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THE POLITICS OF FOREIGN DIRECT INVESTMENTS  
INTO TURKEY: 2002-2019

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TÜRKİYE'YE YAPILAN DOĞRUDAN YABANCI YATIRIMLARIN

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## ABSTRACT

The thesis attempts to demonstrate the relation between Foreign Direct Investment (FDI) inflows to Turkey and political (in)stability, since political risk is considered as the most important determinant of FDI in developing countries. In order to achieve this, the last 18 years under AKP (Justice and Development Party) rule was chosen, because the single party government stabilizes one of the most important variables of the political risk perception. In doing so, the thesis will depict the political economy of Turkey between 2002-2019 in three parts and discuss the relationship between political events and FDI inflows. Dividing the given time frame into three, these distinct periods are chosen according to the macroeconomic trends and episodes of the different political conflicts. Then, the thesis will discuss this relationship from the perspective of liberal approaches. The main argument of the thesis is: there is a strong negative relation between FDI inflows to Turkey and the increasing political instability, as the political events of the last two decades such as external and internal conflicts, terrorist attacks and corruption increase the perceived political risk for Multinational Enterprises (MNEs). Therefore, the thesis reached the following conclusion: The key factor that affects FDI inflows to Turkey negatively is political instability; however, the incentives and political privileges that are given to the MNCs have a positive effect on FDI inflows in the short run.

**Keywords:** Foreign Direct Investment, political instability, political risk, Multi-National Companies, Turkey

## ÖZET

Bu tez, geliřmekte olan ÷lkelerde politik risk faktörünün Doğrudan Yabancı Yatırımlar (DYY) üzerinde en önemli etkenlerden biri olması nedeniyle, Türkiye'ye yapılan DYY ile politik istikrarsızlık arasındaki bağlantıyı göstermeyi amaçlamaktadır. Bu amaca uygun olarak, Türkiye'nin AKP hükümeti tarafından yönetildiđi son 18 yıl seçilmiştir. Bu dönemin seçilme nedeni tek parti rejiminin politik risk algısını etkileyen deđişkenlerden önemli bir kısmını sabitliyor oluşudur. Bu nedenle, bu tez 2002-2019 yılları arasını üç parça halinde inceleyecek ve bu süre zarfında gerçekleşen politik olaylar ile ÷lkeye giren DYY miktarı arasındaki ilişkiyi karşılaştırmalı olarak sunacaktır. Bu sürenin üçe bölünerek incelenme nedeni makroekonomik trendler ile politik olayların karşılaştırılmasını kolaylaştırmasıdır. Ardından, bu ilişki liberal teorilerin perspektifinden karşılaştırmalı olarak tartışılacaktır. Tezin ana argümanı, çok uluslu şirketler nezdinde politik risk algısını artıran politik istikrarsızlığın, Türkiye'ye yapılan DYY ile güçlü bir negatif ilişkiye sahip olduğudur. Bu bağlamda tezin ulaştığı sonuç, politik istikrarsızlığın Türkiye'ye yapılan DYY'lerin olumsuz etkilenmesinde kritik rol oynadığı, ancak çok uluslu şirketlere tanınan ayrıcalıklar ve verilen teşviklerin kısa dönemde DYY üzerinde olumlu etki yarattığıdır.

**Anahtar Kelimeler:** Doğrudan Yabancı Yatırım, politik istikrarsızlık, politik risk, Çok Uluslu Şirketler, Türkiye

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## **LIST OF ABBREVIATIONS**

MNE: Multi-National Enterprise

SOE: State-Owned Enterprise

SME: Small and Medium-sized Enterprise

FDI: Foreign Direct Investment

EU: European Union

CU: Customs Union

CBRT: Central Bank of the Republic of Turkey

ISI: Import-substitution Industrialization

AKP: Justice and Development Party

CHP: Republican People's Party

PKK: Kurdistan Workers' Party

YPG: People's Protection Units

ISIS: Islamic State of Iraq and Syria - also known as ISIL, IS and DAES

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## 1. INTRODUCTION

In the last two decades, Turkey has experienced immense economic and political transformation under AKP rule. The economic outlook was positive for a good half of that time, especially the growth rates exceeded the expectations. The liberal market policies implemented by AKP following the 2001 recession created a pro-business climate, which led to a high rate of growth and low levels of inflation. Multinational Enterprises (MNEs) perceived Turkey as one of the most attractive countries to invest in, therefore the FDI inflows skyrocketed from 2002 to 2007. As a result, Turkey had become one of the fastest rebounding economies following the 2001 recession with a growth rate average of 7,14% between 2002-2007 (last year before crisis).

However, concerning alterations to the political and the judiciary systems had started to leave the investors with questions towards the end of the first decade. Cerutti (2017, p. 17) describes the elements of political authoritarianism as *"the non-acceptance of conflict and plurality as normal elements of politics, the will to preserve the status quo and prevent change by keeping all political dynamics under close control by a strong central power, and lastly, the erosion of the rule of law, the division of powers, and democratic voting procedures"*. Based on these elements, AKP's political stance started leaning towards authoritarianism as the political stability of Turkey deteriorated significantly (Somer, 2016). Although some forms of authoritarianism are perceived as beneficial for the sake of investments; political events that occurred in the last decade such as regional conflicts, the refugee crisis, terrorism, democratic protests by the secular people, and allegations of corruption and misrule indicate that Turkey has not provided a stable and secure environment for FDI inflows (Mathur and Singh, 2013). Therefore, FDI inflows to Turkey entered into a cycle of boom and bust, USD 22 Billion in 2007 and USD 12,5 Billion in 2014 for instance, as MNEs were not able to predict the sudden political turmoil that transpired repeatedly.

The regional conflicts such as Turkey's involvement in Syrian civil war have also taken their toll on Turkey's economy, by adding more political risk factors to the equation (Stein, 2017). As of the end of 2019, Turkey has experienced a dramatic change in domestic policies challenging universal (liberal) norms (such as laws that give the government more control over judiciary system) and in its foreign policy

agenda conflicting with US interests, mainly in the Middle East (Bloomberg, 2018). Moreover, Turkey's long-term goal of becoming a part of European Union appears to be a lost cause due to the inability to comply with the EU laws, and human rights violations<sup>1</sup> as well as European reluctance in global crisis conditions. All in all, as it is the case with all developing countries, the state of Turkish economy depends on Turkey's ability to find its way back to political stability before it becomes too volatile for the MNE's to invest in.

The structure of the thesis will be as follows: First, the thesis will go into the theoretical grounds of political institutions, and present both traditional and contemporary approaches of the liberal theory. The thesis will then review the literature on the factors that affect MNEs decisions to invest in the host countries. Furthermore, the thesis will emphasize political risk and political instability, and how political instability has become the most important FDI determinant over the last few decades, especially for developing host countries. Second, the thesis will deliver a brief outline of the economy of Turkey throughout the history. Third, the thesis will focus on the main political events that took place under AKP rule in three abovementioned chapters, and emphasize how and why these events might have affected the FDI inflows to Turkey. Last, the thesis will discuss AKP's political and closely interlinked economic policy from the perspective of the liberal schools of institutionalism that are introduced in the first chapter. The thesis concludes that, although the incentives created by AKP benefit MNEs and attract FDI in the short run, the increasing amount of political instability has a larger-scale effect on the FDI inflows to Turkey, as it alters the perception of political risk.

The foundation of this thesis consists of the extensive debates and several empirical studies on the effects of political instability on FDI inflows in the literature. The abundance of research that emphasize the relation between these two concepts has made the case study of Turkey more reliable. For the quantitative aspect of this study, the thesis has used a significant amount of economic data and the country reports on Turkey available by international institutions, such as the World Bank and UNCTAD.

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<sup>1</sup> EU's stance against Turkey's membership is discussed further on the third chapter of this thesis.

Moreover, the political risk indices by the World Bank, Transparency International and AM Best has made measuring political stability of Turkey possible.

## **2. THEORETICAL AND HISTORICAL FRAMEWORK**

### **2.1. The Theory of Political Institutions**

In his study “International Relations: One Word, Many Theories” (1998, p. 31-41), political scientist Stephen Walt constructed a three-dimension model to emphasize modern policy analysis. The said dimensions are Realism, Liberalism and Constructivism. Walt states that realism concentrates on shifting distribution of power; liberalism emphasizes reforming of sovereignty, justice and human rights, and further examines the effects of religion in politics; and constructivism focuses on collective norms shaped by elite beliefs. Each of these theories have different views of policymaking: Realism recognizes the authoritarian power and its capability of building stable and strong institutions, but also warns that the power will deteriorate if it overreaches. Constructivism argues that a consensus on a stable political system is possible, however in almost all cases a power struggle of classes will determine the ultimate outcome. Liberalism underlines the importance of democratization through effective and transparent political institutions.

The most significant criticism towards liberalism is that it is naïve in terms of believing in social and international justice to solve every conflict (Korab-Karpowicz, 2018). In the last few decades, it became apparent that as the economic liberalization proceeded, the governments of previously liberal market economies transformed into more and more conservative and authoritarian regimes. This state-centric shift in policymaking has proven some aspects of realism to be more functional than liberalism in today’s world. As the political conflicts increase globally, states turn to realism in order to protect and preserve political power. Yet it is unclear in the literature where the state-centered institutionalism stops and authoritarianism starts, and when the power struggle becomes overreach (Edwin and Kelly, 2009).

In their book “Why Nations Fail: The Origins of Power, Prosperity, and Poverty”, Acemoğlu and Robinson state that what makes a country a success or a failure is

measured by the economic institutions, which are determined by political institutions. Acemoğlu and Robinson theorize that “extractive” political institutions are created when the political power is in the hands of a few, without proper supervision of law. Therefore, extractive economic institutions that are created by these political institutions lack regulation, creating trade barriers and blocking markets from functioning properly. “Inclusive” political institutions on the other hand, allow all market actors to participate in policymaking, while allocating constraints on politicians by hand of law. Accordingly, inclusive economic institutions created by these political institutions are regulated and relatively open to free entry of international actors. Furthermore, the authors stress that economic growth is ensured when inclusive institutions are created as these institutions encourage investment, generate broad participation in the market, and allocate the resources better. Although seemingly the extractive institutions align with realism and the inclusive institutions align with liberalism, the authors also mention that “political centralization to some degree” is necessary in order for inclusive institutions to be established and regulated by law (Acemoğlu and Robinson, 2012).

From the perspective of authoritarianism, extractive political institutions make perfect sense for two groups: the politicians and the economic elite who own the monopolies in the system. By transitioning the political institutions into inclusive, the politicians and the represented ideology would lose power and the elite would lose their privileges in the economy. Thus, these two groups would do everything in their power to maintain their power and privilege at the cost of investment and growth. In another study, Acemoğlu and Robinson (2006, p.115) state that “a switch towards more inclusive economic institutions may reduce the ability of the ruler to maintain power”. This brings the debate between realism and liberalism to another level: Is it possible to maintain economic growth while building extractive institutions in authoritarian states? In other words, for these powerful politicians, is it possible to *have it all*?

In regard to this thesis' main argument, this point of view is extremely important in the sense that AKP's political agenda of creating a privileged elite including the MNEs benefits both sides greatly, which would generate and guarantee FDI inflows to Turkey for the foreseeable future.

Acemoglu and Robinson (2012) conclude that it is in fact possible to achieve growth under authoritarian regimes, however, not for the long run. In the short run, growth can be achieved in two ways under extractive political institutions: by allocating resources to the industries controlled by the elites, and by allowing some relatively inclusive economic institutions to develop under strict control. However, in the long run, these solutions would not be sustainable because the global dynamics of free market economy would shy away from the strict control of the state. The authors give China as an example for authoritarian growth, and predict that the growth will slow down eventually because of the state interference in the economy creates extractive institutions that prevents other actors to enter the system and guarantee free capital flows. In his review of this study, political scientist Fukuyama (2012) argues that political inclusiveness of the developing and authoritarian states are subjective, and the "success" of such states - China in particular - is not yet determined.

Whereas the theory of inclusive and extractive institutions focuses on the inward power dynamics within the nations, transnational institutions seem to determine the level of economic inclusiveness for many countries. Dependency school of the comparative political economy might shed light on this matter, as it explains that dependent economies in fact create extractive political institutions in their countries by hand of MNEs (Ferraro, 2008, p. 58-64). O'Donnell (1978) argues that there is a distinction between political development and economic development, and developing countries with authoritarian regimes indeed show progress in the latter. Recent research on transnational institutions reveals that in dependent states, MNEs have great bargain power over economic institutions such as labor costs and resource allocations (Nölke, 2011, p. 7). From this point of view, it can be deduced that MNEs join the elite in the host country in benefiting from the authoritarian regime, hence the extractive institutions.

On the other hand, the theory of "open economy politics" is largely made of neoliberal institutionalism: It studies the interaction between domestic and transnational policymaking, and its effects on the growth potential. Cao (2009) states that although domestic policymaking is crucial for nations to sustain economic and political stability, the forces of globalization integrates transnational institutions into the domestic institutions as the economic openness expands. Economic openness is

broadly linked to the democratization level of a country in the literature. Therefore, global investors are more inclined to invest in the developing host countries that are in the process of democratization - in other words, in the process of establishing inclusive institutions. The main point of criticism on open economy politics is that it is limited to certain examples and the "observable behavior", which leads political scientists to refer to it as "ideational liberalism" (Paul, 2010). This department of the contemporary liberalism associates the liberal-democratic institutions with pluralism, public justification and reason, and a collaboration of individual and collective interest. Nonetheless, according to Moravcsik (1997), this approach raises concerns on the legitimacy of political institutions and the economic institutions created thereafter. The perceived legitimacy of domestic political institutions heavily affects the cooperation of states, and the integration to the transnational institutions. Similarly, Tomz (2007) states that MNEs are unable to correctly measure the level of risk that domestic political institutions expose, therefore the investment decisions heavily depend on the new information and perceived legitimacy. Moreover, in authoritarian states, the legitimacy of political institutions is typically measured by the legitimacy of political regime.

Keohane (2011) argues that liberal democratic theory does not fit in reality of the global governance; therefore the concept of legitimacy that consists of "minimal moral acceptability, inclusiveness, epistemic quality, accountability, compatibility with democratic governance within countries, and comparative benefit" would lead policymakers to establish the most effective political institutions. He further emphasizes that multilateral institutions does not always follow these criterion, and they could further deepen the problem of creating the oligarchic elite, violating the minority rights, and diminishing the reliability of political institutions within the nations (Keohane, 2011). In an earlier study, Keohane (2001) concludes that this "liberal governance dilemma" creates both powerful transnational political institutions and a possibility of the abuse of power. He further advises policymakers to establish global standards by hand of NGOs in order to determine the legitimacy of political institutions. In the literature, this approach is named "normative liberalism" which puts the burden of establishing a globally integrated economy while maintaining the nation states onto the international policymakers (Paul, 2010).

The standpoint of normative liberalism is that a policy is liberal only if it consists of pre-determined values (Rossi, 2008). This accentuates the realization that the concept of legitimacy blurs the lines between liberalism and constructivism. Further, it raises philosophical questions about pluralism as the standardized political institutions tend to favor the public good, even if it means to restrict the individual liberties. In this context, it is worthwhile to consider that whether the concept of legitimacy leads to the suppression of peoples and legitimize authoritarian regimes for the sake of functioning global markets.

In Turkey's case, this supports the idea that the creation of the powerful elite benefited AKP in the sense of its internal and external policy agenda. Internally, it constructed the extractive institutions to strengthen the power-centric rule. Externally, it guaranteed the privileges for MNEs, therefore the dependency of Turkish economy to FDI inflows was counterbalanced. From the perspective of normative liberalism, it could be argued that MNEs do not mind the extractive institutions since they benefit them greatly, and Turkey remains open to the capital flows. However, it is also unclear that whether the increasing political risk created by those extractive institutions will bring MNEs to a point that investment in Turkey would seem "too risky" or not.

## **2.2. FDI Determinants**

The literature is distinguished into traditional and non-traditional approaches when it comes to the foreign direct investment (FDI) determinants. The early literature persistently states that the gross domestic product (GDP) of a country is a major determinant of foreign direct investment (Basi, 1963; Green, 1972; Kobrin, 1978; Davidson, 1980). This conventional approach implies that the countries with higher GDP would attract greater amounts of FDI regardless of other conditions. Prior to the late 1990s, the literature on FDI determinants and the selection of host countries by MNEs geared towards "traditional demand factors such as wage rates, capital costs, market size, and the proximity of the local market" (Biswas, 2002, p. 492). One discussion point employed by conventional theorists such as Hymer (1960) and Caves (1971) is that FDI is simply "a means of exploiting firm-specific assets in a foreign

market". From this point of view, FDI is perceived as an opportunity to reducing the production costs, whilst gaining access to natural resources and base commodities. Furthermore, FDI reduces the trade barrier problems and other costs such as transportation and labor. However, the non-traditional factors such as incentives, political stability and economic institutions gained more importance towards the end of 20th century (Harms, 2002; Jensen, 2003; Busse and Hefeker, 2007).

Although the FDI determinants that guarantee foreign capital inflows are still heavily debated, a large number of existing studies in literature have examined the determinants for the FDI under six main topics: market potential, factor costs, openness of the economy, political risk, economic institutions and incentives. In the remainder of this section, the literature on these determinants that affect MNEs' decisions of choosing the host country for investment will be further reviewed.

Market size measured by GDP and its growth potential is deemed to be one of the most popular determinants among both the traditional and non-traditional approaches. As GDP grows, demand grows, therefore creates a larger market. *Ceteris paribus*, a large market with a potential growth attracts the "market-seeking FDI" (Asiedu, 2003). Several studies suggest that an inadequate market size would decelerate the specialization of productive factors. For instance, a study focused on FDI inflows from western countries to Turkey by Tatoglu and Glaister (1998) concluded that market size and growth rate of the economy is the most compelling factor that influenced the FDI inflows to Turkey. Other studies focused on the market potential of Turkey by Erden (1996) and Coşkun (2001), supported this finding. A more recent empirical study by Artige and Nicolini (2010) shows that regional market size and market potential is also crucial to the MNEs when deciding on a host country. The authors argue that *"the foreign firms that invested in these regions may have done so after considering the strengths of the local business climate, imperfectly represented here by market size and labour productivity"* (p. 17). However, regional studies like this one focused heavily on Europe and other developed regions to stabilize other important determinants such as political risk.

As mentioned above, traditional approaches to the FDI determinants argue that FDI is a means of gaining access to natural resources of the host country. MNEs prefer to invest in developing countries in order to benefit from low-cost resources that would

not be accessible or high-cost otherwise. According to Resmini (2000), neoclassical theory of FDI determinants describe the fundamental motivation of a MNE to invest is the cost advantages. The empirical studies conducted by Resmini (2000), Bevan and Estrin (2004), and Carstensen and Troubal (2004) conclude that the low-cost labor force has a major impact on the FDI inflows to the Central and Eastern Europe. A controversial study by Coskun (2011) implies that low-cost labor force does not have a significant impact on FDI decisions in developing countries, considering the transition economies also have this leverage. The majority of prior research recognizes the transport costs as a limited determinant as opposed to the labor costs (Esiyok, 2010, p.33).

The role of the nondomestic transactions and trade in an economy, in other words economic openness, is widely accepted as an important determinant of the FDI inflows. Research conducted on CEE Countries<sup>2</sup> by Galego et al. (2004) implies that there is a strong positive relation between trade openness and FDI inflows by stating that "trade and FDI are complements, not substitutes". An empirical study conducted on Asian developing countries by uz Zaman et al. (2018) confirms this relation, suggesting further trade policy implementations to ensure stable FDI inflows.

Political risk could be measured by the democratization level of a country, as well as the amount of political disturbances that occur within a certain amount of time. As studied extensively in the past two decades, political risk is accepted as the most important factor that affects investment decisions of the MNEs. Empirical studies conducted by Haksoon (2010), Krifa-Schneider and Matei (2010), Barry and DiGiuseppe (2018), Samimi et al. (2011) and Akhtar and Yasin (2015) all suggest that there is a very strong connection between political risk and FDI inflows, especially in the cases of developing countries. While a number of researchers have recognized low levels of political risk to be a stimulant of FDI inflows as it also boosts the profits, after a certain threshold the uncertainty becomes too much for MNEs to even consider an investment. Moreover, Azzimonti and Sarte (2007) emphasize the importance of regional and political factors when choosing the host country to invest in, arguing that once an investment is made, a MNE cannot avert the political risk.

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<sup>2</sup> CEE countries are EU member states which were part of the former Eastern bloc.

AM Best, a United States based credit rating agency, argues that political risk comprises nine main factors: international transactions policy, monetary policy, fiscal policy, business environment, labor flexibility, government stability, social stability, regional stability and legal system. These factors are closely tied together and when political risk arises, they start to deteriorate altogether. Research by Mudambi and Navarra (2003) suggests that MNEs prefer host countries that center-right parties are in power. However, "nationalization risk" is another type of risk that comes with centre-right politics<sup>3</sup>. Moreover, as has been reported in the previous literature, highly nationalized countries bear the possibility of implementing self-sufficient economic policies instead of relying on foreign trade and FDI. The most common political risk factor is political instability, which will be discussed extensively throughout the thesis.

The importance of economic institutions in the growth and development of a country has been discussed by a great number of authors in the literature. A strong "governance infrastructure" (OECD, 2001) is made of a transparent and independent legal system, government policies that advocates free and open markets, and public institutions that are transparent and reliable. A large number of existing studies in the literature that examined developing countries that have unreliable economic institutions such as CEECs and Middle Eastern countries, concluded that inadequate quality of the institutions cause uncertainty and MNEs avoid such conditions in order to protect their capital from unexpected barriers. Studies conducted by Li and Rescnik (2003), Lewer and Saenz (2005) and Kobeissi (2005) also agree with this, moreover, they emphasize on the importance of protecting intellectual property rights are of crucial importance when it comes to investment decisions.

The World Bank has established the factor of "good governance" in Worldwide Governance Indicators (WGI), which comprises six concepts of governance: voice and accountability, political stability and absence of violence, government effectiveness, regulatory quality, rule of law, and control of corruption. Empirical studies of the data collected from the host countries suggest that good governance overall positively affects the amount and quality of FDI inflows.

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<sup>3</sup> Far left politics also bear the risk of nationalization, however it is not discussed as it falls outside of the scope of this thesis.

For economically dependent emerging countries, attracting FDI plays a crucial role in the economic development. Many countries develop incentive programs and establish promotion agencies to be chosen as a host country by MNEs. Whether it be easing the legal procedures, reducing tax burden on MNEs, or providing partial insurance for the investments; these countries go to great lengths to attract more FDI. However, Blomström (2001) argues that targeting MNEs when implementing incentives is not an effective strategy, implying that FDI does not have any advantages over other types of investments. A study conducted by Oman (2000, cited from the OECD website) for the OECD suggests that incentive-based competition is ineffective since almost all developing countries have implemented free market based policies. Furthermore, Fitzgerald (2001) discusses that regulatory incentives competition between host countries leads to a welfare loss.

In regard to FDI inflows to Turkey; market potential, low factor costs and openness of the economy seem to have minor to moderate effect on FDI inflows. An empirical study conducted by Esiyok (2010) concluded that the determinants that fall under political risk have significant positive relation with the FDI inflows to Turkey. As for the incentives, the privileges given to the MNEs by making them a crucial part of the economic elite ensures the continuity of FDI inflows. The political risk will be discussed extensively in the following chapters, as it is the most important determinant of FDI in Turkey.

### **2.3. Understanding Political Instability**

Early literature on political risk consists of identification of the sources, analysis of these factors and research on the ways of correctly anticipating the level of risk. Roback (1971) argues that political risk occurs when 1- the international business environment changes, 2- these changes are results of the political change, and 3- these changes are difficult to anticipate. Pearson (1981) agrees and further concludes that political changes do not necessarily cause political risk if they do not affect the business environment of the host country. Haendel (1979) emphasizes the distinction between political risk and political uncertainty, stating that political uncertainty

cannot be measured whereas political risk is a probability estimate, therefore can be measured objectively.

Before the early 1970s, political risk was used interchangeably with political instability. However, the two concepts differ from each other in the ways of occurrence and process. Starting with Robock (1971), political risk is defined as a type of investment risk that occurs when political decisions of the host country lead to a profit loss for MNEs. Political instability is broader in meaning, describing a situation that affects the host country wholly.

Considering political stability is one of the important factors that constitute political risk, it comprises both measurable and immeasurable aspects. MNEs seek political and economic stability in a host country, due to the fact that they cannot avoid political events once they tie their investments into the chosen country. Regime changes and major conflicts can wipe out the investment climate in the host countries, which may cause a closedown effect and MNEs may not be able to take action on time. Because of the nature of such political risks, MNEs tend to avoid entering the market altogether if the politics of host country becomes highly unstable, and the resource extraction is not profitable enough to cover the risk (Witte et. al., 2016).

A large number of comprehensive research on political instability conclude that it can be defined as politically relevant events occurring in a country or region through an undetermined amount of time. These political events may include but not limited to elections, foreign affairs and conflicts, terrorism and acts of violence, protests and uprisings, coups and other military conflicts, corruption, civil wars and refugee crises. Feng (2003) states that "regular government changes" may lead to political instability as well as "irregular governmental changes", therefore affect the FDI inflows. Furthermore, Feng argues that MNEs can get great returns for their investments under any type of economic policy, as long as there is not any type of political instability in the host country. However, Feng's research is primarily focused on government changes, which is only one type of political instability. Zak (2002) explains that "socio-political instability" will decrease FDI due to the fact that it creates an unstable business environment and the economic policies are harder to follow when such political events develop. Zak claims that especially in developing countries, FDI "escapes" under high pressure of the socio-political instability. Terrorism and acts of

violence are other political instability factors that severely affect the FDI inflows, since the host country cannot guarantee security of the investments of MNEs (Bano et al., 2019). Another study by Akhtar and Yasin (2015) further concludes that the security concerns are rather a "pre-requisite" for the FDI inflows to the host country, than a factor. As demonstrated in the following chapters of this thesis, FDI inflows to Turkey have a negative relation with the high political instability, which is created by the vast amount of political events and conflicts that occurred under AKP rule.

Authoritarian regimes are also a concern of MNEs for investment decisions. Previous research suggests that a country's democratization level shows the level of its pronity to political instability. A study on Latin American and East Asian countries by Feng (1995) supports the hypothesis that economic growth is affected negatively by authoritarianism. A contradicting hypothesis is suggested by Bastiaens (2016), stating that some of the authoritarian developing countries continue to attract FDI inflows due to their adoption of liberal economy policies and international investment treaties. Nonetheless, it is clear that the investment decisions heavily rely on the confidence, the prejudice and the risk perception of MNEs (Krugman, 2009).

In his controversial study, Williams (2010) states *"political instability distorts incentives for development, but it's also possible that some dosage of political instability might be necessary to move a country to a good equilibrium by removing a corrupt regime from political office so as to restore confidence in governance."* Furthermore, the author argues that this "productive instability" might have a positive effect on the productivity of a country in the medium to long run. The empirical implications of this study are that there are different political instability factors that affect FDI inflows for every region, therefore it is hard to draw a general conclusion except that political instability in general does affect FDI inflows. Moreover, there seems to be a threshold below which political instability does not affect any macroeconomic indicators.

Corruption is another important aspect of political instability, moreover, previous research implies that it has a negative relation with the level of democratization (Mathur and Singh, 2013). Therefore, it can be argued that authoritarian regimes are more prone to corruption scandals and the uncertainty perception that comes with it. The Corruption Perception Index (CPI) by Transparency International attempts to

measure the perceived levels of public sector corruption. In 2018 CPI Global Analysis, it is stated that since 2006, 113 countries have experienced a decline in their democracy levels, which leads to a higher perception of corruption. According to the report, the least corrupt region is Western Europe and the most corrupt region is Sub-Saharan Africa. For Middle East, the report calls for a "crisis of democracy". A study conducted by Türedi (2018) provides empirical evidence that low levels of perceived corruption attract more FDI inflows, therefore developing countries are recommended to take measures for implementing more reliable institutions to attract the MNEs by the author. For Turkey, Tosun (2016) found that there is a positive relation between corruption and FDI inflows, which could be explained with the MNEs' expectation of having more privileges in a host country that has more room for "bending the rules".

It is important to look into the regional political instability as well, as some developing regions possess high political risk that affect all the countries in that region. For instance, the civil wars and regional conflicts in the Middle East lead to a broader decrease in FDI for all neighbor countries. In the 2018 Country Risk Report of AM Best, it is suggested that the political instability and social unrest in Middle East region impact the neighbor countries' macroeconomic indicators negatively. An empirical study conducted on 16 countries in MENA (Middle East and North Africa) by Al-Khouri and Abdul Khalik (2013) demonstrates that regional political instability affects the FDI inflows significantly. The authors further observe that corruption and external conflict are the two main political instability factors that have close negative association with FDI inflows. Chan and Gemayel (2004) further emphasize that for MENA, the degree of political instability is a more crucial determinant of FDI inflows than it is for developed countries.

Despite the broadly researched negative relation between political instability and FDI inflows, developing countries with high political instability seem to be getting extensive amounts of FDI from developed countries. Li and Resnick (2003) argue that uncertainty is the main reason for the escape of FDI, not the political instability itself. This means that if MNEs are able to successfully predict the conflict, they adjust their behavior accordingly, therefore the political instability has little or no effect on FDI. However, unexpected events of political instability would heavily affect the FDI inflows. Brouters et al. (1998) point out that MNEs have to have control over

potential risk/cost and potential return to make the right decision to choose the host country. High political risk may cause higher internalization of the investment in host country, especially in developing or rural areas, thus reducing the external market risk. Therefore, emerging markets become more and more attractive to the MNEs as they are able to take the risk of political instability for higher profits in return. Investment insurance, incentives and government policies minimize the political risk in most developing countries.

According to Mihalache (2010), MNEs in fact play a political role in developing countries, using the host country's dependency on FDI inflows as leverage. Therefore, MNEs can directly affect the political instability, or initiate political events themselves. Moreover, this ability can give MNEs the advantage of successfully predicting political instability. In the light of this approach, Mihalache argues that FDI inflows to the tertiary sector seems to lower the probability of civil conflict in developing areas of the host country.

While political risk and political instability are broadly discussed in the literature, this review concludes that further research is required, especially in the inter-state and regional conflicts area. It remains uncertain that to what extent Turkey's involvement in Syrian Civil War would affect the perceived political risk, and thus FDI inflows. As Feng (2003) argues, internal political instability remains the highest element of political risk for MNEs in Turkey. The trust in investment security is prone to irregular or sudden government changes such as coups – putting Turkey in a high risk position, given its history. Nonetheless, as suggested by Bastiaens (2016), MNEs do not seem to be affected negatively by the authoritarian tendency of the AKP rule, as long as the economic policy remains liberal. Furthermore, as mentioned before, MNEs could prefer a more authoritarian rule in a developing country in order to acquire privileges from maintaining a close relationship with the government. As Mihalache (2010) states, the political bargain power MNEs have in such countries including Turkey could create a cause-effect-cause relationship between political instability and FDI inflows.

#### **2.4. The Economy of Turkey and FDI: A Brief History**

It is important to see where Turkey started off to better understand how FDI transformed the economy. Turkey was founded after a devastating collapse of Ottoman Empire and a war of independence against the most powerful countries in the world. Modern Republic of Turkey was formed in 1923, and ever since it has gone several major transformations in industrialization, economic structure and politics. Rising from the ashes of Ottoman Empire, Turkey took liability of its foreign debt, agreeing to pay 62% of the pre-1921 and %77 of the post-1912 debt in the Treaty of Lausanne. Until the last payment was made in 1954, Turkey was struggling with both building its own institutions to develop and the financial burden of a fallen empire (Aysal, 2013).

Turkey went through three distinct phases in its economic structure towards industrialization. First, it focused on growth strategy. Following Mustafa Kemal Atatürk's vision of social statism (later broadly addressed as Kemalism), the state has regulated all economic activity and controlled several industries, establishing government owned corporations. These state-owned enterprises (SOEs) pioneered industrial development and technological advancement (World Bank, 1993). Consequently, it can be deduced that private companies and MNEs were not prioritized when it came to investment decisions.

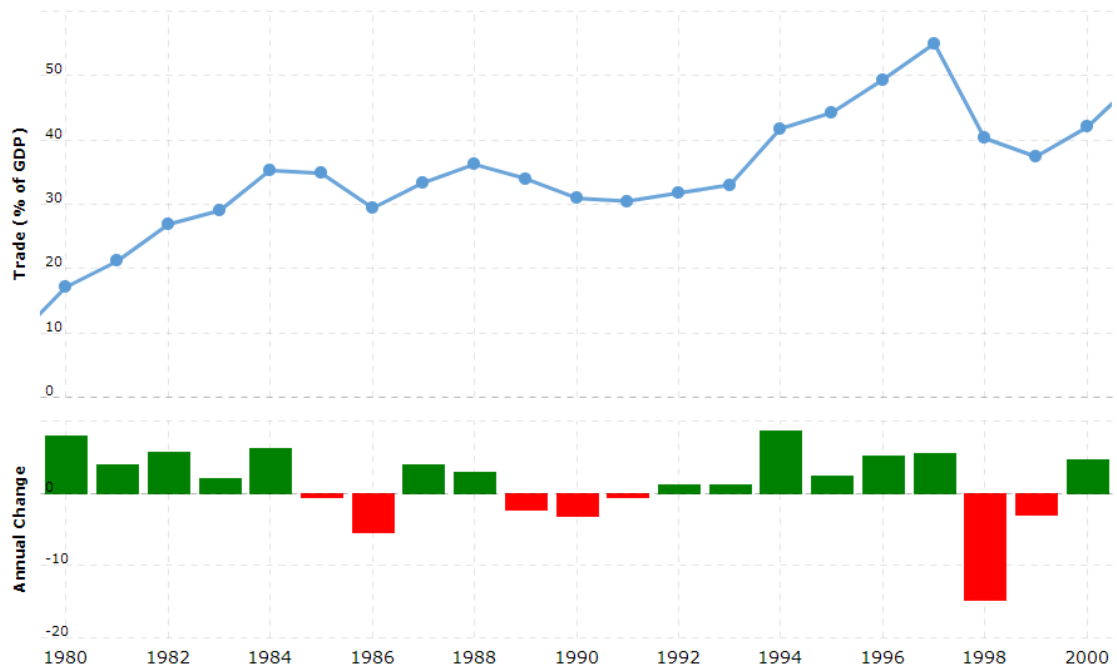
The second phase started after World War II. Although Turkey technically did not participate in WWII and remained neutral until the final stages, it still was one of the beneficiaries of the Marshall Plan (officially the European Recovery Program - ERP). This was largely due to the American vision of "containing communism". With the Marshall Plan, Turkish economy made a progress towards liberal system, thus the growth of private sector. Although Marshall Plan overall helped Turkish economy, it also impacted the development of technology in Turkey by causing the termination of aircraft production (Carver, 2011).

After WWII, a hybrid economy approach was accepted, where the growth strategy focused on domestic production supported by import of technology. The economy has experienced accelerated growth in almost all sectors, averaging 5% between 1960 and 1980. However, until 1980, Turkish government pursued import-substitution industrialization (ISI) policy which significantly altered imports and focused on 5-year national development plans (Keyder, 1987). The decrease in imports generated

demand for subsidized imports by lowering exports. The inward growth strategy, financed from short term foreign loans resulted in a balance of payments crisis in 1979. This severely impacted Turkey's development, causing the government to change the point of view on ISI policy (Dağdemir, 2016).

In 1980, Turkish government implemented an export-led industrialization model to break out of the vicious cycle of rapid growth and deflation. Turkey adopted a series of liberal economic policies -widely referred as January 24th Decisions- that included devaluation of Turkish Lira, flexible exchange rates, rigid control of money supply, elimination of subsidies, tax reforms, and encouragement of FDI. In Prime Minister Turgut Özal's opinion, the new liberal policy has prepared Turkey to the globalization movement that started in 1990s, by accelerating the integration process to European Union (EU) (then European Economic Community - EEC). The efforts in actualizing Turkey's long term goal of becoming an EU member state had resulted in the foundation of a Customs Union (CU) in 1995. CU has established a free trade area between Turkey and EU for industrial products, which increased both imports and exports significantly. Total exports increased to USD 20 billion in 1990 from USD 3 billion in 1980 (Pamuk, 2008), whereas the exports-to-GDP ratio has risen from 20% to 35% in 15 years, from 1980 to 1995 (OECD, 2019). Graph 1 shows trade-to-GDP ratio of Turkey from 1980 to 2000.

**Graph 1:** Trade-to-GDP Ratio of Turkey



**Source:** macrotrends.net, **Data Source:** World Bank

Industry-wise, agriculture decreased to 16% while manufacturing increased to 40% by early 1990s. The most significant growth happened in the service sector, covering almost half of the GDP by 1994 (Pamuk, 2008).

The rapid growth and the improvements in economic indicators did not stabilize the Turkish economy in the long term. Largely due to the lack of strong institutions, the inflation rate and unemployment climbed again towards the end of 1980s. Although Turkish economy greatly benefited from the Iran-Iraq war (1980-1988) by way of trade and oil pipelines, it subsequently suffered from the Persian Gulf War (1991) as a consequence of the UN embargo on Iraq. The remarkable growth in the 1980s resulted in good credit notes from international rating agencies, attracting foreign investment in the financial markets. The capital inflows encouraged commercial banks to borrow at international interest rates and lend at higher domestic rates. Consequently, the short term foreign debt rose drastically (Bayrak and Esen, 2012).

In the meantime, the disputes between Turkish Government and the independent Central Bank of the Republic of Turkey (CBRT) induced disturbance in the financial markets and resulted in the flight of foreign capital. The CBRT lost 40% of its reserve

assets in 1994, followed by the depreciation of Turkish Lira. Correspondingly, a stabilization program was established by Turkish government, which required financial aid from International Monetary Fund (IMF). The measures taken included encouraging the privatization of SOEs (IMF, 2000).

Following the Early 2000s Recession, Turkey had gone under significant institutional transformations. With guidance of IMF, Turkey worked on eliminating the effects of 2001 crisis by reforming the private sector, reinforcing competitiveness of the financial sector and completely transforming the social security system (Erkoç, 2014). For the last two decades, the economic policy has been focused on normalizing inflation rate, encouraging FDI and implementing pro-liquidity policies. The regime transformation from fixed interest rates to floating interest rates in 2001 was under advisory of IMF as a part of the new liquidity regulations. Later, CBRT adopted a more rigid monetary policy to prevent high inflation rates following the Great Recession of 2007-2008 (Yeldan and Ünüvar, 2016). According to the CBRT 2015 Financial Stability Report, despite the measures taken restrained the inflation rate, the foreign exchange rates became unstable and food prices have risen above the expectations.

For an emerging market like Turkey, FDI has crucial role in economic globalization and development. Rather than indirect investments which only provides short term capital, direct investments contribute more to the economy in the long term. FDI supplies employment, technologic advancement and even public image. Turkey has become heavily dependent on FDI following the stock market crash in 2001, despite the radical measurements taken. Simultaneously, the victory of a centre right political party made Turkey more attractive to MNEs as a stable developing country (Mathur and Singh, 2013).

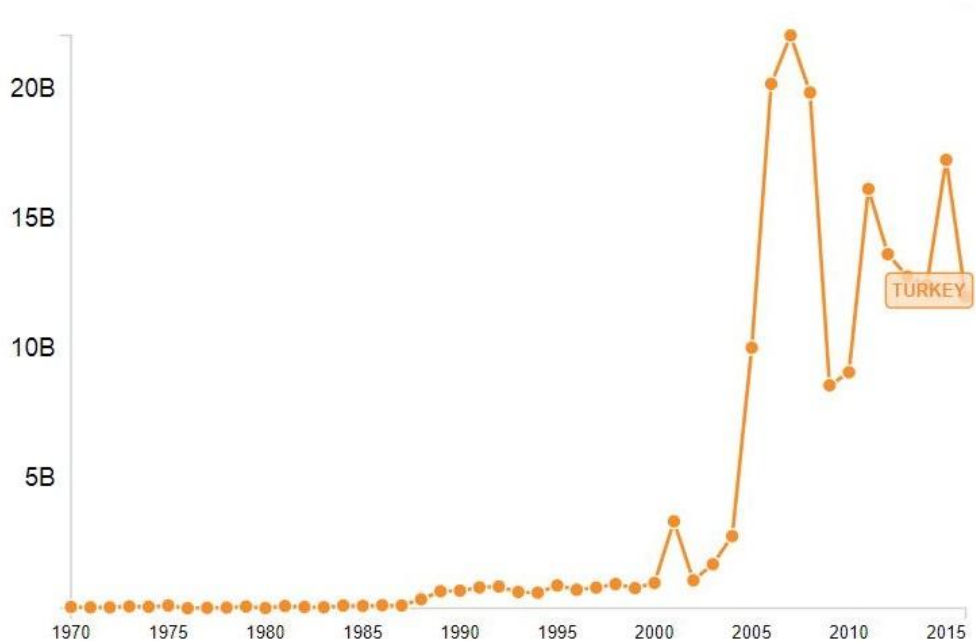
The predominant argument in the literature is that FDI has a broad positive effect on Turkey's economic growth, yet, it doesn't contribute to the other aspects of economy such as unemployment and factor costs as expected (Ekinci, 2011; Kahveci&Terzi, 2017). It is argued that the sectors that receive FDI heavily in Turkey are limited employment capacity ones such as finance, communication and transportation (Saray, 2011). This could also suggest that the technological advancement MNEs bring to the

host country might reduce the necessity for manpower, which in the long term could also generate unemployment.

Prior empirical studies that focused on FDI determinants specific to Turkey have mainly indicated that the macroeconomic factors directly affect the FDI. In the study of Ekinçi (2011, p. 60) the top three locational factors that affect FDI for Turkey have been found to be: "market size, growth rate and geographical proximity". Additionally, the top three problems faced by investors have been found to be: "corruption, informal economy and uncertainties arising from the macroeconomy" (Ekinçi, 2011, p. 80). Thus, it can be determined that having stable macroeconomic indicators is sufficient enough to attract high amounts of FDI into Turkey.

Following the January 24th decisions, Turkey started offering incentives to promptly attract FDI. However, the effect of the incentives remained unimportant and the FDI didn't reach the target levels. Hazman (2010) suggests that the incentives were weak compared to the greater political risk that kept investors away. Graph 2 shows the FDI inflows into Turkey between 1970-2018, in USD Billions. As the figure illustrates, FDI levels remained insignificant until early 2000s.

**Graph 2:** FDI Inflows to Turkey 1970-2018



**Source:** World Bank

Prior research in the political studies (Acemođlu and Üçer, 2016; Chan and Gemayel, 2004; Coskun, 2001; Ekinci, 2011) suggest a strong contrary opinion that the most important determinant of FDI into Turkey is political risk, as it is the case in most developing countries. Political instability caused volatile credit ratings over time from international credit rating agencies, which is another important factor that foreign investors considered when deciding the host country of the investments. Moreover, prior research also indicates that political instability produces uncertainty in the economy, therefore affects the domestic economic activities negatively and ultimately curbs the growth rate. In the following chapter, there will be a comprehensive analysis of the political events that cause the political instability in Turkey.

### **3. THE POLITICS OF FOREIGN DIRECT INVESTMENTS INTO TURKEY**

#### **3.1. Political Events of the Last Two Decades**

Turkey's political history has always been a turmoil since it was founded. It is filled with military coups, terrorism, political uprisings, coalitions, and governments that could not see the end of their mandate<sup>4</sup>. This thesis focuses on the last 18 years under the rule of AKP, which could be considered the "most stable" political period of Turkey for having one party rule<sup>5</sup>. However, the research mentioned in the following sub-chapters suggest that this period might be feeding into a bigger systemic issue, presenting itself as political instability with long term consequences for Turkish economy. For the purposes of this thesis, the AKP rule timeline was divided into three parts according to the macroeconomic and political developments: 2002-2006, 2007-2012 and 2013-2019. This periodization is based on the research conducted by Öniş (2015), in which the author describes these three chapters of AKP era as: golden age,

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<sup>4</sup> Four or five years, depending on different constitutional amendments.

<sup>5</sup> "Most stable" refers to a government that could fulfill its mandate and also has no obligation to another coalition partner.

stagnation and declining. The first period is characterized by high growth rates, low inflation, spiking FDI inflows on the economic side, and democratization, the start of EU access negotiations and peaceful "zero problems with neighbors" foreign policy on the political side. However, the 2007 general election after the first uprising of secular people and the following constitutional change that made important changes on presidential elections marked the beginning of a new political chapter for AKP. Economically, the stagnation period of AKP goes through 2007-2011 (Öniş, 2015). This period is characterized by the effects of global financial crisis in 2008, however as it is explained in the following sub-chapters, the economic decline of Turkey started before the crisis. The reason that this thesis takes 2013 instead of 2012 as the start of the "declining" period of AKP is the amount of political events that transpired in 2013. The said events played a big role in the political decline of AKP and the level of political risk perception among MNEs, which affected the economy greatly. The third chapter of AKP era is characterized by these political events, and stagnant macroeconomic indicators such as growth rate, unemployment and current account deficit (Yeldan and Ünüvar, 2016). In the following sub-chapters, the important political events that occurred under AKP rule will be emphasized, and the ways they affected the FDI inflows to Turkey by altering the MNEs' investment decisions will be demonstrated.

Arguably the most effective political promises of AKP that won them the first election in 2002 were to abolish the Kemalist elite and re-establish the rights of previously-oppressed religious people (Dewdney and Yapp, 2019). However, in the light of political events that occurred in the last 18 years, it became clear that AKP has created its own elite, who benefits from the close proximity to the government (Somer, 2016).

The second promise was to "fix" the economy, as Turkey was dealing with extensive foreign debt at the time (IMF, 2000). For the first five years of AKP government, things seemed to be positive by all means for Turkey. The growth rates were outstanding, FDI was skyrocketing, the EU affairs seemed to be developing. Concurrently, an economy based on regulatory and social neoliberalism was firmly endorsed by EU (Öniş, 2019). It was speculated in the media that AKP was to bring a brand new economic system that would put an end to Turkey's traditional "boom-and-

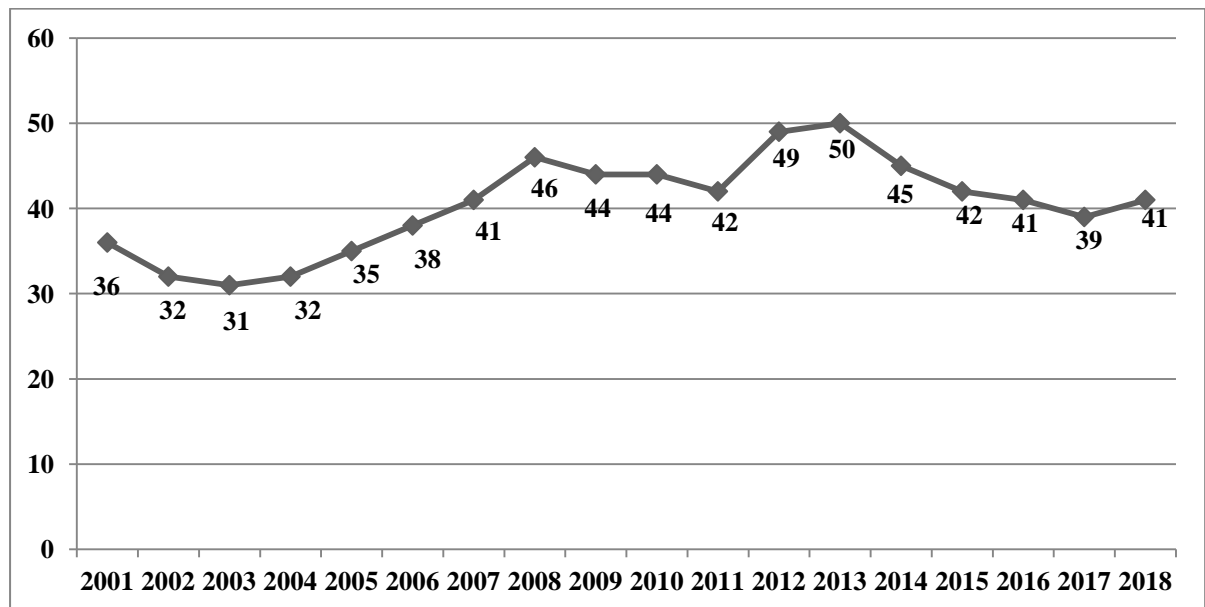
bust" growth cycles. Indeed, the aftermath of 2001 financial crisis had shown that radical structural reforms were needed (Acemoğlu and Üçer, 2016).

Turkey's long term aspiration to become a part of EU had taken a positive turn in 2005 with the start of accession negotiations. This generated the biggest leap in FDI in Turkey's history, with a USD 10 Billion increase from 2005 to 2006. FDI inflows made a peak of USD 22 Billion in 2007, and started rapidly decreasing in relation to the political stability indicators. This period also marks the beginning for consequences of the social and cultural fragmentation in Turkey. Starting with 2007, the underlying tone of authoritarianism and violation of democratic rights, combined with marginalization of the secular people has induced civil unrest. Following the 2007 presidential election and 2007 constitutional referendum, foreign investors' trust in the Turkish financial markets started rapidly decreasing. The negative impacts on growth rate and inflation rate followed shortly. The growth rate that was 6% on average between 2002-2006, decreased sharply to 3% from 2007 through 2014. The global financial crisis masked some of these negative changes, however, research indicates that the slowdown started before the crisis, starting 2006 (Acemoğlu and Üçer, 2016). Following the 2009 financial crisis, growth accelerated at 10%, which wasn't sustainable in the long term. At this period, a considerable amount of monetary and fiscal reforms was made by the CBRT to stimulate the growth and attract investment (Yeldan and Ünüvar, 2016). Nonetheless, Turkey was unable to achieve high levels of investment, possibly due to the increasing political instability fueled by the political events mentioned in the following chapters.

It is important to realize that FDI inflows are in high relation with the political risk perception for the host country, due to the common understanding that one of the foundational objectives of the economic globalization is the advancement of democracy. Jensen (2006, p.30) demonstrates that democratic institutions reduce the political risk greatly for foreign investors. Measuring the advancement of democratic institutions is complicated, however, independent analyses conducted by international organizations such as Transparency International, World Bank and AM Best provide insight that is helpful to the purpose of this study. The political and economic analysis of the above-mentioned developments will be separately discussed in the following chapters.

The Corruption Perception Index (CPI) by Transparency International reflects public sector corruption level of a country according to the experts and businesspeople. In other words, it shows the trust level to a country's democracy, which affects investment decisions based on political instability greatly.

**Graph 3:** Corruption Perception Index - Turkey: 2001-2018



**Source:** Transparency International, **Range:** 0 (highly corrupt) - 100 (highly clean)

As illustrated in Graph 3, CPI significantly increased after AKP got elected for the first time in 2001 through 2008, which indicates that the investors' trust was higher.

Starting with 2008 through 2001 it decreased by 4 points. When the corruption allegations occurred in 2013, CPI or in other words, trust in AKP government was at its highest - by 50 points. 2013 was a turning point for AKP in terms of political stability. Furthermore, following many political events that increased political risk perception, CPI score of Turkey decreased by 11 points between 2013 and 2017.

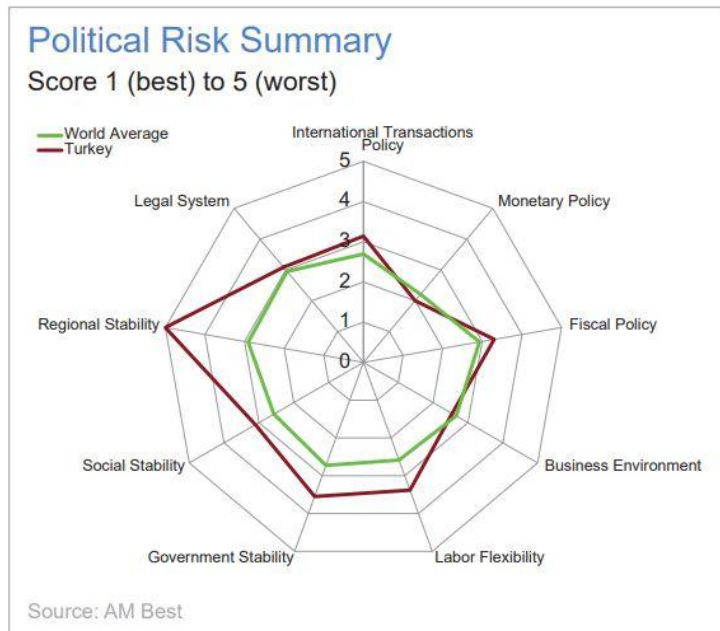
According to Transparency International (2019), "there are no full democracies that score below 50 on the CPI". Moreover, The Economist Intelligence Unit (2018) classified Turkey as a "hybrid regime" for scoring below 40 on the CPI index in 2017. Similarly, the 'Freedom in the World 2018' report of Freedom House changed the status of Turkey from "partly free" to "not free". The report (2019) explained that the status change is due to "a deeply flawed constitutional referendum that centralized power in the presidency, the mass replacement of elected mayors with government appointees, arbitrary prosecutions of rights activists and other perceived enemies of the state, and continued purges of state employees, all of which have left citizens hesitant to express their views on sensitive topics." Given these points, it can be argued that Turkey has lost its image as a full democracy in the investors' eyes since Turkey changed its regime via referendum to a presidential republic system in 2017 (Kirişçi and Sloat, 2019). All in all, corruption perception is one of the many indicators of perceived political risk, and Turkey's low scores on this index demonstrates that investor trust is on the decrease.

In the Country Risk Report (2018) of AM Best, Turkey is rated CRT-4 (Country Risk Tier 4) which represents high level country risk. The rating system considers 3 main risk categories: Economic, Political and Financial System Risk. Turkey is rated "High Risk" in all three of the categories. In the Economic Risk section, the report demonstrates that high level government intervention to the interest rates provokes high inflation levels. Following the 2018 currency crisis, Erdoğan pressured CBRT to keep the policy interest rates low in order to promote rapid growth, however this proved to be unsustainable in 2019 (Reuters, 2020). Combined with high and volatile inflation, the interest rate cuts were followed by Fitch Ratings' declaration of "weak monetary policy credibility" (Fitch Ratings, 2020). The highly dollarized status of the financial system, which makes the economy vulnerable to currency rate volatility and

further weakens Turkish lira, also increased the perception of political risk among foreign investors and decreased the trust in investment security (CNBC, 2020).

As for the Political Risk section of the report (AM Best, 2018), it is expressed that there are heightening concerns for an authoritarian regime as President Erdoğan continues to hold the power, which might lead to more political demonstrations and protests against the government oppression in the near future. The report also emphasizes on the questionable status of human rights, corruption and foreign affairs. Moreover, according to the report (AM Best, 2018), regional risk from Middle East, especially Syrian Civil War plays an important role in Turkey's political risk status. Graph 4 shows a diagram of political risk factors for Turkey, naming regional instability the most concerning issue for foreign investors.

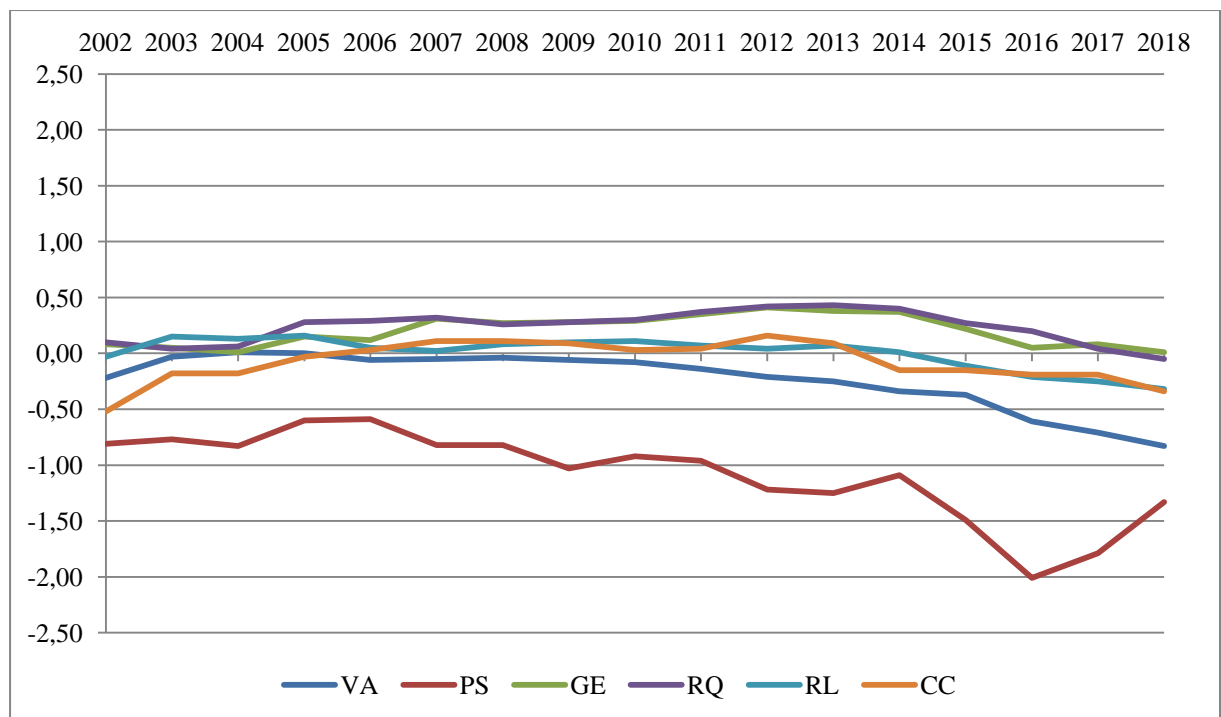
**Graph 4:** Political Risk Summary of Turkey 2018



**Source:** AM Best

Another important indicator of political risk is World Bank's Worldwide Governance Indicators (WGI) data. Similar to the other reports mentioned above, World Bank measures these indicators by performing surveys on a large scale of enterprises, businesspeople and experts. WGI measurements cover six topics: voice and accountability (VA), political stability and absence of violence/terrorism (PS), government effectiveness (GE), regulatory quality (RQ), rule of law (RL), and control of corruption (CC). All indicators give a score to each country between -2,5 (weak) and 2,5 (strong). Turkey's scores for the last 17 years are shown in Graph 5.

**Graph 5: World Governance Index (WGI) - Turkey: 2002-2018**



Source: World Bank

In the policy research paper for WGI, Kauffman et. al. (2010) state that these indicators are crucial to measure a country's governance level, therefore the strength of its institutions. As illustrated in Graph 6, Turkey's score has not been doing well under the rule of AKP. The trends demonstrate that especially after 2013, all indicators have decreased gradually – in the case of political stability, sharply. Voice and accountability score, which is defined in the report (World Bank, 2018) as "perceptions of the extent to which a country's citizens are able to participate in selecting their government, as well as freedom of expression, freedom of association, and a free media" has varied the most, decreasing by 0,61 points since 2002. Political stability and absence of violence/terrorism which had 0,52 points decrease, is the most volatile indicator. It took the biggest fall, hitting -2,01 in 2016, after Turkey had experienced a full year of continuous terrorist attacks between June 2015 and July 2016. Accordingly, FDI inflows decreased by USD 6,4 Billion in the following two years (World Bank, 2019).

The abovementioned research conducted by international organizations indicates that the political risk perception of Turkey continues to remain high. The incentives and privileges granted to MNEs are not enough to eliminate the effects of the increasing number of internal and external political conflicts completely (Azzimonti and Pierre-Daniel, 2007). Given these points, this thesis will attempt to demonstrate that the political events described in the following sub-chapters formed and intensified political instability, and consequently decreased the FDI inflows to Turkey.

### **3.1.1. 2002-2006**

When AKP came to power with the 2002 general elections assuming 34,28% of all votes, Turkey was in the aftermath of 2001 crisis, and the economy was in transformation. AKP was portrayed as committed to liberal economy and pro-western, with Islamic right-wing roots (Erkoç, 2019). It was supported by the USA and the EU, and one of its biggest campaign points was to have Turkey become a member of the EU (Pamuk, 2008). However, over time, the relations were weakened between EU and Turkey, and AKP seemed to adopt a new vision of becoming a union

with the Middle Eastern Islamic countries (Erkoç, 2019). The debates over whether AKP would continue to respect the secular politics tradition of Turkey started since it was founded in 2001 (Bilgili, 2011). Nevertheless, the promises of fixing the economy, giving the religious women the right to wear hijab in public institutions, and making peace with the Kurdish minority lead to AKP's success of becoming the first party to win an outright majority in 11 years.

In 2003, AKP leader Recep Tayyip Erdoğan took over the prime minister seat from Abdullah Gül. Shortly after, TBMM passed several laws that support freedom of speech, minority rights and weakening the military's role in Turkish politics as part of negotiations with the EU (Cremer, 2011).

PKK (Kurdish Workers' Party)<sup>6</sup>, who had been in armed conflict with Turkey since 1984, declared a unilateral ceasefire in 1999 following the capture of their leader, Abdullah Öcalan. PKK stated that it would continue its political agenda through peaceful processes. However, in 2004, the ceasefire ended due to the decision of the leaders of PKK that without armed guerillas the political propaganda weakened. The armed conflict between PKK guerillas and Turkish armed forces intensified until 2012, when AKP started peace negotiations - widely referred as the "Solution Process". The process came to a halt when the relations strained again over Syrian Civil War, later in 2015 (International Crisis Group, 2016).

Looking at the macroeconomic indicators, Turkey did very well economically in the 2002-2006 period. The GDP per capita grew at almost 6%, which was the fastest growth per capita Turkey has seen since the 1960s. The share of private investment in GDP increased to 22% from 2001 through 2006 (Yeldan and Ünüvar, 2016). Economic growth was achieved through firm-level productivity in the private sector. Rural development in Anatolia generated employment and lowered the income inequality. Inflation has dropped from 45% in 2002 to 8,6% in 2004.

Combined with the promising macroeconomic indicators, Turkey attracted tremendous amounts of FDI in this period. The FDI inflows raised to USD 20,2 Billion from USD 1,1 Billion between from 2002 through 2006 (World Bank, 2019).

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<sup>6</sup> PKK is designated as a terrorist organization by Turkey, the United States, European Union, Australia and Japan.

The record FDI amount of USD 22 Billion in 2007 marked the economic success of AKP. This indicates that MNEs were positively affected by the growth of Turkey's economy, as well as the political stability that was achieved during this time. Moreover, credit ratings of Turkey in this period scored significantly higher (Trading Economics, 2019), indicating that there was a positive outlook for Turkey's future in the international markets. The general criticism for this period is that AKP did not face any important challenges: picking up the economy right after the 2001 Financial Crisis, and building political stability on already established ceasefire with PKK (Pamuk, 2008).

Şanlısoy and Kök (2010) state that the positive effect of economic growth has benefited AKP greatly in establishing political stability, however, they also stress that the cultural fragmentation has started in this same period. Thus, the uncertainty about AKP's long term political agenda could be eliminated through establishing democratic institutions. All in all, political and economic indicators for 2002-2006 period support this thesis' argument that the perception of political stability combined with AKP's liberal economy agenda lowered the political risk significantly for Turkey, thus attracted the FDI inflows to Turkey (Öniş, 2015).

### **3.1.2. 2007-2012**

The events that lead up to the 2007 general election had already raised concerns about preserving the secularity of the regime (The Economist, 2007). On April 14th, 2007, an estimated 300.000 people marched in Ankara, capital of Turkey, "to demand that religion and politics should be kept separate in Turkey" (BBC, 2007). The protests continued for several weeks in several cities of Turkey. Ultimately, it was announced that Abdullah Gül would be running for president instead of Erdoğan. The parliament boycott of the main opposition party CHP made it impossible to elect the president with the parliament votes, and eventually lead to the reschedule of the general election (Migdalovitz, 2007). AKP won the rescheduled 2007 general election with 46,6% of all votes. Gül was elected president in the third round of parliament votes.

Following the 2007 general election, AKP proposed a constitutional reform package, claiming that the current way of electing the president by parliament votes caused

deadlocks in the parliament and therefore failed the political system. The package consisted of the following key reforms:

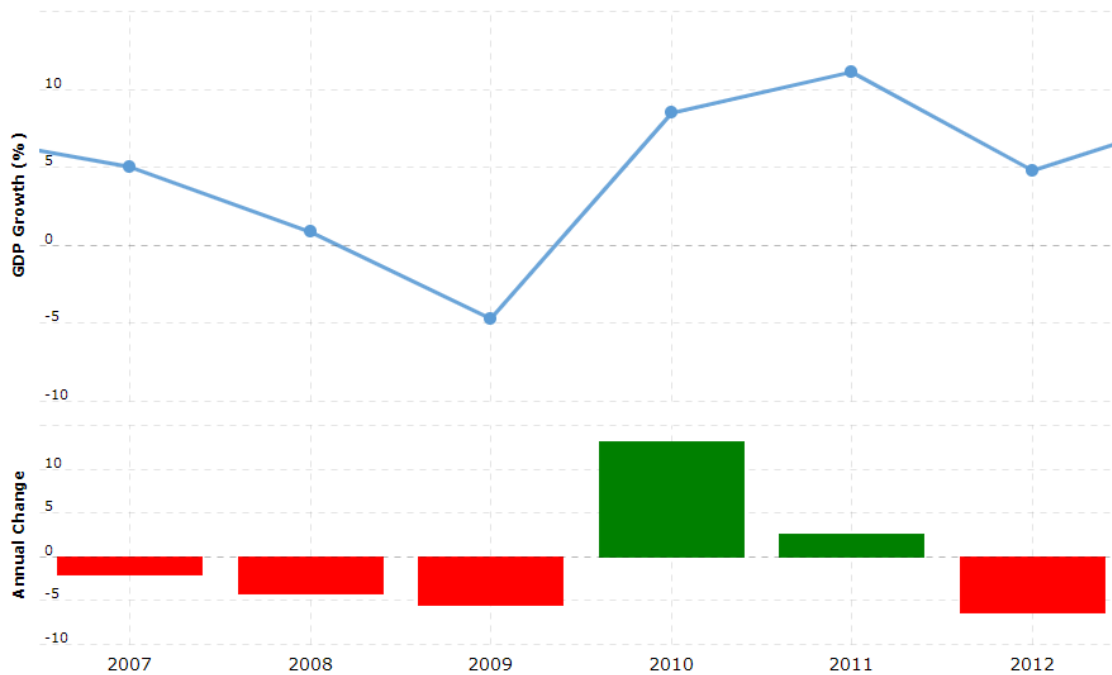
- President to be elected by popular vote instead of parliament vote
- Elected president to hold the position for 5 years instead of 7
- President to be allowed to run for a second term
- General elections to be held every 4 years instead of 5 (Yeğen, 2017).

After initially getting vetoed by then President Ahmet Necdet Sezer, the reform package was re-proposed and a referendum was held to decide whether to accept it. The reform package was approved by 69% of all votes, changing the fundamentals of Turkey's political regime (Yeğen, 2017). As mentioned earlier, the regime change started raising concerns internationally that Turkey was transitioning into an authoritarian state (Migdalovitz, 2007).

The first significant external conflict under AKP rule occurred in 2010, when Turkey-Israel relations strained as Israel made a military operation against “Gaza Freedom Flotilla”, six civilian ships that carried humanitarian aid to the Gaza strip. On the Turkish ship MV Mavi Marmara, Israeli navy faced resistance from the activists. A total of 10 Turkish activists died in the armed struggle, and several wounded (United Nations, 2010). The UN report on the incident stated that Israeli army used imbalanced power on the unarmed civilians. The tension between two countries remained high until the settlement negotiations began with a formal apology in 2013 (CNN, 2013), and the agreement was concluded in 2016.

Simultaneously, the macroeconomic indicators started to change for the negative. The first decline to catch the eye was that GDP per capita growth decreased to 3%, which illustrated a general slowdown in the economy (Acemoğlu and Üçer, 2016). It is mentioned in prior research (Bayrak and Esen, 2012; Kahveci and Terzi, 2017; Williams, 2017; Erkoç, 2019) that the economic decline of Turkey had begun before the 2009 recession started.

**Graph 6:** GDP Growth of Turkey 2007-2012



**Source:** macrotrends.net, **Data Source:** World Bank

According to Acemoğlu and Üçer (2016), “the global economic crisis may have helped mask the growing weaknesses in Turkey’s growth dynamics”. Accordingly, Graph 7 illustrates that the slowdown of Turkey’s economy started in 2007, and after the unsustainable rebound of 2009 recession, it proceeded to decline according to the overall trend. Unemployment rate also started climbing in 2007, reaching its peak in 2009 at 12,58% and declining sharply thereafter. Turkey managed to keep the inflation rate mostly below 10% throughout this period, only exception being 2008 when the rate occurred at 10,4%.

Towards the end of this period, the international media started questioning AKP’s political agenda, as Erdoğan repressed the freedom of press in Turkey and almost one hundred journalists ended up in prison (New York Times, 2012). Large media groups were pressured into censoring content in order to stay on good terms with the government (Hürriyet, 2008). According to the "Democracy in Crisis: Corruption, Media, and Power in Turkey" report published by Freedom House (2020, p. 7), the media groups that did not bow down to the pressure such as Doğan Media Group, faced punishments in form of large amounts of tax fines. Doğan Media Group had to give up Milliyet and Vatan newspapers to settle the tax fine, which made the group

lose its influence over Turkish media. Others who stayed in close relationships with the government such as Doğu Holding, İhlas Holding and Demirören Group received incentives in the form of government contracts (Freedom House, 2020, p. 12). These developments in Turkish media followed the internal politics agenda of AKP: creating a powerful and wealthy elite, while weeding out the opposing voice (Huffpost, 2014).

Due to the fact that there was a global recession in this period, it is harder to demonstrate a cause-effect relationship between political events and FDI inflows. However, as the other macroeconomic indicators, FDI inflows started declining in 2007 – two years before the recession – as well. Moreover, it did not rebound as strong as expected after the recession, and never reached to its peak levels in 2006-2007 period again (Acemoğlu and Üçer, 2016). This suggests that the establishment of extractive institutions in this period started increasing perceived political risk, therefore reducing FDI inflows to Turkey.

### 3.1.3. 2013-2019

As demonstrated in the previous sub-chapters, economic indicators of Turkey started changing for the worse since 2007, and the vast amount of internal and political conflicts in this third chapter of AKP has made these indicators deteriorate even more (Acemoğlu and Üçer, 2016). A timeline of all the political events occurred can be summarized as follows:

**Table 1:** Political Events of Turkey 2013-2019

<b>Year</b>	<b>Political Events</b>
<b>2013</b>	- Gezi Park protests - Corruption allegations & Gülen Movement conflict
<b>2014</b>	- First presidential election by popular vote - Kurdish riots for Kobani
<b>2015</b>	- 2015 general election & AKP losing outright majority for the first time

	<ul style="list-style-type: none"> <li>- 2015 constitutional referendum</li> <li>- Turkey-Russia conflict</li> <li>- EU refugee deal</li> <li>- ISIS &amp; PKK terrorist attacks</li> </ul>
<b>2016</b>	<ul style="list-style-type: none"> <li>- Attempted coup d'état</li> <li>- ISIS &amp; PKK terrorist attacks</li> </ul>
<b>2017</b>	<ul style="list-style-type: none"> <li>- 2017 constitutional referendum</li> </ul>
<b>2018</b>	<ul style="list-style-type: none"> <li>- Olive Branch military operation in Syria</li> <li>- Turkish-Kurdish armed forces<sup>7</sup> conflict in northern Iraq &amp; northern Syria</li> </ul>
<b>2019</b>	<ul style="list-style-type: none"> <li>- 2019 local election</li> <li>- Turkey-USA conflict on PKK/YPG</li> </ul>

Gezi Park protests, which started on May 2013, could be considered as the turning point for AKP in terms of perceived political risk. What started as a peaceful sit-in protest of the environmentalists for the preservation of Gezi Park in Taksim, Istanbul turned into a full blown riot that lasted over 30 days and spread across the country after the excessive force used on protesters by Turkish police (Reuters, 2013). The secularist youth and dozens of non-governmental organizations joined and/or openly supported the uprising after the first few days, demanding their rights to freedom of speech, democratic rights, free media and objecting the power-centric state. Then-Prime Minister Erdoğan went from dismissing the protests to openly calling for counter-attack and banning access to social media in the country in hopes to cut the communication between protesters and international press (BBC, 2013). Also the government claimed that a number of foreign actors were behind the protests and it was part of a bigger plan that aimed to destroy Turkish economy (Anadolu Agency, 2013). More than 7,5 million people joined the protests, and a total of 14 protesters died from the excessive force used by the police, with thousands of people critically injured (The Guardian, 2014). Also several protesters were detained and charged by the government in the following years. The protests slowly diminished after civilians

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<sup>7</sup> Kurdish armed forces in northern Syria and northern Iraq have known links to PKK.

faced armed forces, however, Gezi Park was ultimately preserved (Amnesty International, 2013).

The government's handling of the Gezi Park protests resulted in a number of political and economic consequences for Turkey. The severe measurements taken against protesters — such as police brutality, banning social media, pressuring the press and arresting journalists who published news articles on the protests — were widely criticized by international organizations, including United Nations (2013) and Amnesty International (2013). In November, Council of Europe released a report on Gezi Park protests based on the impressions of the commissioner for human rights, stating that:

*“The Commissioner considers that impunity of law enforcement officials committing human rights violations is an entrenched problem in Turkey, which seriously limits the country’s capacity to tackle the root causes of such violations. He urges the Turkish authorities to acknowledge the seriousness of the problem, publicly condemn all instances of misconduct by law enforcement officials, and remove all legislative and administrative obstacles to effective investigations.” (2013, p. 2)*

Furthermore, on June 2013, the European Union ministers agreed on delaying Turkey's membership talks (Financial Times, 2013). As other political issues arose over time, the accession negotiations were put further on hold.

It is important to open a parenthesis here to mention that some EU member states, especially France and Germany are known to be opposed to Turkey's membership for a number of reasons (The Independent, 2016). These states reject the idea of Turkish membership based on "cultural, religious and fundamentally non-European" terms and they insist on a "privileged partnership" instead (Macmillan, 2013). Moreover, Ülgen (2016) states that Turkey's EU accession is not a realistic goal because EU refuses to address some critical issues such as fundamental rights and freedoms, and prefers to reflect the reason to put the negotiations on hold as the Cyprus issue. According to the official statement of the Ministry of Foreign Affairs of Turkey (2019), *"due to the political blockages of member states and Cyprus issue, the accession process have come to a deadlock"*. In the EU General Affairs Council

conclusions in 2019, it was concluded that *"Turkey's accession negotiations have effectively come to a standstill and no further chapters can be considered for opening or closing"*.

Following the significant stock market losses during the protests, rating agency Moody's warned Turkey that current political risks will impact the credit risk if protests go on. Moody's note also stated that continued protests could affect FDI inflows negatively (Reuters, 2013). Before the protests started, more than 20% of the trade balance deficit was eliminated by FDI (Orhan and Nergiz, 2014, p. 142). During the protests, the stock market drops combined with Turkish lira's depreciation forced CBRT to auction over USD 250 Million to contain the fall. In his study, Atalar (2014) demonstrates that the depreciation of Turkish Lira during the protests was largely in response to Prime Minister Erdoğan's speeches. This supports the main argument of this thesis that major political conflicts indicate political instability, which increases the perceived political risk.

Later in 2013, a corruption scandal broke out, involving several important businessmen, Turkish government officials and their family members. The alleged gas for gold scheme's transactions were done through state-owned Halkbank. A total of 91 people were detained, and 14 people were ordered to be arrested by court on the claims of corruption and money laundering (Foreign Policy, 2015). This caused great political pressure on ministers involved, which led to their resignation and other changes in the ministers' cabinet. Prime Minister Erdoğan denied all accusations of corruption and blamed the investigation on Gülen Movement<sup>8</sup> and their leader Fethullah Gülen, claiming that the movement was conspiring against Turkish government (New York Times, 2013). Starting January 2014, hundreds of police chiefs, judges and prosecutors were either dismissed or reassigned. The European Commissioner Füle (2013) stated that the independence and impartiality of the judiciary system should be protected when there is an ongoing investigation on any allegation involving the government, including corruption. However, according to the European Commission, more than 2000 senior police officers, judges and prosecutors were fired or reassigned in the following months (The Guardian, 2014). Later in 2014, the parliament passed a law that gives the government control over judiciary system,

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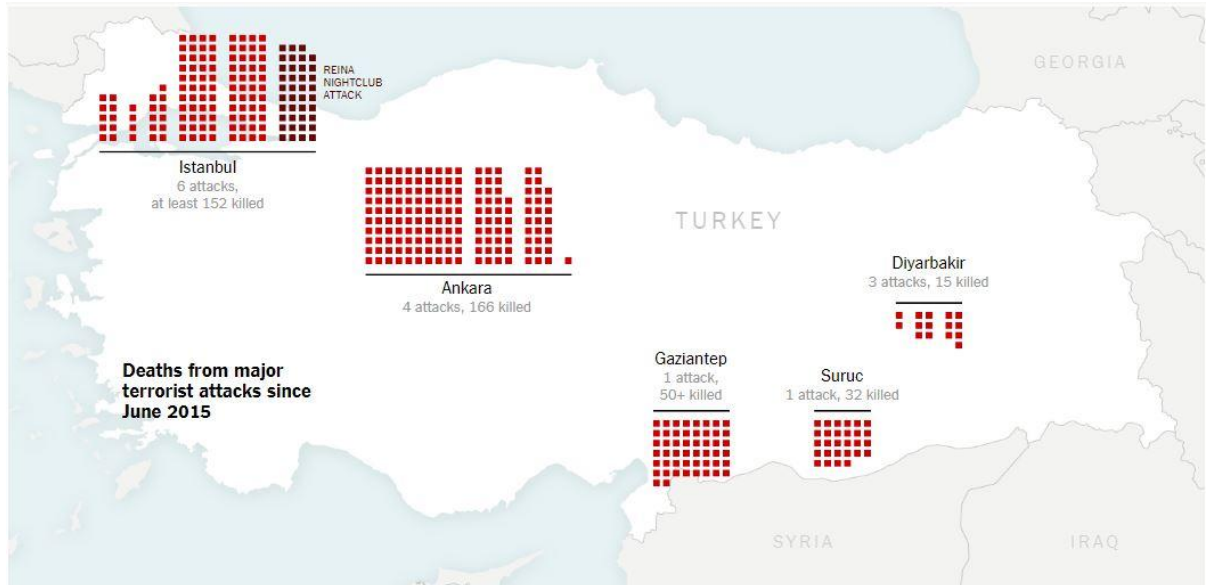
<sup>8</sup> Also referred as FETO/PDY: Fethullahist Terrorist Organization / Parallel State Structure.

which was partially ruled unconstitutional by the supreme court (DW, 2014). Simet et. al. (2014) found that the FDI inflows were affected negatively by the corruption allegations.

In the very first presidency election of Turkey in 2014, Recep Tayyip Erdoğan was elected president by 51.79% of all votes. In the meantime, there was another constitutional referendum package being prepared, which proposed transforming the regime from a parliamentary republic to a presidency system. This proposal raised further concerns that the new system would give even more power to the president (Kirişci and Sloat, 2019). In the same year, the local election became the subject of several claims of misconduct and repeated in 3 months.

The general election time arrived with a lot of internal issues and conflicts on AKP's plate. The Solution Process with PKK resulting in disagreement, the political conflict with the Gülen Movement, aftermath of the corruption scandal, and the economic slowdown were some the most important issues. Moreover, in 2014, several lorries loaded with heavy weaponry were discovered on their way to Syria, which resulted in accusations of high treason and war crimes against AKP government (Reuters, 2015). In the following general election in 2015, AKP won by getting 40.87% of all votes and gaining 258 seats in the TBMM. The significance of this election is that AKP lost its status of the single majority party for the first time since it had come to power in 2002 (Reuters, 2015). This meant that AKP could not form a single party government. AKP has lost 9% of its votes compared to the 2011 results. Representing the Kurdish vote, HDP got a record breaking 13.1% of all votes, claiming 80 seats in TBMM. The coalition negotiations did not result in an agreement; therefore, a hung parliament was formed until another general election was held later in 2015. AKP has won the later election with 49.5%, regaining the outright majority.

**Figure 1:** Terrorist Attacks in Turkey 2015-2017



**Source:** The New York Times

Between July 2015 and January 2017, more than 20 terrorist attacks and bombings happened in Turkey, claimed responsibility by either PKK or ISIS. The tourism suffered greatly, which is one of Turkey's main income sources and makes up about 5% of the GDP and 8% of all employment. According to Turkish Ministry of Culture and Tourism, the number of foreign visitors dropped 30% in 2016, compared to 2015 (ABC News, 2017). The attempted coup d'etat in 2016, allegedly conducted by Gülen Movement controlling some portion the Turkish military units (Vox, 2016), further deepened the security concerns. After the coup failed, Turkish government started a purge among the public sector employees who have alleged links to Gülen Movement that left thousands of people unemployed and incarcerated, many of them were banned from leaving the country and were granted political asylum from the western countries later on (Foreign Policy, 2017).

As a result of the ongoing Syrian Civil War at Turkey's southeastern border, a deal was made between Turkey and the EU to settle the Syrian refugee crisis in 2016. This made Turkey a passing point for Syrian refugees that fled from ISIS (Al Jazeera, 2020). For Turkey's willingness to host the refugees and secure its borders against illegal passage to the EU land, it was promised to pick up the negotiation process for EU membership, and visa liberalization for Turkish citizens. The EU also would donate about USD 3 Billion to Turkey for helping the Syrian refugees (European

Council, 2016). While this deal did cut most of the illegal passages to the EU, other problems arose. As of 2019, Turkey is hosting 3.7 million registered Syrian refugees (UNCHR, 2019). Turkish people have been widely concerned by the social, economic and cultural impact of having the Syrian community in Turkey (Erdoğan, 2019, p.12).

2017 constitutional referendum was also subject to many concerns and opposition, as it proposed an executive presidency system, weakening the role of the parliament considerably and completely abolishing the role of prime minister. In addition, there were several claims of misconduct from the opposition parties and international organizations such as Organization for Security and Co-operation in Europe (OSCE) and Parliamentary Assembly of the Council of Europe (PACE) (DW, 2017). Nevertheless, the voting was declared valid by YSK (Supreme Electoral Council) and the constitutional changes were accepted.

In 2018, a Turkish military operation called "The Olive Branch" in northern Syria started, and went on for two months. Turkey had been involved in the Syrian Civil war since its outbreak in 2011, for the purpose of protecting its borders from ISIS and PKK/YPG. In 2019, Turkey has initiated a cross-border military operation to the Northeastern Syria, named "Operation Peace Spring", following the decision of the US to withdraw from the area and leaving it to Kurdish armed forces. The motivation of Turkey was to expel Syrian Democratic Forces (SDF) led by the armed forces of YPG from the region, which is considered a terrorist organization by Turkey (BBC, 2019). The aim of Turkey was to establish a "safe zone" in Northeastern Syria along the Turkish border, for the purpose of resettling the Syrian refugees that Turkey is currently hosting. For this operation and other military interventions, Turkey has been exposed to severe criticism from the international media, with accusations of "invading" and "occupying" the Kurdish region (NY Times, 2019). Due to the alliance between the US and SDF against ISIS, the international affairs between the US and Turkey have been affected negatively (Stein, 2017). A ceasefire agreement was made between Turkey and the US later in the year.

On the internal politics side, for the first time in 2019 local elections AKP has lost the municipalities of several major cities to CHP, including Istanbul and Ankara. This was perceived as AKP losing its power since the ongoing weakening of Turkish Lira, high inflation and contracting real sector started affecting Turkish people, even AKP

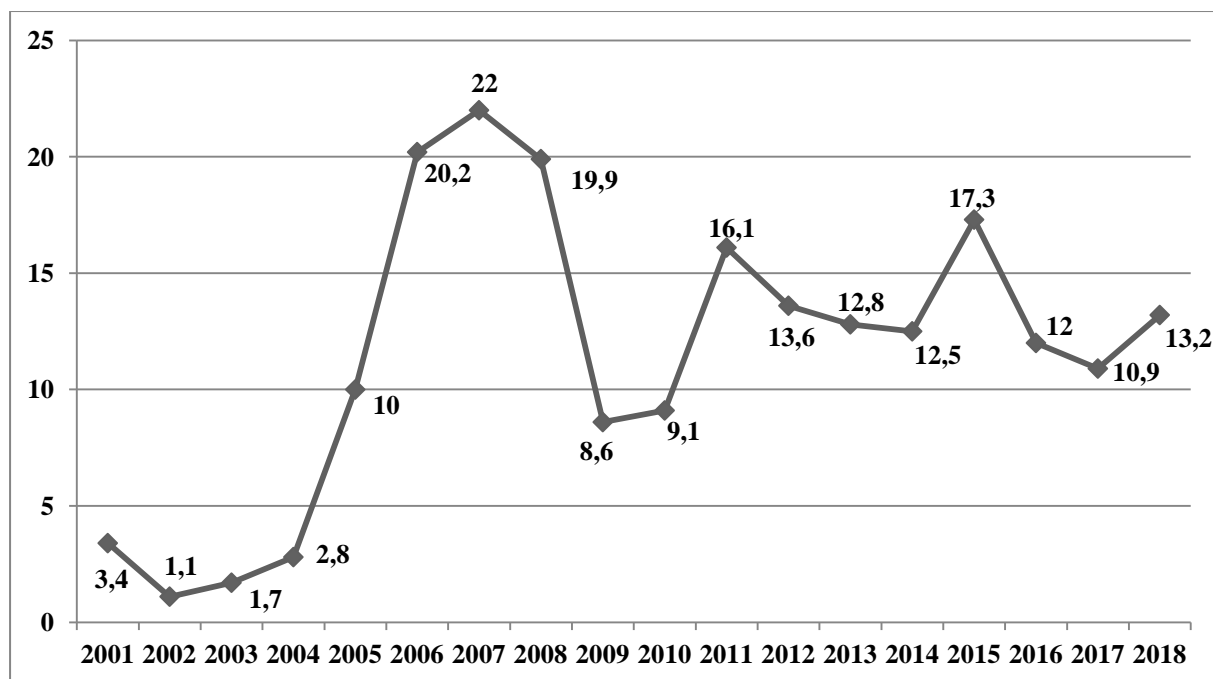
supporters. The election in several cities were deemed invalid by YSK and re-runs were held in those cities. The Istanbul re-run was held almost a month later. The initial Istanbul mayoral election was won by Ekrem İmamoğlu by a very close margin of 0.2% with the runner up Binali Yıldırım, the previous prime minister. The re-run results took the margin up to almost 10% and resulted in the victory of Ekrem İmamoğlu. According to the survey conducted by the research company KONDA (2019) after the re-election, a portion of AKP's voters did not vote in the re-election as a negative reaction due to the misconduct allegations.

### **3.2. Conclusion**

In this chapter of the thesis, the effect of abovementioned political events on Turkey's attractiveness to the MNCs will be discussed in terms of the liberal theory of political institutions. According to liberal theory, the democratization level of a country affects its ability to attract investment from MNCs. This effect can be seen particularly in the developing countries, since they are heavily dependent on FDI in order to achieve successful growth. Open economy politics research suggests that the mobility of capital is secured through domestic institutions such as electoral institutions, trade policy, and property rights (Paul, 2010). Broader empirical research reveals that developing countries benefit from democratization more than developed countries. The underlying argument of this approach is that the low-income working class benefits more from the liberalization of domestic institutions, as well as the process of integration to the global economy (O'Rourke and Taylor, 2006). From this point of view, it is evident that Turkey has benefited greatly from the liberalization of its economy since 1980. According to a study conducted by Milner and Judkins (2004) among OECD countries, there is a strong relation between partisanship and trade policy, as right wing political parties favor free trade more than left wing political parties. Indeed, spearheaded by the centre-right president Turgut Özal, FDI inflows were steadily increasing through the 1980s and 1990s, largely due to the establishment of customs union between Turkey and EU. However, the economists reach to a consensus that FDI inflows to Turkey slightly underperformed during this period. A deeper look reveals that the persistent political instability in this period might be behind this.

At this point, in order to better understand the case of Turkey, the concept of inclusive and extractive political institutions should be revisited. Turkey has started transitioning its political institutions into inclusive institutions since 1980, as it opened its economy to the foreign investments. AKP came to power in 2002 with promises to establish inclusive institutions, and to make Turkey a fully functioning part of global economy. However, following the golden era of AKP between 2002-2006, political instability has become an increasing risk that has been crippling the growth of Turkish economy. According to Acemoğlu and Robinson (2012, p.144), “to be inclusive, economic institutions must feature secure private property, an unbiased system of law, and a provision of public services that provides a level playing field in which people can exchange and contract”. Therefore, the highly criticized government interventions to the judiciary system and elections, the abolishment of freedom of speech, and Erdoğan's anti-secularist stance in general could all be considered as attempts to establish extractive institutions. Acemoğlu & Robinson (2012) state that extractive institutions favor the elite who are closely tied to the politicians in charge, accumulating wealth by taking resources from those who are low income. By creating extractive institutions and reversing the process of democratization, AKP's policy agenda appears to be giving more power to the oligarchic elite of Turkey, as they enter in a symbiotic relationship that benefit each other greatly. Deepening the inequality of income distribution, the pre-tax income of the top 1% raised to 23.4% from 17.4% between 2007 and 2016 (World Inequality Database, 2019). In return, this wealthy and religious elite helps AKP to have control of the media, and spread partisanship by creating certain perceptions about foreign affairs and economy.

**Graph 7:** FDI Inflows - Turkey: 2001-2018 (USD Billion)



**Source:** United Nations Conference on Trade and Development, World Bank

From this perspective, FDI inflows would be expected to be on a steady decrease under the rule of AKP. Although it has been on a decreasing trend, it appears to have rebounded after suffering from a rapid decrease following significant political events. Following the Gezi Park protests in 2013, AKP's intolerance against the secular people has been extremely visible, especially in the international media (Bilgili, 2011). The corruption scandal in 2013 and the attempted coup in 2016 were also globally covered. These events have harmed the perceived legitimacy of the political institutions of Turkey. A national state of emergency was declared after the coup attempt, which created a climate of instability for the domestic and foreign investors (US Department of State, 2019). The capital outflows from Turkey in 2016-2018 also caused the FDI inflows to slightly decrease. Erdoğan declared the Turkish businessmen who took their assets out of the country traitors (Cumhuriyet, 2017), which was deemed against the open market policy and created an unwelcoming environment for free capital flows.

As the FDI inflows are on a decreasing trend worldwide, Turkey has experienced a decrease more than the average (UNCTAD, 2019). Nevertheless, it would seem that MNEs are still interested in Turkey despite all the indicators of political instability,

therefore increased political risk. Turkey has also been receiving poor credit notes from international rating agencies, however the known foreign investors state that Turkey is an important host country for investments that is in their long term investment plans (Anadolu Agency, 2020). This aligns with the dependency perspective that it is indeed possible to achieve growth through FDI for authoritarian states, as MNEs receive privileges from the government easily (Ferraro, 2008). It seems as the extractive political institutions help create incentives that attract the foreign investment. Li and Resnick (2003) also agree that incentives are an important determinant of FDI for the authoritarian states. In such states, MNEs are known to be able to participate in lobbying activities in the host country and make strong connections among the elite. The incentives are a direct product of such connections. As a developing country that is heavily dependent on FDI inflows, Turkey has been trying its best to nurture a warm investment climate for the MNEs. Therefore, AKP government has been leaning towards the incentives aspect to promote the investments.

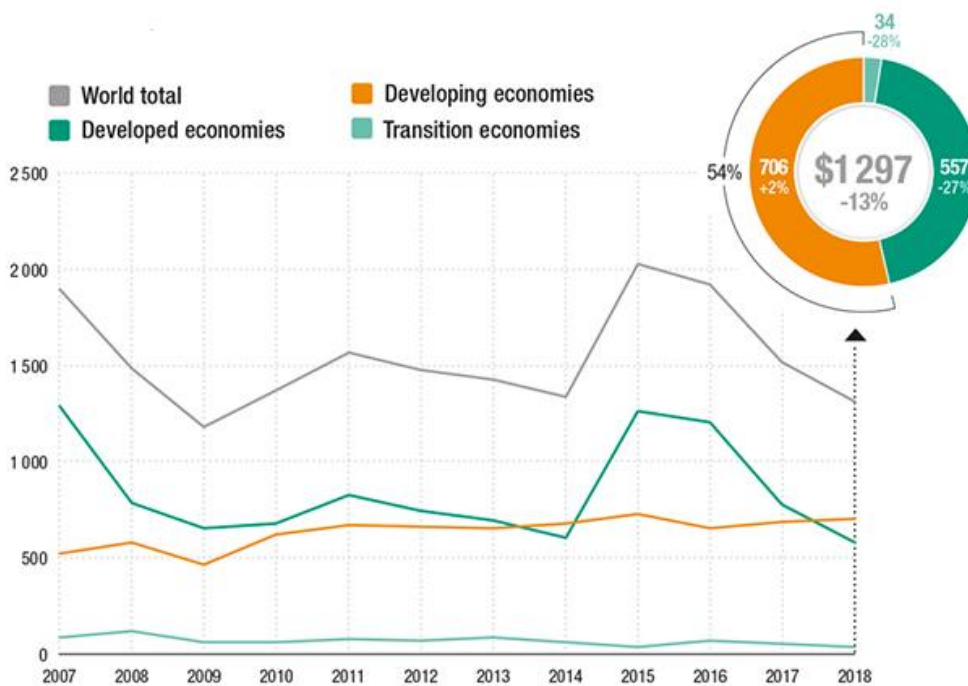
The Global Competitiveness Report (2019) by World Economic Forum shows that Turkey is ranked 104th of 141 countries in judicial independence, which is an extremely low rank. However, it is on the 13th place for market size, and 55th place for the property rights. The property rights are important to the MNEs, as it is one of the determinants of investment protection. However, combined with the negative developments in the freedom of media and judicial independence in Turkey, MNEs could be concerned about the protection of the property rights. Subsequently, this raises some issues with the legitimacy of Turkey's political institutions. As Keohane (2001) argues, this can be considered as an abuse of political power, as AKP government appears to be promoting FDI inflows by implementing privileges that benefit only the foreign investors.

Consequently, as Acemoğlu and Robinson (2012) anticipate, this extractive structure of political institutions has been deteriorating the FDI inflows to Turkey in the long run. As the perceived legitimacy of political institutions changed for the negative, FDI inflows to Turkey have decreased drastically since 2015. With the last local elections, AKP has been losing political power and this will initially have an effect on the FDI inflows. The highly privileged elite and the MNCs undoubtedly will have a reaction

to the changing political climate. While it is evident that there is a strong relation between political instability that is caused by extractive political institutions and FDI inflows, only time will tell whether Turkey is going to be affected negatively in this manner or not.

According to the World Investment Report 2019 by UNCTAD, the FDI inflows are on a decreasing trend in the world, with FDI inflows to the developed countries hitting a 15-year low. Graph 8 demonstrates the World Outlook on FDI inflows. While FDI inflows to the developing countries are stable, they vary greatly according to the region. The report states that political climate and the currency instability in Turkey was the main factors that affected the FDI inflows.

**Graph 8:** FDI Inflows - World Outlook



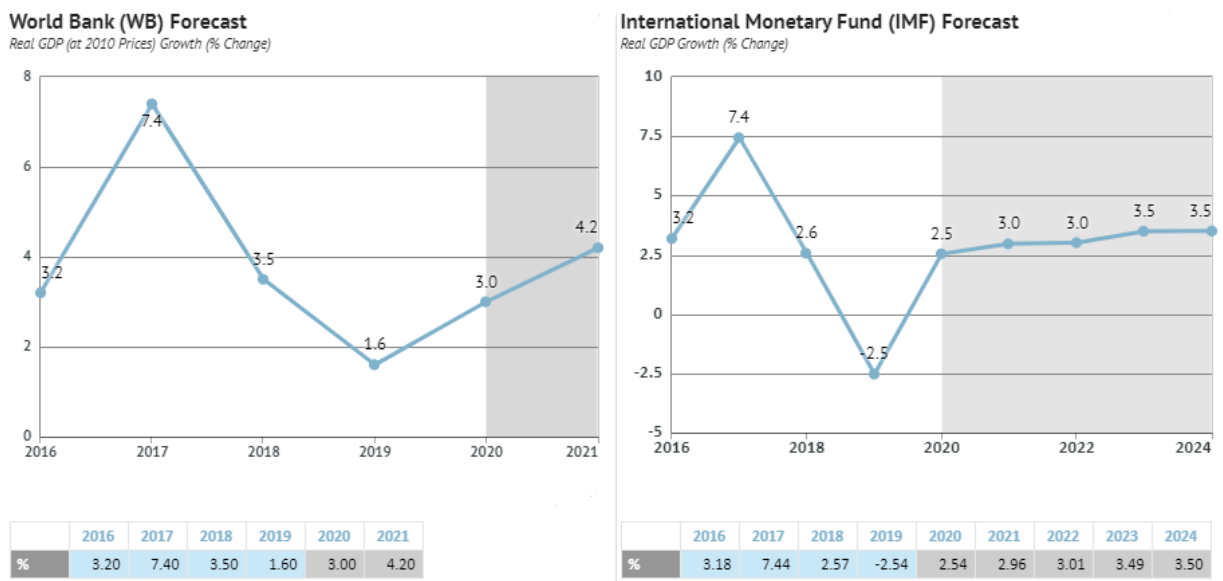
**Source:** UNCTAD

Moreover, according to the Turkey Economic Monitor 2019 report by World Bank, a survey conducted among more than 700 MNEs pointed out that political instability was identified as the most important deterrent to FDI inflows to Turkey, followed by policy and regulatory uncertainty. The report (2019) also argues that the medium term

growth projection heavily relies on private consumption, which contradicts the high inflation rates and unstable currency.

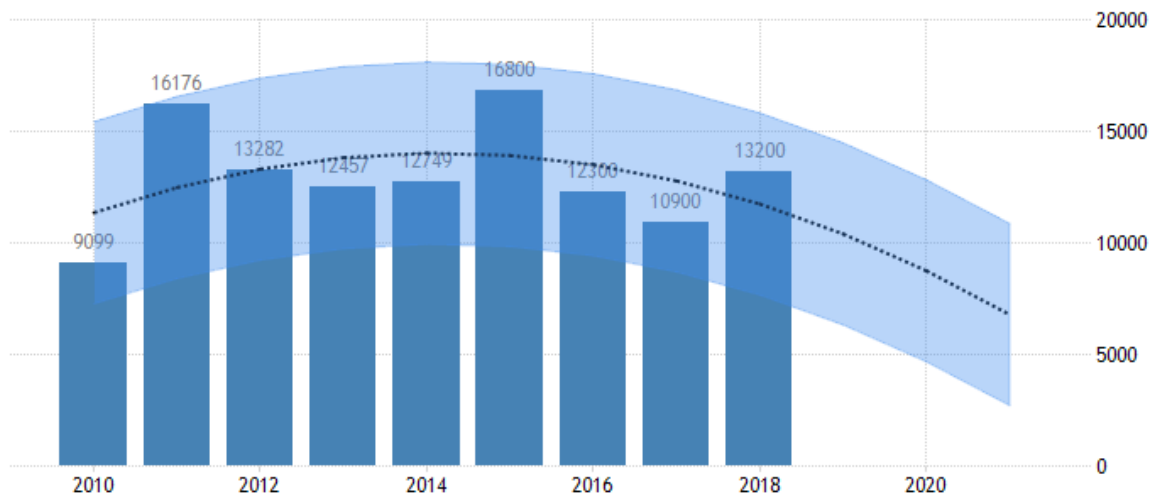
Graph 9 and Graph 10 show the World Bank and IMF forecasts on Turkish economy. The global economy has been in recession in terms of growth and investments, yet AKP claims that the growth rate of Turkey is targeted to be 5% in 2020 (Bloomberg, 2019). The global policymakers state that these unrealistic expectations won't do the Turkish economy any good, since the perceived political risk of Turkey according to the MNEs indicate more of a slowdown in the near future (World Bank, 2019; AM Best, 2019).

**Graph 9: Turkey GDP Forecasts**



Source: knoema.com

**Graph 10: FDI Trend Forecast - Turkey**



**Source:** Investment Support and Promotion Agency (ISPAT), [tradingeconomics.com](http://tradingeconomics.com)

#### 4. CONCLUSION

The thesis has attempted to demonstrate a relation between the political events that transpired in Turkey in the last two decades under AKP rule, and the FDI inflows to Turkey during that time frame. For the purpose of achieving this goal, the timeline of 2002-2019 was divided into three distinctive sections that is believed to reflect the political economy of AKP era. The periodization is based on the research of Öniş (2015), which describes AKP era in three periods: golden age, stagnation and declining. These periods are characterized by a number of economic and political indicators, such as growth rate, FDI inflows, domestic and foreign policy, and political events. The global FDI inflows slowdown affected developed countries more than developing countries (UNCTAD, see Graph 8). Considering the decreasing trend of FDI inflows to Turkey starting 2008, it could be argued that the decrease is not linked to the global events and it is rather linked to Turkey's specific circumstances. Moreover, following the global economic slowdown in 2016, Turkey's growth rate recovered at 7.5%, nevertheless, FDI inflows kept declining. In Turkey's case, this proves that FDI did not seek economic growth. This leaves Turkey's "specific circumstances" to the political climate.

The first sub-chapter (2002-2006) under Political Events of the Last Two Decades reflects AKP's first period of economic success, in line with the political stability and

transforming economic policies that attracted FDI inflows immensely. The second sub-chapter (2007-2012) focuses on the raising concerns of the secular people about AKP's political agenda, and simultaneously deteriorating macroeconomic indicators. 2013 was a critical turning point for AKP, as a chain of major political events starting with Gezi Park protests and the corruption allegations affected the economy severely in the following years. The third sub-chapter (2013-2019) emphasizes that these major political events are triggered predominantly by AKP's changed political stance against democratization, as well as the regional and global political conflicts that significantly affected Turkey's business climate and economy (Öniş, 2019). A last sub-chapter followed with an assessment of these three periods and how these political events affected the FDI inflows to Turkey. In the following Conclusion chapter of the thesis, the political institutions that has been established by AKP are discussed extensively from the perspective of different liberal schools of political institutionalism.

Overall, the findings derived from the said discussion suggest that there is indeed a strong relation between the extractive institutions such as privileges / incentives given out to the MNEs as a reward for keeping close relations with the authoritarian regime and the FDI inflows to the developing countries. Creating an economic elite that benefit from these privileges accelerates growth by attracting FDI in the short run, however it has an adverse effect in the long run. It is exposed that as the act of maintaining an economic elite favors some actors in the economy, it dismisses the other actors and therefore deepens the inequality of income distribution (Acemoğlu and Üçer, 2016).

The traditional approach to liberal institutionalism suggests that in order to be integrated to the global economy and sustain a healthy growth, developing countries should establish transparent and inclusive institutions. However, contemporary approaches argue that it is in fact possible to achieve growth under authoritarian regimes and therefore non-transparent and extractive institutions. Subsequently, it has been witnessed in the last few decades that developing countries have been implementing "hybrid" institutions that favor the MNEs but remain extractive. Moreover, it has been observed that it is possible for authoritarian governments to sustain economic freedom for foreign investors and not sustain the democratic

freedom for their citizens. This is mostly achieved through incentives, which make the host country incredibly attractive for MNEs. Nonetheless, the recent research on this phenomena warns these authoritarian states that the positive effect would not last in the long run, and excessive political power would harm the developing economy tremendously (Acemoğlu and Robinson, 2012).

In this context, the thesis highlighted that the key factor that is affecting FDI inflows to Turkey is political instability, however, the incentives and political privileges that are given to the MNCs have a positive effect on FDI inflows in the short run. Hence, the main point of criticism would be that the AKP rule has created a highly privileged economic elite, and this political and economic structure is extremely unfair for other actors in the economy, such as investors of opposing political views and middle-low income people of Turkey who suffer from the declining macroeconomic indicators. Additionally, it would be fair to state that it is not a sustainable economic model, and slowing growth rates and FDI inflows are the main indicators of this.

There are three main findings of the thesis in regard to the interaction between political instability and FDI inflows to Turkey:

1. The perceived political risk of Turkey has become progressively higher since 2007, and for MNEs, this puts Turkey among countries that are on the cusp of being too risky to invest. For an externally dependent country like Turkey, this is an important factor in the economy. Although creating a powerful privileged elite and attracting MNEs by establishing extractive institutions boosted the FDI inflow in the short run (until 2007), however, it proved to be an unsustainable strategy and the FDI inflows already have been on a decreasing trend along with other macroeconomic indicators.
2. There is a strong relation between the political events that transpire in Turkey and the amount of FDI inflows it receives in the following years. This is a direct result of the decreasing investor trust and concerns of investment security due to increased political risk.
3. The domestic and foreign policy agenda of AKP has been affecting the economy of Turkey negatively. The concerns about Turkey being in the process of becoming an authoritarian state expressed by respected international organizations such as Transparency International, Freedom House, AM Best and World Bank support the

idea that the erosion of the division of powers and the strong control over freedom of speech and media are the main indicators of authoritarianism in Turkey. This perception combined with internal and external political conflicts cause an overall negative effect on Turkey's economy by chasing away FDI inflows and blocking possible economic agreements with other countries or international organizations.

The main conclusion that can be drawn from these findings of the thesis is that, in Turkey's case, FDI inflows have a push-and-pull type of relation with political instability. From the liberal perspective, it is apparent that the increasing amount of political risk caused by the political instability has extensive negative effect on the FDI inflows to Turkey. The decreasing democratization level and the establishment of an authoritarian regime in fact was beneficial to the MNEs and attracted more investment in the short run. However, the decreasing trend of FDI inflows since 2007 indicates that Turkey is on the cusp of exhausting the current political and economic structure. The events in the political scene of Turkey will indeed provide a rich soil for future research, and the contemporary approaches to liberal institutionalism will have a chance to find a testing ground in Turkey's case.

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