CHAPTER 3

THEORETICAL AND EMPIRICAL LITERATURE REVIEW

3.1 Introduction

This chapter discusses the prior literatures on the determinants of FDI inflows by looking to the relevant variables. The focus is given to the association between FDI and economic growth. We review theories on economic growth and empirical findings of previous studies in this chapter. Sub-section 3.1 presents a review of concepts. Sub-section 3.2 is on a review of theories of economic growth while sub-section 3.3 is on a review of empirical evidence. The last part of this chapter, which is sub-section 3.4, highlights the gaps in the existing literature.

3.2 Review of Theoretical Literature

The first section of this chapter emphasizes on concepts and theories of FDI, ED, TO and economic growth. Next, it focuses on the theoretical aspect underpinning the relationship between FDI inflows and ED on economic growth. This section specifically describes the theories or hypothesis that influences the relationship between FDI inflows and ED on economic growth.

3.2.1 Review of Relevant Concepts

3.2.1.1 Foreign Direct Investment (FDI)

Over the last few decades there is an increasing enthusiasm towards the importance of FDI. A number of efforts are put in across the globe to attract FDI in a

sense of liberalizing international trade, limiting governmental control and creating a tax exempted regions. According to OECD (2008), the FDI refers to the cross border investment made to obtain or acquire a long term ownership of a certain entity that operates outside of the investors' country. It involves the process of foreigners or non-resident investors in purchasing a minimum of 10% equity ownership (UNCTAD, 1999). Countries set different thresholds values of FDI ownership and the below table 3.1 shows the restrictions in 2012 on foreign equity ownership across sectors and regions.

Table 3.1: Restrictions on Foreign Equity Ownership across Sectors and Regions (%)

Sector Group	Eastern Europe & Central Asia (21)*	High-income OECD (17)	Latin America & Caribbean (15)*	South Asia (6)	East Asia & Pacific (11)*	Middle East & North Africa (9)*	Global average (103)*
Agriculture and Forestry	98	100	96	78	80	81	90
Mining and Oil & Gas	99	100	92	95	87	71	92
Manufacturing	100	100	100	95	100	94	98
Electricity	96	93	80	80	83	80	87
Waste management and water supply	98	97	93	92	85	78	92
Transport	93	89	95	80	75	64	84
Telecom	99	95	98	94	76	80	90
Media	77	85	77	57	52	53	68
Financial Services	98	100	98	89	89	85	93
Education	100	94	100	87	87	69	93
Accounting	100	92	100	87	87	69	91
Tourism	100	100	100	96	96	94	99

* Number of economies included in each region

Source: FDI Regulations database 2012

Attracting FDI comes with advantages and disadvantages. The main driver behind allowing FDI is the technology spillover whereby the host countries would have to be capable of accessing to the advanced technologies in several sectors. Technological

progress has been proven to be an essential factor in creating wealth and providing a sustainable economic growth. According to OECD (1991) the developing countries rely heavily on the technological transfer to be incorporated in creating industrialization and enhancing the productivity.

In this regards, Apergis et al., (2005) examined the FDI-technology spillover nexus and his findings show that FDI is an essential factor in modernizing the industrial sector through the technological transfer. The second advantage of FDI is the amount of monetary investments. More importantly, the FDI contribute to the capital accumulation, which ultimately lead to a rise in capital circulation of an economy. Therefore, it becomes a preferable method to obtain outside sources and diversify the capital portfolio. It also helps to mitigate the reliance on external debts. This is because the FDI tends to involve in the projects that are risky and unattractive to local companies (Lall, 2000).

The third advantage is the expansion of international trades. This occurs when the exports of the manufactured goods are being allowed to access international market (Blomstrom, 1991). The fourth advantage is pertained to the economic development in which the host country has to go through numerous economic reforms to target the FDI inflows. From legal to banking sectors, these reforms aim to create a supportive environment to the targeted investors. Finally, the FDI plays a vital role in developing the human capital as the managerial and various techniques will be available to a large mass of people to learn. Despite the mentioned advantages, FDI is also associated with a number of inconveniences. These undesirable costs are more likely to make FDI less beneficial.

Firstly, the violation of laws of the host countries in order to maximise revenues is a common practice among non-resident investors. The study of Kurtishi-Kastrati

(2013) provides evidences that FDI inflows tend to pose a real threat to the political atmosphere and economic growth. Golub (2003) finds that economic effects of FDI create a decline in research and development and environmental concerns. Some of the multinational entities (MNEs) tend to manipulate and exploit the weak environmental regulations in the hosting countries by transferring some technologies or procedures that are not permitted in their home countries (OECD, 2008). Indeed, having a desperate need to get more FDI inflows serves as driving factors towards enacting lenient laws to ensure a constant flow of FDI, which lead to disastrous environmental consequences (Kurtishi-Kastrati, 2013).

3.2.1.2 External Debts (ED)

Countries tend to borrow abroad as a way to meet the deficit balance in the budget. By definition, external debts are those loans that a state obtains from countries or financial institutions. In 1980, the world witnessed an unprecedented debt crisis in which many Latin America and other regions were unable to meet the repayment requirements of their debts. The problem began in the summer of 1982 in Mexico by declaring its bankruptcy and incapability of paying back the loans from commercial banks, the International Monetary Fund, and the World Bank (Were, 2001). Following the same approach, other countries joined the bankrupted team including Brazil, Argentina, Bolivia, Venezuela and finally the Philippines, followed Mexico.

Understanding the debts crisis becomes a hot topic among economic researchers. With that several schools of thoughts have emerged to provide explanations and solutions. One school put the blame on the lenders due to irresponsible decisions of excessive lending that leads to a debt crisis (Semboja, 1998). Another school links the rise of oil price and monetary policies undertaken by developed countries led to an acute

increase in the rate of insolvency among the developing countries (Iyoha, 1999). An issue at least equally important is the compound interest rate, which keeps changing and increasing if there is a late payment of defaults. Other views tried to come up with a balanced explanation where both the debtors and creditors need to bear the debts crisis burden as a result of their miscalculations (Radelet & Sachs, 1998).

Historical examples include economic explanations of Ottoman debts crisis is a concrete evidence of the devastating economic policy in general and external debts in particular. To deal with budget deficits, the state decided to embrace the debasements approach which lasted until the 1840s (Pamuk, 2006). Although this approach was a part of the solution but it did not help the state for a long term to overcome its economic decline and as a result, the debasement was abandoned in 1850. The existing literature (Pamuk, 1988; Eldem, 2005; Birdal, 2006) suggest that the shift of the OE to finance these deficits over the external borrowing without undertaking a solid fiscal discipline contributed to the disastrous collapse of the OE economy. The decisions to modernize the state, which started during the era of Sultan Selim III, had forced the state to fall under foreign domination and to lose its political and economic independence. With the passage of time, the OE faced a continuous demand for fund in order to finance the military needs also confronting the political and military movements that destabilized the state (Pamuk, 2006).

3.2.1.3 Trade Openness (TO)

The question whether open economies grow faster compared to closed economies has come to a certain affirmative answer where the empirical studies show a strong favour of trade liberalization. However, the most critical problem facing the

academician is the lack of clear definition of TO. Harrison (1996) describes the concept of openness as a synonym with the notion of neutrality.

Other meaning of openness is free trade. Free trade is a system where all trade distortions must be mitigated by adopting a trade policy that ensures a smooth transfer of goods and service around the globe (Yanikkaya, 2003). The most basic proxy of TO is the ratio of export plus imports divided by GDP. A large number of empirical studies examined the correlation between TO and economic growth and there is a near consensus among the researchers that TO is having a positive and strong relationship with growth (Irwin & Tervio, 2002, Edwards, 1993, Rodriguez & Rodrik, 2000).

To provide more accurate proxy of TO, Anderson & Neary (1992) have developed trade restrictiveness index, which was designed to measure the impact of both tariffs and non-tariff barriers. Hence, it is not a surprise to witness a tremendous growth in the literatures of TO in both developed and developing nations.

3.2.1.4 Economic Growth

According to Denison (1962) the concept of economic growth may reside largely in the increase of real GDP or GDP per capita and it is practically influenced by direct factors such as human resources (increasing the active population, investing in human capital), natural resources (land, underground resources), the increase in capital employed or technological advancements. In principle, the GDP was designed to capture a single figure of all the values of goods and services produced in a society (Bolt et al., 2014). GDP plays a pivotal role in shaping the thinking about economic growth and development in which a large part of economic theories uses the change in GDP as a reliable measurement in forecasting the economic performance of a certain economy. Countless publications on economic growth around the globe and the majority of these

studies attempt to answer the most frequent question on why some countries are rich and others are not. Economic scientists have become more and more interested in investigating the long-run patterns of institutional development of nations.

Historically, the Ottoman economy shows a relevant example to the economic dilemma that the third world is facing. This dilemma is manifested in slower rates of growth of exports, deteriorating external terms of trade, and large debt payments (Pamuk, 1984). Although the economic growth is a concept that has been came to the picture after the World War 1 (WW1 hereafter), yet a close look to the dimensions of the economies prior the WW1 depicts that the macroeconomic policies had significantly contributed to the economic collapse of the Ottoman economy.

3.3 Theories of Foreign Direct Investment

Numerous theories have been introduced to explain the FDI inflow. Theoretically, the literatures pay more attention to six major theories that are more likely to provide reliable explanation of FDI.

3.3.1 Location Theory

It is concerned with the supply and demand variables, which arguably affect the productions lines and processes such as R&D activities and other related matters (North, 1955). It suggests that the location of FDI decisions are cost oriented. This means that the production activities will be located where the cost is relatively low taking into consideration the competitive atmosphere of the international market. Location theory provides more realistic explanation to the FDI as it encompasses two main concepts, cost and market forces (McCann & Sheppard, 2003). In general, this theory provides useful insights on the spatial distribution of production units and the reasons of selecting

a certain country over the others. However, this theory suffers from the lack of addressing the impact of growth rate or the modernization process.

3.3.2 Trade Barrier Theory

This theory borrowed two assumptions from Hechscher-Ohlin-Samuelson (H-O-S) trade theory (Bergstrand, 1990). First, the factors of production are exchangeable between nations. Second, some countries adopt protection policies and thus trade barriers are inevitable. Therefore, the trade barrier theory emphasises on the determinants of FDI that are distance and transportation costs. For the distance aspect, the theory posits that FDI is a response to an artificial trade barrier, which stimulates the decision to engage in FDI where the market is still fresh (Mussa, 1978). Hence, the trade barrier theory predicts the idea that FDI is actually a positive response to profits regulations and opportunities in protected markets.

3.3.3 Restriction on Factor Movements Theory

This theory holds the idea that the FDI is a result of restriction on the movement of different elements of productions inputs between countries. In other words, some products require an onsite processing and with such requirement a direct investments is a response to establish a factory or operations where these resources are easily accessible. In the sense of restriction of labour's mobility, this theory provides a platform to explain the international investment decisions. In case where there is uncertainty over supply or cost advantages, the FDI will be a choice for the mother firm to undertake projects that would ensure the flow of resources in a low cost.

3.3.4 Imperfections in Markets for Technology Theory

The main assumption of this theory is pertained to the transfer of knowledge as the main driver behind the FDI. It argues that transferring technology is costly to produce and the firms who successfully manage to create technology tend to minimize the cost by looking at places where there is minimal marginal transfer costs. This theory helps to address the technology-gap between nations by linking this with strategic plans of MNEs to grow faster with lesser cost using more artificial intelligence.

3.3.5 Imperfect Competition Theory

This theory deals with the monopolistic approach of firms that are considered to be pioneer industrial organizations. These organizations have capabilities to possess unique assets, which convey monopolistic advantages in undertaking investment in foreign markets. Caves (1996) has developed this concept of monopolistic in explaining the horizontal impact of FDI in terms of oligopoly structure. He came up with two different contexts where oligopoly describes FDI in general, and oligopoly with product differentiation motivates horizontal FDI in particular.

3.3.6 Internalization Theory

Unlike to market imperfections theory, the internalization theory builds its framework on the various market variables such as raw material markets, know-how markets, and financial markets. The investment carried out by MNEs aim to maximise the revenues by carrying out these functions internally.

3.4 Theories of Economic Growth

3.4.1 Harrod-Domar Growth Theory

Harrod and Domar introduced the economic growth theory with the inclusion of saving and investments as the key determinants of growth (Sato, 1964). This model was developed firstly by Harrod in 1939 and later was modified by Evsey Domar in 1946. They suggested a model that depicts the main components of an economic growth formula (Liang & Klein, 1989).This formula requires the presence of: 1) the level of national saving (s) and the productivity of capital investment (the capital-output ratio). It is argued that the developing countries have a low rate saving and to boost the economic growth rate, it is necessary to encourage government to increase the level of saving either domestically or externally. Thus, this theory in general predicts a scenario where the transfer of capital to developing world would bring about economic change that is manifested into a higher savings. Below is the cycle of Harrod-Domar model.

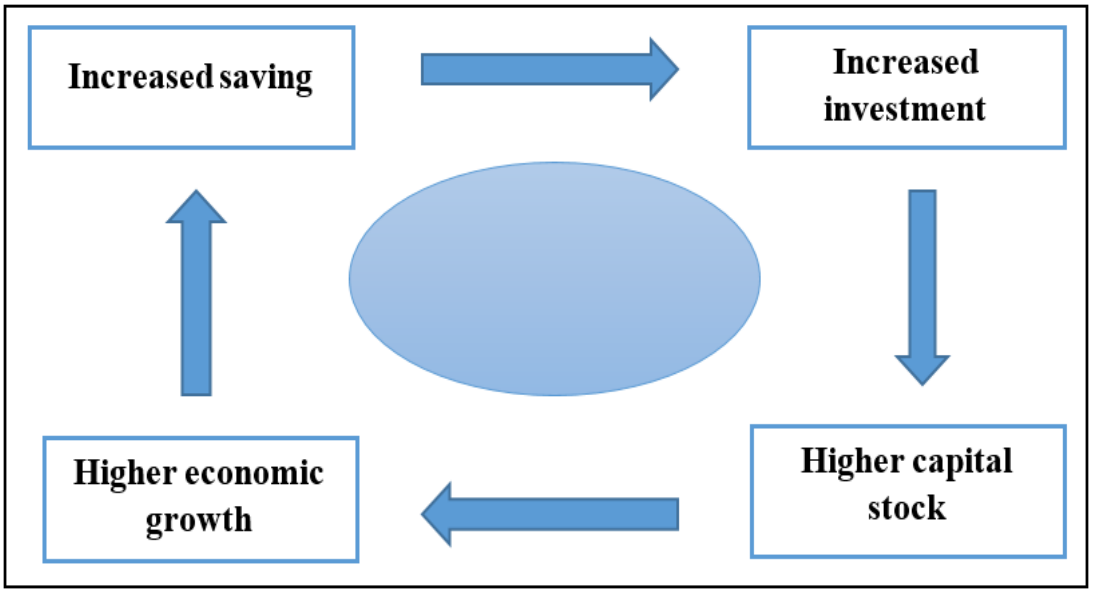

Figure 3.1: Harrod-Domar Economic Growth Cycle

3.4.2 Classical Growth Theory

In his famous 1776 book, "*An Inquiry into Nature and Causes of the Wealth of Nations*" Adam Smith proposed an economic growth model that concentrated on three main production factors, which are land, labour and capital (Solow, 1988). It was a view that has been formulated based on the mercantilist belief and later on became a significant pillar and a predominant model in the modern economic research (Ucak, 2015). Below is the growth cycle as suggested by Adam Smith.

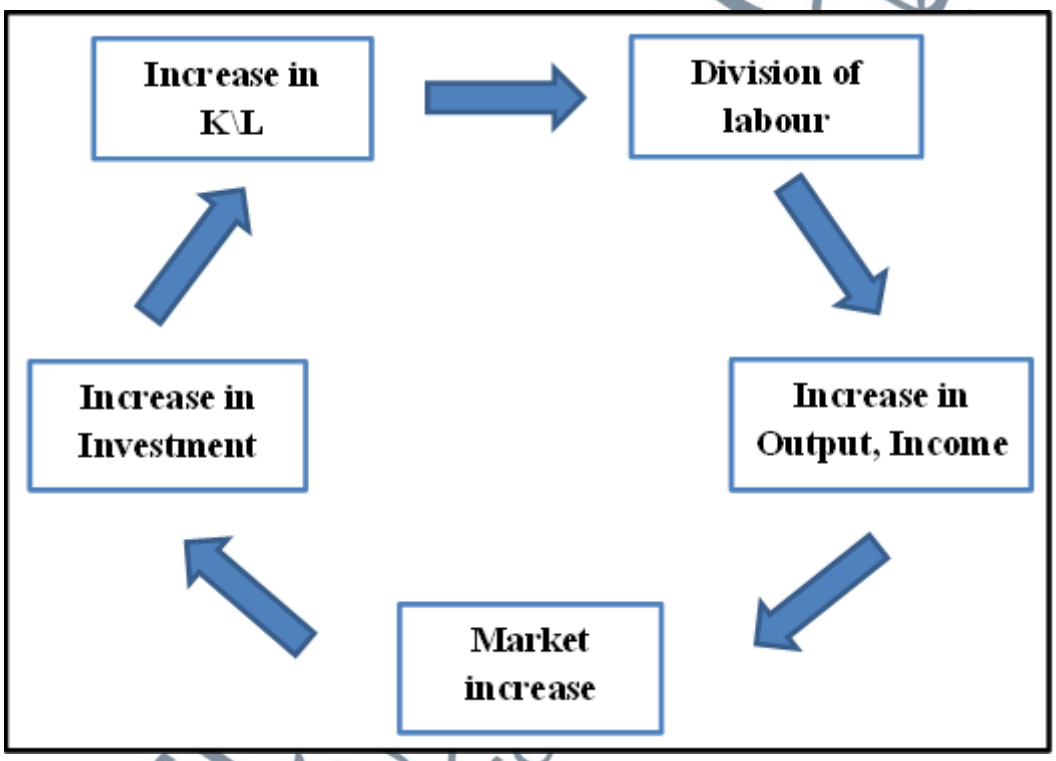

Figure 3.2: Adam Smith Economic Growth Cycle

3.4.3 Neoclassical Growth Theory

Solow-Swan (1956) developed the neoclassical growth model for a long run economic growth. This model was an extension of Harrod-Domar economic growth where the inclusion of productivity growth suggested by Solow and Swan in 1956. This theory emphasises on capital accumulation, labor or population growth, and increases

in productivity, commonly referred to as technological progress. The Solow-Swan model argues that economic growth is more likely to encounter hinders if there is a less advancement in technologies. In other words, the neoclassical growth theory of Solow (1956) and Swan (1956) predicts that the scientific process, which is independent from economic forces, would determine the rate of technological progress. Thus, the neoclassical advocates the notion of exogenous factors and with such understanding the production function takes the form:

$$Y = f(K, L) \tag{3.1}$$

however, with the constant returns to scale assumption, the production function is presented as follows:

$$Y = f(k) \tag{3.2}$$

where *y* is output per worker and *k* is capital per person.

3.4.4 Endogenous Growth Theory

Endogenous growth theory proposes a unique econometric model that explains the long-run growth which derived from the on-going development of technological knowledge. Unlike to neoclassical model, the endogenous builds its assumption on the fact that economic growth is initially determined by forces that are internal to the economic system. The contributing factor of this theory is the inclusion of the state of investment, the size of the capital stock and the stock of human capital.

According to Borensztein, et al., (1998); Lim & Maisom (2000), argue that endogenous models tend to link FDI with various actors including human capital,

exports, technology transfer and capital. Indeed, this theory stress on the fact that the economic growth depends on the economic policies such as subsidies for research and development or education. The first version of this theory comes with AK theory introduced by Frankel (1962) and it is formulated in the production function where Y is proportional to the aggregate stock of capital (K)

$$Y = AK \tag{3.3}$$

3.5 The Theories of External Debt

3.5.1 Debt Overhang Theory

Since the early 1970s and aftermath the debt crisis in the 1980s, the economists perception towards external debts was overwhelmed by the growing trend that was driven by theories of economic growth (Silva, 2004). The theory of debt overhang was an outcome of such new movement in economic thoughts. It was introduced by Sachs (1988) and it is based on the premise that when a country's foreign debt exceeds its future repayment ability with some probability, the expected debt service is likely to be an increasing function of the country's output level. Such economic position could discourage investment as the government tend to increase the tax base via applying more tax (Borzenstein, 1990) and therefore scares off potential lenders. According to Sachs (2002), the overhang theory warns poor countries that have an excessive foreign debt as they are more likely to fall into debt trap. Moreover, the theory postulates the notion that a reduction in the face value of future debt obligations will reduce the distortion caused by a large external debt burden, thereby increasing investment and repayment capacity. Sachs (1988) argues that such undesirable condition might create variance in between the nominal value of debt and the market value of debt. This can

be exhibit the well-known shape of a Laffer Curve as shown in the below figure (Husain, 1997).

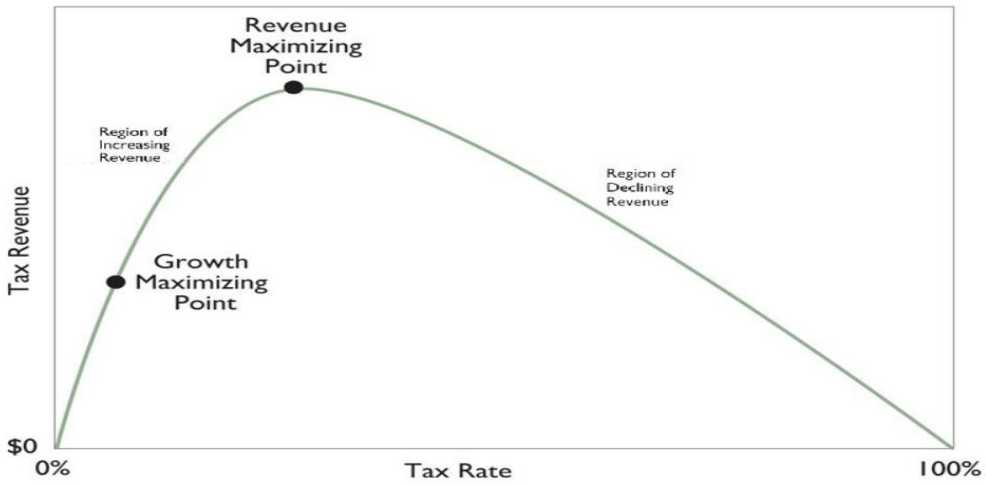

Figure 3.3: Laffer Curve

Formulating the curve into mathematical equation that explain the relationship between the market and the nominal value is as follow:

$$V = f(D, X) \quad (3.4)$$

where V is the market value of debt, D is the nominal amount of claims outstanding and X represents a number of variables which explain the country's ability and willingness to pay ("creditworthiness" indicators).

In the sense of testing this theory, a number of studies (Cordella, et al., 2002; Pattillo et al., 2003; Nguyen et al., 2005; Aguiar et al., 2009) attempt to look at the impact of external debt on economic growth using this theory. These authors argued that high foreign loans could possibly hinder growth by lowering total factor productivity growth. This is because, the debtors' governments would rely on easy funds that are obtained from creditors instead of undertaking economic reforms to upgrade domestic productivity.

3.5.2 Classical Views

David Ricardo and Adam Smith were advocating the fact that the public borrowing is something that fundamentally damage the internal resources and leads to the reduction of the active capacities through "the *perversion of some portion of the annual produce which had before been destined for the maintenance of productive labour towards that of unproductive labour*" (Smith, 1904). To illustrate more on this view David Ricardo makes mention that "*when, for the expenses of a year's war, twenty millions are raised by means of a loan, it is the twenty millions which are withdrawn from the productive capital of the nation*" (Ricardo, 2005). The supporters of this opinion stand on the idea that public debt is a heavy burden to the economic performance and society. They thought that maintaining a good balance of the annual budget is a government own virtue (Salsman, 2017).

3.5.3 The Keynesian View

In contract with the classical view, this Keynesian doctrine argues that public debts are an indispensable tool to ensure the balanced growth of the economy (Bilan, 2016). Unlike to the previous view which limits the intervention of the movement into the market, Keynesian view encourages the movement to interfere and makes the necessary actions such as short term borrowing to ensure the smoothness of the economy and avoid the economic recession.

3.5.4 Neoliberal Economists View

The reappearance liberalism doctrine on the economic scene on 1970s associated with the birth of the Neoliberal thoughts. According to them, when a state turns into public debts to finance budget deficits it is actually creating the so-called crowding-out

effect (Bilan, 2016). This view sees the indebtedness as a driving factor towards a disastrous collapse of a state. Therefore, they are somehow in the same line with the classical view despite that, this view is unlikely to be accepted in the modern economy where the most advanced countries such as Japan where the ratio of debt-to-GDP was of 233%.

3.5.5 Conventional View

In an attempt to propose a different paradigm, the advocates of the conventional view have combined the classical arguments and Keynesian ones, in a way that they differentiate between public debt on economic growth over the short-term and over the medium- and long-term (Bilan, 2016). As for short term, this view adopted the Keynesian framework in which funds have to be provided to meet the market demands but it has to be limited in the sense of time and amounts. From the perspective of longer period, this view embraced the classical doctrine, which prohibits the government to involve in any public debts simply because this will ultimately lead to the reduction of total (public and private) savings, the increase of the interest rate, decrease of investments and the reduction of capital stock.

3.6 Theory of Trade Openness

3.6.1 Heckscher-Ohlin Theory

Traditional trade means the exchange of goods and services between two people or companies and thus, the international trade is the exchange between people or entities in two different countries. Theoretically, various theories have been formulated to provide logical explanation on international trade and the Heckscher-Ohlin theory is one of them. This theory predicts that the developing nations tend to have a higher level

of import compared to export and if this is the case, the situation might drive the economy to a budget deficit (Debaere, 2003). This creates an economic interruption whereby the state is more likely to face challenging situations to pay back the borrowed amounts, which in turn contribute to the economic crisis.

Indeed, the theory contends that the international trade is responsible in increasing in the wage inequality (Aghion et al., 1999) and its primary hypothesis postulates the idea that there is no basic difference between domestic trade and international trade as the latter is a special case of inter-regional trade. Further, Heckscher-Ohlin theory views the foreign exchange rate the main distinguishing factor between domestic and international trade. It is also known as general equilibrium theory of international trade as it is based on the assumption of equilibrium analysis of price determination.

According to Debaere (2003) the Heckscher-Ohlin theory provides a solid platform and comparative advantages that can largely explain international trade. The explanatory power of this theory was tested using in the context of structural exchange trades between the Republic of Croatia and other European Union (EU). In their study, Bilas & Bošnjak (2015) found that the international merchandise trade between Croatia and EU members is actually in accordance with the assumed by Heckscher-Ohlin comparative model. Taking into account the assumption of production factors abundance proposed by this theory, the current study will examine the exchange trades between OE and the European countries during the last quarter of 19th century.

3.7 Review of Theoretical and Empirical Literature

In this section, the discussion focuses on the theoretical aspects underpinning the relationship between the dependent and independent variables in accordance with the

objectives of this study. It specifically addresses the previous studies that have a similar paradigm and match with the whole context of the current study.

3.7.1 Literature Review on Determinants of Foreign Direct Investment Inflows

From the perspective of MNEs, FDI is a fundamental investment choice to maximise the profit and reduce costs, which in turn helps to be more competitive. The existing literature suggests that the determinants of FDI are theoretically categorized into micro and macro level.

3.7.1.1 Microeconomic Determinants of FDI

Within this context, a number of economists attempt to comprehend the behaviours of corporation at the level of FDI framework using the business school theories. For instance, Dunning (1980) introduced the explanatory determinants of FDI known as Ownership-Localization-Internalization (OLI) framework. OLI is relatively well-established pattern that explain the decision of MNEs in carrying on abroad investment. Besides that, OLI is used to elucidate the fact that foreign investors choose to invest in certain location.

Dunning (1980) proposes three arguments to justify his framework. First is ownership advantages. Overall, the argument is based on the intangible and tangible assets that a company acquire such as patents, brand name, technology, differentiated management formulas, and marketing organizations. These assets provide MNEs with a number of advantages over the local firms. With that, the MNEs would be able to achieve its financial targets and revenue growth easier than the local competitors would.

Second is location-specific advantages. It refers to the privileges given by a host country in terms of economic, geographical and political features. It can be summarised in the following features: access to quality production factors, market size, communication, trade distance to major markets, availability of infrastructure, transport, and skilled labour, laws and regulations and distance to major markets.

Third is internalization advantages. This is a combination of above two advantages ownership and location. For example, a firm might have a number of choices to widen its international network by signing a partnership with another firm and thus creating subsidiaries abroad. Various mechanisms can be used to do so such as, having a joint venture with another company and form alliances or sell franchises.

3.7.1.2 Macroeconomic Determinants of FDI Inflows

In keeping with the FDI discussion, the notion of macroeconomic determinants becomes an interesting economic research topic. The emphasis is actually pertained to the economic growth, trade openness (TO) and external debts (ED). The empirical analyses of FDI's determinants have received a considerable attention by academicians and economists.

The theoretical studies on FDI inflow and growth can be traced within the context of neoclassical and endogenous model of growth. The neo classical theory proposes that FDI inflow supports the growth of an economy in many ways. De Mello (1997) contends that FDI helps the accumulation of capital stock, which in turn contributes, to the economic growth cycle. He added that the FDI, which is generated through mergers and acquisitions, might not serve the growth in better way. This is because FDI under this scenario symbolizes the transfer of an assets' ownership from local to overseas hand. The second generation of growth model is widely known as endogenous growth

model introduced by number economists such as Lucas (1988), Rebelo (1991) and Romer (1986).

According to Romer (1986), Barro & Sala-I-Martin (1995), Lucas (1988), FDI is found to be a fundamental pillar in positively driving the growth of the host country through technological spillover and technology transfer. In the sense of developing countries, the FDI has various advantages over the other economic growth factors. First, FDI provide the platform for the accumulation of capital through the transfer of the invested amounts to the local banks and markets. Second, it helps to establish a network of investments all over the country via the promotion of exports. Third, foreign investments tend to augment of labour skills and develop the managerial techniques. In short, it is important to mention here that theoretically the FDI helps the economy in creating an attractive environment for a further investment and growth.

The economic growth rate provides an important sign for the foreign investors in measuring the performance of the targeted economy. This rate is an economic indicator that is reflected through production, consumption, and varieties of goods and other economic facilities produced within a country. Fundamentally, the economic growth rate is proxied by GDP and the higher the better. Economists such as Biglaiser & DeRouen (2011) found that high GDP could display a higher value of FDI investment. In the same vein, Martinez-Zarzoso (2011) demonstrates that high level of GDP shows a positive sign to the investor and increases their confidence level. Several other studies arrive at similar conclusions suggesting that high GDP countries attract FDI (Herzer et al., 2008).

In the case of TO, the macroeconomic aspect is determined by the flow of FDI into the host country. To prove the positive impact of TO on FDI, Edwards (1990) finds that free trade policy will result a better FDI inflows as the overseas capital and investors

may have more privileges in the investment decisions. However, the argument that openness might cause a damaging impact on FDI is still debatable. According to Asiedu (2002), the TO leads to curb the growth of FDI in the hosting countries. This is because the foreign investors tend to create a restricted and monopolized economic environment. Adding to that, the export-oriented investors prefer susceptible countries where the regulations are lenient towards environmental issues and trade protections. Dunning (1993) argues that TO could have either a positive or negative impact on the FDI inflow, depending on the actual motivation to engage in FDI activities by MNEs. A number of researchers follow the same pattern (Grossman & Helpman, 1991; Liu et al., 2001).

Theoretically, the relationship between TO and FDI is largely driven by the attempts to cut cost policy and trade barriers. Athukorala & Wagle (2011) provide evidences that the degree of openness level might attract more investors if the economic environment less volatile. Adding to that, the market size of financial growth is said to have a certain positive linkage with the FDI inflow. The prior literatures such as, Choong (2012); Azman-Saini et al., (2010) and Alfaro et al., (2010) provide evidences that the economic expansion is significantly relied on the ability of the market to absorb FDI inflows consistently.

From another angle, the World Bank report (2016) makes a clear statement that many developing countries rely on external borrowing to finance their domestic investment. Nunnenkamp (1991) concludes that the sovereignty of the indebted countries and the debt overhang were contributing to the decline of FDI inflows during the 1980s. Reinhart & Rogoff (2009) asserted that the interrelationship between the three variables debt-FDI-growth is highly regarded as a driving factor for MNEs decisions to invest abroad. In fact, MNEs, pays a considerable attention to the reputation of target FDI markets given the probability that a debt-defaulting country might not be

an appropriate place to locate their investment. Bayar & Kilic's (2014) examine the Turkish economy and taking into consideration sovereign credit ratings. The study confirms the influence of ED on FDI inflows.

Recently, Tanna et al., (2018) investigated the correlation between external debts and FDI inflows in 39 developing countries between 1984 - 2010. The study has developed a model that encompasses the nonlinear FDI-growth relationship in order to measure the influence of ED on FDI. This study also used Hansen's threshold estimation methods to test the implication of the developed model. According to the finding of the study, the ratio of net FDI inflow to GDP show that the nexus FDI- growth relationship is considerably weaker for the nations with high volume of external debts.

Ang (2008) examined the determinants of FDI in Malaysia between 1960 to 2005. The study uses the two-stage least squares approach to analyse the collected data. Interestingly, Ang (2007) found that FDI functions as driving force of good economic growth in general and it contributes to the acceleration of Malaysian economy in competing with the neighbouring countries. The result also show that the market size and growth rate were positively associated with the growth of FDI. Besides, the exchange rate is found to be insignificant in affecting the FDI inflow. In addition to that, the author has tested the FDI determinants within the context of US economy. The outcomes reveal that only the economic growth and domestic credit were capable of influencing and attracting FDI inflow.

Lautier & Moreaub (2012) investigated the effect of domestic investment on FDI inflow for a period of 30 years covering 68 developing countries. It was predicted that higher growth would probably lead to a certain access to a large market where domestic investment create an opportunity for business. This prediction leads the author to assume that FDI inflows is an attractive sign on the stability of the economy. This study

has used autoregressive errors and the findings demonstrate that there is a strong influence of lagged domestic investment on FDI inflows within the developing countries paradigm. With that, he concludes that domestic investment is proven to be a stable predictor for FDI.

Bekhet & Al-Samadi (2015) have gone through a similar approach but the focus was only on Jordan. This study emphasizes on the macroeconomic determinants for FDI inflows. Using annual data from 1978 to 2012 and applying the Autoregressive Distributed Lag (ARDL), the results of the study show the increase in GDP, EO, N2 and SMI have led towards a noticeable augmentation in the level of FDI inflows. On the other hand, the inflation rate is found to be negatively significant in the sense of its association with FDI inflows. This is because the higher inflation the lesser economic growth.

Additional insights into this nexus within the context of Ottoman economy are invaluable in helping to comprehend the FDI inflows during the 19th century. There is, however, a void in the literature in terms of quantitative documentation of Ottoman economy. The theoretical answers for this gap originate mainly from the absence of data, which is the main constraint to go further. Historical examples include economic explanations show that FDI was a key factor in the shaping the Ottoman economy.

Geyikdagi & Geyikdagi (2011) hold a strong conviction that the perception of intellectuals towards the flow of foreign capital and technology are mixed. The presented findings show that overall the dominant perception was in favour of restricting FDI by applying certain barriers against the free trade with European powers. Akarli (2001) make mention that an acute increase in the rate of the inflow of foreign investment in the Ottoman markets which prevented the birth of infant industries within the Ottoman territory. He added that the domination of industrialised economies over

the Ottoman economy was mainly pertained to the series of 1838 Anglo-Ottoman trade treaties and as a result the Ottoman underdevelopment was perpetuated.

In the same vein, Pamuk (2004) agrees on the fact that the economic integration was also been observed in the Ottoman economy via the door of FDI and the Anglo-Ottoman trade treaty 1838 was the main apparatus to achieve that. Geyikdagi (2011) argues that the FDI was negatively affecting the Ottoman economy and industrialization process. Indeed, at the end of 1913, 42% of £3700 million aboard British capital was invested in railroads. According to McLean (1976), Ottoman economy had long been a central feature of British foreign policy to defend its trading interests.

In his book on political economy, Ahmed Midhat (Efendi) (1844 –1912) criticized the government on the used approach to attract foreign direct investment and viewed the policies as not protective in nature and rather they were serving the foreigners. To him, the best method was to make imports difficult for them [foreigners], by imposing heavy duties on foreign imports in order to protect the domestic industry. More importantly, some voices were raised to enlighten the public on the upcoming danger of FDI. For instance, Parvus (2005) who was a popular novelist criticised the capitalist ideology holding the belief that this doctrine could harm the Ottoman society severely. He suggested that the country could create a good economic progress if it got rid from the grip of European imperialism and their FDI and the external funds.

Table 3.2: Summary of Studies on Determinants of Foreign Direct Investment Inflows

Studies	Sample and period	Method		Explanatory variables
		Time series	Cross country/ Panel	
Tanna et al., (2018)	39 developing countries 1984 - 2010		Linear regression model with autoregressive errors	Economic growth FDI External debt Human capital Civil conflict Financial crises
Ang (2007)	Malaysia 1960 to 2005	2 SLS estimation		Foreign direct investment at 1987 prices, financial development, GDP, annual growth rates, government spending on transport and communication, TO, real exchange rate, statutory corporate tax rate, and dummy variable for Asian financial crisis 1997-1998.
Lautier and Moreaub (2012)	68 developing countries 1984 to 2004		Linear regression model with autoregressive errors	Ratio of FDI on GDP, GDI, country risk index and real GDP per capita.
Bekhet and Al-Samadi (2015)	Jordan 1978 to 2012	ARDL estimation		FDI, real domestic per capita, TO, CPI, money supply, M2 and stock market index.

3.7.1.2.1 Postulation of FDI Determinants

The above presented findings are consistent with Dunning (2009) outcomes where the macroeconomic determinants such as growth rate, openness to trade, and external debts are keys factors in influencing the flow of FDI. According to the research of Lee & Vivarelli (2006), the FDI inflows in developing countries is targeting low cost labour and this has a certain impact on the income distribution. It is important to mention here that MNEs selects the locations that match with the strategy of where the business operation would be able to achieve maximum profits with lesser cost. The relationship between FDI inflows and local investment is empirically proved to be significant in the sense that the FDI inspires the technological transformation.

Form another aspect, Edward (1990) suggested that a better economic performance is highly relied on a consistent and efficient FDI inflow. To him, TO is paying a considerable role in facilitating and attracting the FDI. This is because, free trade abolish several impediments that might face an international exchange of goods and service. This leads to highlight the FDI –economic growth nexus that is still receiving a great attention by experts. The prior literature provides several evidences on a positive signs between these two factors either in developing or developed world. This fact is yet to be empirically investigated within the Ottoman paradigm. This is an issue at least equally important in the economic history research, which needs to be addressed. From this perspective, it seems relevant to highlight the role of macroeconomic determinants in shaping and designing the FDI inflows. In addition to that, the past literature introduced many variables to explain FDI and some of these variables will be used in the postulation of the determinants. Hence, it is important to postulate the fact that the FDI inflow might be impacted by a set of explanatory variables as it is shown in chapter four where the econometric model is presented.

3.7.2 Literature Review on Determinants of External Debt

The prior literatures present some driving factors that contribute to debt accumulations. These factors can be divided into internal and external aspects. For the internal, authors have provided these determinants that function as push factors, poor policy making and economic mismanagement (Easterly, 2002), unrealistic macroeconomic policy (Burnside & Dollar, 2004), excessive government spending (Edo, 2002), variability in export revenue and government expenditure (Ajayi & Khan, 2000), primary budget deficits (Bilquees, 2003), fiscal deficits (Folorunso & Falade, 2013), and balance of payments (Kemal, 2001). The external determinants, can be capital flight (Tiruneh, 2004), interest rate shocks (Hajivassiliou, 1987), trade liberalization (Zafar & Butt, 2008).

It is important to mention here that albeit debt is a popular topic, a noticeable shortage in the empirical evidences. This could be pertained to the lack of comprehensive data on debts in the developing countries. Also, a large portion of the existing literatures tend to examine the relationship between external debt and economic growth. In this respect, Grennes et al., (2010) used the economic model of Hansen (2000) to analyse the nonlinear relationship between debt and long-term growth of 79 countries. Their finding reveal a threshold of 77.1 percent of public debt-to-GDP for the countries that surpassed costs 0.0174 percentage points in annual average real growth. Pyeman et al., (2014) examined the possible macroeconomic determinants of external debt of Malaysia form1972 until 2012. Their finding exhibited that GDP, exports, and FDI were important indicators affecting the external debt of the country.

Tiruneh (2004) examined the demand for external borrowing of sixty heavily indebted poor countries and non-heavily indebted less-developed countries over a period from 1980 to 1990. The outcomes depict that capital flight, debt service

payments, the imports to GDP ratio, income per capita, and the growth rate of GDP are the main determinants that impact the decision to seek overseas loans.

In another study, Clements et al., (2003) investigated the nexus external debt and economic growth for 55 low income covering a period from 1970 to 1999. Their provide evidences that beyond a certain threshold, countries with higher external debt tend to experience a lower growth rates of per capita GDP. The threshold is ranged from around 30-37 percent of external debt to GDP or around 115-120 percent external debt to exports. Looking at the association between economic crisis and external debt, Bordo & Meissner (2006) used historical data from 1880 to 1913. Interestingly, their study show that high exposure to external debt may not necessarily lead to a high chance of having a debt crisis, currency crisis, or a banking crisis.

Recently, Waheed (2017) investigates the macroeconomic determinants of external debt in oil and gas exporting and importing countries. The sample contains 12 oil and gas exporting and 12 oil and gas importing countries covering the period 2004-2013. For oil exporting countries, the panel data results show boosting in economic growth, foreign exchange reserves, general government revenue, price of oil, and domestic investment are the driving factors in decreasing external debt. As for oil and gas importing countries, increase in trade deficit, international price of oil, interest payment on external debt, FDI and domestic investment are causing a tremendous spike in the volume of external debt.

Using a Tobit model for 144 developing countries from 1980 to 2000, Gelos et al., (2011) conclude that after the occurrence of debt crisis, the behaviour international capital market towards those affected country is the application of exclusion policy of 4 years. In the same vein, Richmond & Dias (2008) provide relevant estimation to the indebted countries. Their results indicate that the exclusion from the international

capital market to be 5.5 years for debt crisis that occurred in the 1980's, 4.1 years duration in the 1990's and lastly 2.5 years of exclusion for debt crisis in the 2000's. In fact, this period of exclusion from the international capital market will affect the country's ability to obtain other resources for growth and development which means a potential reduction in the output.

Further, Omodero (2019) provide robust evidences that external debt has no significant effect on investment; however, debt service crowds out total investment (not public investment) only in low income countries. Applying logit model, Catao & Sutton (2002) examined the roles of externally induced volatility 25 emerging market countries over the period from 1970-2001. The study found that the following variables, (GDP growth, the ratio of debt services to exports, the ratio of net international reserves to debt, the fiscal balance, the real U.S. interest rate, and the real effective exchange rate) are having a significant explanatory power of the external debt.

Exploring the Ottoman economy, the existing literature have pointed out that the external debt were positively harmful to OE economy. Eldem (2005) notes that the Ottoman government decided to strengthen its ties with the west to a gradual process of integration via the process of the forging loans. He added that the political implications of the external loans were not clear at the early stage but six years after the first loan the OE lost its financial and political autonomy.

Under such uncertain financial conditions, the OE was looking for another source to meet the increasing expenditures and external loans were offered by European to put an end to the glory days of OE. This view is supported by a number of economists such as Conte & Sabatini (2014) who posit that foreign loans, as well as increasing the empire's public spending, played as an influential factor that ended the greatness of the OE. Tezel (1972) concludes his study by saying that the reckless economic policy of

external debts led the state to face unexpected results ended up with the establishment of foreign economic and political control over the ottoman periphery.

Several economic indicators namely budget deficit and financial institution contributed to the rise of external debts. With regards to budget deficit, the study of Pamuk (2006) found that the reached their peak during the 1820s and 1830s and despite the attractiveness of external borrowing, the OE paid a heavy price due to the absence of an efficient fiscal discipline that can monitor the ongoing economic changes. More recently, Mitchener & Weidenmier (2010) in their article refer to another dividing line which is the usage of extreme sanctions such as gunboat diplomacy and ‘‘fiscal house arrest’’ on the defaulters during the period 1870 –1913. Using a data of 25 countries including the OE, they found out that after a ‘‘super-sanction’’ was imposed, a country improved its fiscal discipline. The authors conclude that some type of external fiscal or monetary control may be help to improve the revenue of the state. The above concerns might correspond to bringing in the theoretical dimension of the debt overhang theory which views the reliance on the external debts for the long run will ultimately create a poisoned economic environment and certainly the economic growth will negatively be affected.

3.7.2.1 Postulation of External Debt Determinants

It is based on the premise that when a country's foreign debt exceeds its future repayment ability with some probability, the expected debt service is likely to be an increasing function of the country's output level. Such economic position could discourage investment as the government tend to increase the tax base via applying more tax (Borzenstein, 1990) and therefore scares off potential lenders. According to Sachs (2002), the overhang theory warns poor countries that have an excessive foreign

debt as they are more likely to fall into debt trap. Moreover, the theory postulates the notion that a reduction in the face value of future debt obligations will reduce the distortion caused by a large external debt burden, thereby increasing investment and repayment capacity. Sachs (1988) argues that such undesirable condition might create variance in between the nominal value of debt and the market value of debt. This can be exhibit the well-known shape of a Laffer Curve as shown in the below figure (Husain, 1997). Hence, it is vital to suggest the external debts is more licly to be influenced by various variables such as economic growth, government expenditure, interest rates and others. To test this assumption, the econometric model has been suggested in the next chapter.

3.7.3 Review on Foreign Direct Investment, Trade Openness and External Debts on Economic Growth

3.7.3.1 Relationship between Foreign Direct Investment and Economic Growth

De Gregorio (1992) investigates the FDI on economic growth of 12 countries in Latin America. The study found a strong positive effect of FDI on economic growth. Based on the findings of the study, the researcher suggested to the policy makers to provide platforms that are more efficient for the FDI due to its advantages in helping the country to accumulate capital and transfer technology. Borensztein et al., (1998) analysed the economic growth and FDI inflows for 69 developing countries over a period of 1970-1989. The result shows a significant association between FDI and growth. The study further explained that the increase in technological progress helps to attract the foreign investors, as they are keen to invest in location where the labour and raw materials are accessible with a reasonable cost.

Similarly, Zhang (2001) who examined the link between FDI and economic growth in two continents using a sample of 11 countries in East Asia and Latin America for a period of 1960 - 1970. Using an econometric model namely as cointegration technique and error correction model, the results of this study are consistent with the above stated papers where there FDI is positively affecting the economic growth. However, the author has put some notes whereby the growth is depending on country-specific characteristics such as human capital conditions, improved education and human capital conditions, liberalized trade regimes, and effective macroeconomic conditions.

Recently, Pegkas (2015) employed a time series method to analyse a data belongs to Eurozone covering a period 2002-2012. The study predicts that FDI has a certain impact on the economic growth. Using a fully modified OLS and dynamic OLS methods, the findings supports the proposed hypothesis and confirms the FDI-growth nexus. Additionally, Hansen & Rand (2006) conducted an empirical research on 31 developing countries. The obtained data was analysed using bivariate vector autoregression technique to test the contribution of FDI to economic growth. The outcomes provide positive evidences of a long run relationship between FDI and growth. Further, the study reveals a bidirectional causality between FDI and economic growth.

In contrast to the above literatures, Anyanwu & Yameogo (2015) investigated the FDI inflow effect on economic growth in West Africa countries. The study used an OLS technique to estimate the examined association. The study revealed interesting findings where an inverse relationship between FDI and economic growth has been spotted. Similar results were identified in the study carried on by Saltz (1992) who examined the third-world countries 1970 to 1980. Using time series approach, Saltz found a

negative effect of FDI on economic growth. Focusing on Bangladesh, Rahman (2015) has performed an empirical analysis on the FDI-economic growth nexus for a period 1999 – 2013. Multiple regression was utilized and the result is showing a negative correlation between the two variables.

In the same vein and taking Pakistan as a source of data, Saqib et al., (2013) assessed the link between FDI and economic growth for 30 years. The results indicate a negative relationship between FDI and economic growth. Other studies conducted FDI growth nexus reported weak or no significant relationship. Carkovic & Levine (2002) used a sample of 72 countries from 1960-1995, the authors employ Generalized Method of Moments (GMM) estimation technique to analyse the connection between FDI and economic growth. The findings depict a weak linkage in both developed and developing countries. Similarly, Louzi & Abadi (2011) found no impact of FDI on economic growth in Jordan for a period between 1997-2006.

Focusing on the post-1780 period, Pamuk (1984) provide evidences that the growth rate of Ottoman trade with European countries was stagnant to below 0.5% per year. This rate had changed rapidly after signing the free trade treaties whereby it reached 5% between the years 1839 to 1873. Over the course of the 19th century, the Ottoman economy was performing in a strange way and the economic growth fluctuated as a result of political instability and many other factors. For instance, Arbatli (2016) found that, Ottoman GDP per capita could have grown about 0.63 – 0.80 percentage points faster on average per year over the period 1800 – 1870.

The key hypothesis from his framework is that for many countries greater integration with the global economy led to greater macroeconomic volatility. Most importantly, Pamuk (2006) put forward the notion that per capita income levels in 1950 were about the same as those in 1913 (Pamuk, 2006). Although such studies are helpful

in widening our understanding on the structure of economic growth, yet they are in general incapable of yielding the forces that affect it. Besides that, the economic theory provides an open-ended explanation to the economic growth phenomena. For example, Sala-i-Martin (1997) identifies around 60 variables that need to be correlated with economic growth. This intense debate over the factors influencing the economic growth has led numerous economic scientists to investigate the link between openness and overall volatility. Both cross-country and industry-level studies find that increased openness in international trade is positively linked with higher volatility in growth rates of GDP and consumption (Herzer & Klasen, 2008). With that in mind, the below table 3.3 listed a number of the studies that are relevant to the research study.

Table 3.3: Summary of Studies of Foreign Direct Investment and Economic Growth

Authors	Country	Period	Methodology	Variables	Empirical Evidences
Borensztein et al, (1998)	69 developing countries	1950-1985	Seemingly Unrelated Regression Technique (SUR)	FDI, GDP growth, Initial GDP per capita, Domestic Investment, Human Capital	Positive Effects but the magnitude of it is dependent on existing capital stock
Zhang (2001)	11 East Asia and Latin America Countries	1960-1970	Cointegration Test and Vector Error Correction Model	FDI stock, Real GDP	Positive Effect
Hansen and Rand (2006)	31 developing countries	1970-2000	Bivariate Vector Auto Regression	GDP, FDI (% of GDP), FDI (% of GCF)	Positive Effect; Bidirectional causality between FDI and Economic Growth.
Choe (2003)	80 countries	1978-1996	Cointegration Test and Vector Error Correction Model	GDP, FDI	Long-run steady state relationship GDP and FDI; bidirectional causality between FDI and GDP
Louzi and Abadi (2011)	Jordan	1997-2006	Cointegration Test and vector error correction mode	FDI, Growth, Domestic Investment and Trade Liberalization	No significant effect
Saqib et al. (2013)	Pakistan	1980-2010	Least Squares and Augmented Dickey Fuller Technique	GDP per capita, FDI per capita, Total Debt Service, Gross Domestic Savings as % of GDP, Inflation and Trade as % of GDP	Negative relationship
Carkovic and Levine (2002)	72 countries	1960-1995	Generalized Method of Moments	FDI inflows per capita, real per capita GDP growth, Average years of Schooling, Inflation, Government Size, Openness, Black Market Premium Private Credit	Positive Effect

3.7.3.2 Relationship between Trade Openness and Economic Growth

Earlier economists such as Kruger (1978) asserts on the role played by trade in accelerating the economic engine. The international trade is believed to establish a competitive and dynamic economic atmosphere. The concept of comparative advantage was initially introduced by David Ricardo in which every country has to be specialized in a bulk of products that match with natural resources and then export the goods to other countries where this particular product is relatively limited. Thus, resources are more optimally distributed. The theory of endogenous growth assumes that the technology is an economic element that is developed internally. With adoption of trade openness policy, the advancement in technology could occur in a rapid manner and eventually improve the quantity and quality of the manufactured goods and services. Moreover, the theory of international trade "Heckscher-Ohlin-Samuelson" predicts a similar scenario where substantial gains can be generated if the international transactions between countries take into consideration the allocation of resources.

Empirical studies on the influence of TO on economic growth has been highly analysed by experts and World Bank. The TO – growth nexus remains indistinctive. For instance, Daumal & Özyurt (2011), contend that an open economy is more likely to bring about various benefits including skills and dexterity of its labour force. They added that the integration into the world economy helps in providing a wide range of ideas and innovation to local producers to come up with new products. Harrison (1996) employed a measurement of TO that is based on trade volume divided by GDP, has concluded that the finding of his study supports the fact that TO is positively affecting the economic growth. In a similar study, Chen (1999) has reported that TO due to government policies is an essential factor in fostering the economic growth.

A study by Idris et al., (2016) investigated the relationship between trade openness and economic growth in 87 countries of the Organizations for Economic Co-operation and Development (OECD) and developing countries 1977–2011 periods. Using general method of moments (GMM), this study found a bidirectional causal relationship for both developing and OECD countries. Using the same statistical approach GMM, Gries & Redlin (2012) examined the relationship between TO and growth for 158 countries from 1970 to 2009. Their findings support the endogenous assumption whereby a positive causal relationship has been found in the long term. Zeren & Ari (2013) conducted an investigation on the causality relationship between trade openness and economic growth for the developed countries between 1970 and 2011. Using the Granger non-causality test for heterogeneous panel data, the outcomes of the study prove that openness increases economic growth in the G7 countries. Using a vector error correction models (VECMs), Saad (2012) managed to gather evidences that support the positive linkage between TO and economic growth in Lebanon from 1970 to 2011. Kurt & Berber (2008) studied TO- growth in turkey using a data that covers 1989 –2003. This study utilizes VAR techniques and the findings demonstrated bidirectional causality between economic growth and TO.

The historical literature offers limited insights on the Ottoman's foreign trades with Western Europe as most of the available literatures on this domain are descriptive /qualitative nature. However, it is generally accepted among experts that the total Ottoman exports or imports expanded rapidly during the nineteen's century which could be explained by the fiscal reforms and capitulation treaties. This has raised the question on whether the movement of local relative price of exported goods compared to the imported once, i.e., the terms of trade (ToT) can influence economic growth of Ottoman economy. Here, the primary argument resides largely on the fact that countries with the

greater integration into the world economy are more likely to have a volatility in its ToT (Arbatli, 2016). According to Williamson (2008) the rapid growth in ToT was one of the driving forces behind the Great Divergence between the industrialized and non-industrialized nations.

The economic integration was also been observed in the Ottoman economy via the door of FDI and the Anglo-Ottoman trade treaty 1838 was the main apparatus to achieve that. This treaty was imposed by the British after the war between the OE and Egypt in which the state was reaching to unprecedented deterioration in its internal and external military and political problems (Geyikdagi, 2011). It forced the state to abolish the protective tariffs and state monopolies so the cheap manufactured goods of the advanced capitalist states soon were able to destroy Empire's craft industries (Ergil & Rhodes, 1975). With its harsh condition, the Anglo treaty put a considerable pressure on the Ottoman government to abandon debasements and establish reforms in the fiscal system.

Thus, the empire found itself under the monopoly of the European powers and becoming an open market and dependent state within the world capitalist economy. Bailey (1942) contends that with the absence of protective tariffs the OE lost the chance to move forward with the industrialisation program and rather it led to the country's industrial backwardness (Geyikdagi & Geyikdagi, 2011). In the same vein, Blaisdell (1929) views the free trade agreement between the OE and Britain in 1838 as a key factor in weakening the economy through the creation of legal framework for the European entities to enjoy the tax heaven.

Pamuk (2004) examined the behaviour of prices inside OE and compared them with those in Western Europe during the period from 1469 – 1914. This study found that the integration was noticeably high during the first half of the 19th century. Focusing

on the post-1870 period, Blattman et al., (2007) provide evidence that the ToT volatility had a big adverse impact on economic growth in the pre modern economies. Comparing the Ottoman experience with the rest of the poor nations, Pamuk & Williamson (2011) conclude that the OE, along with Egypt, had gone through one of the greatest upswing in ToT up to 1860s. Observing the Ottoman ToT and using the economic model suggested by Blattman et al., (2007), the study of Arbatli (2016) offers a relative contribution on the ToT volatility literature within the Ottoman context over the period 1800 – 1933. Their study reveals an interesting outcome in which the Ottoman GDP per capita could have grown about 0.63 – 0.80 percentage points faster on average per year over the period 1800 – 1870.

3.7.3.3 Relationship Between External Debts and Economic Growth

Several attempts by economist have been witnessed to empirically assess the relationship between external debts and economic growth. For instance, Fischer (1991) examined the correlation between external debts and the economic growth for the period 1970 to 1985. The study revealed that the ED coefficient has a negative impact on economic growth. Borensztein (1990) examined ED – growth nexus in Philippine and the result show that debt overhang had an adverse impact on private sectors, which led to decline in the performance of the economy. Using a data from 1970 to 1994, Iyoha (1999) analyse the impact of ED on economic growth in the region of Sub-Saharan African countries. The econometric model manifests the ED in a form of ratio (debt services to export) and the findings indicate a negative sign, which means that ED is curbing the economic growth. He concluded that countries with heavy debt burden have more difficulties to attract foreign investments.

Clements et al., (2003) studied the channels of ED and its linkage with the economic growth for 55 low-income countries for a period 1970-1999. The study employed fixed effects and system GMM to analyse the collected data. According to the result, ED has a deleterious impact on growth specifically after exceeding the threshold level. The study puts a range to the threshold to be around 50 percent of GDP. Further, the authors found that debts service has a negative impact on economic growth and on average, every 1% increase in debt service as share of GDP reduces public investment by 0.2 percentage points.

Hansen (2001) examined the same nexus ED- growth in developing countries. The study used cross-country regressions to predict the correlation between the two variables. The outcomes provide strong evidences of a negative impact of debts and debts service on investment and economic growth. In contrast with the above studies, Cohen (1993) reported no evidences with regards to the existence of a debt overhang in developed countries. Yet, for the developing countries, the result differs as a negative impact on growth was detected. Using a time series, Were (2001) investigated the effect of ED on economic growth in Kenya from 1970-1995. The study explores three different proxies of ED, current flow of debt as a ratio of GDP, past debt accumulation (debt lagged) as a ratio of GDP, current debt services to exports, and accumulation debt services as a ratio of exports (lagged debt services). The results were negatively significant at 5% level. The study show an interesting outcome where the service debts was positive and significant at 5% level and this was explained by the author that Kenya was having a less debt service compared to other African low income countries.

Using a large scale of data, 93 developing countries over a period of 1969-1998, Pattillo et al., (2002) tested the assumption of negative impact of ED on economic growth. The study uses four types of econometric models: OLS, instrumental variables,

fixed effects, and system GMM. The dependent variable was per capita growth. The independent variables were: secondary school enrolment rate, openness, debt to GDP ratio, lagged income per capita, the investment rate, net present value to GDP ratio, population growth rate, openness, debt to GDP ratio, debt to export ratio, debt services to export ratio, net present value to GDP ratio, and net present value to export ratio. The study finds a negative correlation between ED and economic growth.

Observing the historical aspect of ED and economic growth is vital to comprehend this relationship in different environment. Empirical evidences demonstrate that the involvement of OE in wars such as the Crimean war **(**1853 –1856**)**, left the state in a serious economic crisis (Birdal, 2006). This mainly associated with the rise of military expenditures that were financed directly out of the state treasure (Pamuk 2014). This particular war was the *coup de grâce* to all the attempts to find a local solution of the OE chronic financial malaise (Eldem, 1999). It is because the immediate consequence of this war was the signing of the first loan from the west with unfavorable condition (Rodkey, 1958).

By 1863, a total of six loans with a value of 39 million pounds sterling had contracted and secured by various direct and indirect tax revenues such as: custom duties and the Egyptian tribute. A large part of these loans were used to pay for military and unproductive activities which eventually led to a rapid increase in the external trade deficit and making the repayment of the borrowed amounts virtually unmanageable. Therefore, of this unprecedented situation, the state was unable to avoid the frequent defaults of debt payments and it reached with declaration of its bankruptcy in 1876 (Pamuk, 1984). The existing literature (Pamuk, 1988; Eldem, 2005; Birdal, 2006) suggest that these series of crises sharply created a favorable economic conjuncture for the landers to impose more pressures on the Porte to engage in different polices that

marked a dead end to the reforms of Tanzimat in 1876. With the establishment of Ottoman Public Debt Administration (OPDA hereafter) in 1881 and during the period between 1881 -1898, the debt repayments net of new borrowing averaged £1.9 million per year (Pamuk, 1984).

Clearly, these figures point to an unprecedented decline in the economic performance of the economy and the capital accumulated through the inflow of foreign debts was relatively unhelpful to successfully integrate the state into the world economy and boost the economic growth. It should be emphasized, however, that there are very limited numbers of quantitative studies that discuss this matter and such scarcity needs to be taken into account by economic historians.

3.7.3.3.1 Postulation of Foreign Direct Investment, Trade Openness and External Debts on Economic Growth

The literature on FDI inflows and economic growth has been largely discussed among numerous researcher, policy makers and financial institution. The question whether FDI inflow creates a value added to the economic growth is still debatable and the mixing results posit a serious need to tackle this matter within the historical framework. Indeed, the results would reveal enormous diversities due to the different type of method, sample, and time trend of the observations. Numerous studies include Li & Liu (2005); Pegkas (2015); Borensztein et al., (1998); Balasubramany et al., (1996); Shahbaz & Rahman (2010); Choong (2012) claim to report a positive relationship between FDI inflow and economic growth. The notion that FDI inflow and economic growth are positively linked involves discussion on the need to consider the opposite view, which shows no relationship. Meanwhile, some commentators including economists argued that FDI does not necessarily bring about an in augmentation in the

economic growth rate. For instance, Akinlo (2004), Hanson (2001), Herzer et al., (2008) found no relationship between economic growth and FDI inflows. They assert that FDI have a relatively little effect on the performance of an economy instead, it mostly impair the factors of financial growth in the host country.

A similar relationship appears to hold for earlier periods. For instance, focusing on the post-1870 period, Geyikdagi (2011) argues that the FDI was negatively affecting the Ottoman economic growth and the industrialization process. However, if there is anything we can take away from the existing literature is the fact that there is serious shortage of the literature in terms of quantitative documentation using historical data. With these developments in mind and with the new economic data of Ottoman Empire this might correspond to bringing in a new outlook of the relationship of FDI inflow and economic growth. In keeping with the internalization theory and imperfect competition theory in which the monopolistic approach of firms that are considered to be pioneer industrial organizations. These organizations have capabilities to possess unique assets, which conveys monopolistic advantages in undertaking investment in foreign markets. Thus, this study starts from the premise that the effect of FDI inflow on economic growth is positively predictable and it is reasonable to postulate a linkage between the two variables within the context of OE.

Concerning the trade openness, the theoretical explanation "Heckscher-Ohlin theory" argues that trade liberalization enhance the economic growth (Krueger, 1998). It also assumes that international trade encourage growth as it enhance the specialization and division of labour. Among researchers who tend to agree with this fact are Edwards (1998); Greenaway et al., (2002); Wacziarg & Welch (2008); Squalli & Wilson (2011) & Harrison (1996). In addition to that, other economists Balasubramany et al., (1996) Brecher & Findlay (1983), provide empirical evidences on the idea that effect of FDI

inflow on the economic growth provided depends on the degree of TO. Given this, the inflow of fearing capital to the host countries brought along many benefits such as: bigger production efficiency, technology transfer, better human capital, internationalization and broadening of host countries' markets, innovation, employment opportunities, investment and capitalization, and research and development actions (Javorcik, 2004; Agosin & Mayer, 2000; Bosworth & Collins; 1999; Harzing & Sorge; 2003).

Following the uncertainty in the economic outlook, some researchers criticize the positive relationship TO and economic growth. They hold the idea that free trade surges the state revenue in a short term but this would not contribute to a sustained growth in the long-run. Redding (1999) contends that the liberation of trade is more likely to decrease the economic growth of the economies that specialize in sectors with dynamic comparative disadvantage. James (2001) has noticed that in terms of TO-growth nexus, the formula of success for some developing countries might not be the same for other.

The industrial revolution marked a turning page to the production and goods as a result of the factory system which adopted initially by Britain and later on by the rest of Europe. Furthermore, the trade treaties signed with a number of European countries such as England in 1583, Holland in 1613, Austria in 1718, and Russia in 1784, the Ottoman economy was stagnant and reliant on Europe and had a very poor performance (Ergil & Rhodes, 1975). Thus, the empire found itself under the monopoly of the European powers and becoming an open market and dependent state within the world capitalist economy. Bailey (1942) contends that with the absence of protective tariffs, the OE lost the chance to move forward with the industrialisation program and rather it led to the country's industrial backwardness (Geyikdagi & Geyikdagi, 2011). In the same vein, Blaisdell (1929) views the free trade agreement between the OE and Britain

on 1838 as a key factor in weakening the economy through the creation of legal framework for the European entities to enjoy the tax heaven. Thus, this study would therefore put forward as a postulation of a positive relationship between TO and economic growth in Ottoman Empire for a period from 1881 – 1913.

The mid of 19th century witnessed a growing expansion of foreign credits from the core to the peripheries. However, this augmentation in the level of public debts was followed by bankruptcies of many debtor countries including: Ottoman Empire (1876), Greece (1843-1893), Portugal (1892), Spain (1873) Argentina (1890), Brazil (1898), and Egypt (1876). OE faced a continuous demand for funds to finance the military needs and confronting the political and military movements that destabilized the state.

Several studies have pointed out that the external borrowings policies created a very challenging environment to the OE economy. Eldem (2005) argues that the political implications of the external loans were not clear at the early stage but six years after the first loan, the OE lost its financial and political autonomy. This view is supported by a number of economists such as Conte & Sabatini (2014) who posit that foreign loans, as well as increasing the empire's public spending, played an influential factor in the decline of OE. Tezel (1972) concludes his study by saying that the reckless economic policy of external debts led the state to face unexpected results ended up with the establishment of foreign economic and political control over the Ottoman periphery.

Further, Pamuk (2006) asserts that Ottoman budget deficits increased after the late 1760s and reached its peak during the 1820s and 1830s. He added that, despite the attractiveness of external borrowing, the OE paid a heavy price due to the absence of an efficient fiscal discipline that can monitor the unstable economic changes. In his study, Tuncer (2015) concludes that the increasing dependence of the OE's treasury on loans floated in Western Europe converted the state into a poor nation with a total of

£200 million sterling. The above concerns might correspond to bringing in the theoretical dimension of the conventional theory which views the reliance on the external debts for the long run will ultimately create unbalanced economic environment.

3.7.4 Review of the Causal Link between FDI and Economic Growth

Much attention and analytical effort has been devoted in recent decades to decompose cause and effect of FDI and economic growth. A key focus of the current literature on the casual link between these two macroeconomic factors is to provide an answer to question originate mainly from the need to elucidate our understanding on the bidirectional causality. From the standpoint, Basu et al., (2003) investigated the causal link between FDI and economic growth for a panel of 23 developing countries. Using the panel cointegration technique to testify the collected data over a period 1978-1996. The authors found a bidirectional causality between GDP and FDI, which means that a reverse causation between the two variable existed.

Further, Choe (2003) used a sample of 80 countries to measure the casual linkage between FDI and economic growth. Employing the panel vector auto regression estimation Technique, the study has delivered empirical evidences that FDI and economic growth have bidirectional relationship and with a stronger effects from economic growth towards FDI. In another study, Chaowdhury & Mavrotas (2005) examined the same topic by suing three different countries (Chile, Malaysia and Thailand). A time series method was applied for every country and the results were in accordance with prior research in which the results of Malaysia and Thailand provide evidences on a positive impact of FDI on growth. However, in the case of Chile the outcomes show a unidirectional causality deriving from GDP to FDI.

Additionally, Sridharan et al., (2009) assess the casual relationship between FDI and economic growth in five BRICS countries (Brazil, Russia, India, China and South Africa). Using quarterly for the period 1992-2007 and applying the vector error correction approach. The study manages to prove bidirectional causality between FDI and economic growth in Brazil, Russia and South Africa. Yet, for both India and China, the results indicate unidirectional causality running from FDI to economic growth. Bhattacharya & Bhattacharya (2011) examined the same nexus in India. Their study extracts the data from 1996 – 2008 and in order to perform the analysis, they used vector error correction model. The findings revealed a bidirectional causality between FDI inflows and economic growth with two-way causation.

According to the authors, India is in need to diversify its policy liberalization measures to attract FDI inflows. Middle East and North Africa Countries (MENA) were subject to a similar investigation. Omri & Kahouli (2014) who tested the casual link between FDI inflow and economic growth for the period 1990-2010. Using GMM technique, the study found a positive casual linkage FDI inflow and economic growth as well as domestic capital and economic growth. Several other studies arrive at similar conclusions, Whalley & Xian (2010) examined the causality between FDI and economic growth in Taiwan using a data from 1978-2009. Vector Error Correction model was used to perform statistical tests and the results show a reverse relationship between FDI and economic growth. In other words, there is a two-way causation between FDI and economic growth.

The usage of quarterly data is quite common among researchers and with that Iqbad et al., (2010) have examined the casual link between FDI and growth in Pakistan. The results indicate a strong casual linkage between both factors. More and more studies all over the globe support the above findings in different regions. For instance,

Angelopoulou & Liargovas (2014) conducted a study to measure the possible casual linkage between FDI inflow and economic growth in three different country group (European Union member countries, European Union monetary zone member countries and countries in transition). Their study revealed a positive relationship between FDI and growth. Yet, the causal linkage was not found. Quantitatively, both cross-country and time series studies have demonstrated that the causal link between FDI and economic growth is relatively positive. In contrast to the arguments provided by supporters of this argument, few other researchers have come up with results showing no relationship. In fact, numerous doubts persist with regard to such linkage within the context of OE. In seeking to understand the causality between FDI and economic growth, it therefore becomes more appropriate to concentrate on the Ottoman economy.

3.8 Summary

This chapter begins with the theoretical discussion on FDI, external debts, trade openness and economic growth. Following the theoretical discussion, a deep understanding of the proposed theories was provided in which the connections between the selection of variables and the theoretical platform is taken into consideration.

Equally important is the literature review of the prior studies that share the same interests. This particular part, the focus was on the empirical studies as they are more reliable to construct the structure of this study. The extensive work carried on by economists using various types of econometric model have helped the researcher to deepen his understanding and widen his spectrum. However, the author can conclude that a remarkable shortage of empirical studies on Ottoman economy is identified. This despite the effort given by Turkish statistical centre to provide the economic data for the years from 1878 – 1924. Therefore, this study intends to tackle this gap.

Another point, several studies examined relationship between FDI and TO, were based on cross-country analysis or panel data analysis. Cross-country panel data studies provide a general analysis using cluster variables that differ from region to another which might not very helpful to the decision maker to undertake a firm decision. Having said that, the time series is more practical and helpful. This is because the time series studies has the ability to provide a comprehensive analysis. Further, the latest studies elucidate the significance of dynamic studies since the time series provide a certain consistency from country to another for a long run. Thus, to investigate the long run and short run, this study employs the ARDL approach.

Finally, this prior literature have provided a little attention to external debts and economic growth in both panel or times series approach. No doubt, the debt crisis is still a persistent problem and looking back to the history to learn lesson is a considerable contribution. Hence, the aim of this study is to ensure that this matter receives a sufficient attention by all the interested parties and stakeholders. The next chapter is designed to provide a methodological discussion on the establishment of econometric models and its outcomes.