Trade Openness, Financial Development, and Economic Growth in Turkey: Linear and Nonlinear Causality Analysis

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Abstract

This paper aims at empirically investigating the direction of causality among trade liberalization, financial development, and economic growth in Turkey. By employing monthly data for the period January, 1989-November, 2007, both linear and nonlinear causality approaches indicate that (i) there is bi-directional causality between economic growth and trade openness, (ii) economic growth causes financial development, and (iii) financial development leads to trade liberalization. Thereby, linear and nonlinear approaches confirm strong causal linkages among financial development, trade openness, and economic growth in Turkey. These results partially imply that economic growth depends upon trade liberalization through external finance in Turkey which has been experiencing capital account liberalization since 1989.

1 Introduction

It has been theoretically argued that both trade liberalization and financial development may play a crucial role in economic development. Trade liberalization reduces inefficiency in the production process and financial development facilitates the intermediation between savers and investors. Thus, they have a great deal of potential to positively influence economic growth in the developing countries. The theoretical and empirical studies mainly concentrate on either the relationship between trade and growth or the association between finance and growth. However, until recently, the empirical linkages between trade liberalization and financial development have not received sufficient attention in the literature.

Turkey has been implementing trade oriented development strategy since 1980 and has been experiencing financial liberalization process since 1989. Nevertheless, even though Turkey had faced to serious economic turbulences in 1994 and in the early 2000, she has recorded an impressive growth performance during the last decade. These dynamics of the Turkish economy provide us room to examine the nature of causal linkages between trade openness, financial development, and economic growth. To best of our knowledge, there is not any study on this subject for Turkey and thereby identifying the causal linkages among the variables of interest is timely and important to design financial system and trade policies for sustainable development.

The aim of this paper, therefore, is to econometrically investigate direct linkages among trade liberalization, financial development and economic growth for Turkey by employing monthly data for the period January, 1989- November, 2007. In particular, this work tries to empirically find an answer for the question of whether financial development leads trade liberalization or of whether trade liberalization leads financial development in Turkey in a trivariate framework by including economic growth which is interrelated with both trade openness and financial development. In addition to linear causality analysis, we carried out the nonlinear causality test in order to see whether the causal linkages among the variables of interest is sensitive the structural shifts and asymmetries in the series. In brief, we find from both linear and nonlinear approaches that financial development is the cause of trade liberalization and there is bi-directional causality between economic growth and trade openness and between economic growth and financial development. Thereby, linear and nonlinear approaches confirm strong causal linkages among financial development, trade openness, and economic growth in Turkey.

The novelty of this study is three-fold. First, this paper is the first that employs monthly income data in the literature on the finance-growth nexus for Turkey. Second, we conduct the financial development index -that is good able to capture of different dimensions of financial development- by means of principal component analysis. Third, in addition to linear causality analysis, we conduct nonlinear causality tests in order to determine whether there are asymmetric causal linkages between trade openness, financial development, and economic growth in Turkey.

2 Theoretical Framework and Empirical Evidence

The impacts of trade liberalization and financial development on economic growth have increasingly obtained a significant attraction in the literature. It is argued that both policy instruments fasten economic growth in the developing economies through various channels. Trade liberalization by allowing the allocation of factors of production across sectors (Grossman and Helpman, 1992; Redding, 1997), by increasing the competition in the domestic economy and hence improving productivity (Greenaway and Milner, 1993; Aghion, Dewatripont and Rey, 1997), by enlarging the market for domestic producers and leading to take advantage of the economies of scale (Taylor, 1994; Grossman and Helpman, 1991), by increasing number of inputs that have no domestic
In fact, the role of financial sector on economic growth has long debated in the literature. Schumpeter (1912), one of the earliest pioneers, emphasized the importance of finance for growth. In the same line, Patrick (1966) introduced two new concepts which highlight the demand and supply side conditions, namely demand-following and supply-leading hypothesis. While the former states that demand in the real sector is the engine for creation of financial services, the latter emphasizes that supply in the financial sector is the driving force behind the development of real sector. Patrick’s (1966) argument brought about the discussion whether the direction of causality from finance to growth or vice versa.

The literature moved to highlight the importance of mobilization of domestic resources in the early 1970s. Specifically, McKinnon (1973) and Shaw (1973) suggested the liberalization in the financial sector in terms of lifting any sort of restrictions in the sector. They argued that lack of saving is a widespread phenomenon rather than lack of investment in the developing countries. Therefore policies should focus on increase in saving through a positive real interest rate policy.

With the emergence of endogenous growth theory (Romer, 1986) in the mid-1980s, it is argued that financial development might be one of the sources for the increase rate of return (Renelt, 1991). Financial development by increasing the possibility of choosing more productive investments through improved management of liquidity risks (Bencivenga and Smith 1991), by collecting information on the efficiency of various investment projects and/or investors’ abilities (Greenwood and Jovanovic, 1990; King and Levine 1993) and by diversifying more efficiently investors’ portfolios (Levine, 1991; Saint-Paul, 1992) might positively contribute to economic growth (Levine, 1997). These arguments based on endogenous growth theories implicitly assume that financial development promotes economic growth (Hermes, 1994).

The literature, in the 2000s, started to focus on the determinants of financial development. In order to understand the dynamics of the differences in the level of financial development, several factors are proposed for this purpose: Legal origin (La Porta et.al., 1997; Demetriades, 2008), public bank ownership (La Porta et.al., 2002; Andrianova et.al., 2008; Demetriades, 2008), initial conditions and institutional structure (Acemoglu et.al., 2001, 2004; Demetriades, 2008), trade liberalization (Rajan and Zingales, 2003; Do and Levchenko, 2006; Huang, 2006; Demetriades, 2008; Law, 2008, 2009), capital account liberalization (Chinn and Ito, 2002, 2006; Law and Demetriades, 2006; Klein and Olivei, 2008), prudential supervision and effective regulation (Cuadro et.al., 2003; Brownbridge et.al., 2005), deposit insurance (Cull et.al., 2001), required reserves (Di Giorgio, 1999; Arestis et.al., 2002) and macroeconomic policies (i.e. Inflation, exchange rate) (Montiel, 2003; Cuadro et.al., 2003; Bittencourt, 2008; Ben Naceur et.al., 2008).

Although the theoretical literature assumes linkages both between trade liberalization and economic growth and between finance and growth, the multi causal linkages between economic growth, financial development, and international trade has recently attracted attention. Rajan and Zingales (2003) emphasize the role of the supply-side factors and the resistance of incumbent industrialists and domestic financial intermediaries who have a vested interest in a closed financial sector and therefore oppose the developments in the financial market. It is argued that these incentives may be weakened with the opening domestic financial sector to foreign competition and to international flows of capital.

On the contrary, Svaleyrd and Vlachos (2000, 2002) highlight the importance of the demand-side factors and the possibility of risk diversification with the trade liberalization which creates new demands for external finance. This external resource for firms is a necessity to overcome short-term cashflow problems and adverse shocks.

In order to fill the theoretical gap for the linkages among trade openess, financial development, and economic growth in a multi causal conceptual framework, Blackburn and Hung (1998) suggest that trade liberalization by leading new product development may contribute to economic growth. Financial development may be resulted from trade liberalization which encourages the number of new producers who need access to finance their activities. Similarly, Feeney (1994) argues that integration in the financial sector may enhance the probability for risk sharing that allows product specialization and, in turn, benefits trade. These studies imply an indirect theoretical link between trade liberalization and financial development via new products.

In sum, the above reviewed studies fall short of establishing direct linkages between trade liberalization and financial development. Ginebri et. al. (2001) emphasize the issue of complementarity between trade and finance and propose a direct relationship between trade liberalization and financial development. In particular, the complementarity is theoretically based upon the fact that trade liberalization enhances entrepreneurial development which in turn increases a need of new instrument from the financial system.

The relationship between trade liberalization and financial development has been a subject matter for a limited number of empirical works which provide evidences for the argument that trade liberalization is a crucial step to enhance financial development and/or vice versa in a single country or a group of countries (Beck, 2002;
As far as the empirical works for Turkey are concerned, there is not any consensus on the direction of causality not only between trade and growth (Ghatak, Milner and Utkulu, 1995; Bahmani-Oskooee and Domac, 1995; Yiğidim and Köse, 1997; Özmen and Furtun, 1998; Doğanlar and Fisunoğlu, 1999; Özmen et. al, 1999; Hatemi-J ve Irandoust, 2000; Tuncer, 2002; Şimşek, 2003; Bilgin and Şahbaz, 2009) but also between finance and growth (Şiklar, 1992; Akçoraoğlu, 2000; Kar and Pentecost, 2000; Doğan, 2002; Unalmuş, 2002; Aslan and Korap, 2006; Aslan and Kütükçüaksoy, 2006; Kar and Ağır, 2006; Acaravcı, 2007; Halıcıoğlu, 2007; Öztürk, 2008; Yücel and Altıntaş, 2009). The results imply that the selection of both variables and the methodology determines the direction of causality between the concerned variables in these empirical works.

There is a limited work which concentrates on the relationship between finance and trade for Turkey. Utkulu ve Kahyaoğlu (2005) examines the impacts of both financial and trade openness on economic growth and find that while financial openness negatively contributes to economic growth, trade liberalization has a positive effect on growth in Turkey. Açıkgöz, Balcılar and Saraçoğlu (2009) also investigate the causal linkages among financial development, financial openness and trade openness by employing bounds test developed by Pesaran et.al. (2001) and Pesaran and Shin (1999) for the period 1989-Q1-2007-Q2 and provide empirical evidence that both financial and trade openness have a positive impact on financial development for Turkey. Kar, Peker and Kaplan (2008) examines a long-run relationship between trade liberalization, financial development and economic growth for the period 1963-2005 in Turkey and concludes that openness and finance has a positive impact on growth in the long-run. Yücel (2009) finds a bi-directional causality between each pair of the variables, namely financial development (measured by the broad money to GDP ratio), trade and economic growth, for the period 1989-M1-2007-M11 in Turkey. Ağır (2010) provides empirical evidence that trade, among other variables, plays a significant role in explaining financial development in Turkey.

### 3 Econometric Methodology

#### 3.1 Linear Granger Causality Test

The standard Granger causality test requires carrying out zero restrictions on coefficients in Vector Autoregressive (VAR) model based on the Wald principle. Wald test for Granger causality may result in nonstandard limiting distributions based on the cointegration properties of the system and possibly on nuisance parameters. These nonstandard asymptotic properties are due to the singularity of the asymptotic distributions of the estimators (Lütkepohl, 2004: 148). Toda and Yamamoto (TY) (1995) developed the modified Wald (MWALD) test for Granger causality which overcomes this singularity problem.

The standard Granger causality analysis is based on estimating a VAR (p) model. In order to correct the singularity problem TY (1995) suggest using a VAR (p+d) model in which d is the maximum integration degree of the variables. The following VAR model is therefore estimated in the TY procedure:

\[
y_t = v + A_1 y_{t-1} + \ldots + A_p y_{t-p} + \ldots + A_{p+d} y_{t-p-d} + \mu_t,
\]

where \(y_t\) is vector of k variables, \(v\) is a vector of intercepts, \(\mu_t\) is a vector of error terms and \(A\) is the matrix of parameters. To test for the null of no-Granger causality against the alternative hypothesis is tested by imposing zero restriction on the first \(p\) parameters in equation (1). The MWALD statistic has asymptotic chi-square distribution with \(p\) degrees of freedom irrespective of the number of unit roots and the cointegrating properties.

Hacker and Hatemi-J (2006) investigate the size properties of the MWALD test and find that the test statistic with asymptotic distribution poorly performs in small samples. Monte Carlo simulation of Hacker and Hatemi-J (2006) shows that the MWALD test based on the bootstrap distribution has much smaller size distortions than those of the asymptotic distribution. Hacker and Hatemi-J (2006:1492-1493) extends the TY approach based on the bootstrapping method developed by Efron (1997). In this new approach that is so-called the leveraged bootstrap Granger causality test, the MWALD statistic are compared with the bootstrap critical value instead of the asymptotic critical value.

#### 3.2 Nonlinear Granger Causality Test

The linear Granger causality test does not account for nonlinear causal relationships among the variables. The Monte Carlo study of Back and Brock (1992) demonstrates that in the presence of nonlinearity, the forecasting performance of nonlinear approach is better than that of linear modelling. In order to test for the null of nonlinear non-Granger causality, the nonparametric test of Hiemstra and Jones (HJ) (1994) is widely employed. However, the HJ test may over rejects the null hypothesis in the case of increasing sample size, which is stemming from ignoring the possible variations in conditional distributions (Diks and Panchenko, 2005). The nonlinear causality test recently developed by Diks and Panchenko (DP) (2006) overcomes this drawback of the HJ test.
DP (2006) offer the following statistic to test for nonlinear Granger causality.

\[ T_n(\varepsilon_n) = \frac{n-1}{n(n-2)} \sum_i \left( \hat{f}_{X,Y,Z}(X_i,Y_i,Z_i) - \hat{f}_{X,Y}(X_i,Y_i) \hat{f}_{Y,Z}(Y_i,Z_i) \right) \]  

where \( \hat{f}_W(W_i) \) is a local density estimator of a \( d_u \) - variate random vector \( W \) at \( W_i \) defined by

\[
\hat{f}_W(W_i) = (2\varepsilon_n)^{-d_u} (n-1)^{-1} \sum_{j \neq i} I_{ij} \varepsilon_n \]

that \( I_{ij} = I(W_j-W_i < \varepsilon_n) \) with the indicator function \( I(.) \) and the bandwidth \( \varepsilon_n \). For one lag (i.e. \( lx=ly=1 \)), if \( \varepsilon_n = Cn^{-\beta} (C > 0, \frac{1}{4} < \beta < \frac{1}{3}) \), the test statistic is asymptotically distributed as standard normal. Since the statistic diverges to positive infinity under the alternative hypothesis, the calculated statistic greater than 1.28 implies the rejection of the null hypothesis at 10 percent level of significance.

In the DP test, value of the bandwidth plays an important role in making a decision on nonlinear causality. Since the bandwidth value smaller (larger) than one generally results in larger (smaller) \( p \)-value (Bekiros and Diks, 2008: 1646), the bandwidth value is equal to one in this study.

4 Data

This paper employs monthly observation for the variables for the period 1989:M1-2007:M11 in Turkey. In particular, the Turkish Statistical Institute has provided a quarterly GDP series since 1986 and there is not a monthly data for this variable. The monthly real GDP series used in the analysis is generated by Taşdemir (2008) by utilizing steady-space approach. The time span for income series (monthly real GDP) restricts the range of other series employed in the analysis.

Trade openness (TO) is measured as the ratio of total trade (exports plus imports) to the GDP as a proxy for trade liberalization. Data for trade openness and financial development indicators are respectively collected from the on-line database of TurkStat (Turkish Statistical Institute) and of the Central Bank of Turkish Republic.

Financial development is a multifaceted issue and has not a direct measurement. Instead, a number of proxies have been used in the literature. This paper develops a financial development index by utilizing principle component analysis that is a statistical tool to transform a number of correlated variables into a smaller number of uncorrelated variables (Creane et al., 2003; Saci and Holden, 2008; Jalli et al., 2010). The financial development index (FD) is constructed from the ratio of M2 to income (M2Y), the ratio of domestic credit to income (DCY), the ratio of private sector credit to income (PSCY), and the market capitalization ratio (MCR). The market capitalization ratio is measured as the ratio of stock market index to income. FD carries information not only about the monetary and credit aggregates but also capital markets.

<table>
<thead>
<tr>
<th>Eigenvalues: (Sum = 4, Average = 1)</th>
<th>Cumulative</th>
<th>Cumulative</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number</td>
<td>Value</td>
<td>Difference</td>
</tr>
<tr>
<td>1</td>
<td>2.251237</td>
<td>1.205801</td>
</tr>
<tr>
<td>2</td>
<td>1.045436</td>
<td>0.384093</td>
</tr>
<tr>
<td>3</td>
<td>0.661343</td>
<td>0.619359</td>
</tr>
<tr>
<td>4</td>
<td>0.041984</td>
<td>---</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Eigenvectors (loadings):</th>
</tr>
</thead>
<tbody>
<tr>
<td>Variable</td>
</tr>
<tr>
<td>PCSY</td>
</tr>
<tr>
<td>DCY</td>
</tr>
<tr>
<td>M2Y</td>
</tr>
<tr>
<td>MCR</td>
</tr>
</tbody>
</table>

Table 1: Results from principal component analysis

Table 1 reports the results from principal component analysis. The eigenvalues for three principal components show that the first principal component (PC1) explains the highest proportion of variance by accounting 56.28 percent of the standardized variance. Accordingly, the financial development index is constructed by using the factor loadings based on the first principal component.


5 Empirical Findings

Before proceeding with the TY and the DP procedures, the maximum integration degree (d) of the variables – that are expressed in logarithmic form- are determined by three unit root tests developed by Dickey and Fuller (1979) and Phillips and Perron (1988) which test for the null of a unit root and Kwiatkowski et al. (1992) that tests for the null hypothesis of stationary. The results reported in Table 2 indicate that while the series in log-levels appear to be non-stationary and they are stationary in first-differences. The results accordingly imply that d will be equal to one in the TY procedure, and the series in first-differences will be used in the DP test.

<table>
<thead>
<tr>
<th>Levels</th>
<th>ADF</th>
<th>PP</th>
<th>KPSS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Constant</td>
<td>FD</td>
<td>-0.68</td>
<td>-0.69</td>
</tr>
<tr>
<td></td>
<td>TO</td>
<td>-0.91</td>
<td>-3.43</td>
</tr>
<tr>
<td></td>
<td>GDP</td>
<td>-0.63</td>
<td>-0.68</td>
</tr>
<tr>
<td>Constant</td>
<td>FD</td>
<td>-1.54</td>
<td>-1.51</td>
</tr>
<tr>
<td>And trend</td>
<td>TO</td>
<td>-2.94</td>
<td>-8.09</td>
</tr>
<tr>
<td></td>
<td>GDP</td>
<td>-3.11</td>
<td>-4.99</td>
</tr>
<tr>
<td>First Differences</td>
<td>FD</td>
<td>-17.76</td>
<td>***</td>
</tr>
<tr>
<td></td>
<td>TO</td>
<td>-5.06</td>
<td>***</td>
</tr>
<tr>
<td></td>
<td>GDP</td>
<td>-24.08</td>
<td>***</td>
</tr>
<tr>
<td>Constant</td>
<td>FD</td>
<td>-17.83</td>
<td>***</td>
</tr>
<tr>
<td>And trend</td>
<td>TO</td>
<td>-5.05</td>
<td>***</td>
</tr>
<tr>
<td></td>
<td>GDP</td>
<td>-24.03</td>
<td>***</td>
</tr>
</tbody>
</table>

Notes: The optimal lags for ADF test were selected based on Schwarz information (SBC); the bandwidth for PP test was selected with Newey-West using Bartlett kernel. ***, **, and * denote statistical significance at the 1, 5, and 10 percent level of significance, respectively.

Table 2: Results for unit root tests

The results for linear causality analysis are illustrated in Table 3. Since the TY procedure is based on ordinary least squares estimator, one need to justify the validity of assumption of that estimator. In that respect, we carry out a diagnostic checking procedure. The Breusch-Godfrey’s serial correlation test implies that the residual of the estimated models are free from auto correlation problem. The Ramsey’s model miss-specification test clearly shows that the functional forms of the models are appropriately specified. The White’s heteroscedasticity and Engel’s autoregressive conditional heteroscedasticity (ARCH) tests indicate the validity of homoscedasticity assumption.

<table>
<thead>
<tr>
<th>Critical Value</th>
<th>MWALD</th>
<th>1%</th>
<th>5%</th>
<th>10%</th>
</tr>
</thead>
<tbody>
<tr>
<td>FD &lt;-&gt; TO</td>
<td>11.92</td>
<td>***</td>
<td>9.58</td>
<td>6.35</td>
</tr>
<tr>
<td>TO &lt;-&gt; FD</td>
<td>2.64</td>
<td>9.43</td>
<td>6.05</td>
<td>4.66</td>
</tr>
<tr>
<td>FD &lt;-&gt; GDP</td>
<td>2.24</td>
<td>9.33</td>
<td>6.12</td>
<td>4.66</td>
</tr>
<tr>
<td>GDP &lt;-&gt; FD</td>
<td>22.65</td>
<td>***</td>
<td>9.55</td>
<td>6.01</td>
</tr>
<tr>
<td>GDP &lt;-&gt; TO</td>
<td>16.89</td>
<td>***</td>
<td>9.54</td>
<td>6.08</td>
</tr>
<tr>
<td>TO &lt;-&gt; GDP</td>
<td>10.78</td>
<td>***</td>
<td>9.57</td>
<td>6.31</td>
</tr>
</tbody>
</table>

implies non Granger causality. The optimal lags in VAR(p) model was determined based on SBC. The bootstrap critical values were calculated based on 10,000 replications. *** indicates statistical significance at 1 percent..

Table 3: Linear causality analysis

The findings indicate uni-directional causality from trade openness to financial development. With respect to causal linkages between economic growth and financial development, the results show that the causality runs from economic growth to financial development. Thereby, the nature of causation between economic growth and financial development support evidence on the demand-following hypothesis. As regards to causality between trade openness and economic growth, there is bi-directional causality between economic growth and trade openness, which proves support on the feedback hypothesis.

One drawback of linear causality methods is the possibility of overlooking nonlinear relations. It is thereby important to investigate nonlinear causal linkages among the variables of interest. In that respect, we conduct the DP nonlinear causality analysis. The nonlinear Granger causality analysis is carried out in two steps (Bekiros and Diks, 2008). In the first, the DP test is applied to the stationary series to detect nonlinear interrelationships. In the second step, the DP test is reapplied to the filtered VAR residuals to see whether the nature of causation is strictly nonlinear. After removing linear causality with a VAR model, any causal linkage from one residual series...
to another can be considered as nonlinear predictive power (Hiemstra and Jones, 1994: 1648). Note that the results for the DP test are discussed for one lag.

Table 4 present the results from the nonlinear causality test. The DP test on raw data indicates that there is a nonlinear causality from financial development to trade openness, which is consistent with linear causality analysis. Even though the nonlinear causality test implies a nonlinear feedback from financial development to trade openness, the DP test should be reapplied to filtered VAR residuals to see whether this causality is strictly nonlinear in nature (Bekiros and Diks, 2008: 1647). The results for the DP test on the VAR residuals substantiate the findings from raw data. Hence, the nonlinear analysis provides evidence on significant and persistent nonlinear causal linkage from financial development to trade openness in Turkey.

<table>
<thead>
<tr>
<th></th>
<th>Raw data</th>
<th>VAR residuals</th>
</tr>
</thead>
<tbody>
<tr>
<td>FD → TO</td>
<td>1.97</td>
<td>** [0.0240]</td>
</tr>
<tr>
<td>TO → FD</td>
<td>1.04</td>
<td>-0.29 [0.1480]</td>
</tr>
<tr>
<td>FD → GDP</td>
<td>-0.44</td>
<td>[0.6733]</td>
</tr>
<tr>
<td>GDP → FD</td>
<td>1.34</td>
<td>*** [0.0899]</td>
</tr>
<tr>
<td>GDP → TO</td>
<td>1.22</td>
<td>[0.1128]</td>
</tr>
<tr>
<td>TO → GDP</td>
<td>1.72</td>
<td>** [0.0431]</td>
</tr>
</tbody>
</table>

**implies nonlinear non Granger causality**: the series in first differences; the residuals of VAR(p+d) model. \( lx=ly=1 \). Numbers in brackets are p-values. ***, **, and * indicates statistical significance at 10, 5 and 1 percent, respectively.

### Table 4: Nonlinear causality analysis

When we look at nonlinear causal linkages between economic growth and financial development, it seems that there is bi-directional nonlinear causality from economic growth to financial development. Furthermore, this nonlinear causality appears to be strict due to the fact that the nonlinear causality based on the VAR residuals rejects the null hypothesis of nonlinear non-causality. The finding from nonlinear causality analysis between economic growth and financial development is thereby consistent with that from the linear causality test, implying the demand-following hypothesis. The nonlinear causal linkages between trade openness and economic growth analysis show that there is nonlinear causality from trade openness to economic growth. However, this causal linkage does not seem to be strictly nonlinear since the causality test from the VAR residuals does not show any causal linkage from trade openness to economic growth. Thereby, the nonlinear causality analysis provides weak evidence on the validity of the export-led growth hypothesis. This finding hence is particularly consistent with that from linear causality analysis. On the other hand, the nonlinear causality test supports evidence on the strict nonlinear causal linkage from economic growth to trade openness.

### 6 Summary and Discussion

This paper has empirically tested the causal linkages among trade liberalization, financial development and economic growth for Turkey. To this end, both linear and nonlinear approaches have been employed to detect the direction causality among the concerned variables by employing monthly data for the period January, 1989-November, 2007. Empirical findings methodologically show that the nonlinear causality analysis captures all information provided by linear approach and furthermore it provides important information on whether the causal linkages among trade openness, financial development, and economic growth are in nature strictly nonlinear.

The non-linear analysis shows that trade liberalization causes economic growth (export-led growth), economic growth leads to financial development (demand-following) and financial development causes trade liberalization. These results provide empirical support for both the export-led growth and demand-following hypotheses. In addition, there is evidence on that financial development mobilizes resources to meet the need of trade sector. The results from the linear approach indicate that the relationship between trade and economic growth is rather bi-directional. In addition, the causality between both economic growth and financial development and openness is as in both nonlinear models. Specifically, economic growth causes financial development and financial development leads to trade liberalization.

Furthermore, keeping the analysis period (1989:M1-2007:M11) in mind, these findings partly support the view that economic growth depends upon trade through external finance in Turkey which has been experiencing capital account liberalization since 1989. Financial sector play a key role in this process. Sources of financial deepening may be both domestic as well as external. Whatever the sources, development in the financial markets seems to mobilize resources for the utilization of both import and export. The results imply that economic growth dependent upon trade seems to be sensitive financial development which may resulted from domestic and external sources. Although this paper does not focus on the sources of financial development whether domestic
or external factors are dominant, it highlights the risk for sustainable economic growth if there is a lack or reverse of capital inflows which expand the domestic credit in Turkey.

References


