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INTERACTIONS BETWEEN ECONOMIC INTEGRATION AND FOREIGN DIRECT INVESTMENT : A COMPARATIVE ANALYSIS BETWEEN SPAIN AND TURKEY

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INTERACTIONS BETWEEN ECONOMIC INTEGRATION
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ABSTRACT

This study tried to extract the effects of economic integration on foreign direct investment by comparing the performance of an economically integrated and an unintegrated country , Spain and Turkey , respectively . Locational determinants of foreign direct investment and appropriate proxies to test their significance , which have been shaped through the last three decades by the discussions of the students of the subject , were used to compare the locational attractiveness of the countries for foreign investors . In accordance with the huge literaure in this area , the main result of the study was the acceptance of the existence of the positive effects of economic integration on foreign direct investment.

OZETCE

Bu calismada ekonomik butunlesmenin dolaysiz yabanci sermaye yatirimlari uzerindeki etkileri , bir toplulukla ekonomik olarak butunlesmis ve bu tur bir butunlesmenin disinda kalmis iki ulkenin , sirasiyla Ispanya ve Turkiye'nin deneyimleri karsilastirilarak ortaya cikarilmaya calisildi . Ulkelerin yabanci sermayeyi kendi bolgelerine yonlendirebilme ozelliklerini karsilastirmak icin , son otuz yilda bircok arastirmacinin katkisiyla olusturulan , dolaysiz sermaye yatirimlarinin bolgesel belirleyicileri ve bu belirleyicilerin anlamliligini denemek icin gerekli olcum birimleri kullanildi . Konuyla ilgili arastirmalarin cogunlukla vardigi sonuc gibi , bu calisma da , bir toplulukla ekonomik olarak butunlesmenin dolaysiz yabanci sermaye yatirimlarini olumlu yonde etkiledigi onermesini destekledi.

TABLE OF CONTENTS

1 - INTRODUCTION

The last decade coincided with a considerable inflow of foreign direct investment into both Spain and Turkey . Considering that the former is economically integrated with Western Europe and the latter is not , this study tries to extract the effects of economic integration on foreign direct investment by comparing the performance of the two countries . This comparison will focus on the interrelation between the locational attractiveness of the countries for foreign investors and the quantity of inward direct foreign investment .

The second chapter will be devoted to rephrase the determinants of foreign direct investment . I especially shall focus on the locational determinants and I shall investigate each of them by surveying the previous studies , questioning their validity and finding out a measure to be able to compare them for two countries . In the following chapter , the revealed measures of each of the locational determinant will be compared for Spain and Turkey , and the possible differences will be identified . In the fourth chapter the two countries' foreign direct investment performance , especially in the last decade will be presented . Finally , in the last chapter

I shall try to extract the effects of economic integration on foreign direct investment by the use of the comparisons conducted in the previous chapters.

As can be seen in the above abstract , the main purpose of the study is to reveal the locational determinants of foreign direct investment and by comparing two countries to see the effects of economic integration on foreign direct investment , and not to end up with any welfare implications . However , realizing that any study on foreign direct investment without mentioning its effect on welfare is somewhat incomplete , I shall be focusing on the subject in the following section.

1.1 - SOME WELFARE IMPLICATIONS

The remainder of this chapter considers welfare implications particularly the character of welfare gains from direct investment and their distribution between the lending and the borrowing countries . In the neoclassical / liberalist approaches to foreign direct investment , capital movements not only increase the investible resources in the host countries and consequently raise their rates of growth , but also increase the efficiency of the market by strengthening competition and introducing better methods of organization . As a result , a more

efficient global allocation of resources would be achieved and the resultant international development would be beneficial to all parties.(1)

The oligopoly approach presents a radical challenge to the conventional analyses of foreign direct investment and provides a comprehensive critique of the operations of transnational corporations especially in the third world countries . This approach is a reaction to neoclassical conception of foreign investment in which international capital movements were attributed to the existence of inter-country interest rate differentials and argues that direct investment is a corporate behaviour of firms located in imperfect home country markets . The imperfections in home market give competitive advantages to some firms and led to increasingly concentrated industry structures in their national markets . It is the consciousness on the part of these national firms that the ownership of these special oligopolistic advantages can far outweigh the disadvantages of operating in a foreign environment , which led to the desire to exploit these ownership advantages in other countries .

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(1) Kirim (1988)

The followers of oligopoly approach not only explain the roots of transnational corporations' expansion , but also study their impact on welfare. For example , Caves (2) argues that foreign direct investment occurs mainly in industries characterized by certain market structures in both home and host countries . Oligopoly type of industrial organization with product differentiation normally prevails where corporations make horizontal (3) investments . Oligopoly , not necessarily differentiated , in the home market is typical in industries which undertake vertical direct investments to produce abroad a raw material or other input to their production process at home . He further suggests that in the absence of externalities and market imperfections , the case for free movement of direct investment as a means of maximizing world welfare is simply the case for allowing any factor or product to flow towards locations where it has the greatest excess of marginal value over marginal

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(2) Caves (1971)

(3) Foreign direct investments can take any of three forms : horizontal extension (producing the same goods elsewhere) vertical extension (adding a stage in the production process that comes earlier or later than the firm's main processing activity) , or conglomerate diversification .

cost . In the context of more complex question of national welfare , he argues that even if borrowing countries face a supply of foreign equity capital already restricted through collusion among foreign corporations , further monopolistic restriction will nevertheless raise their welfare if the supply of direct investment is less than perfectly elastic . In the case of horizontal direct investments , given some dispersion in the profit rates which foreign international corporations can earn in borrowing country's markets , its most satisfactory instrument for capturing some of the gains from foreign investments might be an excess profit tax on rates of return beyond what is deemed to be the limit rate . Given these doubts about the extend of gains available to the borrowing country , other sources of potential gains are corporation income taxes , benefits from manpower training , and uncaptured productivity spillovers . The tax flow guarantees a substantial source of real benefits from foreign investment to the borrower . Apart from tax revenues , benefits to the borrower from direct investment depend on the inability of the foreign subsidiary to capture the full social product resulting from the capital , managerial skills and technological knowledge that it transplants to the host country . Two sources of leakage are manpower training and productivity gains to domestic firms induced by the subsidiary's market behavior . The

host economy will not benefit from labor training if workers invest in their own training up to the point where its marginal costs to them equal the present discounted value of its marginal benefits and if corporations provide training to the extend that maximizes their profits . High productivity in a subsidiary , if captured in the firm's profits , yields no direct social benefit to the host country apart from extra tax revenue . However , in a number of ways , the subsidiary may fail to capture the full value of its social product . One instance overlaps with the factor of labor training . To the extend that the firm instructs in unique skills employees who switch to domestic firms may transplant knowledge that provides a basis for imitative productivity gains there without real resource cost . Productivity gains may leak out from subsidiaries by channels other than the transfer of personnel , however . In markets where the domestic firms engage in gentlemanly competition , the arrival of a foreign subsidiary may force them to raise productivity .

In the case of vertical investments where the subsidiaries engage in the extraction and processing of raw materials for export , Caves argues that one difference arises in the welfare significance of taxation by host country of subsidiaries' profits , because the profits of the extractive subsidiary are

likely to include both a pure return to capital and an intra-marginal rent on the natural resource deposit which it exploits . The large scale of resource deposits which attract foreign investments and the fewness of potential bidders for rights mean that great uncertainty will constrain the ability of resource owner to strike a prior agreement that will succeed in capturing all forthcoming rents . Spillover benefits to the domestic economy from extractive subsidiaries , while not totally absent, are likely to be smaller than for horizontal investment in manufacturing . The subsidiary is likely to be capital-intensive , offering fewer opportunities for the training of the local labor force for an equivalent amount of capital transferred . Finally , it sells largely on world markets and buys few local inputs , so that little pressure for efficiency gains is put on competing or supplying domestic firms .

According to Dunning (4) , another follower of oligopoly approach who argues that in the case of Europe as a host region , foreign investment has tended to make for more oligopolistic market structure and to encourage industrial rationalization and concentration . When a country imports capital , it does not just

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(4) Dunning (1969)

increase its foreign reserves , essentially , it buys a package deal comprising three ingredients : entrepreneurship (the fourth factor of production) ; technological and managerial expertise (in other words knowledge capital) ; and money capital . He argues that most kinds of direct investment involve the transfer of both kinds of capital : these can affect , for good or bad , not only the production functions of the firms invested in by foreign capitalists , but , trough the competitive mechanism , those of a large number of other firms and institutions in the host economy as well . When there is a wide knowledge gap between two industrially oriented countries , investment by multinational corporations of the advanced country may be strongly growth-oriented , through its impact on the innovatory development and efficiency of the host country , and on its international competitive position . It follows , then , that inward investment is most likely to stimulate growth where it is directed towards those industries which are in the van of technological progress , and which are particularly suited to the host county's resources.

Foreign investment not only opens up new markets to the investing country , but also it makes possible a technological shortcut for the host country , and provides knowledge capital with a multiplier effect , the value of which goes well beyond

the initial investment involved . This is not to deny that , in some cases , it is possible for these countries to acquire knowledge by alternative , and possibly less expensive means than by direct capital inflows . The less developed countries are extremely conscious of the servicing costs of direct foreign investment and are actively seeking other ways to obtain the benefits of such investment without these , and related costs . But assuming for the moment that direct investment is one of the best ways of obtaining both money and knowledge capital , it stimulates the host country's growth and efficiency .

Apart from political objections and prejudices , there are ten main economic objections to the participation of foreign firms .

1 - The fear that foreign investors , far from bringing new capital and technology into the country , will simply use their presence to attract and absorb scarce domestic capital and skills , thereby depriving nationals of the use of those sources. This fear is not without foundation even if the end result is a net increase in the national product .

2 - The possibility that decisions taken by the parent companies of foreign subsidiaries , which affect these subsidiaries , may not always operate in the best interests of

the host country . Every government is aware that a multinational corporate group which is able to provide export markets for the products of its country is also capable of withholding and cutting off jobs that depend on such exports .

3 - The belief that where foreign subsidiaries are mainly manufacturing branch plants relying on parent companies for research and development expertise , indigenous research and development may be curtailed . Part of the cost of this may be brain drain of skilled manpower from the host country as opportunities for employment become less . There is the additional charge of foreign investors buying local companies and exporting the know-how back home , or engaging in unfair price competition , by use of the fighting company .

4 - The belief that if foreign firms gain control over vital sectors of the host economy , they can interfere with national sovereignty and government policy .

5 - The cost to the host country's balance of payments of servicing the debt . This applies where most foreign participation is in equity capital , the profits of which will rise the growth and prosperity of the host country. To pay for this more capital has to be imported or more imports save or more

exports promoted . It is shown that foreign investment in the less developed areas has been more than counterbalanced by the flow of profits and dividends in the reverse direction .

6 - Where an economy is fully extended , the import of capital may be inflationary , unless domestic investment and/or consumption are curtailed or the investment brings about a more efficient allocation of resources .

7 - Foreign firms may also increase local inflations by bidding up wages in certain areas or industries beyond the normal level .

8 - Most countries welcome investments by multinational companies largely because they create additional employment when there is domestic unemployment in these countries . However , in case of business depression multinational companies might be less preoccupied by job reductions in the host country than national companies would be .

9 - Most governments show considerable concern regarding balanced economic growth in the various regions . There is a fear that multinational companies might be less inclined than national ones to comply with the orientations given by public authorities of the host country .

10 - Multinational companies manipulate internal price relations so as to locate their profits either in the country of the mother company or in the countries where taxes are lowest . This behavior entails tax losses for host countries.

There is another approach to the effects of foreign direct investment on welfare taken by Kojima who argues that there are two polar models of foreign direct investment . These models are typical of the American and Japanese economies . The so called American model is characterized by a substitutability between trade and investment so that foreign investment results in a decrease of comparative advantage . On the contrary , the Japanese model uses foreign investment to enhance the comparative advantage among countries , i.e. , Japanese investment abroad takes place in industries in which the foreign country has a comparative advantage relative to Japan which results in an increase in exchange and welfare . It is concluded that the Spanish case is in between these two extreme models (5) . The Spanish level of industrial development allows for a potential market which is attractive to foreign investors according to the American model . This contrasts with the traditional source of

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(5) Caballero Sanz et al (1989)

comparative advantage linked with the lower price of Spanish labor.

The same reasoning can be reached for Turkey , i.e. , the Turkey case is also in between two extreme models of foreign direct investment of Kojima's approach , namely , the American model and the Japanese model . Considering that relatively significant foreign direct investment inflows into Turkey has begun after a certain level of industrial development had been reached and an adequate infrastructure had been established (6) , the American model of foreign direct investment can be said to be effective . But , at the same time , Turkey with its low level of real wages , appears to be an attractive location to foreign investors as an export base and a point of entry into European Community , Middle East and Eastern Europe which implies a Japanese model of foreign direct investment with its above described welfare increasing effects .

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(6) Onis (1990)

2 - DETERMINANTS OF FOREIGN DIRECT INVESTMENT

The main point concerning foreign direct investment is , of course , why it takes place at all . Most analysts accept the answer advanced by Hymer and expanded by others , that the investing firm must possess an advantage in terms of product , process or management that is sufficient to outweigh its obvious disadvantages relative to actual or potential indigenous competitors in the host country . Furthermore , most analysts associate with required advantage with the existence of significant market imperfections .

Despite nearly unanimous agreement on this aspect of the underlying rationals for foreign direct investment , further elaboration is required in order to generate hypotheses concerning the distribution of foreign direct investment across countries . Although the authors who have contributed to the huge literature in this area have differed in their emphases , Dunning's synthesis in his proposed ' eclectic theory ' provides a convenient means of classifying the major themes .

Dunning's approach identifies three broad categories among the determinants of foreign direct investment . He suggests that foreign direct investment takes place when the following three

conditions are satisfied (7) :

1 - <u>Ownership advantage</u> : The firm must have some specific advantages in operating in particular foreign markets that allow it to compete in those markets compared with others , and in particular indigenous firms .

In practice , this usually refers to a technological advantage . In most empirical studies , Research and Development or labor-skills variable has been used to measure ownership advantage . Without the ownership advantage , there is no source of benefits to the investing firm to offset the additional costs of operating abroad .

2 - <u>Internalization advantage</u> : The firm believes that the ownership advantages can be best exploited internally rather than transacted directly through spot markets or offered to other firms by means of non-equity arrangements , e.g. licensing arrangements or management contracts .

3 - <u>Locational advantage</u> : There are locational attractions of a foreign as compared to domestic production base in the manufacture of all or part of products of the firm .

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(7) Dunning and Norman (1984)

This means that the host country must offer a locational advantage in terms of costs of serving a particular market . These costs may reflect the traditional components of comparative advantage and transport costs , as well as policy-determined costs and benefits arising from tariffs and non-tariff barriers , labor legislation , pollution control policies , incentives to or restrictions on foreign direct investment and so on . In the absence of locational advantage , exporting will be chosen over foreign direct investment as a way of exploiting the firm's ownership advantage .

For the present study , in which the aim is to extract the effects of economic integration on foreign direct investment by comparing two locations , namely Spain and Turkey , I shall concentrate on the locational advantages assuming the first two , ownership advantage and internalization advantage are held . In other words , assuming that the firm having an ownership advantage , believes that this can be best exploited internally , is at the point to decide where to invest . The factors which affect the decision for the location of investment can be extracted from the studies of survey approach to foreign direct investment . Though the students of this approach aim to explain the extend and character of foreign business operations by asking

the companies themselves to identify the reasons for their behavior , their studies are more useful in identifying the factors which influence international production .

The survey approach has confined itself to analysing the initial decision to produce abroad , and usually the questions have been formulated in the most general terms , e.g. ' what are the main factors which influenced your decision to invest overseas ? ' , and rarely does any guidance seem to have been given to the respondents as to assumptions underlying the questions asked .Because of this , the surveys have produced a wide range of answers , which reflect as much the respondents' interpretation of the questions as the determinants of the investment decision .

In a Dunning's paper (8) , a summary of determinants of foreign direct investment is put together using selected studies of the survey approach . Although the part-b of the table , which summarizes the studies trying to find the determinants of foreign direct investment in specific countries is of more interest for the present study , it is worthwhile to take the whole table here .

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(8) Dunning (1973)

times factors mentioned) .

Name of researcher	Foreign investment in general					In specific country		
	Robinson	Behrman	Basi	Kolde	Forsyth	Brash	Deane	Andrews
(a)Marketing factors								
1-Size of market	262	...	141	...	...	...	21	...
2-Market growth		19	158	7	82	89		28
3-To maintain share of market	130	...	126	12	35	...	30	...
4-To advance exports of parent company	...	1	...	...	2	...	...	...
5-Maintain close contact with customers	...	7	...	...	5	...	15	...
6-Dissatisfaction with existing market	...	3	...	25	...	...	...	...
7-Export base for neighboring market	104	3	...	...	...	30	...	39
(b)Barriers to trade								
1-Barriers to trade	130	14	...	21	28	78	76	11
2-Preference of local customers to local products	...		...	...	1	24	...	...
(c)Cost factors								
1-To be near source of supply	...	...	...	...	3	...	14	...
2-Availability of labor	209	...	...	...	...	...	...	...
3-Availability of raw materials	...	12	114	...	...	...	7	...
4-Availability of capital/technology	...	...	78	...	...	...	...	40
5-Lower labor cost	79	...	103	...	...	...	...	
6-Lower other production cost	...	7	...	20	...	11	...	
7-Lower transport costs	...	...	...	...	...	22	...	
8-Financial ,etc. inducements by governments	50	...	...	...	1	13	...	45
9-General costs levels more favorable	...	...	134	...	...	...	14	...
(d)Investment climate								
1-General attitude to foreign investments	...	...	145	6	...	...	10	...
2-Political stability	115	...	159	...	...	...	...	...
3-Limitation to	20	...	...	...	...	...	...	...
4-Exchange regulations	105	...	...	...	...	...	...	...
5-Stability of foreign exchange		...	151	...	...	...	...	...
6-Tax structure	...	...	131	4	...	...	...	...
7-Familiarity with country	...	...	100	...	...	...	...	...
(e)General								
1-Expected higher profits	182	20	144	...	...	...	...	...
2-Other	252	14	112	5	14	37	39	50

Source : Dunning (1973)

As Table 1 illustrates , almost without exception , the studies stress host government's attitude to inward foreign investment , political stability , and the prospects of market growth as the most important considerations encouraging foreign activities ; next in order come the fear of losing an existing market , the likelihood of exchange rate fluctuations , limitations imposed on foreign ownership , and barriers to trade.

From the determinants of foreign direct investment shown in the Table 1 , I extract the following to study in detail which are seem to be most important and comparable between two countries :

- *Size of the market*
- *Market growth rate*
- *Barriers to trade (or tariff discrimination)*
- *Labor cost*
- *Familiarity with country (or previous export flows)*
- *Exchange rate changes and regulations*
- *Political stability*

To above determinants extracted from the survey studies , I want to add the following which are also found to affect foreign direct investments by various students of the subject .

- *Lagged fixed assets of foreign affiliates*
- *Liberalization of foreign direct investment legislation*

- Government incentives or disincentives

2.1 - SURVEY OF THE RELATED STUDIES

Much of the work on the test of the relevance of determinants of foreign direct investment began in 1960s to concern with the flow of United States' investment to Europe especially after the formation of European Community .

Balassa (1966) investigates the U.S. direct investments in Western Europe and concludes that within this region , the countries of European Community increased their importance as a location for U.S. affiliates . He focuses on the costs of expansion in domestic and in foreign markets for the firm and concludes that although the cost of entry into foreign markets may be substantial , it will often be easier for the firm to carve out a new market for itself than to increase its domestic share - especially if the rate of growth of demand (in our terminology market growth rate) is greater and market structures are more fluid abroad . He also emphasizes the effect of familiarity with conditions abroad and considers the impact of cost-factors (production costs , transportation costs , and tariffs) , and nonprice factors (the availability of funds , antitrust legislation , and the servicing of foreign markets) on

also finds some evidence that foreign investors have preferred to invest in European countries in which the rate of increase in wage costs has risen the least and/or output per man hour risen the most (11) .

D'Arge (1969) also examines the impact of a customs union on direct investment flows . He compares U.S. flows to the E.C. with U.S. flows to E.F.T.A. (12) , and finds that there has not been a shift in the E.C. countries after E.C. is formed , but that the formation of E.F.T.A. increased flows into that area . Schmitz (1970) reexamining the tests of Scaperlanda (1968) and D'Arge (1969) finds evidence that the formation of the E.C. has increased flows to the E.C. and has decreased flows to E.F.T.A. countries .

Caves (1971) concludes that tariffs cut the profitability of exporting , and therefore encourage the inflow of direct investment . He also stresses the importance of market size by indicating that 'large size of a country's domestic market , other things being equal , will favor inflows of direct investment because the foreign firm contemplating an investment

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(11) Dunning (1969)

(12) European Free Trade Association

will not be deterred by problems of securing an efficient level of output (13) .

Scaperlanda and Mauer (1971) expand the investigation of direct investment by trying to identify the determinants of direct investment . They argue that the direct investment model should incorporate two more proxies for the influence of size of the market and growth of the market on direct investment in addition to the tariff discrimination proxy . Reporting sixteen regressions that attempt to test and discriminate between three hypotheses for three potential explanatory variables - size of the market , growth of the market , and trade barriers - they conclude that only the size of the market coefficient is significant . Later , Goldberg challenging the results of Scaperlanda and Mauer argues that the level of income should not be important unless larger GNP implies that more companies can begin to take advantage of economies of scale , or that a larger GNP means a larger initial investment . He states that there is no reason to presume either so he does not include size of the market as a variable in his model . In his statistical tests he finds that growth of the market is the only significant

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(13) Caves (1971)

determinant of direct investment .

In a study on the determinants of U.S. direct investments abroad , Schwartz (1976) developing the model of Scaperlanda and Mauer puts forward the following determinants to be effective on foreign direct investment : size of the market , market growth rate , tariff discrimination , exchange rate changes , investment for expansion purposes and political stability .

In a paper which seeks for the causes of direct investment in Canada and United Kingdom , Caves (1979) ends up with a new determinant of foreign direct investment , namely labor costs .

As a result of a statistical test on the determinants of foreign direct investment , Lunn (1980) finds the size of the market as an important variable , but not the only significant one . He suggests that tariff discrimination hypothesis is also supported , as is the growth of the market hypothesis with some reservations .

In the last paper about the subject Scaperlanda , with Balough , (1983) expands his earlier work concerning the specification of a model to identify the determinants of U.S. direct investment in the E.C. . Compared to earlier studies , a longer data series is used , an improved tariff discrimination

proxy is employed , and 'predicted sales' are estimated and used as the output variable in the empirical work . A variable to capture the effect of the U.S. capital control programs is also included . The findings reaffirm the importance of market size as being an important determinant of foreign direct investment. Strong support is also found for growth hypothesis . Consistent statistical support is found for the tariff discrimination hypothesis . In addition , the findings imply that a variable to capture the effects of fluctuating exchange rates should be included in future studies (14).

Finally , in a recent paper , Culem (1988) tests the impact of two other would-be locational determinant of foreign direct investment , namely unit labor costs and export flows in addition to the other determinants such as market size , its growth rate and tariff barriers which are found to have influence on direct foreign investments .

2.2 - DETERMINANTS OF FOREIGN DIRECT INVESTMENT

2.2.1 - Size of the market : The appearance of size of the market as a locational determinant of foreign direct investment

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(14) Scaperlanda and Balough (1983)

coincides with the studies on the relationship between economic integration in Europe and the U.S. direct investments into this integrated region . It is clear that large size of a country's domestic market , other things being equal will favor inflows of direct investment because the foreign firm contemplating an investment will not be deterred by problems of securing an efficient level of output . A small market not only prohibits firms from exploiting scale economies , it also limits the degree to which factors of production can be specialized . As the market expands increased specialization can occur and eventually economics of scale can be exploited and large scale production begin .

If we go beyond the domestic markets , we will find a more important aspect of the size-of-the-market determinant : this is the larger national markets provided to foreign investors as a result of economic integration which is first put forward by Balassa . He states that by allowing for the construction of larger plants and for increased intraindustry specialization , a wider market creates possibilities for exploiting economies of scale that contribute to reductions in costs . Plants established in any of the member countries can now cater to the entire area , and producers may specialize in different varieties of a given

commodity , or in its parts , components , and accessories in factories located in the various member countries . In turn , the possibilities of increasing productivity by applying U.S. production and organizational methods in the enlarged market give promise to for rapid increases in consumer incomes and demand. Lastly , the uncertainty associated with the establishment of plants by supplying the markets of the partner countries is reduced by reason of the assumed irreversibility of the elimination of all trade impediments (15).

He also argues that the size-of-the-market determinant accounts for the observed differences in the behavior of U.S. investors in the E.C. , the United Kingdom , and the continental E.F.T.A. countries . Prior to 1958 , the United Kingdom appeared to be the most desirable location for setting up foreign manufacturing facilities in Western Europe , since Commonwealth markets could be supplied from Britain . The establishment of E.C. has changed the situation , and the creation of a unified market equal to nearly one-half of the U.S. domestic market has provided a powerful incentive for locating in

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(15) Balassa (1966)

one of the member countries . By contrast , the addition to markets supplied from British plants through the establishment of the European Free Trade Association has been relatively small. On the one hand , the combined gross domestic product of the continental E.F.T.A. countries hardly exceeds one-fifth of that of the Common Market ; on the other , tariffs in these countries were low to begin with .

Like Balassa , many of the students of foreign direct investment find that there is a strong relationship between the size of E.C. markets and the intensity of U.S. investment in the E.C. (16) , except for Goldberg (1972) who rejects the market size hypothesis by claiming that it is untestable because theoretical relationship between investment and size of the market is undefined .

In previous studies , the market size is generally measured by GNP . Recently , Scaperlanda and Balough (1983) claim that the value of output (sales) of the foreign firms is theoretically more appealing than total output (GNP) . But , since such data

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(16) Scaperlanda and Mauer ,1969 ; Dunning , 1969 ; Caves , 1971 ; Schwartz , 1976 ; Lunn , 1980 ; Scaperlanda and Balough , 1983 ; Lunn , 1983 ; Culem , 1988

are not available for the countries which I shall compare , the best proxy at hand is real GNP . Moreover , a larger host market size is more appealing for would-be foreign investors since the economies of large - scale production are more likely to be captured . therefore , market size determinant measured by real GNP will be used in the present study .

2.2.2 - Market growth rate : As of the size of the market , its growth rate is appeared as a locational determinant with the studies on the relationship between economic integration in Europe and the U.S. direct investments into integrated regions of Europe . The growth of the market in a country can affect directly the demand for capital and thereby the demand for investment funds in the host country . In the previous studies , the specifications used to test the effects of growth in the market on direct investment are :

1) the absolute change in the market size as measured by changes in GNP .

2) the ratio of the percentage rate of growth in GNP of the host countries to the percentage rate of growth of home country (generally U.S. since almost all studies are related to the U.S. investments) . This specification is also supported by Balassa (1966) who puts forward that although the cost of entry

into foreign markets may be substantial , it may be easier for the firm to do it than to increase its domestic share especially if the rate of growth of demand is greater abroad . This can find its application in U.S. investments in Western Europe . In the postwar period , demand for durable consumer and producer goods has been rising more rapidly in Western Europe than in the United States .

Therefore , it may be concluded that continued flows of direct investment abroad are not only dependent on growing foreign markets , but also on foreign markets growing faster than the home markets .

The validity of market growth rate as a locational determinant of foreign direct investment is approved by many researchers (17) , moreover Goldberg (1972) claims that when the size-of-the-market hypothesis is deleted on both theoretical and statistical grounds , the growth-of-the-market hypothesis yields highly significant results .

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(17) Balassa , 1966 ; Scaperlanda and Mauer , 1971 ; Goldberg , 1972 ; Schwartz , 1976 ; Lunn , 1980 ; Scaperlanda and Balough , 1983 ; Lunn , 1983 ; Culem , 1988

As stated earlier , most studies use growth-of-the-market determinant measured by annual percent growth rate of real GNP. Recently , Scaperlanda and Balough (1983) use the market growth variable measured by the annual percent growth rate of the sales of the subsidiary which , then reflects growth of subsidiaries' outputs rather than growth of total output in the host area. However , as a result of the inadequacy of that kind of data , growth-of-the-market determinant measured by the annual percent growth rate of real GNP (18) , will be used in this study .

2.2.3 - Barriers to trade (tariff discrimination) :No other determinant of foreign direct investment has been as much discussed and empirically tested as barriers to trade . It is agreed for a long time that high tariffs can induce foreign direct investment or 'tariff jumping' . If a country has high import tariffs , then firms might choose not to export to it , but to invest in that country and undertake local production instead . The tariff jumping idea has become an important part of the received theory of foreign direct investment .

Tariff discrimination is an another aspect of barriers to

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(18) Growth of GNP should be a suitable proxy since it's found to be highly correlated with sales growth by Lunn (1980).

trade and may lead to an expansion , rather than contraction of flow of capital into the protected national economies . Moreover, in the case that tariffs are eliminated and the chances for their reimposition is small , international firms will act as if they faced a single market . Tariff discrimination gives rise to both trade creation and trade diversion effects . Trade diversion implies a market loss for the nonpreferred third country exporting to the preference granting region . A possible response of a threatened third country exporter is direct investment in the preference receiving region for the purpose of establishing production facilities there to service the market of the preference granting region . The investment flow generated from outside the preferential trading area as a direct response of the trade diversion effects of the discriminatory tariff changes is known as the investment creation effect of preferential trading. Trade creation and the new opportunities for specialization it creates call for the reallocation of the production facilities. This reallocation may entail reallocation of production facilities from the preference granting region to the preference receiving region . Therefore , in response to the trade creation effects of preferential trading arrangements , investment reorganization within the preferential trading area will be required . This is the investment diversion effect of

preferential trading . Investment diversion is foreign direct investment generated in response to the stimulus of trade creation to which the preferential trading arrangement gives rise (19) .

In the E.C. context , while the sheltering of national markets by tariffs provides an incentive for U.S. firms to locate plants in the individual countries , the formation of E.C. has had double effect of discriminating against U.S. exports in favor of sales from plants located in the partner countries , and enlarging the market for the individual producer . To varying degrees , both of these influences have contributed to the rapid expansion of U.S. investments in the European Community.

The effect of tariff discrimination on foreign direct investment pattern can be seen not only within the E.C. context , but also in the relatively less developed countries to which nonreciprocal geographically discriminatory tariff reductions are applied by European Community .

The statistical significance of barriers to trade as a locational determinant of foreign direct investment is approved

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(19) Yannopoulos (1987)

by Lunn (1980,1983) , Scaperlanda (20) and Balough (1983) and Culem (1988) .

The choice of the tariff discrimination proxy varies from study to study . Earlier studies used as a proxy the ratio of U.S. exports to the E.C. divided by the exports of the Member States of the E.C. to each other (21) . However , the value of this proxy is affected by autonomous flows of direct investment since if a U.S. firm exporting to the E.C. decides to invest there , U.S. exports to the E.C. will fall while this direct investment may also stimulate higher intra - E.C. trade . Goldberg (1972) suggests a modification of the above proxy to overcome this difficulty by replacing the numerator of the above ratio by either world exports to the E.C. or developed economies' exports to the E.C. from which (in both cases) U.S. exports and intra - E.C. exports are subtracted . However , such a modification is appropriate if one is concerned with world or

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(20) In an earlier work , Scaperlanda and Mauer (1969,1972) were unable to confirm that the common E.C. tariff has had the effect of accelerating U.S. direct investment and decelerating U.S. exports .

(21) Scaperlanda and Mauer (1969)

non-U.S. and non-E.C. developed economies' investment in the E.C. (22).

Lunn (1980) uses as an alternative proxy U.S. exports to the E.C. divided by U.S. exports to the world , minus the same ratio from the previous year . This is not totally satisfactory either . The search for more appropriate proxies to test the tariff discrimination hypothesis led to Scaperlanda and Balough (1983) to try a dummy variable to capture more directly the effects of the progressive dismantlement of industrial tariffs in intra-E.C. trade . This proxy variable is measured as one minus the proportion of the original tariff rate in existence for the given year and it therefore portrays the decrease in trade barriers internal to the European Community . Recently , Culem (1988) proxies tariff barriers by the share in percent of 1968 tariffs applied on industrial imports .

Since , unlike the studies surveyed , my concern is unique countries instead of group of countries , none of the above proxies suits to this study . For that reason , barriers-to-trade determinant will be discussed in the context of the differentials of the trade regimes of the related two countries .

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(22) Scaperlanda and Mauer (1969)

2.2.4 - Labor costs : Other things being equal , firms are expected to prefer lower wage locations . Although this statement is used in many studies of foreign direct investment , its statistical validity is tested by only two researchers . The first one is Caves (1979) who found evidence that low Canadian labor costs had affected the choice of U.S. firms between trade and investment in the proposed way . He also tested the labor cost determinant for the choice between trade and investment in the United Kingdom , but could not find his proxy to be statistically significant . The second researcher is Culem (1988) who stated that a lower hourly wage is attractive only insofar as it is not compensated by a lesser productivity or an overvalued currency . So he used unit labor costs , i.e. hourly wages corrected by hourly productivity , and expressed them in a common currency , the U.S. dollar . He used the labor-cost proxy measured in relative rather than in absolute terms taking into account the cost of labor conditions in the investing country . Finally , he found host country unit labor cost to have a significant influence in the expected direction on the amount of inward foreign direct investments . Therefore , a high unit cost of labor , caused either by a high nominal wage rate , or by a low productivity or even by an overvalued currency , is a significant deterrent to inward foreign direct investments both

in absolute and in relative terms .

Although not proved statistically , Balassa (1967) , also , found evidence that labor-cost is a locational determinant of foreign direct investment . During the period in which most U.S. investment was directed to the Common Market countries , wage costs (wages plus social security) in the manufacturing industries of the Common Market countries and the United Kingdom were still in the range of 30 to 40 percent of that in U.S. manufacturing despite the rapid increases in wages in the Western Europe during the postwar period . At the same time , differences in labor efficiency between the United States and Western Europe were found to be small and diminishing over time .

As a result of the lack of necessary data on social security costs , hourly wages expressed in a common currency , the U.S. dollar , will be used in the present study .

2.2.5 - <u>Familiarity with country</u> : Some of the students of foreign direct investment have the idea that sales from domestic plants usually precede the establishment of plants in foreign countries . First , because of the lack of familiarity with conditions abroad , the risk of setting up foreign plants increases . Second , time may be needed to increase sales to the

level where the establishment of a foreign plant is profitable . Besides these two important ones , the other reasons to test the foreign market by exports before shifting to local production through a subsidiary are the time needed for better adaptation of the product to the local market and for the improvement of the quality of ancillary service that can be provided .

Familarity-with-country determinant , measured by previous export flows , is first discussed by Vernon as a locational determinant of foreign direct investment , who argues that the production of many new products and processes , first discovered in one country , is later transferred to another by a variety of means , one of which is through affiliates of the innovating firms . This assumes that the innovating firms both create new markets , and supply these markets initially from a foreign location and , in doing so , they may induce a certain response from other firms and create a market structure which may influence future locational decisions . More generally , exports are the usual way of serving a foreign market in a first stage . Only when that market turns out to be large and profitable enough , may the firm decide to undertake foreign production insofar as this is more advantageous .

Although Balassa (1966) , Caves (1971) and Dunning (1973)

Both levels and changes in the levels of central bank liquidity of the host country were utilized as predictors of the possibility of exchange rate changes and the possibility of encountering restrictions on the repatriation of profits . In his study , if either the actual stock of international reserves or absolute changes in the level of international reserves exhibited a decline , it was assumed that the flow of investment would decline in response .

Scaperlanda and Balough (1983) also agree with the others concluding that a future work should include a variable to represent the direct investment control which results from movement of exchange rates .

In accordance with the unique statistical approach realized by Schwartz (1976) , the exchange-rate-changes-and-regulations determinant of foreign direct investment measured by the actual stock of international reserves and absolute changes in the level of international reserves will be used in this study .

2.2.7 - <u>Political stability</u> : Theoretically , an unstable political climate would lessen the investment flow by increasing the evaluated risk of the investment . For some , political risk is best illustrated by politically caused losses - for example :

(a) confiscation of property without adequate compensation ,

(b) damage to property or actions against personnel ,

(c) governmental interference with the terms of privately negotiated contracts ,

(d) bans on remittances of currency ,

(e) discriminatory taxation or other arbitrary requirements on the firm .

Others search for the fundamental cause of these losses and point out to a factor such as political instability . Having isolated this factor , they may then focus on various social , political , and economic factors as tending to cause instability:

(a) strong internal fractions (religious , racial , language , tribal , or economic) ,

(b) social unrest and disorder ,

(c) recent or impending independence ,

(d) new international alliances and relations with neighboring countries ,

(e) forthcoming elections ,

(f) extreme programs ,

(g) vested interests of local business groups ,

(h) proximity to armed conflict .

There are two methods at hand to measure political-stability

determinant of foreign direct investment . One is proposed by Robert Green who bases his work on the assumption that the political structure of a society is a crucial factor in determining the political risk to a foreign investor . He asserts that the risk of radical political change in a society can be determined from the level of political instability in the given nation . He offers a classification of political systems based on both economic and political characteristics (23).

The other method is put forward by Schwartz (1976) who attempts to account for political stability on annual basis . The dummy variable specification of zero or one is employed to test the effects of political stability on direct investment flows. Any country which did not undergo unique or violent political upheavals during a given year is assigned a value of zero ; otherwise a value of one is assigned . He identifies the political instability on the basis of six major events : major cabinet changes by nontraditional means , assassinations of major political figures , general strikes , guerilla warfare , purges ,

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(23) Green's political system classification scheme for estimating risk of radical political change will be shown below , in the context of comparisons .

and revolutions . If a country experienced a revolution , it is assigned automatically a value of one . With respect to the other five mentioned political events , a combination of at least two must have occurred in order for the country to be viewed as unstable politically .

Both methods will be used in the present study to measure the effects of political stability on foreign direct investment.

2.2.8 - Lagged fixed assets of foreign affiliates : This determinant is derived from the distinction between new ventures and expansion investment associated with already existing foreign direct investment (24) . Goldberg noted the possibility that the flow of investment for expansion purposes may be affected by the size of the already existing stock of investment . If it is assumed that all additional investment beyond the initial investment is merely for replacement purposes , one would expect the relationship between the flow of direct investment and the pre-existing stock of investment to be negative . Therefore , foreign direct investment flows must be negatively related to lagged fixed assets of foreign affiliates , insofar as they are means of adjusting capital stocks to desired levels . Lunn (1980)

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(24) Goldberg (1972)

and Scaperlanda and Balough (1983) find empirical support for this .

However , the reverse relationship between these two variables may be extracted if one considers that as foreign firms gain the informational advantages associated with investing abroad , barriers to further investment for purposes of expanding ownership are overcome . In this case , the pre-existing stock of investment is used as a proxy for the effects of these informational advantages on further investment .

Given these two opposing views , it is not possible to predict the sign of relationship between the flow of direct investment and the proxy measuring the lagged fixed assets of foreign affiliates . Schwartz (1976) measures this determinant by comparing the stock of investment with GNP of the host region , and Lunn (1980) measures it with net fixed assets of foreign affiliates in the host region , where the latter will be used in this study .

2.2.9 - <u>Liberalization of foreign direct investment legislation</u> : Considering that the two countries to be compared had experienced a closed economic system in the past , liberalization of foreign direct investment legislation becomes a

determinant of foreign direct investment . The degree of liberalization of foreign direct investment legislation of the two countries will be compared and their would-be effect on inward capital movements will be searched in the present study .

2.2.10 - <u>Government incentives or disincentives</u> : Any type of government activity in the host country can influence significantly the decision of foreign firms to invest in that country . Government incentives are generally composed of tax concessions , generous depreciation allowances , tariff protection and various forms of subsidies . However , especially tax concessions appear to be of little significance in attracting foreign direct investment . Most transnational corporations regard such incentives to be too volatile and transitory .

Government disincentives stem from the effort to control and regulate the operations of foreign firms . Such regulations though differ from country to country , generally include entry regulations specifying the sectors and industries in which foreign firms are not allowed to operate (25) ; stipulations concerning the extent of foreign equity participation ;

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(25) These are , to a great extent , services sector , e.g. telecommunications , finance , insurance , etc.

requirement that existing foreign firms should dilute their equity in favor of local nationals ; performance requirements covering some export obligations , utilization and processing of domestic raw materials , employment generation and the setting up of domestic research and development facilities ; requirement that local nationals should be appointed to managerial positions ; and imposition of ceiling on rates of royalty and duration of technology licensing agreements (26) .

Each of these incentives and disincentives will be searched to exist or not in the specified two countries and their would-be effects on foreign direct investment will be argued in this study .

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(26) Balasubramanyam (1984)

3 - COMPARISONS BETWEEN SPAIN AND TURKEY CONCERNING LOCAL DETERMINANTS OF FOREIGN DIRECT INVESTMENT

In this chapter , I shall compare the data for Spain and Turkey for each of the locational determinant of foreign direct investment examined in the previous section trying to find out possible differences between two countries which in conclusion may affect the attractiveness of these countries for foreign investors . The data will comprise the period of 1975-1989 unless otherwise is mentioned .

3.1 - Size of the market : As mentioned in the related section of the previous chapter , market-size determinant measured by real GNP will be used for comparison. I shall use the data given in International Financial Statistics (27) for Gross National Product (28) . Since these data are given at market prices of each country , they have to be converted into a reference currency to be able to make them comparable . The U.S.

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(27) International Financial Statistics , Yearbook , various editions .

(28) The GNP data for 1983-88 period for Turkey is taken from Main Economic Indicators Turkey , T.R. Prime Ministry State Planning Organization , Oct. 1990 .

TABLE 2 : GNP of Spain and Turkey in the 1975-1989 period (in billions of U.S. dollars) .

Years	GNP of Spain	GNP of Turkey
1975	104.5	37.1
1976	107.5	42.1
1977	120.0	48.5
1978	145.3	53.2
1979	194.4	70.8
1980	210.3	58.3
1981	181.4	58.9
1982	175.5	53.6
1983	152.5	51.0
1984	153.7	50.1
1985	162.0	53.6
1986	226.0	58.4
1987	286.7	68.3
1988	336.4	70.7
1989	376.7	80.4

Sources : Own calculations using the data of International Financial Statistics (1989) ; Main Economic Indicators (1990) .

dollar will be used throughout the study as a reference currency. In order to reach the best solution , the period average rates of the national currency per unit of U.S. dollars given in International Financial Statistics will be used for standardization .

As Table 2 illustrates , market size of Turkey measured by GNP is approximately one-third that of Spain . Considering also that Spain is integrated with Western Europe , its effective market size is much more than that of Turkey , since tariff barriers in E.C. is less and diminishing over time . Since large size of a country's market , other things being equal , will favor inflows of direct investment , Spain's large market size compared to Turkey can let her to be a more desirable location for foreign investors .

3.2 - Market growth rate : For the comparison of market growth rate for Spain and Turkey , the annual per cent growth rate of real GNP will be used here .I shall use the data given in International Financial Statistics (29) except for the 1984-1989 period for Turkey for which the data given in Main Economic

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(29) International Financial Statistics , Yearbook , various editions .

TABLE 3 : Annual pecentage growth rate of real GNP in the 1975-1989 period for Spain and Turkey (percentage change).

Years	Annual percentage change in real GNP of Spain	Annual percentage change in real GNP of Turkey
1975	1.1	7.9
1976	3.0	7.7
1977	3.3	7.0
1978	1.8	-2.9
1979	0.2	2.6
1980	1.5	-1.1
1981	-0.3	4.1
1982	1.2	4.5
1983	1.8	3.4
1984	1.8	5.9
1985	2.3	5.1
1986	3.3	8.1
1987	5.5	7.5
1988	5.0	3.6
1989	4.9	1.6

Sources : Own calculations using the data of International Financial Statistics var. eds. for Spain and 1975-1983 period of Turkey . For 1984-1989 period of Turkey, data given in Main Economic Indicators (1990) is directly taken .

Indicators (30) will be used .

As can be seen from Table 3 , average market growth rate of Turkey is greater than that of Spain especially in 1980s which are more concern of us . However , while the market growth rate of Turkey fluctuates , there is a steady increase for market growth rate of Spain . Considering these two counterbalancing facts , it can be concluded that there is no significant difference in market growth rates of the two countries to affect their locational attractiveness to foreign investors .

3.3 - Barriers to trade (or tariff discrimination) : As stated earlier , there is no proxy for comparing unique countries instead of group of countries for barriers-to-trade determinant of foreign direct investment . For that reason , in order to be able to extract the differences of the two countries' trade barriers , I shall compare the foreign trade regime , more specifically , import regime of them .

3.3.1 - The import regime of Spain : The regulation of imports in Spain has had origins in the liberalization process of

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(30) Main Economic Indicators Turkey , T.R. Prime Ministry State Planning Organization , Oct. 1990 .

Spanish economy initiated by the Stabilization Plan in 1959 until the entry to E.C. . As it had been in the previous decades , administrative controls were used for imports as an additional mechanism to protect Spanish economy . Some of these controls were so strict that the protection through tariffs were unnecessary . There were mainly three types of import regimes in the pre-integration period :

a) Imports under liberalization list ,

b) Imports subject to previous authorization ,

c) Prohibited imports .

Until the entry to E.C. , the general principle was that almost all types of importation require licence or previous authorization . However , these restrictions and limitations to foreign trade were smoothed through decades . After the integration with Western Europe , the existent import controls according to products or type of operations have been simplified, so that numerous import licences disappeared . On the contrary, the acceptance of Community's commercial policy brings complexity since different import regimes according to country to trade are applied . Since the basic idea of the new regulation is free trade , the general character of this regulation is import freedom and the restrictions are considered as exceptions . As a

result of this philosophy , only two types of import regimes are valid now : imports under liberalization list and imports subject to authorization (31).

With respect to trade with E.C. , there is a continuing annual fall in trade barriers . As a result of entry into the E.C. , it is agreed that industrial tariffs are to be dismantled on a reciprocal basis over a period of seven years . The first tariff cut was 10 per cent in March 1986 . This was followed by a 12.5 per cent cut in January 1987 , a 15 per cent cut in January 1988 , a 15 per cent cut in January 1989 , 12.5 per cent cut in January 1990 and an another 12.5 per cent cut in January 1991. There will be cuts of 12.5 per cent in 1992 and 10 per cent in the final year , reaching a 100 per cent accumulated reduction in tariffs in the year of the beginning of the E.C. open market .

With respect to extra-E.C. trade , the E.C. common external tariffs are generally much lower than that of Spain . Spanish tariff and non-tariff barriers will be progressively reduced over the 1986-1993 period .

3.3.2 - <u>The import regime of Turkey</u> : Since the end of

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(31) Sanchez Munoz (1988)

1950's , until 1980's , Turkey has followed an import substitution strategy which had provided considerable protection to domestic industry through a system of import licensing, import quotas , and restricted access to foreign exchange , in addition to tariffs . Annual import programs had itemized commodities under the free import list (Liberalization List I), the restricted list (Liberalization List II) , the Quota list , the E.C. consolidated list , and the list including imports under bilateral clearing arrangements . Furthermore , until January 1980 , the Central Bank determined the amount of foreign exchange available for import transfers , and therefore controlled allocations of foreign exchange .

In January 1980 , import regulations were simplified and commercial banks were allowed to retain a higher proportion of foreign exchange deposited with them . Reforms introduced in January 1981 carried further the liberalization process , in particular through the abolition of the Quota list and the transfer of some items from the restricted list to the free import list which is a process continued until present and now it is possible to say that imports are unrestricted with three main exceptions listed below :

(a) Prohibited : Certain livestock , most agricultural produce

and leather .

(b) Permit required : Seeds , alcoholic drinks , some chemicals, and various semifinished goods .

(c) Subject to import surcharge : Luxury consumer goods .

With respect to trade with E.C. , under an additional protocol to the 1963 Agreement of Association , signed between E.C. and Turkey in November 1970 , Turkey agreed to eliminate customs duties over a period of 12 years on a list of commodities amounting to about 50 per cent of its imports from E.C. . For the remaining imports , tariffs were to be eliminated over a period of 22 years (32).

3.3.3 - Comparison of import regimes : As a result of the above discussion , one can conclude that there is no much difference in the import regimes of Spain and Turkey , not only for the time being , but also in the past , to affect their attractiveness to foreign direct investment . Furthermore , both countries are supposed to eliminate customs duties for imports from E.C. member countries until 1993 , so no change for their attractiveness based on their import regimes are expected in the future , especially from E.C. countries .

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(32) Turkey Industrialization and Trade Policy , World Bank , 1982 .

3.4 - Labor costs : As stated earlier , labor-cost determinant of foreign direct investment measured in hourly wages in manufacturing expressed in U.S. dollars will be used here to compare the data for Spain and Turkey . For hourly wage rates, data from Year Book of Labour Statistics (33) will be taken. However ,the data for Spain is given per hour and that of Turkey per day , so , the values for Turkey is divided by '9' , average work hours per day in Turkey . Furthermore , since the data are expressed in national currencies , they are converted to a common currency , the U.S. dollar , by the use of the period average rates of the national currency per unit of U.S. dollars given in International Financial Statistics (34) in order to be able to make any comparison .

Real wages in Spanish economy , excluding agriculture , rose an estimated 7.5 per cent per annum in 1975-1980 period , but have moderated since 1981 as a result of Spain's anti-inflation policy . By the early 1980s agreed collective wage rises were below the inflation rate . However , in 1987 , the increase in

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(33) International Financial Statistics , Yearbook , various editions .

(34) Year Book of Labour Statistics , various editions .

TABLE 4 : Wages per hour in manufacturing in Spain and Turkey in the 1975-1989 period (in U.S. dollars) .

Years	Wage per hour in Spain	Wage per hour in Turkey
1975	1.82	0.69
1976	2.03	0.87
1977	2.04	0.79
1978	2.58	1.03
1979	3.60	1.09
1980	3.97	0.67
1981	3.75	0.57
1982	3.63	0.49
1983	3.18	0.49
1984	3.20	0.40
1985	3.32	(1)
1986	4.43	(1)
1987	5.49	(1)
1988	(1)	(1)
1989	(1)	(1)

(1) Data is not available .

Sources : Own calculations using the data of International Financial Statistics (1989) ; Year Book of Labour Statistics , various editions .

collective wages was above the inflation rate for the first time in this decade and this trend has continued until the present .

Turkish wages in manufacturing are considerably below those of its European trading partners even in 1978-1979 when they were highest for all times . But , later , with a systematic increases much below the increases in the inflation rates during 1980s , wages have fallen to a level even below than that of the East and South Asia . With respect to wages in Spain , as Table 4 shows , Spanish wages in manufacturing are approximately eigth times those of Turkey . Therefore , it's not difficult to conclude that with its lower labor costs Turkey , other things being equal , has an obvious locational advantage over Spain to attract foreign direct investment .

3.5 - Familiarity with country : For the familiarity-with-country , the best proxy at hand is the lagged exports of the world to the determined country . In accordance with the previous studies , I shall use one-year lag . The data is taken from International Financial Statistics (35) for imports , cif for both countries . Since the data is in national currencies , it is

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(35) International Financial Statistics , Yearbook , various editions .

TABLE 5 : One-year lagged imports of Spain and Turkey in the 1975-1989 period (in millions of U.S. dollars) .

Years	One-year lagged imports of Spain	One-year lagged imports of Turkey
1975	15,409.9	3,833.5
1976	16,237.6	4,778.4
1977	17,494.8	5,165.1
1978	17,780.4	5,827.8
1979	18,670.9	4,666.4
1980	25,385.1	5,743.2
1981	34,179.9	8,065.5
1982	32,175.0	9,012.8
1983	31,543.8	8,990.5
1984	29,118.7	9,432.4
1985	28,794.5	11,003.5
1986	29,835.3	11,415.7
1987	34,921.8	11,209.8
1988	48,833.0	14,410.9
1989	60,430.1	14,392.9

Sources : Own calculations using the data of International Financial Statistics , Yearbook , various editions .

converted to U.S. dollar using the period average rates of the national currency per unit of U.S. dollars , again , given in International Financial Statistics .

As Table 5 illustrates , the world exports to Spain , in other words Spanish imports are four times that of Turkey and as it is stated in the related section of the previous chapter , this implies that foreign investors are more familiar with Spain than they are with Turkey .

3.6 - Exchange rate changes and regulations : The exchange-rate changes and regulations determinant of foreign direct investment predicted by the actual stock of international reserves is used here . For actual stock of international reserves proxy , the data is taken from International Financial Statistics (36) , summing two items ; total reserves minus gold and gold in national valuation both expressed in dollars . The absolute changes in the level of international reserves are derived from the actual stock of international reserves by the use of the previous year of the beginning of the period .

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(36) International Financial Statistics , Yearbook , various editions .

TABLE 6 : Actual stock of international reserves (in millions of U.S. dollars) and their absolute change (percentage change) for Spain and Turkey.

Years	Actual stock of international reserves of Spain	Absolute change of international reserves of Spain	Actual stock of international reserves of Turkey	Absolute change of international reserves of Turkey
1975	6,108	-5.7	1,095	-36.1
1976	5,306	-13.1	1,141	4.2
1977	6,586	24.1	791	-30.7
1978	10,725	62.8	956	20.9
1979	13,841	29.1	813	-14.9
1980	12,480	-9.8	1,232	51.5
1981	15,158	21.5	1,083	-12.1
1982	11,321	-25.3	1,235	14.0
1983	11,229	-0.8	1,443	16.8
1984	15,787	40.6	2,094	45.1
1985	14,897	-5.6	2,125	1.5
1986	18,540	24.5	2,687	26.5
1987	34,436	85.7	3,360	25.1
1988	41,840	21.5	3,924	16.8
1989	46,886	12.1	6,354	61.9

Sources : Own calculations using the data of International Financial Statistics , Yearbook , various editions .

Since , if the actual stock of international reserves exhibited a decline , it was assumed that the flow of investment would decline in response , I expect a fall in direct foreign investments in the years 1975 , 1976 , 1980 , 1982 , 1983 and 1985 for Spain and 1975 , 1977 , 1979 and 1981 for Turkey . Absolute change in international reserves is difficult to interpret because of the fluctuations observed .

3.7 - <u>Political stability</u> : As mentioned earlier , two methods will be used to measure the effects of political stability on foreign direct investments in Spain and in Turkey . One is proposed by Robert Green , who offers a classification of political systems based on both economic and political characteristics (see Table 7) whereby the risk of radical political change increases as one goes down this scale .

Though , according to Green's political system classification scheme , Turkey appears to be less risky with respect to Spain , considering that it was put forward in 1960s , we need another method to be able to compare the two counties' political stability performance . Table 8 shows the result of the second method proposed by Schwartz (37) .

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(37) Schwartz (1976)

TABLE 7 : Green's political system classification scheme for estimating risk of radical political change .

I . Modernized Nations

A . Instrumental - adaptive systems

e.g. the United States , United Kingdom

B . Instrumental - nonadaptive systems

e.g. France , Italy

II . Modernizing Nations

A . Instrumental and quasi-instrumental systems attempting adaptive politics

e.g. India , Turkey , Mexico

B . Modernizing autocracies

e.g. Spain

C . Military dictatorships

e.g Burma , Ghana

D . Mobilization systems

e.g. China , Cuba

E . Recently independent systems

e.g. much of Black Africa

Source : Haendel (1979)

TABLE 8 : Political stability in Spain and Turkey accounted on annual basis according to Schwartz's method (a '0' is assigned for years of political stability and a '1' is assigned for years of political instability).

Years	Political stability of Spain	Political stability of Turkey
1975	1	0
1976	1	0
1977	0	0
1978	0	1
1979	0	1
1980	0	1
1981	1	0
1982	0	0
1983	0	0
1984	0	0
1985	0	0
1986	0	0
1987	0	0
1988	0	0
1989	0	0

Source : Own interpretation using the method of Schwartz (1976).

As Table 8 illustrates , after the politically unstable years of 1970s and the first years of 1980s , both countries seem to be politically stable in recent years .

3.8 - Lagged fixed assets of foreign affiliates : As indicated in the related section of the previous chapter , one year lagged fixed assets of foreign affiliates in the host region is used as a proxy . The data for Turkey is taken from Yabanci Sermaye Raporu (38) and the data for Spain is taken from El Sector Exterior de la Economia Espanola (39) and La Inversion Extranjera Directa en Espana durante 1989 (40) . Since the data for Spain is in pesetas , it is converted into U.S. dollars using the period average rates of pesetas per unit of U.S. dollars given in International Financial Statistics (41) .

As discussed in the related section , there are two opposite views about the effect of lagged fixed assets of foreign affiliates on foreign direct investment . One was that foreign direct investment flows must be negatively related to lagged

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(38) Yabanci Sermaye Baskanligi , DPT , various editions .

(39) Sanchez Munoz (1988)

(40) Boletin Economico (1990)

(41) International Financial Statistics , Yearbook , 1989 .

TABLE 9 : Lagged fixed assets of foreign affiliates (in millions of U.S. dollars) .

Years	One-year lagged fixed assets of foreign affiliates in Spain	One-year lagged fixed assets of foreign affiliates in Turkey
1975	2,601.3	189.6
1976	2,574.7	204.7
1977	2,636.2	213.6
1978	2,988.7	222.8
1979	4,208.9	234.5
1980	4,969.9	228.1
1981	4,820.7	263.1
1982	4,963.1	404.1
1983	4,684.1	507.1
1984	4,997.8	594.1
1985	5,765.4	756.1
1986	8,383.0	914.1
1987	12,110.0	1,084.1
1988	16,643.9	1,255.1
1989	22,154.1	1,661.1

Sources : Yabanci Sermaye Raporu , various editions ; El Sector Exterior de la Economia Espanola , Sanchez Munoz (1988) ; La Inversion Extranjera Directa en Espana (1989); International Financial Statistics , Yearbook , various editions .

fixed assets of foreign affiliates , insofar as they are means of adjusting capital stocks to desired levels , where the reverse relationship is true if one considers that as firms gain the informational advantages associated with investing abroad , barrier to further investment for purposes of expanding ownership are overcome . As far as Table 9 is concerned , the latter relationship seems to be true since the inflow of direct investment increases as fixed assets of foreign affiliates increase and Spain has a clear advantage with respect to Turkey as a location for foreign direct investment with its foreign affiliates' fixed assets more than ten times that of Turkey .

3.9 - Liberalization of foreign direct investment legislation : Here , the two countries' legislations will be examined separately first , and then compared .

3.9.1 - The Spanish case : Spanish legislation on foreign direct investment is being progressively liberalized . In general terms , foreign investments made in Spain by private investors with a monetary contribution from abroad are unrestricted and do not require prior administrative authorization . However , in some cases prior verification of the projected investment by the Department of Foreign Transactions

(DGTE) is required . This verification is visualized as a mere control device , and approval can be withheld only in exceptional cases where the authorities consider that the projected investment might give rise to adverse consequences for the country's economy . The verification process is normally completed in less than one month , and the projected investment is tacitly deemed to be approved if no reply is received within thirty days . All foreign investments , whether unrestricted or not , have to be declared to DGTE's Foreign Investment Register.

The income earned from a foreign investment , the invested capital and the capital gains obtained are freely transferable abroad , provided that the investment has been duly declared to the Foreign Investment Register and that tax obligations established by current tax law have been complied with .

There are four types of exemptions to the unrestricted nature of Spanish legislation on foreign direct investment . They are determined by (42) :

- The public nature of the investor .

- The specific nature of the sector in which the investment is made .

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(42) A Guide to Business in Spain (1989)

- *The atypical input method .*
- *The atypical form of investment .*

In case of public investment and investment in specific sectors , a previous administrative authorization is required . Legislation defines public investment as that made by governments or public entities in a broad sense . In other words , this includes public enterprises and those other enterprises in which the state's influence on the administration is decisive . The sectors considered to be specific with regard to foreign investment are gambling , activities directly related to national defense (including strategic mining and telecommunications services) , television , broadcasting and air transport .

3.9.2 - The Turkish case : Until 1980s , in spite of a liberally couched legislation dating back to 1954 , the restrictive application of the law by the Turkish administration and lengthy bureaucratic procedures were dominant in Turkey . Since 1980 , this trend has significantly changed through making the administrative procedure and legal regulations governing foreign investment more transparent and less complicated .

Under the current legislation , the most important governmental authority for foreign investment is the Foreign

Investment Department (FID) , a department of the State Planning Organization . FID has been charged with coordinating foreign investment in Turkey and reviewing project submitted for approval within two to four weeks .

Besides simplifying and speeding up administrative procedures , the current legislation lays down the conditions for foreign investment . Foreign capital can be used in all fields which are also open to domestic firms .

Repatriation of capital and earnings is free . The Central Bank is required by law to give a foreign exchange permit immediately to foreign investors for the proceeds of the sales of shares to a Turkish resident or of liquidation , provided the price of the shares is based on the stock exchange price (if available) or on the evaluation of the FID . Principal and interest on foreign currency loans may be remitted in accordance with the terms of agreements as registered with Treasury . Dividends may be remitted immediately after the appropriate resolution has been passed at the annual general meeting of the shareholders . The remittances are made by the commercial banks on the basis of the profit distribution table approved by shareholders and an undertaking that the tax declaration and tax

payment slips are submitted to the bank when filed (43) .

3.9.3 - Comparison of legislation : The above discussion reveals that , currently , there seems no significant difference in the foreign direct investment legislation of Spain and Turkey. However , while the liberalization of foreign investment legislation in Spain has begun in the end of 1950s , that of Turkey has begun in early 1980s , at least in application ; because , as stated earlier , since 1954 , although the legislation is liberal , the application of the law is restrictive .

3.10 - Government incentives or disincentives : As in the case of legislation , two countries' government incentives and disincentives will be stated first and compared later .

3.10.1 - The Spanish case : In Spain , foreign investment does not receive incentives other than those granted to domestic investment . Therefore , it receives no special treatment , although it may benefit from the same large range of incentives granted to Spanish investment . In general , there are two types of such incentives : fiscal and financial . Fiscal incentives are granted to companies which generate employment,

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(43) Doing Business in Turkey , Price Waterhouse , 1990 .

and they consist of tax deductions in function of the employment generated . There are three types of financial incentives :

a) Participation in the capital of the economy created ,

b) Financing at interest rates lower than the market rate ,

c) Subsidies .

The aim of the incentives is to encourage investment in regions which have not made significant industrial expansion , or which have economic difficulties , so two types of incentives are available : programs for the Zones of Urgent Industrialization , and for the Large Areas for Urgent Industrial Expansion . The first one is a program of subsidies for new industrial companies and expansion of existing ones , which lead to job creation , and covers mainly industrialized areas . The benefits of the program are subsidies , priorities for official loans , special transportation facilities and tax benefits . The latter program supports investment on new plant , or expansion , modernization in the agricultural, industrial and service sectors in specified, generally underdeveloped regions . The planned investments must provide new jobs . The benefits of the program are subsidies , priority for official loans , a deduction of customs duties and various deductions in tax obligations (44) .

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(44) Investment Incentives Worldwide , I.B.I. (1987)

The only disincentive to foreign direct investment that I registered for Spain is restricted foreign participation in some sectors .

3.10.2 - <u>The Turkish case</u> : As in the case of Spain, investment incentives are available equally to domestic and foreign investors . Government policy is to encourage investment in manufacturing and other specific industries , with higher incentives for underdeveloped regions , and to encourage exports. Incentives are generally a mix of tax incentives (allowance on capital investment in addition to the accelerated depreciation already available under the corporation tax law and customs duty exemptions) , and non tax incentives (taxable cash investment grants , low interest credits and exemption from certain fees and charges) . Regional incentives are in the same categories of incentive , but with higher amounts . Besides the above general incentives , there is an export incentives system which includes in addition to higher level of general incentives stated above , the exemption from VAT on all goods and services exported .

In addition to above investment incentives , there are four Free Trade Zones . Operations in the Free Zones qualify for investment , but not export incentives . The taxation advantages

of operating in the zone are as follows (45) :

a) No corporation taxes , withholding tax or VAT .

b) No income taxes on earnings of employees (but social security is payable) .

c) No custom duties on goods imported from abroad to the zone .

In case of government disincentives , there are a few industries closed to private investors , but there is no discrimination between foreign and domestic investors . There are also some export obligations , but again there is no discrimination between foreign and domestic enterprises .

3.10.3 - Comparison : There seems no significant difference between the two countries in the case of government incentives and disincentives given to foreign direct investors . Both countries do not discriminate foreign and domestic investment and offer more or less the same incentives to investors . Export incentives are stressed in Turkey while locational incentives are dominant in Spain , but the types of incentives given such as reductions of or exemptions from tax and custom duties , low interest credits , etc. are the same . However , it must be

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(45) Doing Business in Turkey , Price Waterhouse , 1990

mentioned that the similarity of incentives between Spain and Turkey is true for the post-1980 period . During 1960s and 1970s foreign investors were subjected to discriminatory treatment in the implementation of incentives and also they were subjected to restrictions concerning their ability to transfer payments ; significant pressures were exerted on firms with foreign capital to increase local equity participation and to expand exports ; and foreign investors faced with considerable delays in obtaining approval for setting up a plant in Turkey (46) , while there are no such strong disincentives for foreign investors in Spain since 1960s .

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(46) Onis (1990)

4 - FOREIGN DIRECT INVESTMENT PERFORMANCE OF SPAIN AND TURKEY

In this chapter , foreign direct investment performance of Spain and Turkey will be presented .

4.1 - Performance of Spain : Direct investment from abroad has played an important role in the economy of Spain since 1960s. Between 1960 and 1974 , direct investments followed a slow growth . During this period some U.S. $2.1 billion was authorized by the Bank of Spain to be invested directly in Spanish enterprises , allowing foreign investors to hold more than 50 per cent of equity . Although the annual amount of authorized direct investment never exceeded more than 2 per cent of total annual investment spending , the share in industry will have been much higher . More importantly , foreign capital was an important source of modernization and technology transfer . Well over three quarters (47) of authorized direct foreign investment went into industry . In 1960s , the largest share of such investment went into chemicals ; in 1971-1974 the chemical industry was replaced

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(47) 78 per cent in the 1960s and 87 per cent in the early 1970s .

TABLE 10 : Foreign direct investments (1) in Spain during 1975-1989 (in millions of U.S. dollars) .

Years	Foreign direct investments in Spain (actual inflows)	Percentage increase in foreign direct investments in Spain
1975	398.9	-4.9
1976	418.5	4.9
1977	380.5	-9.1
1978	696.5	83.1
1979	1,099.4	57.8
1980	1,237.1	12.5
1981	1,085.4	-12.3
1982	1,152.4	6.2
1983	917.5	-20.4
1984	1,110.4	19.9
1985	1,139.1	3.5
1986	2,294.2	101.4
1987	3,591.7	56.6
1988	5,869.7	63.4
1989	6,775.1	15.4

(1) Since the data is in pesetas, it is converted to U.S. dollar using the period average rates of pesetas per unit of U.S. dollars .

Sources : Own calculations using the data of International Financial Statistics , Yearbook , various editions ; El Sector Exterior de la Economia Espanola , Sanchez Munoz (1988) ; La Inversion Extranjera Directa en Espana (1990) .

by the transport equipment as the main recipient of foreign capital .

The importance of foreign capital in Spanish industry can also be seen from the fact that by 1971 , among the 600 largest enterprises (in terms of sales) , enterprises with majority foreign capital accounted for over 50 per cent of sales in several industrial branches . Another indicator of the importance of foreign capital in Spanish industry is that by 1974 enterprises with majority foreign capital were responsible for around 25 per cent of Spain's industrial exports .

The slow growth of inflow of foreign direct investments to Spain continued until 1974 and Spain entered into the period of 1975-1989 , which is more concern of us , with a fall in foreign capital inflow suffering from both the international crisis and internal political and social instability . However , as Table 10 illustrates , beginning from 1978 , the direct investment inflow has recovered , and fluctuated around U.S. $1 billion level in the first half of 1980s , with many new companies being set up as well as capital bases being enlarged . Then , in 1986 , foreign investment in Spain more than doubled to U.S. $2.3 billion and continued with approximately 50 per cent increase in 1987 and in 1988 . However , in 1989 the rate of increase fell to 15.4 per

TABLE 11 : Foreign direct investment in Spain by country groups excluding Spain (1) during 1985-1989 (percentage share in total investment) .

Country groups	1985	1986	1987	1988	1989
E.C.	47.01	50.70	49.10	69.09	71.65
Non-E.C. O.E.C.D. countries of Europe	11.12	6.61	10.63	10.20	14.64
Non-Europe O.E.C.D. countries	33.07	14.43	10.86	7.38	8.26
Total O.E.C.D.	91.22	71.74	71.69	86.67	94.55
Non-O.E.C.D. European countries	0.42	0.08	0.04	0.14	0.31
Fiscal paradises	3.16	5.48	2.42	7.23	3.30
Rest of the world	5.21	22.70	25.85	5.96	1.84
Total non-O.E.C.D.	8.79	28.26	28.31	13.33	5.45
Total	100.00	100.00	100.00	100.00	100.00

(1) In other words , excluding capital increases or takeovers by subsidiaries of foreign companies established in Spain .

Sources : Inversion Extranjera Directa en Espana, various editions.

cent . Most of the new investment over 1985-1989 went into increasing the capital of existing subsidiaries in order to finance expansion with acquisitions accounted for approximately 30 per cent of the direct investment inflow .

The source of foreign direct investment is dominated by the O.C.D.E. , with the E.C. increasing its participation as a consequence of the incorporation of Spain in the E.C. as shown in Table 11 . During the five-year period that the table covers , E.C. countries have increased their share from 47.01 per cent in 1985 to 71.65 per cent in 1989 .

The foreign direct investment inflow over the last decade went largely into just four sectors : chemicals and non-energy minerals ; financial services ; metal products , machinery and transport ; and commerce , hotels and restaurants . As much as 57 per cent of the total went into manufacturing , much of it into export-oriented businesses such as cars .

In general , subsidiaries of foreign multinationals dominate the vehicles industry , electronics , tyres , pharmaceuticals , computers and office machinery , detergents and perfume , chemicals and plastics , paint , car rentals and advertising . The foreign presence is also significant in food and drink ,

glass , home appliances , metallic mineral mining , investment banking and tourism .

The actual extend of the importance of foreign capital in Spain is not presently known . However , in 1980 , 12.1 per cent of all equity capital was owned by foreign interests of which 64.6 percentage points were in concerns where the foreign interests owned over 50 per cent . Since 1980 the economy has grown relatively fast , but at the same time the inflow of foreign capital has risen even more swiftly . Therefore it is likely that the share of foreign capital will have increased .

4.2 - Performance of Turkey : In the pre-1980 period , foreign investment in Turkey had been very small in international standards as a result of restrictive application of legislation by administration and lengthy bureaucratic procedures as discussed earlier . Until 1975 , the accumulated foreign capital was only U.S. $189.6 million . The number of enterprises with foreign capital was counted as 109 in 1975 . The manufacturing sector had so far proved to be most attractive field for foreign investors and within the manufacturing sector electrical and non-electrical machinery ; food , drink and tobacco ; chemicals ; and motor vehicles took the lion's share .

TABLE 12 : Foreign direct investments in Turkey during 1975-1989 period (in millions of U.S. dollars) .

Years	Foreign direct investments in Turkey (actual inflows)	Authorized foreign direct investments in Turkey (1)	Percentage increase in actual inflow
1975	15.1	(2)	296.1
1976	8.9	(2)	-41.0
1977	9.2	(2)	3.4
1978	11.7	(2)	27.2
1979	-6.4	(2)	-154.7
1980	35.0	(2)	646.9
1981	141.0	(2)	302.8
1982	103.0	(2)	-26.9
1983	87.0	97.1	-15.5
1984	162.0	259.2	86.2
1985	158.0	211.1	-2.5
1986	170.0	333.5	7.6
1987	171.0	476.3	0.6
1988	406.0	670.6	137.4
1989	738.0	1,054.78	81.8

(1) Authorized total foreign investment minus portfolio investment .
(2) Data is not available .

Sources : Yabanci Sermaye Raporu (1983-1986) , Yabanci Sermaye Raporu (1987-1989) , DPT .

Turkey's foreign direct investment performance had worsened further during 1974-1979 period in the face of economic crisis and political instability during which , instead of inflow , outflow of capital was observed and the number of enterprises with foreign capital fell below hundred (48) . These problems were compounded by difficulties associated with profit repatriation , particularly with the onset of foreign exchange crisis in the late 1977 .

In 1980 , the inflow of foreign capital reached an all time peak as a result of 1980 stabilization program which includes the introduction of new incentives to foreign investors and an improvement of investment environment . As Table 12 illustrates , authorized foreign investment in Turkey amounted to U.S. $97 million in 1980 . Between 1981-1987 period , the real inflow of direct investments fluctuated between U.S. $87 million and U.S. $171 million . Though these values show a success with respect to pre-1980 period , they are much below the international standards considering that the average annual rate of direct foreign investments in the world is counted as U.S. $50 billion (49) .

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(48) Karluk (1983)

(49) DPT (1987)

Then , in 1988 , foreign direct investments in Turkey more than doubling the year before reached U.S. $406 million . The growth continued in 1989 with U.S. $738 million of actual inflow of foreign capital .

Most of the authorized new investments in the 1980-1989 period went into new acquisitions (45 per cent) with 35 per cent going into increasing of the capital of existing subsidiaries . Finally , 19 per cent was for participating the existing enterprises .

The source of foreign direct investment is mainly O.E.C.D. countries as shown in Table 13 with U.K. , Germany , Netherlands, Italy , France and U.S.A. having the major contribution . Japan has also increased its share in recent years .

61 per cent of the authorized foreign direct investment which amounts U.S. $4.4 billion during the last decade went into manufacturing while 36.2 per cent went into services sector . The rest is divided between agriculture and mining , 2 per cent and 0.7 per cent , respectively . Within manufacturing , chemicals , food and beverages , iron and steel , electronics , textiles and automotive are the most attractive sectors to foreign investors . Within services , most of the foreign capital went into tourism ,

TABLE 13 : Authorized foreign investment in Turkey by country (1) during 1984-1989 (millions of U.S. dollars) .

Countries	1984	1985	1986	1987	1988	1989
Belgium	9.29	0.16	17.12	4.50	3.84	29.85
Denmark	9.28	6.90	4.67	2.05	0.58	31.64
France	5.24	14.92	8.31	20.97	73.58	251.23
Germany	7.50	22.49	45.26	63.89	94.36	120.47
Iran	1.26	2.78	7.09	8.03	11.17	12.07
Iraq	1.35	0.42	0.30	0.91	0.62	13.10
Italy	11.68	0.10	4.83	21.71	39.94	84.05
Japan	0.05	3.45	2.63	45.29	67.10	71.67
Netherlands	20.61	8.70	2.40	12.67	39.15	99.16
Saudi Arabia	0.93	4.36	75.77	7.27	17.32	11.05
Sweden	0.15	0.85	1.03	6.88	3.97	12.01
Switzerland	7.32	20.01	53.29	108.18	107.15	157.68
U.K.	4.18	26.49	22.83	72.04	125.50	279.16
U.S.A.	171.02	21.71	24.53	49.48	131.87	130.42
Rest of the world (2)	21.54	101.16	93.94	84.77	108.32	166.85

(1) Capital increases or takeovers by subsidiaries of foreign companies established in Turkey is not included .

(2) Includes invesment inflow from a group of countries .

Sources : Yabanci Sermaye Raporu (1983-1986) and Yabanci Sermaye Raporu (1987-1989) .

trade and banking sectors .

The following data may help to understand the actual extend of the importance of foreign capital in Turkey (50) :

- With respect to the end of 1989 , there are 1542 companies with foreign capital .

- Their accumulated capital is declared to be U.S. $2,074 billion , with foreign capital accounted for 50 per cent .

- In 1988 , they realized 13 per cent of the total exports of Turkey .

- Again in 1988 , they were found to employ 100,000 workers.

- 66 out of 500 largest enterprises of Turkey have foreign capital .

- Among these 500 largest enterprises , enterprises with foreign capital accounted for 14.9 per cent of value added , 17.7 per cent of sales , and 21.4 per cent of exports in 1988 .

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(50) DPT (1990)

5 - THE EFFECTS OF ECONOMIC INTEGRATION ON FOREIGN DIRECT INVESTMENT

As stated earlier , much of the work about the locational determinants of foreign direct investment began in 1960s to concern with the flow of U.S. investment to Europe after the formation of European Community , in other words , after the beginning of the process of European integration ; and much of the author agreed that the integration implying the formation of a customs union would alter the flow of direct investment since the size of the market and the height of trade barriers would be affected by integration . In accordance with this general agreement , I shall try to extract the effects of integration on foreign direct investment performance of Spain by comparing it with that of an unintegrated country , i.e. Turkey . But , before that , I want to look into the effects of integration on foreign direct investment in a broad sense .

The first stage of the customs union of the E.C. was accomplished during the period 1957-1967 , which coincided with a considerable inflow of foreign direct investment into the E.C. , especially from the United States as mentioned before . The countries of European Community accounted in the period before the formation of the E.C. (1950) for 5.4 per cent of the world

total value of U.S. direct investment abroad (51) . A few years before the full completion of the first stage of European customs union , the Community countries accounted for 12.2 per cent of the world total value of U.S. direct investment abroad which as of the end of 1981 amounted to almost 45 per cent (52) excluding Canada (53) .

In non-E.C. Europe , a different integration initiative in the form of thee European Free Trade Area was launched shortly after the start of the European Common Market . If regional integration schemes affect the pattern of location of international investment , then one would expect that E.F.T.A. , too , would have experienced an upwards deflection of the pre-integration trends in inwards direct investment from abroad . Some authors attempted a comparison of the impact of the two different economic integration schemes , namely , E.C. and E.F.T.A. , on United States foreign direct investment (54) . For

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(51) Yannopoulos (1990)

(52) The expansion of E.C. must be considered while comparing this value with the previous two .

(53) Buxbaum (1986)

(54) D'Arge (1969) ; Schmitz (1970)

example , D'Arge showed a contrast between the E.C. and E.F.T.A. effects on U.S. direct investment . In case of E.F.T.A. , the impact of economic integration on U.S. direct investment was through a once-for-all shift as indicated by the positive magnitude associated with the intercept shift variable and by the negative value of the slope shift variable following E.F.T.A.'s formation . In the case of E.C. both the slope shifting and the intercept shift variables were positive , but only the coefficient for the intercept shift in trend variable was statistically significant at the 5 per cent level . Later , Schmitz found that the coefficients of the slope shift variables were positive and statistically significant for both the E.C. and E.F.T.A. . In the view of the above results , it is concluded that subsequent to the formation of the E.C. , the pattern of

TABLE 14 : Flows of U.S. direct investment to Western Europe (percentage)

	1950	1957	1964
Western Europe	100.0	100.0	100.0
European Community	45.6	36.5	50.5
E.F.T.A.	48.9	59.7	44.1

Source : Yannopoulos (1990)

total U.S. direct investment significantly changed and , also , the E.C. attracted significantly more of the growth in total U.S. direct investment than did E.F.T.A. (see Table 14) .

However , there are still some contradictory views about the conclusion reached above . For example , Ferreria claimed that Portugal's accession to the European Community was unlikely to increase the attractiveness of the country to foreign investors to any great extend (55) .

Only limited attention has paid to another aspect of the subject , namely European Community non-domestic direct investment in European Community . Internal direct investment flows have been completely free in the E.C. since 1970s . In accordance with the theoretical expectation that direct investments increase as soon as companies become convinced of the advantages of selecting optimum locations within an enlarged market area , direct investments by companies from the original six in other E.C. member states increased very fast in the 1966-1970 period . Therefore , the motive for European Community transnational firms to invest in other member countries is not the tariff-jumping effect of integration , but the advantage of

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(55) Ferreria (1989)

TABLE 15 : Direct investment flows between the member countries of the European Community 1975-1983 (billions of E.C.U.) .

From\to	Germany	France	Italy	Neth.	Bel/Lux	U.K.	Denmark	Ireland	Spain	Portugal	Greece	EC12
Germany	-	1.8	0.6	0.3	1.8	1.1	0.2	0.1	0.7	0.1	0.1	6.8
France	0.9	-	1.0	0.4	0.9	0.7	0.0	0.0	1.3	0.2	0.0	5.4
Italy	0.1	0.5	-	0.0	0.1	0.0	0.0	0.0	0.1	0.0	0.1	0.9
Nether«	0.3	1.3	0.2	-	1.1	3.4	0.0	0.5	0.4	0.0	0.0	7.2
Bel.Lux.	0.6	1.0	0.5	0.4	-	0.2	0.0	0.0	0.3	0.0	0.0	3.0
U.K.	1.4	1.4	0.5	1.2	0.6	-	0.2	0.7	0.5	0.1	0.1	6.7
Denmark	0.2	0.0	0.0	0.0	0.0	0.2	-	0.0	0.0	0.0	0.0	0.4
Ireland	0.0	0.0	0.0	0.0	0.0	0.1	0.0	-	0.0	0.0	0.0	0.1
Spain	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-	0.1	0.0	0.2
Portugal	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-	0.0	0.0
Greece	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-	0.0
EC12	3.5	6.1	2.8	2.3	4.5	5.7	0.4	1.3	3.3	0.5		30.7

Source : Molle (1990)

settling in optimum locations in the face of the small diminishing or absent customs duties between the member countries and large market size .

The flows of direct investment among European Community as given in Table 15 show that the poorer member states Greece , Ireland , Italy , Spain and Portugal with France and Belgium are net importers of capital while richer countries U.K. , Germany and The Netherlands are net exporters of capital .

These patterns are highly illustrative of the European integration process . They indicate that there is a net flow of capital towards the less developed E.C. countries . The accession of Spain to the E.C. has accelerated the pre-integration trend shown in Table 15 for her and has attracted a growing inflow of direct investment , of which most has come from the E.C. as stated in the previous chapter .

As it is clear from the above discussion European integration has affected foreign direct investments in the integrated region in two ways : one is the inflow of direct investment from third countries , mainly U.S.A. , since the size of the market and trade barriers are affected by integration and the other is the direct investments by companies of European

Community in other member states as a result of the awareness of the advantages of selecting optimum locations within an enlarged market area . Now , it is time to check this general agreement about the effect of integration on foreign direct investment for Spain by the use of the comparisons held in the previous chapters .

Comparing the Table 10 and the Table 12 reveals that there is a huge difference between the actual inflow of direct investments into Turkey and into Spain with the latter having a much better performance . This differential must not be attributed to only the integration process of Spain , because it is not a characteristic of post integration period of Spain , but in 1970s , also , inflow of direct investment to Spain is more than twenty times that of Turkey .

The main reason for the aforementioned differential in 1970s is related to two of the locational determinants examined earlier , namely liberalization of foreign direct investment legislation and government incentives or disincentives . As stated in section 3.9.3 , the liberalization and the liberal application of foreign direct investment legislation began in the end of 1950s in Spain , while that of Turkey has begun in the

early 1980s with the introduction of structural adjustment program . The same is true also for the government-incentives-or-disincentives determinant of foreign direct investment , i.e. while there has been no strong disincentives for foreign investors in Spain since 1960s , they were valid in Turkey until 1980 . Therefore , it is not meaningful to compare the other determinants and ending up with any conclusion using these comparisons for the pre-1980 period .

With respect to post-1980 period , we found in Chapter 3 that not only in the cases of foreign direct investment legislation and government incentives or disincentives determinants , but also in the cases of political stability , barriers to trade and market growth rate determinants , there seems no significant difference between Spain and Turkey . Among the rest of the locational determinants of foreign direct investment , only in labor costs Turkey has a marked advantage over Spain . However , its effect may be said to be more than counterbalanced by the Spanish advantages in case of locational determinants such as lagged fixed assets of foreign affiliates (considering a positive relationship between direct investment inflows and lagged fixed assets of foreign affiliates as discussed in section 3.8) , familiarity with country and size of

the market (whether or not the enlarged market of Spain as a result of economic integration is taken into account) . In case of exchange-rate-changes-and-regulations determinant of foreign direct investment , a decline in inflow of investments was expected in years in which the actual stock of international reserves exhibited a decline which is generally supported by the actual inflows , especially for Spain (56) . In a comparative sense , there seems no significant difference between the two countries with respect to exchange-rate-changes-and-regulations determinant .

A profound examination of Table 10 and Table 12 reveals that direct investment inflow into Spain stabilized around U.S. $1 billion during the pre-integration period , the amount which was almost reached in 1989 in Turkey . Therefore, it may be concluded that , given the same legal base and incentives , the two countries' locational attractiveness to foreign investors would be more or less equal if Spain were to remain out of the European economic integration process . However , as it is shown in Table 10 , foreign direct investment in Spain more than doubled in 1986 , the year of entry to the European Community , and reached

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(56) See Tables 6,10 and 12

nearly U.S. $7 billion in 1989 . It is not difficult to attribute this enormous increase in inflow of direct investment to Spain to the process of economic integration . Furthermore , as it is shown in Table 11 , the source of foreign direct investment in Spain is dominated by the other European Community countries which implies that E.C. transnational firms select Spain as an optimum location for production .

The inflow of direct investment to Spain from third countries seems not to be affected to a great extend from the economic integration of Spain with the European Community which is clear from the falling share of non-E.C. countries as a source of foreign direct investments directed to Spain in the last 5 years (57) .

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(57) See Table 11

6 - CONCLUSIONS

In this study , I tried to rephrase the effects of economic integration on foreign direct investments in Spain . For this purpose , I first revealed the locational determinants of foreign direct investment by surveying the previous studies on the subject which are mainly concentrated on the direct investment flows from U.S. to the E.C. in the 1960s and 1970s , as a result of the U.S. companies' awareness of their ownership advantage in technology and management , and desire to exploit locational advantages of European market which was liberalized internally and protected externally . The next step was to check the significance of locational determinants of foreign direct investment appeared in these studies and to find a measure to be able to make them comparable between Spain and Turkey . The chosen of Spain was due to the enormous inflow of direct investment into this country in recent years ; and the chosen of Turkey to compare with Spain was due to the resemblance of the characteristics of the two countries except for the membership of Spain in European Community ; so that , it would be possible to extract the effects of economic integration on foreign direct investment in Spain by comparing the measures found for each of the locational determinant , and foreign direct investment

performances of the two countries . Therefore , in accordance with this aim , the measure of each locational determinant of foreign direct investment was compared between Spain and Turkey first ,and their foreign direct investment performance was compared later .

In accordance with the huge literature in this area , the main result of the study was the acceptance of the existence of the positive effects of economic integration on foreign direct investment in Spain . Also , it is found that , there has been a great differential in actual inflow of direct investments into Spain and Turkey in favor of Spain , not only during the post-integration period of Spain , but also in 1970s . Considering that the liberalization of foreign direct investment legislation began in the end of 1950s in Spain , while that of Turkey has begun in the early 1980s , this led us , though not directly related to the aim of the study , to the conclusion that the main obstacle to the inflow of foreign direct investment to a country is a non-liberal foreign direct investment regime and the dominancy of investment disincentives over incentives faced by foreign investors . Therefore , these two locational determinants of foreign direct investment seem to be dominant over others in order to a country be able to attract significant direct

investment from abroad in international standards .

With respect to the countries concerned , proxies for aforementioned dominant locational determinants showed no significant difference for the post-1980 period , as proxies for political stability , barriers to trade and market growth rate determinants . Among the rest of the locational determinants of foreign direct investment , only in labor costs Turkey found to have a marked advantage over Spain , but its effect was said to be more than counterbalanced by the Spanish advantages in case of lagged fixed assets of foreign affiliates , familiarity with country and size of the market . In case of exchange rate changes and regulations determinant of foreign direct investment , there seemed no significant difference between the two countries . Therefore , it was concluded that the two countries' locational attractiveness to foreign investors would be more or less equal if Spain were to remain out of the European integreation process, a tendency which is supported by the fact that the amount of direct investment inflow to Spain , which was found to be stabilized in the end of pre-integration period , was almost reached in 1989 in Turkey . However , it is found that foreign direct investment in Spain more than doubled in the year of entry to the European Community which led to the conclusion that

economic integration has positive effects on foreign direct investment , considering that proxies for the locational determinants have shown no significant differences for the two countries in 1980s . Furthermore , it was concluded that the increase in foreign direct investments in Spain , following the economic integration , was dominated by intra-E.C. investment and the inflow of direct investment from third countries seemed not to be affected much , contrary to the fact that the direct investment interactions between the E.C. and the third countries are , in general , larger than those among the E.C. countries themselves , a tendency which seems to become stronger with time despite the increased trade and policy integration within the European Community ,i.e. direct investment flows with third countries have grown much faster than those among European Community countries (58) .

A final result may be the expectation that the amount of the direct investment directed to Turkey is about to reach its maximum level , on condition that she will be left out of the European integration process, an expectation which stems from the experiences of Spain , i.e. the stabilization of the amount of

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(58) Molle (1990)

foreign direct investment in Spain in the last years of the pre-integration period as discussed earlier , and the resemblance of the characteristics of Spain and Turkey in case of locational determinants of foreign direct investment.

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