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# Influences of Decree No. 32 on capital movements in Turkey: A theoretical analysis

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Based on findings of theoretical and empirical studies in the literature, it is more likely that financial liberalization is a means of enhancing capital mobility rather than being an objective. The main purpose here is to make use of foreign savings to fund the country's development. Considering foreign financial sources that enter the country in the form of foreign debt and capital, it is apparent that the foreign capital option is the preferred approach. The financial liberalization process was initiated by the deregulation of interest rates and it has been supplemented by numerous legal and corporate regulations. The process was finalized when the council of ministers passed Resolution No. 32, which ensured the integration of local markets with the foreign market and deregulated the movement of capital. This analysis is focused on the influences of Decree No. 32 on the movement of capital.

**Key words:** Financial liberalization, Resolution No. 32, capital movements.

## INTRODUCTION

Looking for ways to finance development, numerous developing countries have regarded financial deregulation as the solution for capital deficiencies. Indeed, some countries have succeeded in achieving their goals with this approach, but in other countries it was disputed heavily, since financial deregulation was considered to be the main reason for unexpected economic crises. As is the case for other developing countries, the basic problem in Turkey is that there are insufficient sources of revenue to finance development. Once domestic savings fall short in funding national development, the use of foreign savings is the most frequently suggested solution. Numerous regulations have been developed and promulgated in order to make use of foreign debt and foreign capital. The results of such regulations have been the reduction of public intervention in the real markets, incentives to encourage foreign trade, a focus on privatization, and similar liberal economic policies. The process is supplemented in the financial markets, for example, by establishing capital markets, introducing new banking regulations, and deregulating domestic interest rates, all of which have the goal of liberalizing the financial system. The regulations classified under the first group are referred to as internal financial liberalization. The others that lead the way for the movement of foreign capital to

shift the balance of payments in favor of Turkey are as financial liberation.

First in this analysis, financial liberalization is explained, and then periodic analyses are made to determine how the process is operating in Turkey. The last section deals with the implications of Resolution No. 32 for providing the legal basis for the liberalization of capital movements in Turkey.

## PROCESS OF FINANCIAL LIBERALIZATION

In its narrow context, financial liberalization means to abandon controls on the accounts and interest rates. In its wide context, however, it means reducing or abandoning the control of foreign currencies and minimizing the practices that impede the entry of foreign financial corporations into the national financial system. These changes will facilitate the entry of domestic entities into foreign financial markets and reduce the taxation of the operations of the financial markets (Williamson and Mahar, 2009). The collapse of the Bretton Woods system in the 1970s terminated fixed exchange rates and opened the way for the free exchange rate system. This marked the emergence of financial liberalization, a process that

accelerated after the 1980s. However, even the rapid development of data processing and telecommunication technologies were not powerful enough in some countries to give rise to the simultaneous occurrence of the financial liberalization. Developed countries adopted the process first, followed later by the developing countries (Alp, 2002: 87). The fluidity of the international financial capital tended to increase during the second half of the 1980s, and it reached a significant level under the influence of the technological developments during the 1990s. Therefore, it is possible to conclude that main growth of financial liberalization occurred during the period beginning in the mid - 1980s and continuing into the 1990s (Williamson and Mahar, 2000:11).

The theory of financial liberalization emerged from the works of McKinnon (1973) and Shaw (1973), who were famous economists at Stanford University. However, the theory was actually a version of the Orthodox Neoclassical finance theory designed for the developed countries that backed supply - side policies. The theory is based on the assumptions that financial liberalization regulates the distribution of savings on an international scale and that arbitrage possibilities are eliminated by equalizing the interest rates between the countries (Williamson and Mahar, 2000:8). In their works, performed independently of each other, McKinnon and Shaw asserted that the prices of money, such as interest rates and exchange rates, are to aberrate by the partial or complete financial pressure policies and state intervention in these markets. They further asserted that these prices reduced the real size of the financial systems, and thus the rate of growth of the economy, when compared with the non-financial assets in the developing countries. Therefore, effective source distribution and a high rate of economic development are likely just by releasing the financial pressures and ensuring the financial deepening. As a result of all these factors, the financial pressure strategy adversely affects the development process (Emek, 2000:67). Contrary to the Neo- Keynesian policy and structural policies, the state should not intervene in the markets, but, rather, it should favor competitive conditions with respect to accounts and interest rates so that savings will tend to shift toward investments. Otherwise, interest rates have negative effect on consumption. The more highly developed the financial system is, the more equal the distribution of sources becomes, with the larger share enjoyed by the rational and efficient areas (Duman and Lee, 2000:8). In short, financial deregulation and liberalization that are aimed at relieving restrictions in the financial markets will reduce the cost of capital, increase competition, diversify fund supplies and demand, activate the distribution of sources, and, finally, produce a higher rate of economic growth.

In their works performed using the regression method, Haslag and Koo (1999) and Roubini and Sala-i Martin (1992) proved that financial pressures decrease the rate of economic growth as the McKinnon-Shaw School antici-

pated. King and Levine (1993) and Beck et al. (2000) determined that there is a powerful and positive relationship between financial liberalization and economic growth. The increase of economic growth in line with financial development was also proven by Fry (1997) in his work performed by making use of the findings of others as well as his own works. All these works confirm the McKinnon-Shaw school.

It can be argued that a financial system that is set free within specific limits is more beneficial than a controlled system, and this argument is generally accepted from an economic point of view. On this basis, the majority of the developed countries, except the U.S., have abandoned the use of intervening policies since the 1970s. At the end of this period, it was observed that intervening policies have been discontinued by the EU and by many other free - market economies (Williamson and Mahar, 2000:7). The reasons why most countries have abandoned the restrictions imposed on capital movements are listed below (Da li and Terzi, 1994: 32):

- The specialization encouraged by the capital market resulting in an increase in international trade due to the competition introduced by the liberalization of the capital movements.
- The most effective use of economic resources as a result of employing the savings in the most efficient areas.
- Investors search for portfolio diversification by making use of the accruals of stable income, free from domestic shocks.

There are both pros and cons associated with financial liberalization. The developing markets that have used the process of the financial liberalization have faced numerous problems, contrary to the optimistic expectations at the very beginning. Liberalization in such countries has made a positive contribution to the integration of the financial markets, but it has fallen short in terms of establishing independent monetary policies, currency rate policies, and interest rate policies. Such a paradoxical relationship has impeded the efforts of these countries to achieve their growth targets and to achieve development rates commensurate with their own capabilities. In particular, financial liberalization was blamed for the frequent financial crises observed in the developing countries, which were accompanied by high unemployment rates, poverty, and distress (Seyido lu, 2003:143).

In their study of 53 countries during the period of 1980 - 1995, Demirgüç-Kunt and Detragiache (1998) proved that financial liberalization impeded the power of the markets by fostering the competition. In particular, they emphasized the insufficient legal and corporate regulations and the absence of a sound system infrastructure, which were the main reason for the banking crises. These factors increased the tendency for economic crises to occur in many countries, such as Argentina, Mexico, Brazil and

Turkey, due to the ethical implications of financial liberalization. Recently, it was argued that the occurrence and frequency of the financial crises encountered in the developing countries in particular were closely related to the capital movements that resulted from financial liberalization (Calvo, Leiderman, and Reinhart (1996); Guitian (1998); Mathieson, Richards and Sharma (1998); Stiglitz (2000); Daniels (2003). Emphasizing the difference between the liberalized and real markets due to the asymmetrical information that is typical for the financial markets, Stiglitz stated, "The free and competitive markets that form the basis for a capitalist economy are valid for the real economy, however, the same is not true for the financial liberalization, since the competition cannot be maintained, if the access of full information as not ensured." According to Stiglitz, the majority of the developed countries, in particular the U.S. and Japan were very sensitive about capital movements and consolidated their economies until they were able to cope with the foreign companies. According to the author, rapid liberalization is as hazardous as protectionism. Stiglitz's comments on the liberalization of the capital movements were, "The hot money left the country upon the liberalization of the capital movements left an intensive damage behind. The developing countries are like small boats. Rapid liberalization of the capital movements imposed by IMF looks like to sail out with a small boat in a stormy weather without repairing the damages on its hull, having its captain trained properly and lacking to be equipped with the life belt. Even under most favorable conditions, their overturning is likely when a big wave hit it." (Stiglitz, 2002:38-39).

## **FINANCIAL LIBERALIZATION IN TURKEY**

Financial liberalization in Turkey emerged as a product of the introduction of the structural transformation program according to Neoclassical Theory in the January 24 Resolutions package. The resolutions anticipated diminishing the public's share in the economy, privatizing public - owned enterprises, abolishing the limits in front of foreign currency movements, and establishing exchange rates under market conditions. In addition, stepwise liberalization would be introduced in foreign trade to open the way for the financial markets (Uzuno lu, Alkin and Gürlesel, 1995:93) . Added to the financial liberalization introduced by the January 24 Resolutions and implemented during the 1980s, the integration of the domestic and foreign markets was realized by abolishing the limitations on the capital movements in line with the liberalization in the financial markets, let alone the trade liberalization.

In the course of the process of the financial liberalization in Turkey, the analysis should also include the conditions prevailing during the emergence of the process as well. To this end, it is possible to classify the

financial liberalization in Turkey under three main headings that is the period prior to the 1980 market when import substitution policies were in effect, the Domestic Financial Liberalization period from 1980 - 1989 in which liberal economic policies were dominant, and the period after 1989 that is highly disputed by virtue of its liberalization of the capital movements in line with foreign financial liberalization.

### **Period before financial liberalization**

In the first years of the Republic, even if liberal economic policies had been favored, it would have been impossible to follow independent exchange policy due to the heavy provisions imposed by the Lausanne Agreement. Except for the first years of the Republic, Turkey adopted tight exchange policies until the code on protection of the value of the Turkish Lira (CPVTL) was enacted in 1980. In the pre -1980 period, the Turkish Lira was revalued many times with respect to the currencies of other countries. As a result of the intervention policy followed during this period, the purpose of the exchange rate policies was to stabilize the rates by keeping the rate fixed. This was not, however, sufficient enough to prevent the creation of black - market prices for foreign currency.

After the great depression, Code no. 1567 on protection of the value of the Turkish Lira (CPVTL) was issued in 1930 in order to introduce new regulations of foreign currencies, which remained in force throughout the period. Let alone the disputed performance of Code no. 1567 in protecting the value of the Turkish Lira, the code mandated the transfer of revenues in foreign currency into the country, allocation of such currencies by the public together limitations also in making use of the foreign currency within the domestic purposes. The code authorized the council of ministers to issue regulations under the code on protection of the value of the Turkish Lira. From the time the code was enacted until 1980, the council of ministers issued 24 regulations on foreign currency. The structure of the financial system before 1980 can be summarized as follows. The accounts and credit interest rates were controlled, which, for the most part, had negative effects. Considerable limitations were introduced in foreign currency operations. Foreign currencies could not be included in personal portfolios. The preferred credits dominated the monetary policies of the central bank. Favorable credit rates were supplied for prioritized regions in economic growth. There was no incorporation of the financial system, and the cost of broker was considerable. Significant limitations were imposed on the participation of local and foreign banks in the financial markets. Corporate funding had to be acquired mainly from the banks due to the lack of the financial markets. In particular, the public played a dominant role in financial liberalization during the period.

Considerable limitations were imposed on interest rates

during the pre - 1980 period. The public provided favorable credit to prioritized industries through numerous credit facilities. Toward the end of the 1970s, the real interest rates turned out to be negative as inflation increased. Negative interest rates reduced the cost of capital, and, therefore, companies were encouraged to use external funds. However, they disregarded efficiency and profitability criteria in making investment decisions. Since this process favored consumption, savings flowed into investments, and the result was the shrinking of the financial system (Alp, 252:2002).

### **Internal financial liberalization period**

During the 1980s, numerous legal and administrative regulations were introduced at different stages in the course of financial liberalization. In this context, fixed exchange rates were abandoned, a free exchange rate system was adopted, and controls were removed from interest rates. The 1982 brokerage crisis, which was attributed to the increase in interest rates, was inevitable due to absence of relevant legal and administrative regulations. The result was the bankruptcy of small banks and numerous brokerage corporations. These were bitter experiences, and, therefore, a more cautionary approach was observed from 1983 until – 1988, and interest rates on the deposit accounts were controlled during this period. The liberalization of interest rates after 1980 was only part of the financial liberalization (internal financial liberalization). The liberalization of interest rates was a necessary, but insufficient, change for genuine financial liberalization (Uzuno lu, Alkin and Gürlesel, 1995:93-94). It was also necessary to introduce a series of regulations to ensure the sound operation of the financial markets. To this end, the Capital Market Board and the Istanbul Stock Market were established, and a new banking code was introduced in an effort to incorporate the financial markets. A new step was taken in 1984 with the introduction of Code no. 30 for the liberalization of exchange rate regulations. With this code, it was possible for residents to have foreign currency. This code also allowed foreign borrowing so the private sector could have access to the funds required.

In 1985, The Treasury initiated the selling of public debentures via tender. The Treasury's tender contributed to a relative easing of the pressures on the Central Bank's statements due to the public's deficits. In April 1986, the interbank money market was established. In February 1987, the Central Bank initiated open market operations, and, in August 1988, the interbank foreign currency markets were established (Central Bank, 2006:18) . As a result of the regulations introduced, the M2/GNP ratio, which indicates the size of the financial system in Turkey as does for numerous other countries, increased to 28% in 1999 from its 1980 value of 17.4%, while the ratio of financial assets to GNP increased to 83.5% from 17.5% over this same period (Alp, 2002:252).

### **Foreign financial liberalization**

Following the financial liberalization in which the exchange rates were determined based on supply and demand, the complementary foreign financial liberalization was introduced to ensure the integration of the domestic market with the international market, and it emphasized market conditions by eliminating any intervention relative to foreign currencies. (Williamson and Mahar, 2000:10). In line with the necessity encountered upon integration of the domestic economy with the foreign markets after 1980 in Turkey, the limitations on foreign currencies were abandoned, and the financial markets were liberalized by the introduction of Decree No. 32 of the Council of Ministers in 1989. The influences that gave rise to the liberalization of the capital movements in 1989 can be outlined as follows. In the past, the private sector was forced out of the financial markets that provided credit, since the domestic sources were used mainly to fund public deficits. In particular, an increase in short - term capital inflow was observed as a result of the liberalization of foreign accounts in order to let foreign funds enter the country, which was designed as an alternative for funding public deficits.

According to Celasun (2002), the basic motive behind the resolution on the foreign financial liberalization was the revival of the economy, funding public spending, and increasing real wages (Celasun, 2002:1). The last step in the course of the foreign financial liberalization since 1980 was Decree No. 32 of the Council of Ministers, enacted on August 11, 1989. As opposed to decrees enacted earlier, the characteristic feature of Decree No. 32 was full liberalization of capital movements. Decree No. 32 and subsequent related regulations have been the basis of Turkish exchange legislation, in combination with Central Bank bulletins. The provisions provided under Article 1 of Decree No. 32 on protection of the value of the Turkish Lira (TL) reads: "This code provides the provisions for regulating and limiting the exchange rate operations with respect to the foreign currency and documentary foreign currency (including securities and other capital market instruments), saving and management of the foreign currency, import and export of Turkish Lira and documentary Turkish Lira (including securities and other capital market instruments), operations with respect to precious ores, stones and goods, issue of free import via collection of the premium, import and export operations, exclusive import and export operation, invisible operations and capital movements in order to protect the value of Turkish Lira."

With Decree No. 32 of the council of ministers, which has introduced the most liberal regime of all the periods since the 1980s, the process related to the liberalization of foreign currency operations and capital movements was concluded. Since 1989 when the code was enacted, Turkey has been classified as one of the countries that have adopted the free exchange rate regime, although

further modifications on the practical implementations of the code were enacted between 1990 and 2003. Since one year after its enactment in 1989, Decree No. 32 has been the legal basis for registering the TL as the convertible currency by the IMF. The basic regulations introduced by Decree No. 32 with respect to capital movements are as follows (TCMB, 2006:16):

- Turkish residents are entitled to purchase and possess foreign currency from banks and private financial corporations without any limitations.
- Turkish residents are entitled to transfer the foreign currency revenues obtained in the services rendered on behalf of foreigners into Turkey.
- Turkish residents are entitled to export securities to foreign countries and import them from foreign countries.
- Turkish residents and corporations may have access to foreign currency denominated foreign credits.
- Foreigners are entitled to open Turkish Lira denominated accounts and transfer any interest, and similar assets, abroad.
- Foreigners are entitled to purchase immovable in Turkey and transfer any revenue abroad.
- Turkish residents are entitled to open foreign agencies and correspondence offices.
- The import and export of securities and other capital market instruments are allowed.
- Foreigners are allowed to have their companies registered in Turkey, obtain stock options of current and future companies, invest via their branch offices established in Turkey, and engage in operations for the production of goods and services.
- Foreigners are entitled to export and public sale-out securities and other capital market instruments from Turkey within the framework of established capital market legislation.
- Foreigners are entitled to purchase and sell securities and other capital market instruments via banks and other brokerage corporations in accordance with established capital market legislation and transfer the revenue obtained by purchasing and selling such securities and other capital market instruments via banks.
- Turkish residents are entitled to purchase and sell securities in foreign financial markets via authorized brokerage corporations and effect the payments for such securities and other capital market instruments via banks.
- Except for public organizations and corporations, the transfer of financial market instruments issued by Turkish real and corporate residents is allowed upon registration with the Capital Market Board within the framework outstanding capital market legislation. Decree No. 32 also makes provisions for the liberalization of the operations related to foreign trade and invisible items.

### **INFLUENCE OF DECREE NO. 32 ON CAPITAL MOVEMENTS**

Since its enactment, Decree No. 32 has had a series of

influences, especially on the interest rates of capital inflow, economic growth volume of investment, savings, consumption level, and financial crises. The increase in the volume of capital inflow upon the full liberalization of the capital movements in Turkey as of 1989 was temporarily successful in eliminating the problems attributed to Turkey's internal dynamics, it fell short in introducing a long-term, sustainable - growth process. In fact, two big crises encountered in the post - 1990 period were attributed to financial liberalization in Turkey (Alper and Öni , 2001:205).

Upon enactment of Code No. 32, capital inflow into the Turkish economy exerted pressure on the monetary variables, and the share of foreign assets in overall assets tended to increase steadily. The implementation of a monetary program after 1990 was mainly because of uncontrolled increase in foreign assets. As of 1990, the net foreign asset inflow had resulted in the enlargement of the monetary basis. After such an extensive inflow of foreign capital, the Turkish Central Bank was forced to issue debentures to purchase the excess amount from the market in order to confine rapid increases in the exchange rates. Another approach used to limit the enlargement of the monetary basis was to sterilize the instruments issued by the Central Bank, which might boost interest rates and public deficits. In fact, increasing the interest rates to attract foreign capital resulted in an increase in public debt and disturbed the public balance. In practice, it was not effective for curbing the increases in interest rates or the continuous increase in prices. This was the main reason that tight money and credit policies were not implemented, and, therefore, the excess liquidity was absorbed by the public via the Treasury instruments instead of by sterilization. Then, high interest rates impeded investment and growth, and, therefore, the expected improvement of capital movements did not occur (Yentürk, 2005:282; Uzuno lu, Alkin and Gürlesel, 1995:68).

The control and supervision imposed on capital movements were abandoned after the liberalization of the capital movements in 1989, and the financial markets were left under the influence of short - term capital movements. Capital inflow operates in favor of the value of the local currency, irrespective of the exchange rate regime. The phenomenon of bottom assets - high interest rates made interest rates sensitive to exchange rates, preventing the Central Bank from using these instruments as tools that were independent of each other. To establish financial balance under such conditions, a compromise was made by accepting the proceeds of domestic interest rates to be higher than speculative foreign currency revenues that have high domestic interest rates. This motivated the inflow of currency from short - term foreign sources, but it also necessitated funding public deficits with foreign savings, thereby increasing the volumes of imports and consumption. In an economy squeezed by the policy of high interest rates - low exchange rates, the

**Table 1.** Foreign capital inflow before Decree No. 32 (million\$, %).

| Year | Direct invest. | Portfolio invest. | Other invest. | Total invest. | Growth | Domestic savings | Index ratio* |
|------|----------------|-------------------|---------------|---------------|--------|------------------|--------------|
| 1980 | 18             | -                 | -             | 18            | -2.8   | 16.0             | 98.7         |
| 1981 | 95             | -                 | -             | 95            | 4.8    | 18.3             | 35.4         |
| 1982 | 55             | -                 | -             | 55            | 3.1    | 17.1             | 26.5         |
| 1983 | 46             | -                 | -             | 46            | 4.2    | 16.5             | 30.5         |
| 1984 | 113            | -                 | -             | 113           | 7.1    | 16.5             | 50.3         |
| 1985 | 99             | -                 | 1.515         | 1.614         | 4.3    | 18.9             | 43.2         |
| 1986 | 125            | 146               | 2.166         | 2.437         | 6.8    | 21.9             | 29.6         |
| 1987 | 115            | 307               | 2.448         | 2.870         | 9.8    | 24.1             | 32.0         |
| 1988 | 354            | 1.184             | -1.062        | 476           | 1.5    | 26.3             | 70.5         |
| 1989 | 663            | 1.445             | -1.640        | 468           | 1.6    | 24.8             | 63.9         |

\* Ratio between the consumer and producer price indices. Source: Central Bank balance of payments statistics, state planning organization for economic and social indicators (1950-1992), Treasury direct investment statistics, 2007.

available funds foster a boom in import, favoring the current account deficits (Yeldan, 135:2004). According to Kazgan, the capital inflow increased in response to funds availability in the developed countries that had been rendered idle during the post-1989 period, and they were seeking to enter the developing countries. So, in addition to the financial liberalization policies adopted in Turkey, the country's economy became vulnerable to instability in the foreign markets (Kazgan, 1994:14).

### Foreign capital movements to Turkey

It might be asserted that in the first years of the Republic of Turkey, foreign capital was welcomed, so long as the national benefits were not jeopardized. Efforts were made to increase national capital reserves after the code on incentive for foreign capital was established in 1927, but, until 1950, there was no significant foreign investment after the Republic of Turkey was established. The governments at that time were reluctant to use special measures to encourage an influx of foreign capital to contribute to the economic development of the country. As a result of the liberalization policies implemented in 1946, legislation was introduced, and the Code on Incentive for Foreign Capital was enacted. Even so, no significant foreign capital inflow was observed until 1990. It should be noted that Decree No. 32 has been the milestone in attracting foreign capital into Turkey.

Table 1 gives the foreign capital inflow and its components into Turkey after 1980. The figures for the components of the foreign capital are given in terms of direct foreign investments, portfolio investments, and other foreign investments, as classified by the Turkish Central Bank. The percentages are given for the growth, domestic savings, and inflation in the respective years in order to see the influence of the capital movements on the macroeconomic variables.

When the progress of capital movements in Turkey after 1980 is evaluated in Table 1, two points are worth mentioning. The first point is the numerical increase in the capital movements, and the second point is the foreign capital inflow in terms of the portfolio investment and other foreign capital inflows that are not relevant for the period before 1980 (Kepenek and Yentürk, 2000: 296). In fact, portfolio investments emerged in 1986, and significant increases in the volumes of such investments were observed after Code No. 32 was enacted. Table 1 shows that direct foreign capital investments (DFI) during the post-1980 periods were low and that annual increases were very small, if they occurred at all. On the other hand, portfolio investments and other investments fluctuated at rather low levels during the period before Code No. 32. Again, the table reveals that growth was negative in 1980, while the domestic rate of saving was 16 percent, reflecting the influence on growth by macro variables, such as capital movements, savings, and inflation. Saving rates increased steadily from 1980 until 1989 when foreign financial liberalization was introduced. The economic growth, however, performed well during the 1981 - 1987 period, which was not the case in 1988 or 1989. When inflation data were based on ratio of price indices (consumer/producer), the rate of inflation decreased until 1987 and then tended to increase after 1988. Care should be observed not to relate the improvement in the economic variables during the period of 1980 - 1989 completely to financial liberalization, because the economic variables were radically modified, and financial liberalization was only one of many other policies that were implemented.

Table 2 gives the capital movements towards Turkey and their influence on the growth, inflation, and saving percentages after Code No. 32. As can be seen in Table 2, significant increases were observed in the type and volume of the capital movements toward Turkey after of 1980 - 1989 completely to financial liberalization,

**Table 2.** Foreign capital inflow after Decree No. 32 (Million\$, %).

| YEAR | DIRECT INVEST | PORTFOLIO INVEST | OTHER INVEST. | TOTAL INVEST. | GROWTH | DOMESTIC SAVINGS | INDEX RATIO* |
|------|---------------|------------------|---------------|---------------|--------|------------------|--------------|
| 1990 | 684           | 681              | 3. 199        | 4. 564        | 9. 2   | 23. 4            | 52. 3        |
| 1991 | 810           | 714              | -1. 240       | 284           | 0. 4   | 21. 6            | 55. 4        |
| 1992 | 844           | 3. 165           | 2. 896        | 6. 905        | 0. 4   | 21. 7            | 62. 1        |
| 1993 | 636           | 4. 480           | 7. 655        | 12. 771       | 7. 6   | 21. 9            | 58. 4        |
| 1994 | 608           | 1. 123           | -8. 397       | -6. 666       | -6. 1  | 21. 4            | 120. 7       |
| 1995 | 885           | 703              | 3. 939        | 5. 527        | 8,0    | 22. 1            | 86           |
| 1996 | 722           | 1. 950           | 3. 970        | 6. 642        | 7,1    | 19. 8            | 75. 9        |
| 1997 | 805           | 2. 344           | 6. 531        | 9. 680        | 8,3    | 21. 3            | 81. 8        |
| 1998 | 940           | -5. 089          | 6. 762        | 2. 613        | 3,9    | 22. 7            | 71. 8        |
| 1999 | 783           | 4. 188           | 3. 566        | 8. 537        | -6,1   | 21. 2            | 53. 1        |
| 2000 | 982           | 1. 615           | 10. 389       | 12. 986       | 6,3    | 18. 2            | 51. 4        |
| 2001 | 3. 352        | -3. 727          | -12. 296      | -12. 671      | -9,5   | 17. 4            | 61. 6        |
| 2002 | 1. 133        | 1. 503           | 1. 603        | 4. 239        | 7,9    | 19. 1            | 50. 1        |
| 2003 | 1. 752        | 3. 851           | 4. 461        | 10. 064       | 5. 9   | 19. 3            | 25. 6        |
| 2004 | 2. 885        | 9. 411           | 14. 658       | 26. 954       | 9. 9   | 20. 3            | 10. 7        |
| 2005 | 10. 029       | 14. 670          | 20. 976       | 45. 646       | 7. 6   | 20. 4            | 10. 3        |
| 2006 | 19. 918       | 11. 402          | 30. 047       | 61. 367       | 6. 0   | 16. 6            | 5. 1         |

\* Ratio between consumer and producer price indices. Source: Central Bank balance of payments statistics, state planning organization for economic and social indicators (1950-1992), Treasury direct investment statistics, 2007.

because the economic variables were radically modified, and financial liberalization was only one of many other policies that were implemented.

Table 2 gives the capital movements towards Turkey and their influence on the growth, inflation, and saving percentages after Code No. 32. As can be seen in Table 2, significant increases were observed in the type and volume of the capital movements toward Turkey after Code No. 32. Direct foreign investments that amounted to \$684 million (US) in 1990 increased to \$940 million in 1998. A period of economic crisis occurred in 1994, and the economic shrinkage resulted in a decrease in direct foreign capital inflow. The direct foreign investments amounted to \$982 million (US) in 2000, whereas they decreased after the 2001 economic crisis before increasing again in the succeeding years.

According to the data in Table 2, significant increases were observed in direct foreign investments and portfolio investments after the foreign financial liberalization that allowed free capital movements. Although there were decreases in direct foreign investments in 1993 and 1994 even though no crises occurred, the succeeding years showed an increasing trend. Portfolio investments first appeared in Turkey in 1986, and, even though such investments were very small for the first three years, significant increases were observed in the volume of portfolio investments in response to the enactment of Decree No. 32 in 1989. Similar trends were likely for other foreign investments as well. Again, as the table shows, portfolio investments and other foreign invest-

ments tended to decrease during the 1994 economic crisis, as also was the case for direct foreign investments. However, the decreasing trend in portfolio investments and other foreign investments was sharper than it was for direct foreign investments. Mention must be made of the \$5 billion (US) outflow that occurred due to the crisis in Southeastern Asia and Russia in 1998. This supports the general opinion that "portfolio investments and other short-term foreign investments are more fragile in a crisis than are direct foreign investments." Again, a similar process was observed in the case of the 2001 economic crisis in that portfolio investments and other foreign investments were quickly withdrawn from the host country during the crisis period. It is also apparent that direct foreign investments are adversely influenced during crisis periods, but their responses were delayed, and they were withdrawn at a slow pace.

Table 2 proves that the intensive foreign capital inflow in 1990 as a result of Decree No. 32 was the main reason for the achievement of a high rate of growth that is 9.2%. The growth rate fluctuated in the years that followed, and it was negative only in 1994, due to the crisis at that time. The growth rates were positive until 1999, but they decreased again in both 1999 and 2001 due to crises during those years. The growth rates increased after 2002, but they declined again after 2005. Once again, the savings remained the same for a while after Code No. 32, and then it fell in the period that followed. Thus, Turkey's experience was contradictory to the assertion in neo-classical theory that "the financial liberalization operates

in favor of the savings ratios."

## Conclusion

In response to financial liberalization, the investors in the developed countries enter into the markets of the developing countries with an expectation of higher returns on their investments. This, in turn, provides the opportunity for the developing countries to access the funds needed for their economic growth. This may seem simple and sound at first sight; however, it also has its own implications when the outcomes are considered. As a result, some people support financial liberalization, and other people oppose it. According to those who support financial liberalization, foreign capital increases investment funds, boosts competition in the domestic market, facilitates the dynamics of the market, and finally encourages economic growth. In addition, liberalization of capital movements will make the savings orient to the more profitable markets, which enables the developing countries to have access to these resources in return for high interest rates. In practice, liberalization integrates the financial markets, while freed money is deprived of the regulations on the exchange rate and exchange rate policy tools. As a result of liberalization, the increased volume of foreign capital inflow boosts consumption, increases the national banking foreign currency denominated debts and lets the banks and companies have to face the risks associated with uncertain exchange rates.

Financial liberalization in Turkey was first initiated by freeing the deposit account and credit interest rates in July 1980. In financial terms, this marked the internal financial liberalization. In a country where the growth model includes being open to foreign markets, integration with the financial markets was inevitable with such financial liberalization. The final regulation in the liberalization was Code No. 32. This code abandoned the regulations that imposed restrictions on the capital movements in Turkey. The effects of financial liberalization were observed after 1990, when foreign currency input rendered the TL over-valued, as has been the case for the majority of the developing countries. In this period, foreign resources were supplied for funding the public deficits, which eventually increased the foreign currency gap.

Turkey's entry into the international finance system by liberalization of its financial markets without financial deepening fell short in providing solutions for economic problems. Even though this occurred quite early when compared to the majority of the developing countries, there were numerous disputes that resulted from the

timing of the financial liberalization. In short, it is likely that the financial liberalization will result in diverse outcomes, depending on the prevailing economic conditions of the relevant countries. It may not contribute to increased savings even if it is applied in a wide range of applications in many countries. The increased inflow of foreign capital that occurs as a result of liberalization, as has been the case in Turkey, may still cause the emergence of a financial crisis.

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