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THE IMPACT OF FINANCIAL SECTOR DEVELOPMENT TO THE ECONOMIC GROWTH IN SMALL ISLAND DEVELOPING STATES

UGUR H. CAN

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Supervisor: Assist. Prof. Dr. Erdal Güryay

Department of Economics

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Approval of Head of the Institute

Prof. Dr. Fakhraddin Mamedov

We certify that this thesis is satisfactory for the award of a degree in Master in Economics

Examining committee in Charge

Prof. Dr. Jouni Suistola	Chairman of the committee, Dean, Faculty of Economics and Administrative Sciences - NEU
Assist. Prof. Dr. Erdal Güryay	Chairman, Department of Business Administration – NEU (Supervisor)
Assist. Prof. Dr. Hüseyin Özdeşer	Chairman, Department of Economics - NEU
Assist. Prof. Dr. Okan Şafaklı	Department of Business Administration – NEU
Dr. Ali Dayıoğlu	Department of International Relations – NEU

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ABSTRACT

An efficient financial sector is on of the pillars of a well functioning market economy and it affects the economic growth directly. On the other hand, when considering the features of the Small Island Developing States (SIDSs), this impact will be understood better. Due to this reason, the financial sector in an economy facilitates the conducts and growth of economic transactions through the use of money for payments, savings and investments.

This thesis aims that to imply the importance of financial sector to economic growth in lighting of the features of Small Island Developing States.

Introduction

The impact of the financial sector on the real economy is subtle and complex. On the other hand, when considering the features of the Small Island Developing States (SIDSs), this impact will be understood better.

Basically, financial sector mobilizes savings and allocates credit across space and time. It provides not only payment services, but more importantly products which enable firms to cope with economic uncertainties by heading, pooling, sharing and pricing risks. An efficient financial sector reduces the cost and risk of producing and trading goods and services and thus they make a significant contribution to increasing standard of living.

The financial sector is currently undergoing radical changes throughout the whole world. Consequently, it is not possible to be affected by the changes that this global sector is going through for the SIDSs.

This thesis has been prepared to put together the impact of financial sector to economic growth and additionally, it also examines in the light of the role of government in maintaining an efficient financial system by considering SIDSs. However, the data, which used to complete this thesis, are limited by Literatures, institutional reports such as World Bank, International Monetary Found and relevant web sites.

In the first section, researches will take place in order to provide clear information and also for better understood the Economic Growth concept.

In the second section, it will be proceed to introduce Theories of Growth and Development. In this chapter, basically, the economic growth theories will be presented in details.

The third section considers the concept of Globalization and Economic Growth. Under this heading the relationship between Globalization and Development, Finance, Production, and Labor force and also its Economic Effects will be discussed.

In the fourth section, Small Island Economies will be introduced considered by the characteristics of Small Island Developing States.

In chapter five, Financial Sector Development will be discussed. As it was known, the role of financial sector to economic growth is significant. In this section, it will be discussed that why financial sector is require for economic growth and in order to attain the economic growth how the regulations should be set up for an efficient financial market.

In section sixth, addition to these, relevant strategies will be offered for economic growth. At the end of this study, the economy of the Turkish Republic of Northern Cyprus will be evaluated considering by financial system structure and characteristics of small island economies.

As stated in the relevant parts of this thesis, the importance of financial sector plays a significant role in economic growth.

Basically, *high inflation* and *political instability*, which are the two principal problems of developing countries - the situation is not different in SIDSs. - Addition to these factors that the banking sector has an important role in island economies. Lowering inflation and ensuring political stability will enable the banks to operate in a more stable system and also by formulating longer-term strategies.

The sector has positive expectations about lowering inflation but at the same time, this is perceived as very much dependent on political stability, for which the sector has non-uniform expectations. While lowering inflation is very much dependent on political stability, it is unclear how consistent low-inflationary policies can be utilized without first ensuring political stability and enabling the necessary infrastructure developments.

According to the results of the survey, the sector expects the government to increase its regulatory role, with future regulatory amendments mainly aiming at the protection of investors and depositors and ensuring standardization and transparency in the application of accounting standards and principles.

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List of Abbreviations

IACs	Industrially Advanced Countries
LDCs	Less developed countries
SIDSs	Small Island Developing Sates
UNDP	United Nation Development Programme
HDI	Human Development Index
PPF	Production Possibility Frontiers
IMF	International Monetary Found
MNCs	Multinational Corporations
GDP	Gross Domestic Product
GNP	Gross National Product
SIDSs	Small Island Developing States
COGS	Cost of Good Sold
USA	United States of America
NPLs	Non-performing Loans
AMC	Asset Management Company
SMEs	Small and Medium Sized Enterprises
DFIs	Development Finance Institutions
NNP	Net National Product
R&D	Research and Development
TRNC	Turkish Republic of Northern Cyprus
TL	Turkish Lira
UN	United States
NBFIs	Non-bank financial institutions

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Chapter 1

THEORY AND MEASUREMENT IN ECONOMIC GROWTH

I. THEORY AND MEASUREMENT IN ECONOMIC GROWTH

1.1. Development vs. Growth:

The concepts Development and Growth can be defined under two headings separately;

- **Development** is a *qualitative* change, which entails changes in the structure of the economy, including innovations in institutions, behavior and technology.
- **Growth** is a *quantitative* change in the scale of the economy – in terms of investment, output, consumption, and income.[1]

As it seen from these definitions, the terms *economic development* and *economic growth* do not imply the same things. Firstly, *development* is both a prerequisite and a result of growth and it can be said that it is prior to growth. But, on the other hand, *growth* contains new changes in the economy. Together, these two concepts allow increasing the productivity.

Basically, by regarding the economic criteria, development can be evaluated as follow:
Development means the condition for the realization of the human personality. Whether there has been a reduction in (i) poverty, (ii) unemployment, (iii) inequality. Some countries have experienced not only rapid growth of per capita income, but also increase in poverty, unemployment, and inequality. Measures of development at the family level based on nutrition, health, infant mortality, access to education and political participation.

A related opinion which will express the goals of development has been made in 1971 by Professor Denis Goulet who attended to the studies about development ethics, comparative development strategies, environmental economics, and development indicators. According to D. Goulet;
There may be considerable merit, in asking whether higher living standards, self-sustained growth, and modern institutions are good in themselves or necessarily constitute the higher priorities. Goulet also argued for three general development goals: life sustenance, esteem and freedom.[2]

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[1] Roger Vaughan and Peter Bearse, **Federal Economic Programs: A Framework for Design and Evaluation,** Washington DC, 1981, p.p. 309
[2] Dennis Goulet, **The Cruel Choice,** New York, 1971, p.p. 85

- **Life Sustenance:** There can no dispute that food, health, adequate shelter, and protection are essential to human well being. When they are sufficient to meet human needs, a state of development exists; when they are insufficient, a degree of underdevelopment prevails.
- **Esteem:** All people value respect esteem or recognition is closely associated with material prosperity. It is often difficult for these who are materially deprived or underdeveloped to experience a sense of pride or self-worth. Mass poverty prevents people and societies from receiving due recognition or esteem. These people may even reject development for example; if people are humiliated or disillusioned through their contacts with the "progress" introduced by foreigners, they may return to their traditional ways in order to regain a sense of self-respect.
- **Freedom:** Freedom can be defined as "the capacity, the opportunity to developed and express one's potentialities". As with life sustenance and esteem, the degree to which freedom exists in a society can be used to access development.

Freedom of expression and achievement of a human lifestyle are ultimate essentially irresolvable issues. Basically, development goals includes the following:

i- a balanced healthful diet
ii- adequate medical care
iii- environmental sanitation and disease control
iv- labor opportunities
v- sufficient educational opportunities
vi- individual freedom of conscience and freedom from fear
vii- decent housing
viii- economic activities in harmony with the natural environmental
ix- social and political milieus promoting equality

However, development is used as synonym for economic growth. But growth is not development, except insofar as it enables a country to achieve the nine goals, which are mentioned above. If these goals are not the objectives of development, if modernization is merely a process of technological diffusion, and if spatial integration of world power and world economy is devoid of human referents, then development should be redefined. The realities of the contemporary world, however, do not offer much hope for achieving these human objectives anytime soon.[3]

1.2. How Economic Development is Measured

Economic growth results when the output of an economy grows because more land, labor, capital, and entrepreneurial skills are devoted to the production process and/or because the productivity of these factors of production rises. Growing markets, technological improvements, and additional investment in human beings (human capital) all have played a part in increasing productivity.

Economists measure the concept of economic development through a number of social, economic, demographic and politic indexes.

1.2.1. Per Capita Income

Per capita income is a statistic that is seldom readily available to economists. However the Gross National Products (GNP) and the population of a country are more easily acquired. Consequently, by dividing GNP by the number of people in a country, the economists can determine GNP per capita.

Per capita purchasing power is a more meaningful measure of actual income per person. Per capita purchasing power includes not only income, but the price of goods in a country.

1.2.2. Economic Structure of Labor Force

The economic structure of a country also bespeaks its economic development. Economists divide employment into five categories;

i- The primary sector mainly involves the extraction of materials from the earth-mining, lumbering, agriculture and fishing.

ii- The secondary sector includes assembling raw materials and manufacturing.

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[3] Fredrick P. Stutz – Anthony R. de Souza, **The World Economy,** 3rd Ed., New Jersey, 1998, p.p. 528 – 529

iii- The tertiary sector is devoted to the provision of services most notably wholesaling, retailing, and professional and personal services, including medical, legal and entertainment.

iv- The quaternary sector of the economy includes information processing, such as finance, insurance, real estate and computer related fields.

v- The quinary sector includes medical care, research, education, arts and recreation.

1.2.3. Consumer Goods Produced

The quantity and quality of consumer goods purchased and distributed in a society is a good measure of the level of economic development in that society. Different types of consumer goods means that a country's economic resources have fulfilled the basic human needs of shelter, clothing, and food and more resources are left over to provide nonessential household goods and services.

In developing nations, only a few this products exists for a thousand people. For instance, the ratio of persons to television sets in developing countries is 150 to 1 and population to automobiles is 400 to 1. In California, the ratio for these consumer items is almost 1 to 1. The number of consumer goods such as telephones and televisions per capita is a good indicator of a country's level of economic development.

1.2.4. Education and Literacy of a Population

The more men and women who attend school, usually the higher the level of economic development in a country. The literacy rate of a country is the proportion of people in the society who can read and write. Because more people can read and write, a proliferation of newspaper, magazines and scholarly journals improve and faster communication and exchange, which leads to further development.

1.2.5. Health and Welfare of a Population

Measure of held a welfare, in general, are much higher in developed nations than in Less Developed Countries (LDCs). People in developed nations also have better access to doctor, hospitals, and medical specialist. For relatively developed nations, there is one doctor for 1000 people, but in developing countries, each person shares a doctor with many thousands of others.

1.2.6. Demographic Characteristics

Industrially Advanced Countries (IACs) have much lower infant mortality rates then those of LDCs. In developed nations, on the average, fewer than 10 babies in 1000 die within the first 100 days. In many less developed nations, more than 100 babies die per 1000 live births. Some developing nations show a 3% per annum growth, which means that the population doubles in 17 year, although the average for LDCs is closer to 2%, with a doubling time to 35 years. In contrast, most developed nations have a less than 0.8% relative increase per year, and a few nations are at zero population growth.[4]

Age structures also differ substantially. In developing nations as many as 50% of the people are younger than age 15. In IACs, however, median ages range from 30 to 40, and life expectancy is longer.

1.2.7. Political Characteristic

Political development, involves the creation of specialized and differentiated government institutions that effectively carry out such functions as raising tax revenue, defending the national borders, maintaining political stability, stimulating economic development, improving the quality of human life, and communicating with the citizenry.

Developed governments must be responsive to broad segments of society and must respect the population's fundamental freedom and civil rights.

Political development also tends to correlate with economic and social development. More educated countries tend to be more stable, responsive, and democratic than the desperately poor nations, indeed. Third world countries are very unlikely to became democracies unless they have attained a minimal threshold of socioeconomic development. That economic

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[4] **ibid.** p.p. 537 – 542

threshold is a necessary, but not sufficient, condition for democratization. That does not imply that wealthier countries are assured of becoming or being democratic.

Moreover, there is at least correlation between economic and political development. As countries became more developed, economically there is seldom a steady movement toward greater stability, democracy or the other components of political development.[5]

1.2.8. Human development index

The Human Development Index (HDI) is a summary measure of human development. It measures the average achievements in a country in three basic dimensions of human development - *a long and healthy life, knowledge and a decent standard of living.*

Data used in the human development index is calculated using international data available at the time the report is prepared. *(Please see appendix A for more information about how to calculate the HDI)* For a country to be included in the index, data ideally should be available from the relevant international statistical agency for all four components of the index.

Conventional measures of productive activity focus on paid economic activity. But for a comprehensive picture of work and employment, especially the activities performed by women, it is essential to measure subsistence agriculture and other unpaid productive activities as well as unpaid housework. Time use surveys provide a unique means to collect data on such activities.

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[5] Econ 409 **Economic Development, Lecture Notes**, Nicosia, NEU, 2001

Summary

Before moving on the many details of economic growth theories, let's quickly review the main points made above.

Consequently, although the concepts of development and growth are sometimes used in same meaning development can be used as synonym for economic growth. But growth can not be used as development.

- Firstly, it was defined Development and Growth concepts. **Development** is a *qualitative* change like innovations in institutions, behavior and technology etc. **Growth** is a *quantitative* change in the scale of the economy – in terms of investment, output, consumption, and income.
- Economic Development is measured by the following:

a) Per Capita Income
b) Economic Structure of Labor Force
c) Consumer Goods Produced
d) Education and Literacy of a Population
e) Health and Welfare of a Population
f) Demographic Characteristics
g) Political Characteristic
h) Human development index (HDI)

Chapter 2

THEORIES OF GROWTH and DEVELOPMENT

II. THEORIES OF GROWTH AND DEVELOPMENT

2.1. Adam Smith's Model of Economic Growth

According to Adam Smith, one of the key characteristics of growing economies is the increasing specialization of individual economic activity. He wrote in "the wealth of nations"; *"The greatest improvements in the productive powers of labor, and the greater part of the skill dexterity and judgment with which its any where directed, or applied seem to have been the effects of the division of labor."*[6]

Smith's appreciation for the gains from specialization or what he refers to as the division of labor, naturally led him to the concept of the absolute advantage which came very close to the basic principle of trade, ***comparative advantage***. This principle asserts that a country will specialize in the export of this product it can produce at the lowest relative cost.

He also described the phenomenon that its called as ***economies of scale*** which basically states that a given amount of productive resources result in more output when they are brought together in a single large production facility rather than being spread among a large number of small production units.[7]

Adam Smith's theory of economic growth had two parts[8]:

1) Increasing division of labor increases the productivity of labor.

We have discussed Smith's ideas on the division of labor above. In several example, Smith described how workers in a modern economy do jobs that are different and that enhance the productivity of one another. Thus, a group of people working in this way (whether they are aware of it or not) produce much more per person than they would be able to produce if they worked independently. Smith saw this as the main reason for rising productivity and for high standards of living, or, in his words, "that universal opulence which extends itself to the lowest ranks of the people."

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[6] Edwin Cannan, **An Inquiry into the Nature and Causes of the Wealth of Nations - Adam Smith,** Chicago, University of Chicago Press, 1977, p.p. 7
[7] Van Den Berg Hendrik, **Economic Growth and Development,** New York, McGraw Hill Higher Education, 2002, p.p. 88
[8] http://william-king.www.drexel.edu

2) That the Division of Labor is limited by the Extent of the Market

He writes "the extent of this division of labor must always be limited by the extent of that power, or, in other words, by the extent of the market. When the market is very small, no person can have any encouragement to dedicate himself entirely to one employment ..."

Taking the example of nail-making, he goes on, " Such a workman at the rate of a thousand nails a day, and three hundred working days in the year, will make three hundred thousand nails in the year. But in [a small market in an isolated community] it would be impossible to dispose of one thousand, that is, of one day's work in the year." Thus large markets are essential to division of labor, and to high productivity, and growing markets are essential to increasing division of labor and growing productivity.

It is when we put these two ideas together that we get an explanation of economic growth. First, higher productivity can lead to higher incomes, and higher income leads to increased demand and bigger markets, therefore higher productivity could create the opportunity for more division of labor. But more division of labor in turn leads on to higher productivity.

The concept of relative cost and price differences are basic to the theory of international trade. And it's known as the Free trade based on the principle of comparative advantage, have two major theoretical benefits: the first one is trade enables all countries escape from the confines of their resource endowments and consume commodities in combinations that lie outside their production possibility frontiers (PPF) – *figure shows output combinations that are production efficient* [9]. In so, free international trade will benefit all nations of the world, even though the benefits may be disproportionately distributed depending on world demand conditions and cost differences will be occurred in different countries for different commodities. The second one is free trade will maximize global output by permitting every country to specialize in what it does best. So, specialization and trade can therefore lead to world output increase for all traded commodities.[10]

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[9] David Begg, Stanley Fischer, Rudriger Dorbusch, **Economics,** 4th Ed., England, Mc Graw Hill Book Company Europe, 1994, p.p. 327

[10] Michael P. Todaro, **Economic Development in the Third World,** New York, 1981, p.p. 243-344

Comparative Advantage and Economies of Scale together form the foundation of the process of specialization and the division of labor. Output increases through specialization because factors of production are used where they are most productive.
Specialization, whether based on comparative advantage for increasing returns to scale, requires the exchange of goods and services. There are no benefits from comparative advantage or economies of scale unless people can exchange the goods and services they produce for those produces by others who enjoy different comparative advantages and economies of scale.[11]

Adam Smith has emphasized the importance of free trade in increasing the wealth of nations. According to Adam smith mutually beneficial trade is based on principle of absolute advantage – a country may be more efficient in the production of some commodities relative to another nation.

Adam Smith has been frequently criticized for suggesting a simplistic policy of laissez – faire - *the belief that an economy functions best when there is no interference by government* [12] - for dealing faced by economies.

However, his writing makes it very clear that he was aware of the difficulties associated with his growth recipe. Smith was quite modern in that he recognized the need to establish the institutions necessary for markets to work properly. By institutions, it means such things as laws, rules, regulations, customs, justice systems, and social pressures that encourage or constrain people in their quest to maximize their welfare.

Additionally, there is also relationship between macroeconomic policies and economic growth. Stanley Fischer - First Deputy Managing Director, International Monetary Found (IMF) – has focused on the same idea in 1993. According to Fischer, "a stable macroeconomic environment, meaning a reasonably low rate of inflation and a small budget deficit is conducive to sustained economic growth.[13] The macroeconomic framework can be described as stable when inflation is low and predictable, real interest rates are appropriate,

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[11] Van Den Berg Hendrik, **Economic Growth and Development,** New York, McGraw Hill Higher Education, 2002, p.p. 89
[12] Matthew Bishop, **Pocket Economist - The Economist Books,** London, Profile Books Ltd, 2000, p.p. 426
[13] Stanley Fischer, **The Role of Macroeconomic Factors in Growth,** Journal of Monetary Economics, Vol: 32, 1993, p.p. 485 - 512

fiscal policy is stable and sustainable, the real exchange rate is competitive and predictable and the balance of payments situation is perceived as viable. This definition goes beyond the stability of macroeconomic policy variables to include also the creation that policy related variables are at levels conducive to growth.[14] It was used three variables by Stanley Fischer to represent the macroeconomic policies of governments: *the rate of inflation*, *the budget deficit*, and *distortion in the foreign exchange markets.*[15] The first two obviously proxy the soundness of monetary and fiscal policy and the latter is directly related to international trade and investment policies.

2.2. Ricardo and Economic Growth

David Ricardo (1772-1823) was the apostle of capital accumulation. In his view *the growth of capital was the great source of economic expansion and economic policy should be directed toward promoting it.* To prove his point, he developed a theoretical model of the economy that dominated the thinking of economist for fifty years. He believed that economic freedom led to maximum profits, that profits were the source of investment capital and that a competitive economy would lead to profit maximizing investment. In Ricardo's view policies that benefited business would lead to maximum economic growth.[16]

The classical model also took into account;[17]

- the use of paper money
- the development of institutions to supply in appropriate quantities
- capital accumulation based on output in excess of wages
- division of labor (limited primarily by the size of the market)

A major tenet of Ricardo was the Law of Diminishing returns referring to successively lower extra outputs from adding an equal extra input to fixed land. For Ricardo, diminishing returns from population growth and a constant amount of land threatened economic growth. Since Ricardo believed technological change or improved production techniques could only

[14] http://papers.nber.org
[15] Van Den Berg Hendrik, **Economic Growth and Development**, New York, McGraw Hill Higher Education, 2002, p.p. 426
[16] Daniel R. Fusfeld, **The Age of the Economist,** 9th Ed., Boston, Pearson Education, Inc., 2002, p.p. 41
[17] E. Wayne Nafziger, **The Economic of Developing Countries,** 3rd Ed., USA, Prentice Hall, USA, 1997, p.p. 88

temporarily check diminishing returns increasing capital was seen ass the only way off setting this long run threat.

His reasoning took the following path. In the long run, the natural wage is at subsistence – the cost of perpetuating the labor force (or population, which increases at the same rate). The wage may deviate but eventually returns to a natural rate at subsistence. On the one hand if the wages rises, food production exceeds what is essential for maintaining the population. Extra food means fewer deaths and the population increases. More people need food and the average wage falls. Population growth continuous to reduce wages until they reach the subsistence increases deaths and eventually contributes to a labor decline increases which raises the wages once again to the subsistence level.

In both instances, the tendency is for the wage to return to the natural subsistence rate. With this iron law of wages, total wages increase in proportion to the labor force. Output increases with population but other things being equal output per worker declines with diminishing returns on fixed land. Thus the surplus value (output minus wages) per person declines with increased population. At the same time land rents per acre increase with population growth, since land becomes more scarce relative to other factors.

The only way of offsetting diminishing returns is by accumulating increased capital per person. However, capitalists require minimum profits and interest payments to maintain or increase capital stock. Yet since profits and interest per person declines and rents in case with population growth, there is a diminishing surplus (profits, interest , and rent) available for the capitalists' accumulation. Ricardo feared that this declining surplus reduces the inducement to accumulate capital. Labor force expansion leads to a decline in capital per worker or a decrease in worker productivity and income per capita. Thus Ricardian model indicates eventual economic stagnation or decline.

Critique:

Paradoxically the stagnation theory of Ricardo was formulated amid numerous scientific discoveries and technical changes that multiplied output. Clearly he underestimated the impact of technological advance in offsetting diminishing returns. Since Ricardo's time, rapid technological progress contributed to unprecedented economic growth. Furthermore the iron law of wages did not foresee the extent to which population growth could be limited, at least in the west through voluntary birth control.

Moreover it did not occur to Ricardo that private ownership of land and capital is not an economic necessity. Land and capital would still be used even if rents and interest were not paid, as in state ownership of these means of production.

Ricardian stagnation might result in a Marxian scenario, where wages and investment would be maintained only if property were confiscated by society and payments to private capitalists and landlords stopped.

Contemporary neoclassical economists take the classical stress on savings, free trade, and freedom from government restriction and add an emphasis on technological change as important component of economic growth. These ideas are major features of the neoclassical theory of growth, a dominant present – day theory of economic growth.

2.3. Marx's Historical Materialism

Karl Marx's views were shaped by radical changes in Western Europe: the French Revolution; the rise of industrial, capitalist production; political and labor revolts; and a growing secular rationalism. Marx (1818-83) opposed the prevailing philosophy and political economy, especially the views of utopian socialist and classical economist, in favor of a worldview called *historical materialism.*[18]

Theory:

Marxists consider classical and later orthodox economic analysis as a still photograph, which describes reality at a certain time. In contrast, the dialectical approach, analogues to a moving picture, looks at a social phenomenon by examining where it was and is going and its process of change. History moves from one stage to another, from feudalism to capitalism to socialism, on the basis of changes in ruling and oppressed classes and their relationship to each other. Conflict between the forces of production (the state of science and technology, the

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[18] **ibid.** p.p. 89

organization of production, and the development of human skills) and the existing relations of production provide the dynamic movement in the interpretation of history. *The interaction between forces and relations of production shapes politics, law, morality, religion, culture and ideas.*

Accordingly, feudalism is undercut by:

1- The migration of serfs to the town
2- Factory competition with handcraft and manorial production
3- Expanded transport, trade, discovery and new international markets on behalf of the new business
4- The accompanying rise of nation states

2.3.1. The views of Marx about Capitalism

According to Marx economic relationships are the fundamental driving force in any society. Particularly under capitalism, people are motivated primarily by their own economic interest. In a capitalist society, according to Marx, the two great economic interests are those of capitalist and worker. These two classes stand in opposition to each other, since the capitalist can prosper only the latest in a series of social organizations in which one class exist at the expense of another.

Marx started his attacks on capitalism with the labor *theory of value.* Recall that this theory, which was developed by the economic liberals and the classical economists, stated that the true value of any product or service was simply the amount of labor used in its production.
In Marx's view, labor under capitalism is exploited because it is not paid the full value of the products and services it produces. The capitalist employs workers at the current wage rate and works them for as many hours each day as possible, making sure the value of workers ' output is greater than the wages paid. This difference between the wage and the value added by the worker, which called as *"surplus value"* becomes the capitalist's profit.

Capitalism faces repeated crises because the market dependent largely on worker consumption expands more slowly than productive capacity. Moreover, this unutilized capacity creates, in Marx's phrase, a reserve army of the unemployed, a cheap labor source that expands and contracts with the boom and bust of the business cycles. Furthermore, with the growth of monopoly, many small business people become property less workers who no longer have control over their workplaces.

2.3.2. The Breakdown of Capitalism

Marx believed that capitalism was not doomed, and he developed an intricate analysis of the *"laws of motion"* of capitalist society to prove it.[19] The one of the argument is related with *moral basis: inherent justices of capitalism lead ultimately to economic and social conditions that cannot be maintained.* Another argument is *sociological: class conflict between wealth of capitalists and working class.* And the last argument is *economic: the accumulation of capital in private hands makes possible economic abundance.* According to Marx, the *exploitation of labor* is the starting point to breaking down of capitalism. It leads to inadequate purchasing power and through surplus value and capitalist competition to accumulation of capital.[20]

Another affect, which is capital investment, had played a significant role in breaking down of capitalism. Capital investment leads to substitution of capital for labor. Indeed, this is the only way that the capitalists can increase the accumulate surplus value. Therefore capital accumulation creates technological unemployment and pushes wages and purchasing down.

There is also other side of medallion; changes also take place within the capitalist class. These changes can be summarized under the following headings:

- the rate of profit declines, as investment in machinery and equipment gradually becomes an increasing proportion of total investment.
- the business cycles shaped: by capitalism the big capitalists had started to gobble up the little ones.
- the firms with the largest financial resources survive

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[19] Daniel R. Fusfeld, **The Age of the Economist,** 9th Ed., Boston, Pearson Education Inc., p.p. 64
[20] **ibid.** p.p. 65

Critique:

Marx's main analysis was of capitalism, but his discussions of socialism and communism were not well developed. Even his analysis of capitalism, and the transition to socialism had a number of flaws. He had theorized worker revolt in the industrialized. West, but the revolution occurred first in Russia, one of the least developed capitalistic countries in Europe.

Marxists suggest several reasons why western workers have yet to overthrow capitalism. Having realized the dangers of a rebellious working class at home the capitalists have developed a tactic of divide and rule that depends on exploitation of workers outside the west. Furthermore, the news media, educational institutions and churches create a false consciousness supporting ruling class ideologies. And the capitalist state has powerful legal, police, military and administrative machinery to quell potential resistance.

Marx also overlooked the possibility that the interests of workers and capitalists might not conflict. Thus workers in the West may have supported capitalism because they gained more in the long run by receiving in relatively constant share of a rapidly growing output than by trying to acquire a larger share of what might have been a more slowly growing output under an alternative system.

2.4. Vicious Circle Theory

The vicious circle theory indicates that poverty perpetuates itself in mutually reinforcing vicious circles on both the supply and demand sides.[21]

a) Supply Side:

Because incomes are low, consumption cannot be diverted to saving for capital formation. Lack of capital results in low productivity per person, which perpetuates low levels of income. Thus the circle is complete. A country is poor because it was previously too poor to save and invest. Japan's high savings rates during the periods of rapid economic growth during the 1950s, 1960s, 1970s and the high savings rates of the Asian tigers; Singapore,

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[21] E. Wayne Nafziger, **The Economic of Developing Countries,** 3rd Ed., USA, Prentice Hall, 1997, p.p. 94.

Taiwan, Hong Kong, Malaysia, and Thailand imply the other side of the coin of the vicious circle. As countries grow richer they save more, creating a virtuous circle where high savings rates lead to faster growth.

b) Demand Side:

Furthermore, because incomes are low, market size (for consumer goods such as shoes, electric bulbs and textiles) is too small to encourage potential investors. Lack of investment means low productivity and continued low income. A country is poor because it was previously too poor to provide the market to spur investment.

Critiques

- Insufficient Saving

The vicious circle theory seems plausible to those Westerns who imagine that the entire population of the third world is poor and hungry. They are surprised that anyone in the less developed countries' (LDCs) saves. But it can be probably identified some flaws in these views.

- Westerners may be judging the saving potential in LDCs on the basis of Western standards of living
- Low-income countries can save substantially more than they do. The highest income groups in low income LDCs live for above subsistence levels
- Personal savings are usually a small proportion of total saving in a LDCs. Corporate saving, public enterprise profits, social security contributions, life insurance premiums and provident and pension fund reserves may be other sources for saving.

2- Small Markets

Another critique for this theory is small markets. The market is ample for using modern production methods effectively for products commonly consumed by low-income people. Even a fairy small improvement in productivity for commodities - which are consumed by these people - would capture a sizeable market.

Moreover, large establishments require not only large markets but, more importantly complex machinery and process, which demand entrepreneurial, managerial and technical skills and experience that are frequently scarce in developing countries.

2.5. Balanced versus Unbalanced Growth

A major development debate from the 1940s through the 1960 concerned balanced growth versus unbalanced growth. Some of the debate was semantic, since the meaning of balance can vary from the absurd requirement that all sectors grow at the same rate to the more sensible plea that some attention be given to all major sectors - industry, agriculture and services.

2.5.1. Balanced Growth

The synchronized application of capital to a wide range of different industries is called as balanced growth. On of the advocates - Ragnar Nurkse – considers this strategy the only way of escaping from the vicious circle of poverty. He does not consider the expansion of exports promising, since the price elasticity of demand for the LDCs' predominantly primary export is less thus reducing export earnings with increased volume, other things being equal.

- Big Push Thesis:

The application of capital to all-major sectors supported by the big push *Thesis, arguing that a strategy of gradualism is doomed to failure. A substantial effort is essential to overcome the inertia inherent in a stagnant economy. The situation is analogous to a car being stuck in the snow: it will not move with a gradually increasing push; it needs a big push.*[22]

A demand and investment, which made in infrastructure do not increase the contribution to economic growth, but are subject to sizable jumps or indivisibilities.

[22] **ibid.** p.p. 95

These indivisibilities result from flows created in the investment market by external economies that is cost advantages rendered free by one producer to another. These benefits spill over to society as a whole.

Lets take as example the steel industry to understand better the theory.
Assume that, increased production, decreased average costs and labor training and experienced that result from additional investment will benefit other industries as well. Greater output stimulates the demand for iron, coal and transport. Lower cost may make vehicles and aluminum cheaper.

In addition, other industries may benefit later by hiring laborers who occurred industrial skills in the steel mills. Thus, the social profitability of this investment exceeds its private profitability. Moreover, unless government intervenes total private investment will be too low.

Additionally, advocates of balanced growth emphasize a varied package of industrial investment at the expense of investment in agriculture, especially exports.

Critique of Balanced Growth:

As it mentioned before, balanced growth theory emphasize of industrial investments at the expense of investment in agriculture. But country cannot growth rapidly if it fails to specialize where production is most efficient. Recent experience indicates that LDCs cannot neglect agricultural investment if they are to feed their population, supply industrial inputs and earn foreign currency.

Furthermore, as it said before, infrastructure is not so indivisible. Roads, rivers, canals, or air traffic can substitute for railroads. Large infrastructure facilities are not essential for LDCs growth.

An other critique to this theory, its assumed that LDCs start from scratch by advocates of balanced growth. In reality, every developing country starts from a position that reflects previous investment decision.

2.5.2. Hirschman's strategy of Unbalance

It was developed by Albert O. Hirschman. He contends that unbalancing the economy, in line with a predesigned strategy is the best path for economic growth. He argues that the big push thesis may make interesting reading for economists but its gloomy news for the LDCs:

They do not have the skills needed to lunch such a massive effort. The ability to invest is dependent on the amount and nature of existing investment. And also Hirschman believes that poor countries need a development strategy that spurs investment decision. Additionally, he suggested that since resources and abilities are limited a big push is sensible only strategically selected industries within the economy.

Even a government that limits its major role to providing infrastructure can time its investment projects to spur private investments. Government investment in transport and power will increase productivity and thus encourage investments in other activities.

Critique of Unbalanced Growth:

Hirschman fails to stress the importance of agricultural investments. According to Hirschman, agriculture does not stimulate linkage formation so directly as other industries. However empirical studies indicate agriculture has substantial linkages to other sectors; moreover, agricultural growth makes vital contributions to the nonagricultural sector through increased food supplies added foreign exchange labor supply capital transfer and larger markets.

2.5.3. Baran's Neo – Marxist Thesis

The late US Marxist, Paul A. Baran, incorporated Lenin's concepts of imperialism and international class conflict into his theory of economic growth stagnation. For Baran, capitalist revolution, homegrown variety, in LDCs was unlikely because of Western economic and political domination, especially in the colonial period. Capitalism arose not through the growth of small competitive firms at home, but through the transfer from abroad of advanced monopolistic business. Baran felt that as capitalism took hold, the bourgeoisie – middle and business classes – in LDCs, lacking the strength to spearhead institutional change for major capital accumulation, would have to seek allies among other classes.

Critique

The theory fails to examine a number of economic and political conflict of interest. Although there are certainly many local agents, managers, merchants, industrialist, bureaucrats, and politicians who benefit considerably from foreign controlled capital and technology, there are also some local capitalists whose interests compete with foreign business.

2.6. Dependency Theory

Celso Furtado, a Brazilian economist was an early contributor to the Spanish and Portuguese literature in dependency theory in the 1950s and 1960s.[23] According to him, since the eighteenth century, global changes in demand resulted in a new international divisions of labor in which the peripheral countries of Asia, Africa and Latin Americas specialized in primary products controlled by foreigners while importing consumer goods in the central countries of the west.

A major dependency theorist, André Gunder Frank implied that developed countries were never underdeveloped though they may have been undeveloped. His basic thesis is that underdevelopment does not mean traditional economic political and social institutions but LDC subjection to the colonial rule and imperial domination of foreign powers.

According to André Gunder Frank, the following economic activities have contributed to underdevelopment.[24]

- Replacing indigenous enterprises with technologically more advanced, global subsidiary companies.
- Forming an unskilled labor force to work in factories and mines and on plantations
- Recruiting highly educated youths for junior posts in the colonial administrative service
- Workers migrating from villages to foreign dominated urban complexes
- Opening the economy to trade with and investment from developed countries

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[23] **ibid.** p.p. 106
[24] **ibid.** p.p. 107

André Gunder Frank has also underlined the following important three concepts [25]:

- **The expropriation / appropriation of the surplus;** using Baran's (1957) concepts of "potential" or potentially investible economic surplus (an economic surplus that is not available to society because its monopoly structure prevents its production, or if its produced, its appreciated and wasted through luxury consumption), Frank argued that the non realization and unavailability for investment of "potential" economic surplus was due essentially to the monopoly structure of capitalism.

- **Metropolis – satellite polarization;** the metropolis expropriates the economic surplus from its satellites and appropriates it for its own economic development leading to polarization in which there is development at the center and underdevelopment at the periphery. One important corollary of this thesis is that if its in fact the case that satellite status generates underdevelopment, then it follows that the weaker the metropolis satellite relationships, the greater are the possibilities for the local development of the satellite.

- **The contradiction of continuity in change;** the structural essential of economic development and underdevelopment are continuous and even though important historical changes have taken place in specific parts in specific parts of the system, the basic condition of underdevelopment is constant and has been so far centuries, ever since the capitalist system expanded across the world.

Two major implications of Frank's analysis require brief mention.[26] At the political level the conclusion is drawn that the Latin American bourgeoisie is incapable of undertaking its "historical tasks" that is it can not because of its origins and economic connections adopt independent, nationalist policies leading to democratic political system and independent national development.

The second major point is that according to Frank most of Latin America was incorporated in to the world capitalist system during the very first phase of its colonial history and thus it does

[25] Colman D. and Nixson F, **Economics of Change in Less Developed Countries,** Cambridge University Press, Harvester & Wheatsheaf, 1994, p.p. 52 -53
[26] **ibid.** p.p. 53

not make sense to speak of feudal, and semi feudal or archaic elements in Latin American society. This is an attack on both orthodox nations of dualism.
While explaining the dependency theory, it should be also expressed the views of Dos Santos as well.

Dos Santos (1973) dependency theorist defines dependence as a "conditioning situation" in which the economies of one group of countries are conditioned by the development and expansion of others". That is dependence is based on an international division of labor, which allows industrial development to take place in same countries while restricting it in others " whose growth is conditioned by and subjected to the power centers of the world. [27]

The concept of dependence must take into account the articulation of dominant interest in both the metropolitan centers and the dependent societies - domination is only possible when its supported by local groups which profit from it.

According to these information the following significant conclusion can be made;

If dependence defines the internal situation and is structurally linked to it, a country can not break out of it simply by isolating herself from external influences; such action would simply provoke chaos in a society which is of its essence dependent. The only solution therefore would be to change its internal structure.

Situation of dependency are not stable and permanent and do not necessarily generate further underdevelopment and dependency. Its necessary to analyze both mechanism within that bring about change. Furthermore dependency and imperialism are not simply viewed as the external and internal side of single coin, with the internal aspects reduced to the condition of "epiphenomenona". The impact of imperialism depends, inter - alias, on the forms of local societies colonized or otherwise incorporated into the global capitalist economy.[28]

However, it can be said that a system is dependent when "the accumulation and expansion of capital cannot find its essential dynamic component inside the system". The dominant centers of world capitalism possess by definition the technological and financial sector (*the role of*

[27] **ibid.** p.p. 54-55
[28] **ibid.** p.p. 56

financial sector in the economic growth will be discussed in chapter 5) essential to production and capital accumulation.

Even the semi – industrial LDCs however, remain dependent as their capital goods sectors are not strong enough to ensure the "continuous advance of the system, in financial as well as in technological and organizational terms.

Critique:

A significant criticism has been made by Laclau (1971) who argues that Frank confuses the concept of the capitalist made of production with participation in an world capitalist economic system.

The following criticizes can be presented for the dependency theory[29]:

- Dependency theory was static in that although in some versions it recognized the possibility of dynamic development; only the forms of dependency changed not the situation or condition of dependency itself.
- The center – periphery model was taken as given political independence, nationalism, and industrialism in a number of key LDCs.
- Direct foreign investment, transitional corporations could not be assumed to command political (or even economic) power in host LDCs – the dependency perspective seriously underestimated the bargaining power of the LDC state.
- Most dependency theorists incorrectly assumed imperialism to be monolithic, thus failing to recognize the possibilities for the LDCs exploiting intra - imperialist rivalries.
- LDCs did not respond in an identical manner to stimuli emanating from developed capitalist economies – the capacity to respond varied between countries and illustrated the role of policy choice in determining actual development.

[29] **ibid.** p.p. 57 – 58

2.7. Mahalanobis's Model

By considering simply aggregate investment, the basic Harrod – Domar model in effect assumes that all forms of investment are equally productive and also that capital is infinitely. Neither assumption is realistic as is recognized by those extensions to the model which allow for different sectoral capital - capital output ratios and for the level of investment in any particular sector to affect capacity in other sectors. Among the most celebrated of these extensions was the model developed by Mahalanobis (1955). The multisectoral version of this model was employed in establishing sectoral targets for the achieving these were implemented by the government the model may be said to have influenced economic policy particularly with respect to the recommended emphasis on the development of heavy industry.[30]

The Malahonobis model that output is a function of capital only (labor and other inputs being in abundant supply) that at equilibrium in the economy the output of any one sector will equal its stock of capital times its output – capital ratio, and that there is no international sector. The model can be applied in simplified forms to two sectors only, which are defined as producing consumption and investment goods respectively.

In the investment goods sector two types of machine are assumed to be made, those required to make more machines.

Since all savings are invested in machines it follows that; [31]

- The rate of growth of consumption goods output depends in the short run upon that sector's share of the new machines produced in any period.
- The rate of growth of consumption goods output ultimately depends upon the share of new investment in the investment goods sector. The larger this sector becomes the greater the economy's capacity to produce machines for consumption goods manufacture
- If the marginal rate of savings is raised above the average rate, the share of new investment in the heavy goods sector can be increased at the expense of the

[30] **ibid.** p.p. 29
[31] **ibid.** p.p. 30

consumption goods sectors since the marginal growth rate in consumer demand will be correspondingly reduced.

- When the average and marginal rates of savings are equal, an equilibrium in which machine capacity is fully employed is achieved when the rates of growth of national income, investment goods sector's of investment time its outputs capital ratio.

2.8. Theories of Economies Dualism

Theories of Economies Dualism – to be distinguished from the socio – political dualism of Boeke (1953) – have been ostensibly more concerned with describing certain aspects of the structural transformation which occurs within LDCs than with generating tools to assist in playing development. The influence and attractiveness of this line of theorizing is due to a considerable extent to the fact that it fills an important theoretical vacuum. The theories about economic dualism specially relate to traditional sector, which is dominated by subsistence agriculture, and the informal sector and seek to provide an explanation of how a primarily agrarian economy is transformed via a dualistic state into a mature economy.[32]

The dual economy theory was first formally stated in a seminal article by Lewis (1954) and has been the subject of numerous extensions and modifications, most notably by Ranis and Fei (1961) Jurgenson (1961, 1967) and by Lewis himself (1968).[33]

The purpose of the dual economy is assumed that to be divisible into two sectors which will designate "industry" and "agriculture". The concept of dualistic economic structure is capable of many aspects of development, and formal dual models have a number of alternative applications. For example, the two sectors might be labeled;

- modern and subsistence
- capitalist and non capitalist
- export enclave and domestic

In each case which mentioned above, the essential distinction is between that small and rapidly growing sector which uses relatively large amounts of capital with labor hired for a contractual wage or salary and much larger sector dominated by subsistence agriculture,

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[32] **ibid.** p.p. 35
[33] **ibid.** p.p. 36

where little capital is used labor productivity is low and where payment is more in kind than in cash.

The main assumptions of the basic dual economy theory can be explained as follow[34];

- The economy is closed economy and there is no internal trade in goods and no foreign owner ship of capital.
- It is assumed that land for agricultural production is in fixed supply is only approximately true for LDCs.
- It is assumed that there is exogenously given technological change in both agriculture and industry which increases the productivity of all factors of production.
- In industry, output is taken to be a function of capital and labor and these two factors are assumed to be substitutes for one another.
- It is further assumed that the whole of capitals' share of industrial output is saved and reinvested in additional industrial capacity.
- Two alternative sets of assumptions may be made relating to the productivity of agricultural labor. One assumption is that there is sufficient distinguished unemployment in the agricultural sector for the marginal product of laborer to be zero. The second one is "there has been an extended debate as to whether or not LDCs suffer from disguised unemployment in agriculture in the above sense.
- It is assumed that there is some maximum level of population growth but that actual growth may be restricted by Malthusian mechanism – that economic growth caused population growth to rise and the extremely slow economic growth as the result of population growth continually undermining the gains from economic growth.[35]

Critique:

The dual economy models have a falsely optimistic picture of the ease with which poor, untrained rural dwellers can be assimilated in to the industrial labor force. In fact a number of LDCs have not yet reached the stage where the scale of growth of the industrial labor force is sufficient to require a decline in the agricultural labor force. As we all known, the number of workers in agricultural sector has been growing rapidly in the LDCs and may still be expected

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[34] **ibid.** p.p. 37

[35] Van Den Berg Hendrik, **Economic Growth and Development,** New York, McGraw Hill Higher Education, 2002, p.p. 242

to continue to grow for a fair number of years. Not only do the activities, which fall under the umbrella label of industry, not generate as much demand for labor as the numerical assumption s, they also tend to require skilled (highly valued) rather than unskilled labor.

Thus, a large differential emerges between the wages of skilled urban industrial workers and agricultural labor. The differential attracts agricultural workers to the towns on the off chance of obtaining skilled jobs and a high wages.

2.9. Harrod – Domar Growth Model

It is one of the significant theory for economic development. Due it essentially was produced by the two authors – Harrod, 1939 and Dommar, 1946 – it is so called.

Their prime intention was to explore the conditions for stable economic growth in developed countries[36]. According to Harrod – Domar growth model *every economy must save a certain proportion of its national income.* However, in order to grow, new investment representing net additions to the capital stock are necessary.

If its assumed that there is some direct economic relationship between the size of the total capital stock and total GNP; capital is always necessary to produce a 1$ stream of GNP.[37] So it follows that any net addition to the capital stock in the form of new investment will bring about corresponding increases in the flow of national output, GNP.

Roy F. Harrod is concerned with keeping total spending and productive capacity in balance but he focuses on the growth path of income.[38]

Evsey D. Domar emphasizes that present investment while contributing to aggregate demand today also provides new productive capacity. If this capacity is not adequately used it discourages future investment, thus increasing surplus capital and depressing the economy.[39]

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[36] **op. cit.** p.p. 27
[37] Michael P. Todarro, **Economic Development in Third World: An Approach,** New York, 1981, p.p. 70
[38] E. Wayne Nafziger, **The Economics of Development Countries,** 3rd Ed., New Jersey, Prentice Hall, p.p. 123
[39] **ibid.** p.p.123

But if investment increases at the correct rate, aggregate demand will be sufficient to use fully the newly added capacity. Domar also indicates the rate at which investment would have to grow for this process to take place.

Critique:

The model's instability follows from some peculiar assumptions about producer behavior.[40] If producers guessed correctly yesterday about demand and their supply just equaled market demand, they will plan today to increase their output by the some percentage as they increased it yesterday. If they produced too much, they will reduce yesterday's growth rate of output and again produce too much today because demand will fall below expectations. If they produced too little yesterday, so there was excess demand, today's output growth will increase over yesterday's and there will gain be excess demand.

Additionally, there are several problems with the Harrod – Domar model. The first is Harrod's assumption about producer behavior including the premise that producers do not modify behavior as they learn how the economy previously responded to divergences between warranted and actual growth.

A second problem is that Harrod 's accelerator has no lag, implying that capital goods are produced simultaneously with the increased output requiring this production.

A third problem which is also characteristic of the Domar model is the assumption of fixed capital labor proportions which omits the possibility of adjusting capital labor ratios to avoid surplus capital and output ceilings that might cause the warranted rate to be the actual rate. Models that aloe for substitution between factors - such as the neoclassical growth model and others using a Cobb – Douglas approach – overcome this last problem of the Harrod – Domar model.

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[40] **ibid.** p.p. 124

2.10. Rostow's Stages of Growth

It was developed by the economic historian Walter W. Rostow. According to the Rostow doctrine, the transition from underdevelopment to development can be described in terms of a series of steps or stages through which all countries must proceed.[41] These steps can be explained under following headings;

- The traditional society
- The transitional stage: the preconditions for take off
- Take off
- The drive to maturity
- The stage of high mass consumption

- The traditional society

Rostow's preconditions stage for sustained industrialization includes radical changes in three non-industrial sectors: [42]

- increased transport investment to enlarge the market and production specialization
- a revaluation in agriculture, so that a growing urban population can be fed
- an expansion of imports including capital, financed perhaps by exporting some natural resources

These changes including increased capital formation require a political elite interested in economic development. This interest may be instigated by a nationalist reaction against foreign domination or the desire to have a higher standard of living.

- Take off

Rostow's central historical stage is the take off, a decisive expansion occurring over 20 to 30 years, which radically transforms a country's economy and society.[43] During this stage,

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[41] Michael P. Todarro, **Economic Development in Third Third_World: An Approach,** New York, 1981, p.p. 70

[42] E. Wayne Nafziger, **The Economics of Development Countries,** 3rd Ed., New Jersey Prentice Hall, p.p. 91

barriers to steady growth are finally overcome, while forces making for widespread economic progress dominate the society so that growth becomes the nominal condition.

Rostow indicates that three conditions must be satisfied for take off.

- Net investment as a percentage of net national product (NNP) increase sharply
- At least one substantial manufacturing sector grows rapidly. The growth of a leading manufacturing sector spreads to its input suppliers expanding to meet its increased demand and to its buyers benefiting from its larger output
- A political, social and institutional framework quickly emerges to exploit expansion in the modern sectors: this condition implies mobilizing capital through retained earning from rapidly expanding sectors, an improved system to tax high income groups , especially in agriculture, developing banks and capital markets and in most instances foreign investment

- Drive to Maturity

After take off three follows the derive to maturity a period of growth that is regular expected and self sustained. This stage is characterized by a labor force that is predominantly urban increasingly skilled less individualistic and more bureaucratic and looks increasingly to the state to provide economic security.[44]

- Age of high mass consumption

The symbols of this last stage reached in the United States in the 1920s and in Western Europe in the 1950s are the automobile sub - urbanization and innumerable durable consumer goods and gadgets. In Rostow's view other societies may choose e a welfare state or international military and political power.

2.11. Structural Change Model

Structural change theory focused on the mechanism by which underdeveloped economies transform their domestic economic structure from a heavy emphasis on traditional subsistence, agriculture to a more industrially diverse manufacturing and service economy.

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[43] **ibid.** p.p. 91

[44] **ibid.** p.p. 92

There are two well known representative examples of the structural change approach are the "two sector surplus labor" theoretical model of W. Arthur Lewis and the "patterns of development" empirical analysis of Hollis B. Chenery.[45]

2.11.1. The Lewis Theory of Development:

It is one of the best-known models of development that focused on the *structural transformation* of a primarily subsistence economy.

The *Lewis two sector models* become the general theory of the development process in surplus – labor third world nations during most of the 1960s and early 1970s. In the Lewis model the underdeveloped economy consist of two sectors: [46]

- A traditional over populated rural subsistence sector characterized by zero marginal labor productivity
- A high productivity modern urban industrial sector into which labor from the subsistence sector is gradually transferred.

The primary focus of the model is on both the process of labor transfer and growth of output and employment in the modern sector. Both labor and transfer and modern sector employment growth are brought about by output expansion in that sector. The speed with which this expansion occurs is determined by the rate of industrial investment and capital accumulation in the modern sector. Such investment is made possible by the excess of modern sector profit over wages on the assumption that capitalists reinvest all their profits.

Finally, the level of wages in the urban industrial sector is assumed to be constant and determined as a given premium over a fixed average subsistence level of wages in the traditional sector.

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[45] Michael P. Todarro, **Economic Development in Third World: An Approach,** New York, 1981, p.p. 74
[46] **ibid.** p.p. 74

Criticisms of the Lewis Model:

After giving these informations, which are related with the Lewis Model, the following criticism can be made.

First, the model implicitly assumes that the rate of labor transfer and employment creation in the modern sector is proportional to the rate of modern sector capital accumulation.[47] The faster the rate of capital accumulation, the higher the growth rate of the modern sector and the faster the rate of new job creation. But what if capitalist profits are reinvested in more than just duplicating the existing capital as is implicitly assumed in the Lewis Model?

The second question able assumption of the Lewis Model is the notion that surplus labor exists in rural areas while there is full employment in the urban areas. The most contemporary research indicated that the reverse is more likely true in many third world countries – there is substantial unemployment in urban areas but little general surplus labor in rural locations.

The third unreal assumption is the notion of competitive modern sector labor markets that guaranties the continued existence of constant real urban wages up rural surplus labor is exhausted.

In order to entice labor into the manufacturing sector capitalists pay a wage slightly higher than the agricultural real wage. The manufacturing wage is just high enough to compensate labor for relocations costs etc

2.11.2. Structural Change and Patterns of Development

The patterns of development analysis of structural change focuses on the sequential process through which the economic, industrial and institutional structure of an underdeveloped economy is transformed overtime to permit new industries to replace traditional agriculture as the engine of economic growth. [48] However, in constant to the Lewis model and the original stages view of development, increased savings and investment are perceived by patterns of development analysts as necessary but not sufficient conditions for economic growth. In

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[47] **ibid.** p.p. 77
[48] **ibid.** p.p. 79

addition to the accumulation of capital both physical and human a set of a interrelated changes in the economic structure of a country are required for the transition from a traditional economic system to a modern one. These structural changes involve virtually all-economic functions including the transformation of production and changes in the composition of consumer demand, international trade and resources use as well as changes in socioeconomic factors such as urbanization and the growth and distribution of a country's population.

Structural change analysts emphasize both domestic and international constraints on development. The domestic ones include economic constraints such as a country's resources endowment and its physical and population size as well as institutional constraints such as government policies and objectives. International constraints on development include access to external capital, technology and international trade. Differences in development level among developing countries are largely ascribed to these domestic and international constraints.

The major hypothesis of the structural – change model is that development is an identifiable process of growth and change whose main features are similar in all countries. However, the model does recognize that differences can arise among countries in pace and patterns of development depending on their particular set of circumstances. Factors influencing the development process include a country's resource endowment, size, its government policies and objectives, the availability of external capital and technology and the international trade environment.

Structural change in the economy has affected the way of people live in many ways. Perhaps the most noticeable change in lifestyle over the past two centuries has been the sharp rise in proportion of people who live in urban areas. [49]

The model of structural change identifies the following patterns of change:

Shift from agricultural to industrial production; steady accumulation of physical and human capital; the change in consumer demands from emphasis on food and basic necessities to desires for diverse manufactured goods and services; the growth of cities and urban

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[49] Van Den Berg Hendrik, **Economic Growth and Development,** New York, McGraw Hill Higher Education, 2002, p.p. 14

industries as people migrate from farms and small towns; and decline in family size and overall population growth as children lose their economic value and parent substitute child quality (education) for quantity.

Today, in the highest income countries, at the last three – fourths of all people live in urban areas. A similar pattern emerges when it observes the urban – rural distribution of populations across different countries.

Structural change is probably the most controversial aspect of economic growth. [50] Clearly, if in a highly developed economy only 4 percent of output consist of agricultural products, whereas a less developed economy may devote over 50 percent of its resources to producing agricultural products, then as an economy grows, workers will have to shift from agriculture to either the industrial or the service sector of the economy if they hope to enjoy per capita incomes on par with everyone else in the country. But such shifts can be difficult; they may involve substantial transportation costs breakups of extended families, and moves from one part of the country to another or even from one country to another.

In short, empirical studies on the process of structural change lead to the conclusion that the pace and pattern of development can vary according to both domestic and international factors many of which lie beyond the central of an individual developing nation.

2.12. The International Dependence Revolution

During the 1970s international dependence models gained increasing support especially among third world intellectuals.[51]

Essentially, there are three major stream of thought:

- The neocolonial dependence model
- The false paradigm model
- The dualistic development thesis

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[50] **ibid.** p.p. 14

[51] Michael P. Todarro, **Economic Development in Third World: An Approach,** New York, 1981, p.p. 81

2.12.1. The Neocolonial Dependence Model

The first major stream, which it's called as neocolonial dependence model, is an indirect outgrowth of Marxist thinking.

The existence and continuance of third world underdevelopment primarily to the historical evaluation of a highly unequal international capitalist system of rich country - poor country relationships whether because rich nations are intentionally exploitative or unintentionally neglectful, the coexistence of rich and poor nations in an international system dominated by such unequal power relationships between the center (the developed countries) and the periphery (the LDCs) renders attempts by poor nations to be self reliant and independent difficult and sometimes even impossible.

2.12.2. The False Paradigm Model

A second and a less radical international dependence approach to development, which it might be called, is the false paradigm model. The model attributes the world underdevelopment to facility and inappropriate advice provided by well meaning but often uniformed, biased and ethnocentric international expert advisers from developed country assistance agencies and donor organizations.[52] These experts offer sophisticated concepts elegant theoretical structure s and complex econometric models of development that often lead to inappropriate or incorrect policies. Because of institutional factors such as the central and remarkably resilient role of traditional social structures the highly unequal ownership of land and other property rights the disproportionate control by local elites over domestic and international financial assets in many cases merely serve the rested interests of existing power groups both domestic and international.

2.12.3. The dualistic development thesis

Implicit in structural change theories and explicit in international dependence theories in the notion of a world of dual societies of rich nations and poor nations and in the developing countries, pockets of wealth within broad areas of poverty. [53]

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[52] **ibid.** p.p. 83
[53] **ibid.** p.p. 83

Dualism is concepts widely discussed in development economies. It represents the existence and persistence of increasing divergences between rich and poor nations and rich and poor peoples on various levels.

2.13. Solow's Neoclassical Growth Theory

Economist, Robert Solow developed the neoclassical theory of growth and he stressed the importance of saving and capital formation for economic development and for empirical measures of sources of growth.

Unlike the Harrod Domar model of growth, Solow allowed changes in wage and interest rates, substitutions of labor and capital for each other, variable factor proportions and flexible factor prices.[54]

In addition to these he showed that growth need to be unstable since as the labor force outgrew capital wages would fall relative to the interest rate or if capital outgrew labor wages would rise.

The neoclassical model predicts that incomes per capita between rich and poor countries will converge. But empirical economist cannot find values for parameters and variables that are consistent.

While examining the Robert Solows theory it's necessary not to forget Theodore W. Shultz. According to Shultz, human capital as well as physical can yield a stream of income overtime. He also argues that a society can invest in its citizens through expenditures on education training, research and health that enhance their productive capacity. While there are diminishing returns to physical capital by itself there are constant returns to all (human and physical) capital.

Additionally, Neoclassical economists assume the following points:[55]

- Technological discoveries are global public goods so that all people can use new technology at the same time. Indeed, its technologically possible for every person and firm to use the internal – combustion engine microcomputer and other innovations

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[54] E. Wayne Nafziger, **The Economics of Development Countries,** 3rd Ed., New Jersey Prentice Hall, p.p. 113

[55] **ibid.** p.p. 116

- The innovator receives no monopoly profits from their discoveries. However, because individuals and firms control information flows and petition for patents to restrict use by rivals and charge prices for others to use the technology
- Neoclassical economist emphasize capital formation
- Output growth result from one or more of three factors: increases in labor quantity and quality, increases in capital and improvements in technology

2.14. The Neoclassical Counterrevolution

The central argument of the neoclassical counterrevolution is that *underdevelopment result from poor resource allocation due to incorrect pricing policies and too much state intervention by overly active.* [56] *Third world governments and additionally the activities, which are, belong to first world and international agencies have an impact and play a significant role on developing countries.*

Additionally, they argue that promoting competing free markets, privatizing public enterprises supporting exports and free international trade, liberalizing trade and exchange rates, allowing exchange rates to attain a market clearing rate, removing barriers to foreign investment, rewarding domestic savings reducing government spending and monetary expansion and removing regulations and price distortions in financial resource and commodity markets will spur increased efficiency and economic growth.

Contrary to the claims of the dependence theorists, the neoclassical counterrevolutions argue that the third world is underdeveloped not because of the predatory activities of the first world and the international agencies that it controls but rather because of the heavy hand of the state and the corruption, inefficiency and lack of economic intensives that permeate the economies of developing nations.

Neoclassical counterrevolutions policies are reflected in following components: [57]

- *Price decontrol.* Neoclassicists favor immediate lifting of controls on commodity factor and currency prices

[56] Michael P. Todarro, **Economic Development in Third World: An Approach,** New York, 1981, p.p. 85
[57] **op. cit.**, p.p. 111

- *Fiscal discipline.* Budget deficits of governments or central banks should be small enough to be financed without using inflationary financing.
- Public *expenditure priorities.* LDCs should reduce government spending, and redirect expenditures from politically sensitive areas like administration, defense, indiscriminate subsides, and "white elephants" to infrastructure, primary health, and education.
- *Tax reform.* This includes broadening of the tax base, improved tax administration, sharpening of tax incentives, reduced marginal tax rates, diminished tax evasion and loopholes, and taxing interest on assets held abroad.
- *Financial liberalization.* The immediate objectives are to abolish preferential\ interest rates for privileged borrowers and charge nominal\ interest rates in excess of inflation rates, while the ultimate objective is market-determined interest rates to improve capitals allocative efficiency.
- *Exchange rates.* Countries need a unified, competitive rate to spur a rapid expansion in exports.
- *Trade Liberalization.* Laces should replace quantitative restrictions with tariffs, and progressively reduce tariffs until\ they achieve a uniform low tariff rate (about 10 to 20 percent).
- *Domestic savings.* Fiscal discipline, cutbacks in government spending, tax reform, and financial liberalization divert resources from the state to highly-productive private sectors, where savings rates are higher. The neoclassical growth model, discussed below, emphasizes the importance of savings and capital formation for rapid economic development.
- *Foreign direct investment.* Neoclassicists favor abolishing barriers to the entry of foreign firms; additionally, foreign firms should compete with domestic firms on equal terms.
- *Privatization.* State enterprises should be privatized.
- *Deregulation.* Governments should abolish regulations that impede new-firm entry and restrict competition unless safety or environmental protection justifies regulations.
- *Property rights.* The legal system should provide secure property rights without excessive costs to all land, capital, and building

Critique

The neoclassical models can be criticized due to following reason,
The model has several weaknesses including the assumptions that markets are perfectly competitive and the level of technology is the same throughout and the world. Indeed, neoclassical progress takes place completely independent of decision by people, firms and governments. And also its not possible to become same level of technology in all places of the world.
Like the dependence revolution of the 1970s the neoclassical counterrevolution of the 1980s had its origin in an economic cum ideological view of the third world and its problem.[58] There can be little doubt that market price allocation usually does a better job than state intervention. Many third world economies are so different in structure and organization from their western counterparts that the behavioral assumptions and policy precepts of traditional neoclassical theory are sometimes questionable and often incorrect. Competitive markets simply do not exist nor given the institutional, cultural and historical context of many LDCs would they necessarily be desirable from a long-term economic and social perspective.

2.15. The New (Endogenous) Growth Theory

The new growth theory provides a theoretical framework for analyzing endogenous growth persistent GNP growth that is determined by the system governing the production process. [59] In contrast to neoclassical growth theory, this model hold GNP growth to be a natural consequence of long run equilibrium. The principle motivations of the new growth theory are to explain both growth rate differential across countries and a greater proportion of the growth observed.

The most significant theoretical differences stem from three factors:

Models of endogenous growth discard the neoclassical assumption of diminishing marginal returns to capital investments permit increasing returns to scale in aggregate production and frequently focus on the role of externalities in determining the rate of return on capital investment.

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[58] **op. cit.** p.p. 86
[59] **ibid.** p.p. 89

The new growth theory reemphasizes the importance of saving for achieving rapid growth in the third world. It is also leads to several implications for growth.

First there is no force leading to the equilibration of growth rates across closed economies national growth rates remain constant and differ across countries depending on national savings rate sand technology levels. Furthermore there is no tendency for per capita income levels in capital poor countries to catch up with those in rich countries with similar saving rates. A serious consequence of these facts is that a temporary or prolonged recession in one country leads to a permanent increase in the income gap between itself and wealthier countries.

The most interesting aspect of endogenous growth models is that they help explain anomalous international flows of capital that exacerbate wealth disparities between the first world and third worlds. The potentially high rates of return on investment offered by developing economies with low capital labor ratios are greatly eroded by lower levels of complementary investment in human capital (education) infrastructure or research and development (R&D).

In turn, poor countries benefits less from the broader social gains associated with each of these alternative forms of capital expenditure. Because, individuals receive no personal gain from the positive externalities created by their own, investments, the free market leads to the accumulation of less than the optimal level of complementary capital.

Critique:

An important shortcoming of the new growth theory is that it remains dependent on a number of traditional neoclassical assumptions that are often inappropriate for third world economies.[60] Economic growth in developing countries is frequently implied by inefficiencies arising from poor infrastructure and imperfect capital and goods market. Because endogenous growth theory overlooks these very influential factors, its applicability for the study if economic development is limited, especially when country-to-country comparisons are involved.

[60] **ibid.** p.p. 90

Summary

However, in the past, economists had developed many theories, which are related with growth. Some of these theories are Adam Smith's Model of Economic Growth, Ricardo's Economic Growth, Marx's views, Hirschman's strategy of Unbalance, A major dependency theorist, André Gunder Frank, Mahalanobis's Model, Harrod – Domar Growth Model, Rostow's Stages of Growth, The Lewis Theory of Development, Structural Change and Patterns of Development, and The Neoclassical Growth Theory by Robert Solow can be countable.

Most of the models which were mentioned above point the same conclusion. For example, the Harrod Domar growth model claims that there is a simple linear relationship between savings and growth, neoclassical Solow model predicts that a higher saving rate leads to a higher steady - state level of real income. Despite the theoretical support, however, there is surprisingly little evidence that a high rate of savings is indeed a sufficient, or even a necessary, condition for economic growth. Roy Harrod, a British economist, led in the modern work on the theory of economic growth. He wrote about two concepts of the rate of economic growth. Seeing that both investment and increasing labor productivity would be necessary to permit economic growth, Harrod treated investment and labor productivity as independent limits on economic growth.

Harrod observed that the rate of economic growth would depend on the growth of capital, and thus on the proportion of income to be saved and invested. Since businessmen are profit-seekers, investment would in turn be limited by profits. In the view of businessmen, investment would be "warranted" (that is, reasonable view) only if the businessmen could expect that it would be sufficiently profitable. Businessmen's expectations of profits would determine one limit on the rate of growth. This would be the "warranted" rate of growth.

On the other hand, the supply and productivity of labor also set a limit to the rate of growth. This – the sum of the rate of growth of population and the rate of growth of labor productivity – is the "Natural Rate of Growth" in Harrod's thinking. Conversely, in order to keep unemployment from increasing, it would be necessary for demand to grow as fast as the population, plus any increases in labor productivity.

Chapter 3

GLOBALIZATION
AND
ECONOMIC GROWTH

III- GLOBALIZATION AND ECONOMIC GROWTH

3.1. The concept of globalization

The concept of Globalization includes both positive and negative meaning; sometimes it is defined as "*a development and it should not be prevented*", and sometimes it is called as "*the other name of imperialism in the 21st century*". But economically these definitions can be converted to the following definitions alternatively including;

Globalization is "the growing economic interdependence of countries worldwide through the increasing volume and variety of cross-border transactions in goods and services and of international capital flows, and also through the more rapid and widespread diffusion of technology and international actions taken by states to create a new markets for capitalist countries".

In order to better understand the term of Globalization should be evaluated its history. The concept of globalization has developed three cases in different ways during its history:[61]

3.1.1. First Globalization (Wave after 1490's)

The concept of globalization, which has started in this date, can be explained as the attempt of west to oversees discoveries. West commanders by using the superior weapon technologies they had realized their discoveries. As a reason for these, they had shown that "to move the values of Christianity to the idolater lands". As a result of this globalization the colony empires have been established. But due to technology which were existing in that day, these occupiers could not integrated with metropolis country and so, the economies of these countries could not be developed.

3.1.2. Second Globalization: (Wave of 1870's)

The second spread of west has started after 1870 and was instituted in 1890s. The technology, which was used in this period, was created by industry revolution. In the other words in back of this spread, there was industrial revolution. In this period there were three methods:

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[61] Baskın Oran, **Küreselleşme ve Azınlıklar,** İmaj Yayıncılık, 3.Baskı, Ankara, 2000, s: 4

- Missionaries
- Trade companies
- West companies

But at that time the duty was not only movement of Christianity, in addition this it was white man 's burden and mission of civilization. The second spread has occurred as a result of industry revolution and it was more important than the first one. The spread became an answer for economic and financial pressure which was coming through Europe. In 1980's financial capital became sovereign on industrial capital in Europe. At the result of this process by establishing monopoles, system was enlarged. But in this period some structural difficulties have occurred. These difficulties can be summarized as follows:

- to provide cheap and continuously raw material for metropolis industry
- to find out new markets for the excess of production
- to export capital because of decreasing marginal effectiveness of capital
- and to prevent excess of population.

Consequently, a merciless competition has started and this event has decreased the profit margin. National bourgeoisies wanted to set a limit for foreign competition. Consequently, trades of world would have been decreased and to solve this problem there was only one positive way: to discover the places of world which have not been included to in international trade and relations (in other words colonies)

All these developments can be summarized as follow:

- At the end of 19^{th} century, capitalism had to face with the necessity of restructure. Second spread provided and created possibilities for the system reproduce itself. The concept that was known as colonies until that time but now it has gained a new name and was called as imperialism since.

3.1.3. Third Globalization (Wave of 1990)

Today, once again there is a debate about Globalization; but one more concept has appeared, namely the New World Order. But this concept has shown itself again determined period of history. At least the concept of new world order has appeared two times in 20^{th} century: firstly, in 1919 during the peace meeting, and second one during the Second World War.

In first two phases of globalizations, the number of independent countries has increased. The fights have increased and were accelerated. The identity crises have occurred in LDCs. The reason for this was that, the European market was not self sufficient in this period.

The west was trying to restructure itself, because of this reason it had to widen its economic market and had to move new cultural matrix to the less developed countries. Now, when its observed that same patterns are repeated. The domestic markets of west are not self sufficient and, consequently, the is the need for expanding them. Western culture has a position to dominate the world.

In international system, third wave of globalization became the cause of collapse for Soviet Block. But the third wave was more powerful than first two due following reasons:

- Since 1970's multinational companies have dominated whole world economy
- In 1980's communication revolution such as optic cable, computers, communication satellite, internet etc. took place
- Since the disintegration of the Soviet Union in 1991 west has been the single power center.
- During the first two waves there were no such concepts as human and minority rights. Spain in Latin America, other Europeans in North America, Holland and England in South Africa had had a merciless attitude toward indigenous people. However, especially in 1990s it has been replaced with democracy, human rights considerations intensively. These kinds of problems have been used in order to create pressure on poor countries.

Table 3.1 Historical Background of Globalization

	First Globalization Wave after 1490	***Second Globalization Wave of 1890's***	***Third Globalization Wave of 1990's***
Source of Power	Developments in Maritime, mercantilism	Industrialization and its requirements	In 1970's, multinational companies, in 1980's communication revolution, in 1990's no opponent of West
Methods	Firstly Discoveries, then Military Occupancy	Firstly Missionaries, then Discoveries, then Trade Companies, latest Occupancy	Cultural and Ideological affect, so every place of country effected automatically economically, politically, and socially)
Expressed Reasons	To convert the primitive natives to Christian religion instead of tothenism	"White man's burden" and "Mission of Civilization", Racist Theories	"The highest civilization level", "the volition of international community", "invisible hand of market", "globalization is common interest of everyone"
Result	*Colonies*	Imperialism	***GLOBALIZATION***

Source: *Küreselleşme ve Azınlıklar, Baskın Oran, p. 9*

3.2. Globalization and its Economic Effects

The new wave of globalization, which began in 1980s, has shown its effects on economy. First, and most spectacularly, a large group of developing countries broke into global markets. Second, other developing countries became increasingly marginalized in the world economy and suffered declining incomes and rising poverty.[62]

There is an increasingly close relationship between economies and globalization concept. The flows of capital and people across borders have also been important concept in recent years for economies. This concept impinges on development from several directions. The significant components of globalization, which affects the economic development, can be evaluated as follow:

- growth of trade
- capital flows and financial capability
- migration
- diffusion of technology
- different culture in labor force etc.

All parts of the world are affected by globalization through these channels, which were mentioned above, but it is important to remember that the full force of changes are felt by relatively small number of upper and middle income countries.

The growth effects of globalization and liberalization affect both absolute poverty, through poverty reduction, and relative poverty, through changes in a country's income distribution. If economic growth is initially slow and, at the same time, inequality grows, absolute poverty may not decline and conjectural poverty could increase. On the other hand, globalization has helped supplement, through corporate savings and investment, the role of household savings in fueling investment. In such circumstances, poverty has declined as a result of the jobs created. In fact, to the extent that the globalization process has encouraged the reinvestment rather than the consumption of profits, a worsening of functional income distribution has not necessarily aggravated household income inequality.

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[62] World Bank, **Globalization, Growth and Poverty: Building an Inclusive World Economy,** Research Report, Oxford University Press, 2002, p. p. 31

By the end of the millennium economic activities, which are applied by the countries, has played a significant role in their economic development stage. Due to some of the features such as difference policy implications, natural geographic advantages and disadvantages and economies of scale, countries have different GNP density. (*Please see appendix B*). As it can be shown in the map Africa has a very low output density. However, industrialized countries have affected most of the countries.

Trade is central to globalization and the starting point of the discussions for developing countries and their policies. There are so many opinions about the relation between trade, total factor productivity and growth by the most of the authority and institution.[63]

The role of trade can be summarized as following:

- trade enlarged the markets
- it allows to reap scale economies
- it forced the domestic producers to be competitive
- it offered intensives and opportunities for new technologies

The most encouraging development in globalization is that some developing countries succeeded for the first time in harnessing their labor abundance to give them a competitive advantage in labor-intensive manufacturing and service sectors. In 1980 only 25 percent of the exports of developing countries were manufacturers; by 1998 this amount had risen to 80 percent.

The developing countries that have shifted into manufacturers trade are quite diverse. Another important change in the pattern of developing country export has been their substantial increase in export of service. In the early 1980s, commercial services made up 17 percent of the export of rich countries but only 9 percent of the exports of developing countries. By the effects of globalization the share of services in rich country export increased slightly – to 20 percent – but for developing countries the share almost doubled to 17 percent. The reason for this shift is changing economic policy. Tariffs on manufactured goods in developed countries

[63] Shaid Yusuf, **Globalization and The challenge for Developing Countries,** Report for Globalization, World Bank, DECRG, June 2001, p.p. 8

continued to decline, and many developing countries liberalized barriers to foreign investment and improved other aspects of their investment climate.

In the developing countries, for manufacturers and services, and the re – emergence of migration and capital flows, have affected poverty and the distribution of income between and within countries. Domestic policy choices unrelated to globalization also affect income distribution.

To conclude, since 1980 the global integration of markets in merchandise has enabled those developing countries with reasonable locations, policies, institutions and infrastructure to harness their abundant labor to gain a competitive advantage in manufacturing and service sectors. The initial advantage is in providing the cheap labor force. The increased export earnings financed more imports, thereby both intensifying competition and widening choice. Consequently, it can be said that other factors had a significant role in growth and that trade is not sufficient for growth.

3.3. Globalization and Development

Globalization refers to worldwide processes that change the world. Its economic system and its society become more uniform, more integrated, and more interdependent. Above all, Globalization is the process of the economy becoming worldwide in scope. It is a useful way to explain why the movement of people, goods, and ideas within and among world regions are becoming more and more important not only to economic but also to cultural, political and environmental systems.

The world economy is at work in creating a global cultural uniformity. Companies, societies, and individuals that were once unaffected by events and economic activity elsewhere now share a uniform economic world with other companies, societies and workers. The globalization of the economy has meant that national and state borders and differences between financial markets have become clearly less important because of a number of trends:

(1) *The globalization of finance*,

(2) *The increasing importance of transnational corporations*,

(3) *Global foreign direct investment from the core regions of the world*,

(4) *Global specialization in the location of production*,

(5) *Globalization of the tertiary sector of the economy,*

(6) *The globalization of the office function,*

(7) *Global tourism.*

3.4. Globalization of Finance

In the past, companies had some difficulties moving small amounts of money from one country to another. International monetary exchanges frequently involved cumbersome procedures that could tie up the funds for weeks until all the paperwork had been completed.

Modern telecommunications and transportation have made possible the technical aspects to move money, materials, products, technology, and other economic assets-factor flows – around the world.

The telecommunication revolution has allowed a single global capital market. Computers can now monitor and trade in national currencies stocks, bonds and annuities listed anywhere in the world instantaneously. Banks, financial houses, and corporations can operate worldwide partly because of the decision centers that control the global economy.[64]

The explosive growth of global financial activity since the 1980s and the complexity of global financial markets have transformed the management of developed economies. This growth provides significant opportunities for governments and corporations to tap into large and liquid capital markets and allows investors to earn the best return worldwide. However, while global financial markets play a key role in the worldwide allocation of capital, they do so in a manner that has profound implications for national sovereignty and autonomy.

Contemporary global finance is marked by both high intensity and relatively high volatility in exchange rates, interest rates and other financial asset prices. Exchange rate often diverges from values consistent with either interest rate differentionals or underlying national economic fundamentals. In a perfectly integrated global financial market this should not occur; rather, theory predicts that prices should adjust quickly to shifts in underlying economic conditions. But, as noted previously, large-scale speculative activity exists.

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[64] Frederick P. Stutz and Anthony R. de Souza, **The World Economy**,3rd Ed., New Jersey 1998, pp. 8-10

As a result, national macroeconomic policy is vulnerable to changes in global financial conditions.

Speculative flows had immediate and dramatic impact on the East Asian currency turmoil of 1997. Contemporary financial globalization has altered the costs and benefits associated with different national macroeconomic policy options, at times so radically as to make some options prohibitively expensive. These costs and benefits, moreover, vary between countries and over time in a manner that is not entirely predictable.

Besides these decisional impacts, contemporary patterns of financial globalization also have significant institutional, distributional and structural consequences for states in advanced capitalist societies.[65]

3.5. Globalization of Production

Today, globalization of production is organized in large scale by Multinational Cooperation (MNCs). Their pre-eminence in world output, trade, investment and technology transfer is unprecedented. Even when MNCs have a clear national base, their interest is in global profitability above all. MNCs have grown from national firms to global concerns using international investment to exploit their competitive advantages. Increasingly, however, they are using joint ventures and strategic alliances to develop and exploit those advantages or to share the costs of technological innovation. But the growing globalization of production is not limited to MNC activity, for over the last three decades there has been a significant growth in producer-driven and buyer-driven global production and distribution networks.
The globalization of business is thus no longer confined to the MNC but also embraces small and medium-sized enterprises.

MNCs, however, are the linchpins of the contemporary world economy. Around 53.000 MNCs account for at least 20 per cent of world output and on some estimates up to 70 per cent of world trade. Despite regional concentrations of production, transnational business networks span the three core regions of the world economy, linking the fortunes of disparate communities and nations in complex webs of interconnectedness. Contrary to the skeptics,

[65] David Held &Anthony McGrew, David Goldblatt & Jonethan Perraton, **Global Transformations,** UK, 1999, p.p. 227-228

MNC s are not simply "national firms with international operations", nor are they, as the hyperglobalizers argue, "footloose corporations" which wander the globe in search of maximum profits. Rather MNCs play a much more central role in the operation of the world economy than in the past and they figure prominently in organizing extensive and intensive transnational network of coordinated production and distribution that are historically unique. MNCs and global production networks are critical to the organization, location and distribution of productive power in the contemporary world economy. [66]

The MNCs are able to provide the developing world with new technology (called technology transfer). Today, MNCs develop profits from the foreign use of technologies that they have developed in the home country but that are now used in the foreign-based plants under their own control by a foreign subsidiary.

Transnational corporations evolve in four stages;

i- Demand abroad, was satisfied by export of a commodity from the corporations home country to a new foreign market

ii- The transnational corporation established production facilities abroad to supply these new markets. Export of the same item from the home country dropped.

iii- The foreign production facilities supplied foreign markets other than the local market first serviced.

iv- The foreign production facilities exported back to the home country products produced more efficiently.[67]

3.6. Globalization of Labor Force

Globalization is a process through which finance, investment, production, and marketing are increasingly dominated by agents whose vision and actions are not confined by national borders or national interests. While trade is becoming more free, labor unions are still

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[66] **ibid.** p.p. 282
[67] **op. cit.** p.p. 11-14

restricted from organizing in most countries. Labor is not a homogeneous resource, and market forces, including trade, can help one class of worker while hurting another.

The reason of workers move from one country to another is partly to find out better employment opportunities. Most migration in developing countries occurs between because of this reason. But the flow of migrants to advanced economies is likely to provide a means through which global wages converge. There is also the potential for skills to be transferred back to the developing countries and for wages in those countries to rise.

Summary

Basically, globalization can be defined as the growing economic interdependence of countries worldwide through the increasing volume and variety of cross-border transactions in goods and services and of international capital flows, and also through the more rapid and widespread diffusion of technology and international actions taken by states to create a new markets for capitalist countries".

The economic effects of Globalization can be summarized as follow;

- a large group of developing countries broke into global markets.
- other developing countries became increasingly marginalized in the world economy
- suffered declining incomes and rising poverty.
- the flows of capital and people across borders have also been important
- growth of trade
- migration
- diffusion of technology
- different culture in labor force etc.

The globalization of the economy has meant that national and state borders and differences between financial markets have become much less important because of a number of trends: (1) *The globalization of finance*, (2) *the increasing importance of transnational corporations*, (3) *global foreign direct investment from the core regions of the world*, (4) *global specialization in the location of production*, (5) *globalization of the tertiary sector of the economy*, (6) *the globalization of the office function*, (7) *global tourism*.

Modern telecommunications and transportation allowed the technical aspects of moving money, materials, products, technology, and other economic assets-factor flows – around the world.

The telecommunications revolution has allowed a single global capital market. Computers can now monitor and trade in national currencies stocks, bonds and annuities listed anywhere in the world instantaneously. Banks, financial houses, and corporations can operate worldwide partly because the decision centers that control the global economy.

Transnational corporations evolve in four stages;

v- Demand abroad, was satisfied by export of a commodity from the corporations home country to a new foreign market

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Chapter 4

SMALL ISLAND ECONOMIES

IV. DEFINING A SMALL ECONOMY

4.1. Smallness concept and Small Island Developing States

While defining the Small Economies, it's not possible to find out single and clear definition. Because the "size" term which becomes in relation with the "smallness" is relative concept. Additionally, by adding the term "island" to small economies, some economical determinants such as GDP, population, external trade volume, per capita income, technology level of country help us to understand about what they are. But population highly correlates with territory size as well as with GDP; therefore, use of population as a *main indicator* of size helps highlight small states limited resources.[68] However, *the main criteria are land area and population used in evaluations these types of countries because of the two main forces that are Supply and Demand determined by these values.* According to United Nations, the countries that have land areas up to 4000 km^2, are assessed as small countries.

As indicated in "*Economic Growth of Small Nations*"[69] by Simon Kuznets it's accepted that there is an upper limit of 10 million people. According to this view, 134 national economies can be accepted as small. In addition to this, there are some indicators such as territory size and GDP that are used in order to define the small island developing countries. However, certain characteristics and features shared by many states.

Economically, Small Island Developing States (SIDSs) depend on outside markets (often far away), they have scarce human capital, and they rely on a few products, such as bananas, sugar or tourism. SIDSs seek more secure market access, to be competitive, greater predictability, and diversification to reduce risk. But, in a globalizing world, it would not become easy.

Basically, the characteristics of Small Island Developing Countries (SIDSs) can be evaluated as following figure:

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[68] Richard L. Bernal, **The Integration of Small Economies in the Free Trade Area of the Americas,** Centre for Strategic and International Studies (CSIS) Policy Papers on the Americas, Volume IX, 1998
[69] Hiroshi Kakazu, **Sustainable Development of Small Island Economies,** Oxford Westview Press, 1994, p.p.1

Figure 4.1 Characteristics of Small Island Developing Countries

Characteristics of SIDSs

Geographical and Environmental characteristics

- small size
- narrow range of natural resources
- limited resource
- susceptibility to natural environmental events
- distance from continents and external competition fosters
- little overall climate variability but potential for climate upsets
- essentially distant from the other center
- dominance of the sea

Socio-economic characteristics

- external relations of trade, aid technology flows and investment
- more dependent on foreign trade than larger countries
- high dependence on the external sector and openness of their economies
- low economic resilience in recovering from shocks
- intimate association/relation between economic development and environmental assets
- narrow range of skills and specific difficulty in matching local skills with jobs
- dependence on tourism sector

Basically the SIDS(s) have some disadvantages. These disadvantages are classified under five headings, namely: ***(a) small size; (b) remoteness and insularity; (c) disaster proneness; (d) environmental fragility; and (e) other factors.***

In both economic and environmental terms, the risks for small countries are high. Due to have small size the sudden "*shocks*" which might be occurred can affect whole sectors or islands. As a result, "*resilience*" to shocks becomes a desired policy goal, flexibility, recovery, and insurance against disasters.

Additionally, the following features can be observed in SIDSs;

- small states have higher levels of per capita income than larger states,
- small states have on average the same growth rate as larger states;
- small states have more volatile growth rates; but
- There are unexploited opportunities to reduce the adverse impact of volatility by diversification via international financial markets.

4.2. Characteristics of Small Island Developing States

The following characteristics have important implications for development and are shared by many small states:[70]

- ***Small Size and Limited Natural Resources***. The size of a country can be measured in terms of its population, its land area or its gross national product. As it was understood from their names, smallness is a common and basic characteristic of SIDSs, but some of them are extremely small. Small size often implies poor natural resource endowment and low inter-industry linkages, which makes the economy highly dependent on foreign exchange earnings.

- ***Limitations on import substitution possibilities***. The small size of a domestic market severely limits import substitution possibilities. In many SIDSs, import substitution policies were adopted, higher prices and a parallel market in nondomestically produced goods.

- ***Remoteness and insularity.*** Generally, they are located far from major markets and some are widely dispersed multi-island microstates. The remoteness and isolation of many small states, particularly in small economies, has significant economic and administrative implications. Isolation means that these countries are far from the major centers of trade and commerce center.

It becomes more difficult to establish a market linkage between major and domestic market because of limited size.

Small economies also pay higher transportation costs because of the relatively small volume of cargo, small cargo units. High international transport costs serve to increase the cost of exports, thereby reducing their competitiveness and reducing export returns.

When the limited domestic market size combined with large distances from overseas markets normally reflects as lack of competition; in some instances the size of the market can only support a single producer. As a result, the economies of small states do not benefit from the effects of competition on improving efficiency, lowering costs, and spurring innovation.

- ***Small domestic market and dependence of export markets.*** SIDSs have small domestic market and relatively large amount of foreign exchange to pay for the large import accounts.

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[70] **ibid.** p.p.5

And also they have high dependence on exports by regarding the economic conditions in the rest of the world.

- ***Dependence on a narrow range of products.*** In many cases, small size restricts the country's ability to diversify its exports, and this renders the country as dependent on a very narrow range of goods and services.

- ***Limited ability to influence domestic prices.*** SIDSs have negligible control on the prices of the products they export and import. All developing countries are able to called as a price takers, but SIDSs are price takers due to the relative very small volume of trade in relation to the world markets in products they import and export.

- ***Limitations on domestic competition.*** Domestic competition tends to be curtailed in small economies due to the fact that small size does not support a large number of firms producing a similar product. This situation creates the concept of oligopolistic and monopolistic organization.

- ***Susceptibility to natural disasters.*** Most small states are situated in regions, which are highly susceptible to natural disasters, and they are frequently affected by adverse climatic and other natural events which, typically, affect the entire population and economy. They may also be susceptible to severe environmental and ecological threats. Such type of natural disasters and ecological threats affect their economic situation. Notably, the entire physical environment, population and economy are affected neighboring countries.

- ***Limited institutional capacity.*** Sovereignty necessitates certain fixed costs of providing public services, including policy formulation, regulatory activities, education and social services, justice, security, and foreign affairs. Indivisibilities in the provision of these public goods mean that small states face higher costs per person unless ways can be found to pool such costs, for example on a regional basis.

- ***Openness.*** Openness to trade means that small countries have a larger and a stable trade environment than the world trade. While most small states produce a relatively narrow range of goods and services, they consume a wide range of them and, as a result, they have high trade to GDP ratios Participation in the world market also helps to channel new ideas and information about opportunities to firms and consumers in small states. Openness to capital flows is important for small states. Like other developing countries, they stand to benefit from foreign direct investment flows. Many small states depend heavily on official development aids in order to help their financial development.

- ***Limited diversification***. Because of their narrow resource base and small domestic markets, many small states are necessarily relatively undiversified in their production and exports. So capacity in the private sector is also limited, posing difficulties when faced with a need to respond to changing external circumstances. It should be noted that a major reason why small size may be disadvantageous is that it constrains the opportunities for diversification, and promoting efficiency through domestic competition

- ***Access to external capital***. Access to global capital markets is important for small states, and is one way to compensate for adverse shocks and income volatility. But the evidence is that private markets tend to see small states as more risky than larger states, so that spreads are higher and market access more difficult.

- ***Poverty and Income volatility.*** There is some evidence that poverty levels are higher, and income distribution more uneven, in smaller than in larger states. The people who live in small states have higher volatility in their incomes than people living in large states.

The main causes can be explained as follow;

- the economies are more open to fluctuations in world market prices because in small states a much larger share of domestic economic activity is accounted for by exports and imports than in larger economies
- small states have relatively undiversified production and exports
- many of the small states are particularly prone to natural disasters, which because of small size affect the whole community.

Major contributor sector: Tourism. Tourism is often identified as a main sector in SIDSs, it has become the major contributor to the gross domestic product (GDP). Tourism has many linkages with other economic sectors, and if integrated into national development plans with adequate provisions for intersectoral linkages, it can contribute to the growth of all tourism-related activities in all of the major economic sectors - agriculture, including fishing, industry and services, including transportation. The importance of these factors varies widely among small states. Small island developing states must orientate their national development policies outwards to the rest of the world.

As per capita incomes steadily rise, tourism has become the largest industry in the global economy.[71] According to the World Travel & Tourism Council, it accounts for 11.5 per cent

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[71] http://www.ourplanet.com

of the world's GDP and 12.5 per cent of its employment. Small island states have long benefited from this growth: in some Caribbean nations, for example, tourism employs as much as 25 per cent of the workforce, contributes some 30 per cent of GDP, and provides the bulk of foreign exchange earnings.

Foreign direct investment brings not only capital but is often critical in linking the more isolated small states to developments abroad. Foreign firms can be an important source of know-how for improving private sector capacity and providing information on new technologies and market opportunities.

Even when they have good policies for development by regarding the domestic producers and investor it can be said that *foreign direct investment*s creates an risk.

Private sector capacity. Most firms in small states are small, largely because small domestic markets and poor endowments of physical resources limit entrepreneurial opportunities. Small firms are at a disadvantage because they cannot realize economies of scale (which are important in some sectors), are not attractive business partners (often because they are less well known and hence are perceived as unreliable), and cannot spend significant funds on marketing, market intelligence, and research and development.

Competitive advantage is more likely to occur when the domestic economy is large enough to support clusters of firms in any given sector, with horizontal and vertical relationships. Small size and isolation also limit development of new knowledge and technology oriented to the domestic market.

Moreover, small firms in small states are often nevertheless monopolies or oligopolies in terms of the local market, without the advantages of the spur of local competition. Regulating local monopolies is often too great a challenge for a thinly spread administration. Moreover, the task can be made more difficult in some very small states when the regulator and the regulated are from the same family or childhood friends; or where the local monopoly is owned by a large and powerful overseas investor.

Summary:

1- In order to define the SIDSs economy there is no single definition. Because, the size and smallness is relative concepts.

2- The population, territory size, GDP is main determinants for these type of countries.

3- The main characteristics of SIDSs can be divided under two headings namely; (a) Geographical and Environmental characteristics and (b) Socio-economic characteristics.

4- The SIDSs have some disadvantages. These disadvantages are classified under five headings, namely: (a) small size; (b) remoteness and insularity; (c) disaster proneness; (d) environmental fragility; and (e) other factors.

5- The following characteristics have important implications for development and are shared by many small states;

- Small Size and Limited Natural Resources
- Limitations on import substitution possibilities
- Remoteness and insularity
- Small domestic market and dependence of export markets
- Dependence on a narrow range of products
- Limited ability to influence domestic prices
- Limitations on domestic competition
- Susceptibility to natural disasters
- Limited institutional capacity
- Limited diversification
- Openness
- Access to external capital
- Poverty and Income volatility

Chapter 5

FINANCIAL SECTOR DEVELOPMENT

V. FINANCIAL SECTOR DEVELOPMENT

In this chapter it will be focused on the impacts of financial sector to economic growth by regarding the SIDSs. While analyzing the concepts of financial sector and economic growth, the following questions come to minds?

- What are the main factors, which become in back of economic growth?
- What is a good financial system?
- Why is financial sector development important for growth?

Basically, these questions can be reply on as following;

5.1. Definition and role of the financial sector

An efficient financial sector is on of the pillars of a well functioning market economy and it can be said that a well performing financial system is expected to promote growth by positively influencing the rate of accumulation and efficiency of capital.[72] The financial sector forms the structure of arrangements in an economy, which facilitates the conducts and growth of economic transactions through the use of money for payments, savings and investments.

5.2. Savings, Investment and Economic Performance without a Financial Sector

In order to understand the role of the financial sector in enhancing economic performance, it is useful to stress the importance of financial instruments. Without financial instruments each household would necessarily be self-financing and would make autonomous savings and investment decisions without regard for the opportunity cost of using those resources elsewhere in society.

Basically, three fundamental decisions which influence economic performance:

1- How much to save and how to allocate the flow of savings
2- How much to consume; and
3- How to allocate the existing stock of wealth -- would depend on each autonomous household's opportunities, present and expected future income, tastes, health, and family composition, the costs of goods and services, and confidence in the future.

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[72] www.erf.org

In fact, this growth achieved exacerbated existing problems of financial systems, and some external and internal risk management and control systems which has applied in these countries has become inadequate level.

It consists of financial policies and financial infrastructure, which support the financial system. (Institutions, instruments and markets)

Basically, the components of financial sector can be implied as follow briefly;[73]

- *Financial policies* relate mainly to the money supply, interest rates, public deficit financing and the provision of financial services.
- *Financial infrastructure*, consist of the support for financial transactions, the practices support for financial transactions, the practices surrounding audit, accounting, and the operations of the payment system
- *Financial institutions* include, government entities such as central banks, national debt offices financial supervisory authorities, insurance companies, and other specialized institutions

The main functions of financial sector are the following;

- To reduce transaction cost by providing a stable and widely acceptable medium of exchange[74]
- To encourage savings in financial instruments with attractive yields and different maturities
- To make risky investment practicable by pooling, pricing and redistributing risk of financial assets

The *main objective* of the financial system is *to ensure that savings from surplus economic units are efficiently mobilized and shifted to high yielding investments in deficit economic units with an appropriate balance of risk.*

The adequacy of financial institutions, instruments and markets can affect the volume of financial savings mobilized and the efficiency with which they are allocated to productive uses.

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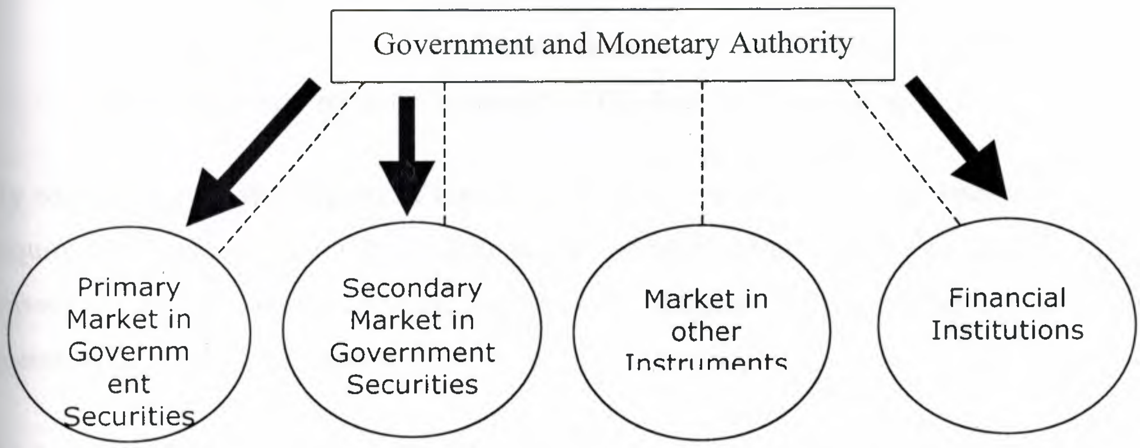
[73] http://www.sida.se

[74] It is one of the functions of money. Money is any generally accepted means of payment for delivery of goods or settlements of debt and it is medium of exchange.

It is the task of the government to create this confidence and to enable the environment for the operations in the financial markets.

The government should make sure that the actors in the market perform in the interest of customers, investors and savers. The role of governments is therefore to regulate, monitor and supervise the financial system as well as to promote competition within the system.

Figure 5.1. The role of Government in Financial System



----: Supervise, regulate, or insure

Source: The Role of the Financial Sector in Economic Performance, Working Paper 95 – 08 edited by R.J Herring and A.M. Santomero, The Wharton School University of Pennsylvania, p:26

Government regulation may impose many different kinds of cost on the financial system. These costs must be clearly recognized and weighed to provide a balanced assessment of regulatory policy. [75]

[75] R.J Herring and A.M. Santomero, **The Role of the Financial Sector in Economic Performance,** Working Paper 95 – 08, The Wharton School University of Pennsylvania, p.p. 36

These include:

1- *direct cost such as fees, reserve requirements and taxes*: these costs is perhaps the most obvious. Costs, which result from Central Bank action, have direct transfer effects from the industry to the government sector.
2- *changing of market prices that are the result of regulations which cause misallocations of economic resources:* The second type of cost arises when market signals are distorted by the presence of regulation.
3- *regulations which cause uncompensated transfer of wealth between private transactions:* this cost of regulation centers on intersectoral effects. To the extend that regulation favors one sector over another, a comprehensive evaluation of such regulation should include the impact of this transfer on social welfare.

By considering the risk factors of investors in financial markets, the regulatory authority may require that banks partially insure their deposits with private insurance companies. Although private insurance companies could not provide complete fully credible deposit insurance against risks might be a solution.[76]

As a result financial markets are critical to the development of a modern economy. Indeed effective financial markets require a suitable regulatory, legal and judicial framework.

The development of domestic capital markets is key in reducing reliance on short-term bank funding for financing longer-term investments. Governments can do many things to help develop capital markets. They can:

- pursue prudent macroeconomic policies,
- abstain from capturing savings through preferential savings-schemes,
- establish benchmark yield curves for long-term corporate bonds through the market-based issuance of long-term Government paper,
- harmonize the tax treatment of various financial instruments,
- develop the institutional investor base through pension and insurance market reforms,
- increase the supply of blue-chip share issues through privatizations,
- create the necessary market infrastructure and legal and regulatory framework for securities.

[76] **ibid**. p.p. 37

In a market economy, the financial sector has a special role, due to mobilizes resources and allocates them to those investments that are capable of generating the highest returns on capital. Financial sector can better perform this role, and the better and stable economic conditions can be created in the long run.

The impact of the financial sector on the real economy is subtle and complex. What distinguishes financial institutions from other firms is the relatively small share of real assets on their balance sheets. Thus, the direct impact of financial institutions on the real economy is relatively minor. Nonetheless, the indirect impact of financial markets and institutions on economic performance is extraordinarily important. The financial sector mobilizes savings and allocates credit across space and time. It provides not only payment services, but more importantly products which enable firms and households to cope with economic uncertainties by hedging, pooling, sharing, and pricing risks. Financial systems that are more effective at pooling the savings of individuals can profoundly affect the economic development. Besides the direct effect of better savings mobilization on capital accumulation, better savings mobilization can improve resource allocation and boost technological innovation.[77] Thus by effectively mobilizing resources for projects, the financial system may play a crucial role in permitting the adoption of better technologies and thereby encouraging growth. Briefly, an efficient financial sector reduces the cost and risk of producing and trading goods and services and thus makes an important contribution to raising standards of living.

5.3. The causal relationship between financial development and economic growth

It can be identified two possible causal relationships between financial development and economic growth. The first one called as *demand following* - views the demand for financial services as dependent upon the growth of real output and upon the commercialization and modernization of agriculture and other subsistence sectors. Thus the creation of modern financial institutions, their financial assets and liabilities and related financial services are a response to the demand for these services by investors and savers in the real economy[78] On this view the more rapid the growth of real national income, the greater will be the demand by enterprises for external funds and therefore financial intermediation, since in most situations firms will be less able to finance expansion from internally generated depreciation allowance

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[77] Ross Levine, **Financial Development and Economic Growth,** Views and Agenda, The World Bank, Policy Research Department, Finance and Private Sector Development Division, October 1996, p.p. 22
[78] Patrick H.T, **Financial Development and Economic Growth in Underdeveloped Countries,** Economic Development and Cultural Change, 14, 174-189

and retained profits. The financial system can thus support and sustain the leading sectors in the process of growth. In this case an expansion of the financial system is induced as a consequence of real economic growth.

The second causal relationship between financial development and economic growth is termed *supply leading*. Supply leading has two functions: to transfer resources from the traditional, low-growth sectors to the modern high-growth sectors and to promote and stimulate an entrepreneurial response in these modern sectors. This implies that the creation of financial institutions and their services occurs in advance of demand for them.

Thus the availability of financial services stimulates the demand for these services by the entrepreneurs in the modern, growth-inducing sectors.

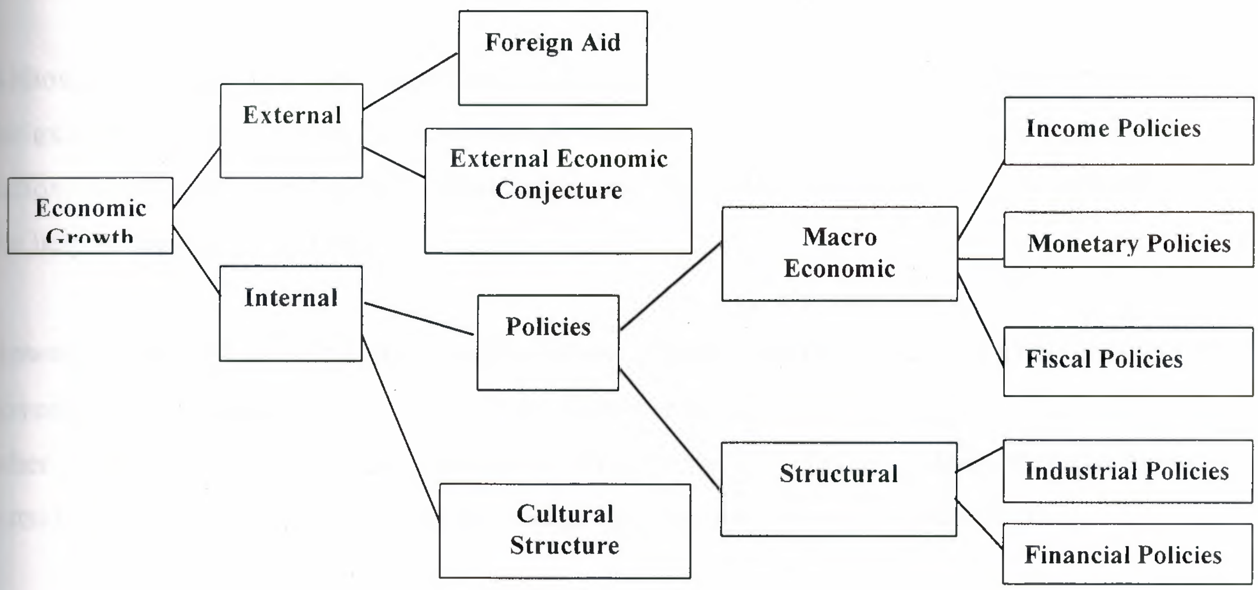
Many Asian countries achieved significant economic growth rates. However, this growth has not been sustainable, as the Asian financial crisis showed. Basically, these financial crises have occurred from the following reasons: [79]

- the weaknesses of regional financial system which included the absence of well developed domestic capital markets
- severe deficiencies in financial governance practices
- unsustainable foreign exchange rate policies
- sudden loss of confidence in these economies
- sharp depreciation of their overvalued currencies

[79] http:/www.adb.org

In briefly, the factors that affect the economic growth can be summarized as following figure:[80]

Figure 5.2. Main Factors of Economic Growth



Source: *Murat Yülek,* ***Asya Kaplanları: Sanayii Politikaları ve Kalkınma****, Alfa Press, 1998, p: 6*

External factors had played a significant role in its growth stages of Asian countries; especially, the rapid growth rate of western countries in 1960s had affected the Singapore, and it's occurred the import demand for Asian countries. Secondly, United States of America (USA), and some European countries (especially; Germany and England) and Japan have shifted their production systems into the countries, which have cheaper labor force.

Additionally, USA, by changing duty regulations, has recorded a decline in their cost of good sold (COGS), and Japan, Germany and England had followed the USA respectively.

Thirdly, the USA has supported the Asian countries such as South Korea, Taiwan, and Japan, in order to break down the communist block in Asia.

Foreign aids were not be affected the development stages of these countries directly, but it has an effect in lower level.

80 Murat Yülek, **Asya Kaplanları: Sanayii Politikaları ve Kalkınma,** Alfa Yayıncılık, 1998, p.p. 6

Cultural structure is the one of the main factors that plays an important role in development stage of these countries: honesty, loyalty, hard working, to seeking national prestige are certain characteristics of economic development. [81]
The significant point, which is necessary to be underlined, is the *economic policies*, which have been applied by government.

Although these policies have common points, in oppositely, they also have different points: for example, in the concept of foreign investment, South Korea and Japan have performed a nationalist approach; on the other hand Singapore and Malaysia have recorded the growth by the help of foreign investment.

However, there are some common points of these policies applied. Especially interventions of governments and applied industrial policies can be evaluated as a common point. One of the other common points in these countries is the economic policies. Instead of focusing on outside of country, they preferred to encourage their investment inside of the country.

Many small island developing states, some of which are independent states, have a relatively large financial sector and they serve as off – shore financial centers in different parts of the world. As it was defined in chapter 4 due to some features of small islands (that are small size, narrow range of natural resources, limited resources, distance from continents and external competition) some economic activities were not adequate and many islands have therefore had to seek alternative routes for economic development with tourism and financial services.

However, it can be understood why many island succeed in tourism, and some features help to understand the background of success, such as warm climate and sea, sand and sun endowments attracting tourist and also tourism policies implied properly.

On the other hand, another significant concept which is called as "*financial sector*" has also been successful in many small developing islands. This type of economic activities demand specialized personnel - (often a scarce commodity in small island) – and requires that the host country keep peace with global technological developments in financial services.

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[81] **ibid.** p.p. 7

What is the relationship between a country's financial development and its economic growth? And how do a country's financial development and economic growth relate in the global economy? In particular, is there a relationship between domestic financial development and participation in global capital markets?

These are the broad questions that imply the financial sector development for economic growth. To address the questions and to attempt to answer them it's necessary to define what is the good financial system.

5.4. Financial System Components

Basically, a good financial system has five key components. [82] These components are;

- sound public finances and public debt management
- stable monetary arrangements
- a variety of banks some with domestic and others with international orientations
- a central bank to stabilize domestic finances manage international financial relations
- well – functioning securities markets

5.4.1. Public finance

The first components in list of financial system refer largely to historical reasons. In economies, good financial systems emerged out of the needs of the nation state for financing - often to fight its wars with other nation states. Sound public finance includes setting and controlling public expenditure priorities, raising revenues adequate to fund them efficiently.

5.4.2. Stable money

Money is useful as a medium of exchange, a store of value and a standard of deferred payments. All three functions uses, but especially the latter two are harmed if money fluctuates and depreciates in value in unpredictable ways.

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[82] http:/www.nber.org

5.4.3. Banks and Banking

These concepts have played large roles in modern economies. Once a monetary base is specified, banks of deposit, discounts and note issue amplify it into a money stock that consist largely of blank money convertible into the monetary base. They do this by granting credit to entrepreneurs and other users of funds.

A lot of the risks that banks manage arise from borrowing short and lending long. Individual banks and banking systems become troubled.

Banking systems dominate the financial sectors of SIDSs. In order to be productive in financial sector, the policies, which are applied by banks, have importance. The significant Banking Criteria that affect the financial sector development in the 21st century can be summarized in following table[83]:

Table 5.1. Significant Banking Criteria Affecting The Financial Sector

General:
Suitable and elastic pricing policy
Efficient marketing policy
Image and prestige
Reliability
Efficient usage of technology
Customer orientation
The power of find out sources
Ability to ensure the adaptation into changing market condition
Service quality
Ability to provide new banking services
Product variety
A good number of investor customers
A good number of customers taking credit

For potential individual market:
Service quality
Taken commissions by banks
Reliability
Expected yield
Behaviors against customers
For high-income customers:
Service quality
Reliability
Expected yield
Product variety
Behaviors against customers
Importance of secrecy
International relations
Previous experience and relations
Taken commissions and fees

[83] www.tbb.org.tr

Meanwhile the efficient usage of advanced technology will play an important role in choosing bank for high-income customer.

The concept of "*customer service quality* and *reliability*" has been accepted as the most significant criteria in banking sector by considering the financial sector development. Another concept, which is the *power of finding source*, will be less important in the 21st century.
By combining the efficient usage of technology and distribution and communication channels in 21st century will be important for all banks apart from big-scaled banks. This opinion has been accepted by all banks around the world and also in SIDSs.

5.4.3.1. Distribution Channels of Banking and Financial Services

The distribution channels of banking and system of financial services have become more complex. Today the phone banking system and Automatic Transaction Machines (ATMs) have been used by most of the countries. Additionally, the usage of Internet financial services has increased rapidly.

Generally the people who use the Internet in their financial transactions are high-income people. So, the contributions to profitability are significant. At the same time Internet provides the financial information and mediation possibilities to the people.

The first contribution will be to the "Relationship Banking System". On the other hand, the services and products will be various and the competition will only be on prices of activities. On the customer side, they will be able to compare the prices of provided products easily. Therefore, the banks will have to evaluate their objectives and services once again and some concepts -such as quality, productivity, quick respond – will be more important.

5.4.3.2. Human Resources in Banking and Financial Services

Although most of the banks prefer the usage of the advanced technology in their activities, any decrease in the number of human resources has not been observed. Generally, banks prefer employing skilled personnel. The banks, which expect are decrease in numbers of personnel, they have shown the increased use of information technology as their reason.

5.4.3.3. The Cost Management in Banking Sector

There are some techniques in order to decrease the costs of banks or to increase the operational productivity. The most important of these can be summarized as:

- to use the technology efficiently
- to improve the knowledge, experience and abilities of personnel
- to reorganize the following of work to increase the productivity
- to improve cost management etc.
- to increase the motivation of personnel
- to provide educational programs
- to outsource some services

The services outsourced, can be explained as follow:

- accounting service
- internal supervision
- operation services
- human resources consultation
- tax consultation
- system operation
- management consultation
- law
- education
- system development

5.4.3.4. The Information Technology in Financial Sector

The role of information technology in financial and banking sector can be summarized as follow:

- to increase the ability of quick respond the needs of market
- to increase the ability of responding to the demands for special product or services of individual and institutional customer
- to provide the information which will manage the cost and risk
- to constitute environment to share the knowledge and to increase the creativity

- to increase the quality of product and services
- to increase the speed of process
- to provide the required information for financial report

5.4.3.5. Performance Measurement in Banking Sector

Performance measurements of banks can be evaluated under two headings:

a) The Financial Indicators

In performance measurements of banks the following information can be obtained through financial indicator:

- yield through profit centers
- profitability of departments
- profitability of branch offices
- credit portfolio
- total assets
- the yield of assets
- profitability of product
- profitability of customer
- profit level of operation

b) The Non-financial Indicators

While evaluating the following information, can be used non-financial indicators:
- the number of branch offices
- the number of customer per branch office
- error rate
- complaints of customers
- productivity of working people
- market share
- pressure of customer

5.4.3.6. Risk Management in Banking Sector

In order to be able to provide an efficient risk management, the following factors are needed:

- well- trained managerial staff
- efficient internal supervision
- highly educated and skilled personnel

Technologic infrastructure, written policy and procedures should support the factors mentioned above.

Nowadays, in developed financial markets of the world, the risk management is important for regulatory institutions operating within those markets.

In 1990s due to financial crises some of the big scale financial institutions have been greatly effected. The main reasons for this were consequence inadequate supervision system, unbalances in risk concentrations, inadequate policy and procedures.

In addition to these factors others such as-inadequate managerial staff, technique infrastructure-concepts have also played important role by increasing the risk. On the other hand, technology will also be efficient in solving of risk management problems.

5.4.4. Central Banks

The fourth of key components of a modern financial system can prevent such problems from arising, or at least alleviate them when they do arise. They do this by monitoring and regulating the operations of individual banks in a banking system with the goal of preventing problems.

Central Banks also act in the areas of other financial system components. For example, they often serve as the government's bank that is as an adjunct of public finance. And they act to stabilize the value of a country's money, both domestically and internationally

5.4.5. Securities markets

The last components facilitate the issuance of public and private debt securities and private equity securities. Specialized banks - investment or merchant banks - serve here as financial intermediaries between the borrowers / issues (governments and business enterprises) of bonds, stocks and other forms of securities and the lenders / investors who purchase securities.

Another important theme associated with financial service activities is to scope and incidence of international regulation.

Higher returns on financial instruments may encourage saving; but higher returns also enable savers to achieve a target stock of wealth with a lower rate of saving. Thus in theory the impact of expected returns on the overall savings rate is ambiguous. Empirical studies across a number of countries have not been able to resolve the question. Nonetheless, higher returns on financial instruments will induce households to allocate more savings to financial instruments than to real assets (and, in an open economy, to shift from foreign to domestic assets). Efficient financial markets will allocate financial claims to projects which offer the highest, risk-adjusted returns and so income and total savings are likely to rise even though the savings rate may not.

5.5. Key Constrains on Financial Sector Development

A well-developed financial sector plays a central role in promoting economic growth in a country. It raises the savings rate and improves the transformation of savings into more productive investments, by efficiently allocating these resources among competing investment projects.[84]

The most important constraint on financial sector development is *slow economic growth,* which has limited the demand for improved credit provision and accumulating savings. If financial sector are to develop faster, the rate of growth in real sector activity will accelerate.

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[84]Asian Development Bank, **Financial Sector Development In The Pacific Developing Member Countries,** Philippines, 2002, p.p. 143

Faster sustained economic growth requires increased private sector investment to be supported by good quality public investment in physical and human capital.

Financial sector development also has been retarded by intrasectoral constrains through appropriate policy changes.

The following deficiencies are constraints for financial sector;[85]

- **Lack of competition in banking sectors:** Competition is hindered by the high level of concentration of foreign banks and by the large amount of excess liquidity in the banking systems, which is reflected in high net interest margins.

- **Poor governance:** Poor governance has been a general issue in all SIDSs and has increased the risk for and affected the performance of government owned financial institutions and for banks in most SIDSs. There has been a high level of government involvement and in some cases political interference, and as well as in some areas of lending. Such interference combined with poor management, inadequate pricing of risk, a lack of appropriate supervision, weak loan appraisal and accounting systems has affected the financial sector performance.

- **Inadequate supervision:** Supervisory function is particularly important in small, uncompetitive financial sector. Despite an improved legislative environment for supervision and strengthened supervision activities, the quality and effectiveness of central banks' supervisory capacities still needs upgrading. Briefly, improved supervision capacities will increase the scope for adding financial products and services and improving financial intermediations.

- **Obstacles to development of money and bond market:** the lack of autonomy and low profitability of central banks, together with the high liquidity of national provident funds has hindered the development of money and bond markets.

[85] **ibid.** p.p. 147 -151

5.6. Financial Service Location and Competition among Financial Centers

Competition among financial service centers can be evaluated as a reason for economic growth. There are important national and regional centers in many countries for the financial service operations and some of them have a characteristic as a major specialist centers such as Luxembourg, Liechtenstein, Malta, Monaco, etc. These centers focus on particular activities such as offshore fund management, tax and financial planning and the provision of a range of ancillary services complementary to other operations including group treasury, insurance and collective investments for the firms in the principal centers. By considering the competition concept for these centers six activities play an important role. These activities can be implied as follow:[86]

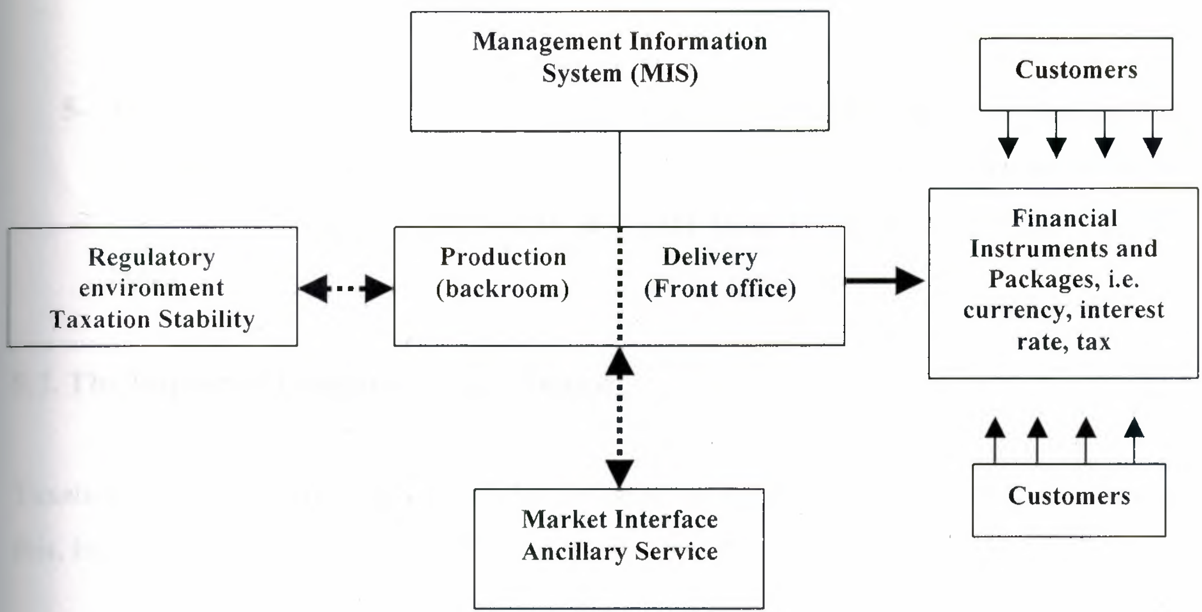
- financial packaging
- delivery system
- production activities
- regulation
- management information system
- market interface

These various components used to be carried out in the one location but market and technological advances in recent decades have made it possible for them to be geographically separated.

Location decision in financial service activities is made by financial enterprises engaged in the provision of financial services and these location decision govern the business in financial centers. In figure 5.3 the financial service operations will be implied schematically:

[86] Marvyn K. Lewis, **Banking and Finance in Islands and Small States**, London, p.p.10

Figure 5.3. Representation of Financial Service Operations



Source: Marvyn K. Lewis, **Banking and Finance in Islands and Small States**, p: 10

Financial Instruments provided to customers can be regarded as packaging together a number of financial characteristic currency term to maturity, interest rate structure tax obligations.[87]

1- Delivery or front office activities involve contact with the customer and often require intensive use of human resources when financial products are "sold" rather than "bought" included in this category are bond transactions, credit evaluation, investment management.

2- Back office or production activities are process of a repetitive nature such as transaction processing, loan application processes and servicing, credit accounting.

3- Regulatory environment denotes that this production takes place within an economic setting under a set of regulatory rules and conventions and taxation arrangements and political and currency stability.

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[87] **ibid.** p.p.10

4- Management Information System embrace human resources management, inventory control, strategic planning cost control and profitability analysis and risk exposure and management treasury operations.

5- Market interface involves access to news and market information services and use of accounting and legal services while provisions of payment services by banks relies upon correspondent arrangements and inter bank cooperation through the clearing house.

5.7. The Impact of Taxation in Small Island

Taxation concept has also influenced the financial activities. The opinion, which will support this, has been made by R. A. Johns: [88]

" ...Taxation has also influenced the geography of finance and the favorable tax and business regimes offered by various islands and small states have produced a worldwide proliferation of financial centers..."

The small states in Europe are Andorra, Cyprus, Iceland, Liechtenstein, Luxembourg, Malta, Monaco, and San Marino. With the rise of global financing came an associated demand for centers in law tax, stable economies where fund raising can be deposited and intra firm financing made facilitating cash management and tax planning at an international level. These centers are also bases for investment trusts, captive insurance and international pension schemes. Many of the operations are of a wholesale nature, closely linked to head office.

Success as an offshore location begins with the domicile having political economic and fiscal stability and a stable local currency. In addition to this, it must have solicitors, accountants stockbrokers and other professionals providing management and fiscal services along with good communications in the same time zone as a major centre to allow a link – up with onshore operations.

[88] Johns R. A, Offshore Banking, **New palgrave Dictionary of Money and Finance,** Mac Millan Press London, Vol 3, 1992

An appropriate mix of financial secrecy, company laws, taxation, accounting requirement, reporting requirements, entry requirement, licensing and regulations are required. The aim is to achieve a long run reputation for business stability and security of investment. Solvency and prudential oversight are needed for depositor and investor protection. Regulation must be flexible according to new changes.

5.8. Requirements for an efficient Financial Service Activity

For an efficient financial service activity the following conditions are provided:[89]

Table 5.2. Requirements for an efficient Financial Service Activity

1- Space Requirements	**2- Labor Pool**
- Availability of Greenfield sites - Land price - Property prices - Office rents - Quality of office space	- Supply of labor - Male / female mix - Labor turnover - Cost of labor
3- Labor skill	**4- Communication**
- Data processing skills - Keyboard skills - Facility with computers - Graduate recruitment	- Advance telecommunications - Fiber optic, satellite links - Road transport links - Rail – high speed trains - International / domestic airlines
5-Technological Facilities	**6- Complementary Service**
- Computer hardware - Software system - Automated delivery systems - Head office and branch facilities - Networking capacity - Access to data base	- Accounting and Tax advise - Legal service - Management service - Real estate - Property management
7- System Security	**8- Quality of Life**
- Bank robbery - Labor union disruption	- Standard of housing - Cost of housing - Education - Cultural activities - Recreational facilitates

Source: *Marvyn K. Lewis,* ***Banking and Finance in Islands and Small States****, p.p. 19*

[89] Marvyn K. Lewis, **Banking and Finance in Islands and Small States**, p.p. 18

5.9. Evaluation of Asian Countries' Economic Performance

The summary of the economic growth in Asian countries, Japan is the leading nation in the region: its gross national product at the beginning of 1960s was less than 10 per cent of US GNP, but, by the end of the 1980s the proportion had risen to 40 per cent. It had taken 30 years for Japan to achieve what the United States achieved in 90 years.[90]

Today, Japan is the world's second largest economy, third largest trader and largest capital exporter. But on the other hand, it's a mistake to think of rapid growth in terms of Japanese experience alone. The "Asian tigers" namely Singapore, Taiwan, Hong Kong, Malaysia, and Thailand have average growth rates well above the Japanese rate at the same stage of development.

The final piece in this rapid development is the comparatively recent emergence of China. The amazing growth performance of these countries can be summarized with the following common explanations:

- Advantages nature of the geographical location of nations in the region. All the six nations mentioned above are in comparatively close proximity and their development has been stimulated by the expansion of interregional trade. (Close proximity means lower transport cost and a competitive advantage over nations exporting from a greater distance.)
- A second explanation is the shared cultural tradition of the region. However, there are element of great tradition of East Asia which relate to the rate of economic growth, these elements can be implied that – high value placed by East Asian communities on disciplined formal education, social cohesion and capacity to accept unpopular reforms, the work ethic of these communities and the common attachment to a growth ideology.
- The form and style government might be one factor for growth. But it does not seem to influence the pattern of growth, for example while Japan is a parliamentary democracy, on the other hand China is a dependent on a Chinese interpretation of Marx and Lenin with a substantial legacy of central planning.

[90] Bruce Felmingham and James W. Dean, **Banking and Finance in Islands and Small States,** Financial Deregulation and Offshore Banking: Lesson for Malta from Australasian / Asia – Pacific Experience, p.p. 36

- Finally, the size of the Asian economies does not impede growth. Singapore and Hong Kong are small city – state whereas China and Japan are Asian giants.

When considered the role of government in the stages of economic growth of East Asian countries, it can be implied two different opinions:[91]

- According to Neoclassic opinion, the role of government has limited with some service that are to providing economical stability, to providing education and to provide technical infrastructure. Apart from, these, its claimed that the government has no intervention in determining the price of goods of financial activities.
- Another opinion which as called as Revisionists, in oppositely, defense that the government plays an important role in determining price.

Actually, the policies which were applied in these countries can be divided into two groups: *Macroeconomic and structural policies.*

In the *macro economic policies*, the concept "*excess of budget*" has been observed for all countries in East Asia. However, this concept has been adjusted with the industrial policies harmoniously. Income policies are significant at least as much as monetary and financial policies. *In the first stage of growth, government by encouraging the foreign investment, it has increased the competition.* When the rate of employment increased, the wages has hold under pressure for a specific time. After this process, it has been passed to the policy of "*high wage – high value added" (i.e. policy that aims to protect the local and strategic industry)* has been applied.

[91] Murat Yülek, **Asya Kaplanları: Sanayii Politikaları ve Kalkınma**, Alfa Yayıncılık, 1998, p.p. 11

There are some significant points in order to be made more effective the financial systems[92];

- Governments should improve the resource allocation processes by allowing greater use of market-based mechanisms.
- Regulations of interest rates should allow financial institutions to determine price of financial products in accordance with the "risk" concept.
- Financial sector policies should encourage competition by creating a level between domestic and foreign, and between private and state-owned financial institutions.
- Market regulation and supervision are fundamentally significant for an efficient financial market. Because of this reason, a regulatory framework should be established which has considering dependent regulatory bodies with sufficient enforcement powers, a transparent regulatory environment, and adequate regulatory standards for an efficient market.

5.9.1. An Individual Look at Crisis Countries

Generally the applied policies in the Crisis countries for financial sector can be summarized as follow; [93]

Indonesia. Indonesia's first step toward structural reform in the financial sector was to create new institutions. The Indonesian Bank Restructuring Agency was formed in January 1998 as an independent body to restructure troubled banks and their assets. Within this agency, a specific Asset Management Unit was created in April 1998 to acquire Non-performing Loans (NPLs) from troubled banks. By the end of 1999, it held around two thirds of all NPLs. So far, however, the Indonesian Bank Restructuring Agency has done little to recover these assets, although the legal, organizational, and regulatory framework is in place. Greatest progress has been made in restructuring private banks. At the end of July 1997, before the onset of the crisis, Indonesia had 160 private banks. In September 1998, all private banks were classified into categories of A, B, or C, based on their capital adequacy. All group C banks and nonviable group B banks were closed in March 1999. In the span of one year, 66 banks were closed and 12 taken over by the state. Consequently, the state banking system accounts for 75 percent of the liabilities of Indonesia's banking system and 90 percent of its

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92 http://www.adb.org

93 Asian Development Bank, **Asian Development Outlook 2000,** Corporate and Financial Sector Reform: Progress and Prospects, 2000, p.p. 27

negative net worth. Unfortunately, the restructuring of these state banks has just begun. By some estimates, around 80 percent of all outstanding loans are non-performing. As a result, most Indonesian financial institutions remain insolvent or undercapitalized, and lending operations are severely curtailed. One of the major causes of the collapse of the banking system was the absence of an effective bank supervision system. Realizing this weakness, Indonesia has taken steps to improve prudential regulations, bank supervision, and enforcement capabilities. Nevertheless, bank supervision remains limited because of weak enforcement capacity and a lack of trained staff.

As in the financial sector, Indonesia's efforts at corporate reform initially focused on *creating new institutions and improving legislation*[94]. First, the government set up the Indonesian Debt Restructuring Agency in July 1998 to help restructure foreign debt. This agency allows debtors and creditors to insure themselves against exchange risks, once they have reached rescheduling agreements. Indonesia then created the Jakarta Initiative for out-of-court corporate settlements, following the example of the London approach to corporate workouts. Legislation to improve corporate governance included new bankruptcy and anticorruption laws. In August 1998 a new bankruptcy law was introduced, which modernized the legal infrastructure for bankruptcy and facilitated the rapid resolution of commercial disputes. In 1999 a law against corruption, collusion, and nepotism was passed. Despite this comprehensive legal and institutional framework, the progress of corporate restructuring has been disappointing. The Indonesian Debt Restructuring Agency has registered little debt. By the end of June 1999, only 80 bankruptcy cases had been registered, although almost half of Indonesian corporations were insolvent and experiencing increased difficulties in meeting debt service obligations. One of the biggest constraints on the speed of corporate debt restructuring has been the lack of financial system reform. Weak undercapitalized banks lack the resources or technical skills to resolve corporate debts within the framework of the Jakarta Initiative. Another constraint is the enormity of Indonesia's foreign debt. Without relief from foreign creditors, including Japan, Indonesia probably cannot service this debt, in particular the $36 billion owed to foreign banks.

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[94] **ibid.** p.p. 29

Malaysia. Malaysia's experience of financial restructuring differed from the other crisis countries in two crucial aspects.[95] First, Malaysia began with a *stronger financial sector*. Before the crisis it had developed more effective bankruptcy and foreclosure laws, as well as a stronger supervisory capacity. The banking sector was also well capitalized, with capital-asset ratios exceeding 10 percent. Second, Malaysia altered its macroeconomic course in September 1998, choosing to impose capital controls rather than accept an International Monetary Found (IMF) rescue package.

However, like the other countries, Malaysia began its financial and corporate restructuring effort by creating new institutions. In June 1998, the authorities set up Danaharta, an Asset Management Company (AMC) to acquire non-performing bank loans. In August 1998, Danamodal was created to recapitalize financial institutions whose capital adequacy ratios fell below 9 percent. In the same month the Corporate Debt Restructuring Committee was established to facilitate the out-of-court restructuring of corporate debt.

Both Danaharta and Danamodal made significant progress in restructuring banks. Danamodal injected \$1.6 billion into ten financial institutions, while Danaharta purchased 50 percent of outstanding NPLs, about the same ratio as Korea. The level of NPLs appears to have peaked in mid-1999 at over 20 percent of total loans. The total fiscal cost of the restructuring is estimated at around 10 percent of GDP.

In an effort to accelerate the rationalization and consolidation of the banking system, instead of closing affected institutions as in Korea and Thailand, Malaysia continued to encourage financial institutions to merge and consolidate. The central bank approved the formation of ten banking groups and the selection of the anchor banks and their respective partners in January 2000. Accordingly, 54 domestic banking institutions —reduced from 88 at the end of 1997—will be further consolidated. With a relatively sound legal system and a good institutional framework for financial restructuring, the prospects for Malaysia successfully restructuring its financial system seem bright. Before the crisis, Malaysia's corporations were less heavily indebted than firms in other crisis countries in East Asia. Consequently, corporate distress in Malaysia was less acute than elsewhere, although firms were hit hard by the rise in

95 **ibid**. p.p. 30

interest rates because of heavy dependence on bank financing. Malaysia's troubled firms are concentrated in the real estate, construction, and infrastructure sectors.

Nonetheless, debt workouts and operational restructuring through the Corporate Debt Restructuring Committee have been slow, partly because of a lack of adequately trained staff. To address the problem, the government has established agencies to deal with corporate restructuring: the Loan Monitoring Unit of the central bank assists small corporate borrowers in restructuring, a rehabilitation fund helps viable Small and Medium Sized Enterprises (SMEs) restructure, and the Finance Committee on Corporate Governance works on reforming corporate governance practices.

Philippines. While the Philippines was affected by the Asian crisis, it suffered significantly less than the other four crisis economies. No broad banking crisis occurred and no emergency rescue assistance from the IMF was needed. The country was resilient because it had virtually no short-term foreign currency borrowing, its banks were well capitalized after two decades of financial sector reform, and its manufacturing sector was smaller and less leveraged than the other economies. The mildness of the Philippines' crisis affected the scope and nature of the country's financial and corporate reforms. Compared with the four worst hit crisis economies, the Philippines followed a market led reform process with less government involvement.

Its major reform elements included (a) strengthening the prudential and supervisory systems overseeing the financial sector, (b) adopting an early intervention system to deal effectively with problem banks and keep the banking system sound, (c) strengthening and modernizing state banks through privatization, (d) reducing the intermediation costs of financial institutions, and (e) improving the legal and regulatory framework. To improve the supervisory framework, the central bank required banks to set up 2 percent general loan-loss provisions, as well as increasing specific loan-loss provision on individual loans, which reached 2 percent by 1 October 1999. The central bank also limited banks' exposure to the real estate sector to 20 percent of total loans, and reduced the allowable loan value of real estate security from 70 to 60 percent. It imposed a 30 percent liquid cover on all foreign exchange liabilities from foreign currency deposits. To deal more effectively with problem banks, the central bank adopted an early warning system that included formalizing sanctions on undercapitalized banks. To strengthen and modernize state banks, the government concentrated on selling shares to private investors. Statutory reserve requirements were reduced from 10 to 8 percent in May 1998 to reduce the costs of financial intermediation. Regulatory improvements have been significant.

The central bank has proposed major revisions to key banking laws to (a) limit the ability of universal and commercial banks to invest in firms; (b) redefine the functions, authority, and minimum capitalization of trust entities; (c) adopt the Basle Capital Accords, a set of standards for measuring capital adequacy; (d) strengthen provisions to guard against bank overexposure to risky assets; (e) guard against credit concentration among borrowers; (f) grant the central bank the right to examine banks once a year; and (g) authorize the central bank to issue regulations requiring bank subsidiaries and affiliates to maintain a balanced position in foreign exchange transactions.

These reforms contributed to the early recovery of financial markets. Nonetheless, problems remain. First, many of the new prudential norms and international standards are poorly implemented. Second, banks still hold many real estate NPLs, which continue to curtail banking sector operations and stall overall economic activity. The liquidity of property markets also means that loan-loss provisioning may not reflect all real losses. Informal loan-for-property swaps without formal legal foreclosure proceedings pose an additional problem.

Thailand. Like other crisis countries, Thailand began structural reform in the financial sector by creating new institutions. In October 1997, three months after the onset of the financial crisis, the government established the Financial Sector Restructuring Authority to organize the workout of failed finance companies, and the Asset Management Company to buy non-performing assets and recover them. In December 1997, the Financial Sector Restructuring Authority closed 56 of 58 suspended finance companies, and since then has been disposing of their assets. AMCs purchased its first NPLs at a Financial Sector Restructuring Authority auction in March 1999.

After closing the finance companies, to help regain investor confidence the government adopted a market-based approach to restructuring and recapitalizing the remaining financial institutions. By gradually introducing stricter loan classification and loan-loss provisioning requirements, the Thai authorities hoped to give private investors the incentive – and time – to provide fresh capital. However, this strategy did not succeed because private investors had little incentive to invest in those banks and in other financial institutions that were amassing large numbers of NPLs because of continuing recession. The government shifted to a more interventionist approach in August 1998, announcing a new comprehensive financial restructuring package. This package allowed viable financial institutions to recapitalize using public funds under clear safeguards. It offered incentives for accelerating corporate debt restructuring and promoting new lending to the private sector. It also created a legal basis for establishing private AMCs and clear resolution strategies for financial institutions in line with the government's longterm objective of strengthening the financial system. Even this interventionist approach faced problems. Thai bank owners remain as reluctant to take advantage of public funds as they were determined to maintain ownership and control of their institutions. By January 2000, only four banks had accepted the government's recapitalization scheme, and most banks limited new lending and resorted to complex private arrangements to raise capital. The level of NPLs in commercial banks is so high—as much as 50 percent of total loans or more—that for banks to recapitalize through normal business operations seems impossible. Thailand's strategy for corporate restructuring, like that of the other countries, consisted of new institutions, better incentives, and improvements in the legal framework. In August 1998, the government created the Corporate Debt Restructuring Advisory Committee. It also endeavored to create an effective legal framework for recovering debt through bankruptcy legislation, and provided tax and other incentives to encourage corporations and banks to restructure bad debt. Progress has been made, and the results of the corporate restructuring account for about 25 percent of NPLs. The growth of NPLs has outpaced the rate of corporate restructuring completion. SMEs account for more than two thirds of this aggregate corporate debt, which makes restructuring complex: transactions are small, costly, and diffuse, with firms scattered over the country. Banks have also been reluctant to deal with the debts of SMEs, preferring to scale back lending. Thailand has made greater progress in improving the supervisory and regulatory framework surrounding the financial sector. The authorities are enforcing new loan classifications and provisioning requirements, and the supervisory functions of the Bank of Thailand are being strengthened. All financial institutions have signed a memorandum of understanding that describes their plans to raise capital. The more stringent provisioning requirements for non-performing assets are being phased in from the second half of 1998 until the end of 2000. The Bank of Thailand also began implementing a modernization program aimed at redesigning the bank's organizational structure, streamlining work processes, and improving corporate governance. As part of these efforts, experts from some central banks of industrial countries have offered recommendations on strengthening central banking and bank supervision. The Bank of Thailand has also set up a school for bank examiners.

Korea. Korea's financial sector strategy initially focused on restoring market confidence with government guarantees to prevent a run on the banks. However, once the situation stabilized, priority shifted to restructuring or closing insolvent financial institutions and rehabilitating viable ones. At the same time, adoption of international standards of regulation and supervision was emphasized, as well as capital market development. In December 1997, the Korean Parliament passed 13 financial reform bills, and streamlined bankruptcy law. In January 1998, the government, corporations, and unions agreed on a national council to discuss economic restructuring. A legal framework for corporate sector restructuring *(please see Appendix C for more detail about restructuring model)* was created in February1998. In April 1998 the powerful Financial Supervisory Commission was created to monitor and supervise all financial institutions. During the crisis, however, it focused on financial and corporate restructuring, accelerating the reform process.

In early 1998, two of Korea's largest banks, Korea First Bank and Seoul Bank, were recapitalized with public funds and effectively nationalized. Korea First Bank was subsequently sold to a foreign consortium. On 29 June 1998, the Financial Supervisory Commission announced that five insolvent commercial banks would be closed and absorbed by healthier banks. Mergers involving the five largest banks have been completed. Two years after the crisis, the number of banks has been reduced from 33 to 23 through closures and mergers. The government has also closed down or suspended 21 of 30 merchant banks, and 22 other financial institutions. The public sector contribution to this restructuring has been huge.

Second, the mid-ranking large corporations have been subject to out-of-court workouts with their designated lead creditor banks, based on the London approach.

Third, the restructuring of SMEs has been left to the creditor banks and largely postponed. To prevent insolvency and preserve employment, these firms were allowed easy access to working capital loans. In Korea, compared with other crisis countries, SMEs account for a relatively small fraction of outstanding bank loans. While this justifies the delay in restructuring SMEs, a comprehensive program to work out these debts is urgently needed.

The restructuring of the Big Four and out-of court workouts of other large corporations have had mixed results. The lead banks have been accused of including firms that should have been immediately liquidated. Given their financial fragility, the banks have been reluctant to absorb losses, and are trying to keep many troubled firms on their balance sheets that in fact are unlikely to survive the crisis. The lead banks have also been unable to devise a comprehensive set of workout criteria involving debt-equity swaps, debt write-downs, and debt rescheduling. The absence of comprehensive criteria has raised concerns about the fairness and effectiveness of using differential measures to support different firms in various industries. Disagreements over loan-loss provisioning, disputes over asset valuation, and managers' resistance to losing control all have further complicated the process. Consequently, many firms are likely to fail to meet their obligations to their lead banks.

The restructuring impact of the Big Deals is also mixed. Whether or not the excess capacity problems that plagued Korea's chaebols have been solved is not clear. Evidence is also mixed on whether the Big Four has fulfilled its commitments to improve corporate governance and slim down to a few core businesses. Most of the banks, including restructured ones, have seen substantial improvement in the quality of their assets and profitability of their operations. Their lending capacity also has increased, supporting the ongoing economic recovery. However, financial restructuring is far from over. The Financial Supervisory Commission has been struggling to restructure the three largest investment trust companies, which hold many corporate bonds issued by corporations engaged in out-of-court workouts. Many non-bank financial institutions, including life insurance companies, also need rehabilitation. The banks have faced major losses from the corporate workouts. For instance, the restructuring of Daewoo, - Korea's second-largest company - until domestic creditors decided on a debt-rescheduling program for its subsidiaries, caused bank losses estimated at $10.4 billion.

5.10. The role of globalization and financial activities

Today's globalization of finance does not imply the borders among countries. All financial systems, no matter, operate in a worldwide market. In reality, national borders keep out its important for financial systems.

On the other hand, some very small economies have developed substantial off-shore financial services industries. On the other hand, some small and advanced countries also have relatively focused on off-shore financial services industries, most notably Luxembourg, but many of these are not members (for example, Liechtenstein) or are not sovereign states

The growth of most off-shore financial centers has been linked with tax avoidance and, to some extent, with money laundering. However, it cannot be produced a solution for all small financial systems. Furthermore, the presence of off-shore finance often does not contribute significantly to the quality of finance in small economies.

Financial infrastructure refers to the systems, actors, rules, and practices that define the field of action where financial agents negotiate and perform financial transactions. Some of these are established and maintained by government bodies, reflecting their character as public goods; others are normally in the private sector. Financial infrastructure includes legal and regulatory frameworks (including enforcement mechanisms); central banking services; supervision, accounting, and auditing rules, resources, and practices; information provision (such as credit bureaus, rating agencies, public registries); payments and securities settlement systems; and exchange systems (such as trading and listing services, trading rules, and communication and information platforms).

Small financial systems can indeed be unstable but, because of their size, the crises which are occurring in these types of countries have much impact on the remainder of the world's financial system. From that aspect, these countries are of little importance. The reverse, however, is not true. As these financial systems become more open, even occurred any crises according to the rest of the world's financial system will have little impact.

5.11. The role of Stable Macroeconomic Policies

Probably the most important contribution the government can make to the efficient functioning of financial markets is to provide a steady, consistent, table macroeconomic policy. This consists of predictable interventions in financial markets and stable fiscal policy. The government enters the financial markets directly through its issuance of bonds in the primary market.

5.12. The Channels More Efficient Allocation of Capital

A financial system is efficient when it allocates funds to those projects with the highest marginal product of capital. In the above framework, by allocating capital more efficiently, a financial system could improve the productivity of capital, and hence economic growth.

However, this process is costly. First, in order to find the most profitable project, financial systems need to monitor or screen alternative projects. Even if high-return projects are detected, their possible high risks might discourage individuals from investing in these projects. Thus, financial systems must play a role of risk-sharing and induce individual investors to invest in riskier but higher-return projects.
The role of information acquisition and risk-sharing by financial intermediaries has an importance. In financial intermediaries, there are two production technologies, *a safe and low-return one and a risky and high return one.* A risky technology has two disturbances: *an aggregate and a project-specific shock.*

Financial intermediaries can eliminate *project-specific shocks* completely by managing their portfolios and can detect the existence of an aggregate shock by noting simultaneous disturbances involving more than one project. Hence financial intermediaries can allocate resources to the place where they earn the highest return, while individuals without financial intermediaries cannot select the appropriate technology for the realisation of a shock.

Another important role of financial intermediaries is to provide *liquidity to individual investors.* Unless financial intermediaries (or financial markets) exist, households can invest only in illiquid assets (for production). However, their precautions against an idiosyncratic liquidity shock might discourage them from investing in higher-yield, but more illiquid assets. Financial intermediaries can reduce such inefficiency by pooling the liquidity risks of depositors and invest funds in more illiquid and more profitable projects.

Summary

The financial sector of an economy affects a country's rate of economic growth in several ways: the rate of saving may be change. More importantly, however, the rate of productive investment is likely to increase. And in the long run a more efficient financial sector will channel more funds to the most promising entrepreneurs.

Basically, the ***components of financial sector*** can be implied as follow briefly;

- *Financial policies* consist of the money supply, interest rates, public deficit financing the provision of financial services.
- *Financial infrastructure*, consist of the support for financial transactions, audit, accounting, and the operations of the payment system
- *Financial institutions* include, government entities such as central banks, national debt offices financial supervisory authorities, insurance companies etc.

Basically, ***a good financial system*** has five key components. These components are;

- sound public finances and public debt management
- stable monetary arrangements
- a variety of banks some with domestic and others with international orientations
- a central bank to stabilize domestic finances manage international financial relations
- well – functioning securities markets

The main functions of financial sector are the following;

- To reduce transaction cost
- To encourage savings in financial instruments
- To make risky investment practicable

The *main objective* of the financial system is *to ensure that savings from surplus economic units are efficiently mobilized and shifted to high yielding investments in deficit economic units with an appropriate balance of risk.*

The role of Government has important; Government regulation may impose many different kinds of cost on the financial system. These costs must be clearly recognized and weighed to provide a balanced assessment of regulatory policy.

- *direct cost such as fees, reserve requirements and taxes*
- *changing of market prices that are the result of regulations which cause misallocations of economic resources*
- *regulations which cause uncompensated transfer of wealth between private transactions*

Governments can do many things to be developed the capital markets. These implications can be summarized as follow;

- pursue prudent macroeconomic policies
- abstain from capturing savings through preferential savings-schemes,
- establish benchmark yield curves for long-term corporate bonds through the market-based issuance of long-term Government paper
- harmonize the tax treatment of various financial instruments
- develop the institutional investor base through pension and insurance market reforms
- increase the supply of blue-chip share issues through privatisations
- create the necessary market infrastructure and legal and regulatory framework for securities.

The relations between financial development and economic growth briefly can be summarized that, The first one called as *demand following* - views the demand for financial services as dependent upon the growth of real output and upon the commercialization and modernization of agriculture and other subsistence sectors. The second relationship is termed *supply leading*. Supply leading has two functions: to transfer resources from the traditional, low-growth sectors to the modern high-growth sectors and to promote and stimulate an entrepreneurial response in these modern sectors. This implies that the creation of financial institutions and their services occurs in advance of demand for them.

Thus the availability of financial services stimulates the demand for these services by the entrepreneurs in the modern, growth-inducing sectors.

Although it was reached the significant economic performance in the Asian countries, it is lived the some crisis in these countries. The reasons are as follow,

- the weaknesses of regional financial system which included the absence of well developed domestic capital markets
- severe deficiencies in financial governance practices
- unsustainable foreign exchange rate policies
- sudden loss of confidence in these economies
- sharp depreciation of their overvalued currencies

The reasons for economic growth basically depend on following conditions; External factors that are occurred in outside of the country and it can be divided into two in each other: Foreign aids (if there is) and External Economic Conjecture. Internal factors which are occurred in inside of the country. As applied policies generally related with the macro levels such as Income Policies, Monetary Policies etc. and structural policies are significant for economic performance.

The following deficiencies are constraints for financial sector; lack of competition in banking sectors, poor governance, inadequate supervision, and obstacles to development of money and bond market.

Though the broad principles of financial and corporate restructuring have been similar in the Asian countries, the details and rates of progress have varied considerably. Korea and Malaysia have gone furthest in restructuring their corporate and financial sectors, but with different approaches. Korea adopted tight macroeconomic policies under an IMF program and aggressively closed, merged, or suspended insolvent financial institutions. Malaysia declined an IMF rescue plan, opting for capital controls, and closed no financial institutions. After dramatically downsizing the financial sector by closing virtually all its finance companies, Thailand adopted a more gradual, market-based approach to restructuring, with banks allowed to raise equity capital over a long period through phased-in requirements for loan provisioning. Indonesia lags behind the other three countries, and has only recently taken steps to deal with banking problems and corporate distress. As a less severely affected economy, the Philippines adopted a market-led reform process, with the government and the central bank focusing on reforming the supervisory systems.

Chapter 6

STRATEGIES FOR FINANCIAL DEVELOPMENT

VI. STRATEGIES FOR FINANCIAL SECTOR DEVELOPMENT

Financial sector development is both a function and a determinant of economic development.[96] Promotion of economic development through creation of an enabling environment for the private sector, public enterprise reform, and efficient and effective fulfillment of the core functions of government (including the maintenance of macroeconomic stability) will also promote financial sector development. At the same time, economic development depends, among other things, on creating efficient, competitive and responsive financial systems, capable of mobilizing savings for the funding of investment projects.

One of the primary requirements for financial market is the development of enabling environments that allow deep, liquid and competitive financial markets.

These environments include: *the maintenance of macroeconomic stability and policy consistency, the establishment of appropriate legal and regulatory environments.*

Without macroeconomic stability and appropriate legal structure may lead to chaotic market situations and force government interventions at a high cost to the economy. Price stability and confidence in the consistency of future economic policies are essential for individuals and firms to make judgments regarding investment opportunities. Macroeconomic instability creates uncertainty a resulting increase in price volatility.

In promoting the enabling environments that are needed for financial markets to develop policy makers need to focus on the legal and regulatory framework. This framework forms the foundation upon which all financial market activities are built.

In most of the SIDSs, government can improve resource allocation process by allowing greater use of market - based mechanism. Financial markets require a clear definition of the rights and responsibilities of those who enter into financial operations. Because of this reason, governments play an important role in growing of economies in these types of countries.

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[96] http://www.adb.org

In order to record a growth in financial sector, the following strategies can be applied in SIDSs.(of course the economic, politic and social conditions of country, applied strategies for productivity and other things which will affect the economic growth they will be determinant in determining and applying the strategies.)

Place much more emphasis on managing risk.

- Governments should pursue financial and economic policies that reduce country risk. They should promote sound and efficient financial systems through strengthened supervision, and improve their corporate governance environments. Government can also help to reduce the credit risks of lenders.
- Governments should improve the resource allocation processes by allowing greater use of market-based mechanisms.
- Regulations of interest rates should allow financial institutions to determine price of financial products in accordance with the "risk" concept.
- Market regulation and supervision are fundamentally significant for an efficient financial market. Because of this reason, a regulatory framework should be established which has considering dependent regulatory bodies with sufficient enforcement powers, a transparent regulatory environment, and adequate regulatory standards for an efficient market.
- By creating an appropriate environment and diversifying investment products they can reduce risk factors for financial sector and capital markets.

Private sector development

- Private sector development requires stable and credible macroeconomic policies to create an environment that is relatively free from policy – induced trade, tax, and price distortions. It also needs a regulatory and legislative environment that facilitates business activity. So, private sector takes a major role in SIDSs.

- Due to reasons, which were mentioned above, governments should be reduced the markets risks for the private sector, however, procedures for improving risk assessment also need to be put into place, perhaps by establishing a regional center of excellence that could provide training and undertake specific risk assessments.

- Additionally, financial sector policies should encourage competition by creating a level playing field between domestic and foreign, and also between private and state – owned financial institutions.

- Also in order to reduce the risk factors in financial institutions a small venture capital fund could be help to recording economic growth.

Promote more effective competition for foreign banks:

- To promote more effective competition for foreign commercial banks, governments of SIDSs *should encourage the development of nonblank financial intermediaries – finance companies, development finance institutions, investment banks, and related institutions.*

- Another strategies for financial sector, *governments should also enhance competition in financial sectors by allowing national provident funds to invest more of their money offshore and perhaps by requiring them to invest a minimum amount overseas.* This can be evaluated as a strategy, which allow to increase the value of saved money.

- Central banks *should adopt effective monetary policies.* To do this would require the following measures:
  - (i) The solution of central bank funding problems, so that the interest cost of monetary policy do not prevent effective open market operations
  - (ii) The establishment of open market operations based on government securities or central banks bills
  - (iii) Close cooperation between monetary and fiscal authorities for liquidity projection purposes

- Pricing policy of securities, which are determined by central banks, *should be market oriented* and consistent with deposit lending rates, so that they do not distort interest rates.

- Regulations which are related with the financial sectors *should be designed and implemented according to competitive conditions.*

- All activities, which are done by institutions in questions, should be restricted.

- Industrial groups should not be allowed to own and control banks or banking groups and vice versa.

- Government ownership of banks should be phased out.

- All banks and banking groups should be subject to full scale consolidated supervision

Strengthen supervisory systems and develop financial sector infrastructure:

- Especially, Central Banks in SIDSs must have more autonomy, both for monetary operations and for effective supervision.
- On a longer-term perspective, SIDSs should continue to enhance and strengthen the process of regional cooperation and consultation in regulatory and supervisory matters.

Non-bank Financial Institution:

- By considering the non-bank financial institutions, the necessary efforts should be made to improve *Development Finance Institutions* (DFIs) performance by increasing both their commercial orientation and their independence from government.

- The composition of board of Non bank Financial Institution should be adjusted to increase the level of private sectors representation.

- Common regional policies based on best practices should be established for DFIs.

These polices could include the following:

(i) setting standards for disclosure

(ii) setting minimum capital adequacy requirements

(iii)setting levels of provisioning

(iv)harmonizing training requirements throughout the region

(v) establishing loan system

- DFIs should formally report to respective central banks, providing the following information:

(i) loan classification by sector and type
(ii) connected lending and loans to individuals and cooperation
(iii)level and types of loans
(iv)capital adequacy to reflect the risk of DFIs
(v) policies on interest rates of DFIs and their rates to market levels

- In addition to this, Non bank financial institutions should not be permitted to:

(i) take deposit
(ii) represent itself as a bank
(iii)have direct access to the account payment and credit facilities of the central bank

- Non bank financial institutions should be regulated by an entity that is clearly separate from the central bank and other bank regulators.

- The scope of regulation for such institutions may be less in tense than that of the banks but additionally, regulators should be politically independent.

For the capital markets

Develop effective, efficient infrastructure for company registration and monitoring:

Development of the capital market in the SIDSs, can potentially provide an alternative to the commercial banks. The small size of the SIDSs can be an appropriate growth tools for the growth such kind of countries. In order to facilitate the transactions of capital markets, there is a need to ensure that sound companies acts are in place with efficient mechanism for registering companies. Where required, the infrastructure for the registration process should also be improved with training for staff and companies. Harmonization of the relevant laws is not prerequisite or not adequate for the development of a regional growth, but it would be of considerable assistance.

Create an appropriate investment environment

SIDSs governments should consider passing simple securities acts or appropriately amending companies acts for the people who offer investment services in the domestics market. And also it is recommended that the regulator of persons offering investment services should be the relevant central bank. Countries need to consolidate existing reforms for their financial markets. Due to this reason, they must prepare to deal with new instruments and new kinds of risks, bringing laws and regulation up to international standards.

Establish a regional capital market

In order to promote capital markets on a regional basis in SIDSs, it is recommended that a distributed, networked regional facility, which is supported by technology, should be provided to companies and investors.

There are several advantages to this proposal; that these advantages can be explained as following;

- The facility can be recognized by governments
- Companies which are operating in the financial sector, by establishing own regulations according to the laws they can be operated in the market by protecting both investors and own company.
- By providing regional settlement facilities, effective financial markets can be created for the investors and companies.

The development of domestic capital markets is key in reducing reliance on short – term bank funding for financial longer – term investments. Government can do many things to help develop capital markets. They can:

- pursue prudent macroeconomic policies
- abstain from capturing savings through preferential savings – schemes
- harmonize the tax treatment of various financial instruments
- develop the institutional investor base through pension and insurance market reforms
- create the necessary market infrastructure and legal and regulatory framework for securities

Privatize state – owned enterprises through a public share offering:

It is further recommended that that the various privatization bodies in the SIDSs should, where possible, identify and privatize profitable state owned companies through the mechanism of a public offer of a significant proportion of the shares.

Chapter 7

THE ECONOMY OF THE TURKISH REPUBLIC OF NORTHERN CYPRUS

VII. THE ECONOMY OF THE TURKISH REPUBLIC OF NORTHERN CYPRUS

7.1. General Outlook

Since 1974, the economy of the Turkish Republic of Northern Cyprus (TRNC) has experienced a rapid change and reasonably high growth rate in spite of the political difficulties caused by lack of recognition.

The economy of the TRNC has island economy features, limited natural resources, transportation and problem for energy, smallness, and low economic resilience covering shocks such as features can be observed in TRNC.

The second and more important one of the problem is TRNC has not being recognized by other nations except for Turkey diplomatically.

The main objectives of the Development Program in TRNC, are to secure the achievement of the highest possible rate of growth with maintenance of economic stability.

But the relations between Turkey and TRNC economically and politically, the usage of as currency Turkish Lira, have affected the TRNC economy structurally. In order to establish an economically self-sufficient TRNC, several Economic Co-operation Protocols were signed between the Governments of Turkey and the TRNC. The most recent protocol was signed on January 3, 1997. This protocol aims at improving the economic balances harmed by unfavorable conditions faced recently, realizing the structural adjustment required for rapid development and raising the standards of living. In this context the Turkish Government agrees to provide support up to US $ 250 million. The most important issues included in the Protocol are: the amendment of the banking, money foreign exchange and foreign investment regulations; the reformation of the tax system; speeding up the privatization process; and the realization of infrastructure projects, the major ones being energy, water and tourism; providing the same credit conditions for the Turkish and Turkish Cypriot investors in tourism, industry, agriculture, education and artisans; co-operation between the two countries in trade, tourism and agriculture.

After 1974, the economical relations with Turkey, especially trade with suitcase, tourism has affected the economy of TRNC in positively. In accordance with the free-market economic system adopted by the government since 1987, the promotion of the private sector with limited government intervention, rational use of natural resources, encouragement of investments in priority sectors, namely, tourism, industry, trade, transportation and higher education, retain their priority and importance.

But, due to free foreign trade policy of Turkey, the trade with suitcase has declined. In agriculture sector, in the period of 1989 and 1991, the production losses occurred has increased the fluctuations in growth rate.

Additionally, the Gulf crises in 1991 and the decreasing value of the TL in 1994 has also affected the structural problems in TRNC.

In order to increase the welfare of people, some populist policies have been applied by government. But these kinds of policies have no affect in medium term stably. The policies, which are mentioned above, have reflected as booming in public employment.

One more reason that is the size on internal market. The inadequate internal market and the decision of European Community in 1994 have affected the TRNC economy in negatively as well.

Due to connection with Turkey, if the TRNC does not apply the appropriate policies, both for Turkey and TRNC, the common international policies will be affected dramatically.

In 1994, the crisis, which occurred in Turkey, affected the TRNC economy negatively. The inflation rate in Turkey, due to usage of TL as currency in the TRNC, increased the interest and inflation rate directly.

Approximately, the share of 25% of exports is realized by Turkey; because of the reasons, which mentioned above the internal demand level has narrowed and the economic activities have decreased sharply.

Additionally, in July, the decision of European Union Court of Justice has also affected the imports on agricultural products and common custom duty has been started to the industrial products. So, in 1981 and 1991 the economy of TRNC has narrowed once again.

Small size and Limited Natural Resources:

Cyprus is located in the eastern Mediterranean Sea and covers an area of 9,282 square kilometers. The Turkish Republic of Northern Cyprus (TRNC) covers an area of 3,355 square kilometers, as a 36%. As the nearest neighboring country to the TRNC, Turkey lies at a distance of only 65 kilometers to the north. The TRNC is situated 100 kilometers west of Syria, 420 kilometers, north of Egypt and 965 kilometers Southeast of Greece.

Approximately, 36% of whole island belong to the TRNC, other 59% is Southern Cyprus and the rest of 5 % is United Nations (U.N) and English bases.

According to data of December 15th, 1996 the total number of population of the TRNC is 200,587. After 1977, by considering the population growth has increased regularly and 10 years average growth of population has been increased by 1.1%.

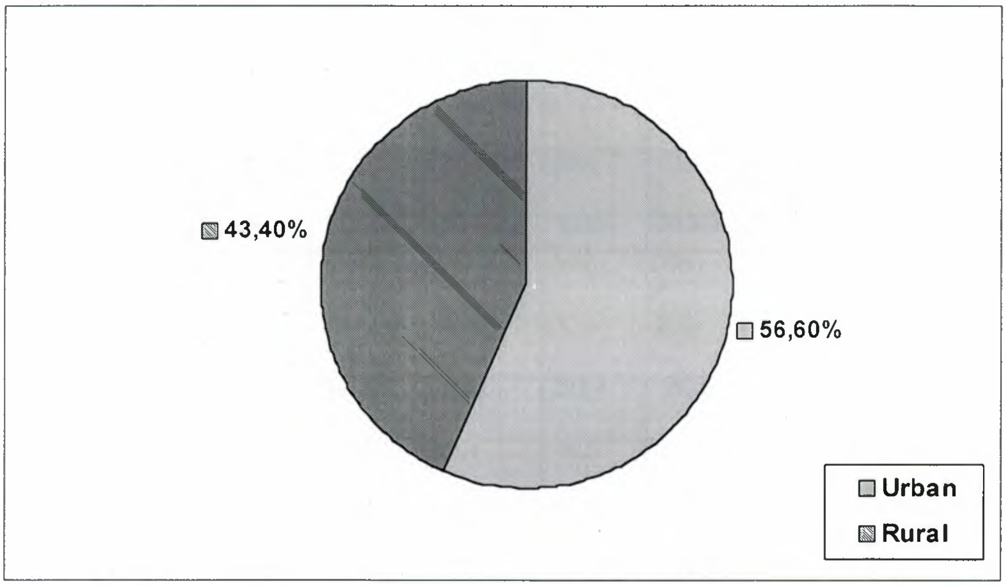
Basically, the population of the TRNC can be summarized as follow;

Table 7.1 Distribution of Population in the TRNC

TOTAL NUMBER OF POPULATION	TOTAL	URBAN	RURAL
Nicosia district	62,295	42,493	19,802
Famagusta district	52,875	31,286	21,589
Kyrenia district	38,715	15,160	23,555
Iskele district	19,179	5,246	13,933
Güzelyurt district	27,523	19,355	8,168
Total (TRNC)	**200,587**	**113,54**	**87,047**

Source: TRNC Prime Ministry, ***Statistical Yearbook 2000,*** *State Planning Organization Follow up and Coordination Department, p: 9*

Figure 7.1 Distribution of Population by districts in the TRNC



As it can be seen from Figure 7.1, the 56,60% of total population live in urban area, and the rest of 43,40% in rural area in the TRNC.

As it was implied before the concept of small size can be measured in terms of its population, land area, or its gross national products. On the other hand, the TRNC has very poor natural resources. Because of this reason it can be said that the TRNC has no adequate natural resources, and these resources are able to used in very scarce level. When evaluated the water resources a solution, which is water transfers by balloons, has been used for inland usage.

Basic economic Indicators

Table 7.2. Basic economic Indicators in TRNC

	1980	**1985**	**1990**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**
Real growth rate	0,9	7,5	5,7	2,6	2,9	4,1	6,0	7,4	-0,6	-3,6
Population	149,610	160,287	171,469	181,363	200,587	201,914 [5]	204,225	206,562	208,886	
GNP per capita ($) [1]	1463	1498	3447	4167	4222	3763	4361	4666	4978	3561
Inflation rate (end of year, %)	93,0	43,0	69,4	72,2	87,5	81,7	66,5	55,3	53,2	76,8
Budget deficit (million, $) [2]	20,9	23,7	31,9	83,7	32,0	22,6	29,6	66,6	68,6	83,1
Employment	52,631	61,499	71,525	76,454	80,314	83,204	85,013	87,515	89,327	89739
Number of unemployed	1789	1405	849	752	946	754	836	957	1416	1508
Unemployment rate (%)	3,29	2,23	1,18	0,98	1,16	0,90	0,98	1,08	1,56	1,65
Import (million$)	94,4	143,0	381,5	366,1	318,4	356,6	430,5	412,7	424,9	301,0
Export (million$)	47,1	32,4	65,5	67,3	70,5	57,7	53,4	52,4	50,4	46,0
Foreign trade balance	-49,9	-96,7	-316,0	-298,8	-247,9	-298,9	-377,1	-360,3	-374,5	-255,0
Tourists arrivals	84,511	125,075	300,810	385,759	365,116	399,364	393,027	414,015	432,953	353,952
Turkey	69,808	103,791	243,269	298,026	289,131	326,364	315,797	334,400	347,712	269,003
Other	14,703	21,284	57,541	87,733	75,985	73,000	77,230	79,615	85,241	84,949
Net tourism revenues	24,0	47,3	224,8	218,9	175,6	183,2	186,0	192,8	198,3	105,9
Bank deposits (million, $) [3]	45,9	88,2	277,6	499,8	581,3	659,1	735,7	837,2	920,3	n.a
Number of accommodation establishment [4]	n.a	na	90	93	99	104	109	115	116	na
Bed capacities [4]	na	na	6125	7774	8267	8940	9365	9932	10520	na

Source: TRNC Prime Ministry, ***Economic and Social Indicators,*** *State Planning Organization Follow up and Coordination Department*

[1] The sharp decline in GNP per capita is due to the population estimate based on the 1996 General Census
[2] Foreign aid is not included.
[3] Includes Turkish Lira and foreign currency deposits.
[4] Source: Tourism Planning Office, State Planning Organization

Limitations on Import substitution Possibilities

When TRNC evaluated for this concept, the TRNC has no import substitutes possibilities. But on the other in order to protect some industrial goods for domestic products government is applying some policies. The economy of TRNC has the characteristics of an island economy with limited resources.

During the period of 1977-2000 there was an increase in the volume of the foreign trade. The volume of foreign trade, which was 105.9 million in 1977 rose to 475.3 million dollars in 2000. During this period the imports of the TRNC increased from 82 million dollars in 1977 to 424.9 million dollars in 2000, while the exports rose from 23.9 million dollars in 1977 to 50.4 million dollars in 2000. The foreign trade deficit, which was 58.1 million dollars in 1977, reached 374.5 million dollars in 2000.

Table 7.3. Foreign Trades in the TRNC

(Million US$)

	1995	**1996**	**1997**	**1998**	**1999**	**2000**
Imports	366.1	318.4	356.6	430.5	430.5	424.9
Export	67.3	70.5	57.7	53.4	53.4	50.4
Foreign Trade Deficit	298.8	247.9	298.9	377.1	377.1	374,5

Source: TRNC Prime Ministry, ***Economic and Social Indicators,*** *State Planning Organization Follow up and Coordination Department*

TRNC has adopted a liberal trade policy and practices no discrimination against any foreign country. She has succeeded in establishing trade relations with more than 60 countries all over the world. The share of Turkey and other countries and, the foreign trade by countries can be seen in the tables 7.3 and 7.4.

Table 7.4. Foreign Trade by Turkey and Other Countries between 1995 and 2000

(Million US$)

	1995		1996		1997		1998		1999		2000	
	Imp.	**Exp.**	**Imp.**	**Exp.**	**Imp.**	**Exp.**	**Imp.**	**Exp.**	**Imp.**	**Exp.**	**Imp.**	**Exp.**
1. Turkey	194.8	20.2	176.1	34.0	202.0	27.1	251.5	27.0	256.4	27.9	275.1	18.7
2.Other Countries	171.3	47.1	142.3	36.5	154.6	30.6	179.0	26.4	156.3	24.5	149.8	31.7
2.1.EC Countries	102.0	36.5	81.0	24.7	87.5	23.9	113.2	22.3	99.8	20.4	103.2	20.3
2.1.1. United Kingdom	49.4	23.8	44.0	15.0	45.1	15.0	54.4	16.5	47.4	15.9	43.3	18.8
2.1.2. Other EC Countries	52.6	12.7	37.0	9.7	42.4	8.9	58.8	5.8	52.4	4.5	59.9	1.5
2.2. Middle East Countries	8.1	1.6	4.6	5.8	5.4	1.9	5.3	1.5	4.9	2.2	7.5	3.9
2.3. Far East Countries	26.8	-	15.4	-	11.0	-	8.2	-	8.1	-	6.3	-
2.4. USA	2.8	0.1	4.3	0.7	2.9	0.3	7.0	0.2	6.3	-	5.2	0.2
2.5. Other Countries	31.6	8.9	37.0	5.3	47.8	4.5	45.3	2.4	37.2	1.9	27.6	7.3
	366.1	**67.3**	**318.4**	**70.5**	**356.6**	**57.7**	**430.5**	**53.4**	**412.7**	**52.4**	**424.9**	**50.4**
TOTAL	*433.3*		*388.5*		*414.3*		*483.9*		*465.1*		*475,3*	

Source: *TRNC Prime Ministry,* ***Economic and Social Indicators,*** *State Planning Organization Follow up and Coordination Department*

The economy of the TRNC has the peculiarities of an island economy with limited resources so foreign trade emerges as the major sector of the economy.

The main agricultural and industrial products including agricultural based processed goods exported from TRNC can be explained as Readymade Clothes, Citrus, Concentrated Citrus, Dairy Products, Refreshments, Medicine, Carobs (Seed and Grounded), Hides and Leather, Alcoholic Beverages, Tobacco, Cigarette

The Value of the Imports by Commodity Groups for the years 1995-2000 is seen from table 7.5.

Table 7.5. Value of Imports by Commodity Groups between 1995 and 2000

(Million US$)

Items	1995	%	1996	%	1997	%	1998	%	1999	%	2000	%
Food, Live Animals	54.3	14.8	53.1	16.7	60.2	16.9	70.3	16.3	53.0	12.8	60.6	14.3
Beverages and Tobacco	20.0	5.5	19.2	6.0	22.1	6.2	28.4	6.6	26.5	6.4	26.9	6.3
Crude Materials, Inedible Other Than Fuels	5.9	1.6	5.7	1.8	6.3	1.8	6.7	1.5	5.6	1.4	6.0	1.4
Mineral Fuels, Lubricants and Related Materials	33.8	9.2	32.8	10.3	37.3	10.5	30.9	7.2	32.9	8.0	44.4	10.5
Animal and Vegetable Oils and Fats	3.1	0.9	2.9	0.9	2.9	0.8	5.0	1.2	4.1	1.0	3.5	0.8
Chemicals	27.2	7.4	29.2	9.2	33.1	9.3	36.5	8.5	35.9	8.7	35.0	8.2
Manufactured Goods Classified Mainly by Materials	94.5	25.8	77.4	24.3	81.1	22.7	94.2	21.9	85.4	20.7	91.0	21.4
Machinery and Transport Equipment	98.7	27.0	73.5	23.1	85.5	24.0	126.0	29.3	135.9	32.9	125.5	29.6
Miscellaneous Manufactured Goods	28.6	7.8	24.6	7.7	28.1	7.9	32.5	7.5	33.4	8.1	32.0	7.5
TOTAL	**366.1**	**100.0**	**318.4**	**100.0**	**356.6**	**100.0**	**430.5**	**100.0**	**412.7**	**100.0**	**424.9**	**100.0**

Source: *TRNC Prime Ministry,* ***Economic and Social Indicators,*** *State Planning Organization Follow up and Coordination Department*

Table 7.6. Composition of the Exports in the TRNC between 1995 and 2000

(Million US$)

	1995	%	1996	%	1997	%	1998	%	1999	%	2000	%
1. Agricultural Products	26.9	40.0	31.0	44.0	18.5	32.1	14.8	27.7	20.1	38.4	16.0	31.7
Citrus	22.1	32.8	22.6	32.1	15.1	26.2	12.8	24.0	12.1	23.1	13.4	26.6
Potatoes	1.4	2.1	0.9	1.3	0.4	0.7	0.6	1.1	0.1	0.2	0.1	0.2
Other	3.4	5.1	7.5	10.6	3.0	5.2	1.4	2.6	7.9	15.1	0.3	0.6
2. Industrial Products	39.8	59.1	38.4	54.5	38.5	66.7	38.3	71.7	32.1	61.2	2.2	4.3
Processed Agricultural Goods	11.9	17.7	13.2	18.7	11.8	20.4	13.6	25.5	12.5	23.8	34.2	67.9
Clothing	23.8	35.3	21.7	30.8	24.0	41.6	21.5	40.2	17.8	34.0	12.2	24.2
Others	4.1	6.1	3.5	5.0	2.7	4.7	3.2	6.0	1.8	3.4	22.0	43.7
3. Minerals	0.6	0.9	1.1	1.5	0.7	1.2	0.3	0.6	0.2	0.4	0.2	0.4
TOTAL	**67.3**	**100.0**	**70.5**	**100.0**	**57.7**	**100.0**	**53.4**	**100.0**	**52.4**	**100.0**	**50.4**	**100.0**

Source: *TRNC Prime Ministry,* ***Economic and Social Indicators,*** *State Planning Organization Follow up and Coordination Department*

Remoteness and Insularity

In theoretically, many small islands are far away from major markets and their remoteness and isolation play a significant role in their economic growth. Basically, it was defined the isolations means that countries are far from the major centers of trade and commerce centers.

However, this evaluation can be acceptable considering the other small islands. By considering the TRNC, it can be said that the TRNC is not far away from the major markets because of economic cooperation with Turkey. Although this cooperation, due to some reasons such as lack of recognition, embargoes, limited capacity of transportation has affected the economy of the TRNC negatively.

Dependence on a narrow range of products:

Due to limited resources and size the TRNC can be accepted as a dependent country on goods and services apart from a few special goods. Moreover, as accepted a dependent country, it can be also called, as *price taker* because of it has no affect for prices on selling and selling. The mentioned explanation before which are can be shown as reasons for the TRNC that are lack of recognition, limited resources, limited transportation limited export capacity, internal economic conditions etc.

Limitations on Domestic Competition:

Limited domestic market size combined with large distances from overseas markets often results in a lack of competition. In same cases, the size of the market can only support single producers.

When evaluated the TRNC market because of the market is limited capacity, the operating firms are normally competing in internal market effectively. And due to other main reason, which is embargos, the economy has to focus the firms on certain sectors such as public sector, tourism and education sectors.

Major contributor sector: Tourism

Tourism is considered to be a personal or a consumer service. However, argues that tourism is more than the service; it is a composite product, a combination of material goods and services. The production and consumption of these products takes place simultaneously in the same location.

The tourism sector has a priority in development in the Cyprus. Cyprus is as ancient land of relics of Great Mediterranean cultures and civilizations. The territory of the TRNC extends from one end of the island to the other along the whole of the northern share.

One of the major goals of the development program called for an import substitution policy as a tool to achieve industrialization and greater economic development. In addition, the plan also aimed at taking advantage of the island's natural resources. As a result, the tourism sector received considerable attention by the government, which provided subsidies and tax allowances to the parties involved.[97]

Although this sector has a priority, the rate of occupancy is not at the desired level. When the world recognizes the TRNC and removes all of the embargoes imposed on the TRNC, she will take place it deserves in economic development.

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[97] Michael Kammas, **The Cyprus Review a Journal of Social, Economic and Political Issues**, Intercollege University of Indianapolis, USA, Volume 5, Spring 1993, No: 1

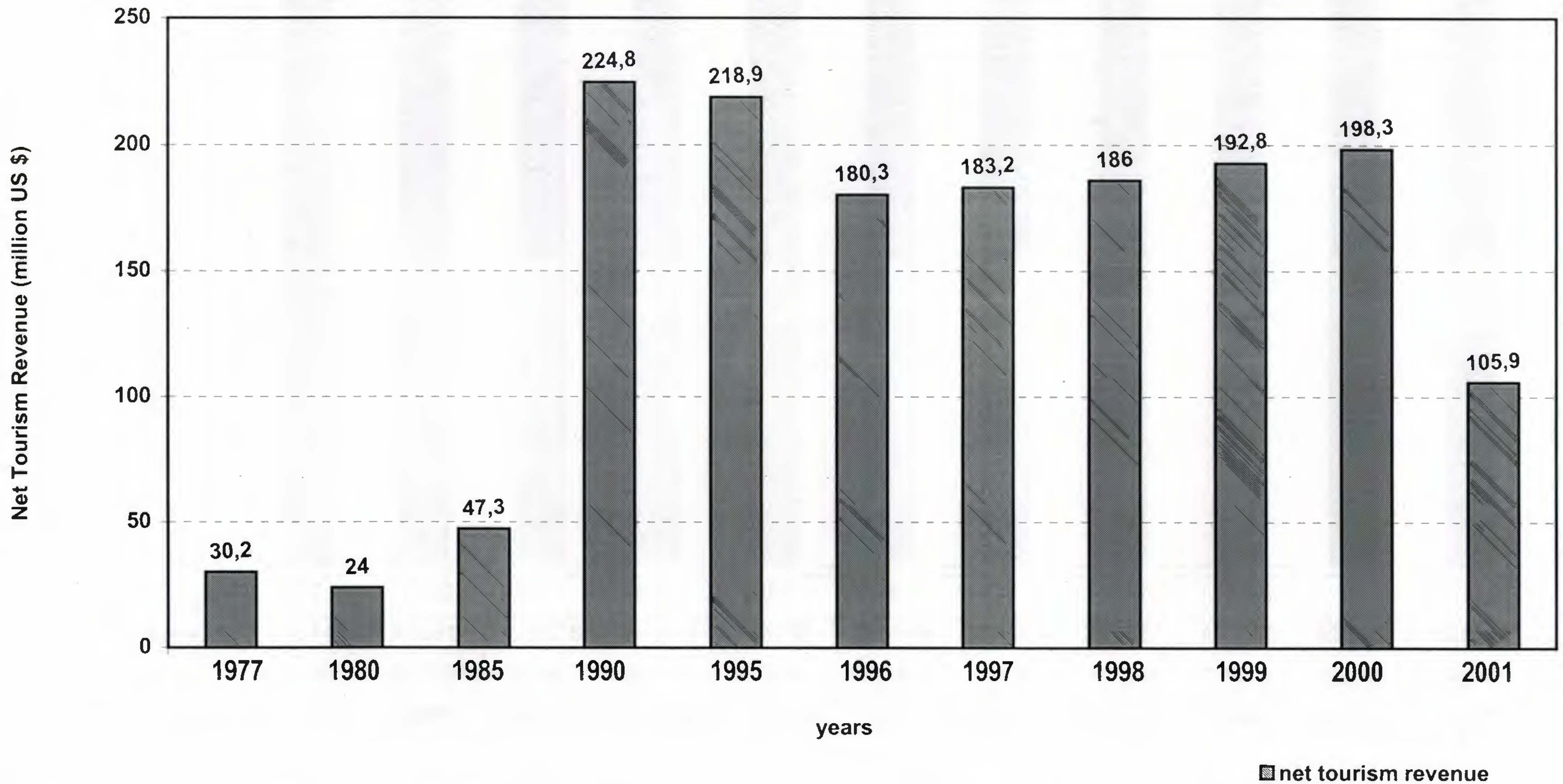
Table 7.7. Tourism Revenues and Number of Tourists that visit the TRNC

Years	Net tourism revenues US $ Million	Turkish Republic	Other	Tourist Arriving Total
1977	30.2	108106	5130	113146
1980	24.0	69808	14703	84551
1985	47.3	103791	21284	125075
1990	224.8	243269	57541	300810
1995	218.9	298026	87733	385759
1996	175,6	289131	75985	365116
1997	183,2	326,364	73,000	399,364
1998	186,0	315,797	77,230	393,027
1999	192,8	334,400	79,615	414,015
2000	198,3	347,712	85,241	432,953
2001	105,9	269,003	84,949	353,952

Source: *TRNC Prime Ministry,* ***Economic and Social Indicators,*** *State Planning Organization Follow up and Coordination Department*

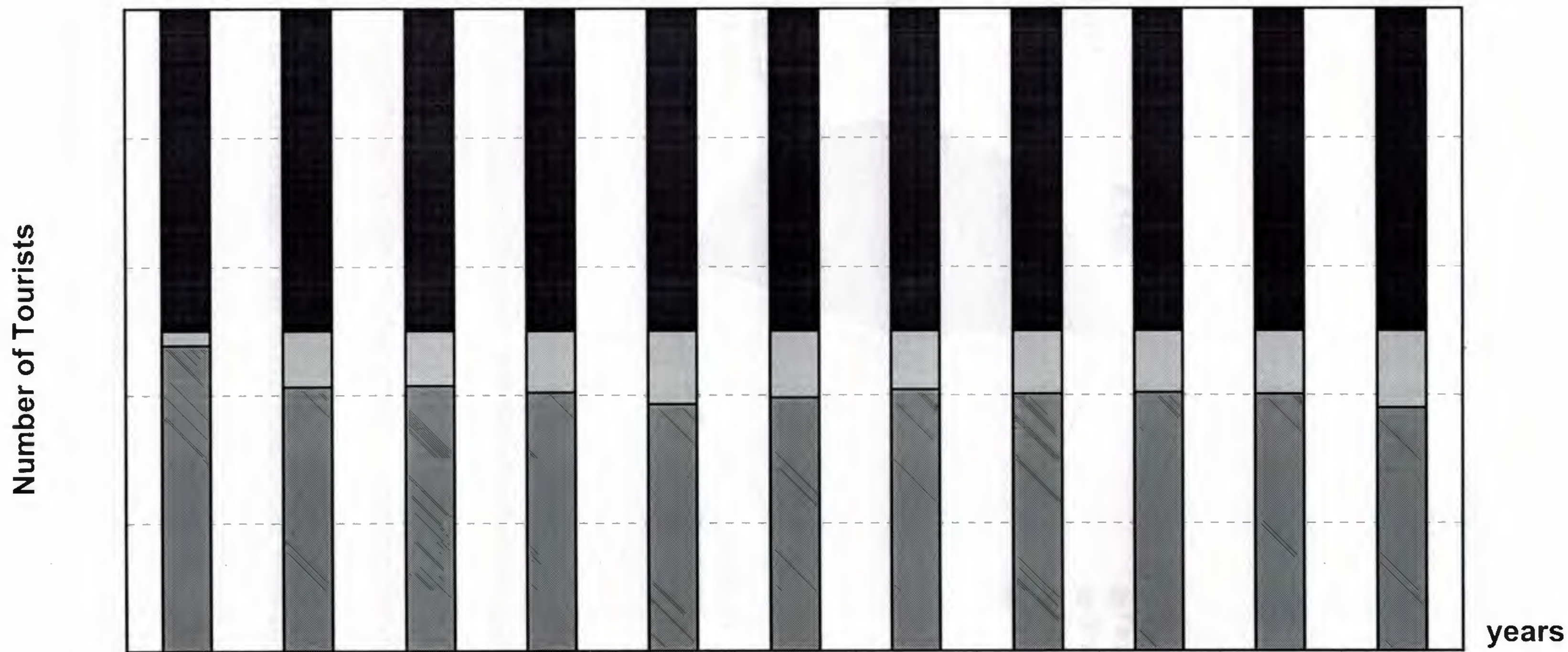
Although tourism revenues were about US $ 30 in 1977, especially in 1990s the people those visit the TRNC has increased the 5 times approximately. And after this date up to end of 2000s this rising has continued regularly.

Graph 7.1. Net Tourism Revenue according to years in the TRNC



Source: *TRNC Prime Ministry,* ***Economic and Social Indicators,*** *State Planning Organization Follow up and Coordination Department*

Graph 7.2. Number of Tourists that visit the TRNC according to years



	1977	1980	1985	1990	1995	1996	1997	1998	1999	2000	2001
■ Total Tourist Arriving	113146	84551	125075	300810	385759	365116	399364	393027	414015	432953	353952
□ Other	5130	14703	21284	57541	87733	75985	73000	77230	79615	85241	84949
▩ Turkish Republic	108106	69808	103791	243269	298026	289131	326364	315797	334400	347712	269003

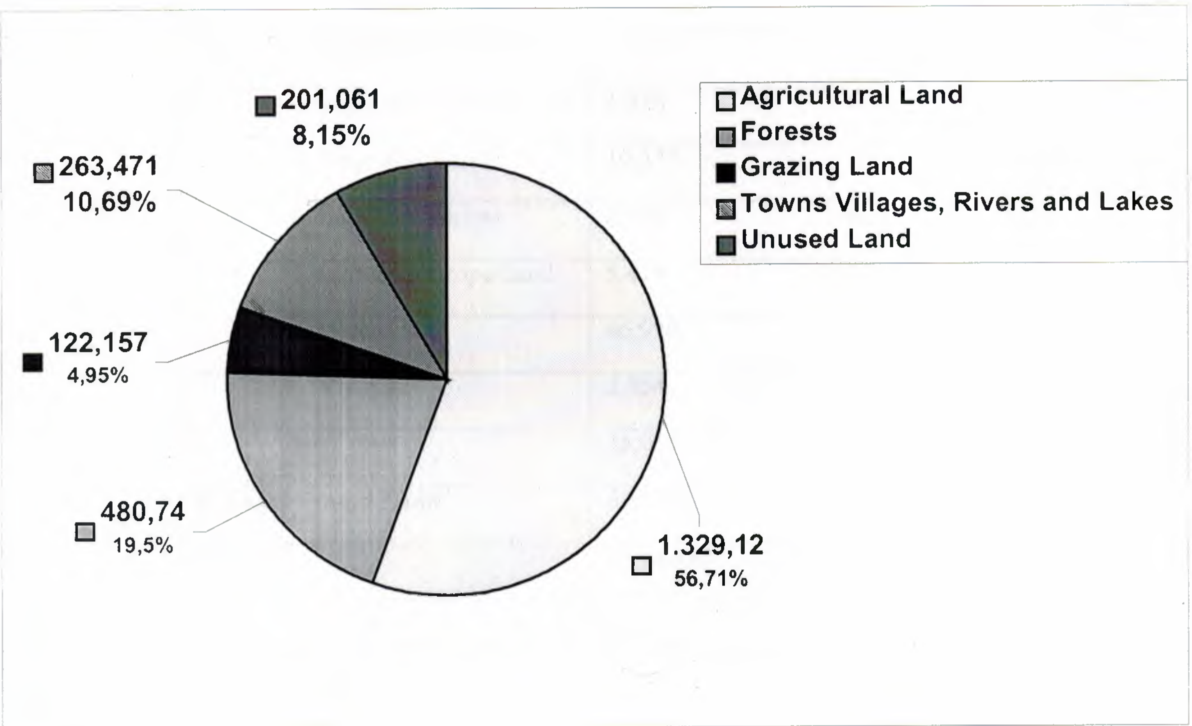
■ Total Tourist Arriving
□ Other
▩ Turkish Republic

Source: TRNC Prime Ministry, ***Economic and Social Indicators,*** *State Planning Organization Follow up and Coordination Department*

The Role of Agriculture in TRNC

Because of the TRNC has limited water resources and agricultural land the growth of agriculture sector has affected negatively on the TRNC.

Figure 7.2. Land distributions on the TRNC



Source: *TRNC Prime Ministry,* ***Economic and Social Indicators,*** *State Planning Organization Follow up and Coordination Department*

Basically, agriculture is one of the major economic sector on the SIDSs; because of this reason big share of exports are released by agricultural products, naturally the percentage of agriculture in GNP is high. This event affects the working people in the economy and the main portion of population is working in agricultural sector.

As seen from the graphic the total land area is equal to 2,465,550 (G.D), agricultural land is 1,398,123 (G.D) and it is the 56.71 % of total land. Unused land is the 8.15 % of total land.

Table 7.8. Use of Land in TRNC, 1999

Type of Land	Area (G.D.)	%
A. Arable Land	**847,345**	**60,61**
1. Land for Crops	589,152	42,13
2. Fallow Land	70,739	5,05
3. Legumes For Folder	72,529	5,19
4. Legumes For Food	1,928	0,13
5. Vegetable Land	10,523	0,76
6. Land For Melons	2,986	0,21
7. Industrial Crops Land	5,418	0,39
8. Orchards	46,980	3,36
9. Vineyard	2,054	0,14
10. Citrus	45,036	3,22
B. Uncultivated Land	**550,778**	**39,39**
Total	**1,398,123**	**100**

Source: TRNC Prime Ministry, ***Economic and Social Indicators,*** *State Planning Organization Follow up and Coordination Department*

The Structure of the Financial Sector and Institutions in TRNC

Liberal economic system has been adopted in the TRNC. Under this system the promotion of the private sector with limited government intervention, the rational use of natural resources, the encouragement of investments that generate high value added and employment preserve their priority and importance.

GNP per capita has been 4,978 US$ in 2000, but this amount has been 3561 US$ in 2001 and which indicates that the TRNC is in the category of middle-income country group.

The economy of the TRNC has the peculiarities of an island economy with limited resources so foreign trade emerges as the major sector of the economy. Due to the TRNC has adopted a liberal trade policy there is no discrimination against any foreign country. Approximately, she has trade relations with more than 60 countries all over the world.

The financial system in the TRNC consists of the Central Bank, Commercial banks (some of them locally incorporated institutions and branches of foreign banks); nonbank financial institutions (NBFIs), credit cooperatives, exchange offices and insurance companies. The offshore banks also evolving money and credit transactions; they operate under the special status.

The central bank of the Northern Cyprus emulates the functions of a central Bank, but the scope of its activities is limited. Established in 1984, the main aim of the bank was to exercise control of the monetary system on behalf of and under the control of the government. Because of the TRNC does not have its own currency and Turkish lira used as the medium of exchange, it is not possible to determine the amount of money that is circulating in the country.

Neither can the Central Bank set monetary policy. It receives daily exchange rates from the central banks; but it has no means of influencing the rate, as the banks are free to set these up at the given interest rate ceiling. The Central Bank is the banker of the government. It holds aid money provided by Turkey and earns profit on this money by placing it on deposit either in Turkey or elsewhere.

On the other hand, outside the Central Bank of TRNC, most important of the financial institutions are the retail or commercial banks. They established for the purpose of accepting deposits giving loans and other banking services to the people of Northern Cyprus. Commercial banks are facing a fierce competition among themselves. In 2000, the numbers of commercial banks commencing banking service the country were more than 35, and 50 offshore banks licensed under the Off-shore Banking Services Law.

One of the reasons for having so many banks in Northern Cyprus is the fact that capital requirement was extremely low; and most of the businessman preferred that to establish their own banks in order not to pay commission to other banks while carrying out their transactions. But later, minimum amount of paid-up capital required is determined as the amount of US$ 2,000,000 equivalent Turkish Liras on establishment and opening of a branch.[98]

Money and Banking

The official currency in the TRNC is Turkish Lira (TL). Real persons and corporate bodies are free to keep and save foreign currency, to use foreign currency as a means of foreign exchange and to express in foreign currency figures appearing on payment orders and contracts. The official rates of exchange are fixed daily by the Central Bank and announced. Banks, foreign exchange bureaux and the Central Bank are free to fix different rates of exchange for the purchase and sale of foreign currency.

Performance of Commercial Banks

Total lending by commercial banks in 1999 was 541,068,793 million TL. Table 7.9. shows the breakdown by lending category; the largest was Public Enterprises and Institution, followed by foreign and Domestic trade and business and Personal Loans.

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[98] http://www.devplan.org

Table 7.9. Bank Loans by Sector, 1999

Sector	Million TL.
Agriculture	7,721,656.0
Manufacturing	5,460,597.0
Public Enterprises and Institution	307,237,745.0
Transportation	562,553.0
Building and construction	8,825,463.0
Tourism	8,782,531.0
Foreign and Domestic trade	142,730,101.0
Business and Personal Loans	59,748,147.0
Total	**541,068,793.0**

Source: *Ministry of Economy and Finance, Central Bank of the TRNC, State Planning Organization; p: 49*

Bank Deposits

The Turkish Lira deposits increased from 5,483,804.7 million TL in 1994 to 172,426,892 million TL in 1999. The increase in the amount of deposits was due to the rise of interest rates which attracted more deposits and diverted sight deposits to time deposits.

The foreign currency deposits which were 283.2 million US $ in 1994 increased by 82.8% and reached to 517.6 million US $ in 1999.

The developments in the bank deposits during the period 1994-1999 are seen in the following table.

Table 7.10. Turkish Lira Deposits

(Million TL and $)

	1994	**1995**	**1996**	**1997**	**1998**	**1999**
Sight Deposits (TL)	1,237,290.4	1,870,048.2	3,656,146.9	8,354,263.3	9,251,557.3	24,395,707.0
US $	32.2	31.5	34.1	40.8	29.6	45.2
Time Deposits (TL)	4,246,514.3	7,976,709.2	15,113,353.6	33,464,116.7	64,499,329.6	148,031,185.0
US $	110.6	134.5	140.7	163.6	206.5	274.4
Total (TL)	5,483,804.7	9,846,757.4	18,769,500.5	41,818,380.0	73,750,886.9	172,426,892.0
US $	142.8	166.0	174.8	204.4	236.1	319.6

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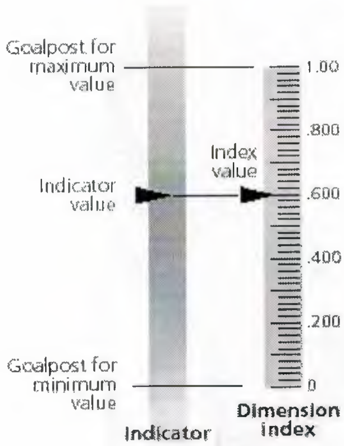
Appendixes

Calculation of Human Development Index

Before the HDI itself is calculated, an index needs to be created for each of these dimensions. To calculate these dimension indices —the life expectancy, education and GDP indices—minimum and maximum values (goalposts) are chosen for each underlying indicator.



Performance in each dimension is expressed as a value between 0 and 1 by applying the following general formula:

$$\text{Dimension index} = \frac{\text{actual value} - \text{minimum value}}{\text{maximum value} - \text{minimum value}}$$

The HDI is then calculated as a simple average of the dimension indices. The box at right illustrates the calculation of the HDI for a sample country.

Goalposts for calculating the HDI

Indicator	Maximum value	Minimum value
Life expectancy at birth (years)	85	25
Adult literacy rate (%)	100	0
Combined gross enrolment ratio (%)	100	0
GDP per capita (PPP US$)	40,000	100

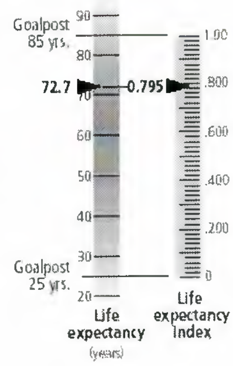
Calculating the HDI

This illustration of the calculation of the HDI uses data for Armenia.

1. Calculating the life expectancy index

The life expectancy index measures the relative achievement of a country in life expectancy at birth. For Armenia, with a life expectancy of 72.7 years in 1999, the life expectancy index is 0.795.

$$\text{Life expectancy index} = \frac{72.7 - 25}{85 - 25} = \mathbf{0.795}$$

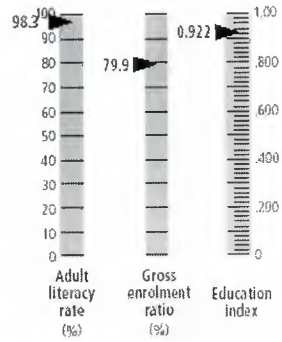


2. Calculating the education index

The education index measures a country's relative achievement in both adult literacy and combined primary, secondary and tertiary gross enrolment. First, an index for adult literacy and one for combined gross enrolment are calculated. Then these two indices are combined to create the education index, with two-thirds weight given to adult literacy and one-third weight to combined gross enrolment. For Armenia, with an adult literacy rate of 98.3% and a combined gross enrolment ratio of 79.9% in 1999, the education index is 0.922.

$$\text{Adult literacy index} = \frac{98.3 - 0}{100 - 0} = 0.983$$

$$\text{Gross enrolment index} = \frac{79.9 - 0}{100 - 0} = 0.799$$

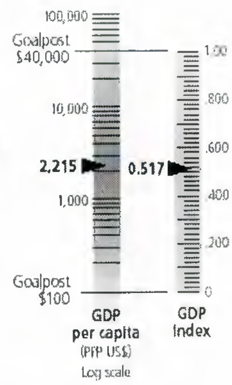


Education index = 2/3 (adult literacy index) + 1/3 (gross enrolment index)
= 2/3 (0.983) + 1/3 (0.799) = **0.922**

3. Calculating the GDP index

The GDP index is calculated using adjusted GDP per capita (PPP US$). In the HDI income serves as a surrogate for all the dimensions of human development not reflected in a long and healthy life and in knowledge. Income is adjusted because achieving a respectable level of human development does not require unlimited income. Accordingly, the logarithm of income is used. For Armenia, with a GDP per capita of $2,215 (PPP US$) in 1998, the GDP index is 0.517.

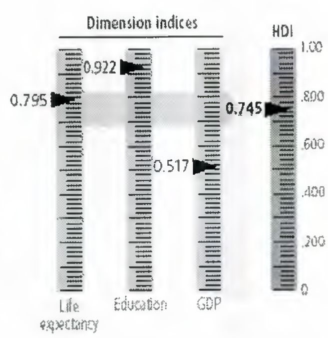
$$\text{GDP index} = \frac{\log(2{,}215) - \log(100)}{\log(40{,}000) - \log(100)} = 0.517$$



4. Calculating the HDI

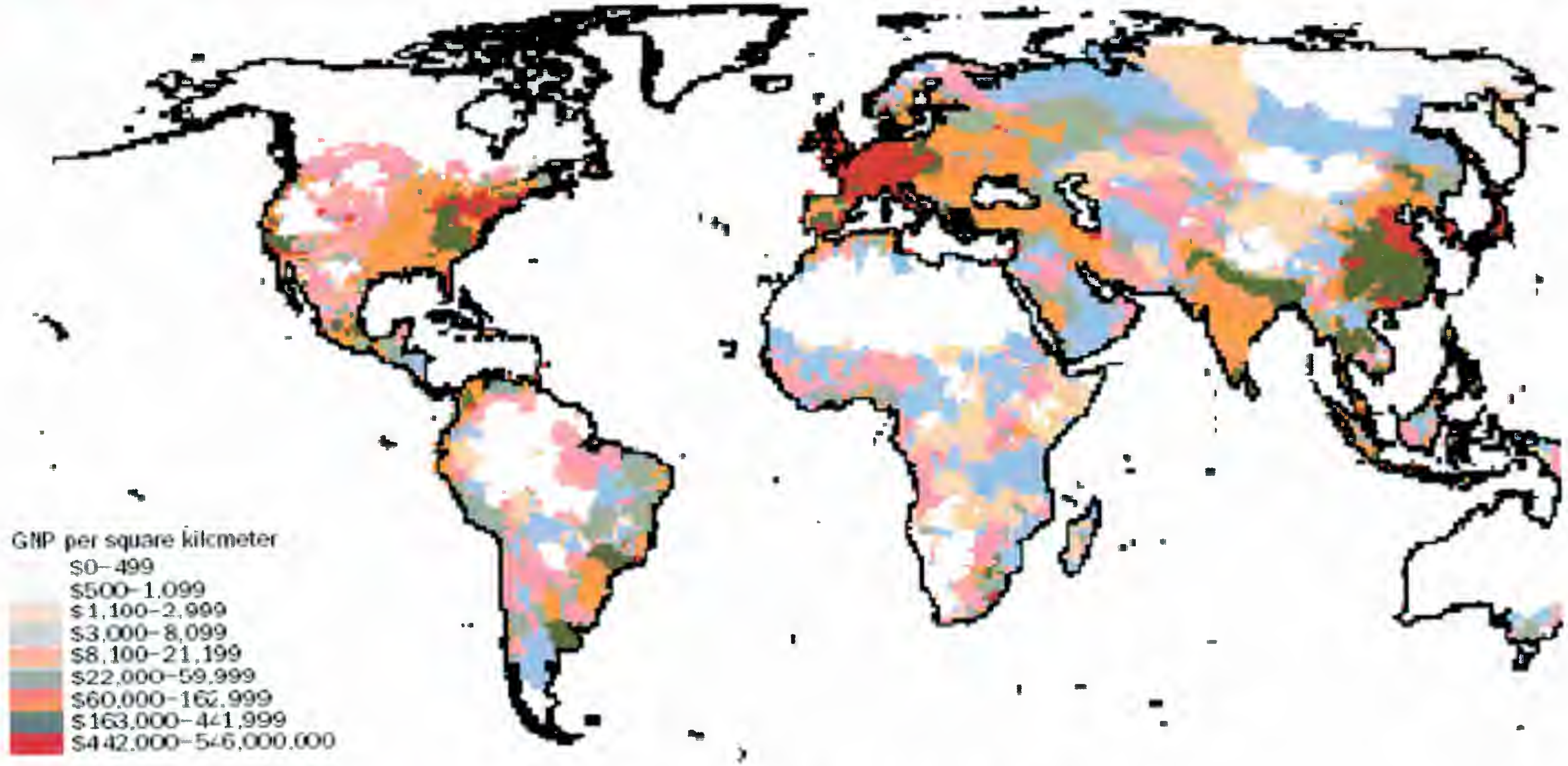
Once the dimension indices have been calculated, determining the HDI is straightforward. It is a simple average of the three dimension indices.

HDI = 1/3 (life expectancy index) + 1/3 (education index)
+ 1/3 (GDP index)
= 1/3 (0.795) + 1/3 (0.922) + 1/3 (0.517) = **0.745**



Source: Published for the United Nations Development Programme (UNDP), New York, Oxford University Press, 2001, pp: 110

GNP Density



Source: Globalization Growth and Poverty, A World Bank Policy Research Report, 2002

Models of Corporate Restructuring

There are three popular approaches to corporate sector restructuring: **centralized, decentralized, and the London approach.**

In the **centralized approach**, the government plays a leading role. This is effective when the size of problematic debts is small, corporate structure is simple, and the government enjoys high levels of confidence. Sweden in the early 1990s and Hungary in the mid-1990s used a centralized approach to corporate restructuring.

At the other extreme, interested parties use a **decentralized approach** to reach voluntary restructuring agreements. This is considered more useful than the centralized approach if the bad debts are large and the corporate structure is complex. Corporate restructuring in the United States tends to follow this model.

The **London approach** evolved in the United Kingdom when numerous firms faced bankruptcy in the recession of the early 1990s. During this period, more than 160 British companies used the London approach, in which creditor financial institutions and indebted firms work under the close coordination of a government institution (in the British case, the Bank of England), but outside the formal judiciary process.

The London approach includes

- Full information sharing between all parties involved in a workout
- Collective decision making among creditor banks on whether and on what terms a company should be given a financial lifeline
- Standardized agreements between debtors and creditors and among creditors themselves
- A clear timetable to achieve timely resolution
- Binding agreements between banks and firms to participate in and honor the restructuring agreements
- The principle of "shared pain" in the allocation of losses, meaning equal treatment for all creditors of a single category
- The possibility of penalties if the agreements are not adhered to.

To be successful, this approach demands strong confidence in the official mediating institution. In the British case, the parties concerned held the Bank of England in high regard, a crucial ingredient for success. Superficially, the corporate debt workouts under government coordination in Indonesia, Korea, and Thailand resemble the London approach. However, the Asian countries lacked the equivalent of the Bank of England, a government institution with high credibility. They also suffered a lack of mutual trust and confidence between financial institutions. This process is now gradually changing, as both financial institutions and corporations become more confident in the ability of government to oversee corporate debt restructuring.