increase the economy's total savings rate, contrary to what is desired in Turkey, but rather merely caused a shift sector in the composition of savings in favor of the financial sector.

Towards the end of 1980, the capital market activities reached important amounts, furthermore due to the increase in the interest rates and the unhealthy functioning of these markets as a result of the uncontrolled structure of the system led companies to meet financing needs from the bankers. After these bankers started to collect deposits from the people and subsequent increasing repayment problems caused the "Bankers Crisis" in December 1981 and the "Case of Kastelli" in June 1982. High inflation rates and the legislation restricting deposits and bond rates are indicated as the main reason behind these events. Thus there emerged a need for a series of arrangements in order to increase supervision and control in the capital markets. First of all, the Capital Market Law No. 2499 dated 27.07.1981, the Decree Law Concerning Securities Exchanges No. 91 dated 06.10.1983, and in order to protect depositors and eliminate bankers Decree Law No. 35 were passed (Bolak, 1998: 22-26; Küçüksözen, 1999: 75-77). The main purpose of the regulation no. 2499 was mentioned as follows; "Once the basic condition of the formation and development of the capital market is to work in the context of confidence and stability and the protection of the savers' rights. This trust and determination should be considered as a guarantee for the future of the market." The implication of "the "Private Finance House" started by the Decree No. 83/7506 dated 16.12.1983 has opened the door for foreign capital inflows from Islamic countries. During this period, it is seen that institutions such as Al Baraka, Faisal Finance, Kuwait Bank and Bank Mellat entered the market either by opening branches directly or by establishing joint ventures with other Turkish banks (Sayim and Özmen, 2001: 612; Gungen, 2010: 182).

The year of 1989 can be considered a turning point for the Turkish financial markets. Along with the Decree No. 32 dated 11.08.1989 regarding the protection of the value of the Turkish currency, the financial liberalization was achieved thus the entry and exit of domestic and foreign capital into the country was facilitated. This decision constitutes the last stage of financial market liberalization and initiated the period of "Fully Open Foreign Exchange Regime" which is still being implemented today (Kazgan, 2009: 165-166). Through the decision, the tendency of Turkish banks to open out was strengthened, both the foreign currency reserves and foreign currency assets of banks increased. In addition, foreigners had the opportunity to obtain domestic debt instruments and the banks and private finance houses had the opportunity to obtain foreign debt instruments. The most important effect of this decision is that all legal obstacles to short-term capital (portfolio investments) were removed. Thus, in the 1980-1990 period, 8 of the 19 trading banks operating in Turkey constituted foreign banks (Erdem, 2010: 132; Tellalbaş, 2011: 102; Coşkun et al., 2012: 18). Another regulation introduced in the same period was the agreement which was going to be carried out by the sub-foundation of the World Bank and aiming to insure foreign investments against political risks in particular. According to this agreement; foreign investments would be insured against political turmoils or governmental changes for 15 years in 1988 (Kazgan, 2009: 184-185). As all these practices that were realized without ensuring fiscal discipline and economic stability have had consequences supporting criticisms regarding the timing and level of liberalization.

Another development in the context of integration efforts into the world financial markets is the disclosure of the risk-based capital adequacy consensus by the Basel Banking Committee in 1988 in accordance with the growing concern about the capital adequacy of banks in the international arena. Within the scope of this consensus, the requirement of keeping risk-based capital with the Banking Law No. 3182 dated October 26, 1989, was introduced in Turkey (Altıntaş, 2006: 56-57). The principles of establishing a bank in free zones and opening branches by foreign banks were determined with the decision taken on October 20, 1990. Furthermore, off-shore banks were allowed to carry out intermediary activities in the capital markets (Fevzibeyoğlu, 1991: 21-22). Along with the 1990s, technological developments gained speed much higher than in previous periods and reduced the transaction costs of investments; thereby increased the transaction volumes in the financial markets. Moreover, the free and rapid movement of fund flows also increased the fluctuations in financial markets. Another result seen in this period was the development of new financial instruments in parallel to the derivative markets' gaining importance (Baştürk, 1999: 12).

Moreover, continuous borrowing at increasing interest rates in 1993 without taking structural measures resulted in the foreign exchange crisis in money markets in 1994 (Yıldırım and Altun, 1995: 147; Özatay, 2010: 65 - 68). Hot money flows are known to be influential as the greatest cause of the 1994 crisis. The funds entering through the stock market into the country initially appeared later on treasury bills (Kara, 2001: 36). The salient feature of this crisis is its emergence associated with an intense financial sector crisis. The banking sector was in a heavy external debt burden and this was partly due to foreign currency (Mangır, 2006: 464). High inflation and real interest rates, increasing current account deficit, and increases in the public sector borrowing requirement, are the basic indicators of this unstable crisis period (Ağır, 2010: 61). “The April 5th Decisions” taken right after the crisis, were basically aiming to stabilize the financial markets. In this context, measures have been taken towards the Central Bank of the Republic of Turkey (CBRT), the banking sector and the capital market (Turan, 2011: 64-65). From the 1994 crisis to the 2001 crisis, about 27 banks went bankrupt and the economy was heavily burdened (Soral, 2009: 132). Moreover, despite the fact that the Turkish economy was not much affected by the first shocks of the 1997 Asian crisis, the crisis that broke out in 1998 in Russia, which became an increasingly important trading partner, had negative effects on the domestic and foreign macro balances of Turkey, caused demand shrinking in the national goods markets and began to reflect the negative effects of the financial crisis. Due to the effects of the decline in growth rates since 1997, the domestic debt dynamics have deteriorated especially in 1999 and the real interest rate of the budget has reached very high levels (Ağır, 2010: 66-68). As the ongoing crises started to affect the economy more frequently and deeply after the 1980s, it supported the idea that the implementation of liberalization was realized without adopting necessary structural measures. Because the rapid increase in domestic and foreign debts and the volatility in the exchange rates and interest rates were also influential on these crises (Chambers, İşeri, and Çilingirtürk, 2003: 11-12). Figure 4 represents the inflation and deposit interest rates for the period of 1980 and 2001. Accordingly, despite interest rates rise rapidly above inflation rates until 1987 it has an unstable and rising trend. After 1987 inflation rates exceed interest rates mostly causing a loss in real returns. It is only after 2001 that this trend becomes reverse.

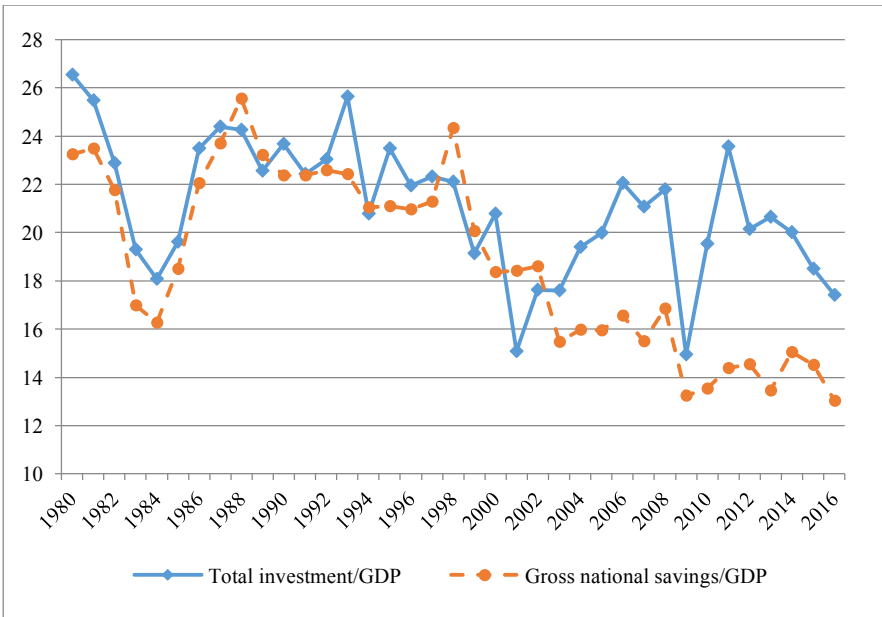


Source. Worldbank, World Development Indicators, <http://data.worldbank.org/country/turkey>, Accessed: 15.03.2017.

**Figure 4.** 1980-2001 Period Inflation and Deposit Rates

The dollarization process is an important consequence of the developments experienced in the financial system during the 1990-1999 period. Because of the lack of adequate diversification of financial instruments, cash was the widely used payment instrument. While high returns on real interest rates and stock market assets were obtained despite public deficits and high debt ratios, there observed an increase in the foreign portfolio investments (Çokgezen, 2010: 167-171). After the developments in the liberalization of trade and foreign exchange regime accompanied by the developments in computer and communication technologies, it was seen that the banks were mainly engaged in activities such as financing of foreign trade, leasing, factoring, forfaiting and securities intermediation. Foreign exchange position deficits of the banks started to grow especially in the 1990s due to the pressure caused by the increasing borrowing requirement of the public (TBB, 2008: 15). The crisis in the financial sector in November 2000 deeply affected the real sector as well. The short positions in foreign currencies of banks, open positions of public banks, duty losses of public banks, public

sector debt stock and the misapplied policies were all shown as the cause of the November 2000 crisis (Cicioğlu, 2009: 88). During the February 2001 crisis, not only interest rates rose, but also maturity periods began to fall. The Turkish economy shrank considerably, unemployment increased, a significant amount of capital outflow and a decrease in the production level were experienced after this crisis (Özatay, 2010: 89-100).



Source: IMF, World World Economic Outlook Database, <https://www.imf.org/external/pubs/ft/weo/2016/02/weodata/index.aspx>, Accessed: 15.03.2017.

**Figure 5.** Investments and Savings in Turkey (1980-2016)

Figure 5 represents the share of savings and investments in GDP in Turkey between 1980 and 2016. After 1989 which was the year liberalization of financial markets was completed by bringing convertibility to Turkish Lira through regulation no. 32 and "Fully Open Foreign Exchange Regime" period in Turkey started, it is seen that both share of investments and savings in GDP have declining and quite volatile tendency, yet the investments are relatively higher which negatively affect the current account

balance. As of 2002 despite savings and investments have a decreasing tendency, share of investments is much higher than the savings affecting current account balance in a negative way. It is also seen that during serious crises of Turkey in 1994, 1998 and 2001 and the global financial crisis in 2008, there seem to be sharp decreases in the investment ratios followed by quick increasing periods.

## **Conclusion**

As it is seen, liberalization in the financial markets has emerged as a process after the collapse of the current monetary system in the 1970s, led by the developed countries and supported by the studies of economists like Shaw and McKinnon. With this implementation, it aimed that the funds are used more efficiently in the world through flowing from low-return and high-risk locations to high-return and low-risk locations. Despite these aims, increasing financial crises after liberalization process as of the 1980s have led to the questioning of this concept and the extent to which expectations pointed by the academic studies are achieved.

Analyzing the 1980s period in Turkey, it is seen that important steps were taken towards the financial liberalization process, financial deepening began to take place through the institutions established in the financial system and diversified investment instruments. Although financial liberalization movements were not fully realized, significant progress was made through this direction. On the other hand, executing this process within a macroeconomically unstable system has led this transition period to be experienced in turbulence and instabilities for Turkey. The banking system became the external debt provider of the government and could not carry out its main functions in terms of providing credit for domestic investors thus prevented the economy from developing healthily during the 1990s. The fragile structure that the system has fallen into led to financial crises which left the economy unsettled.

## **End of Chapter Exercises**

1. What is the motivation behind financial liberalization implications?
2. How did the liberalization process start in Turkey?
3. What are the arguments of academic studies supporting financial liberalization process?

4. What are the common features of the economy policies before the liberalization process?
5. What are the critics against financial liberalization process?

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# 13 | The Relation of Foreign Trade and Globalization: A Practice in Turkey

*İbrahim ÇÜTCÜ*

*Abstract*

*Globalization is considered as a process that transcends national boundaries, integrates national economies, cultures, technologies and governance, and produces a complex relationship of interdependence. Globalization, which considers the degree of communication and interaction among people, society and states living in different regions of the world within the concept of interdependence, is also affecting many economic policies, especially foreign trade, especially after the 1980s. The foreign trade potential of a country is known as an important element of global competition for development and growth in international economy. In the study, it is planned to analyse the relationship between globalization and foreign trade for the years 1970-2016 depending on the availability of data for Turkey. While the globalization index variable planned to be used as an independent variable in the analysis is addressed in three dimensions; economic, social and political, the foreign trade variable to be used as a dependent variable consists of import and export data. In the study in which the cointegration analysis and the causality test will be implemented with the data obtained from the Swiss Economic Research Institute and Turkish Statistical Institute, a time series analysis will be conducted as a method and it is aimed to reveal the results of the relationship between globalization and foreign trade.*

*Keywords: Foreign Trade, Globalization, Economic Development*

*Jel Codes: F19, F60, F62*

## **Introduction**

The terms such as global trade, global competition, global life are notable titles which are going to run and run and subject to several studies in recent years. Due to the globalization that is the basis of the terms is explained by different disciplines with particular perspectives, its definitional statements also differ. In this study that is analyzed the relation between globalization and foreign trade based on the variables used, the globalization is integration and co-operation of countries around the world in economic, political, social and cultural fields. It could be attributed to the studies before 400 years when the root of the term of global is analyzed while it is mentioned that the globalization process has just entered in social sciences literature as a new fact. It could be said when the literature is reviewed that the first empirical studies revealed in the 1960s and the period on the markets were seen in the 1980s (Waters, 1995: 2-5). The globalization process that carries the mark and effect of the socio-political, cultural and technological improvements could be mentioned as a system where the international trade (import-export) could be improved, the effectiveness of the production factors are increased, the functionality of the technological transfer mechanisms is improved by being finished the political dissidence. When viewed from this aspect, the globalization is a term includes different subjects in various fields such as developing the relations between countries, being known the different cultures and beliefs, intensifying the international relations (Çelik, 2012: 57).

Also discovered the characteristics of the capitalist system when being approached to the term of globalization from ideological standpoint. Especially the production mode of the capitalist system has the general features of globalization while is implemented on worldwide successfully and competitively. This globalization process also expressed by K.Marks and F.Engels (Kartal, 2007: 255). According to K.Marks and F.Engels, the bourgeoisie succeeds to develop the forces of production as gigantic and more mass than previous generations in its more than a hundred years rulership. By this means, nature were brought under control, the technology developed and the improved machines were applied on agriculture and the industry, the steam-operated ships were built, the railways were built for the sectors of transportation and logistics, the cultivated lands were enlarged (Marks and Engels, 1972: 64). But the globalization found an

implementation area by passing to the market economy and liberalization in the 1980s; then, for this purpose, the tendency of integration of local markets with global markets by being attempted on the free circulation of the capital, goods, and services. Dispersing the USSR (Union of Soviet Socialist Republics) by the year of the 1990s and becoming the world unipolar accelerated this process (Bakan and Şentürk, 2012: 46). Moreover, the international organizations such as NATO, EU, NAFTA, EFTA played an active part in regional socio-economical integrations. Although the globalization process became more popular after the 1980s, its foundations were laid in conferences of Bretton Woods in 1944 after the 2nd World War by being established the IMF-World Bank-United Nations. In this study where the econometric analysis examines the relationship between globalization and foreign trade, firstly the globalization process is evaluated conceptually, and its historical development, dimensions and the effects on the foreign trade are analyzed; afterward the consequences of the globalization of the economy of Turkey are scrutinized. The relation between globalization and foreign trade is interpreted in the analysis part of the study through Cointegration and Causality Tests with the data between 1970-2016 and the data from Switzerland Economics Research Institute and Turkish Statistical Institute.

### **Theoretical and Conceptional Framework**

The word of globalization was firstly used by Merriem Webster's Dictionary in 1944 and the words of 'globalizing,' and 'globalized' that are the extension of the term were located in Oxford English Dictionary, but in 1962 (Yüksel, 2014: 129). For the conceptional statements, Canadian sociologist Marshall McLuhan who used 'global village' and 'global integration' came into prominence. According to McLuhan, the economic, political, scientific, cultural and commercial activities in the world affect the other countries and societies that are the part of the world system, form the basis for occurring the mutual interaction between states and nations (Şenkal, 2011: 99). Therefore, any development that may ingenerate in the world can affect different geographies, not just the region where the event happened.

The sense of globalization cause unusual comments in various ideologies. Both followers and opponents are damning at the same time. The feelings/perceptions on globalization are subjected to a trio classification as radicals, skeptical and transformational (Held et al. 1999: 1-4). As Yeldan (2002) mentioned, it could be understood how the positive and negative results arising from the globalization are important when being considered

a series of components such as 'profit approach' that is triggered by Fordist mode of production, international 'capitalist competition,' impeding to industrial investments by speculative accumulation opportunities by liberalizing the economic system within the frame of neoliberal policies. These positive and negative results could be summarized as below (Balay, 2004: 64-66);

### Positive Results

- The globalization discourse that eliminates the boundaries the terms of time and place and the events that happened at global scale became the common property of the humanity,
- The humanity started to league together at the common denominator, the collective values of humanity occurred, the civilization and the culture had to be defined again,
- The mutual terms like justice, freedom, equality became the common property of the humanity; thus it is enabled for occurring a new identity for the individuals at confidence and self-believe points,
- The mentality of 'wealth' for everybody was accepted in the society by revealing the terms of social state and social justice,
- The globalization resulted positive in the field of health, and the cures were discovered for several chronic diseases
- Provided the free movement of labor between countries,
- The dealing and dialog started between the cultures, common lifestyles revealed,
- Globalization adopted International education policies, the world countries took a step to internationalization at all stages of the education via protocols developed.

### Negative Results

- With the globalization trend, the states have emerged that claim to be a global power and the nation-states which had to integrate with that ones are exposed to the cultural, social and economic effects of them
- The globalization confronted the societies with the obligation of choosing the two choices. One of these options is getting these communities closer to each

other; the second choice is to create a systematic relations moves on the basis of national discourses. That's why the governments are alone with the danger of jeopardizing the national integrity or staying out of the globalization process.

- The globalization is an advantage for the countries that became industrialize earlier while it is a disadvantage for the countries which completed their industrialization lately.
- The globalization compresses the countries between tradition and global values. This dilemma causes to occur the organisms live tides between traditional line and global values.

The economic, social and political dimensions of globalization and the relation between foreign trade are analyzed in this study and proved that the biggest effect of the globalization is on the economic dimension. In developing countries such as Turkey, the large part of the basic consumption goods, investment, and intermediate goods are obtained by the way of importation, Therefore, the integration of the countries to global economy creates significant interactions in the production and consumption structures of national economies. Integrating the countries with the world economy and the globalization level is measured by proportioning their foreign trade to their GNP (gross domestic product) (Dorman, 2000; 46). The increment of the global trade could be grounded on various factors. Some of these factors are follow; discounts in customs tariff, quota reduce or abrogate, decrease the costs of transportation and communication, global marketing strategies, the existence of organizations for increasing the regional trade such as International Trade Union-IMF, being provided the improvements in financing of foreign trade as national and international, internationalizing the production processes by being used the contract manufacturing more than usual (Adıgüzel, 2013: 4-5). All these factors and long termed data show that the foreign trade has a big share in the national economy before the global effects and world wars and especially in the last periods of the 20st century.

## Literature Research

The term of foreign trade associated with several variables in econometrical analyses. After being reviewed the literature, the relation between international trade and growth were included in the study by macroeconomic variables such as the relation of the foreign trade exchange rate, foreign trade-inflation. It is realized in researches conducted

that the dimensions of the connection between globalization and foreign trade have not been studied adequately. The relation between globalization and foreign trade is analyzed in this research, but the variables are determined with the help of other studies in the literature.

In this study, the data of import and export are included in the analysis as the variable of foreign trade. Foreign trade is computed by the sum of import and export in a lot of reports in the literature, while some of these reports calculate it separately. Shirazi and Manap (2005) tested the effects of import and export on the growth one by one in their study which reviewed the relation between foreign trade and growth between the years of 1960 – 2003 in Pakistan. According to the result of the survey, there is bidirectional causality between import and the growth; one-way causality between export and the growth is also proved. Iqbal et al. (2010) confirmed in their study that there is a one-way causality from export-based import and import to export. Enu et al. (2013) examined the causality relations between foreign trade and economic growth by using the data of annual export, import, and GDP for the period of 1980-2012, and determined a bidirectional causality relation between export and growth and import and growth as well.

The fact of globalization is also described as openness in being associated with the foreign trade. Frankel et al. (1996) observed the relation of foreign trade and the growth for 7 East-Asian countries between the years 1960 – 1985. According to their findings, openness has a powerful effect on the growth. Riezman et al. (1995) investigated the link between commercial openness with export and the growth for 126 countries between the years 1950-1990. According to their findings, there is a bidirectional causality relation between commercial openness with export and the growth. Sinha and Sinha (2000) analyzed the link between openness and the growth for 19 Asian countries between the years 1950-1992. Depending on the outcome of the research, the economic growth has a positive relation with financial openness in Hong Kong, Iran, Israel, Myanmar, Pakistan, China, Singapore, and Iraq. Kurt and Berber (2008) observed the connection between openness and the economic growth between the periods 1989:01 – 2003:04 in Turkey. According to the result of the analysis, there is a bidirectional causality relation between openness and the economic growth. Utkulu and Özdemir (2004) worked on the effect of liberalization of foreign trade in Turkey on the economic growth based on the theory of endogenous growth. Depending on the outcome of the study, there is long termed and positive relation between foreign trade liberalization and the economic growth.

The connection between international trade and the globalization is reviewed in the part of an analysis of this study. As is seen in the literature, the foreign trade is composed of the data of import and export. The globalization indexes which are determined by Switzerland Economic Researches Institute are used as the globalization variable. Three dimensions in principle discuss the variables of the globalization index as economic, social and political. Bakan and Şentürk (2012) express the economic globalization as the integration of national economies into the world economy, in other words, becoming the world like just one market. Günsoy and Kar (2008) mention that the economic globalization has three sub-processes; globalization of production, globalization of the trade and financial globalization. Çelik (2012) dimensioned the systematic linkages of the technology by taking the technology to the forefront as the trigger of the globalization; discussed the technological, economical, political and socio-cultural dimensions as the dimensions of the globalization. Aktel (2001) expressed in the study that he accepted the globalization as laissez-faire democracy on the political platform, free market economy on the economic platform and a term gained a cosmic dimension shows the differences on the cultural platform. Kivılcım (2013) argues in the study where he examined the globalization process through Turkey that besides being effected, Turkey needs to be a country can contribute to the globalization process and create strategies based on this by perceiving the advantages and disadvantages of globalization correctly to increase the competitive capacity and protect the available political, economic and socio-cultural advantages on international platform. Doğan and Can (2016) used the data from KOF Globalization Index as the globalization variable while testing the effect of globalization on the growth by cointegration analysis for the economy of South Korea. Chang and Lee (2010) actualized a research by using the indexes of social and economic globalization and the globalization index as a whole with the Panel Causality analysis for 23 OECD countries and confirmed that there is a bidirectional causality relation between both three globalization indexes and the growth. Potrafke (2010) appointed that there is not a connection between globalization as a whole and the economic growth by the analysis of EKK – GMM in 21 OECD countries. Villaverde and Maza (2011) tested the relation of globalization with the growth in 101 countries by using the data of economic, social and globalization index as a whole via EKK technique.

## **Econometric Analysis**

In the next part of the study, the analysis dimension of the study is evaluated which's conceptional and literature research are below. Within this context, firstly the econometric model that is included into the analysis is generated, then the results of the analysis are evaluated by being transferred the methodology.

## **Econometric Model**

In this study, the relation between foreign trade and globalization are analyzed by the data includes the periods of 1970 – 2016. The data of foreign trade is obtained from Turkish Statistical Institute; the globalization index data is collected from the database of Swiss Economic Institute. The globalization index KOF is derived by being calculated the sub-indexes and indicators through binding to different weights by Swiss Economic Institute. As is also mentioned in the literature, all variables are transformed into an index between 1-100 for calculating the globalization index consisting of 2 main dimensions as economic, social and political globalization. The high values show more globalization for the variables and the weights for the sub-index calculation are obtained by being used the principal components analysis. Two model estimations are actualized within the frame of analysis performed. The export (X) is accepted as the dependent variable in the first model, the import (M) is taken as the dependent variable in the second model. The globalization index (GE) is used as the independent variable for both models. The models are established so as to be purified from the seasonality and being taken the logarithms of the variables. The models established could be expressed as;

$$X_t = \beta_0 + \beta_1 GE_t + \varepsilon_t \quad (1)$$

$$M_t = \beta_0 + \beta_1 GE_t + \varepsilon_t \quad (2)$$

## **Methodology**

The methodology in this study is analyzed the relation between globalization and the foreign trade as follows. From the literature research, the variables analyzed consist of the globalization index data includes economic-social-political globalization dimensions as the globalization; export and import data as the foreign trade. The tests used in econometric research are the cointegration and causality tests. Before these analyses, whether being the series stationary is measured by ADF and PP tests. Primarily, the cointegration test of Engle-Granger is implemented, then the causality analyses are actualized under the models for steady variables at I(1) level. We used the causality analysis of Granger and Toda-Yamamoto for causality analyses which are accepted as new generation econometric tests and utilized by a lot of investigators, then the hypotheses commented comparatively.

## **Findings**

In this part of the study, the connections between the import and export data and the globalization in the period of 1970-2016. Within the scope of these analyses, first of all, the unit root tests of data are actualized, then the tests of cointegration and causality are interpreted.

## **Results of Unit Root Test**

In the econometric time-series analysis, the unit root tests which do not consider the structural breakages are interpreted before being reviewed the cointegration and causality relations. The unit root tests in econometric analyses are actualized to avoid the problem of spurious regression. It will be wrong to talk about a meaningful relation between these variables if the unit rooted series are not stationary and the non-stationary time-series has not a cointegration relation (Harris and Sollis, 2003: 41). Said that there is the problem of spurious regression if the series are unit rooted, the financial comments will be meaningless even if the values of  $R^2$  and  $t$  are significant (Sevüktekin and Çınar, 2014:324). Because of these reasons, the stationarity of globalization index data with terms of foreign trade between the years of 1970-2016 is tested by the methods that were developed by Augmented Dickey-Fuller (1979) (ADF) and Phillips-Perron (1988) (PP).

**Table 1. Results of ADF and PP Unit Root Test**

<i>Level</i>		<i>Variables</i>	<i>ADF</i>	<i>PP</i>		<i>Variables</i>	<i>ADF</i>	<i>PP</i>
		<i>Fixed</i>				<i>1st differences</i>		
	<i>Fixed</i>	LGE	-1.04(0) [0.7442]	-0.99(2) [0.7474]		LGE	-6.31(0) [0.0000]*	-6.31(2) [0.0000]*
		LX	-2.17(0) [0.2190]	-2.17(0) [0.2190]		LX	-6.48(0) [0.0000]*	-6.48(1) [0.0000]*
		LM	-2.18(0) [0.2155]	-2.18(0) [0.2155]		LM	-6.65(0) [0.0000]*	-6.65(1) [0.0000]*
	<i>Fixed+Trend</i>	LGE	-0.78(0) [0.9598]	-0.996(3) [0.9345]		LGE	-6.36(0) [0.0000]*	-6.36(1) [0.0000]*
		LX	-1.97(0) [0.5969]	-1.94(2) [0.6143]		LX	-6.97(0) [0.0000]*	-6.97(0) [0.0000]*
		LM	-3.14(0) [0.1092]	-3.14(1) [0.1092]		LM	-6.99(0) [0.0000]*	-6.99(0) [0.0000]*

The values of \*, \*\* and \*\*\* respectively show the stationarity of the series at 1%, 5%, and 10% significance level. The values in parenthesis show the optimal delay lengths for ADF based on the Schwarz statistical information criteria; for PP based on Kernel method; for “Barlettkernel” and bandwidth based on the “Newey West bandwidth” method. In a case of being the delay length zero, it shows the Dickey-Fuller test. The values in square bracket indicate the probability values.

It is seen when the results of unit root test are analyzed based on the data in Table 1 that all the variables are not stationary in both constancy model and constancy and trendy model at the level values [I(0)] according to the outcomes of ‘Developed Dickey-Fuller-ADF test’. Seen that the variables in both two models become stationary when their first differences [I(1)] are taken. Observed by being reviewed the Table 1 that the test results of Phillips and Perron give similar results.

### Engle-Granger Cointegration Test

After the unit root test, analyzed that if the two or more than two variables move together or not via cointegration tests. After being taken the differences of long termed relation series between the variables and became steady, they are tested by the techniques of Johansen-Juselius (1992) and Engle-Granger (1987) (Barışık and Demircioğlu, 2006: 76). In the study, Engle-Granger cointegration test is used because of its generality and simplicity and being most preferable either. The test of Engle-Granger (EG) tests is based on the ruins (relics). As is known, a regression below is established between the two variables that are steady from the first grade at an early stage of the Engle-Granger test (Yılancı, 2009: 208):

$$Y_t = \alpha_0 + \alpha_1 X_t + u_t$$

In the second part of the analysis, the error term is estimated by the least squares method and looked at the permanent status of ruins by being established an autoregressive model with ruins obtained from the regressions.

$$\Delta u_t = \Delta \rho u_{t-1} + e_t$$

It could be said that the ruins include unit root in case of being  $\rho = 0$ , so there is not a cointegration relation between two variables. Due to the series are the possible values from the regression equation, not the surveyed data, the critical values that are obtained via simulations by Engle-Granger (1987) instead of ADF critical values to test the stationarity of the ruins. Analyzed in this study that the relation between export-import and the globalization in Turkey between the years 1970-2016. Since the steady levels are  $I(1)$  in the unit root test, the test of Engle-Granger is accepted to apply. Two models are established in the analyses; the variables of export(LX)—import(LM) are used in models as dependent variable globalization indicator, globalization index specified (LG) is used as the independent variable at the same time. The tests are actualized by being taken the logarithms of all data for providing convenience in terms of commenting the analyses and the size of data.

$$LX_t = \beta_0 + \beta_1 LGE_t + \varepsilon_t \quad (1.1)$$

$$LM_t = \beta_0 + \beta_1 LGE_t + \varepsilon_t \quad (1.2)$$

It is seen when the test statistics of ruins series that are subtracted from cointegration analysis between the export and the globalization index is compared with the critical values of Engle-Granger that the value of 4,14 is bigger than the key values of 1% - 5% - 10%. For that reason, there is both linear and non-linear long termed relation between export and the globalization.

**Table 2. Engle-Granger Cointegration Test (LM – LGE)**

ADF Test Statistics	The Critical Values of Engle-Granger Cointegration Test		
	1%	5%	10%
-2.22	4,07	3,37	3,03

It is seen when the test statistics obtained from ADF steady test of ruins series that are subtracted from cointegration analysis between the import and the globalization index is compared with the critical values of Engle-Granger that the value of 2,22 is smaller than the critical values of 1% - 5% - 10%. Hence, it could be said that there is not both linear and non-linear long termed relation between the import and the globalization.

### Granger Causality Test

Granger Causality test means being obtained the values of next years time-series by effected from the previous values of annual data of a variable belongs to itself (İsığçık, 1994: 94). Granger Causality test is based on the basis of being tested the significances of delayed values of the independent variable in regression equation (Granger,1969, s.424-438).

$$Y_t = \alpha_0 + \sum_{i=1}^p \phi_i Y_{t-i} + \sum_{i=1}^q \delta_i X_{t-i} + \epsilon_t \quad (2.1)$$

$$X_t = \beta_0 + \sum_{i=1}^p \pi_i X_{t-i} + \sum_{i=1}^q \lambda_i Y_{t-i} + \mu_t \quad (2.2)$$

It is tested in above models that if the coefficients of delayed values of independent variables are equal to zero or not ( $\delta_1 = \delta_2 = \dots = \delta_i = 0$  ;  $\lambda_1 = \lambda_2 = \dots = \lambda_i = 0$  ). If the hypothesis is denied by being used the F test in Equation (2.1), it is accepted that X is the Granger reason of the Y. In Equation(2.2), if the hypothesis is denied, it is accepted that Y is the Granger reason of X.

**Table 3. Granger-Causality Test**

Hypothesizes	Statistics of F	Result
<b>Export is not the reason of globalization.</b>	1.9174(0.1733)	Export is not the Granger reason of globalization.
<b>Globalization is not the reason of export.</b>	1.7306(0.1953)	Globalization is not the Granger reason of export.
<b>Import is not the reason of globalization.</b>	1.0573(0.3038)	Import is not the Granger reason of globalization.
<b>Globalization is not the reason of import.</b>	0.7.0537(0.0111)	Globalization is the Granger reason of import.(at 1% significance level)

\* The value in parenthesis indicates the probability value

\*\*The best-fit delay length is taken based on the information criteria of HQ and SC

\*\*\*The number of observation is 45.

### Toda-Yamamoto Causality Analysis

The causality relation between the globalization and import-export will be tested by Toda-Yamamoto (1995) analysis that is frequently used in new generation econometric analyses for make the results more stable. This analysis becomes addicted because of the condition of being the variables cointegrated in Granger causality analyses. The cointegration relation between the series is significant for causality test via the method of VAR that was developed by Toda and Yamamoto as well as it is sufficient to know the integration level of variables in the model and determine the type correctly (Kızılgöl and Baykal, 2008: 356). According to Toda and Yamamoto (1995), the VAR model that includes the level values of series could be estimated even if the series are not stationary and the standard Wald test is implemented as well. In this method, the VAR model is predicted for Granger causality test at  $[k+(dmax)]$  level, and the Wald test is applied on the first k numbers of coefficients matrix. Toda and Yamamoto (1995) showed that this test has k degree of freedom with the distribution of asymptotic  $2 \chi$  without considering if the relevant series is steady or cointegrated around the trend or not. As a result of this, 'k' means the best-fit delay length of VAR model, 'dmax' shows the maximum integration degree of the variables in the model. Thus and so, the first stage of the method is determining the integration degree of the variables in the system; the second stage is estimating the system. Accordingly, the success of the method hinges upon the correct prediction of delay length of a system (k) and integration degrees of series (dmax). This method that was suggested by Toda and Yamamoto does not

necessitate the potentially inclined pre-tests used to found the features of unit root and cointegration. In this way, being used to this method minimizes the incorrect estimation risk of integration level of series (Yavuz, 2006: 169).

Toda-Yamamoto analysis examines the causality between export and globalization. Before this analysis, the integration degree must be computed. Seen in the unit root tests of ADF and PP for the variables included that all the variables are rooted at the level, and steady when the difference is taken in the 1st degree. For this reason, it is accepted  $asd_{max}=1$ .

**Table 4.** The LX-LGE Proper Delay Length Based on the VAR Model Information Criteria

Lag	LogL	LR	FPE	AIC	SC	HQ
0	-26.52012	NA	0.012917	1.326517	1.408434	1.356725
1	115.4483	264.1272*	2.11e-05*	-5.090617*	-4.844868*	-4.999992*
2	115.9648	0.912959	2.49e-05	-4.928596	-4.519014	-4.777555
3	116.6612	1.166037	2.91e-05	-4.774939	-4.201525	-4.563482
4	118.0415	2.182891	3.31e-05	-4.653095	-3.915849	-4.381221

As is seen in Table 4, the delay number of degree of freedom (k) is 1 based on the AIC-SC-HQ information criteria. Therefore, the causality is actualized within the frame of VAR model from  $k + d_{max} = (1 + 1) = 2$ nd degree.

**Table 5.** LM-LGE Proper Delay Length Based on the VAR Model Information Criteria

Lag	LogL	LR	FPE	AIC	SC	HQ
0	-25.54462	NA	0.012344	1.281145	1.363061	1.311353
1	104.3603	241.6836*	3.54e-05*	-4.574900*	-4.329151*	-4.484275*
2	105.1880	1.462756	4.10e-05	-4.427347	-4.017765	-4.276306
3	105.5508	0.607509	4.88e-05	-4.258175	-3.684761	-4.046718
4	106.6941	1.808053	5.61e-05	-4.125307	-3.388060	-3.853433

In the second model of the study, the causality relation between import and globalization is analyzed by Toda-Yamamoto analysis. The integration degree must be

computed before the analysis. It is seen in unit root tests of ADF and PP for the variables included in the analysis that all variables are unit rooted at the level and steady when the difference is taken from the first order. That's why  $dmax=1$  is accepted. The delay number is seen as 1 for the degree of freedom (k) based on AIC-SC-HQ information criteria according to the Table 5. Thus, the causality is actualized within the frame of VAR model from  $k + dmax = (1 + 1) = 2$ nd order.

**Table 6. Results of Toda - Yamamoto Causality Analysis**

Main Hypothesizes	Delay Length $k=1, dmax=1$	F-Statistics	P-Value	Result
Export is not the reason of globalization.	2	1.1259	0.3344	Export is not the reason of globalization according to Toda and Yamamoto analysis.
Globalization is not the reason of export.	2	0.9666	0.3891	Globalization is not the reason of the export according to Toda and Yamamoto analysis.
Import is not the reason of globalization.	2	1.1366	0.3311	Import is not the reason of globalization according to Toda and Yamamoto analysis.
Globalization is not the reason of import.	2	3.6687	0.0344	Globalization is the reason of import according to Toda ve Yamamoto analysis (at 5% significance level)

According to the results of Toda-Yamamoto analysis in Table 6, the integration degree is accepted as 2 for both models and the last hypothesis 'globalization is not the reason of import' could be denied when looking at the significance values. This circumstance could be stated as  $LGE \rightarrow LM$ . The results of Toda-Yamamoto analysis jibe with the results of Granger Causality test in Table 3. So, it could be reached to the same result from both of two causality analyses. The one-way relation between the globalization and import is determined and the direction of this relationship is from globalization to import while there is not a causality connection between the globalization and the export.

## **Conclusion and Suggestions**

Turkey that follows the industrialization strategy based on the outward oriented export from import substitution policies actualized crucial institutional arrangements to liberalize and globalize the foreign trade by the legal decision of 24th January 1980. Several conveniences were provided such as fair-rate credit, tax immunities, tax refund for liberalizing the export and being encouraged the sectoral production and export by promotions and subventions. Innovated in the process of liberalizing the import such as removing the restrictions on the import, reductions for customs duties, abolishing the quotas. After the 1980s, mostly the globalization dimensions were useful in Turkey that is integrated to the globalization moves rapidly. The effect of the economic globalization which is more effective than social and political globalization on the trade resulted in increasing of foreign trade volume. Since this increment mostly originated in import, it caused to live a current deficit problem in the country. One of the most pressing issues of the current deficit is high costs and low growth problems.

The relation between foreign trade and globalization which is caused by significant macroeconomic effects investigated in this study. It is resulted according to the results of Engle-Granger Cointegration test in the light of the data between the years 1970 – 2016 that there is a linear and non-linear long termed relation between export and the globalization. But it is not determined any long termed relationship between globalization and the import in the same analysis. It could be said as far as the results of studies which are the important findings for the solution of the current deficit problem that the yields of the globalization are effective on export sectors; therefore it needs to be created more effective policies to develop the openness and the exportation.

Two different tests analyze the causality relation between globalization and the foreign trade. The same findings are obtained from the study where the causality analyses of Granger and Toda-Yamamoto are actualized separately. Determined that the direction of one-way causality relation is from just the globalization to the import. Apart from this, no causality link was found between export and globalization. This situation shows that the effectiveness of globalization on the import of Turkey and discussed that this issue must be considered to solve the problems like the current deficit and foreign trade deficit.

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# 14

## Geographical Location Analysis of Sectoral Concentration in the TR63 Region

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### Abstract

*The importance of regional economies, which are sources of national competitiveness in the global economy, is increasing daily, and regions are playing an effective role in achieving economic growth. This study analyzed the sectors becoming prominent in the manufacturing and service sectors in the provinces of Hatay, Kahramanmaraş, Osmaniye and the İBBS Level 2 TR63 region constituted by these provinces, using the method of Location Quotient (LQ). TÜİK 2002 General Industry and Workplace Census data were utilized in calculating location quotients by provinces, while 2009-2013 TÜİK Annual Manufacturing Industry statistics were used to calculate location quotients by regions. Sectoral location quotients were analyzed and the sectors that are becoming prominent in the location dynamics in the region were presented. The sectoral concentration on the level of provinces and regions was analyzed in the context of economic geography.*

**Keywords:** *Economic Geography, Agglomeration Economies, Location Quotient, TR63 Region.*



## **Sectoral Concentration and Regional Development in Economic Geography**

One of the main research areas of economic geography is the spatial location selection for industrial activity and analysis of changes in location selection in terms of determined time scales. On the other hand, economic geography focuses on space and location concepts (Sandal and Şen, 2013:44). One of the main purposes of economic geography studies is to describe and define the meanings of the development of industrial location selection and sectoral concentration from a global scale to a local scale. In this sense, space is a concept that is impossible to assume to be homogenous due to its geographical aspects and potentials.

All geographical events and economic activities take place in an area and one of the main questions of geography that indicates space, “where”, is answered by the concepts of space and location (Şen, 2016: 25). Spatial concentration is considered as an important criterion along with the geographical-spatial proximity among firms. Concentration is related to the number of firms choosing a location in the space, rather than being close. Concentration refers to existence of a relatively high number of firms specialized in a certain economic field of activity in one place (Kaygalak, 2011: 35).

Firms that are spatially close and active in the same branch of industry feel the need to cooperate. Geographical proximity and spatial concentration of economic activities are important in terms of information dispersion and externalities, while they show tendency to stay locally-oriented (Jaffe, Trajtenberg and Henderson, 1993: 577). Spatial concentration and clustering play an important role in the establishment of a competitive industrial structure. Therefore, determining the spaces where there is concentration and clustering of industry and studying the causalities regarding industry and location selection, have great importance for planning the investments to be made on and support to be provided for the sectors that are the driving forces in regional development.

## **Material and Method**

“Sectoral Location/Localization Quotient” (LQ) is a method of measurement used to determine the strategic sectors in a region or a country and measure the location/localization degree of the industry. LQ generally measures the spatial concentration of a sector in a region or nationwide by taking total values in the same

region as reference (Manavgat and Saygılı, 2014: 2). The method of location quotient has become a widely-used method for economic geographers and local economists since 1940s and referred to in various studies with the aim of determining the sectors that have comparative advantages in regions (Moineddin, Beyele and Boyle, 2003: 249).

The data for sectoral employment by provinces were published for the last time in 2002. This is why the data of the year 2002 were used. Additionally, while transition was made at our time to the NACE Rev. 2 classification system, the NACE Rev 1.1 system was used here as it was being used in 2002. 2009-2013 TÜİK (Turkish Statistical Institute) Annual Manufacturing Industry Statistics were used in calculation of region-based location quotients. This study used the data of Annual Industry and Service Statistics – Statistical Region Unit Classifications and Local Unit Number and Employment Based on Economic Activity Areas (2001) NACE Rev 1.1 published by TÜİK. The LQ values of the provinces in the İBBS TR63 Level 2 Region were calculated firstly by referring to the TR63 region, and then taking Turkey as a reference. The LQ value in the following equation shows the calculations made using the employment data. An LQ value of higher than 1 indicates sectoral concentration.

$$LQ_i = (e_{ij} / \Sigma e_j) / (E_{ij} / \Sigma E_j)$$

$e_{ij}$  = the employment of the sector  $i$  in the region  $j$

$\Sigma e_j$  = the total employment in the region  $j$

$E_{ij}$  = the employment of the reference region  $j$  or the country in the sector  $i$

$\Sigma E_j$  = the total employment in the reference region  $j$  or the country

Here,  $e_i$  indicates the employment of the sector  $i$  in the province/region,  $\Sigma e_i$  is the total employment in the province/region,  $E_i$  is the employment of the reference region/country in sector  $i$ , and  $\Sigma E$  is the total employment in the reference region/country. Location quotient is an arithmetic calculation method performed by dividing the employment rate of a certain sector in a region ( $e_i / \Sigma e_i$ ), by the nationwide employment rate of that sector ( $E_i / \Sigma E$ ) (Sungur, 2015: 322).

**Table 1.** Interpretation of Location Quotients

Location quotient	Clustering Situation
Lower than 0.50	None
0.50 – 0.99	Very Low
1.00 – 1.09	Moderate
1.10 – 1.24	High
1.25 and above	Very High

Source: (Yardımcı, 2014: 59).

## Findings

### Sector Prominent in Provinces

Data were calculated for a total of 41 sub-sectors that constitute the manufacturing and service sectors. In this context, in order to make the sector codes discussed in the study comprehensible, Table 2 shows the discussed sectors with their codes.

**Table 2.** Sectors Discussed in the Study (EFİS Rev 1.1 Classification)

CODE	SECTOR
10	Coal mining
13	Metal material mining
14	Other mining and quarrying
15	Food products and drinks
17	Textile products manufacturing
18	Clothing materials manufacturing: processing and dying fur
19	Tanning and processing leather; suitcase, purse, saddlery, harness and shoe manufacturing
20	Manufacturing of wood and wood fungus products (except furniture)
21	Paper stock and paper products manufacturing
22	Press: replication of records, cassettes and similar recorded media
23	Coking coal, refined petroleum products and nuclear fuel manufacturing
24	Chemical materials and products manufacturing
25	Plastic and rubber products manufacturing
26	Non-metallic mineral products manufacturing
27	Base metal industry
28	Except machinery and equipment: fabricated metal products manufacturing
29	Not otherwise classified: machinery and equipment manufacturing
30	Office machines and computer manufacturing

31	Not otherwise classified: electrical machinery and equipment manufacturing
32	Radio, television, communication equipment and devices manufacturing
33	Medical tools: sensitive and optical devices and watch manufacturing
34	Motorized land vehicle, trailer and semitrailer manufacturing
35	Manufacturing of other transportation tools
36	Furniture manufacturing; other manufacturing not specified elsewhere
40	Production and distribution of electricity, gas, steam and hot water
41	Collection, filtering and distribution of water
45	Construction
50	Sales, maintenance and repair of motorized vehicles and motorcycles: retail sales of fuel for motorized vehicles
51	Wholesale trade and trade brokering except motorized vehicles and motorcycles
52	Retail trade except motorized vehicles and motorcycles: repair of personal and household items
55	Hotels and restaurants
60	Land transportation and pipeline transportation
61	Water transportation
63	Supportive and supplementary transportation activities; activities of travel agencies
64	Mail and telecommunication
65	Activities of financial intermediaries except insurance and pension funds
67	Supportive activities for financial intermediaries
70	Real estate activities
71	Lease of machinery and equipment without operators, and personal and household items
72	Computer and related activities
74	Other work activities
80	Education
85	Medical work and social services
90	Collection of sewage material and waste, sanitation and similar activities
92	Activities related to entertainment, leisure, culture and sports
93	Other service activities

Source: <http://ec.europa.eu/eurostat>

While it is not sufficient to use only employment data to measure the localization and concentration levels of an industry or a sector, employment data are used to calculate the location quotient as there is not enough information based on provinces.

**Table 3.** Sectoral Location Quotients of the Manufacturing Industry  
in the TR63 Region

Sector	TR63			TURKEY		
	Hatay	Kahramanmaraş	Osmaniye	Hatay	Kahramanmaraş	Osmaniye
10	(-)	2,7607	(-)	(-)	6,6410	(-)
13	1,0102	(-)	(-)	0,3620	(-)	(-)
14	0,8562	0,8098	2,0056	0,6801	0,6432	1,5930
15	0,7950	1,1419	1,3933	0,7090	1,0184	1,2426
17	0,0909	2,6860	0,0827	0,1199	3,5426	0,1090
18	0,5777	1,5617	1,1318	0,1730	0,4679	0,3391
19	1,1455	1,0037	0,4579	0,4106	0,3598	0,1641
20	1,1834	0,6440	1,2248	1,9253	1,0478	1,9927
21	0,5951	1,9504	0,0893	0,2946	0,9657	0,0442
22	1,1094	0,6801	1,4052	0,3515	0,2155	0,4452
23	(-)	(-)	(-)	(-)	0,0000	0,0000
24	0,3391	0,6827	4,2186	0,0784	0,1578	0,9751
25	1,3244	0,4393	1,2241	0,4276	0,1419	0,3952
26	0,9729	1,0400	0,9984	0,4603	0,4920	0,4723
27	1,9041	0,0666	0,0403	11,8705	0,4150	0,2514
28	0,8270	1,2699	0,9536	0,7978	1,2250	0,9198
29	1,2644	0,7245	0,7257	0,9210	0,5278	0,5286
30	1,3481	(-)	(-)	0,3410	(-)	(-)
31	0,7844	1,3744	0,8468	0,1718	0,3011	0,1855
32	(-)	(-)	(-)	(-)	(-)	0,0979
33	1,4205	0,4714	0,7915	0,4837	0,1605	0,2695
34	1,4707	0,1103	1,5171	0,2591	0,0194	0,2673
35	(-)	(-)	0,0000	(-)	(-)	0,0000
36	0,9729	1,0106	1,0725	0,6079	0,6315	0,6702
40	0,3813	1,9072	0,9807	0,6592	3,2973	1,6956
41	1,0281	1,0111	0,8692	1,4210	1,3974	1,2013
45	0,9082	1,4344	0,2421	0,8563	1,3523	0,2282
50	1,0384	0,7042	1,6042	1,3763	0,9334	2,1263
51	1,1889	0,5740	1,3813	0,8032	0,3878	0,9332
52	1,0395	0,8582	1,2126	1,3732	1,1338	1,6020
55	1,0001	0,8748	1,3151	0,6676	0,5840	0,8779
60	1,0498	0,8330	1,2382	1,4133	1,1215	1,6670
61	1,9609	0,0000	0,0000	0,1033	0,0000	0,0000
63	1,7212	0,2734	0,1889	1,8053	0,2868	0,1982
64	0,9661	0,9430	1,2675	0,8695	0,8487	1,1407
65	1,2154	0,5362	1,3793	0,8738	0,3855	0,9917
67	1,2933	0,7643	0,5194	0,5806	0,3431	0,2332
70	1,1498	0,8035	0,9464	0,3923	0,2742	0,3229

71	1,4876	0,4916	0,4951	1,0002	0,3305	0,3329
72	1,6199	0,1653	0,8324	0,3476	0,0355	0,1786
74	1,0823	0,8732	1,0182	0,7123	0,5747	0,6702
80	1,2192	0,5359	1,3658	1,4955	0,6574	1,6753
85	1,2071	0,6321	1,1680	1,1609	0,6080	1,1233
90	(-)	(-)	(-)	(-)	0,0000	(-)
92	1,2848	0,6125	0,9331	1,0586	0,5047	0,7689
93	1,1738	0,6805	1,1682	1,4957	0,8671	1,4885

(-) LQ values could not be calculated as there were no data in the sector.

According to OECD, one may speak about industry concentration in a region where LQ is higher than one and employment is at least 1150 people. Accordingly, the following table shows the sectors with LQ values of higher than one and employment numbers of more than 1000 (OECD 2007: 141).

**Table 4. Sectors That Are Concentrated in the Provinces Based on LQ and Size of Employment**

Hatay			Kahramanmaraş			Osmaniye		
Sector	LQ	Employment >1000	Sector	LQ	Employment >1000	Sector	LQ	Employment >1000
20	1,9253	✓	10	6,6410	✓	14	1,5930	-
27	11,8705	✓	15	1,0184	✓	15	1,2426	✓
41	1,4210	-	17	3,5426	✓	20	1,9927	-
50	1,3763	✓	20	1,0478	-	40	1,6956	-
52	1,3732	✓	28	1,2250	✓	41	1,2013	-
60	1,4133	✓	40	3,2973	✓	50	2,1263	✓
63	1,8053	✓	41	1,3974	-	52	1,6020	✓
71	1,0002	-	45	1,3523	✓	60	1,6670	✓
80	1,4955	✓	52	1,1338	✓	64	1,1407	-
85	1,1609	✓	60	1,1215	✓	80	1,6753	-
92	1,0586	-				85	1,1233	-
93	1,4957	✓				93	1,4885	-

Accordingly; the first sector in Hatay with location quotient of higher than 1 and employment number of higher than 1000 is “27- Base metal industry” by a value of 11.8705. 9856 people are employed in this sector, which constitutes 13.80% of the

national total. Other sectors in Hatay where concentrations are the highest are; “20- Manufacturing of wood and wood fungus products (except furniture)”, “50- Sales, maintenance and repair of motorized vehicles and motorcycles: retail sales of fuel for motorized vehicles”, “52- Retail trade except motorized vehicles and motorcycles: repair of personal and household items”, “60- Land transportation and pipeline transportation”, “63- Supportive and supplementary transportation activities; activities of travel agencies”, “80- Education”, “85- Medical work and social services”, and “93- Other service activities.”

The sectors with high location quotient values which did not fit the employment criteria of minimum 1000 people are; “41- Collection, filtering and distribution of water”, “71- Lease of machinery and equipment without operators, and personal and household items”, and “93- Other service activities.”

The first sector in Kahramanmaraş with location quotient of higher than 1 and employment number of higher than 1000 is “10- Coal mining” by the value of 6.6410. A total of 2260 people are employed in this sector, which represents the 5.31% of the nationwide total. Other sectors in Kahramanmaraş where concentrations are the highest are; “15- Food products and drinks”, “17- Textile products manufacturing”, “28- Except machinery and equipment: fabricated metal products manufacturing”, “40- Production and distribution of electricity, gas, steam and hot water”, “52- Retail trade except motorized vehicles and motorcycles: repair of personal and household items”, and “60- Land transportation and pipeline transportation.”

The sectors with high location quotient values which did not fit the employment criteria of minimum 1000 people are; “20- Manufacturing of wood and wood fungus products (except furniture)”, and “41- Collection, filtering and distribution of water.

The first sector in Osmaniye with location quotient of higher than 1 and employment number of higher than 1000 is “50- Sales, maintenance and repair of motorized vehicles and motorcycles: retail sales of fuel for motorized vehicles” by the value 2.1263. A total of 1973 people are employed in this sector, which constitutes 0.67% of the national total. Other sectors in Osmaniye where concentrations are the highest are; “52- Retail trade except motorized vehicles and motorcycles: repair of personal and household items”, and “60- Land transportation and pipeline transportation.”

The sectors with high location quotient values which did not fit the employment criteria of minimum 1000 people are; “14- Other mining and quarrying”, “20- Manufacturing of wood and wood fungus products (except furniture)”, “40- Production and distribution of electricity, gas, steam and hot water”, “63- Mail and telecommunication”, and “Education.”

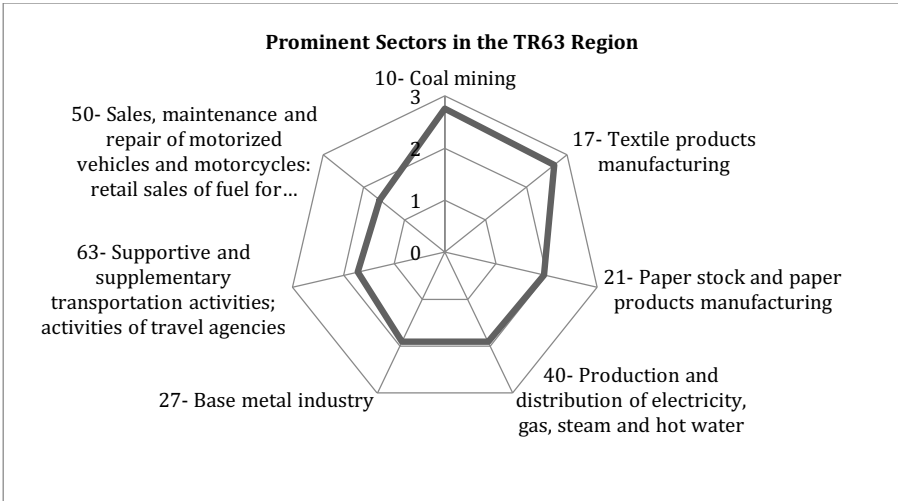
### **Prominent Sectors in the TR63 Region**

The most important sector in the TR63 region, the base metal industry is in the position of providing most exports with the automotive and textile sectors in Turkey. In this sector that is multi-dimensionally affected by international competition with this aspect, it is important to improve product specialization and sectoral R&D work against high energy and raw material costs to improve competitiveness. The other fundamental industrial sector of the region, textile, has an important place in international trade and national industry. The textile sector clustered in the Kahramanmaraş province in the TR63 region is also present in the provinces of Hatay and Osmaniye (DOĞAKA, 2015: 73).

Accordingly, the sector with the highest LQ value in the TR63 region was found as “10- Coal mining” with the value of 2.7607. This is followed by “17- Textile products manufacturing” by 2.6860, “21- Paper stock, paper and paper products manufacturing” by 1.9504, “40- Production and distribution of electricity, gas, steam and hot water” by 1.9072, “27- Base metal industry” by 1.9041, “63- Supportive and supplementary transportation activities; activities of travel agencies” by 1.7212, and “50- Sales, maintenance and repair of motorized vehicles and motorcycles: retail sales of fuel for motorized vehicles” by 1.6042.

**Table 5.** Sectors That Are Concentrated in Provinces and  
by the Region Based on LQ and Employment Criteria

Hatay			Kahramanmaraş			Osmaniye		
Sector	LQ	Employment >1000	Sector	LQ	Employment >1000	Sector	LQ	Employment >1000
13	1,0102	-	10	2,7607	✓	14	2,0056	-
19	1,1455	-	15	1,1419	✓	15	1,3933	✓
20	1,1834	✓	17	2,6860	✓	18	1,1318	-
22	1,1094	-	18	1,5617	-	20	1,2248	-
25	1,3244	-	19	1,0037	-	22	1,4052	-
27	1,9041	✓	21	1,9504	✓	24	4,2186	-
29	1,2644	✓	26	1,0400	-	25	1,2241	-
30	1,3481	-	28	1,2699	✓	34	1,5171	-
33	1,4205	-	31	1,3744	-	36	1,0725	-
34	1,4707	-	36	1,0106	-	50	1,6042	✓
41	1,0281	-	40	1,9072	✓	51	1,3813	✓
50	1,0384	✓	41	1,0111	-	52	1,2126	✓
51	1,1889	✓	45	1,4344	✓	55	1,3151	✓
52	1,0395	✓				60	1,2382	✓
55	1,0001	✓				64	1,2675	-
60	1,0498	✓				65	1,3793	-
61	1,9609	-				74	1,0182	-
63	1,7212	✓				80	1,3658	-
65	1,2154	✓				85	1,1680	-
67	1,2933	-				93	1,1682	-
70	1,1498	-						
71	1,4876	-						
72	1,6199	-						
74	1,0823	✓						
80	1,2192	✓						
85	1,2071	✓						
92	1,2848	-						
93	1,1738	✓						



**Chart 1.** Prominent Sectors in theTR63 Region

Accordingly, it is possible to stay that the sectors in question seen in Chart 1 have a driving effect in the region. Additionally, there are 20 sectors in the regions with location quotient values higher than 1 and number of employed personnel higher than 1000, while there are 34 sectors not satisfying the second criterion despite complying with the criterion about the location quotient.

### **Prominent Sectors in the TR63 Region: 2009-2013**

TÜİK 2009-2012 Annual Industry and Service Statistical Classifications classified according to NACE Rev.2 - Classification of Six Economic Activities (TÜİK, 2013) were used to calculate location quotients in the TR63 region.

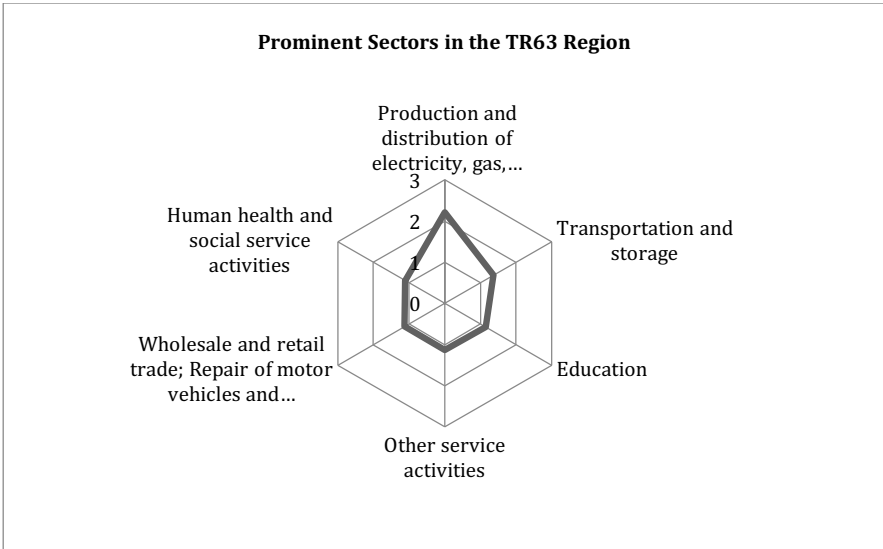
Accordingly, the sector in the TR63 Region with the highest LQ value, therefore the highest concentration, was “Production and distribution of electricity, gas, steam and air conditioning” by 2.2175. This is followed by “Transportation and storage” by 1.3742, “Education” by 1.1478, “Other service activities” by 1.1350, “Wholesale and retail trade; Repair of motor vehicles and motorcycles” by 1.1239 and “Human health

and social service activities” by 1.1052. Additionally, there are three more sectors with location quotients higher than 1.

**Table 6.** Location Quotients in the TR63 Region

Part	Sector	LQ 2013
A	Agriculture, hunting and forestry	0,6791
B	Mining and quarrying	0,5232
C	Production	1,0908
D	Production and distribution of electricity, gas, steam and air conditioning	2,2175
E	Water supply; Sewerage, waste management and improvement activities	0,5419
F	Construction	1,0728
G	Wholesale and retail trade; Repair of motor vehicles and motorcycles	1,1239
H	Transportation and storage	1,3742
I	Accommodation and food service activities	0,5827
J	Information and communication	0,3947
L	Real estate activities	0,5031
M	Professional, scientific and technical activities	0,5582
N	Administrative and support service activities	0,4663
P	Education	1,1478
Q	Human health and social service activities	1,1052
R	Culture, art, entertainment, leisure and sports	1,0264
S	Other service activities	1,1350

Source: <http://ec.europa.eu/eurostat>



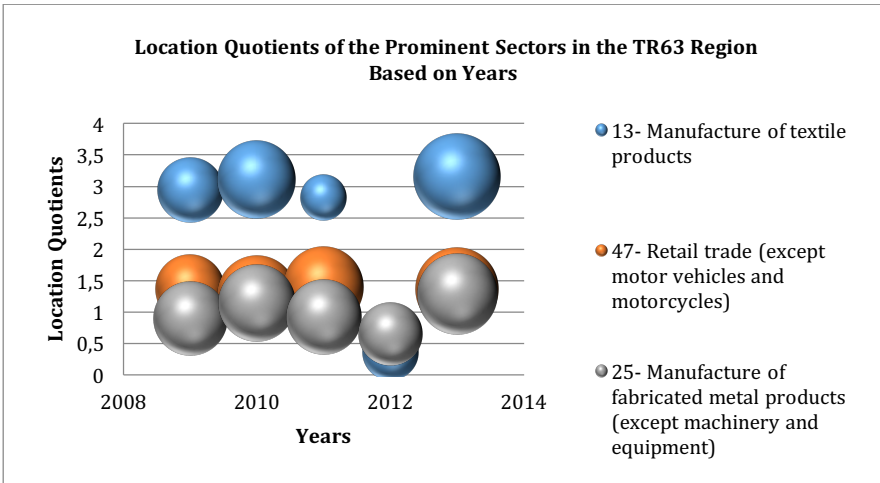
**Chart 2.** Prominent Sectors in the TR63 Region

Accordingly, it is possible to stay that the sectors in question seen in Chart 2 have a driving effect in the region. The sectors will attract more investment and have a more decisive role in regional development.

According to Table 7 which shows the changes in the location quotients of the prominent sectors in the region through the years 2009-2013, the sectors where concentration increased in these years are “13- Textile products manufacturing”, “93- Sports activities, entertainment and leisure activities”, “47- Retail trade (except motorized land vehicles and motorcycles)”, “41- Building Construction”, “25- Fabricated metal products manufacturing (except machinery and equipment)”, and “96- Other service activities” sectors.

**Table 7. Location Quotients of the Prominent Sectors  
in the TR63 Region Based on Years**

Sector	2009	2010	2011	2012	2013
24- Base metal industry	5,3246	5,4662	5,4653	2,9337	5,5315
13- Manufacture of textile products	2,9434	3,1093	2,8301	0,3691	3,1593
35- Production and distribution of electricity, gas, steam and air conditioning	2,6506	2,4347	-	1,6702	2,2175
49- Land transport and pipeline transport	2,0293	1,4532	1,5508	0,5485	1,6119
93- Sports activities, recreational activities	0,8017	1,1702	0,3977	0,5888	1,4517
47- Retail trade (except motor vehicles and motorcycles)	1,3590	1,2757	1,3979	0,9066	1,3666
41- Building Building	0,9175	1,1848	1,2400	0,1144	1,3199
25- Manufacture of fabricated metal products (except machinery and equipment)	0,8937	1,1421	0,9274	0,6460	1,2893
96- Other service activities	1,0529	1,1365	1,0781	0,7678	1,2482



**Chart 3. Location Quotients Change of the Prominent Sectors  
in the TR63 Region Based on Years**

As seen in the table, while there were decreases in all sectors other hand “93- Sports activities, entertainment and leisure activities” in 2012, significant increases were seen in the sectors in question after the year 2012.

## **Conclusion**

The determination of industrial concentration to create local or regional development/ development plans and the methods used in this determination is very important to see which sectors are concentrated in the geographical unit, to supply new business opportunities, to change production and productivity in a positive direction in the industry (Sandal ve Şen,2016: 332).

In this study, with the aim of determining the concentration dynamics of the industry in the Level 2 region of TR63 and present the changes in regionally prominent sectors, sectoral location quotients were calculated on a regional level for the year 2009-2013. Therefore, the sectors with location quotients increasing in time were presented.

The findings obtained in the study show that the sectors showing concentration in the region changed over time (Table 7). While this change is an indicator of the competition in the region, it is also important in the sense that the prominent sectors have a dynamic structure.

As much as the TR63 Region is an area where agricultural activities are widespread, it is among the areas where unemployment is the highest in Turkey despite the existence of labor-intensive industrial organizations such as base metal industry and textile sectors. According to TÜİK data for 2015, the unemployment rate of 10.5% in Turkey is 16.6% for the TR63 Region. Developing employment policies that are suitable for the labor-intensive industrial structure in the region will play an important role in reducing the unemployment rate. Determining the sectors concentrated in the region while preparing projects supported by development agencies and regionally implemented development plans carries great importance in terms of contributions on regional development efforts.

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# 15 | Defense Expenditures and Turkey

*Hamza ŞİMŞEK*

## **Abstract**

*Turkey is obliged to preserve its defense power due to its geographical position. Many countries around the world want to increase their defenses for this purpose. The world defense costs constitute 2,6% of the Gross National Product of the world. The USA is the spearheading of this trend by its enormous expensing budget. Countries need to increase their national income in order to compensate their defense spending. Turkey takes the 17th place by 15,2 billion dollars of military expenditure and 18th in the world in national income. The discussions about the economic effects of these expenditures focus on the economic growth and the foreign trade deficit while the defense expenditures are compared with the resources transferred to other public services. According to the Military Keynesianism that explains the economic effects of the defense expenditures via demand effect of Keynesian approach, the defense expenditures impact the economic growth by enhancing the aggregate demand. According to this method, the military expenditures use the resources of other services; the unproductive military expenditures reduce the investments because of the crowding-out effect. The military spending in Turkey at a reasonable level. In respect to this, the subject needs to be discussed must be the addressing level of the needs of defense from the domestic resources rather than the size of defense expenditures. It is seen that the countries which have a voice*

*in today's global diplomacy and powerful armed forces meet their military requirements from the domestic resources.*

**Keywords;** *Defense Expenditures, Military expenditures, Turkey Defense Industry, Turkey defense expenditures, World defense expenditures, Gross Domestic Product*

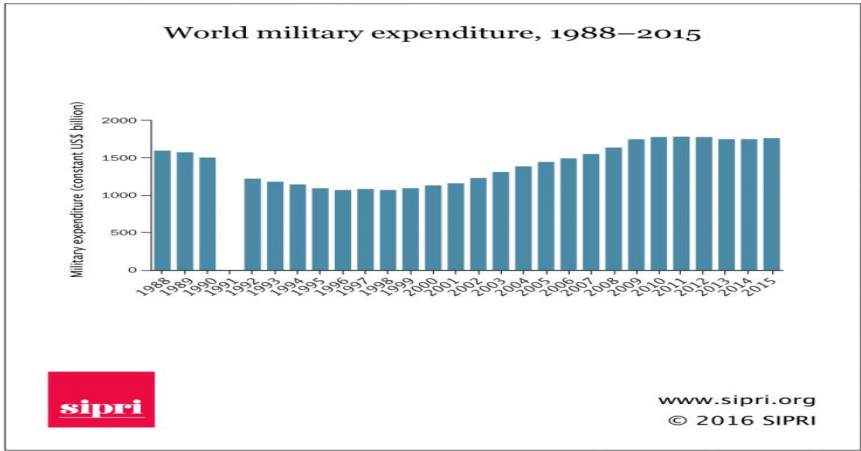
**JEL Codes:** *H 56*

## **Introduction**

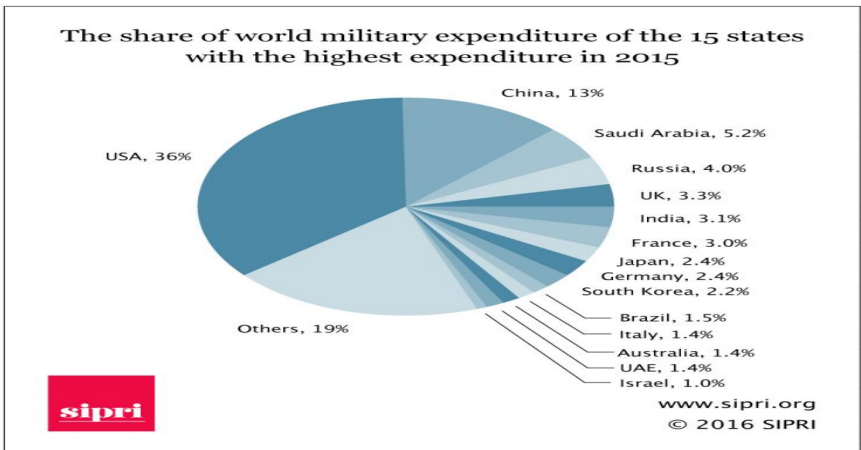
The national security of Turkey needs to be started from the certain areas far beyond our boundaries. These areas are our living quarters at the same time. In other words, these are the extensions our national security outside. If we don't protect the living quarters, we cannot find a chance to live in our native land, we choke. Some regions have strategically importance for us, one of them is the Aegean Sea that is significant in terms of military and political; the other one is Cyprus where has importance in ethnic, military, political, strategically and will also have importance in terms of economically; and others are Mosul, Kirkuk, Tal Afar and north of Iraq becomes more of an issue with regard to ethnic, political, strategically, economical and the military; and the final one is the south of Caucasus hitches us on to Central Asia and provides our energy security as well.

## **Defene Expenditures**

All kind of defense expenditures are actualized for providing to construct maintenance and repair the military establishments, assurance of military vehicles and the civil defense (Turkish Language Association, 2009). By the year of 2016, the defense expenditures have reached to 1, 62 trillion dollars by rapidly increasing all over the world. The course of global defense expenditures is shown in Figure 1. The world defense costs constitute 2,6% of the Gross National Product of the world. Defense expenditure per capita is 236 dollars. The USA is the spearheading of this trend by its enormous expensing budget.



**Figure 1.** Navigation of defense spending in the world




**Figure 2.** Defence Expenditures (2016)

The defense expenditures in the world and the distribution by the regions are presented in Figure 2. It is seen when this figure is evaluated that the USA actualize the highest amount of spending. China ranks number two by 13% shares, Saudi Arabia is the third by 5, 2%share and the fourth one is Russia by 4%. The other world countries actualize the rest part of the expenditure. The data of 15 countries which spend most for the military in the world are shown in Figure 3. The highest military expenditure in the world is actualized by the USA by 596 billion dollars. China is the second by 215 billion dollars expense and the Saudi Arabia is the third by 87,2 billion dollars. Turkey takes the 17th place by 15,2 billion dollars of military expenditure.

Rank			Spending, 2015 (\$ b)	Change, 2006-15 (%)	World share 2015 (%)	Spending as a share of GDP (%) <sup>b</sup>	
	2015	2014 <sup>a</sup>				2015	2006
1	1		USA	596	-3.9	36	3.3
2	2		China	[215]	132	[1.3]	[2.0]
3	4		Saudi Arabia	87.2	97	5.2	13.7
4	3		Russia	66.4	91	4.0	5.4
5	6		UK	55.5	-7.2	3.3	2.0
6	7		India	51.3	43	3.1	2.3
7	5		France	50.9	-5.9	3.0	2.1
8	9		Japan	40.9	-0.5	2.4	1.0
9	8		Germany	39.4	2.8	2.4	1.2
10	10		South Korea	36.4	37	2.2	2.6
11	11		Brazil	24.6	38	1.5	1.4
12	12		Italy	23.8	-30	1.4	1.3
13	13		Australia	23.6	32	1.4	1.9
14	14		UAE <sup>c</sup>	[22.8]	136	[1.4]	[5.7]
15	15		Israel	16.1	2.6	1.0	5.4
Total top 15			1 350		81		
World total			1 676	19	100	2.3	2.3

[ ] = SIPRI estimate. For notes and sources see Perlo-Freeman, S., Fleurant, A., Wezeman, P. and Wezeman, S., 'Trends in military expenditure, 2015' SIPRI Fact Sheet, Stockholm, Apr. 2016.

 [www.sipri.org](http://www.sipri.org)  
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Source: Stockholm International Peace Research Institute (SIPRI)

Figure 3. Military Expenditures (Billion \$)

As is seen the numbers above, the defense expenditures of our country at a reasonable level in comparison with the other countries. In respect to this, the subject needs to be discussed must be the addressing standard of the needs of defense from the domestic resources rather than the size of defense expenditures. It is seen that the countries that have a voice in today's global diplomacy and powerful armed forces meet their military requirements from the domestic resources. The governments that rely the military capabilities on such as the Us, Russia, Iran, France, Israel gain a decisiveness in the political field. Therefore, Turkey should spend for military only if not to drop below a specific level for both to have voice in global politics and fulfill the obligations

While the countries which pay most for the military such as the US, England, France, Germany meet their needs from the domestic industries, almost all the underdeveloped and Middle East countries satisfy these requirements by the importation. In spite of the total of the defense expenditure in the world is 1,62 trillion dollars, just the part of such expenses subject to the trade is about 45–50 billion dollars. While all these exports are actualized from the USA, Israel, Russia and several European countries; some other countries are in importer position such as Turkey. Unlike the other importer countries, Turkey has exported for defense products in recent years as a country rapidly develops its defense industry. The export of defense products of Turkey is about 1.919 million dollars if we add the civil aviation products produced by military capabilities.

### **The Economic Potential In Terms Of The Defense Economy**

There are two concepts measure the economic potential of a country. One of them is 'National Wealth, ' and the other one is 'Gross Domestic National Product (GNP).'

National Wealth is composed of the richness of a country, metals, buildings, bridges, railways, barrages, forests, various machine and the vehicle parks and workforce besides the goods and services produced. In other words, it specifies the total economic assets of an economy at a given moment, in the certain fund of knowledge and a technology level. GDP is the total value of the final good and services produced in a particular period, generally in one year. Table 1 shows some countries and data of GNP between 2012-2016.

It is seen according to the GNP in 2016 that, the list does not change in this year as usual. ABD is placed on the top of the list by the size of the national income, 18,7 trillion dollars. China is the closest follower of the USA by 12,3 trillion dollars. Japanese ranks number three by 4,2 trillion dollars GNP, Germany is the fourth by 3,5 trillion dollars and the England follows Germany by 3,1 trillion dollars. It is expected that the total national income reaches to 41,7 trillion dollars in the USA, China, Japanese, Germany and England; and this number equal to 55% of the total world national income. Tuvalu is the country that has the minimum GDP among from 186 countries, it is expected that this country will reach its income to 35 million dollars by this year. It is predicted that the national income of Turkey will be 721,2 billion dollars. Turkey is 18th of the list by this number.

**Table 1.** World Gross Domestic Product

#		2012#		2013#		2014#		2015#		2016#
1#	USA#	16.244,575#	ABD#	16.724.272#	Usa#	17.437.856#	Usa#	17.968,20#	Usa#	18.697,90#
2#	China#	8.221.015#	China#	8.939.327#	China#	9.761.201#	China#	11.384,80#	China#	12.254,00#
3#	Japan#	5.960.269#	Japan#	5.007.203#	Japan#	5.228.495#	Japan#	4.116,20#	Japan#	4.170,60#
4#	Germany#	3.429.519#	Germany#	3.593.238#	Germany#	3.747.066#	Germany#	3.371,00#	Germany#	3.472,50#
5#	France#	2.613.936#	France#	2.738.676#	France#	2.862.508#	Britain#	2.864,90#	Britain#	3.054,80#
6#	Britain#	2.476.665#	İngiltere#	2.489.674#	Britain#	2.627.351#	France#	2.422,60#	France#	2.488,40#
7#	Brazil#	2.253.090#	Brazil#	2.190.218#	Russia#	2.215.373#	India#	2.182,60#	India#	2.384,70#
8#	Russia#	2.029.813#	Rusya#	2.117.831#	Brazil#	2.169.802#	Italy#	1.819,00#	Italy#	1.867,60#
9#	Italy#	2.014.078#	Italy#	2.068.366#	Italy#	2.147.968#	Brazil#	1.799,60#	Brazil#	1.672,90#
10#	India#	1.841.717#	Canada#	1.825.062#	Canada#	1.886.679#	Çapada#	1.572,80#	Canada#	1.592,30#
11#	Canada#	1.821.445#	India#	1.758.216#	India#	1.749.965#	S. Korea#	1.393,00#	S. Korea#	1.450,10#
12#	Australia#	1.541.700#	Australia#	1.487.971#	Australia#	1.458.907#	Spain#	1.221,40#	Spain#	1.265,10#
13#	Spain#	1.323.500#	Spain#	1.355.660#	Mexican#	1.395.563#	Australia#	1.240,80#	Australia#	1.253,00#
14#	Mexican#	1.177.398#	Mexican#	1.327.021#	İspanya#	1.394.371#	Mexican#	1.161,50#	Mexican#	1.187,10#
15#	S. Korea#	1.129.536#	S. Korea#	1.197.506#	S. Korea#	1.271.252#	Russia#	1.235,90#	Russia#	1.178,90#
16#	Indonesia#	878.536#	Indonesia#	867.468#	Turkey#	867.325#	Indonesia#	872,6#	Indonesia#	875,8#
17#	Turkey#	785.753#	Turkey#	822.763#	Indonesia#	863.208#	Hollanda#	750,8#	Hollanda#	782,9#
18#	Holland#	770.867#	Hollanda#	800.535#	Hollanda#	830.006#	Turkey#	722,2#	Turkey#	721,2#
19#	Saudi Arabia#	711.050#	Saudi Arabia#	718.472#	Saudi Arabia#	746.819#	Swiss#	677#	Swiss#	687,6#
20#	Swiss#	631.183#	Swiss#	646.199#	Swiss#	671.899#	Saudi Arabia#	632,1#	Saudi Arabia#	643,2#

Source:Stockholm International Peace Research Institute (SIPRI).

### Shifting the Resources to the Defense Expenditures

If the conditions necessitate, how should assign the GNP or the available resources of the economy to the targets of defense (war)? There is no limit of the resources to be assigned when the assignment of the resources for the goals of defense is the subject. That is to say, the amount of the resource must be determined by the status of defense (or the war). This situation will affect each side of the economy notably the wealth of the consumer.

When the unlimited resource assignment is being provided, it needs to be careful to escape the possible adverse effects lightly (limiting the consumption opportunities of the civilians, black market, smuggling, difficulties in salary payment).

Under these circumstances, the society must make the best choice between the military production and the civil production; this can be easily explained via the production possibility curve (Figure 4). The society has to make a choice between military and civilian purposes; concentrating on one object needs to make self-sacrifice from another. There is a limit of goods and services can be produced in the short term. The total production capacity can be increased by being enhanced some technological innovations and the production factors.

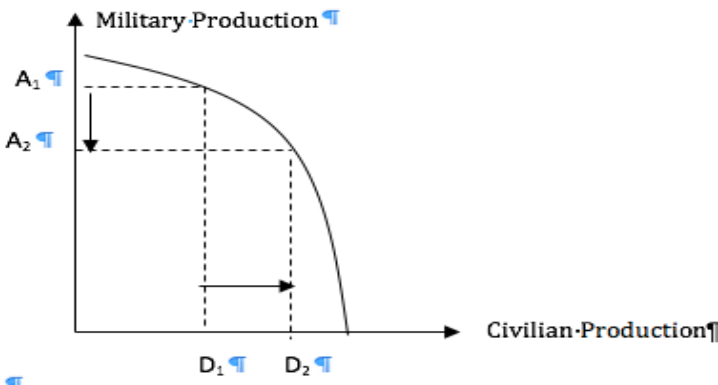


Figure 4. Production Facilities Curve

**Foreign policy approach:**

National Values → Foreign Policy Objectives → Military Strategy Defense Budget

**Domestic policy approach:**

National Values → Protection of private enterprise → A strong industry Building → Raising the welfare of society

**Economic Effects of Defense Expenditures**

**Economic Effects of Defense Expenditures**

The discussions about the financial implications of the defense expenditures are about the economic, social and political side of those expenses. The discussions about the economic effects of these expenditures focus on the economic growth and the foreign trade deficit while the defense expenditures are compared with the resources transferred to other public services. Moreover, since providing the defense products via importation cause for transferring the resources of the country outdoors, there is established a relation between defense expenditures and the borrowing as well. The discussions about the economic effects of the defense expenditures are analyzed under two titles;

**a. Military Keynesianism**

According to the Military Keynesianism that explains the economic effects of the defense expenditures via demand effect of Keynesian approach, the defense expenditures impact the economic growth by enhancing the aggregate demand. The incomes increase based on the increment of the total product; when the increased income improves the savings, the savings increased turn into the investments by stimulation of the demand growth. As a result, the expenditures extend the economic growth while the employment increases. Concerning this approach, a significant substructure is provided by the military investments and goods which are the other important effects of the defense expenditures. Due to the positive erogeneity's created by these effects, an economic expansion emerges. The findings of empirical studies based on the Keynesian approach confirm the positive effects of the defense expenditures.

## **b. Neo-Classical Approach;**

According to this method, the military expenditures use the resources of other services; the unproductive military expenditures reduce the investments because of the crowding-out effect. Furthermore, the defense costs affect the borrowing of the country; increase the borrowing need of the public. As regards to this perspective, the defense expenditures increase the borrowing as well as effect the economy negatively. Also, it decreases the investments and the employment by the crowding-out effect. In contrast to the Keynesian approach, the empirical studies based on the Neoclassical understanding have a tendency to reveal how the defense expenditures affect the economy negatively.

It is observed that the countries have a strong economy spend for defense considerably and most of them also have a domestic defense industry. In respect to this, the economic effectiveness of the defense expenditures manifests itself as a subject of being an importer country or not. As is seen by the results of the studies about this topic, the defense expenditures affect the economic growth negatively in importer countries, also cause foreign trade deficit and to increase the external debts. Having a robust defense industry such as the USA, Germany, England and Israel affects the economic growth of the countries, particularly leads for developing the civilian sectors by the substructure opportunities based on the high-tech provided.

One of the significant benefits of the defense expenditures is providing an important background for the civil economy due to the dual-use technologies. Most of the communication technology products of today's information society such as the internet, GPS were entirely produced for military purposes.

The technology and the products manufactured by the military purposes are launched to the market by being adapted to the civil use after a certain time; this situation gains advantages for the countries in international competition and the economic growth. The technology-oriented economic expansion has been started in the 1990s under the leadership of the USA thanks to the wealth created by the films transform the military technologies into the civil versions.

## Export Capacity Of Our Defense Industry

According to the data of export of Turkish Defense Industry in 2015, the export showed 213% increase compared to the year of 2007. Based on the world export data, Turkey was in the first 15 countries according to the numbers of 2010; thought that Turkey would find a place above of the list when the world numbers of 2012 are explained. The defense and aviation export amount were 1,919,000,000 dollars (1,919 billion dollars) in 2015 based on the sector data analysis of SASAD. The comparisons with the data of 2007, the rate of changes are shown in table 2. The remarkable subject in a table is increasing the exportation in parallel with the endorsement in the average. This circumstance means a steady growth trend in our sector.

Turkish industry export showed 213% increase compared to the year of 2007; 3,91% increase compared to the year of 2014. It is evaluated that the diversity of the new original systems included in the product ranges of the sector players and being taken this into the inventory of Turkish Armed Forces are significant effects for the export increment. The sector can produce and export the technology nowadays. The goods and services in the inventory of Turkish Armed Forces are adored in the world markets and evaluated as confirmed in the war environment.

**Table 2.** Total Export Table (Billion \$)

Years	Total Export	Change by 2007	Annual change
2007	\$ 615		
2008	\$ 784	% 27,48	% 27,48
2009	\$ 832	% 35,28	% 6,12
2010	\$ 853	% 38,70	% 2,52
2011	\$ 1.100	% 78,86	% 28,96
2012	\$ 1.626	% 164,39	% 47,81
2013	\$ 1.570	%155,28	-%3,4
2014	\$ 1.855	%201,62	%18,15
2015	\$ 1.929	%213,65	%3,91

**Source:** Tobb Turkey Defense Industry Sector Report 2015, <http://www.sasad.org.tr/uploaded//performans-raporu-web.pdf>,

The other remarkable issue (Table 3) about the exportation is the 217% increase compared to the previous year in sales out of Europe. The share of the sales to the USA

for aviation and the Gulf countries for the defense has importance in this increase. The deductions in the defense expenditures in developed countries bring the reduction in new platform productions into question while the defense budgets are reserved for maintenance and repair, modernization and renewal of the systems in inventory. In the world markets, the big leaps happen in the fields of civil aviation and space and the drones; and this improvement will continue. The drones are the new favorites of the sector while the logistics (maintenance/service) attracts the attention as another developing area. The sector succeeds to market the new products and the developed technological ability. The activities in this direction must be supported by the logistics promotes of the systems in inventory, being developed the performances of these products and heading towards the services of civil aviation, space.

Our defense product exportation was 1,237,000,000 dollars in 2013, 1,407,000,000 dollars in 2013. The coverage ratio of our exportation for the import is 110%.

**Table 3. 2011 Annual Export Distribution (Billion\$)**

Years	Europe	Out of Europe
2011	\$ 694	\$ 395
2012	\$ 325	\$ 937
2013	\$ 336	\$ 1254

**Source:** Turkey Defense Industry Sector Report 2015,  
<http://www.sasad.org.tr/uploaded//performans-raporu-web.pdf>,

### **Conclusion: An Evaluation on Turkey**

The military spending in Turkey at a reasonable level. In respect to this, the subject needs to be discussed must be the addressing level of the needs of defense from the domestic resources rather than the size of defense expenditures. It is seen that the countries which have a voice in today's global diplomacy and powerful armed forces meet their military requirements from the domestic resources. For this purpose;

- Much as an approach prioritizes to local firms has been adopted in our country over the past decade; there are still imperfections in the tender procedures about the supply of defense industry. The content of 'local firm' means that every firm is located in Turkey, for this reason, the foreign companies who are established on the paper sustain their presence in the sector. That's why there

is need to define the term of 'local firm' again so as to mean the capital and the property are entirely 'national.'

- The regulations should increase the contribution of the national companies for the military equipment supplying. Particularly for the big businesses, it needs to be generalized a supplying approach and sector structuring to produce original technologies provide the technological independence of the country. The direct procurement must not be preferred unless any urgency and a definite necessity occur. Because the direct procurements prevent to gain technical knowledge and the experience, and the country becomes dependent.
- The universities which are accepted as the brain of the sector should be reorganized within a coordination, and the incentives should be provided for the scientific researches. The studies in engineering field must be united with a structure uses the dual use as the base. A coordination institution including all the components of the sector must be established.
- The manufacturing industry is mostly based on the micro-looking small and medium-sized enterprises (SME) in our country. A cooperation ground between the SMEs needs to be established for increasing the national contribution to the supply of the defense requirements of our country
- The final word for being created the national defense industry is that Turkey needs to handle this subject as a national case besides being a developing issue. Much as this case is expensive, our country should make a sacrifice and the company and scientists who reach success in this field must be awarded deservedly.

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# 15 | Inflation, Interest Rates, and Output Level in terms of Globalising Monetary Policies

Canan SANCAR

## Abstract

*Economic globalisation, also defined as the international integration of labour, goods, and capital markets, is in a rapid and powerful continuation process. The fact that there experienced swift transformations in the field of monetary policy and central banking results from the fact that financial markets develop rapidly and that many economic activities at national scale gained international qualifications. Due to the fact that movements in the world's economic and financial conditions gradually got interlinked to each other, the independence of central banks on making decisions to secure price stability and sustainable economic growth got weaker. Within the triangle of inflation, production, and finance, monetary policies got more difficult to be performed. Globalisation weakened the inflation dynamics by causing the replacement of domestic factors with international factors in time, also weakened the efficiency of monetary policies by influencing the volatility of inflation and production as well as the financial stability. Globalisation affected the capability of monetary policy makers in providing prices and output stability through expectations and through the effects of globalisation on the monetary policy transfer mechanisms. According to a recent opinion put forward by the academic and political community, globalisation has become a central driving force in determining the domestic tendencies of inflation and starting from mid 1990s, they have moved together with inflation levels at international level.*

*Globalisation led to high-level convergence and the synchronisation of interest rates (both in the short and long term). Thanks to globalisation, interest rates were started to be determined by fixed-rated regions rather than individual countries and the operations of the monetary policy efficiency of any country got weaker. Developments in the global market, rather than the domestic factors, play an important role in the fact that long term interest rates show an equal level to each other in the 2000s. Therefore, long term interest rates are more affected by the international conditions than the decision of the monetary authority. The increasing economic and financial market integration among countries increased the homogeneity in the monetary policies of countries' central banks. As a result of the developments that emerge with globalisation, the bound among domestic inflation and domestic source use as well as consumption got loose.*

**Key Words:** Globalisation; Monetary Policies; Inflation; Interest Rates; Output Level.

**Jel Codes:** E52;F62;F68.

## Introduction

The mutual dependency caused by the globalisation comes to mean that goods, services, capital, labour force and ideas move gradually and freely across the borders. The limits of the national economies cannot be identified objectively due to the globalisation of economy, almost unstable capital flows, excessive domination of monetary transactions over real economy transactions, development of new informatics and communication technologies, and radical redesigning of organisations and thus, it came to an uncontrollable level. Because, globalisation is a process characterised falsification. Under the effect of these processes, control and domination power of national policy makers started to decline on human and physical capital such as goods, labour, knowledge and capital (Gallino, 20007:28). The decreasing social intervention, downsizing of countries, privatization, deregulation and independence in foreign trade are the key concepts in the phenomena of globalisation. The understanding brought by these key concepts changed the economy policy completely or in other words it brought economic policylessness (Seyrek, 2002:173).

The increasing flexibility of the “New Economy” brought by globalisation made it difficult for short and long-term practices of monetary and financial policies. The short-term difficulties are experienced in determining the direction of the potential output in transition periods when efficiency trend changes. In the long-term, central banks faced

a demand decline against their own responsibilities and lost their efficiency as a policy instrument for initial interest rate (Cecchetti, 2002:1). There are three phenomena that invalidate economic policies in the new globalising economy: First, with the transition to digital economy, technology shows an excessive sensitivity to demand; Second, the flexibility coefficient that is seen in the use of labour force is high; third, globalisation can meet the financial requirements of innovation projects without any limits (Cecchetti, 2002:2).

The literature of economics supported the mutual bound among national economies with numerous theories. In the 1960s and 1970s Mundell-Fleming models in open economies and the New Keynesian models that explain the effect of shocks in an economy on trading partners were the theories explaining this mutual dependency. The suspicions about protecting the large economies' national economic profits and about the practice abilities of independent monetary policies support these mutual dependency relationships at a global scale. The effect of these on globalisation and monetary policies is not only on suppressing the international rivalry, but it also creates major effects on goods, services, financial asset prices and interest rates (Kamin, 2010: 2).

Globalisation affects the capabilities of monetary policy makers in terms of providing prices and output stability from two directions: First, it influences the expectations on inflation and output level; Second, it has effects on inflation and output level through its effect on the monetary policy transfer mechanisms. Monetary policy targets a sustainable maximum employment in the long-term, a performance increase in economic growth, and a sustainable price stability. Some of the targets of monetary policies mentioned above might conflict. The aim of the monetary policy is not only to provide price stability in the short term but also to have the output level and employment fluctuate around targeted rates in the long-term. When central banks decrease interest rates in order to provide stability in the interest rates, this can lead to economic growth and employment growth. However, such a growth will bring inflation with it. Therefore, central banks are forced to make a preference among these aims so that the aims do not conflict with each other (Mishkin, 2008:1).

Globalisation might require a change in the purpose functions of monetary policy makers and can be effective on macroeconomic performance through various channels (Gnan & Valderrama, 2006:2). There are two main channels where globalisation

influence monetary policies. First of these is the influencing channel where globalisation affects inflation dynamics mentioned in the Philips Curve (determined by factors such as current inflation rates, latency inflation, unemployment, and supply shocks). Second of these, external factors gained more importance in determining the interest rates and active prices through intensifying financial integration and changing financial conditions and this leads to a decrease in the efficiency of the monetary policies (Yay, 2009:34). In this section, the effects of globalisation on inflation, interest rates, and output level in terms of monetary policies.

### **Globalisation and Inflation**

In the research carried out on inflation dynamics, the Philips Curve (in some cases the aggregate supply curve) is generally used. In the Philips Curve model, the coefficient of national output gap, which represents the domestic source use, shows the level of the relationship between the inflation rate and the national production developments. In recent studies, it was concluded that the relationship between two variables got weaker with the acceleration of globalisation. In the literature, this condition is expressed as the flattening of the Philips Curve (Eren & Çiçek, 2009:3).

Mishkin (2007) referred to the fact that a decrease in the Philips Curve yields two results; one being positive and one being negative. The positive result is that the increase in inflation would be limited even if there is an excessive warming in the economy; the negative result is that the cost of pushing an increase in inflation out of the system – the rate of sacrifice – would be high. Statements about the progress of inflation and based on the monetary policy change use inflation expectations as an explanatory variable. The fact that inflation expectations are shaped by the central banks that pursuit rule based monetary policies and the fact that economic units entered in an increasing trend in the world starting from 2000s led to an increase in the negative views and to the deepened researches on this topic. In the researches carried out on the decline of the trend in the Philips Curve, three basic factors come to the fore: (1) monetary policy change, (2) good luck, and (3) globalisation.

In the process of globalisation, which is shown as a main indicator of inflation, the replacement degree of international and domestic factors on inflation has been an active dispute topic. Globalisation has become a driving force in determining the domestic inflation tendencies, according to the recent view pointed out by the academic and political societies. At least, from the beginning of 1990s and onwards, there has emerged

evidences on the fact that the process of inflation change. Inflation shows a lower and more stable progress in the world. Inflation seems to have weaker sensitivity for the economic looseness precautions and meanwhile, increases in the cost of input seems to slow down. In parallel to these developments, policy makers have gained the skills to estimate the surprise inflation excessively and to catch up with the actual inflation impressively. In the process of globalisation, there were important steps taken in providing price stability, on contrast to the exceeding trend of inflation expectations in the beginning of 1970s (Borio and Filardo, 2007:1).

Many statements were made in order to take these developments into account. Probably, the fact that monetary policy should be more efficient is the most supported thing. In this contradictory approach, in a long-term balance, real prices are free from total price level or its change rate. Also, the total price level is stabilised with the nominal growth vector that it can be finally related to. In a different meaning, the monetary policy determines inflation by affecting the monetary base of the economy directly or indirectly. This difference between the relative prices ultimately determined by real factors and the absolute prices ultimately determined by monetary powers can be assessed as the fact that developments in the real economy do not determine the inflation rate in the long-term. If so, aspects like the fact that efficiency rate is low or high, that competitiveness capacity of labour force markets is high or monopolistic, and that global economy is unified or fragmented are of no effect on inflation. As a result, it should not be expected for real or financial economic globalisation to have an important effect on the progress of inflation (Borio and Filardo, 2007:1-21). According to Ball (2006), there are a few reasons to think that globalisation change the long-term level of the Philips Curve and inflation (Ball, 2006:15).

According to Rogoff (2004) who is in favour of an opposite view, globalisation can help sustaining low inflation and also it is not a surprise to see the integration of the developing world to the global economy. Globalisation creates the appropriate environment to keep the inflation at lower rates. Globalisation accelerated the exchange of output-inflation (Philips Curve) that Central Banks face. This made the commitments to low inflation more credible and stronger. The competitive environment created by the globalisation increases the price and price flexibility and thus, the output gains that can be obtained from the extending monetary policies decrease against any inflation drive (Rogoff, 2006:6). Policy makers' awareness for the independency of Central Banks and for focusing on inflation control supported by

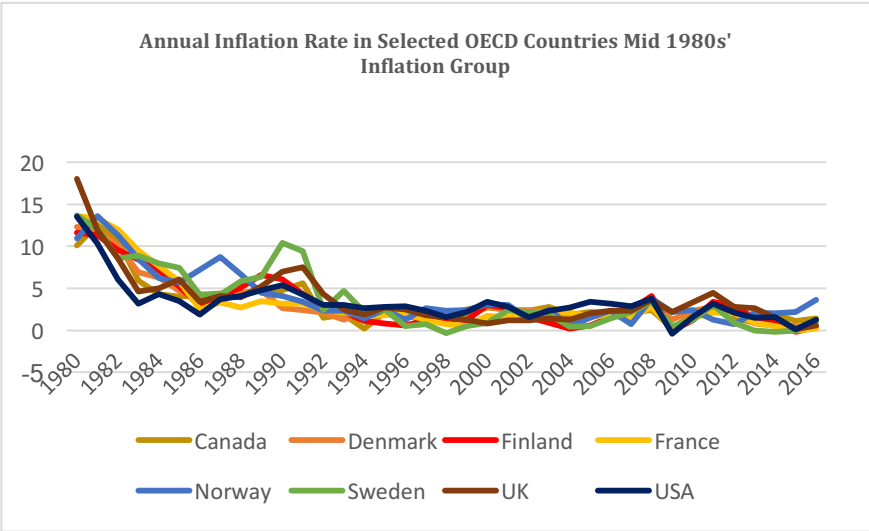
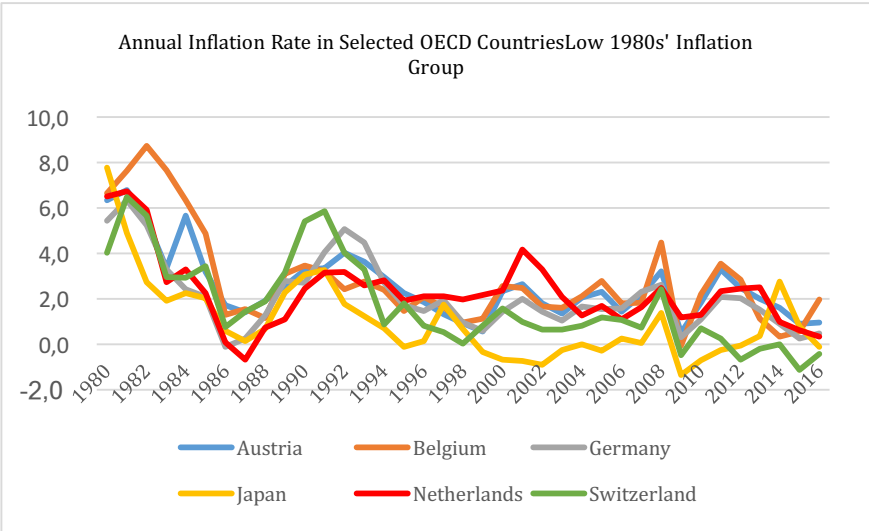
organisational reforms and for being preventive resulted in a better and more credible monetary policy. Standardly, inflation is defined as a function of local production. National monetary policy affects inflation level by influencing factors like total demand, price behaviour, efficiency, and inflation expectations as well as the balance between these factors. Of course, some external shocks like import and energy prices can affect inflation (Ihrig et al., 2007:1).

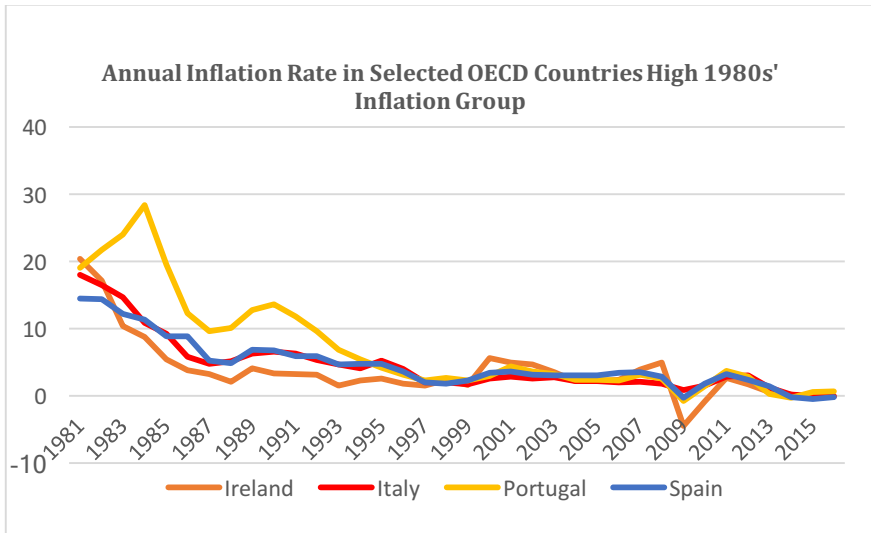
These discussions originate from two approaches in terms of the determiners of inflation: “country centred” and “global centred”. The country centred approach has three basic features. First, looseness precautions determining the excessive demand and inflation are country specific; Inflation in a specific country is influenced by the excessive demand in that country. Second, directly or indirectly inflation is affected in parallel to the scale an official price channel is included. This channel is a function of the specific economic conditions of the related country. Third, international effects are completely caught by foreign exchange effects (this can affect both the supply and demand in that country) and import prices. Global centred approach starts with against precautions. Firstly, it has an easy replacement opportunity for goods produced in different countries. In addition to this, it is assumed that labour features and capital flows are going to be merged globally in the factor input markets. Hence, the opportunity to move capital and therefore “country specific” knowledge among countries helps the better replicability of goods produced in different regions. Therefore, a “global centred” approach where the integration process of the world economy accelerates is important. In cases where domestic inflation is gradually more affected by global capacity limitations, the efficiency of the national monetary policy will go weak in the short-term (Borio and Filardo, 2007:1-21). Woodford, who makes analyses in the New Keynesian environment, expressed that the central banks’ power of controlling inflation will disappear in a world where there is a global integration (Woodford, 2007:1).

Woodford (2007) depends on three bases while he was saying that national central banks cannot have monetary control in a world where there is global integration and that their competence to control domestic inflation will go weak: (1) Liquidity prime is a function of global liquidity, not national central banks’. (2) Real interest rate is determined by global savings-investment balance, not by national savings-investment balance. (3) The inflation rate variable is not only affected by the national output gap but also by the global output gap.

At the basis of the fact that globalisation affects the dynamics of the inflation process lies the view that product prices and factor inputs change according to global supply/demand conditions more than the domestic supply/demand conditions (Ihrig et al., 2007:6). The globalisation process accelerated in the late 1990s thanks to the integration of developing countries to the world market. The growth of the economies of China and India has an inevitable effect in the international market. Even though there is a belief that inflation is eventually a monetary phenomenon, the economic expansion of China and India represented a huge increase mainly in low skilled global supply as a potential. Developing economies that perform the low cost production of goods led to a geographic change in the production. In recent years, low cost manufacturers such as China, Taiwan, Mexico, Singapore, and South Korea have trade surpluses. From the US perspective, the ratio of imported goods to the goods manufactured domestically has drastically speeded up (Kohn, 2006:342). In the process that started back in the 1980s, it was seen that inflation and change rates in OECD countries declined drastically and that inflation expectations reached to a stable level. Even in the developing countries, which experience higher and more changing inflation than industrialised countries, it was seen that the fluctuations decreased since 1990s. Decline in inflation fluctuations occurred in a period when international trade increased (Bowdler and Malik, 2005). Along with the globalisation, as a result of the practices and the fact that most of the central banks focused on price stability targets, lower and stable inflation levels were reached (Crockett, 2003: 2).

Figure 1 shows the changes in the rates between the OECD countries that have a lower inflation rate in 1980s and OECD countries that have a mid or relatively high level of inflation.





Source: Compiled by the author using the data from the electronic database of OECD.

**Figure 1.** Inflation Rates in Selected OECD Countries (1980-2016)

The change in the inflation rates in OECD countries (USA and mostly EURO zone countries) decreased drastically since the beginning of 1990s. The decline trend in the inflation rate supports Rogoff (2006) and Ihrid et al. (2007) who suggested that the globalisation process has an important effect for inflation expectations to have stability. As was expressed by Byrne and Davis (2014), that the inflation rates got closer after the first half of 1990s is a positive side effect of the economic integration process.

### Globalisation and Long-term Interest Rates

From the second half of 1990s, the developments in the bond market caused globalisation and long-term interest rates to be questioned. Although long-term interest rates progressed at different levels worldwide between 1993-95, only in three economies, they show a closer trend. Owing to the strict monetary policy precautions practiced in the USA, long-term real interest rates in China and in Europe raised. These developments reinforced the view that long-term interest rates are affected by the global

shocks in addition to the local economic conditions. The potential effects of globalisation on interest rates can be explained with the equation relationship with interest rates in Equation (1) (Christiansen and Pigott, 1997;6);

$$I(J) = RW + \pi W + E|\Delta S(j) + \sigma(J) \quad (1)$$

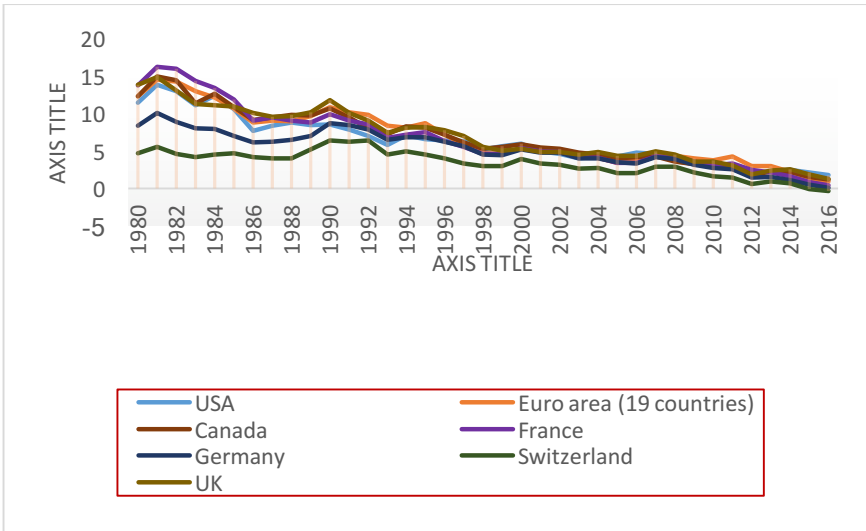
$I(j)$  is the nominal interest rate of the country  $j$ ;  $RW$  is the real interest rate of the World ("World" Second Country);  $E|\Delta S(j)$  is the expected value loss in the country  $j$  in terms of the currency unit when compared to the "world";  $\pi W$  is the expected world inflation; and  $\sigma(j)$  is the risk prime in the bonds of country  $j$ . Here, "world" can be seen as a criterion country like the United States of America or alternatively it can be assess as a mean value of external country values. The real interest rate of the country  $j$  is equal to the total of world real interest rate, change in the expected real foreign currency rate and the risk prime.

Globalisation includes the high rate convergence of the interest rates (both long and short term) and synchronisation in time. Interest rates deal with fixed-interest rated regions rather than individual countries and the operations of the monetary policy efficiency of any country got weaker because of this (Christiansen and Pigott, 1997;6). Monetary policy operations in developed and in many developing economies are carried out through short and long term interest rates. The movements in the short-term interest rate become effective on long-term interest rates, credit supply of banks, asset prices and a series of financial condition through monetary transfer mechanisms and, as a result, it influences the economic activity and price level (Ihrig, et al., 2007;5). An important feature of monetary transfer mechanisms is that it is effective on the usage cost of capital, investments, and consumption in the future through the real interest rates and therefore the long-term interest rates (Boivin et al., 2010;7). According to the expectations theory, long-term interest rates represent the mean of short-term interest rates in the future probably determined by the domestic policy makers. However, since the monetary markets are vulnerable to external shocks, a requirement to add risk primes to long-term interest rates is inevitable. Therefore, thanks to globalisation, long-term interest rates are affected by international conditions more than by the decisions of the national monetary authorities. This condition will lead to important consequences for the monetary policies (Ihrig et al., 2007;6).

From the political perspective, how much domestic and international factors are influential in determining the interest rates can be seen. Especially, in small economies where floating rate system is used, how an independent monetary policy should be is a separate matter of question. With this, the increasing role of global factors in shaping the country specific interest rates and its results in terms of monetary policy were emphasized by the big central banks like FED and ECB (ECB, 2007:31; Humpage, 2005:2). The increase in economic globalisation has made the goods and financial markets more integrated at international level and dependency among countries has increased. There have been dominant views suggesting that economic variables will be least affected by domestic factors and will respond to monetary policies less, and that this condition will yield inevitable results for monetary policy decisions (ECB, 2007:32).

The question of determining the interest rate is frequently approached in the theoretical and empirical literature. In many researches, local and foreign determiners of interest rates were focused on. Blanchard et al. (1984), who made one of the first studies, indicated that interest rates in the US were determined at a global scale during the late 1970s and early 1980s also that interest rates in the US could be explained by the international factors (strict monetary policies and productivity increase). Barro and Sala-i-Martin (1990) approached the total data of OECD's 10 economies as world interest rate. It was emphasized that in addition to the monetary policies of the central banks of countries, stock incomes, petroleum prices and international variables are effective in determining the interest rates. In a study that they carried out in 17 OECD countries, Orr et al. (1995) concluded that domestic interest rates in most of the countries were determined by the international factors. Chinn and Frankel (2003) underlined the fact that fluctuations in the interest rates of the USA and the Euro zone were symmetrical in the short and long term and meanwhile there was an increasing interaction between the interest rates of the USA and those of Europe.

Although it is more evident before and after the 2008 Global Crisis, the interest rate connections between the Euro zone and the US grew stronger recently due to the powerful global factors and they started to give more symmetrical responses against external shocks like petroleum prices (ECB, 2007:3). Figure 2 shows the trend between some of the OECD countries in the Euro zone and the US during the period between 1980-2016.



**Source:** Compiled by the author using the data from the electronic database of OECD.

**Figure 2.** The long-term interest rate trend in selected OECD countries and in the Euro zone (1980-2016)

In Figure 2, the mean of Euro zone (19 countries) can be seen. Also, it can be seen that the trend in the long-term interest rates show a similar and synchronic progress in countries both OECD and EU members, such as France, Germany, the United Kingdom, Switzerland, and Canada, and in the US. Increasing economic and financial market integrations from 1990s onwards when globalisation gained speed increased the homogeneity in the monetary policies of the countries' central banks. Developments in the global markets are the reasons of the fact that long-term interest rates show a similar trend in 2000s, rather than the domestic factors.

With globalisation, there occurred a foreign capital flow towards the developing countries after the zero or close to zero interest policies of the central banks of developed countries. The fact that developing countries create extra demand in their asset markets can be shown as the reason of this increase due to close-to-zero interest rates in developed economies and relatively high interest rates in the developing countries.

Excessive amounts of additional funds to developing countries created positive effects like cheap financing sources, prolonged debt terms, a decline in the general level of interests, and increase in investments. In addition to these, it also brought with negative effects such as an excessive increase in the asset prices, immediate valuation of the local currency, high amount of short term debt level, and rapid increase in domestic credit use.

### **Globalisation and Output Level**

Globalisation keeps the inflation at a targeted rate level on one hand, on the other, it puts a spoke in central banks' wheel in terms of catching up with the inflation rate promoting the economic growth. The increasing integration of the global economy might have various effects on the output. These effects concerns the monetary authorities in terms of making estimations about both the volatility of the output and the future of the economy. Globalisation also has the potential to trigger the efficiency increase since it makes the market more competitive (Mishkin, 2008:2).

Policy makers may allow surprise inflation (one that cannot be anticipated by the economic agents in the inflation rates) in order to provide a temporary increase in the real output level and employment. Price and cost rigidity in the national markets prevents immediate reaction of prices and costs after unexpected monetary expansion. With global competitiveness, that the global prices and costs are more flexible makes the effects of national monetary policies lower and short-termed. In other words, inflation can be accelerated by monetary policy to gain an increase with a temporary qualification at the real output level; The Philips Curve will be flatter. As a result, there is also an increase in the monetary policy decisions and interest rates in order to slow down the increase when the inflation increases. Due to both reasons, there occurs a production level lower than the potential production level in the economy (Mishkin, 2009:1).

The effect of globalisation on the relationship between output level and inflation emerges through various channels. First of these, the total supply and total demand components of countries change as a result of increase in the level of trade openness; production scarcity was attempted to be adjusted through foreign trade gap and the production surplus was attempted to be adjusted through foreign trade surplus. Second, with the spread of the international investment regulations, the fact that many

industrialized countries started to export capital directly to newly capitalized countries such as China and India causes an increase in the efficiency level of these countries that were newly integrated to the capitalist system and that has cheap labour as well as a decrease in the import prices. Thirdly, that the production can swiftly change places regionally in a short period weakens the bargain power of labour force owners and this case makes the connection between price costs and source use more flexible (Eren and Çiçek, 2009:5).

The effect of trade and financial flows that increased with globalisation on output volatility theoretically depends on various factors such as the composition and pattern of these flows and expertise and shock resources. For example, if openness is important in terms of the increase in sectoral expertise and in terms of conjuncture fluctuations during industry specific shocks, it causes an increase in the output volatility. In addition to this, if the increasing trade flows causes vertical expertise among countries, the volatility of output growth might be in question (Köse et al., 2005:35).

There are different views in the literature concerning the relationship among globalisation, output level or volatility. According to Mishkin (2008), globalisation can lead to an output stability by allowing manufacturers serve to a diversified global market rather than domestic market only. Researchers such as Sachs and Warner (1995), Frankel and Romer (1999), Dolar and Kraay (2002), Wacziarg and Welch (2003) suggest that trade gap helps encourage the output increase. Buch et al. (2002) advocated that an increase in the level of trade dependency and trade gap leads to a higher output in developing countries. Some of the researchers presented vice versa views. Among these, Ihrig et al. (2007) advocated the idea that net import is in a negative correlation with domestic demand and therefore with the output level. According to Markusen (2007), trade integrations make countries vulnerable against external shocks and this condition increases the output volatility. According to Helbling et al. (2006), globalisation affected the circular reaction of inflation on output fluctuations with various reasons. Because, prices of many manufactured products are determined by external supply and demand rather than by local factors. The fact that the effect of financial integration experienced at a global scale is defined as an increasing trade balance or surplus weakens the relationship between local production and demand (Helbling et al., 2006:104). According to Prasad et al. (2007), globalisation helps enlargement of the trade gap especially in developing countries and with this respect, there are evidences indicating that it helps lower the output volatility (Prasad et al., 2007:465).

On the other hand, in the analyses focusing on the relationship among globalisation, inflation and output gap, it is suggested that capital moves among countries due to the difference emerged in the interest rates and as a result of this, the control of national central bank got weaker on the amount of money. Due to the fact that the effect of global factors increase in determining the short-term interest rates the relationship between the interest rate and national output gap, which returns the trend deviation value of the production in the realized economy, gradually decreases. In the cases when national output gap exceeds trend value, that the central bank increases the short-term interest rates in order to keep the control of the inflation rate leads to an increase in the foreign demand (import) and capital inputs. This leads to the valuation of national currency against the foreign currency. In such an economic environment, since intervention to the currency will change the national money amount, the amount of national money becomes changeable with the external factors. Therefore, due to financial globalisation monetary control of the central bank and its ability to control domestic inflation rate gets weaker (Helbling et al., 2006:123; Woodford, 2007:1-3).

In economics, in cases when actual output goes higher than the potential output, central banks increase the short-term interest rates in order to keep the inflation rate under control. Through this policy, it was attempted to cool down the economy and the demand was attempted to be taken under control. However, this increase experienced in the interest rate attracts the foreign short term investment during the rapid financial globalisation process and this leads to capital input in an economy where capital movements are independent. With an increase experience in the capital, national currency gains value against the foreign currency. This condition increases import since the value of import materials are low in terms of national currency and local manufacturing decreases. In parallel to these phenomena, the tendency of monetary authorities in open economies to practice expander policies and to create inflation through this should be lesser. This also endangers the dual target of monetary authorities about providing a balance between price stability and output level in the global environment.

## **Result**

Changes emerged in parallel to the globalisation loosened the domestic source use and production through domestic inflation. In a rapidly unifying world domestic inflation is gradually being affected by the global production gaps. Crises, especially brought by

the financial globalisation, lead to down scaling of economies in the countries and to stagnation. Reactions given to the crises that emerge worldwide were realized through monetary policies. The execution of monetary policies within the triangle of inflation, production, and finance in terms of monetary policies is gradually getting harder. That the practiced policies do not created desired results causes the amount of criticism against central banking and monetary policies to increase.

The role of international factors increased in the creation of domestic monetary policies. Short-term interest rates determined by the monetary policy makers in many economies in the global system respond to external financial conditions and to appearance at a level more than before. The reason of this, globalisation makes currency rates more sensitive to the interest rate differences and even the central banks using floating rate might be required to respond to the changes in the foreign currency. It might also be the fact that foreign currencies become an important channel of monetary transfers. Moreover, inflation targeting of central banks and adoption of other better practices made the monetary policy strategies worldwide more homogenous.

Globalisation created radical changes in the process of the economies of countries. As a result of the practices applied in this process, inflation was taken under control and the precautions that should be taken by the central banks against financial stabilities and instabilities became a controversial topic. In the process of globalisation, the long-term interest rates as well as the short-term interest rates were affected by the international developments. Policy makers of the central bank challenged domestic shocks with the reaction they give by taking external shocks into account in addition to understanding the causes of these shocks.

In the process of globalisation, central banks of developed countries that mainly use traditional monetary policy instruments until the financial crisis of 2008 put into effect non-traditional monetary policy instruments after the crisis. Central banks of developed countries started to use zero interest rate policies initially after the crisis. They targeted economic growth and employment growth by lowering fund costs through these policies. Following the practices, there was a capital flow from developed countries to developing countries. That there is an increase in the capital input to the developing countries leads to the evaluation of national currency against foreign currencies. This condition increases the import and then foreign trade gap since the price of import goods decreases in terms of national currency.

While on one hand, excessive amounts of additional funds to developing countries created positive effects like cheap financing sources, prolonged debt terms, a decline in the general level of interests, and increase in investments, on the other hand, it also brought with negative effects such as an excessive increase in the asset prices, immediate valuation of the local currency, high amount of short term debt level, and rapid increase in domestic credit use.

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