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The Financial Flows and the Future of EU-Turkey Relations

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ABSTRACT

This paper focuses on the role of financial flows in the future of EU-Turkey relations. The size of financial flows has increased along with increasing integration between EU and Turkey. In this process many macroeconomic variables in Turkey have been significantly influenced by the movements of financial flows through assets and credit channels. The movements of financial flows can be significantly affected by the tone of the relations between EU-Turkey. Especially, under the assumption that EU stabilizes itself, in a world in which global liquidity evaporates, Turkish policy makers cannot afford the conflict scenario. Even in a world of a high global liquidity, the possibility of financial reversals creates huge uncertainty and a potential high cost for the Turkish part. Therefore, focusing on the role of financial flows, under normal conditions, Turkey EU relations are destined to evolve into either convergence or cooperation options. Furthermore, the vulnerability of Turkish economy to financial flows can increase the leverage of Europe on Turkey. Turkish authorities should find ways to decrease the sensitivity of the economy to the flows in order to increase their negotiation power in the process.

ÖZET

Bu yazı finansal akımların AB-Türkiye ilişkilerinin geleceğindeki rolü üzerinedir. Finansal akımların boyutu, AB ile Türkiye arasındaki entegrasyonun derinleşmesiyle birlikte artmıştır. Bu süreçte Türkiye'de birçok makroekonomik değişken, varlık ve kredi kanalları vasıtasıyla finansal akımlardan önemli ölçüde etkilenmiştir. Finansal akımların yönü ve boyutu, AB-Türkiye arasındaki ilişkilerin tonlamasından önemli ölçüde etkilenebilir. Özellikle, AB'nin kendisini istikrarlı hale getirdiği varsayımı altında, küresel likiditenin buharlaştığı bir dünyada, Türk politika yapıcıları çatışma senaryosunu göze alamazlar. Küresel likiditenin yüksek olduğu bir dünyada bile, muhtemel bir finansal geri dönüş ciddi bir belirsizlik ve potansiyel bir yüksek maliyet yaratmaktadır. Bu nedenle, finansal akımların penceresinden bakıldığında, normal koşullar altında, Türkiye AB ilişkilerinin işbirliği veya yakınsama senaryolarına evrilmesi beklenmektedir. Ayrıca, Türk ekonomisinin finansal akışlara karşı kırılganlığı AB'nin Türkiye üzerindeki pazarlık gücünü artırabilir. Türk yetkililer, bu süreçte müzakere gücünü artırmak için ekonominin finansal akımlara karşı duyarlılığını azaltmanın yollarını bulmalıdır.

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1. Introduction¹

After the 1970s, with the collapse of the Bretton Woods system and increasing liberalization steps, the size and the importance of financial sector and financial flows increased all around the world. Some researchers conceptualize this process as the financialization of the world economy (Epstein 2005). Turkey followed these steps very closely. Domestic and external liberalization policies were put into practice after the 1980s. Since then, financial flows have gradually gained ground and many important macroeconomic variables have become very sensitive to financial flows in Turkey. This paper focuses on the role of financial flows in the future EU-Turkey relations. However, given the fact that financial flows originated from Turkey have not been very significant for Europe, how financial flows can drive EU-Turkey relations will be explored mostly from the Turkish perspective. The directions and the magnitude of financial flows can be affected by future developments in the relations. In turn, financial flows can be considered as one of the major factors which can significantly influence the possible path of EU-Turkey relations. Therefore, the decisions of Turkish policymakers about the EU-Turkey relations are conditional upon the sensitivity of financial flows to their policies regarding EU-Turkey. Given the dependence of Turkey on financial flows, assuming that EU would stabilize its internal problems, Turkish policymakers cannot afford conflict scenarios for a long time. As a result, EU-Turkey relations are expected to evolve into the forms of either convergence or cooperation. If Turkish policy makers find ways to decrease the vulnerability of the economy to the financial flows; this may increase their room for maneuver in the negotiation process.

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The outline of the paper is as follows. First, utilizing descriptive statistics, the historical trends in financial flows to the Turkish economy will be studied. Second, the relative influences of financial flows on the economy will be explored. Third, the implications of EU-Turkey relations for financial flows to the Turkish economy will be investigated. In this part, in light of previous discussions and considering the scenarios of conflict, cooperation and convergence, how financial flows can drive the future of EU-Turkey relations will be discussed too. The last section will conclude.

¹ I am very grateful to Semih Akçomak, Erkan Erdil and Oktar Türel for their very helpful comments. All remaining errors are mine.



2. Historical Trends in Financial Flows in Turkish Economy

Financial flows are composed of portfolio flows, other flows² and foreign direct investment (FDI). As will be elaborated in next parts, different financial flows categories may have different implications for a country. Therefore, in this part, to be able to locate financial flows in Turkish economy properly, trends in the main categories of financial flows will be explained in detail.

Although net flows can give some clues about overall picture of financial flows, it is important to investigate gross flows as much as possible as well (Borio & Disyatat, 2011). However, it is not an easy task to have gross flows data due to fact that any transaction among two parties can be canceled out with a counter transaction. Therefore, our gross flows analysis will be based on assets and liabilities components of portfolio flows, other flows and FDI reported by the Central Bank Republic of Turkey balance of payment statistics (CBRT BOP Statistics)³.

In Turkey, in line with the common practices in the world, before the 1980s, there were heavy restrictions on financial flows. Although domestic financial liberalization steps were taken as early as 1981, considerable external financial liberalization steps began in late 1983. In this vein, the Decree 28 and the Decree 29, which were put into practice in December 1983, introduced very massive external financial liberalization policies⁴. Turkey completed its capital account liberalization before many other relatively advanced countries in 1989. As a result of full financial liberalization both Turkish citizens and foreigners were allowed to make financial transactions without any restrictions. The importance of financial flows has increased further along with rising integration between EU and Turkey.

The difference between purchases and sales of foreign assets by residents is called net financial outflows (here after financial outflows). The magnitude of financial outflows has never reached significant levels in Turkey (see Figure 1). The average amounts of financial outflows from Turkey was only about 230 million dollars for the whole period of 1975-1989 (Table A1 in the appendix). This figure reached to only 5 billion dollars in the period from 2010 to 2016 (Table A1 in the appendix). In total, this implies about 33.6-billion-dollar worth of net purchase of foreign assets by Turkish citizens in this period (Table 1). When one considers financial outflows relative to GDP, this picture does not change much. In this vein, the average amounts of financial outflows was

² Other flows consist of the transactions of central banks, general government, banks and other sectors (non-financial private sector) in the forms of loans, trade credits, currency and deposits.

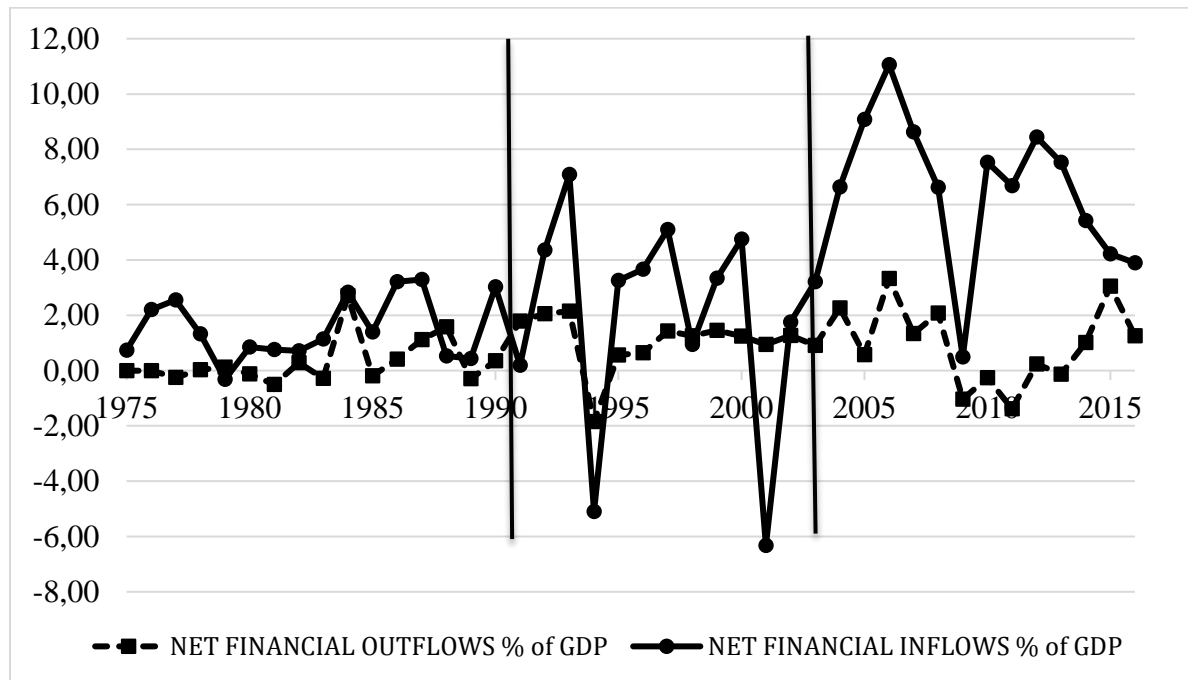
³ The acquisition of financial assets by domestic players increases the accumulated foreign assets of a country. This implies a capital outflow from the country too. The acquisition of domestic financial assets by foreigners means an increase in the accumulated liabilities of the country which is equivalent of a hike in foreign financial flows into the country.

⁴ Therefore, the balance of payments data before 1984 include only FDI inflows and other (mainly official) transactions. No FDI outflows were recorded till 1987. Other investment outflows data start from 1977. But till 1984, the composition of other investments was not reported. The first portfolio inflows (outflows) registration in BOP account took place in 1986 (1987).



0.31, 0.98, 1.29 and 0.54 percent of GDP in the periods of 1977-1989, 1990-1999, 2000-2009 and 2010-2016 respectively (Table A2 in the appendix)⁵.

Figure 1: Financial Inflows and Outflows (% of GDP)



Source: CBRT BOP Statistics and World Bank Development Indicators.

Note: Vertical lines demonstrate three distinct periods of financial flows. These periods are discussed briefly in the text.

Apart from the last period, financial outflows have been mostly in the form of lending and portfolio investments of Turkish investors outside. However, Turkish investors made more purchases of foreign firms (or share of foreign firms) or/and open new plants outside Turkey relative to their lending and portfolio investment activities in the last period. In other words, it seems that Turkish firms’ genuine internationalization attempt regarding FDI activities started slowly after 2010. Turkish investors made 26.8-billion-dollar worth of FDI from 2010 to 2016 whereas this figure was only 1.6 million dollars and 9 billion dollars in the periods of 1987-1999 and 2000-2009 respectively. It is very difficult to trace the sources of financial flows by looking at balance of payment statistics. However, it is relatively easy to trace the sources of FDI into a country. Therefore, although it is not possible to understand the importance of Europe in other components of financial flows, the

⁵ Especially, 2009, 2010, 2011, 2012, and 2013 were exceptional years for the outflows. Turkish citizens seem to have brought some of their wealth back to the country in these years. In the balance of payment statistics this appears as a negative financial outflows record (the sale of foreign assets by the residents). Other outflows and portfolio outflows were either negative or very small most of the time in these years. As a result, although FDI by Turkish residents were positive in these years, net financial outflows were negative (or very small) during the period. This episode may require a more detailed investigation.



importance of European investors in FDI to Turkey and the size of Turkish FDI in European countries can be assessed.

Table 1: The Sum of Financial Flows in Different Periods (millions dollars) *

	Other Investment Inflows	Portfolio Investment Inflows	Direct Investment Inflows	Net Financial Inflows	Other Investment Outflows	Direct Investment Outflows	Portfolio Investment Outflows	Net Financial Outflows	Net Financial Account
1975-1989	9691	3082	1943	14716	3349	9	90	3448	11268
1990-1999	28881	14259	7717	50857	11626	1625	6666	19917	30940
2000-2009	128808	40673	90602	260083	31569	10966	17184	59719	200364
2010-2016	166994	117948	94490	379432	2832	26871	3974	33677	345755
1990-2001	28577	13650	13133	55360	15054	3135	10032	28221	27139
2002-2016	296106	159230	179676	635012	30973	36327	17792	85092	549920

Source: CBRT BOP Statistics

*Footnote 4 is also applicable to this periodization.

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Europe in general and EU countries in specific have been the most important destination for Turkish FDI. Turkish investors made about 5.7 billion-dollar worth of FDI in EU countries in 8 years from 2002-2009. In the next seven years (2010-2016), this figure, in total, reached to about 13.7 billion dollars. As can be seen from Table 2, the Netherlands among EU countries with 10 billion dollars from 2002 to 2016 was the most important country for Turkish FDI. Germany, UK, Malta and Luxembourg followed the Netherlands with 2, 1.9, 1.2 and 1.1 billion dollars during the same period. The difference between purchases and sales of domestic financial assets by foreigners is called net financial inflows (here after financial inflows). Although financial outflows have been relatively very shallow in Turkey, along with financial liberalization of the 1980s, the amounts of financial inflows have gradually increased (see Figure 1). While the average amounts of total financial inflows to Turkey was only about 981 million dollars for the whole period of 1975-1989, on average, 54-billion-dollar worth of financial flows entered Turkey in the period of 2010-2016 (Table A1 in the appendix). This means that Turkey attracted about 380-billion-dollar worth of foreign capital in the forms of borrowings, portfolio investments and FDI in the last 7 years. The increase in the absolute size of financial inflows has been accompanied by a gradual increase in the relative importance of financial inflows as well. The average amounts of financial inflows were 1.45 and 2.59 percent of GDP in the periods of 1975-1989 and 1990-1990 respectively. This figure considerably



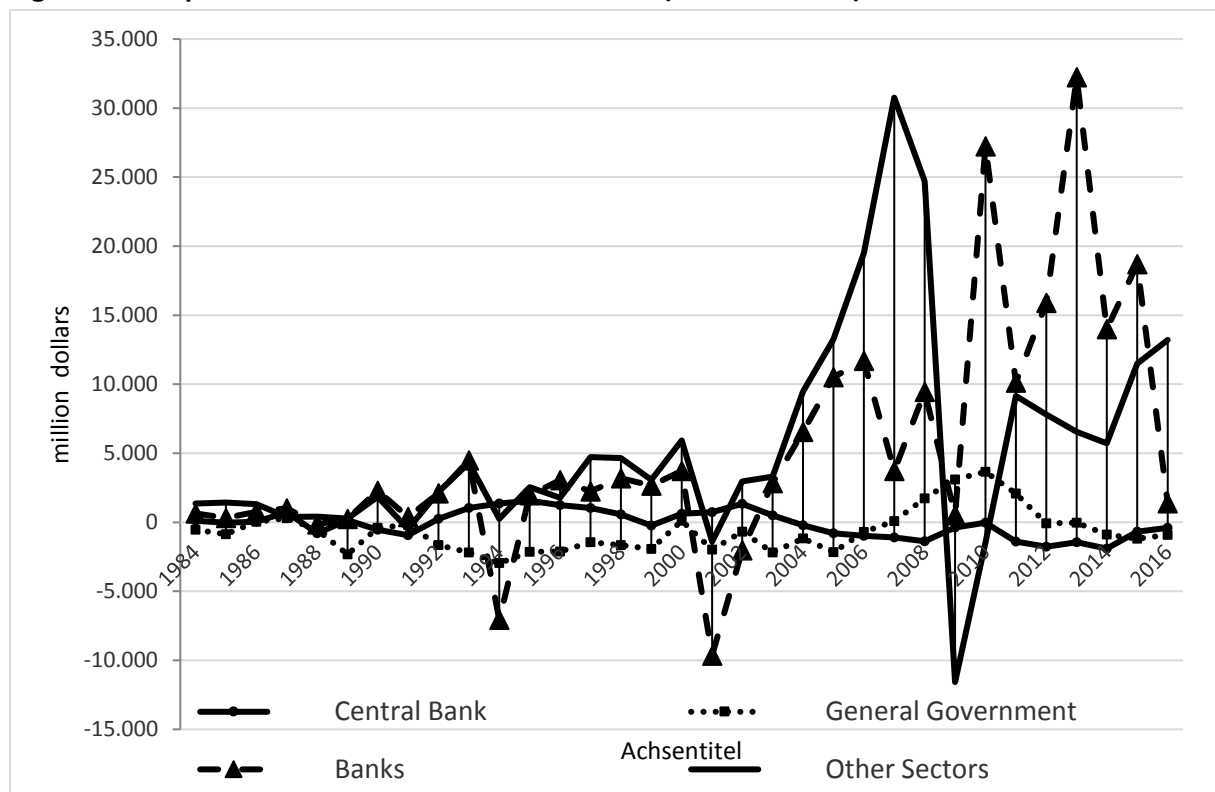
increased and reached to 4.59 and 5.25 percent of GDP in the periods of 2000-2009 and 2010-2016 respectively (Table A2 in the appendix).

Other investments (composed of the international financial transactions of central banks, general government, banks and other sectors in the forms of loans, trade credits, currency and deposits) have been the dominant components of financial inflows to Turkey. Turkey attracted about 128 and 167 billion-dollar worth of other flows in the periods of 2000-2009 and 2010-2016 respectively. In general, the transactions of other sectors (non-financial sector) have been the most important type of flows in other investments account (see Figure 2). Especially, as can be seen from Table 1, Turkish private firms obtained enormous amounts of credits (96.8 billion dollars) for their operations from 2002 to 2008. The borrowings of the Turkish banks have been another significant component of other flows. Financial liberalization process has provided Turkish banks and other firms with ample opportunities to borrow at a lower cost from the international financial markets. Turkish banks attracted 37.4 and 119.5-billion-dollar worth of finance from financial markets in the periods of 2000-2009 and 2010-2016 respectively. As a result of striking borrowings of banks and non-financial firms, while official foreign debt decreased to relatively low levels, the indebtedness of Turkish private banks and firms reached unprecedented levels in Turkey after 2002.

The importance of FDI in financial inflows increased significantly through time. Although, in total, Turkey attracted only about 2-billion-dollar worth of FDI during the whole period of 1975-1989, the accumulated amounts of FDI reached about 90.6 billion dollars and 94.4 billion dollars in the periods of 2000-2009 and 2010-2016 respectively. The surge of FDI into the Turkish financial markets after 2001 was mostly related to the privatization of major public companies in this period. After fundamental changes in the legal framework, a significant portion of public companies were sold to foreign investors. In addition to this, Turkey allowed foreigners to buy real estate and land in Turkey after 2003. Therefore, FDI inflows data reported in the balance of payments statistics also include real estate purchases by foreigners in Turkey after 2003.



Figure 2: Components of Other Investment Inflows (million dollars)



Source: CBRT BOP Statistics and World Bank World Development Indicators.

The purchases of Turkish real estate by foreigners have become a very important source of foreign exchanges for the country after 2003. This also enabled the real estate market to have a lucrative source of demand for especially luxury houses in big cities and touristic areas. The accumulated amounts of real estate purchases by foreigners in Turkey were about 17 billion dollars and 22 billion dollars during the period of 2003-2009 and 2010-2016. In other words, real estate investment of foreigners made up about one fourth of the total FDI inflows in the last period.

Excluding real estate investments of foreigners, Turkey, in total, attracted about 69 (71) billion dollar worth of FDI from all over the world from 2002 to 2009 (from 2010 to 2016)⁶. About 50 billion dollars (45 billions) of this was originated from EU countries from 2002-2009 (2010-2016). From 2002 to 2016 the Netherlands, Austria, UK, Luxemburg, Germany, Belgium, Spain, France and Greece with 21.7, 10, 9.7, 9, 8.9, 8, 7.9, 6.7 and 6.5 billion dollars respectively contributed most to FDI entering into Turkey from EU countries.

⁶ Turkish data on the origins of FDI to Turkey and the destination of Turkish FDI start from 2002.



Table 2: The Destination for and Sources of FDI

FDI Outflows (million dollars)				FDI Inflows (million dollars)			
	2002-2009	2010-2016	2002-2016		2002-2009	2010-2016	2002-2016
TOTAL WORLD	11,213	25,512	36,725	TOTAL WORLD	68,782	70,647	140,176
EUROPE	6,816	15,911	22,727	EUROPE	52,893	50,629	103,833
EU	5,782	13,725	19,507	EU	50,162	44,962	95,200
Netherlands	1,919	8,102	10,021	Netherlands	13,645	8,370	21,760
Azerbaijan	2,433	3,765	6,198	USA	6,366	4,832	11,145
USA	887	3,090	3,977	Austria	3,093	6,661	10,036
Germany	1,029	1,019	2,048	United Kingdom	3,457	6,081	9,756
United Kingdom	212	1,771	1,983	Luxembourg	4,522	4,463	9,021
Malta	1,077	180	1,257	Germany	3,737	5,120	8,989
Luxembourg	528	631	1,159	Belgium	5,739	2,470	8,027
Russia	258	587	845	Spain	1,693	5,943	7,955
Switzerland	421	339	760	France	4,386	2,464	6,752
Ireland	241	501	742	Greece	6,058	809	6,546
Kazakhstan	175	283	458	Russia	1,803	3,379	5,311
Austria	46	395	441	Azerbaijan	105	4,794	5,235
Iraq	44	324	368	UA Emirates	3,511	652	3,990
Italy	141	219	360	Italy	1,774	1,186	2,934
Romania	137	193	330	Switzerland	753	1,688	2,515
UA Emirates	65	251	316	Japan	176	2,023	2,333
Belgium	240	72	312	Saudi Arabia	1,385	564	1,903
Croatia	15	228	243	Kuwait	661	918	1,603
Belarus	100	130	230	Qatar	126	1,350	1,565
Tunisia	212	13	225	Lebanon	136	1,149	1,359
India	42	174	216	Malaysia	33	838	929
Bosnia and Herzegovina	55	154	209	China	7	801	865

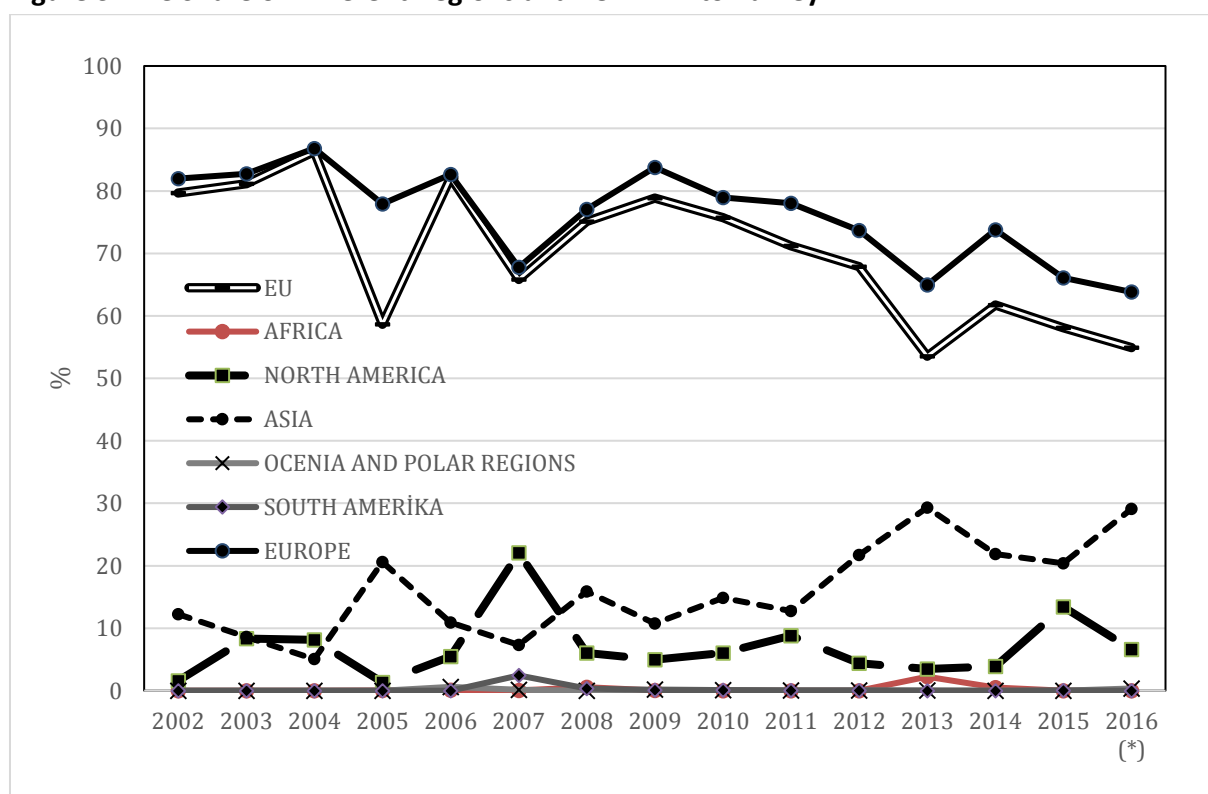
Source: CBRT BOP Statistics

As can be seen from Figure 3, the share of EU in total FDI into Turkey has gradually declined. However, on average, FDI coming from EU still make up more than 65 (76) percent of the total FDI in the period of 2010-2016 (2002-2009). In the same period, there was an increasing trend in the share of Asia in the FDI. Among the Asian countries the role of Near and Middle East countries



gained importance (Figure A2 in the appendix)⁷. In the recent years, in this group of countries, Azerbaijan and Qatar have been distinct in terms of their contribution to the total FDI. For example, Azerbaijan is solely responsible for 8.1, 10.2, 6.9 and 9.45 percent of the total FDI in Turkey in the years of 2013, 2014, 2015 and 2016 respectively (CBRT BOP Statistics). Furthermore, although the share of Qatar is very erratic, it is responsible 5.4 percent of the total in 2016 (CBRT BOP Statistics). However, political and geopolitical uncertainty surrounding Near and Middle East countries may make these countries not very reliable alternatives to FDI originated from Europe. Although FDI inflows have gained importance throughout time and became the second important component of financial inflows in the period of 2000-2009, most of the time, the importance of portfolio inflows has come after the other investment inflows. About 100-billion-dollar worth of portfolio flows entered Turkey from 2010 to 2016. In general, increasing global liquidity and decreasing interest rates in major developed countries have been external driving forces behind the surge of other and portfolio flows to Turkey from 2002 onward.

Figure 3: The Share of Different Regions and EU in FDI to Turkey



Source: CBRT BOP Statistics

⁷ In the data set, Iran, Israel, Bahrain, Qatar, Kuwait, Saudi Arabia, Azerbaijan, Georgia, Lebanon, Syria and Jordan are considered as Near and Middle East countries.



As a result of an increase in financial inflows and relatively low financial outflows, the Turkish economy has generally enjoyed positive net financial flows⁸ in absolute and relative terms (see Figure A1 in the appendix). Net financial flows can be very important for the countries which cannot pay their debt in terms of their own currency (Cömert & Düzçay, 2015). In the literature this phenomenon is known as original sin or hierarchy of money (Eichengreen et al 2003; Mehring 2012). Those countries with accumulated debt should find necessary foreign currencies by either giving current account surplus, depleting its existing foreign exchange reserves or/and being able to continue rolling over its accumulated debt. Those developing countries resorting to the second and third options cannot avoid a crisis sooner or later. If net financial flows are positive, this will contribute to the very much needed supply of foreign currency in the country, which can be used to cover current account deficits, to roll over accumulated external debt or/and to accumulate foreign exchange reserves. Due to mainly restrictions on financial flows, Turkey ended up attracting only about 11-billion-dollar worth of net financial flows from 1975 to 1989. This figure reached to 30.9 billion dollars in the 90s. Then, after the 2000s, there was a spectacular growth of net financial flows to Turkish economy. The accumulated amounts of net financial flows skyrocketed and reached to 200 billion dollars during the period of 2000-2009. In the next seven years, accumulated net financial flows broke another record with 345 billion dollars⁹.

Nominal values may be misleading in an environment in which the size of the overall economy grows steadily. However, when one considers net financial flows relative to GDP, the striking picture does not change. While the average amounts of net financial flows were 1.14 percent of GDP (751 million dollars) during the period of 1975-1989, that of was 5.71 percent of GDP (about 49 billion dollars) in the period of 2010-2016. (Table A2 in the appendix)

As can be seen from our discussions and Figure 1 referred above, three structurally different periods seem to have existed in the movements of the financial flows in Turkey. When one investigates financial inflows and outflows separately, these periods are much more apparent. As expected, due to mainly restrictions, financial inflows and outflows were negligible till the 1990s. The importance of financial inflows increased in the 1990s while financial outflows remained unimportant in the same period. The period after the crisis of 2002 seems to be structurally a different period than the earlier periods. In this sense, the surge of financial inflows (and net flows) to the Turkish economy after 2002 was unprecedented which was the case for many developing

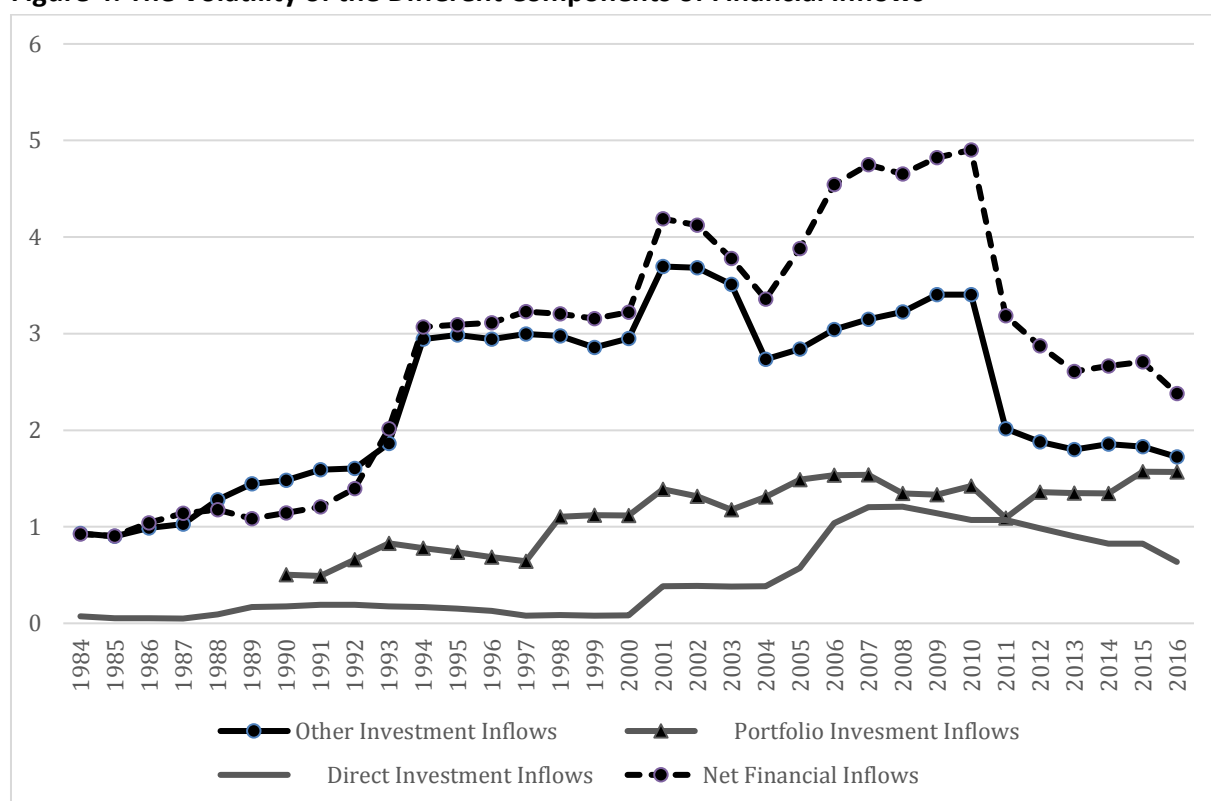
⁸ Net financial flows are calculated by subtracting (net) financial outflows from (net) financial inflows. According to the BP6 guideline prepared by the IMF, a negative sign in front of the figures regarding net financial flows (account) refers to an increase in the liabilities of domestic economy (an increase in foreign capital in the economy). However, for the sake of simplicity, we will not put a negative sign in front of net financial account. In our representation, a positive net financial flows (account), meaning that financial inflows are greater than financial outflows, refers to an increase in the availability of financial capital in the economy (an increase in the net liabilities of domestic economy)

⁹ Indeed, on a yearly base, the absolute amounts of total net financial flows broke a record with 72 billions of dollars in 2013. When one considers financial flows relative to Turkish GDP, this record was broken with 8.5 percent of GDP in 2005.



countries. There was a sudden stop in net financial flows during the recent crisis. However, financial flows reached their pre-crisis levels in a very short time after 2010¹⁰.

Figure 4: The Volatility of the Different Components of Financial Inflows



Source: Author’s calculation based on CBRT BOP Statistics and World Bank World Development Indicators.

One of the key characteristics of these three different periods of financial flows to the Turkish economy is high volatility of the flows. Figure 4 shows the volatility of financial flows based on 10 years moving average of the standard deviations of the different components of financial inflows. Accordingly, the volatility of financial flows increased along with the completion of financial liberalization. A high volatility of financial flows means high uncertainty in the supply of foreign credits and foreign exchanges in developing countries which can be easily translated into foreign exchange or/and financial crises. When one investigates the volatility of different components of financial flows, as expected, net other flows are most volatile components whereas FDI demonstrates relatively more stability (see Figure 4). After 2010, there seems to be a relative decline in

¹⁰ There has been a slowdown in financial flows to Turkish economy in the last couple of years due to mainly global cycles and domestic and regional problems. We need to wait for a while to see if Turkey entered into a new period of slow financial flows or not.



the volatility of other investment inflows and direct investment inflows whereas portfolio inflows became much more volatile.

Overall, as a result of very high financial flows, Turkish economy was able to cover its chronic current account deficits, did not face a debt repayment problem and started to accumulate considerable amounts of foreign currency reserves too. However, when Turkish economy encountered a sudden stop or financial reversals, it could not avoid significant declines in its GDP growth. The crisis of 1994, 2001 and partially 2009 were directly or indirectly caused by reversal/stops of financial flows (Akyüz & Boratav 2003; Özatay 2009; Cömert & Yeldan 2017).

3. The General Macroeconomic Implications of Financial Flows in Turkey

As in the case of many developing countries, financial flows have had many crucial implications for the Turkish economy. There are various transmission channels linking main macroeconomic variables to financial flows. Here, we will shortly explain these mechanisms under the broad headings of credit and asset price channels.

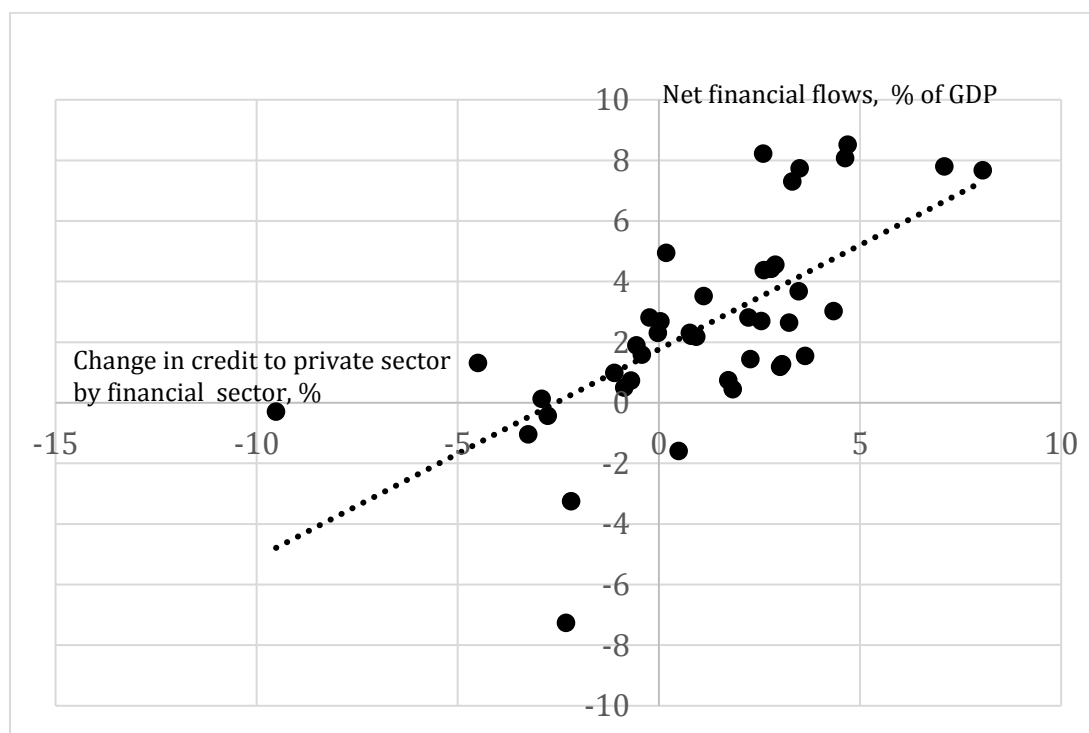
An obvious direct mechanism works through credit creation capacity of financial flows. This mechanism can be simply labelled as credit channel. There are three strands of the credit channel. First, some of big non-financial sector firms can directly borrow from international financial markets which can contribute to the investment capacity of the firms and GDP growth. As mentioned above, thanks to massive liquidity and low interest rates, Turkish private firms obtained enormous amounts of credits (96.8 billion dollars) for their operations from global financial markets from 2002 to 2008 (CBRT Balance of Payment Statistics). The second strand of the mechanism works through banking system. Financial flows in the forms of borrowings of domestically operated banks can increase the capacity of the banks to give more credits to domestic consumers and firms. Those banks with access to cheap credits from international financial markets can generate more credits domestically (Igan & Tan 2015). In this vein, Turkish banks borrowed 37.4 and 119.5 billion dollars from international financial markets in the periods of 2000-2009 and 2010-2017 respectively (CBRT Balance of Payment Statistics). These borrowings were partially responsible for very high credit growth in Turkey. Third, as elaborated below, net high positive financial flows can cause improvements in the balance sheets of banks/other firms. As a result, on the one hand, banks would be eager to give more credits. On the other hand, due to strong balance sheets, non-financial firms would be more eligible to borrow. This link is known as balance sheet effect within the credit channel¹¹. Signaling a healthy prospect for an economy, high GDP growth may also ease credit constraints on domestic firms to borrow from the rest of the world. Therefore, in general,

¹¹ For a different exposition purpose, this mechanism can be also explained as a part of the exchange rate channel. Changes in exchange rates influence balance sheets. And, improvements/deteriorations of balance sheets alter credit capacity or/and eligibility of firms in the economy. We mention the balance sheet mechanism in the exchange rate channel within the broad asset prices channel as well.



high financial flows and high GDP growth can create a virtuous credit circle and feed each other until an external or endogenously driven shock hit the economy. Scatter diagram below in Figure 5 showing a high positive correlation between financial flows and credit growth seems to support this observation in Turkey.

Figure 5: Credit Growth and Net Financial Flows



Source: CBRT BOP Statistics and World Bank World Development Indicators

The second channel works through domestic asset prices. Financial flows may exert an influence on the prices of domestic assets by altering supply and demand conditions in financial markets. The asset prices channel can be broadly further divided into interest rates, stock prices and exchange rate channels. In case of the interest rates channel, in relation to high net positive financial flows, a high demand for domestic bonds can increase the price of domestic assets. Indeed, there was only 13.2-billion-dollar worth of demand for Turkish debt securities such as bonds by foreigners from 1989 to 1999. Turkish investors were able to imports 21.6-billion-dollar worth of securities from 2000 to 2009. There was an unprecedented increase in the demand for Turkish debt securities in next seven years. Foreigners demanded 107.3 billion worth of the securities in this period (2010-2016) (CBRT BOP Statistics).

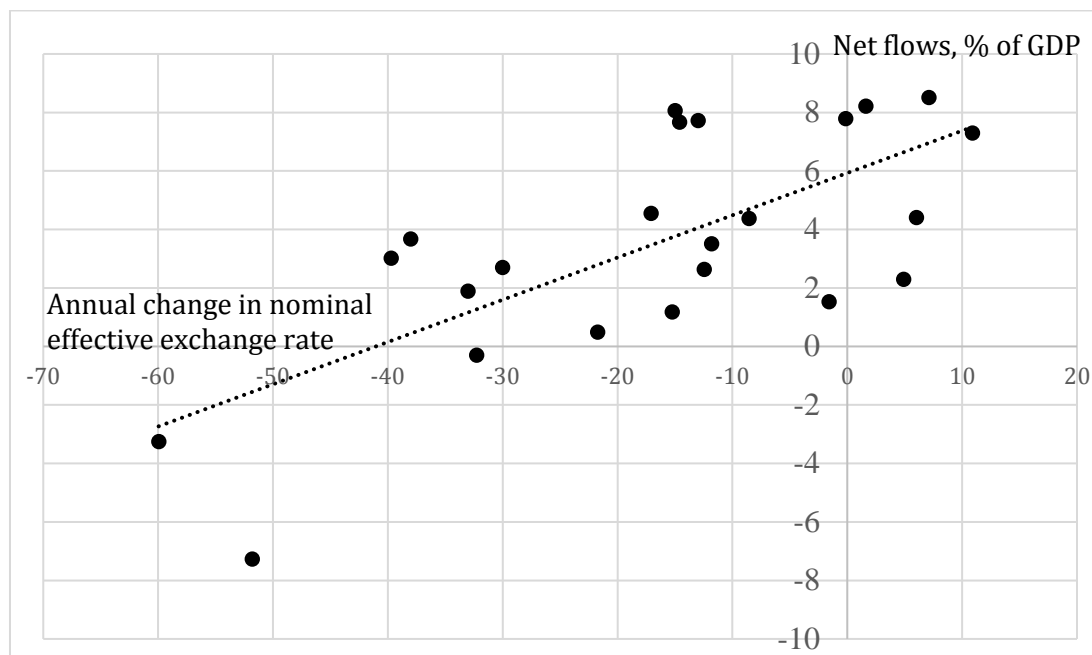


Although, to the best of our knowledge, there is no study investigating the exact amounts of the influence of foreigners on prices of Turkish securities, such big amounts of purchase of domestic securities by foreigners might have contributed to a big decrease in the interest rates on these assets by increasing the prices of these assets. In general, these securities were almost entirely issued by general government for the first two periods. After 2010, non-governmental sectors were also able to issue significant amounts of bonds. However, the net demand for general government securities was still massive with 60 billion dollars from 2010 to 2016. Partially, thanks to this trend, Turkish general government sector has been able to have an access to relatively cheap borrowings. Furthermore, if domestically operated banks find cheap funding from international financial markets, they can decrease their lending rates at home without jeopardizing their overall profits. This may imply a decline in overall interest rates which may induce demand for credit and, in turn, consumption and investment expenditures.

Financial flows may exert some influences on an economy through stock prices too. Portfolio flows include the purchases of domestic stocks by foreigners. The demand for Turkish stocks exchanged in Borsa Istanbul (Turkish domestic stock exchange market) by foreigners can be seen under the headings of equity liabilities reported in the balance of payment statistics. In times of high portfolio inflows in the forms of stock exchange purchases, the stock prices increase. For Turkish equities (broadly referring to shares/stocks issued by Turkish firms) there was about 2.4, 19 and 10.5 billion dollars net foreign demand in the periods of 1989-1999, 2000-2009 and 2010-2016 respectively. Given the fact that the share of foreigners in Turkish market has been more than 65 percent, their operations can easily shape stock prices in Borsa Istanbul. In addition to this, if, due to high financial flows, there is an overall decrease in interest rates in the economy, domestic stock markets may also attract domestic investors which can cause a further increase in stock prices. This may generate a lucrative funding source for the firms issuing stocks at the domestic stock exchange markets. As a result, investment expenditures of these firms may expand. In the countries where there is a widespread public participation in stock exchange markets, high stock prices may also cause a wealth effect. Economic entities holding high amounts of domestic stocks may feel themselves richer and are inclined to spending more in times of high stock prices.



Figure 6: Financial Flows and Exchange Rates (1993-2016) *



Source: CBRT BOP Statistics, World Bank World Development Indicators and Bank for International Settlements (BIS)

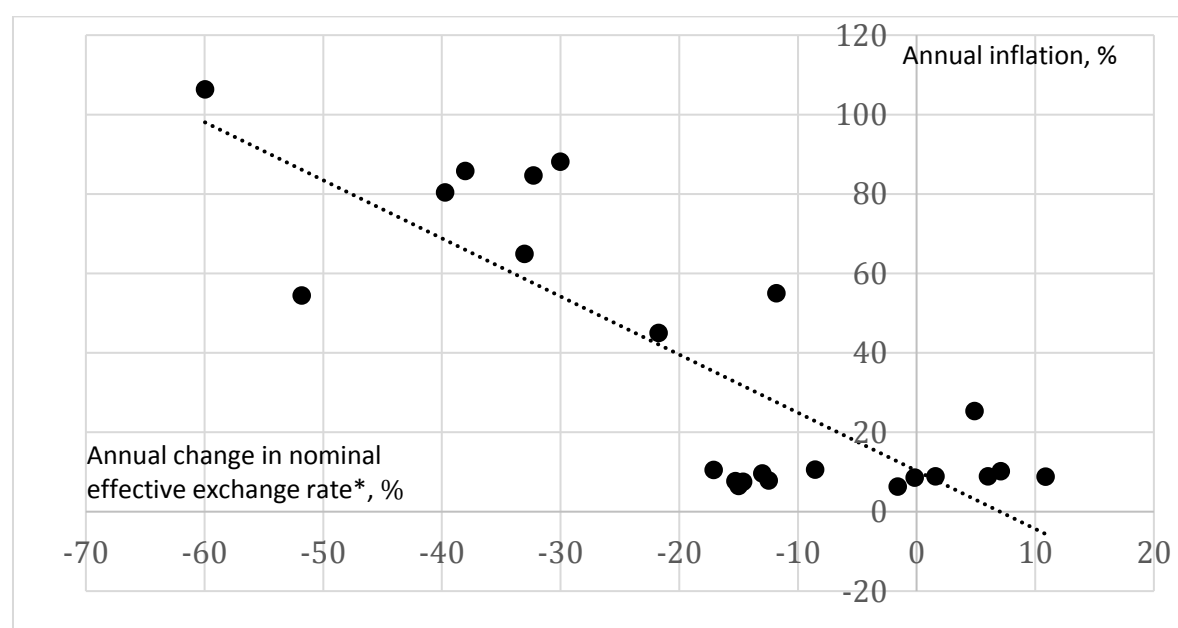
*Here, nominal effective exchange rate calculated by BIS is used. BIS data set is available only after 1992.

In developing countries, exchange rates are among the most important asset prices. In Turkey, an increase in the supply of foreign currencies resulted from higher net financial flows brings about nominal appreciation of TL against major foreign currencies. Figure 6 shows the very apparent relationship between financial flows and the nominal effective exchange rate in Turkey. There is a vast literature on the role of exchange rates in developing countries (Eichengreen & Hausmann 1999; Calvo & Végh 1994). Changes in exchange rates can have impacts on an economy through balance sheets, inflation and current account. If the agents operating in an economy have different foreign assets and foreign liabilities structures, any significant movement in exchange rates may either deteriorates or improves balance sheets of the agents considerably. For example, if the majority of firms have more liabilities denominated in foreign currencies relative to their assets, a considerable appreciation of domestic currency resulted from high net financial flows may improve the balance sheets by decreasing the value of the liabilities in terms of domestic currency. In other words, this process leads to an increase in net worth (the difference between assets and liabilities). As discussed in the balance sheet effect as a part of the credit channel, an increase in net worth can induce more investment by either easing credit constraint or/and creating extra available funds. Nominal appreciation of TL in the periods from 2002-2009 might have induced



more credits and investments in Turkey. As opposed to the case of the appreciation, as documented by the third generation crisis literature, a significant depreciation of domestic currency resulted from financial reversals (abrupt large slowdowns) may generate balance sheet crisis (Krugman 1999). In the Turkish case, the severity of the crisis of 2001 can be partially explained by the balance sheet effect resulted from a sudden and big depreciation of TL (Ozatay 2005). Changes in exchange rates can also directly influence inflation through its impact on imported intermediate goods (Benli alper & C mert 2015; Benli alper et al 2017). Since financial flows affect directly both the price of imported goods and credit conditions in the Turkish economy, CBRT may not easily determine inflation by using conventional monetary policy instruments. Therefore, even under the inflation targeting regime, CBRT might benefit from the nominal appreciation of TL or slowdown in the depreciation of TL to take inflation under control (Benli alper & C mert 2015). Indeed, in the Turkish case, inflation shows a considerable declining trend during the periods of abundance of financial flows causing domestic currency appreciate relative to other currencies (Benli alper & C mert 2015).

Figure 7: Inflation and Nominal Effective Exchange Rate



Source: CBRT BOP Statistics, World Bank World Development Indicators and BIS.

*In the original BIS data set, an increase in the index of nominal effective exchange rate refers to the appreciation of domestic currency. Therefore, negative percentage changes in the graph imply a decline in the value of the index referring to the depreciation of domestic currency.

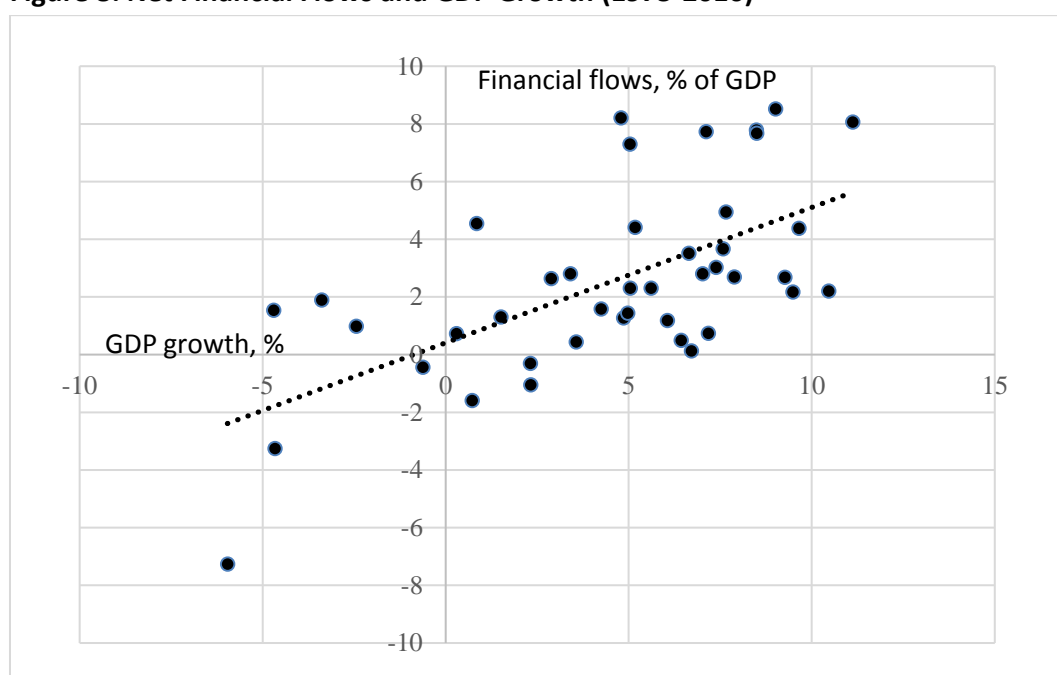
Apart from very rare cases which are mostly related to adverse developments in inflation expectations, the appreciation of domestic currency is mostly translated into real appreciation. The appreciation of the real exchange rates mostly related to financial flows makes Turkish exports more



expansive and imports prices lower which might have been one of the main reasons behind the aforementioned current account deficits. Beside this, whenever Turkish economy starts growing faster coinciding with high financial inflows, current account deficits reach record levels. Therefore, financial flows may also widen current account deficits by suddenly easing credit conditions leading to a demand boom partially boosting imported goods expenditures.

Overall, as detailed above, financial flows exert a great influence on Turkish economy through many different channels such as the asset prices and the credit channels. As a result, GDP growth, inflation and current account balance have been exposed to boom-bust cycles of financial flows¹². Indeed, during the boom periods, the Turkish economy experiences a relatively high growth while the growth either becomes negative or slows down considerably during the bust periods. Figure 7 demonstrates a strong positive relationship between net financial flows (inflows minus outflows) and GDP growth.

Figure 8: Net Financial Flows and GDP Growth (1975-2016)



Source: CBRT BOP Statistics and World Bank World Development Indicators.

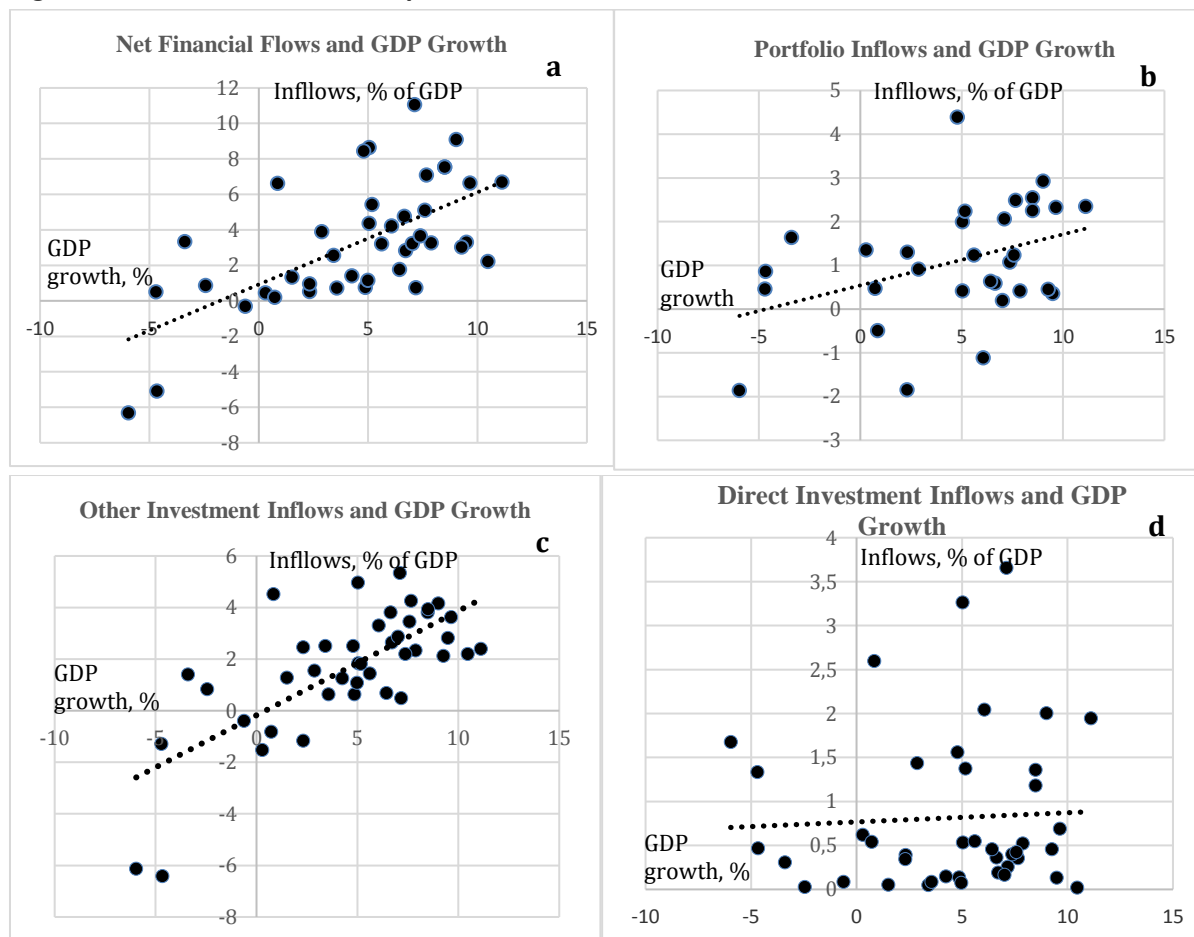
Considering the relationship between the components of financial inflows and GDP growth, although FDI and GDP growth seem to have had a weak connection, GDP growth has a very strong link with especially other flows (Figure 9a, b, c and d). This indicates that, for the Turkish case, investors making FDI are not significantly sensitive to the short-term fluctuations of GDP growth.

¹² Since financial flows may exert a great influence on GDP growth, employment can be significantly affected by the flows too.



These investors seem to have longer planning horizon¹³. Low volatility in FDI data shown earlier also implies less sensitivity to the short-term fluctuations.

Figure 9: GDP Growth and Components of Financial Flows*



Source: CBRT BOP Statistics and World Bank World Development Indicators

*Except for portfolio inflows and GDP growth graph, the relevant period for the all graphs is 1975-2016. For the portfolio inflows and GDP, the data set covers the period of 1986-2016.

More empirical research is necessary to verify these observations. Nevertheless, these findings are supported by simple correlation statistics as well. The simple correlation between net financial flows and growth is 0.67, and 0.71 in the periods of 1975-1989, and 1990-2016 respectively. For the FDI the correlation is -0.157 and 0.03 for the same periods.

¹³ The literature is full of studies praising the benefits of FDI. Although FDI may have direct and indirect contributions to an economy, in some cases, especially huge profit transfers of foreign firms can cause a big source of drainage from the economy. In this vein, primary income transfers from Turkey regarding FDI up surged from about 10 billion dollars in the period of 2002-2009 to 18 billion dollar in the period of 2010-2016. Therefore, there is a need for a careful investigation of the impacts of the profit transfers by foreign investors from Turkey.



Given the indisputable role and volatile nature of financial flows, policy makers have to keep an eye on the developments in the flows and try to prevent the economy from adverse impacts of the flows. The first line of defense is to accumulate huge foreign exchange reserves. In this vein, even though officially the CBRT, as the majority of central banks in developing countries, implements a flexible exchange rate regime, it has also built up some foreign exchange reserves for mostly insurance purposes especially since the crisis of 2001. As of July 2017, CBRT has about 86.5 billion worth of gross foreign currency reserves (excluding gold reserves). Banks keep 48 billion dollar worth of foreign currency reserves at the Bank to meet their required reserve obligations¹⁴. In other words, CBRT has only 38-billion-dollar worth of net foreign currency reserves. At the same time, Turkish economy has to either roll over or pay about 170-billion-dollar worth of debt (short-term) denominated in foreign currency which will be matured in a year (CBRT BOP Statistic). Furthermore, Turkish reserve position relative to its liabilities cannot be considered high among comparable countries (Benli alper et al 2016). Although these statistics cannot be considered as very alarming, it is not very clear how the accumulated reserves would immunize the Turkish economy from a big external shock wave which can be intensified by an increasing insatiable thirst of domestic players for foreign exchanges which would be a most likely rational response of domestic players.¹⁵

4. EU-Turkey Relations and Financial Flows

As highlighted, Turkey with enormous amounts of accumulated liabilities and chronic current account deficits is obliged to attract huge amounts of financial flows each year. Any significant reversal/stop in financial flows to Turkey may have very important impacts on Turkish economy through various channels. This phenomenon can be one of the important determinants of the future of Turkey EU relations in many ways.

Financial flows can be affected by many external and internal factors. However, there is an increasing consensus regarding the existence of global cycles of financial flows to developing countries (Ray 2013). In general, increasing risk appetite of investors coinciding with low interest rates and high liquidity in advanced countries triggers a boom period of financial flows to many developing countries at the same time (Ray 2013)¹⁶. These countries with relatively improved fundamentals, positive prospects and relatively high interest rates attract more flows than others. However, when the risk appetite of the investors declines, the majority of developing countries either

¹⁴ CBRT allowed banking system to keep some part of their required reserve obligations in the form of foreign currency and gold. This mechanism is known as Reserve Option Mechanism (ROM).

¹⁵ Some may argue that the performance of the Turkish economy during the recent crisis would be an indication of an increasing resilience of the economy to the shocks related to the increasing financial integration. However, this would be a misleading observation. The magnitude of the financial shock which hit the Turkish economy during the recent crisis would not be considered very high relative to the shocks of the 1994, 2001. Net financial flows were -2.5 percent and -7.5 percent of GDP in 1994 and 2001 respectively, whereas they were 1.64 percent in 2009.

¹⁶ Indeed, according to many researchers, the VIX, an index considered a proxy for the appetite of investors, is very decisive in affecting the direction of financial flows (Ray 2013)



experiences a slowdown or a financial reversal. These countries with high political and economic risk find themselves in a more problematic situation. Countries such as Turkey may not influence global cycles. However, they can still have some influences on the size and directions of financial flows through improving fundamentals, sustaining a well-respected institutional structure within the global capitalism and having anchors such as EU.

The customs union agreement and succeeding integration steps between EU and Turkey coincided with the increasing role of financial flows in Turkey. EU might act as an anchor in implementing some reforms in Turkish financial markets (Oniř 2007). Furthermore, as FDI data demonstrate, European investors made very considerable investments in Turkey. As a result, EU-Turkish integration process might have contributed directly and indirectly to rising role of financial flows.

One of the mechanisms through which EU-Turkey relations may exert influences on financial flows is how rating agencies or international investors factors EU-Turkey relations in their decision making process. Rating agencies affect the magnitude of financial flows by signaling the riskiness of countries reflected in their grades. In many cases, in the past, international rating agencies rating Turkey mentioned the developments in the EU-Turkey relations (Öniř 2007). For example, during the heyday of EU-Turkey integration process (2002-2007), rating agencies partially justified increases in the grades of Turkish assets based on positive developments in EU-Turkey relations. The choices of Turkey in the EU-Turkey integration process may definitely give signals to rating agencies. Furthermore, the future of FDI investments in Turkey by EU countries can be relatively conditional on political stability and dependent upon institutional structures immune from direct political influences. This means that any positive or negative developments in EU-Turkey integration process may directly and indirectly have an impact on the size and directions of financial flows to Turkey. Given the importance of financial flows for the Turkish economy and possible influences of EU-Turkey relations on the size and directions of flows, any rational policy maker cannot avoid taking the influence of changes in EU-Turkey relations on financial flows into account in deciding the future of the relations. In other words, under the current circumstances, Turkish part seems to be forced to decide on the path of the future of EU/Turkey relations after considering possible consequences of the decisions on this front on the economy through especially financial flows.¹⁷

¹⁷ From a game theoretical point of view, each decision of cooperation, convergence and conflict will lead to different outcomes in terms of financial flows which will lead to different outcomes for the whole economy. In our set-up, at time t , a rational actor formulating policies about the future of EU-Turkey relations is supposed to give decisions by comparing the impact of its decision on possible final outcomes.



Table 3: Different Scenarios

Assumptions /Scenarios	Conflict	Co-operation	Convergence
High global liquidity with uncertainty about a financial reversal shock	Possible reversal, <i>Costly</i>	Increase in financial flows, <i>Not costly</i>	Increase in financial flows, improvement in the composition of the flows (more FDI from Europe), <i>Beneficial</i>
Adverse global liquidity conditions	Reversal of flows, <i>Very costly</i>	Reversal can be less sharp <i>Not very costly</i>	EU support mechanisms, <i>Less costly</i>
Dominance of political concerns (or non-rational actors)	Financial flows can be less relevant for the future of EU-Turkey relations unless materialized cost is too high to put political projects under threat.		
Significant EU social and economic problems	No more EU anchor; EU is less relevant for financial flows		

At present, the future path of EU-Turkey relations is very uncertain. There are many possibilities leading to significantly different outcomes for both parties. Each trajectory may have different implications for financial flows. It is not possible to go through all likely trajectories one by one. However, as Table 3 illuminates, in line with other packages in this project, we will consider three scenarios to investigate how financial flows can be affected which in turn shape the possible policies to be put into practice by Turkish authorities. These scenarios are convergence, cooperation and conflict¹⁸. We will shortly discuss the connection between these scenarios and financial flows under four different assumptions regarding liquidity, EU domestic problems and, political concerns.

As discussed above, global cycles may be very decisive as determinants of financial flows to developing countries including Turkey. In an environment in which interest rates are relatively low and there is high liquidity for a foreseeable future in advanced economies, EU-Turkey relations would be less relevant for the directions and the size of financial flows. In this atmosphere, very positive prospects of EU-Turkey relations may even cause a flood of financial flows to the economy which can increase the amplitude of financial boom-bust cycles. However, there is always a risk of evaporation of global liquidity. The recent speculations about higher interest rates in the US have started to disrupt financial markets in developing countries. In this sense, if global risk appetite decreases abruptly leading to evaporation of liquidity and high interest rates in advanced countries, an increase in the convergence or cooperation between the parties may ease the tension in financial flows to Turkey. As a result, in these cases, Turkey may be less affected by global cycles

¹⁸ Turel (2005) made a similar categorization in his game theoretical framework.



due to EU anchor. Investors may consider Turkey less risky and having a predictable path due to EU anchor. Since the cost of the conflict in case of a possible shock is very high Turkish policy makers may avoid conflict option even under a positive global outlook.

In times of declining global liquidity, if the parties choose the conflict option, this can exacerbate the possible adverse movements in financial flows which can be very costly for Turkey. At the extreme case, the increasing tone of the conflict may reach a point where financial or other sanctions may be implemented or hinted by EU countries. Although this option seems not to be realistic, the recent disagreements with German politicians lead to a point where German counterparts started to imply economic consequences of this escalation. Supposing that policy makers in both Turkey and Europe are rational, EU leverage can be relatively high over Turkish counterparts in times of decreasing global appetite towards developing countries. Because, given the high dependence of Turkish economy on financial flows, a rational response by Turkish policy makers will be to find ways to decrease the tone of the conflict to ease the negative influences of financial flows on the economy. This requires resorting to either convergence or mutually beneficial cooperation processes. There is a possibility of less reversal in case of increasing cooperation process between the parties while convergence scenario can come with extra EU financial support mechanisms to mitigate the consequences of reversals.

There are two other possibilities which can significantly affect the future of EU-Turkey relations. First, EU may find itself in a prolonged existentialist crisis. The doubt within Europe (EU skepticism) about the future of EU and possible economic/social problems may put EU project in danger. In this case, EU project may be relatively a less relevant factor for financial flows to Turkey. In this case, the cost of conflict in terms of financial flows may not be very high for Turkey. Even a rational Turkish policy maker may go with increasing tone of conflict especially in a domestic environment in which the conflict may be utilized as an instrument to consolidate a large support base. Interestingly enough, without being constrained by financial flows, this can increase the leverage of Turkey over Europe in an environment in which Middle East and immigration problems are part of European existentialist crisis.

Second, Turkish side may be less concerned with economic consequences of financial flows due to personal, ideological or another reason. From an economic perspective, this situation can be labelled as dominance of non-rational actors or/and dominance of political concerns over economic concerns. In this case too, financial flows may lose its role as a constraint over policy makers. Therefore, the trajectory of the relations may be investigated without giving much reference to developments in financial flows. However, even an actor who may ignore some economic imperatives in the short-run and medium run may be forced to change his/her attitude if difficulties stemmed from possible changes in financial flows causing very severe economic and social hardships which in turn may endanger the political survival of the actor. Given the fact that in the medium run, important elections are approaching in Turkey, we believe that under current conditions, Turkish policy makers cannot sustain a long-lasting conflict scenario.



Overall, as Table 3 demonstrates, financial flows would be less relevant both in the dominance of non-rational actors and long lasting existentialist problems in Europe. Under normal circumstances (existence of a viable functioning EU project and rational actors from an economic perspective), EU-Turkey relations can be expected to evolve into either convergence or cooperation due to possible high cost of conflict in the world of very high financial dependence on global markets.

5. Conclusion

Financial flows which may influence an economy through many different channels have gradually reached unprecedented levels to Turkish economy. As discussed in the text, main macroeconomic variables have been very sensitive to the flows in Turkey. Furthermore, especially, Turkish private sector has accumulated enormous amounts of liabilities denominated in foreign currencies. A positive high net financial account balance is required for covering the liabilities and not causing a huge slowdown in the economy (giving relatively high current account deficits)¹⁹. Although Turkish central bank has accumulated some foreign exchange reserves, they may not enough relative to accumulated liabilities in case of large changes in global liquidity conditions. Financial flows have been very volatile and affected by many internal and external forces. As a result, Turkish economy is very vulnerable to changes in the directions of financial flows.

In the past, the integration process between Turkey and Europe might have had some impacts on the increasing role of financial flows in Turkey. Different future paths in EU-Turkey relations can have some significant implications for the directions and the size of financial flows. Especially, in case of increasing conflict between EU and Turkey, when global liquidity evaporates, financial flows to Turkey may slow down more than that to other developing countries. Given vulnerability of Turkish economy to financial reversals, in the existence of rational actors, this trend may increase the leverage of Europe over Turkey and force Turkish policy makers to resort to at least cooperation option. However, if serious prolonged social and economic problems of EU continue to exist in near/medium future, EU may become relatively less relevant for financial flows to Turkey. As a result, Turkish policy makers may not be constrained by the threat of financial flows. Apart from the case in which EU project is in a series long-lasting trouble, EU-Turkey relations are expected to take the forms of cooperation/convergence. If Turkish policy makers implement policies to decrease the vulnerability of Turkish economy to the flows, Turkey may have more room for maneuver in the negotiation process.

¹⁹ Turkey can easily solve its current account deficit problem if policy makers are ready to have a very low or negative growth rate. Imported goods are necessary for meeting the requirements of the growing economy depending on high volume of intermediate goods. If economy grows very slowly, lower demand will automatically curb imports. However, politically, this may not be a desirable option.



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7. Appendix

Table A1: The Average Amounts of Financial Flows (millions \$)

	Other Investment Inflows	Portfolio Investment Inflows	Direct Investment Inflows	Net Financial Inflows	Other Investment Outflows	Direct Investment Outflows	Portfolio Investment Outflows	Net Financial Outflows	Net Financial Account
1975-1989	646.07	205.47	129.53	981.07	223.27	0.60	6.00	229.87	751.20
1990-1999	2888.10	1425.90	771.70	5085.70	1162.60	162.50	666.60	1991.70	3094.00
2000-2009	12880.80	4067.30	9060.20	26008.30	3156.90	1096.60	1718.40	5971.90	20036.40
2010-2016	23856.29	16849.71	13498.57	54204.57	404.57	3838.71	567.71	4811.00	49393.57
1990-2001	2198.23	1050.00	1010.23	4258.46	1158.00	241.15	771.69	2170.85	2087.62
2002-2016	21150.43	11373.57	12834.00	45358.00	2212.36	2594.79	1270.86	6078.00	39280.00

Source: CBRT BOP Statistics and World Bank Development Indicators.

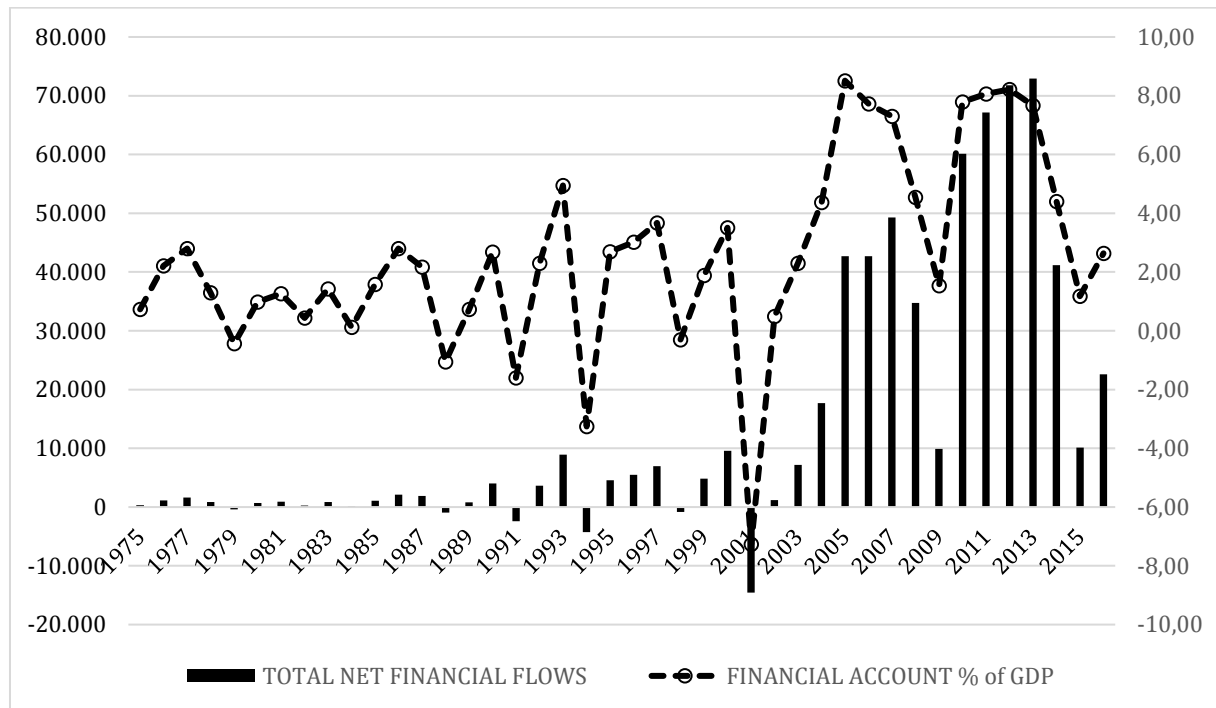
Table A2: Table: Average Financial Flows (% of GDP) in Different Periods

	1975-1989	1990-1999	2000-2009	2010-2016	1990-2001	2002-2016
Other Investment	1.07	1.27	2.11	2.75	0.85	3.00
Portfolio Investment	0.21	0.88	0.83	1.94	0.63	1.61
Direct Investment	0.16	0.43	1.66	1.56	0.52	1.78
Net Financial Inflows	1.44	2.59	4.59	6.25	2.00	6.39
Other Investment, (O)	0.30	0.57	0.66	0.03	0.55	0.39
Portfolio Investment (O)	0.01	0.34	0.40	0.08	0.37	0.22
Direct Investment (O)	0.00	0.07	0.22	0.43	0.11	0.33
Net Financial Outflows	0.31	0.98	1.29	0.54	1.02	0.94
Net Financial Account	1.14	1.60	3.30	5.71	0.98	5.44

Source: CBRT BOP Statistics and World Bank Development Indicators.



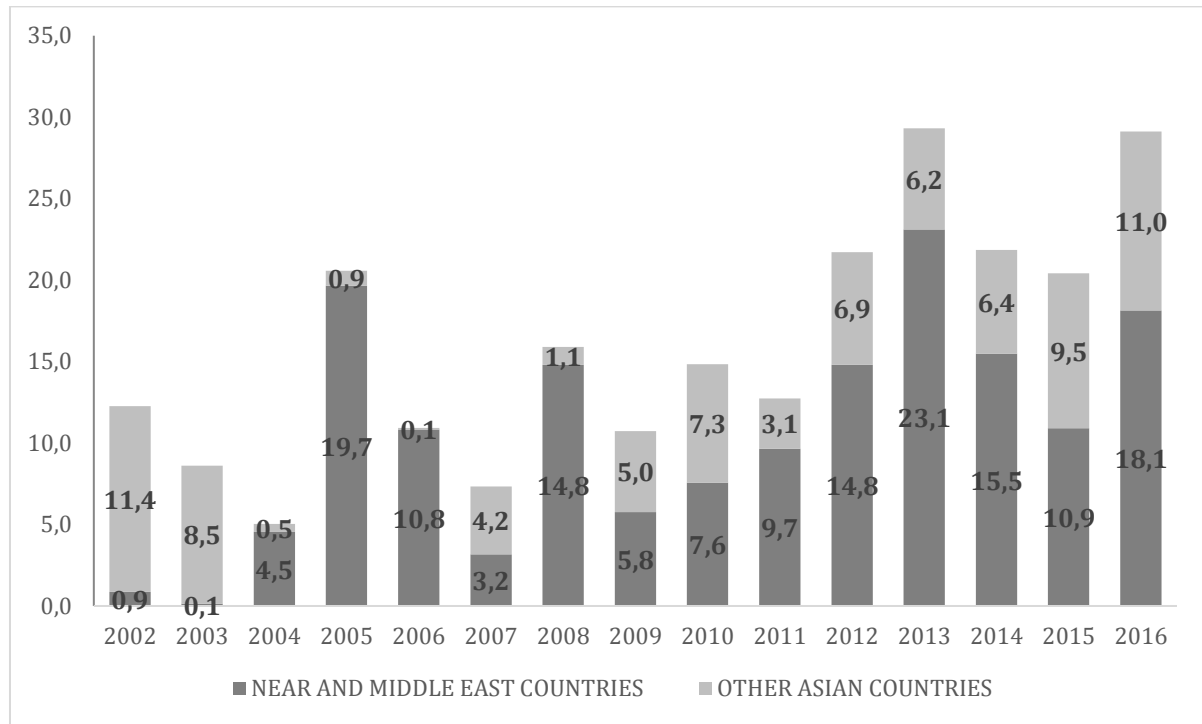
Figure A1: Net Financial Flows, (millions dollars, % of GDP-right axis)



Source: CBRT BOP Statistics and World Bank Development Indicators.



Figure A2: The Share of Asia in Total FDI in Turkey (%)



Source: CBRT BOP Statistics and World Bank Development Indicators.



About the Author



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Dr. Hasan Cömert is involved in FEUTURE’s research in Work Package 3. Dr. Cömert has several international fellowships and publications about financial flows, monetary policy and economic development in peer reviewed academic journals and books.



ABOUT FEUTURE

FEUTURE sets out to explore fully different options for further EU-Turkey cooperation in the next decade, including analysis of the challenges and opportunities connected with further integration of Turkey with the EU.

To do so, FEUTURE applies a comprehensive research approach with the following three main objectives:

1. Mapping the dynamics of the EU-Turkey relationship in terms of their underlying historical narratives and thematic key drivers.
2. Testing and substantiating the most likely scenario(s) for the future and assessing the implications (challenges and opportunities) these may have on the EU and Turkey, as well as the neighbourhood and the global scene.
3. Drawing policy recommendations for the EU and Turkey on the basis of a strong evidence-based foundation in the future trajectory of EU-Turkey relations.

FEUTURE is coordinated by Prof. Dr. Wolfgang Wessels, Director of the Centre for Turkey and European Union Studies at the University of Cologne and Dr. Nathalie Tocci, Director of Istituto Affari Internazionali, Rome.

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