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AVRUPA TOPLULUĐU ENSTİTÜSÜ
AVRUPA BİRLİĐİ İKTİSADI ANABİLİM DALI**

**ECONOMIC INTEGRATION PROCESS AND FOREIGN
DIRECT INVESTMENT: THE CASE OF TURKEY-
EUROPEAN UNION RELATIONS**

YÜKSEK LİSANS TEZİ

Bülent ÖZCAN

İstanbul - 2004

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Danışman: Yrd. Doç. Dr. Sait AKMAN

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To my Mother and Father

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ABBREVIATIONS

AKP	: Justice and Development Party
AP	: Accession Partnership
BOT	: Build-Operate-Transfer
CEECs	: Central and Eastern European Countries
CCT	: Common Custom Tariff
EC	: European Community
ECHR	: European Court of Human Rights
EEC	: European Economic Community
EFTA	: European Free Trade Association
EMU	: European Monetary Union
EU	: European Union
FDI	: Foreign Direct Investment
YASED	: Foreign Investors Association
FIAS	: Foreign Investment Advisory Service
FTZ	: Free Trade Zones
GATT	: General Agreements on Tariffs and Trade
GDP	: Gross Domestic Product
HITA	: Hungarian Investment and Trade Agency
ISI	: Import Substituting Industrialisation
IMD	: International Institute for Management Development
IFC	: International Finance Corporation
IPA	: Investment Promotion Agencies
ISE	: Istanbul Stock Exchange
JETRO	: Japan External Trade Organisation
M&A	: Mergers and Acquisitions
MAI	: Multilateral Agreement on Investment
NPAA	: National Program for the Adoption of the EU Acquis
NAFTA	: North Atlantic Free Trade Agreement
OECD	: Organisation for Economic Cooperation and Development
OLI	: Ownership, Location and Internalisation
PAIZ	: Polish Agency for Foreign Investment
PWC	: Pricewaterhouse Coopers
REI	: Regional Economic Integration
R&D	: Research and Development
TNC	: Transnational Corporations
US	: United States
YOIKK	: Coordination Council for the Improvement of the Investment Climate
YSGM	: General Directorate of Foreign Investment
WBES	: World Business Environment Survey
WTO	: World Trade Organisation

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ABSTRACT

Proliferation of foreign direct investments (FDI) in the European Union originating from intra-EU and third countries is one of the economic consequences of regional economic integration in Europe. An examination of the FDI investment data for the period 1957-2003 reveals that foreign investment inflows in European Union member countries rose quite substantially. During the process of economic integration European regional market has affected foreign direct investments in two ways: first is the inflow of direct investment from third countries, mainly US, since the size of the market and trade barriers are affected by the integration and the second relates to the direct investment by companies of European Community in other member countries as a result of the awareness of the advantages of integration market.

The most important determinants for the location of FDI are economic considerations. They come into full play once an enabling FDI policy framework is in place. Following from the principal motivations of foreign companies for investing in foreign countries, economic determinants can be grouped into four clusters, such as market-seeking, efficiency-seeking, resource-seeking and asset-seeking. Availability of natural resources, cheap unskilled or semi-skilled labor, creative assets and physical infrastructure promotes resource-seeking activities. Another highly important group of economic determinants of FDI is market factors, which are market size, in absolute terms as well as in relation to the size and income of its population, and market growth. For firms, new markets provide a chance to stay competitive and grow within the industry as well as achieve scale and scope economies. The motivation of efficiency seeking FDI is to rationalize the structure of established resource based or market-seeking investment in such a way that the investing company can gain from the common governance of geographically dispersed activities. The intention of the efficiency-seeking foreign companies are to take advantage of different factor endowments, cultures, institutional arrangements, economic systems and policies, and market structures by concentrating production in a limited number of locations to supply multiple markets.

In early years of the European regional integration FDI flows to member countries were mainly tariff jumping investments which sought to benefit from the large regional market. Starting from the mid-1980s, with the effect of the Single Market Program which was

developed to achieve the well-functioning of the European regional market, FDI inflows to the EC sought to benefit from the competitiveness provided through Single Market Program. In this period, it is thought that the investments were affected by the expected changes in the market characteristics and the signs of the formation of an investment environment which provided efficiency in production. After 1985, the accession of new members with different levels of economic development was an important event that helps to understand the factors that lead to increase in the level of efficiency seeking foreign investments. In 1990s, it is seen that the foreign investments directed to the market have lost its importance in the integration area and firms attempting to increase their competitiveness have rather made investments based on strategic asset.

Considering the spectacular growth in the total volume of FDI going around the world over the last decade and developing countries' rapidly increasing share in it, Turkey's performance in this field has largely been disappointing, with inflows staying much below expectations and the country's well-known potential.

However, the analysis implies that Turkey's competitive position is strong when compared to the potential competitor countries within the EU and outside the EU. With its large and dynamic market, low cost labour force, favourable infrastructure and ability to access regional markets Turkey provides important advantages for market, efficiency and resource seeking FDIs. Due to the generous FDI legislation, FDI enabling environment is attractive to foreign investors. Although investment promotion and privatisation facilities are unfavourable, the well operating investment regime and supportive economic infrastructure (banking, capital markets etc) encourage FDI enabling environment. However, the political and economic instability and administrative barriers to investments are weakening the FDI environment.

The attempt started in 1963 to deepen economic relations by the idea of establishing a custom union between Turkey and the EC was an important asset providing - a favourable - environment which can attract foreign investors not only from EC but also from third countries into Turkey. It was also an important initiative of the EC to make Turkey a part of the European regional integration. Similarly, the candidacy status in 1999 is another attempt between two parties to accelerate the existent level of integration, provided through custom union, which can contribute to strengthening the investment environment in Turkey.

It is generally accepted in Turkey that the acceleration of economic integration with the EU would increase the inflow of FDI in Turkey. This has also been an argument in accordance with the huge literature in the field of regional integration that accepts the existence of the positive effects of regional economic integration on foreign direct investment. However, Turkey's performance in attracting the FDI has largely been disappointing despite the success in the establishment of custom union with the EU which makes Turkey a part of European regional market. The level of inflows has stayed much below the expectations. The subject of this study is to analyze the effects of the process of Turkey's integration with European Union on the foreign direct investment in Turkey and the study attempts to find out the reasons behind the low performance of Turkey.

After the analysis of the process of the economic integration, it is clear that the lack of confidence in the relations of the both parties constitute an important obstacle on the attainment of the expected consequences of economic integration. However, both parties are on the eve of a new period different before the past experience. The EU will give its decision about Turkey's future in the accession process. The positive decision of the EU considering the opening up of the negotiations will provide a strong signal for Turkey's eventual membership in the near future. Assuming that the government will continue the current structural reforms with a clear focus on the improvement of the investment environment, the signalling effect of the opening of membership negotiations will be very strong. Such a decision will assure foreign investors that Turkish economy will set on a stable economic growth path towards foreseeable future. For Turkey, the benefit of stability ensured by the membership negotiations will help to convince foreign investors to channel more investments into Turkey.

1. INTRODUCTION

In the post-Second World War period, alongside with the trend of globalisation, the emergence and proliferation of regional economic integration is a significant element that has affected world economy. Due to numerous attempts to establish regional economic blocs among both developed and developing countries, the number of regional economic arrangements has increased dramatically. 194 notifications, that aims to establish regional trade blocs, registered in the World Trade Organisation up until today reveals the fact that almost every country, with some exceptions, belongs to at least one regional economic group.

Regional economic integration is basically concerned with the promotion of efficiency in resource use on a regional basis. The elimination of all barriers to the free movement of goods and factors of production within the integrated area; as well as the curtail of discrimination on the basis of nationality are considered as the necessary conditions for its fullest attainment.

Even though there has been a growing number of regional economic integrations nearly in every part of the world, they vary substantially one from another in terms of their nature, forms, scale, scope, effects etc. Doubtlessly, each regional integration is motivated by different set of circumstances. It is clear that economic aspect is generally the driving force of regional integrations. In the short-run, integration is expected to stimulate intra-regional trade and investment; and in the long-run, it is hoped that the integration of larger markets, increased competition, more efficient resource allocation, and various positive externalities will improve the economic growth of the participating economies. However economic motives can provide only a part of whole picture. Political factors are also crucial when it comes to explain motives for regional integration. In that respect, a wide range of economic and political considerations should be taken into account in explaining the reasons of regional integrations.

European regional integration, which started with political and security motives to reduce the possibility of another conflict in Europe, is now one of the world's giant economic power embraces over 370 million people and a large regional market. From the first attempt in 1951 for the creation of common market for coal and steel industries until today there has been an ongoing progress in achieving economic integration. The European Union (EU),

today, has accomplished an intensified harmonisation in various fields of economy and adopted common standards that are accepted all around the regional market. Integration process starting from the formation of a custom union has reached to a monetary union that adopted a single currency for nearly 70 per cent of the regional market¹. The progress achieved in deepening the regional integration has provided an immense volume of trade in goods and services, economies of scale in production and increased competition in the regional market.

The process of economic integration in Europe led to an increase in the volume of foreign direct investments (FDI), originating from intra-regional and third countries, into European regional market. An examination of the FDI investment data for the period 1957-85 reveals that foreign investment inflows in European member countries rose quite substantially, and that investment from non-EU countries – particularly from the United States - represented the majority of the FDI in EU. The efforts for proper establishment of the common market from 1985 has also increased the FDI inflows, mainly from OECD countries, fourfold in the EU which is higher than the capital formation, GDP or world trade².

Since 1950s the EU has been playing a very important role in Turkey's external economic relations. From the early years of its formation the member countries of the EU have been major trading partners and the source of foreign direct investments in Turkey.

The Association Agreement (Ankara Agreement) concluded in 1963 targetted to promote a constant and well-balanced intensification of trade and economic relations between parties. The establishment of the custom union has been an important step for Turkey's aim to participate in European regional integration. Relations between Turkey and the European Union have developed a new dynamic by the establishment of the custom union in 1996. European Council in Helsinki at end of 1999 provides another remarkable move forward in Turkey-EU relations. The EU has opened a new era in the relations with Turkey by accepting it as a candidate country.

It is generally accepted in Turkey that the acceleration of economic integration with the EU would increase the inflow of FDI in Turkey. This also an argument in accordance with

¹ Monetary Union does not include UK, Denmark and Sweden.

² OECD (1992), International Direct Investment; Policies and Trends in the 1980s, Paris: OECD.

the huge literature in the field of regional integration that accepts the existence of the positive effects of regional economic integration on foreign direct investment. However, Turkey's performance in attracting the FDI has largely been disappointing despite the success in the establishment of custom union with the EU which makes Turkey a part of European regional market. But the level of inflows have stayed much below the expectations.

The subject of this study is to analyze the effects of the process of Turkey's integration with European Union for foreign direct investment into Turkey and it attempts to find out the reasons behind the low performance in Turkey. The study is composed of three parts. The theoretical aspects of the economic integration and foreign direct investment with an emphasis on the determinant motives governing FDI flows will be examined in Chapter 2. The effects of European integration on the FDI in EU will be studied in Chapter 3. In this part, we focus on how the widening and deepening process in the EU affected the FDI. In Chapter 4, we evaluate the locational advantages and disadvantages of Turkey that influence the motives for foreign direct investment (based on the explanations in part 2.3.). In order to make a sound assessment Turkey's position will be compared with that of Spain, Portugal and Greece as EU member countries and Hungary, Poland and Czech Republic as candidate countries in the eve to EU accession (FDI performance of these countries are discussed in chapter 3). An evaluation of Turkey's advantages and disadvantages by making a comparison with these countries is important to reveal the effects of economic integration which will be discussed in more detail in the following part of this chapter. Chapter 4 will end up with an assessment of the FDI policies and the FDI performance in Turkey.

2. THE RELATIONSHIP BETWEEN FOREIGN DIRECT INVESTMENT AND REGIONAL ECONOMIC INTEGRATION: A THEORETICAL FRAMEWORK

2.1. Regional Economic Integration and Foreign Direct Investment

Globalisation of economic production and the growth of regional trade blocs have been the most significant developments that affected international economic relations in recent years. Global production has been accelerated by foreign investments which substantially increased in the last twenty years. On the other hand, the number of regional economic agreements has flourished during the past decade. The agreements notified to the World Trade Organisation (WTO) highlights the enormous increase in the tendencies toward regional economic integration (REI). Of the 194 agreements that had been notified by the end of 1990s, 87 dated from 1990 or after.³

There has been an immense literature focusing on the development of globalisation and the growth of REI that analyse both quantitative and qualitative components of them. However, the developments in the qualitative components of globalisation and regional economic integration due to the changes in the structure of world economy may not be taken into consideration in most of the analysis. Especially, explanations of classical theory become incompetent regarding the developments in the nature of in the globalisation and regional economic integration. Therefore, a complete study focusing on these subjects should take into consideration the changes in the nature of globalisation and regional economic integrations.

The changes in the structure of international economy in the last thirty years have affected not only the factors that determined FDI but also the figures of foreign investments. The most important change in the structure of international economy is the removal of political and technical obstacles in a substantial degree that restricts the free movement of goods and services and factors of production.

The decrease in the cost of accessing and distributing information and the efficiency in coordination and communication among different units of transnational firms located in different countries due to the developments in communication and information technologies

³ Winters, A. and Schiff, M., (2003), "Regional Integration and Development", WorldBank; Oxford University, p.1.

changed the traditional structures of firms' economic activities.⁴ On the other hand, improvement in the liberalisation policies implemented by the countries regarding foreign trade and investment and adoption of these understandings by international level through necessary regulations have also changed the current structure of international investment. In fact, the Uruguay Act, which was signed after the General Agreements on Tariffs and Trade (GATT) negotiations, and the efforts for Multilateral Agreement on Investment (MAI)⁵ were revealed that liberalisation has become a global issue. Another factor that affects the structure and motivation of international investments is the increase in the number of transnational corporations (TNCs). International production continues to grow as TNCs expand their role in the globalizing world economy. In the last thirty years, the number of TNCs increased from 7,000 to 65,000, with 850,000 foreign affiliates across globe.⁶ This implies that international production constituted a significant part of world economy.

The developments mentioned above have important consequences on the factors that determine the orientations of FDI. These can be listed such as:

- TNCs started to enjoy from various instruments (exports, licensing, franchising etc.) in investing foreign markets.
- The ability of TNCs in attaining factors of production in foreign markets became much easier. This situation positively affected the decisions of TNCs in obtaining all kinds of inputs in production. This situation particularly became evident in demand for labour. As the mobility of labour is so limited, a labour intensive industry can be established in a low-wage economy or an industry that needs qualified labour can be operated in a specialised one.
- Large markets in which firms can enlarge their activities have been formed. On the other hand, firms should take necessary measures to preserve their competitiveness on the basis of global and regional market pressures.

⁴ UNCTAD, (1993), "Programme on Transnational Corporations, World Investment Report: Transnational Corporations and Integrated International Production, New York: United Nations, pp.157-165

⁵ In May 1995, the OECD Council, at Ministerial level, committed the Organization to the immediate start of negotiations aimed at reaching a Multilateral Agreement on Investment (MAI), which would (a) provide a broad multilateral framework for international investment with high standards for the liberalization of investment regimes and investment protection and with effective dispute settlement procedures; (b) be a free-standing international treaty open to all OECD Members and the European Community, and to accession by non-OECD Member countries, which will be consulted as the negotiations progress. However, the negotiations on MAI were cancelled in 1998 due to the unagreements among negotiating countries.

⁶ UNCTAD (2002), World Investment Report; Transnational Corporations and Export Competitiveness, p.xv

- The efforts in international environment for the liberalisation of trade through removing tariffs have decreased the importance of market orientation which is one of the traditional factors effecting FDI. At the same time, the importance of differences in costs of production among countries, the quality of infrastructure and the advantages stemming from factors of production started to increase.

Until recent years, REI was evaluated on the basis of the first-best policy of the classic economic theory. According to the classic theory, economic welfare can only be increased by the adoption of policies that aims free trade and full competition. The classic theory assumes that regional economic integrations are mainly in favour of protectionist measures in order to preserve the competitiveness of regional market against foreign competition. Therefore, they introduce new barriers to international trade that negatively affected the efforts for the liberalisation of international economy and world's welfare.⁷ However, the consequences of REIs on the welfare of international economy have been re-evaluated in recent years.⁸ It is argued that the main priorities of REIs are the enhancement of benefits of economic integration through enlarging the markets which support the process of liberalisation in international trade rather protectionism.⁹ Therefore, they constitute the milestones of the liberal structure of international economy in the long term.

The concept of "economic integration" has been changed on the basis of the developments in international economy in recent years. Traditionally, it is accepted that an economic integration can be established through an agreement among countries. However, in recent years, an integration can naturally be realised, without depending any legal framework, with respect to intensive economic relations among countries. The role of economic activities of TNCs in these kinds of economic integration is substantial. By the regional production networks of TNCs an economic integration based on production is naturally formed among countries.¹⁰ Therefore, the new consideration of "economic integration" is highly differs from the classic approach on the REIs.

⁷ Bhagwatti (1995), "The High Cost of Free Trade Areas", Financial Times, 31 May, 13.

⁸ Lawrence, R.Z. (1995), "Emerging Regional Arrangements: Building Blocks or Stumbling Blocks?", in Jeffrey A. Freiden and David A. Lake (eds.), International Political Economy, New York: St.Martin's Press, pp.407-415.

⁹ Kobrin, J.S. (1995), "Regional Integration in a Globally Networked Economy", Transnational Corporations, Vol.4, No.2 (August), pp.15-33

¹⁰ UNCTAD (1993), p.161

The new tendencies in the international economy not only change the structures of FDI and REIs but also re-define the relationship between these two concepts different from the perceptions in the classic theory. In the last decades, the relationship between FDI and REIs are considered as an engine for the acceleration of economic integration in international level. It is accepted that REIs provide substantial opportunities for foreign investments, and foreign investments have an important role in the acceleration of economic integration.¹¹

2.2. The Effects of Regional Economic Integration on Foreign Direct Investment

A large number of studies had been conducted during 1950s as to the effects of REIs on foreign investments. The main characteristic of this period was the substantial increase on the FDI flows from United States (US) to European Economic Community (EEC). It was argued in the studies on the relationship between REI and FDI that the efforts aiming to establish a regional economic integration in Europe streamlined the US foreign investments towards European countries.¹² The common custom tariffs on third countries and income expectations from accessing to an enlarged European market were considered as the main factors that affected FDI to the EEC countries.

The effects of REI on foreign investments can be changed according to the structure of the integration, special policies on certain industries adopted by host countries and the comparative advantage of investor country. However, the effects of regional integration on foreign investments can not be uniform across the region. REI members with stronger locational advantages than others attract most of the FDI. For instance, in the case of the EU, Britain is the most common destination for FDI from the US. Britain's chief advantages, versus other EU members, are a large internal market, cultural similarities, low factor costs, and US firms' extensive experience there from earlier investments. Therefore, it can be said that the measurement of the effects of REIs on foreign investments mainly depends on the structure of REIs. One of the main factors that determine the structure of REIs is the commitments of the member countries with respect to the level of liberalisation on economic

¹¹ Kobrin (1995), p.32

¹² Sheply, S. (1992), "FDI in the context of European Integration", Brussels: EU Commission; Yannopolous (1990), "Foreign Direct Investment and European Integration: The Evidence From the Formative years of European community", *Journal of Common Market Studies*, 28, pp.235-259; and Balassa, B. (1961), "The Theory of Economic Integration", Homewood, Illinois: R. Irwin.

relations. The degree of liberalisation has an important role on the effects of REIs on foreign investments.

The measurement of the net effects of the REIs on foreign investments is important for the theoretical explanation to clarify the consequences of REIs on the structure of foreign investments. Accordingly, certain limitations are needed on the definition of REI for the theoretical explanation on the effects of REIs on foreign investments. The definition of REI in this chapter consists of only the removal of the custom tariffs among member countries and the implication of common custom tariffs to third countries. However, other aspects of REI, have impacts on foreign investments, are also examined during this study if it is needed.

The analysis of the factors that effects foreign investments indicates that the REIs not only encourage the foreign investments but also they have some compulsory components on them. The implication of common custom tariffs on third countries is a compulsory component. REIs are compulsory in a sense that, common custom custom tariffs force the third countries producers to invest in the integrated market. But REIs are also encouraging for third country producers because they increase the motivation for investment by providing access to integrated and larger market. REIs are encouraging for intra-regional foreign investments as well. The enlargement of accessible market and protection by the common external tariffs against third country exporters provide a suitable environment for intra-regional foreign investments. In this regard, the analysis of the effects of REIs in member countries is important to explain the cause-effect relationship between REIs and foreign investments.

2.2.1 Regional Economic Integration: Theoretical Framework

Regional economic integration is basically concerned with the promotion of efficiency in resource use on a regional basis. Necessary conditions for its fullest attainment include: the elimination of all barriers to the free movement of goods and factors of production within the integrated area; and of discrimination on the basis of nationality amongst the members of the group in that respect. In addition, where resources are allocated by the price mechanism, measures will be required to ensure that the market provides the right signals. Institutions will

also be required to give effect to the integrating force of the market.¹³ Arrangements for regional economic integration take a variety of forms. The principal ones - on the basis of their analytical differences – are free trade areas, custom unions, common markets, economic unions and economic and monetary unions.

Aspects of REI	Free Trade Areas	Custom Union	Common Market	Economic Union*
Discriminatory trade policy against third countries	✓	✓	✓	✓
Removal of tariffs and quotas among member countries	✓	✓	✓	✓
Common custom tariffs		✓	✓	✓
Free movement of factors of production			✓	✓
Harmonisation of economic policies				✓

** If the harmonisation of economic policy involves the adoption of a single currency, central bank and monetary policy, it is an economic and monetary union.*

In a free trade area, tariffs (and quantitative restrictions such as quotas) between the participating countries are abolished, but each country retains its own tariffs against third countries. The European Free Trade Association (EFTA) and The North Atlantic Free Trade Agreement (NAFTA), which brings together the US, Canada and Mexico, are the leading examples of this kind of arrangement.¹⁴ Establishment of a custom union involves, besides the free movement of goods within the union, the integration of the tariff policy. The member countries adapt a common custom tariff policy and equalise the rate of tariffs in trade with third countries. A higher form of economic integration is attained in a common market, where not only trade restrictions but also restrictions on movement of factors of production - labour, capital and enterprise - are abolished. An economic union, as distinct from a common market, combines the removal of restrictions on commodity and factor movements with the harmonisation of national economic policies in certain areas such as monetary, fiscal, social etc. Although the arrangements for regional economic integration take a variety of forms, they have three common components:

¹³ Robson, P. (1998), *The Economics of International Integration*, New York and London: Routledge, p.2

¹⁴ op.cit, p.3

- Elimination of discrimination on the basis of nationality amongst the member countries
- Discriminatory trade policy against third countries
- Restriction of the unilateral implication of certain economic policies.

The main reason behind the popularity of economic integration in recent years is that the economic efficiency can only be achieved in a competitive environment provided through free trade. The efficiency in production ensures the rationalisation of production of goods and services and enhancement of welfare level in the future.¹⁵

According to the traditional trade theories, the optimal allocation of limited resources can only be achieved by the first-best situation. In the first-best situation free trade is completely achieved through the removal of all barriers to trade. In this context, a regional integration can not provide the necessary environment for the fulfilment of first-best situation as trade impediments between the region and the rest of the world remain. However, regional integration may still be optimal policy for the countries in that region. In that respect, REIs can be considered as the second-best situation.¹⁶

It can be said that the ultimate objective of regional economic integration is to increase the welfare levels of member countries through efficient utilisation of limited resources. A regional integration can generate potential gains in terms of the national income of the region by encouraging specialisation amongst the member countries on the basis of comparative advantage. The potential gains of the national economies achieved through regional economic integration have been introduced by the theoretical and empirical studies.¹⁷ These gains can be listed as increasing the production capacity of member countries, decreasing the cost of production and increasing the product diversification by achieving economies of scale, improving the terms of trade against third countries, ensuring the efficiency¹⁸ in production through competitiveness in the region and increasing foreign investments and improvement in

¹⁵ op.cit, pp xiv-xv

¹⁶ Lipsey, R.G. (1970), *The Theory of Custom Unions: A General Equilibrium Analysis*, London

¹⁷ Robson (1998), p.1 and Srinivasan, T.N., Whalley, J. and Wooton, I. (1993), "Measuring the effects of regionalism on trade and welfare", in Kym Anderson and Richard Blackhurst (eds.) *Regional Integration and the Global Trading system*, New York and London, p.52-79

¹⁸ The criteria for "efficiency in production" in this study refers to "Pareto Optimum". A Pareto Optimum is defined as a situation in which it is not possible to make any one person better off without making someone else worse off. (Lipsey, R.G., Steiner, P.O and Purvis, D. (1987), *Economics*, New York: Harper and Row, 8th Edition)

technology. In this regard, REI can be considered as not an end itself but it is a mean to increase the welfare levels of the member countries.

All such arrangements for regional economic integration mentioned above rest on the conclusion of official agreements among member countries. The unilateral use of those instruments of economic policy that are harmonised are limited by these agreements.¹⁹ These “de jure” integrations form the necessary environment accelerate the economic relations among member countries.

However, the changes in the dimensions of foreign investments have built up the suitable environment for the establishment of an economic integration that is mainly based on the regional economic activities of TNCs. Different from “de jure” integration, this kind of economic integration is not supported by a legal framework. Therefore, it is a “de facto” integration stemming from the engaged economic relations between countries in a region. A “de facto” integration encourages the establishment of a “de jure” integration.²⁰

As trade barriers fall, communications technologies improve and international competition intensifies, transnational firms are strengthening the links with their foreign affiliates. Transnational firms can coordinate a growing number of activities in different locations of a certain region. These links in economic activities of transnational firms coordinated under a common framework are constituted a micro level integration²¹. These micro level integrations stemming from the regional activities of transnational firms foster the efforts of the countries in that region for the establishment of a “de facto” economic integration.²² In other words, the reduction in tariff barriers throughout the past 45 years and the recent spread of foreign investments have stimulated the formation of a “shallow” form of integration among countries. During recent years, this "shallow" form of integration opens many areas of an economy to the influence of international economic developments. The conditions that stimulate shallow integration also encourage transnational corporations to establish cross-border production systems that lead to "deep" integration, which is integration at the level of the production of goods and services as a result of complex corporate strategies

¹⁹ Robson (1998), p.2

²⁰ Lawrence (1995), p.415

²¹ Micro integration refers the enlargement of a firm’s activities by the introduction of new ones or distribution of firm’s activities to different countries.

²² UNCTAD (1993), p.113

and network structures.²³ In this regard, the argument of Gottfried Haberler, characterizing our age as an “age of integration”²⁴, which was a foresight when it was firstly introduced, has been materialised in recent years.

2.2.1.1. The Effects of Regional Economic Integration on the Economy

One of the most important studies on the economics of regional economic integration was Jacob Viner’s pioneering study in 1950 called “The Custom Union Issue”. In his book, Viner investigated the welfare gains and losses resulting from the creation of a custom union. However, the study of Viner does not solely the economic effects of custom union narrowly defined. Rather, it can be applied to other forms of regional economic integration. Therefore, his conclusions have been based the subsequent studies that aim to explain the effects of regional economic integration.²⁵

The essential features of a custom union are:

- The elimination of tariffs on imports from member countries
- The adoption of a common external tariff on imports from the rest of the world
- The apportionment of customs revenue according to an agreed formula²⁶

The establishment of a custom union will generally alter the relative prices of goods and services in the domestic markets of member countries. The decrease in relative prices will have important implications on trade flows, production and consumption. Theory of custom union mainly focuses on these effects and tries to explain their consequences for resource allocation and for the welfare levels of member countries.²⁷ According to the custom union theory, the main effects of a regional economic integration can be analysed in two groups as static and dynamic effects.

²³ op.cit, p.161

²⁴ Haberler, G. (1994), “Integration and Growth in the World Economy in Historical Perspective”, American Economic Review, 54, p.2

²⁵ Balassa (1961), pp.21-22

²⁶ Robson (1998), p.17

²⁷ op.cit, p.17

2.2.1.1.1. The Static Effects

The static effects refer the effects of the establishment of a custom union on the terms of trade and specialisation and their implications on resource allocation and welfare levels for a member state, for the group as a whole and for the world. In the analysis of static effects the technological progress is assumed exogenous. Moreover, production is carried out processes that are technically efficient. The static effects of custom union are in a temporary manner and they mainly resulted from the removal of tariffs.²⁸ The integration of domestic markets by the establishment a custom union will affect the resource allocation if there are differences in the tariff rates among member countries. In other words, the harmonisation process of tariffs gives rise to the allocational effects of a custom union. The theory of custom union analyses the effects of custom unions on resource allocation in terms of the trade creation and trade diversion.²⁹

Trade creation refers the expansion of trade among member countries of a union through the removal of tariffs within the union. A trade creation arises when domestic production in a certain sector of a member country is replaced, in part or as a whole, by imports from another member which has a comparative advantage in the production of that sector's output. Since the member with a comparative advantage is, by definition, a country which produces that output at a lower cost or more efficiently there are welfare gains associated with trade creation. One of the main aspects of the trade creation, therefore, is the elimination of the production of goods and importation of it from a lowest-cost member country. This has positive implications on production by providing saving in costs of goods resulting from a shift of demand from higher-cost to lower-cost sources of supply.³⁰ The other aspect of trade creation is the increase in the consumption of partner-country's low price goods providing a gain in consumers' surplus by the substitution of high-cost goods in home country. Trade creation ensures re-allocation of resources in a union with respect to the comparative advantages of member countries and rationalisation of the regional production.

²⁸ op.cit, pp.17-19

²⁹ Srinivasan, Whalley and Wooton (1993), p.53-57

³⁰ Balassa (1961), p.27

Trade diversion, on the other hand, occurs when the elimination of barriers upon imports from partners lowers the cost of those imports below the cost of imports from more efficient third parties, as the latter remains artificially high due to the maintenance of restrictions on third party imports. Naturally, such a switch from more to less efficient producers would decrease the importing member's welfare. As in the trade creation, trade diversion also has consumption effects. Trade diversion occurs when consumers have to substitute more expensive imported goods from partner country for cheaper goods previously imported from non-members which are not competitive because of an increase in the tariffs with respect to non-members. Therefore, trade diversion worsens the international resource allocation and welfare. Like trade creation, the overall effects of trade diversion are the sum of production and consumption effects.³¹

The establishment of the customs union leads, thus, to the appearance of both positive effects of trade creation and negative effects of trade diversion. If trade creation outweighs trade diversion, the custom union is regarded as beneficial to welfare of the member countries of the region. The conditions that make the surplus of trade creation over trade diversion can be listed as follows:

- area of the customs union (the bigger it is the greater the trade creation effect),
- scale of tariff reduction as a result of establishing the union (the bigger it is the greater the trade creation effect),
- scale of mutual competitiveness of the economies creating the union (the more competitive the economies are in relation to one another as regards the production of similar goods the more possibilities of production specialization and, thus, the bigger the trade creation effect),
- scale of differences in production costs of the industries protected by tariffs before establishing the union (again, the bigger these differences are the greater the chances for specialization).³²

Moreover, the scope of the custom union is another factor that affects the welfare implications to the member countries. The barriers disturbing the free movement of goods among the countries do not consist of only tariffs. The range of protectionist instruments used

³¹ Robson (1998), p.19

³² op.cit, pp.26-27

during the last few decades has considerably expanded. The tariffs which used to be the main protection instruments have lost, to a big extent, their leading role in recent years. Favourite non-tariff instruments of the so-called New Protectionism observed in the 1980s became import quotas, antidumping procedures and the so-called voluntary limitations of exports. Therefore, if the scope of the agreement establishing custom union involves the elimination of these non-tariff barriers to trade, the welfare effects of a custom union will be more greater.

2.2.1.1.2. The Dynamic Effects

Dynamics effects of economic integration are mainly stemming from the implications of custom union on economic structure, production and efficiency in resource utilisation of member countries by the liberalisation of the trade within the region. In other words, dynamic effects relate to the numerous means by which economic integration may influence the rate of economic growth of member countries.³³ An increase in the size of market made possible by the integration allows firms take advantage of the economies of scale³⁴. The enlargement of the market allows the producers of member countries a regional size production under the protection of common custom tariffs, providing firms to achieve a higher degree specialisation and a fuller utilisation of their resources which lead to a more efficient production and cost reduction. Moreover, the removal of trade barriers and expanded market increase the number of potential competitors.³⁵

The studies on the effects of economic integration indicate that a custom union accelerates the level of internal trade in the region. However, it is argued that the increase in trade mainly resulted from the simultaneous occurrence of exports and imports within the same industry if the member countries have similar economic structures.³⁶ The economies of scale give rise to an intra-industry specialisation in which each firm within a particular industry specialises its production on a variety that is not produced by any other firm. The

³³ Ali El-Agraa (1998), *The European Union; History, Institutions, Economics and Policies*, Prentice Hall, 5th Edition, p.93

³⁴ Economies of scale in production means that production at a larger scale (more output) can be achieved at a lower cost (i.e. with economies or savings). When production within an industry has this characteristic, specialization and trade can result in improvements in world productive efficiency and welfare benefits that accrue to all trading countries.

³⁵ Robson (1998), pp.41-50

³⁶ Agmon, T. (1979), "Direct Investment and Intra-Industry Trade: Substitutes or complements?" in H.Giresch (ed.), *On the Economics of Intra-Industry Trade*, Tübingen: J.B.B.Mohr

activities of transnational corporations in different member countries foster intra-industry trade in regional market.³⁷

Another dynamic effect of a custom union is the potential change in the terms of trade of union with the rest of the world. In general, if the formation of the custom union does not affect the demand for imports from the rest of the world, the union's terms of trade will be unaffected.³⁸ However, the prices of import goods will likely decrease if a fall in the demand resulting from the formation of the custom union. Accordingly, there will be a tendency for the union's terms of trade with the rest of the world to improve.³⁹

The potential benefits of regional integration also arise increased competition for domestic firms. Competitive forces will dismantle domestic monopolistic and oligopolistic power prevailing in the market. The intense competition among large number of firms in each sector and exploitation of economies of scale lead to high productivity and efficiency in the region.

In addition to productivity and efficiency gains resulting from intra-firm's activities, the welfare effects of the enlargement of regional market also provides some externalities to producers. These externalities decrease the cost of inputs required for production and infrastructure. Externalities may be listed as the improvement of management techniques, increased facilities of communication, skilled labour, easy access to raw materials and intermediate goods, increase in quality and decrease in the costs of raw materials and intermediate goods.⁴⁰

Moreover, competition, provided through the formation of a custom union, also encourages firms to invest more in technology and research and development (R&D) facilities. The newly opened opportunities for expansion resulting from regional integration also attract additional investment in the region. Existing foreign firms in the region or firms

³⁷ Yılmaz, E.Ş. (1992), *Dış Ticaret Kuramlarının Evrimi*, Yayın no:178, Ankara Gazi Üniversitesi Yayınları, pp.228-229

³⁸ This is the case when the supply from the rest of the world is less than perfectly elastic.

³⁹ Robson (1998), p.39-41

⁴⁰ Balasubramanyam, V. and Greenway, D. (1993), "Regional Integration Agreements and Foreign Direct Investment", in Kym Anderson and Richard Blackhurst (eds.), *Regional Integration and the Global Trading system*, Harvester, NY, London: Wheatsheaf, p.151

outside the region may expand their network by investing in the region to take advantage of new opportunities in the market and avoid external trade barriers.

The studies regarding static and dynamic effects of a regional economic integration indicate that the consequences of regional integrations would not be the same in each case. This is mainly resulted from the differences in their structures.

2.3. Determinant Motives for Foreign Direct Investments in a Regional Economic Integration

Common external trade policy⁴¹ of member states and advantages of integrated market can be classified as the main factors of regional economic integration attracting foreign direct investments. These two main factors are considered by this study as the compulsory and encouraging factors of REI attracting FDI. Therefore, other factors that affect foreign investments are focused under these headings on the basis of their nature whether they are compulsory (common customs, trade polices, etc.) or encouraging (economics of scale, increase in productivity, etc.).

However, before starting to analyze the implications of these factors on foreign investments, we need to understand the motivation driving firms to invest overseas. To understand the motives of FDI helps us to clarify how a regional economic integration attracts foreign investments.

The main point concerning foreign direct investment is relevant with the reason as to why it takes place *at all*. To explain this we need to understand the motives for firms to invest in another country or a region. One thing is clear that foreign direct investment is basically a strategic decision which is influenced by political and behavioural factors in addition to economic considerations.

There has been a huge literature that tries to find out the determinant motives of FDI. Much of the work regarding this issue began in 1960s concerning with the flow of the US

⁴¹ Common external trade policy refers only the common tariff policy among member countries of a REI.

investments to Europe especially after the formation of the EEC. Balassa investigates the US FDI in the EEC and concludes that within the region, the countries of EEC increased their importance as a location by proving a huge market for US affiliates. He also continues that EEC provided additional cost-advantages (production costs, transportation costs, tariffs, etc.), nonprice advantages (the availability of funds, FDI legislation, the servicing of foreign markets, etc.) and efficiency advantages (productivity, economics of scale, economic growth)⁴².

On the basis of the study of Balassa, Dunning (1993) has identified four generic types of determinant motives for foreign direct investments: resource, market, efficiency and asset seeking FDI⁴³.

Resource Seeking FDI:

Availability of natural resources, cheap unskilled or semi-skilled labour, technological capability, management or marketing expertise and organisational skills promotes resource-seeking activities. The main objective of resource seeking FDI is to acquire particular or specific resources at a lower real cost than they could obtain in their home country.⁴⁴ Even when it was prominent as an FDI determinant, the presence of natural resources by itself was not sufficient for FDI to take place. Comparative advantage in natural resources usually gave rise to trade rather than to FDI. Investment took place when resource-abundant countries either lacked the large amounts of capital typically required for resource-extraction or did not have the technical skills needed to extract or sell raw materials to the rest of the world. Resource seeking FDI generally have export-oriented motives. Therefore, economic environment in foreign markets, transportation costs and commercial barriers are the other factors that affect the decisions of foreign investments.⁴⁵

Balassa found evidence that labour-cost is a determinant motive of FDI. During the period in which most US investment was directed to the EEC countries, wage costs in the manufacturing industries of the EEC countries and the UK were still in the range of 30 to 40

⁴² Balassa, B. (1961), "The Theory of Economic Integration", Homewood, Illinois: R. Irwin

⁴³ Dunning (1993), p.56

⁴⁴ op.cit, p.57

⁴⁵ UNCTAD (1998). World Investment Report 1998: Trends and Determinants, p.106

per cent of that in US manufacturing despite the rapid increases in wages in the European countries⁴⁶.

Market Seeking FDI:

The size of domestic or regional market, growth rate and per capita income are main determining factors in market seeking investments. For firms, new markets provide a chance to stay competitive and grow within the industry as well as achieve “economies of scale”. Apart from market size, foreign firms might be encouraged to engage in market-seeking investment, when their main suppliers or customers have set up foreign producing facilities and in order to retain their business they need to follow them overseas. However, undoubtedly the single most important reason for market-seeking investment remains the action of host governments encouraging such investment. The traditional instrument chosen by governments has been to impose tariffs or other import controls.⁴⁷

The appearance of size of the market as a determinant motive of FDI coincides with the studies on the relationship between regional economic integration in Europe and US direct investments into this integrated region. It is clear that large size of a country’s domestic market, other things being equal, will favour inflows of direct investment because the foreign firms deciding an investment will not be deterred by problems of securing an efficient level of output. In other words, a small market not only prohibits firms from exploiting scale economies, it also limits the degree to which factors of production can be specialised. As the market expands increased specialisation can occur and eventually economies of scale can be exploited and large scale production begin.

Efficiency Seeking FDI:

The intention of the efficiency seeking FDI is to take advantage of different factor endowments, institutional arrangements, economic systems and policies, and market structures by concentrating production. In these kinds of investment, the market in which the investment is made should be able to provide some opportunities that decrease the cost of production. In order for efficiency seeking foreign production to take place, cross-border

⁴⁶ Balassa, B. (1961), “The Theory of Economic Integration”, Homewood, Illinois: R. Irwin

⁴⁷ Dunning (1993), p.59

markets must be both well developed and open. This is why it flourishes usually in regionally integrated markets.⁴⁸ High concentration of research and development and the existence of expertise increases the motives of foreign firms to locate their operations abroad.

Asset Seeking FDI:

The main objective of asset seeking FDI is to promote their long-term strategic targets –especially that of sustaining or advancing their international competitiveness through acquiring the assets of foreign corporations. Therefore, TNC strategies in the micro level are important for asset seeking investments based on strategic assets. Foreign investment is mainly driven by a foreign firm's desire to gain access to valuable assets which are available on better terms to firms operating in the host country than in the firm's home country. This form of investment is usually take places when the domestic firms and foreign investors work together, hence, the strategic assets of the domestic firms and the complementary advantages of the investors come together. Foreign investment through privatisation and mergers and acquisitions are the best examples of asset seeking investments.⁴⁹

In the 1960s and 1970s, the motives of the most FDI were mainly based on resource and market seeking, despite regional integration in Europe was beginning to lead some efficiency seeking FDI, particularly by large US companies in industries like automobiles, consumer electronics and office equipment. There was also a small amount of strategic asset seeking investment by US firms that had not been among the first of their industry to invest in Europe, but encourage by the prospects of market growth, were seeking ways to catch up their rivals⁵⁰.

In the 1980s and 1990s, the motives for FDI has increasingly been efficiency and asset seeking. Contemporary firms view their foreign affiliates and their associated suppliers and industrial customers not as single entities, but as part of a regional or global network of activities. Most investments now taking place in developing countries by transnational companies from developed countries are not autonomous; rather, they form a part of an integrated international economic system. That is, the decisions of transnationals of what to

⁴⁸ *ibid.*, p.59

⁴⁹ *op.cit.*, pp.60-61

⁵⁰ Dunning (1994), “Re-evaluating the benefits of Foreign Direct Investment”, *Transnational Corporations*, Vol.3, No:1, February, p.37

produce in particular country, where to provide their inputs and who to sell the output to ,are based not only on the locational attractions of that country compared to others, but also on the global interests of transnational companies, rather than the interest of one affiliates, or group of affiliates⁵¹.

Over the past thirty years, partly as a result of the enlargement of the markets, mostly through regional economic integrations, and partly as a consequence of changes in international economic system that affecting the strategies of transnational companies, the determinant motives influencing foreign direct investments have dramatically changed. This leads to a situation that these four generic determinants motives for FDI cannot be taken in isolation from one another. One thing is clear that there is a constant trade-off in transnational companies decision-making between proximity and concentration, revenues and costs, and exports and selling locally. Therefore, it can be argues that foreign investments “more and more seek sites that offer both market access and conditions for world-competitive production...Multinationals are using both strategies at the same time.”⁵²

2.3.1 Common External Trade Policy

REI envisages some measures which limit the level of imports from third countries. Through the removal of the barriers for trade within the region, third countries might lose their share in the integration market. According to the early studies on the effects of REI on FDI, it was estimated that the third countries would penetrate into the markets through foreign investments thus try to compensate for their losses.⁵³ These kinds of FDI are called “tariff-jumping” investments.⁵⁴

In this approach, trade (exports) and FDI are regarded as alternative ways to launch goods into a market. Rationale behind this approach is based on traditional paradigm of Heckscher-Ohlin and 2x2x2 model of Mundell. Mundell denotes the relationship between trade and FDI as;

⁵¹ *ibid*, p.37

⁵² Loewendahl, Henry and Loewendahl-Ertugal, Ebru (2001), “Turkey’s Performance in attracting foreign direct investment”, ENERPI working papers no:8, p.16-17.

⁵³ United Nations Transnational Corporations and Management Division (UN-TCMD) (1993), *From the Common Market to EC 92, regional Economic Integration in the European Community and Transnational Corporations*, New York:UN, pp.7-8

⁵⁴ Balasubramanyam and Greenway (1993), p.147

“The movements of goods substitute the movements of factors of production...an increase in trade barriers promotes factor movements and...an increase in the restriction of factor movements promotes trade.”⁵⁵

According to Neo-Classic approach, foreign investments are increased in order to compensate the decrease in the level of exports as a result of the protective measures following the REI. In fact, this argument was confirmed in some empiric studies. Buckley and Artisien⁵⁶ focused on 18 foreign firms operating in the manufactured sectors of developing countries. According to them, the main motives of 17 of the foreign investments were to penetrate into the regional market through direct investment.

Bhagwati's approach⁵⁷ towards the effect of common foreign trade policy of REI on FDI differs from the aforementioned classic approaches. The aim of FDI in integration market is to invalidate the protective measures rather than to penetrate into the market because of high tariffs. Different from the classic approach, foreign investments are launched before the implication of protective measures. The main aim is to prevent the implication of barriers to trade by foreign investments which will contribute to economic growth. In other words, foreign direct investment is considered as the “price” of barriers to trade. These kinds of investments are called “quid pro quo” investments. This situation implies that FDI may increase depending on expectations rather than the transition in foreign trade policy. In the mid of 1980s, EC started a program in order to create “Single Market”, in these years some of the Eastern-Asia originated investments were the best examples of quid pro quo investments.⁵⁸

Views regarding tariff-jumping FDI are based on Neo-Classic international trade approaches. However, Neo-Classic approach does not appropriate to the modern world economy of today. The positive relationship between trade and FDI became doubtful on the basis of the changes in the traditional trade relations. Especially, the downward shift in the

⁵⁵ Mundell R. (1957), “International Trade and Factor Mobility”, American Economic Review, p.320

⁵⁶ Buckley, P.J. and Artisien, P. (1987), “Policy Issues of Intra-EC Direct Investment: British, French and German Multinationals in Greece, Portugal and Spain with Special Reference to Employment Effects” in J.H. Dunning and P.Robson (eds.), Multinationals and the European Community, Oxford, p.105-128

⁵⁷ Bhagwati, J.N (1987), “VERs, Quid Pro Quo FDI and VIEs: Political Economy, Theoretic Analysis”, International Economic Journal, Vol.1, p.1-4

⁵⁸ Balasubramanyam and Greenway, 1993, p.149-150

tariff rates in the last decades has been the best example to this. In the aftermath of the Second World War, tariff rates of many countries were started to decrease in a considerable amount due to the GATT negotiations. According to recent studies, there is not a “substitution” relation between international trade and international investments. Rather there is a “complementary” relation between them.⁵⁹ Following the liberalization of trade within the region in the EC, FDI flows among member states were still realised and most of the international investments were made by developed countries which apply low tariff rates. These makes tariff-jumping FDI became invalid.

	1913	1950	1990
France	21	18	5.9
Germany	20	26	5.9
Italy	18	25	5.9
Japan	30	-	5.3
The Netherlands	4	11	5.9
Sweden	20	9	4.4
Britain	-	23	5.9
USA	44	14	4.8

Source: UNCTAD, World Investment Report 1994: Transnational Corporations, Employment and Workplace.

In this framework, if the domestic market of host country is a “target market”, the importance of preventive trade barriers will be increased. Consequently, common foreign trade policy is important in terms of market oriented FDI. However, in order to be a target market in terms of member states to REI, common foreign trade policy is not the only condition. The population and the GDP per capita of the integration market are other factors that preventive trade barriers can affect foreign investments. Recently, many empiric studies have been conducted to imply the effects of preventive trade barriers on FDI if necessary conditions are ensured.⁶⁰

⁵⁹ Fontagne, L. (1996), *The Links between Foreign Direct Investment and Trade: Empirical Evidence for US and French Industries (1984-1994)*, Paris: OECD Directorate for Science, Technology and Industry, Industry Committee (no page numbers)

⁶⁰ Balasubramanyam, V. and Salisu, M. (1991), “EP, IS and Direct Foreign Investment in LDCs” in A. Koekkoek and L.B.M. Mennes (eds.), *International Trade and Development: Essays in Honour of Jagdish Bhagwati*, London: Rotledge.

2.3.2 Advantages of Integrated Market

FDI are affected by the advantages of integrated market which emerge as a result of dynamic effects of REI. Contrary to the policies for the protection of regional market that create an obligatory motive to penetrate into the regional market for the compensation of trade losses, dynamic effects supportively increase the motives of foreign investors. In the literature of foreign investments dynamics effects of REI are accepted as a separate factor that accelerate the inflow of FDI.⁶¹

Advantages of integrated market are classified into two groups: increase in the quality and quantity⁶² of the market as a result of integration and efficiency in production. After the regional integration enlargement of market positively affect foreign investments through providing profit opportunities. REI increases the importance of member countries in terms of investment decisions of transnational firms based on “optimum location”.⁶³ According to a survey which was carried out by Ernst & Young International Consultancy Company on 1,000 TNCs, scope of the market is the main determining factor in terms of investment decisions.⁶⁴ On the other hand, quality of the market is as important as its scope. GDP per capita and growth rate of GDP determine the quality of the market.⁶⁵ During the period 1991-1995 total FDI flows to China were increased from 28 Billion USD to 38 Billion USD. The main reason was 12 per cent growth performance of China in this period.⁶⁶

Efficiency of REI in the allocation of resources may increase income level of member countries. These increases in the income level of member countries gradually raise the demand which encourages investments decisions of the third country producers. Moreover, regional market is started to be considered as a target market by foreign investors due to the

⁶¹ OECD (1995), p.27; UNCTAD (1993), p.100; UNCTAD (1994), p.29; United Nations Centre On Transnational Corporations (UN-CTC) (1990) Regional Economic Integration and Transnational Corporations in the 1990s: Europe 1992, North America and Developing Countries, UNCTC Current Studies: Series A, No:15, New York:UN; Morrison, A.J. and Roth, K. (1992), “The Regional Solution:an Alternative to Globalisation”, transnational Corporations, Vol.1, No.2 (August), pp.37-55

⁶² While the quality of market refers level of GDP per capita, the quantity implies the population rate.

⁶³ Optimum location refers the best alternative which increase profitability and decrease costs of production.

⁶⁴ Ernst and Young Int. Limited (1994), Investment in Emerging Markets: Opportunity versus Risk

⁶⁵ Wheeler and Mody (1992), “International Investment Location Decisions; the case of US Firms” pp.52-76; Agarwal, P.P., Gubilz, A. and Nunenkamp, P. (1991), Foreign Direct Investment in Developing Countries: the Case of Germany, Tubingen: J.E.B. Mohr, pp.58-60

⁶⁶ UNCTAD (1996b), Programme on Transnational Corporations, World Investment Report 1996: Investment , Trade and International Policy Arrangements, new York and Geneva: UN

increase in the income level.⁶⁷ To take part in the REI market provides some advantages for the producers of third countries; for example the cost of transportation and communication decrease and demands of consumers can be closely traced. Consequently, firms from third countries which still preserve their competitive power despite common custom tariffs and export to integration market may prefer to penetrate to integration market through direct investment due to the advantages of REI. These factors seriously affected direct investment decisions of Japanese firms in the EU market during 1980s and 1990s.⁶⁸

The extent of the advantages stemming from REI mainly determines the level of market oriented FDI inflows. According to REI theory, the removal of trade barriers within the region will lead to an increase in efficiency and a change in the allocation of resources among the member countries. In other words, the comparative advantages of the member countries will be re-structured in the integration market. An increase at the efficiency of resources means that the efficiency in the production increases. Thus, the importance of integration market increases in terms of efficiency seeking FDI.

The conditions for efficiency seeking FDI do not only attract foreign investments but also affect ongoing investments in the regional market. Especially, new inflows boost the rationalisation efforts of ongoing investment. The foreign investments located in member countries before regional integration start to adapt a regional scale production by enlarging their activities to other member countries. These rationalisation efforts lead to the shift of foreign investments among member countries. The shift of foreign investments from one member country to other member country has not tremendous effects on the level of FDI stock in the regional market. However, it influences the location and level of inflows and outflows of FDI in member countries.⁶⁹

On the condition that the member countries specialize on the production of a single product or production of different components (labour or technology intensive) of a final product; supply of cost-efficient and qualified inputs can be increased which is accepted as an important factor for efficiency seeking FDI. The investments in the regional market can

⁶⁷ Hufbauer, Lakdawalla and Malani (1994), "Determinants of Direct Foreign Investment and Its Connection to Trade", UNCTAD Review 1994, New York and Geneva: UN Publications, pp.39-51

⁶⁸ Japan External Trade Organisation (JETRO) (1991), Survey of European Operations of Japanese Companies in the Manufacturing Sector, 7th Survey Report, London, JETRO

⁶⁹ UN-TCMD (1993), pp.57-58

benefit more from this situation if the foreign trade barriers are removed among the member countries. As a result, circulation of goods and trade volume within the region increases.⁷⁰

Economies of scale decrease the cost of production and increase the efficiency thereof. By economies of scale, producers decrease the unit prices, thus they gain power in the competition. Economies of scale which make the production in REI market attractive, play an important role on efficiency seeking FDI⁷¹.

The effects of REI on FDI may differ due to the differences in economic development levels of member countries. On the basis of development gaps, there can not be free movement of production factors among the member countries within the formerly defined limits. As a result, there may occur different labour prices among member countries in the integration market. Labour costs play a significant role in investment decisions for FDI which are based on labour-intensive production. The inflow of foreign investments to the countries which offer low labour prices has been substantially increased in recent years.⁷² Accordingly, both intra-regional and foreign investments have a tendency to move towards low labour cost member countries in a REI. By offering low labour costs Mexico, member country of the North American Free Trade Agreement (NAFTA), has become very attractive not only for US and Canadian investors producing for North American market but also for investors from third countries aiming to access NAFTA regional market. The increase in the volume of FDI during 1992-1994 was recorded as nearly 75 per cent which was only 5.2 per cent during 1984-1991⁷³.

Maximization of profit and efficiency of production are the two important elements of efficiency seeking FDI and asset seeking FDI. These two elements are crucial for enhancement of competition power in the market. Lessening of protectionism and increasing the importance of “competitiveness” in the world economy have considered as the main factors in attracting FDI in recent years. For this reason efficiency seeking FDI have become more common when compare to market seeking FDI. The dynamic effects of REI have

⁷⁰ UNCTAD (1996c), Trade and Development Report, 1996, New York and Geneva: UN

⁷¹ Yanopolous (1990), p.239

⁷² UNCTAD (1996b)

⁷³ Alici, Murat (1997), Bölgesel Ekonomik Entegrasyonların Dolaysız Yabancı Sermaye Yatırımları Üzerindeki Etkisi, Hazine Müsteşarlığı Yabancı Sermaye Genel Müdürlüğü Uzmanlık Tezi, Nisan 1997, pp.69-70

increased the locational advantages of integration market regarding efficiency seeking FDIs. In this context, advantages of integration market provided by dynamic effects of REI play more important role in directing the FDI towards regional market than protective trade barriers.⁷⁴

2.4. Investment Diversion and Investment Creation Effects of Regional Economic Integration

It is generally accepted that the static effects of REI on FDI are investment diverting and dynamic effects are investment creating.⁷⁵ In some approaches there has been parallelism between the investment creation and diversion effects and static trade creation and diversion effects of REI.⁷⁶

In investment diversion, investment supposed to be made to another country on the condition that the REI does not exist, may be diverted to the member states as a result of a discriminating manner against third countries products in the integration market. On the other hand, potential dynamic effects of REI increase the FDI in the region and have an investment creating effect. Investment creating effect plays a complementary role in the trade relations between third countries and the region. In investment diversion, however, trade relations of third countries are substituted by the investments to the region. Both investment creation and diversion increases the level of FDI inflows to the regional market.

When we take into consideration the assumption that the countries in the REI have almost the same development levels and are similarly affected from global fluctuations, it is possible to determine the investment diverting effect of integration “within the region”. However, if the development levels of member countries differ, the estimation of diversion effects will be problematic. Likewise, it is also difficult to estimate the investment creating effects. The investment creation effects are become concrete when the effects of REI on FDIs can be distinguished from the other effects that promote FDIs. As it is implies that the

⁷⁴ Jovanavic, M. N. (1992), *International Economic Integration*, London: Routledge p.85-96

⁷⁵ Balasubramanyam and Greenway (1993), p.158

⁷⁶ The disparity among related approaches are resulted from defination of FDI which will be created or diverted after the formation of REI. The investments of third countries in REI market which are resulted from trade diversion are consired as consequences of investment creation; the investments flowing among member countries which are resulted from trade creation are considered as consequences of investment diversion. (UN-TCMD, 1993, p.11)

assumptions about the effects of both investment creation and diversion are vague. Therefore, it can be said that these effects mainly based on the changes in the structure of FDI after the formation of regional integration.

As it is not possible to establish a database according to the motivations that guide FDI, it can not be clearly defined whether the investments directed towards the REI market shall occur as a result of investment diversion or investment creation effect. However, some factors which guide the investors and which are unique to the investment sectors may help to make a these kind of distinction.⁷⁷ In the following part, the analysis of investment creation and diversion is going to be made with respect to these factors that are unique to the investment sectors.

2.4.1. Foreign Direct Investments not Affected by Regional Economic Integration

FDIs which are based on natural resources are related to a specific geographical area, for this reason, they can not create an investment diversion effect by the influence of a REI. Decisions on FDI in such service sectors as construction, transportation, trade, storage, communication, finance, insurance and banking depend on the location of the investment. Thus, REI does not affect the investors' decisions in determining which countries to invest. On the condition that the target market is not in the country where the investment is made, choice of country for the FDI in service sector depends on some restricting conditions such as proximity to the target market.

As for the manufacturing sector, investments which are not affected by REI are the FDI which are directed towards the market and aim at any market out of REI region. REI can have an effect on FDI only if these investments do not aim at any production towards the domestic market of the target country. Determining the demands of consumers, preventing the discrimination of foreign firms in public procurements and the high transportation costs of penetrating to market through exports are the obligatory conditions that affect market seeking FDIs. Elements of the target market which create motivation and obligation are not directly affected by REI.

⁷⁷ Agarwal (1994), pp.29-44

On the basis of these factors, an anticipated investment diversion in manufacturing sector is based on some assumptions. Firstly, increase in the FDI in regional market which is based on the investment diversion effect result from trade-motivating effect of REI rather than the flourishing global economic environment. Secondly, it should also be considered that investment capacity (capital, qualified management and technical staff) of TNCs's are limited. That is to say, in order to make an investment in a country, another investment has to be abandoned. Finally, the host country in the region can be able to substitute the locational advantages of third countries.⁷⁸

As a result, it is difficult to prove that integration diverts FDI in the third countries. However, diverting effect of integration can be observed on the condition that the development levels of a member country to the REI and other countries where the investments may be diverted are the same.

2.4.2. Foreign Direct Investments oriented by Regional Economic Integration

Since 1960s developed countries diverted some of the production activities to the developing countries in order to get use of relatively low-cost labour force and other factors of production. US investment for electronic house equipment in Mexico and Japanese investments for consumption and textile goods in Eastern-Asia are the best examples. If the objective of these investments is exportation to the REI market, they can be affected by the formation of regional integration.⁷⁹ The protective measures against third countries after the formation of integration negatively affect the advantages resulting from efficiency in production. On the other hand, REI also provides cost advantages through the efficiency in allocation of resources. At this point, the importance of the advantages provided by these two efficiencies determines on what direction REI effects foreign investment.

In recent years, the importance of the labour force prices has increased regarding the efficiency seeking FDIs. The competitiveness in the global economy in recent years oriented industries with labour-intensive production to seek for the most affordable labour force prices while making investment decisions.⁸⁰ As a result, the concept of “delocalization”, which

⁷⁸ UN-CTC (1990), p.2-4

⁷⁹ Agarwal (1994), p.30-32

⁸⁰ OECD (1996b), Financial Market Trends, 64, Paris, OECD

causes foreign trade deficits and decreases in the employment in the developed countries where labour force prices are high and social policies are effective, is started to be used.⁸¹ Delocalization means that local producers no longer be active in their countries due to cost increases in production and they continue their production abroad.⁸² The reasons behind delocalization are the factors that increase the cost of production such as high labour force prices, solid social-security laws, appreciation of local currency.

Delocalization has different effects on FDI of member countries depending on REI. In “de jure” REI which includes free movement of factors of production, a decrease in the labour force prices does not seem to be probable due to strict implementation of social security policies. Thus, they have an adverse effect on efficiency seeking FDI which are sensitive to labour force prices. On the other hand, REI does not have to be official in nature. In “de facto” REI, the countries may have different levels of development and different labour force prices. The concept of delocalization may play an important role on efficiency seeking FDI in such kinds of integration movements.

2.5. Regional Economic Integration and Strategies of Transnational Corporations

The assumptions of neo-classic theory with respect to the effects of REI on FDI have become incompetent due to the economic transition in last quarter of world economy. The structural changes in the world economy have altered the factors that direct foreign investments. The strategies of TNCs in the micro level have become an important factor as the macro components of factors that direct foreign investments.

Neo-classic approaches mainly focused on to reveal the implications of REI on FDI on the basis of the static effects of REI on allocation of resources. The analysis of neo-classic approaches regarding dynamic effects of REI, however, is ambiguous since firms, ownership and internalisation considerations are entirely disregarded.⁸³ When it is considered that TNCs typically account for a significant proportion of world production, investment and external trade, it is evident that the aforementioned disregards are crucial for development of a

⁸¹ Hufbauer, Lakdawalla and Malani (1994), pp.40-41

⁸² Madeuf, B. (1995), “Foreign Direct Investment, Trade and Employment”, in Foreign Direct Investment, Trade and Employment, Paris, OECD,, p.42-45

⁸³ Robson (1998), p.110

systematic consideration of the interaction between regional integration and foreign investments.

In order to make a systematic evaluation of the effects of REI on FDI, it is going to be relevant to explain the strategies of TNCs in the following part.

2.5.1. Transnational Corporations and Foreign Direct Investments

International production continues to grow as transnational corporations expand their role in the globalizing world economy. According to recent studies, it is estimated that there are about 65,000 TNCs today, with about 850,000 foreign affiliates across globe. In 2001, foreign affiliates accounted for about 54 million employees, compared to 24 million in 1990. Their sales of nearly 20 trillion USD were more than twice as high as world exports in 2001, compared to 1990 when both were roughly equal. The stock of outward FDI increased from 1.7 trillion USD to 6.6 USD over the same period. Foreign affiliates now account for one-tenth of world GDP and one-third of world exports.⁸⁴

The investment strategies of TNCs have been taken into considerations by the studies regarding the relationship between REI and FDI due to growing importance of TNCs in the world economy. The theory of international production is one of the most comprehensive and analytical approach to the interactions among TNCs, FDI and REI.

2.5.2 The Theory of International Production

The theory of international production was proposed by John Dunning⁸⁵ in the second half of 1980s to reveal the micro level factors that direct foreign investments by focusing directly on how a decision on FDI on the part of a TNC is affected by integration. By this way, internationalisation theory provides an explanation of growth of the TNCs and gives insights into the reasons for FDI. In this connection the theory emphasizes the distinctive organisational characteristics of the TNC.⁸⁶

⁸⁴ UNCTAD (2002), World Investment Report 2002, pp.xv-xxx

⁸⁵ Dunning, J.H., (1988), Explaining International Production, London, Unwin Hyman.

⁸⁶ Robson (1998), p.113

A widely accepted model of the theory of international production is John Dunning's "eclectic paradigm".⁸⁷ The eclectic paradigm of international production is derived from various theoretical approaches such as theory of firm, trade theory, organisation theory and location theory. It attempts to integrate three general and interrelated concepts to identify and evaluate the significance of factors influencing both the initial act of cross-border production by firms and the growth of such production. Dunning argues that at any given moment of time, the propensity of a firm to undertake foreign production depends on the combination of the following three elements:

1. TNCs are companies, by definition, which undertake production outside the home country. The scope of their foreign production will mainly depend on their comparative *ownership specific advantages* when compared to host country firms. They arise when a firm of one nationality possesses certain specific advantage over the competing firm of other nationalities. They are internal assets which are not available to other firms. These *ownership specific advantages* can be distinguished into three elements;
 - a) Advantages stemming from *size* and *monopoly of power*: These advantages generally base on the ability of TNCs in the access to market, cheaper inputs, knowledge of markets; or ensuring raw materials not available to other competitors which may both generate scale economies and inhibit effective competition.
 - b) Advantages based on *intangible assets*: The utilisation of intangible assets such as patents, trademarks, management skills and R&D activities will enable a higher level of technical or price efficiency and achieve a more market power are also components of these advantages.
 - c) Advantages arise from the multinationality of a TNC: Multinationality enhances above advantages by offering wider opportunities. Multinationality enhances more favoured access to or better knowledge about international markets e.g. for information, finance, labour etc.; ability to take advantage of geographic differences in factor endowments, markets; ability to diversify or reduce risks stemming from host country policies.

⁸⁷ Dunning, J.H., (1988), Explaining International Production, London, Unwin Hyman.

2. The comparative advantages of the host country are considered by eclectic paradigm as *locational advantages*. TNCs mainly try to combine their ownership advantages with host-country (location) advantages to engage in international production. Besides the size of the market and growth rate the following factors are also constituted the components of locational advantages.
 - a) Availability of inputs for production (including infrastructure resources) without encountering any obstacles; and the costs and quality of inputs
 - b) Unavoidable or non-transferable costs and benefits such as taxes, subsidies, investment constraints, training grants, local labour requirements, etc; and economic stability
 - c) The costs of transportation of products from the country of production to the country of marketing; costs of communication; the transparency of commercial and legal arrangements; and proximity in languages and other social and cultural heritages.

3. The *internalisation advantages* arise when a firm internalises the use of its ownership specific advantages. If the conditions for ownership advantages are satisfied, then, generally, it will be more beneficial to a firm possessing these advantages to use them itself through investment rather than to sell them to other firms using contractual instruments (leasing, franchising etc.). The key incentives for a firm to internalise market are market imperfections and uncertainty. These include the reduction of uncertainty and transactions costs in order to generate knowledge more efficiently; and the reduction of state-generated imperfections such as tariffs, foreign exchange controls and subsidies. In order to circumvent and mitigate these market imperfections, the company chooses to organize production across borders through internalization. The greater degree of market imperfections and uncertainty, the greater the incentive and advantage for firm to perform the function of the market itself by internalising the market transactions.

According to Dunning, firms will involve in international production if and only if these all three conditions are satisfied. The configuration of ownership, location and

internalisation (OLI) advantages and disadvantages determine the structure, nature and strategy of the firm. The merit of this paradigm is that it incorporates a major characteristic of the diversity of transnational investment in the global economy.

Although the organisational structure of TNCs are depended on their strategies, external environment, demand for their products and government policies, the main objective of TNCs is to increase the competitiveness through decreasing costs of production. The organisational structure of TNCs is basically distinguished into two as vertical integration and horizontal integration.

The accumulation of the different processes into a single framework of the production of a good, the efficiency in its coordination and monitoring may decrease the costs of production. The production within a single framework provides a “vertical integration”. The vertical integration in production can be oriented through both backward (inputs or intermediate goods) and forward (consumers).

Due to specialisation in production of a good, a TNC may install units, which located in different countries and produce all components of a good, to benefit the competitiveness resulting from the ownership advantages. This organisational structure is called “horizontal integration”. Efficiency in production provided through the horizontal integration ensures costs advantages to firms. The functions regarding R&D, financing, accounting, human capital etc., of units of TNC producing within horizontal integration are executed from the central organisations.

2.5.3. Impacts of Regional Economic Integration on Transnational Corporation Strategies

According to international production approach there are two dimensions of theoretical interpretations on the relationship between REI and FDI. First is the components of Eclectic Paradigm about locational advantages and the other is the potential ability of REI on what kind of a change they can create on the organizational structure of TNCs.

REI increases the locational advantages of the member countries when compared the period before integration. The static and dynamic effects of free trade on resource allocation

provided through REI modify the factors that increase locational advantages (expansion of the market, increase in income level, supplying cheap and high quality production inputs from the market) of REI market.

On the other hand, terminating the tariffs in the integration market with REI, decreases the benefits of the horizontal integrations from the side of TNCs. Units that produce the same goods in different member countries within the integration are gathered in a country that possesses the maximum advantages from Eclectic Paradigm to make production for the regional market. Therefore, the abandonment of horizontal integration is feasible for TNCs to decrease the costs of production.

The potential of the integration in creating cooperation between member countries plays a role for supporting vertical integration and specialization on intermediate goods production within the TNCs which search for lower costs in production and scale economies. TNC decisions related to organizational structure generally affect the investments strategies on REI market. These strategies can be classified as defensive export substituting investment, rationalized investments, offensive export substituting investment and re-organization investments according to the type of the trade affairs before the integration and the characteristics of the countries that are in relation with each other.⁸⁸ There is no foresight of these strategies as it is assumed in neo-classical approaches introducing that there is a complementary or substitute connection between international trade and international investments. Since there is a commercial dimension of these applied strategies, the net impacts that can come out because of trade are considered within the consequences of the strategies (see Table 3).

To analyse the TNC investment strategies regarding the regional market will give us clues for the relationship between REI and FDI.

a) Defensive export substituting investment:

TNCs that export to any of the region countries before the integration are losing their competitiveness against their competitors among the region countries when the commercial

⁸⁸ UN-CTC (1990), pp.2-5

barriers are terminated within the region and applied to the third countries. TNCs that become disadvantaged because of the trade diversion impact of REI can invest in order to protect the market share that is indigenous before the integration with the help of export and carry their production to the regional market with the aim of overcoming the obstacle of tariffs. Therefore, the regional strategy of TNC becomes an investment oriented strategy rather than a commercial one. The determinant factor of this strategy is that the regional trade has been more attractive than the trade from outside of the region. These kinds of TNC strategies are called “defensive export substituting investment” because they are said to defend the existing market share.

b) Rationalized Investments:

The locational advantages of the regional market are increasing through scale economies that are driven by massive production provided by dynamic effects of REI. This situation supports TNCs for increasing their present investments if the regional market provides efficiency and lower costs in production with scale economies. Since investing within the region brings a more rational structure to the production this kind of TNC strategies are considered to be “rationalized investment”. The aim of the strategy is benefiting from the differences in international costs.

c) Offensive export substituting investments:

Another strategy that TNCs follow with REI is “offensive export substituting investment”. TNCs that carry on their trade based strategies or that has no commercial relation with the region, found the strategy of access to the regional market by export not feasible when the impacts of REI such as expansion of the market, increase in demand and rapid technological development arise. Thus, TNCs adopt direct investments to penetrate the regional market. The fundamental aim that shapes the strategy is to benefit the advantages of “antecedent” position in the regional market that has rapid growth potential. TNCs, with this strategy, try to increase their shares in member countries’ or goods markets whose risk component is eliminated by REI.

Table 3: Impact of Regional Economic Integration on Transnational Corporation Strategies

Macroeconomic Impact of Regional Integration	TNC Strategy	Net Impact on Trade	Net Impact on FDI
Regional trade becomes more attractive than trade with outsiders outside the region.	In order to have effective access to the regional market direct investments instead of exports should be made. Defensive export substituting investment	Since the tendency of the substitution of the exports to the region by the sales of the affiliates in the region increases, trade decreases.	FDI to the affiliates in the region increases.
The locational advantages of the member countries are reshaped with the effect of integration.	Existing investments are harmonized with the regional free trade conditions. Re-organization investments	If re-organization investments create factory and country specialization intra-region trade may increase. If regional industries can increase their competition power in global markets, out-region exports may increase.	No impact regarding regional trade FDI. Increase in investments in one of the member states decrease investments in the other.
Production costs decrease. Efficiency in production is achieved.	The activities that produce value added are increased in the region. Rationalized investments	If factory and country specialization is created, regional trade may increase. If regional exports are greater than external exports, trade decreases.	If TNCs increase their supplier units in region, FDI increase.
Market expands, demand increases, and technological innovation is achieved.	Investments are made in order to benefit the advantage of being the “antecedent” investor Offensive export substituting investments	If regional demand increases faster than the foreign capital investments to the region, this doesn’t make any effect on trade. Trade decreases, vice versa.	FDI to the region increases.

d) Re-organization investments:

It is a necessity that the TNCs should re-organize their investments according to the changes in the region since the locational advantages of the member countries also change relative to the condition before the integration. The result of TNCs gathering their activities in the member country that provides the most advantaged cost facilities is the relocation of the

present production activities in the regional market. Transfer of the production activity from one member state to another increases the inflows of FDIs, which is called “re-organization investments” in region.

3. REGIONAL ECONOMIC INTEGRATION IN EUROPE AND ITS EFFECTS ON FOREIGN DIRECT INVESTMENTS

3.1. Historical Context of European Union

The European Community (EC) was established by the Treaty of Rome in 1957 with six member countries: Belgium, Luxemburg, the Netherlands, Germany, France and Italy. The main objective of the member countries in early years of integration was to establish a custom union. This was achieved by the late 1960s, members having eliminated tariff barriers among themselves and having adopted a set of common custom tariffs. Over time the scope of economic integration of the Community has grown substantially. An agreement was signed in 1971 to achieve the status of a common market in ten years, but the oil crisis of 1970s, with the resulting slow rates of growth and high levels of unemployment of among member countries postponed this plan. Another attempt for the establishment of a common market was made in 1987 when the Single European Act was adopted. This was an agreement to remove by the end of 1992 almost all remaining barriers to free trade in goods and services and to allow free movement of labour and capital among member countries. By the Single European Act, the Community not only achieve the free movement of factors of production but also adopt common technical standards with respect to occupational health and safety, consumer protection and the environment. Members started to recognise each other's educational qualifications. National insurance regulations have been reduced and unified. Licensed banks of one member country may now open branches in other member countries.⁸⁹

In Maastricht Treaty of 1991, the member countries agreed to replace their national currencies by a single currency, called as "Euro"⁹⁰, by the year 2000 and to set up a European Central Bank to oversee a single monetary policy. By the end of February 2002 twelve of the EU countries permanently adopt Euro as the currency of the Union and prohibit the circulation of their national currencies. Member countries must now adopt macroeconomic

⁸⁹ Swan, D. (1992), *The Economics of the Common Market*, Harmondsworth, Middlesex: Penguin Books, 7th Edition, pp. 13-43.

⁹⁰ The United Kingdom, Sweden and Denmark refuse to replace their national currencies with Euro.

policies to achieve low inflation and eliminate budget deficits in preparation for monetary union.⁹¹

Even from its earliest stages the deepening of European economic integration is going in parallel with widening process. From the beginning, the EC hoped to embrace the whole of “Europe”. In the Treaty of Rome, the EC calls upon other European countries that share the same ideal to join in efforts for integration. Over the time EC achieved four enlargements that increased the number of member countries from six to fifteen. The first one was completed in 1973 by joining of Britain, Ireland and Denmark. Second was the membership of Greece in 1981. In 1986, Spain and Portugal joined to the EC. Fourth enlargement of EC was completed when Finland, Austria and Sweden became members in 1995. Finally, EU member countries agreed on the fifth enlargement in the European Copenhagen Council in December 2002. In the latest and largest enlargement of EU ten candidate countries (Poland, Hungary, Czech Republic, Slovakia, Slovenia, Lithuania, Latvia, Estonia, Malta and Southern Cyprus) will join to the Community.

Growing from six Member States in 1952 to 15 by 1995, the European Union today embraces more than 370 million people. After successfully growing from 6 to 15 members, the European Union is now preparing for its biggest enlargement ever in terms of scope and diversity. Enlargement of new ten member countries in 2004 will add 75 million consumers into EU Single market by making EU’s total population over 450 million. This should lead to intensified trade in goods and services, economies of scale, increased competition and more flows of investment. Thus, these will boost economic growth in both current and new member countries. In this respect, enlargement will have a positive impact that accelerate the process of completion of single market which the EU experienced in 1990s⁹².

3.2. European Economic Integration and Its Effects on Foreign Direct Investments

It is seen that FDI in EU have changed with the level of integration and in some cases the relationship became very concrete. In early years of the integration FDI flows to member

⁹¹ Commission of the European Communities (CEC) (1992), From Single Market to European Union, Luxembourg: Office for Official Publications of the EC.

⁹² Kok, W. (2003), Enlarging the European Union; Achievements and Challenges, European university Institute Robert Schuman Centre for Advanced Studies Report of Wim Kok to the EU Commission

countries were mainly tariff jumping investments which are in accordance with the basic argument of neo-classic theory. Thus, the rise in FDI flows were mainly related with the static effects of the integration and lacked continuity⁹³. After the middle of the 1980s, FDI to the REI have been affected by the Single Market Program which in case deepened the integration. In this period it is thought that the investments were affected by the expected changes in the market characteristics and the signs of the formation of an investment environment which provided efficiency in production. After 1985, the accession of new members with different levels of economic development was an important event that helps to understand the factors that lead to increase in the level of efficiency seeking foreign investments. In 1990s, it is seen that the foreign investments directed to the market have lost its importance in the integration area and firms attempting to increase their competitiveness have rather made investments based on strategic asset.

3.2.1. The Period from the Treaty of Rome to the Single Market

Since the early 1950s creation of a unified European market had been one of the fundamental objectives of the European Community. There had been achieved a significant progress by the end of the 1960s. Tariffs and quotas on intra-European trade had been abolished, a common external tariff on imports from third countries introduced and, in 1969, a programme announced to remove intra-European technical barriers. For this reason, the 1957-1985 period of EC is shown as an adequate reference to understand tariff effects of economic integration on FDI.

In this first stage of integration, an important part of the FDI towards EC was US originated. After the Second World War, the international activities of the European investors, that failed to establish an international competitive power until the second half of the 1960s, stayed limited. In this period both the quantity of US investments towards EC countries and the share of these investments in total foreign US investments have increased. (see Table below)

⁹³ Robson (1998), p.78

Table 4: Breakdown of US FDI in EC and Other Countries (\$ Billion)								
Year	EC*	% Change	Other Europe	% Change	Developing Countries	% Change	Other Countries	% Change
All Sectors								
1950	0.6	..	1.1	..	5.7	..	4.3	..
1955	1.2	20.0	1.8	12.7	8.0	8.1	8.4	19.1
1957	1.7	20.8	2.5	19.4	10.3	14.4	10.9	14.9
1962	3.7	23.5	5.2	21.6	12.7	4.7	15.7	8.8
1967	8.1	23.8	10.1	18.8	14.9	3.5	23.4	9.8
1972	25.7	..	6.0	..	19.8	..	35.9	..
1977	49.2	18.3	13.4	24.7	21.9	2.1	61.5	14.3
1982	71.5	9.1	21.1	11.5	49.7	25.2	67.3	1.9
1985	81.1	4.5	24.0	4.6	51.8	1.4	72.2	2.5
1988	126.5	14.9	25.7	6.8	61.7	6.0	97.8	10.6
Manufacturing Sector								
1950	0.3	..	0.6	..	0.8	..	2.1	..
1955	0.6	20.0	1.1	17.0	1.5	17.5	3.5	13.3
1957	0.8	17.0	1.4	13.6	1.4	..	3.3	4.4
1962	2.1	32.5	2.8	20.0	2.1	10.0	6.2	8.2
1967	4.9	26.2	5.0	15.7	3.9	17.1	9.0	9.0
1972	15.6	..	1.9	..	6.4	..	14.0	..
1977	27.4	15.1	3.1	12.6	11.3	15.3	20.0	8.6
1982	34.1	4.9	3.7	3.9	18.7	13.	26.4	6.4
1985	41.8	7.5	3.5	-1.8	18.8	0.2	30.2	4.8
1988	65.4	15.2	2.5	9.8	24.7	9.6	40.9	10.3
Services Sector								
1950	0.1	..	0.2	..	2.0	..	1.1	..
1955	0.2	20.0	0.3	5.0	2.5	5.0	1.7	10.9
1957	0.2	0.0	0.4	6.0	2.8	6.0	2.5	23.5
1962	0.5	30.0	1.1	1.4	3.0	1.4	3.4	7.2
1967	1.2	28.0	3.0	6.0	3.9	6.0	6.0	15.3
1972	4.4	..	2.8	..	4.9	..	9.4	..
1977	10.7	28.6	7.8	14.7	8.5	14.7	22.9	28.7
1982	21.7	20.6	12.0	18.4	16.3	18.4	22.1	-0.7
1985	23.5	2.8	14.6	2.9	17.7	2.9	22.7	0.9
1988	45.4	23.6	17.6	7.3	21.9	7.3	35.0	16.7
* 1988 is EC-12; 1972-1977 is EC-9; 1950-1967 is EC-6								
Source: United Nations Corporations and Management Division (1993)								

In 1957-1967 period, the amount of average annual US investments in EC has increased 22,7 per cent while the rate of increase in US investments to other European countries and to the developing countries were 19,9 per cent and 7,5 per cent consecutively. The share of EC in US foreign investments has also shown a stable increase in this period. That the share of developing countries in US foreign investments has clearly decreased in 1957-1977 period and began to show a tendency to increase again in early 1980's, is a sign of the investment diversion effect of EC on the FDI towards developing countries (see table below).

Table 5: Breakdown of US FDI Stock in EC and other Countries (%)					
	EC	Other Europe	Developing Countries	Other Countries	Total
All Sectors					
1950	5.4	9.3	48.7	36.6	100
1955	6.1	9.4	41.5	43.1	100
1957	6.6	9.7	40.6	43.0	100
1962	10.0	14.0	34.0	42.1	100
1967	14.4	17.9	26.4	41.4	100
1972	17.5	18.8	22.7	41.1	100
1977	33.7	9.2	15.0	42.1	100
1982	34.1	10.1	23.7	32.1	100
1985	35.4	10.5	22.6	31.5	100
Manufacturing Sector					
1950	8.3	16.1	22.1	53.6	100
1955	9.1	16.4	22.2	52.3	100
1957	10.4	17.0	17.7	54.9	100
1962	15.9	21.0	16.0	47.2	100
1967	21.5	21.8	17.1	39.7	100
1972	25.3	21.1	16.8	36.8	100
1977	44.3	5.0	18.3	32.4	100
1982	41.1	4.5	22.6	31.8	100
1985	44.3	3.7	19.9	32.0	100
Services Sector					
1950	3.1	6.9	58.3	31.7	100
1955	3.8	7.1	53.1	36.6	100
1957	3.9	6.9	47.5	41.6	100
1962	6.6	13.4	37.8	42.2	100
1967	8.7	20.9	28.7	42.6	100
1972	10.7	22.8	28.2	43.7	100
1977	21.4	15.6	17.0	55.9	100
1982	30.1	16.6	22.6	30.7	100
1985	29.9	18.6	22.5	28.9	100
* 1988 is EC-12; 1972-1977 is EC-9; 1950-1967 is EC-6					
Source: United Nations Corporations and Management Division (1993)					

In line with the predictions of the theoretical approaches, it is seen that the REI effect on FDI is more explicit for manufacturing sector. In 1957-1962 period, the rate of the increase in investments in EC manufacturing sector has increased from 17 per cent to 32,5 per cent. That the share of this sector in US manufacturing sector has doubled in this period is a concrete reflection of REI effect.

While 35 per cent of the US investments in Europe were towards EC countries and 47 per cent as towards England who was not a member of EC in 1950, in 1967 these shares were 49 per cent and 31 per cent respectively. These numbers show a change in the distribution of investments of US investors in Europe after the REI. But it is not possible to identify how much of this change is a result of the REI which followed a discrimination policy towards

third countries and how much is related with the higher growth rates⁹⁴ of EC countries than England.⁹⁵

In 1957, the sales of the affiliate companies of US TNC's in Europe has sold 85 per cent of their products in the regional market, exported 1 per cent of them to US and 14 per cent to other foreign countries. This distribution shows that the investments of US in EC were aimed at regional market⁹⁶. Despite these indicators implies that FDI in this period was mainly tariff jumping, the probable increase in the efficiency of the integration market can be an important factor that attract foreign investments.

Studies demonstrated that in this period intra-regional investments (FDI among member countries) were less than investments made by US and other third countries. 75 per cent of the total FDI in the region has been made by third countries. Within the same period 85 per cent of the foreign investments of the member countries have been directed towards third countries⁹⁷.

According to the data collected, it is understood that within the period of 1960-1970, a large amount of the foreign investments made by Japanese investments were based on natural resources and oriented to developing countries. Since Japan did not have too much foreign investment in other countries during this era when REI came on the scene, it is not possible to make a comparison. However, within the period of 1951-1970 the share of the EC in the foreign investments of Japan, which consist a sum of \$ 628 million, was 17 per cent⁹⁸.

Within the period of 1972-1984, in line with the global increase in the foreign investments of Japan, the investments in EC have also increased in quantity but decreased proportionally. Only 11.4 per cent of the Japanese foreign investments which consisted of a sum of \$ 8.178 million have been directed towards EC. Within the same period Japanese investors focused on the investments towards peripheral countries in Asian region and US⁹⁹. The fact that the share of the Japan within existing investment stocks of member countries

⁹⁴ While the average growth rate of UK is was 4.9 per cent, the EC was recorded 9.1 per cent in the 1957-1967 period.

⁹⁵ UN-TCMD (1993), p.29

⁹⁶ UNCTAD (1996b), p.107

⁹⁷ Molle and Morsink (1991)

⁹⁸ Balasubramanyam and Greenaway (1990), p.178

⁹⁹ UN-TCMD (1993), p.49

were considerably low, display clearly recent acceleration of the Japanese investment activities in EC market (see Table-6).

3.2.2. The Period from the Single Market until the end of 2002

3.2.2.1. The Single Market

Despite the great efforts for the formation on an economic integration from the early 1960s, capital movements, intra-European trade in both goods and services, and free movement of person around the Community for work or leisure purposes were still restricted by numerous non-tariff barriers. In 1985, an internal market programme was initiated by the European Commission in order to establish a well-operated single market and to eliminate all remaining non-tariff barriers between the member countries by the mid-1990s.

The main fact determining the FDI in the EC in the post 1985 period is the Single Market programme that was decided to be completed in 1992. The most impressive motive behind the establishment of the Single Market is to increase the competition capacity of Community TNCs against the US and Japan TNCs rather than increasing the FDI in the region¹⁰⁰.

However, the removal of non-tariff barriers in the intra-community trade and the decreasing of production costs by the free movement of production factors have not yield expected results for the increasing of competition capacity of the Community TNCs'. The completion of the Single Market facilitated the new investments from third country investors and the reconstruction and rationalization of the decisions for the existing investments.

The third country TNCs had a two dimensioned trend towards EC market concerning a "European Fort" is being constructed. These are the protection of the existing market share and increasing the market share in order to maximum facilitates the integration market facilities¹⁰¹.

¹⁰⁰ UN-CTC (1990)

¹⁰¹ Bürgermeier and Mucchielli (1991) pp.82-115

Table 6: Breakdown of Intra-regional and Third Countries Investments to EU Countries* (%)														
Investor Country	Germany	Austria	Belgium / Lux.	Denmark	Finland	France	Nether.	UK	Ireland	Spain	Sweden	Italy	Portu.	Greece
Home Country														
Germany		34.8	19.7	9.9	5.6	11.0	11.7	4.7	8.3	10.7	6.8	7.7	8.7	8.7
Austria	2.1		0.7	0.1	0.0	0.0	0.5	0.2	0.2	0.1	-	0.5	0.2	-
Belg./Lux.	3.9	0.7		4.6	5.6	9.7	12.6	1.7	1.2	4.6	-	9.6	4.2	10.3
Denmark	1.3	0.6	0.2		10.5	0.3	0.6	0.8	0.4	0.5	5.1	0.1	1.5	0.9
Finland	0.7	0.2	1.3	2.9		0.7	0.7	0.3	0.0	0.5	9.7	0.2	1.0	0.1
France	8.2	4.1	25.9	6.1	1.4		4.1	6.3	2.2	15.9	1.7	13.6	14.8	9.6
Netherlands	22.3	7.0	18.6	10.1	14.1	16.4		15.6	2.8	15.4	30.2	10.4	5.4	15.8
UK	7.8	4.2	3.8	17.5	3.6	14.4	15.4		10.8	10.0	7.4	11.4	20.0	9.3
Ireland	0.2	-	0.6	0.6	-	0.3	0.7	0.7		0.5	-	0.0	0.9	0.1
Spain	0.4	2.5	-	-	-	1.1	0.2	0.1	0.1		-	0.3	15.0	0.5
Sweden	2.6	1.6	0.2	20.7	20.4	3.5	3.9	1.5	2.0	0.9		2.9	1.5	0.5
Italy	1.2	3.9	3.0	0.3	0.0	8.2	0.2	0.5	0.3	4.7	-		1.4	22.0
Portugal	0.0	-	0.1	-	-	0.1	0.0	0.0	-	1.3	-	0.0		-
Greece	0.0	-	-	-	-	0.0	0.0	-	-	0.0	-	0.0	-	
EU-15	50.7	59.6	74.1	72.8	61.2	65.7	50.6	32.4	28.3	65.1	60.9	56.7	74.6	77.8
US	25.7	6.1	14.4	5.2	10.4	18.4	21.3	41.3	57.6	6.9	9.1	15.4	4.3	3.4
Japan	6.0	2.9	4.6	0.7	0.0	2.3	3.3	4.4	5.6	2.7	-	1.9	1.3	0.2
Other	17.6	31.4	6.9	21.3	28.4	13.6	24.8	21.9	8.5	25.3	30.0	26.0	19.8	18.6
TOTAL	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: OECD (1996), International Direct Investment Yearbook

*End of 1994; net foreign investment stock of home countries

"0.0" refers minor values

Single Market affected particularly the Japanese TNCs which intensified their investments in the EC Market especially in the second period of 1980s. The Japanese foreign investments in the EC between 1985-1988 have reached a total amount of 21 billion dollars. The most obvious increases have been realized in 1987. The total amounts of investments in 1987 have exceeded the total amount of investments realized in the previous years. The Japanese TNCs had some advantages comparing with the US TNCs while entering in the EC market. The US TNCs have faced the problems of reconstruction during the process of the completion of the Community because they exist in the Community for long periods. On the other hand, the Japanese TNCs took the advantage of determining their investment strategies according to the conditions of the integration region market in which they first penetrate¹⁰².

Japanese companies have realized defensive and offensive investments substituting export, and rationalized existing investments against Single Market initiative of the EC. The motivation behind defensive investments was the concern that EC might impose protective measures against third countries whereas the main incentive for the other two investment strategy was the expectation that Single Market would increase the advantages of integration market.

Japan Honda Company's experiences in motorcycle production in the EC market constituted a good example for the accelerating rationalization strategy in the Single Market transition period. Since 1961 the Company strived to obtain a share in the market through exportation. However, parallel to the increasing influence of REI in production, the Company established a regional organizational structure. In 1961, Honda made its first investment in Germany for the post-sale services, and immediately after one year an assembly plant was set up in Belgium producing specific models for the regional market. The success of these investments in both sales and marketing in the region and local employment and also facilitating the integration market's cost reducing advantages stimulated further investments in Italy (1977) and in Spain (1987). In spite of the fact that different models were produced in these plants; these investments established a regional integration besides partnerships have been exercised with local producers when required. For example; Honda acquired a 25 per cent share in French Peugeot Motorcycles, and installed the motors produced in France on the primary models produced in Italy. In the following years, each plant has expertised in

¹⁰² JETRO (1989)

different models and benefited the economies of scale while marketing all the models in each point of EC market with interactive stock and goods exchange within each other. Thus, common distribution and marketing facilities have been created¹⁰³. The liberalization of investment and trade within the EC has played an essential role in shaping the vertical and horizontal organization of the Company in the EU according to the conditions of the integration market.

In the transition period of the EC to the Single Market, the Japanese TNCs like Sony, Toshiba and Nissan have increased their investments by implementing different combinations of strategies towards REI¹⁰⁴. According to a survey of JETRO aiming to understand Japan TCNs approaches to the REI's, the EU region is still being considered as the most profitable investment area when considered with other regional integration areas. Table 8 indicates that despite growth of market was the leading factor, the decrease in the costs of production due to regional integration was also an important one. This implies that efficiency seeking FDI's have been trying to benefit from the cost advantages stemming from integration market.

Table 7: The Attitudes of Japanese TNCs towards REI										
	Number of Firms in the Survey		Enlargement of Market		Decrease in Cost of Production		Increase in exports to regional market		Others	
	Nu.	%	Nu.	%	Nu.	%	Nu.	%	Nu.	%
-The advantages of REI	324	100	178	54.9	118	36.4	24	7.4	4	1.2
	Number of Firms in the Survey		AFTA		NAFTA		EU		Others	
	Nu.	%	Nu.	%	Nu.	%	Nu.	%	Nu.	%
-Which of REI is more advantageous?	61	100	18	29.5	23	37.7	31	50.8	5	8.2
	Number of Firms in the Survey		Re-organisation of affiliates in EU, North America and Asia		Increase domestic production		Investment in regions		Others	
	Nu.	%	Nu.	%	Nu.	%	Nu.	%	Nu.	%
-Plans regarding REIs	266	100	80	30.1	123	46.2	49	18.4	14	5.3

Source: JETRO (1997), Survey of State of Export and Import Activities of manufacturers Accompanying Overseas Investment

¹⁰³ UNCTAD (1996b), p.101

¹⁰⁴ Morrison (1992), pp 37-55

The effects of single market on the US investments were mostly recognised as the increase in the re-structuring investments. In this period, as table 6 indicates that the share (ratio) of EC in US foreign investments was increased. However, the volume of increase in this period was not so large as the increase during the early years of regional integration due to re-structuring existing investments in EC. The US origin TNCs in EC reorganised the regional diversification of their investments in order to achieve rationalisation and specialisation in regional production¹⁰⁵. For instance, Procter & Gamble, one of leading firms of US in chemicals, formed Euro-Mark teams responsible for gathering specific categories of products in determined centres to accelerate process of rationalisation and coordination in the accession to single market¹⁰⁶. Therefore, in general, it can be seen from the strategies of the TNCs in EU, the improved market accessibility resulting from the implementation of single market have been increasingly encouraging companies, no matter they are EU or non-EU originated, to adapt a pan-European view.

However, one thing is clear that foreign companies followed different strategies, depending to the ownership, the different length of time the company had been established in the EU, and the particular competitive position covered within the EU, in response to the progress achieved during the implementation of single market. As in the example of the US TNCs, strategies pursued by the US companies during the period between 1957-1985 were mainly characterised by defensive import-substituting FDI undertaken to preserve market shares already acquired through trade servicing of EU markets. The result was an increase in the degree of corporate integration by US companies. During the period after 1985, restructuring of marketing and distribution activities were predominant. Therefore, by the end of the 1980s US companies in EU - also other TNCs - adopted a single market strategy in their strategic plans undertaking large corporate restructuring¹⁰⁷.

When we came to year 1993, it can be realised that the investments are becoming export oriented rather than market oriented as a result of increasing production efficiency and rise of exports up to 31 per cent to third countries from some of the firms of US companies located in Europe¹⁰⁸. US investors in EU market started to give importance to strategic asset

¹⁰⁵ Dunning (1993), pp. 490-98

¹⁰⁶ UNCTAD (1993), p.130

¹⁰⁷ Clegg, J. (1996), "US FDI in the EU – The Effects of Market Integration in Perspective" in F. Burton, M. Yamin and S. Young (eds.), *International Business and Europe in Transition*, New York: St. Martin Press

¹⁰⁸ UNCTAD (1996b), p.107

seeking investments contributing to international competitive power as much as efficiency seeking foreign investments. This can be understood from the big share of Germany and England, which have international competitive power, within total FDI in EU (see table 7). The relatively low wages in Ireland has affected the share of US in Ireland's total foreign direct investment¹⁰⁹.

Rationalization and rebuilding activities in current investments have strategies followed by EC multinational companies during transition to single market as much as third countries. The share of intra-regional investments within total external investment of member countries in 1980 was 25 per cent whereas this ratio has increased to 40 per cent in 1988 with the expectation of single market¹¹⁰. Holland-England co-owned Unilever's re-shaping of soap production with a regional perspective, French Thomson Company's structuring of an horizontal organization among production units involved in TV production aiming specialization in production and German Hoechst Company's structuring of a vertical organization based on functional division of labour are important examples showing the effects of regional economic integration on FDI¹¹¹.

Even not intensified as it was in the Single Market process, the production rationalization of the regional TNC's in the EU continues as the integration market creates new cost advantages. For instance, the British illumination tools manufacturer TLG Company re-organised to offer standard products to the whole EU market by changing its production structure into vertical integration in order to benefit from the cost advantages due to the harmonization of the standards and increase in the similarity of the customer preference in the EU¹¹².

In 1994, there has been a substantial decrease in the FDI amount in the big economies of the EU. The social regulations of the EU, difficulties introduced by the hard labour laws and the decrease in the competitive power due to high wages are the main reasons of this development. High tax rates of Germany and the revaluation of the Deutsch Mark are the other factors affecting the decrease in the FDI. Some member countries have partially lost their positional advantage due to similar reasons. Although 1995 was a year that the FDI

¹⁰⁹ Mendes (1987), pp. 86-87

¹¹⁰ UN-CTC (1991), p.33

¹¹¹ UNCTAD (1993), p.132

¹¹² Rich (1997)

amount seems increasing in figures, this was mainly due to large-scale mergers and acquisitions (this issue will be discussed in the forthcoming sub-chapter). As it is seen, if the REI deepens and the integration much more affects the social policies, REI may also create negative effects on FDI.

Form 1996, there has been observed an increasing trend in the FDI inflows to EU. Between 1996 and 2000, EU FDI inflows grew at an average annual compound rate of 33 per cent. Although this was less than the 41 per cent growth recorded for outflows over the same period, it was equally well regarding the record in the recent past. Mainly led by US companies, growth of EU inflows had a record year in 1998 as 126 per cent and a second peak of 59 per cent in 2000.

1 January 1999 was another milestone of the European economic integration after the completion of the single market. Twelve¹¹³ EU countries agreed to create a monetary area in which they adopt a single currency, namely “Euro”,. The adoption of the Euro as a single currency is a further stage of the economic union and has further deepened the level of economic integration among the member countries.

Economic theory clearly predicts a positive impact of the single currency on both trade and foreign investments flows between member countries of economic and monetary union (EMU). The adoption of single currency allows to remove the transaction costs stemming from conversion charges on the exchange rate market, hedging against currency fluctuations, in-house costs associated with management of multiple currencies and banking charges on cross-border payments. In 1990, the costs of these transactions in EU were estimated at about 0.3-0.4 per cent of GDP in the EU as an average. In addition, single currency also enhance the level of stability of exchange rates and foster price transparency in the regional market. In this context, the adoption of the single currency by twelve EU member countries may be considered as a crucial complement to the EU’s single market¹¹⁴.

However, the empirical literature on the effect of EMU on the FDI flows to EU is so sparse contrary to the research on the impact of the single market on EU FDI flows. In contrast, the link between FDI and exchange rate uncertainty has generated a relatively large

¹¹³ UK, Denmark and Sweden are the EU countries that are not involved in EMU.

¹¹⁴ CEC (2003), Quarterly Report on the Euro Area, III/2003, p.18

empirical literature. Although most of the studies¹¹⁵ conclude that the decrease of volatility in exchange rates boost foreign investments flows, it cannot be so easy to provide a link between the relation of uncertainty exchange rates and investment flows¹¹⁶.

The late 1990s have seen a substantial increase of FDI flows to and from the euro area. According to the Eurostat, annual outward FDI flows from the Euro-Area countries rose from 110 billion euro in 1996 to nearly to 680 billion euro in 2000. The record was more remarkable in the case of inward FDI flows which multiplied 11-fold over the same period, increasing from about 60 to 690 billion euro¹¹⁷. The analysis of inward FDI flows indicates that the euro area became a comparatively more attractive location for foreign investment in the late 1990s. During this period, the share of inward FDI in GDP increased more rapidly in the euro area than in the US and, to a lesser degree, in the UK. The share of the inward FDI in GDP remained sizeably higher in the euro area in 2001, at 4.7 per cent compared with 3.7 per cent in the UK and 1.2 per cent in the US¹¹⁸.

It can be argued that regarding the recent FDI flows into the euro area the attractiveness of the euro area as a destination for foreign investment has increased significantly since the launch of the single currency, euro. However, FDI is determined by a large number of factors among which the degree of a positive effect of EMU is difficult to assess.

3.2.2.2. Mergers and Acquisitions in the European Union

The effects of regional integration in Europe on foreign direct investments in the member countries become more concrete after the finalisation of the Single European Act in 1992. During the 1990s, the TNCs (origination from both member countries and third countries) in the integration market had to review their organisational structures due to the impact of the efforts for the establishment of a common market. The progress in technology

¹¹⁵ As the studies of Molle, W.T. and Morsink, R.L.A. (1991a), Intra-European direct investment, in B. Bürgenmeier and J.L. Mucchielli (eds.), *Multinationals and Europe 1992*, London:Routledge and Barrel, R., Gottschalk, S.D. and Hall, S.G. (2003), "Foreign direct investment and exchange rate uncertainty in imperfectly competitive industries", National Institute of Economic and Social Research, Discussion Paper, No.220

¹¹⁶ As in the studies of Goldberg, L.S. and Kolstad C.D. (1995), "Foreign Direct investment, exchange rate variability and demand uncertainty", *International Economic Review*, 36 (4), pp. 855-73 and De Menil (1999), "Real capital market integration", *Economic policy*, 28, pp. 167-89

¹¹⁷ CEC (2003), *Quarterly Report on the Euro Area*, III/2003, p.23

¹¹⁸ *ibid.*, p.25

and increase in competition in this period led to important changes in the structure of FDI flows coming from third countries. In order to overcome the competitive power of domestic competitors in the common market, TNCs' tendencies towards mergers and acquisitions (M&A) were enormously increased. The strategic asset seeking nature of the FDIs in EC during this period had an important role in this change.

Table 8: Breakdown of Total M&A into Domestic, Community and International Operations (%)					
	Domestic	Community	International	Bidder Unknown*	Total
1991	54.3	11.9	14.5	19.3	100
1992	58.1	11.6	14.2	16.1	100
1993	57.4	11.7	18.8	12.1	100
1994	58.7	12.9	20.5	7.9	100
1995	57.4	12.9	22.8	6.9	100
1996	54.8	12.6	26.0	6.6	100
1997	56.0	14.0	26.0	4.0	100
1998	53.5	14.1	28.4	4.0	100
1999	55.7	14.2	26.4	3.7	100
2000	54.7	15.2	25.4	4.7	100
2001	54.1	14.9	24.1	6.9	100

Source: European Commission Directorate-General for Economic and Financial Affairs (EC) (2001), European Economy; Supplement A Economic Trends, No:12, December 2001

The number of M&As were substantially increased from the first efforts for the establishment of the Single Market in 1986. Since 1992, there has been a strong upward trend in M&As operations of TNCs. As it can be seen from the Table-8 the share of International operations increased rapidly up to 1998. In 2001 International operations reached to about a quarter of the total. The Single Market has not only encouraged the M&As operations resulting from third countries but also boosted the domestic and Community M&As operations. Domestic operations account for more than half of the total. Although the share of these operations rose substantially in the first half of the 1990s, it had fallen back to its initial level by the year 2000. The proportion of Community operations has increased quite steadily to reach about 15 per cent in the last two years. All three types of operation reached their peak, in terms of numbers, in the year 2000. The world-wide economic slowdown in 2001

was reflected in a sharp downturn in all types of operation¹¹⁹. The distribution of total M&A activity in the period 1991- 2001 between the Member States is shown in Table-9. The U.K. accounts for by far the largest proportion, followed at some distance by Germany and France and then by the Netherlands and Italy.

	Bel.	Den.	Ger.	Gre.	Spa.	Fra.	Irl.	Ita.	Lux.	Net.	Aust.	Por.	Fin.	Swe.	Bri.
M&A Activity in EU	2.83	2.55	16.28	1.12	5.00	13.5	1.68	6.23	0.48	6.45	2.09	1.21	3.85	5.34	31.39

Source: European Commission Directorate-General for Economic and Financial Affairs (EC) (2001), European Economy; Supplement A Economic Trends, No:12, December 2001

	Domestic Operations	Community Operations	International Operations	Total
EU-15	70.8	18.7	10.5	100
Germany	79.5	12.3	8.2	100
Austria	22.4	65.7	11.9	100
Belgium	60.2	31.9	7.9	100
Denmark	67.0	22.0	11.0	100
Finland	78.8	14.4	6.8	100
France	66.0	24.5	9.5	100
The Netherlands	57.9	30.5	11.7	100
Britain	73.8	12.9	13.3	100
Ireland	36.9	49.0	14.1	100
Spain	80.9	11.5	7.6	100
Sweden	56.8	29.4	13.7	100
Italy	77.8	14.9	7.3	100
Luxemburg	2.0	86.1	11.9	100
Portugal	64.9	35.1	0.0	100
Greece	73.1	19.2	7.7	100

Source: European Commission Directorate-General for Economic and Financial Affairs (EC) (1996), European Economy; Supplement A Economic Trends

¹¹⁹ European Commission Directorate-General for Economic and Financial Affairs (EC) (2001), European Economy; Supplement A Economic Trends, No:12, December 2001, p.5-6

Table-10 shows, for each Member State in the period 1990-1995 (the period just after Single market), the distribution of the number of operations between Domestic, Community and International transactions targeting firms in the member countries. The share of domestic operations was comparatively high (over 50 per cent) in most of the member countries, thus it was clear that the M&As for rationalisation of production in this period were mainly national character. As it can be seen in the Table-10, the M&As in Spain, Germany and Finland were mainly achieved among firms in national level. Intra-regional M&As were mainly concentrated in Luxemburg, Ireland and Austria. International operations account for between 7 per cent and 15 per cent in most member countries. The share of international operations was highest in Ireland (14.1 per cent) and Sweden (13.7 per cent) and lowest in Portugal (0 per cent).

Table 11: Growth Rates of numbers of Operations in Euro-zone and Other Member Countries (%)				
	Domestic Operations		Cross-Border Operations	
	EUR-12	Others	EUR-12	Others
1992	3.4	-3.5	5.9	-25.4
1993	-22.5	4.6	-8.9	22.3
1994	-0.8	14.6	12.1	8.4
1995	8.8	3.7	9.0	7.0
1996	-17.3	-7.2	-1.7	-4.6
1997	3.9	20.7	16.0	25.5
1998	4.3	17.0	9.9	26.2
1999	50.4	14.3	12.3	6.3
2000	19.9	8.3	14.4	18.0
2001	-29.3	-21.1	-24.0	-30.5
<i>Source: European Commission Directorate-General for Economic and Financial Affairs (EC) (2001), European Economy; Supplement A Economic Trends, No:12, December 2001</i>				

Besides the effects of Single Market, it needs to be compared the growth rates of the domestic and cross-border M&As operations in Euro-zone and in other member countries in order to evaluate the effects of European Monetary Union (EMU) on M&As operations of TNCs. Table-11 shows that the number of domestic operations grew much more rapidly in the Euro-zone than in the other member countries in the first two years of EMU, but also fell

much more steeply in 2001. The same is true of cross-border acquisitions made by EUR-12 firms. Cross-border operations with a target in EUR-12 showed a higher growth rate in 1999 but grew less than cross-border acquisitions of firms in the other Member States in the following year and also declined less in 2001. From this evidence, it does not appear that EMU has made euro-zone companies more attractive for cross-border acquisitions. On the other hand, the rapid rise in domestic and cross-border acquisitions made by EUR-12 firms in 1999-2000 may be evidence that the greater integration of financial markets in EMU has made it easier for firms in the Euro-zone to raise the capital needed to launch takeover bids¹²⁰.

Table-12: Breakdown by Foreign Countries of International Operations with an EU Target, 2000-2001 (%)

Bidder Country	Bel.	Den.	Ger.	Gre.	Spa.	Fra.	Irl.	Ita..	Lux.	Net.	Aust.	Por.	Fin.	Swe.	Bri.	EU-15
US	60.8	37.0	55.2	16.7	55.9	60.5	69.2	63.4	26.7	61.4	33.3	23.3	44.1	47.8	67.5	58.6
Switzerland	17.6	8.6	24.1	6.7	15.7	16.7	1.5	15.7	20.0	10.0	31.1	26.7	11.9	7.8	3.4	11.6
Norway	6.8	33.3	3.7	3.3	0.0	4.2	6.2	1.3	0.0	2.9	2.2	0.0	25.4	31.1	2.2	6.4
Canada	4.1	6.2	2.4	0.0	2.9	6.5	9.2	2.0	6.7	7.1	8.9	13.3	3.4	3.3	5.7	4.9
Japan	2.7	3.7	2.9	0.0	6.9	4.2	3.1	4.6	0.0	5.0	2.2	0.0	3.4	1.7	2.4	3.1
Australia	4.1	0.0	1.9	6.7	2.0	0.8	1.5	1.3	0.0	2.9	4.4	10.0	0.0	1.7	3.7	2.5
S.Africa	0.0	0.0	1.3	0.0	1.0	0.0	3.1	0.0	0.0	0.7	2.2	0.0	0.0	0.6	3.4	1.6
Israel	0.0	0.0	1.6	0.0	2.9	1.5	0.0	2.6	0.0	1.4	2.2	0.0	0.0	0.6	1.7	1.5
Other	4.1	11.1	6.9	66.7	12.7	5.7	6.2	9.2	46.7	8.6	13.3	26.7	11.9	5.6	10.0	9.7
Total	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100

Source: European Commission Directorate-General for Economic and Financial Affairs (EC) (2001), European Economy; Supplement A Economic Trends, No:12, December 2001

There were nearly 2,500 acquisitions of EU firms by non-EU companies in the period 2000-2001. Table-12 gives a breakdown by Member State of the M&As made in that period by the main extra-EU countries. The US is the main source of operations for M&As, with nearly 60 per cent of the total. US companies account for particularly large shares of international acquisitions in Ireland and the UK, probably because a common language and similar legal systems are important factors influencing cross-border M&A. Switzerland ranks second as a third country with nearly 12 per cent, followed at some distance by Norway and Canada.

¹²⁰ *ibid.*, p.6

3.2.2.3. Foreign Direct Investments in EU after the Membership of Spain, Portugal and Greece

The southern enlargement of the EU was accomplished when Spain and Portugal joined the Union by the year 1986, following the membership of Greece in 1981. The statistics regarding FDI flows to these countries reveal that there was a tremendous increase in inward FDI flows after the EU membership compared to pre-accession period. As can be seen from the Table-13 that there was a substantial increase in the FDI inflows into Spain in the year of accession. While the average FDI levels of inflows were around 1.5 billion \$ per year between 1980-1985, in 1986 it was recorded as 3.5 billion \$. It was observed that the accession to the EU was impulsive the inflows of FDI to Spain. In 1992, after a continuing increase, the levels of FDI inflows were reached to 13 billion \$. However, a decline in the levels of FDI inflows were observed by 1993. The trend started to increase again in 1997 reaching an average of over 25 billion \$ between the years 2000-2002.

As in Spain, FDI inflows into Portugal started to increase by the accession to the EU. Although the level of inflows reached over 2 billion \$ in 1991, in the following years there were a decrease nearly two-fold. 1995 was a turning point and the inflows started to increase again. After 2000, the inflows reached over 6 billion \$ implying a historical record from the accession.

Greece was experienced the poorest record among the South European countries that became members in the 1980s. While the level of FDI inflows were around 500 million \$ in the year of accession to the EU, the average levels of inflows after the accession were remained around only 1 billion \$.

These countries were far behind the development levels of current member countries when they joined to the Union. The development gap by the membership of new countries in the region resulted in investment diversion effects. As it is mentioned before, the differences in the levels of economic development among the member countries is one of the fundamental factors of regional integration that causes investment diversion. The extent of investment diversion from the developing countries outside the region stemming from the accession of Spain and Portugal to the EU has been evaluated by various studies. Especially, the comparison between the US FDI in these countries and North African countries, which are

geographically very close to Spain and Portugal, during the period 1977-1989 shows that there was an enormous shift in the level of FDI inflows. The US inflows to North African countries decreased by 300 per cent during 1984-1986 and 100 per cent during 1987-1989 which was recorded the same levels before the accession of Spain and Portugal to the EU. The stability of FDI inflows in other developing countries in the same period is an important factor indicating investment diversion¹²¹.

In the early years of EU membership, most of the foreign direct investments to Spain and Portugal were originating from neighbouring member countries. Especially, the French investments were in a substantial level when compared to German, Japanese, British and US investments¹²². The cost advantages of these countries in labour prices, transportation, environment taxes were the main locational advantages promoting resource seeking foreign direct investments.¹²³ Especially, due to the low labour costs, a shift in the investments of other member countries to Spain was occurred. Spanish accession to the EU was led to a re-organisation of investments by the other member countries (especially Germany and France). This can be seen from the increase in the volume of foreign investments in manufacturing sector such as automotive and chemistry where Spain has cost advantages comparing with other member countries¹²⁴.

The comparative advantage of Spain in the sectors such as automotive and chemistry increased the motives of efficiency seeking FDI the end of 1980. Economics of scale providing through high productivity in these sectors encouraged the intra-regional investment to search for mergers and acquisitions. The partnership between French Renault and American Ford and General Motors in 1987, the acquisition of Spanish Iberica Motors by Nissan, and Seat by Volkswagen were some of the famous examples in automotive sector. The acquisition of Antibiotics, one of the biggest Spanish company, by Italian Montetison was the most important one¹²⁵.

¹²¹ UN-TCMD, 1993, p.40

¹²² Alıcı, M. (1995), "Ekonomik Entegrasyonun İspanya'ya Yönelik Yabancı Doğrudan Sermaye Yatırımları Üzerindeki Etkisi", *Ekonomik Yaklaşım*, Cilt 6, Sayı 16, İlkbahar, p.(s)55-57

¹²³ The average labour costs in Spain were 43 per cent lower than OECD average in 1985 (Alıcı, p.55).

¹²⁴ Alıcı, M. (1995), pp-56-57

¹²⁵ *ibid*, pp.59-60

Table 13 – FDI in Spain, Portugal and Greece

FDI inflows in Spain (millions of dollars)															
Before Accession															
1970-1980	1981	1982	1983	1984	1985	1986									
7275,61	1706,77	1782,69	1622,39	1771,83	1967,8	3450,6									
After Accession															
1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
4570,7	7020,57	8428,38	13983,6	12492,8	13275,7	9681,48	8876,46	6161,15	6584,72	7696,73	11796,7	15758,1	37523,5	28005,1	21193,4

Source: UNCTAD, World Foreign Direct Investment Statistical Yearbook, online version, www.unctad.org

FDI inflows in Portugal (millions of dollars)															
Before Accession															
1970-1980	1981	1982	1983	1984	1985	1986									
896,4	174,49	144,03	146,3	194,6	274,04	238,15									
After Accession															
1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
465,87	921,58	1736,89	2610	2448,5	1873,4	1533,9	1269,7	684,6	1488,24	2476,82	3144,25	1233,5	6787,3	5892,2	4276,4

Source: UNCTAD, World Foreign Direct Investment Statistical Yearbook, online version, www.unctad.org

FDI inflows in Greece (millions of dollars)																
Before Accession																
1970-1975	1976	1977	1978	1979	1980	1981										
300	305	387	428	613	672	520										
After Accession																
1982	1983	1984	1985	1986-1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
436	439	485	447	3818	1135	1144	977	981	1053	1058	984	85,1	571,2	1089,1	1589,34	50,26

Source: UNCTAD, World Foreign Direct Investment Statistical Yearbook, online version, www.unctad.org

3.2.2.4. The Accession Process of the Central and Eastern European Countries and Foreign Direct Investments Flows from the EU

Since the process of transition started in 1989, economic integration between the Central and Eastern European Countries (CEECs) and the EU has proceeded rapidly, with trade and foreign direct investment as the two main instruments of economic integration. The ties between EU and CEECs were greatly fostered by the Europe Agreements, which provide the institutional framework for bilateral relations. The Europe Agreements envisaged a reciprocal free trade in industrial products, by removing all tariffs and quantitative restrictions. In addition to the liberalisation of trade in industrial products, The Europe Agreements also contain steps towards the free movement of services and capital, as well as, commitments by the CEECs to approximate some of their economic legislation to that of the EU¹²⁶.

Table 14: Candidate Countries' Exports to the EU (million \$)

	1993			1997			2002		
	Total	EU	Share of EU (%)	Total	EU	Share of EU (%)	Total	EU	Share of EU (%)
Hungary	8.1	5.7	70	16,8	11,9	71,2	23.0	16.7	73
Czech Rep.	13.0	6.5	50	20,1	12,1	59,9	26.3	16.3	62
Poland	13.6	9.8	72	22,3	14,3	64,2	30.1	18.3	61

Source: Worldbank (2002), World Development Indicators

Under the Europe Agreements, trade between the EU and the CEECs grew rapidly, showing that quickly after the collapse of COMECON a massive re-direction of trade towards the EU countries has occurred in the CEECs. As their single largest source of trade, assistance and investment, the EU soon became the main economic partner for the countries of the region. Indeed, from the beginning of 1990s, the EU had become the most important market for exports originating in the region, absorbing more than half of the total. By 2003, the EU absorbs over 60 per cent of exports from the CEECs (see Table-14).

The Europe Agreements recognised the associated countries' aspiration to become members of the European Union, an objective that was later confirmed in the individual

¹²⁶ European Commission Directorate-General for Economic and Financial Affairs (EC) (2001), The Economic Impact of Enlargement, Enlargement Papers No:4, June 2001, p.5

applications for membership by these countries¹²⁷. Despite the preparations for the fourth enlargement of the EU¹²⁸, EU quickly responded to the applications of the CEECs for the EU membership. In the Madrid European Council in December 1995, the European Commission was called on to submit an assessment of the candidates' applications for membership, and to prepare a detailed analysis of the eastern enlargement of the EU. In July 1997, the Commission presented Agenda 2000, a single framework in which the Commission outlines the broad perspective for the development of the European Union and its policies beyond the turn of the century; the impact of enlargement on the EU as a whole; and the future financial framework beyond 2000, taking into account the prospect of an enlarged Union. It also included the Commission's opinions on the candidate countries' applications for membership. On the basis of the Commission's evaluations regarding the situation of each country in relation to the accession criteria¹²⁹, the accession negotiations were started with the Czech Republic, Estonia, Hungary, Poland, Slovenia and Southern Cyprus by the decision of the European Luxemburg Summit in December 1997. Two years later, in the Helsinki European Council, negotiations also started with six other candidates, including five CEECs (Lithuania, Latvia, Slovakia, Bulgaria and Romania).

Today, the CEEC countries are in the eve of the EU membership. The negotiations process was completed (except Bulgaria and Romania) and by the 1st of May 2004 these countries will be acceded to the EU. One thing is clear from the beginning that the political will for the membership of the CEECs has been strongly underlined by the EU in every instance. Thus, the confidence for the future accession to the EU created political and economic stability, which is the most important factor in attracting foreign investments. The prospect of being future member of the EU guarantees the investment flow into the area.

Moreover, the progress made in reforms towards a functioning market economy and achieving macroeconomic stability and the investors' confidence in the stability of the regulatory and legal environment have also affected FDI flows. Low labour wages and well-trained labour force offered another advantage for the companies that were willing to

¹²⁷ While Hungary and Poland applied for full membership in 1994, Romania, Bulgaria, Latvia, Slovak Republic, Lithuania and Estonia applied in 1995 and Czech Republic and Slovenia in 1996.

¹²⁸ Austria, Sweden and Finland

¹²⁹ The Copenhagen summit of 1993 acknowledged that CEECs would be able to become full members of the Union provided some specific conditions were fulfilled. The so-called 'Copenhagen criteria' stated that applicants must have stable institutions guaranteeing democracy, the rule of law, human rights and protection for minorities, as well as functioning market economies and the capacity to cope with competitive pressures within the Union and necessary administrative structures to adopt *acquis communitaire* of the EU.

dislocate their factories to take advantage of cost efficiencies. The elimination of tariff barriers created an incentive for foreign investors to locate their facilities in the CEECs. They benefited from the free access into the EU market for industrial goods.

Table 15: FDI Inflows to the CEECs over 1990-2002 (million \$)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	Total
Hungary	311	1462	1479	2339	1146	4453	2275	2173	2036	1944	1957	2599	858	25032
Poland	88	359	678	1715	1875	3659	4468	4908	6365	7270	10000	5713	4000	51098
Czech Rep.	207	400	1004	654	869	2562	1428	1300	3718	6324	4595	5641	9305	38007

Source: World Investment Report 2002; OECD Reviews of Foreign Direct Investment 2001

With the largest population in the region, Poland is the leader with foreign direct investments over 50 billion \$ between the period 1990-2002 (see Table-15). According to the Polish Agency for Foreign Investments¹³⁰, the largest investments were made in food processing, tobacco, car assembly, financial services and retail trade. The foreign companies initially located their companies in Poland to benefit from the growing consumption in the country but they are more likely to use their factories as an export facility towards the European market. The investment of Toyota and Fiat are mainly based on the existing export opportunities into the EU¹³¹. From 2000, over 40 per cent of Polish exports have been realised by foreign firms in Poland¹³².

From 1990 till 2002, Hungary attracted FDI inflows of around 25 billion \$. Foreign-owned companies currently generate about 70 per cent of Hungary's foreign trade. Hungary is the only country in the region that completed its cash privatisation of its telecom, banking and energy sectors. One-third of all FDI has come from privatisation transactions. The private sector currently produces about 80 per cent of GDP. This has resulted in the rapid growth and change in the composition of exports. Therefore, FDI has played a pivotal role in integrating the Hungarian economy into international markets and improving economic performance¹³³.

The inflows of FDI into the Czech Republic has gradually increased in recent years, reaching 38 billion \$ at the end of 2002. With the open investment climate and stable political environment, the continuous growth of FDI inflow is likely continue. FDI particularly has a

¹³⁰ <http://www.paiz.gov.pl/>

¹³¹ OECD (2002), OECD Economic Survey: Poland, 2002, p.23

¹³² <http://www.paiz.gov.pl/>

¹³³ Bevan, A., Estrin, S. and Grabbe, H. (2001), "The Impact of the EU Accession Prospects on FDI inflows to Central Eastern Europe", ESRC One Europe or Several Programme Policy Papers, 2001, pp.3-8

significant effect on the export success of the Czech automotive industry-Skoda Auto. The investment of the Volkswagen Group in the company created the largest firm and the largest exporter in the country¹³⁴. The sale of part of tobacco enterprise to Philip Morris in the early 1990s was another successful privatisation transaction of the Czech Republic. In the mid-1990, Czech government sold an almost 50 per cent share in the petrochemicals sector to an Agip/Shell/Concoco consortium and a 27 per cent share in SPT Telecom to a Dutch-Swiss consortium. In more recent years major privatisation transactions in the banking sector have boosted FDI inflows. The sale of Ceskoslovenska Obchodni Banka to KBC, a Belgian Bank, and the acquisition of the state's 52 per cent share in Ceske Sporitelna, the second largest Czech Bank, by the Austrian Erste Bank are the most important ones¹³⁵.

The European Union Member States were the main sources of FDI for the CEECs from the beginning of 1990s. In 1999, they provided 79 per cent of the total FDI transactions in CEECs¹³⁶. In 1999 stock, EU residents provided 86 per cent of FDI in the Czech Republic, 82 per cent of Hungary and 80 per cent in Poland. In Czech Republic, Germany is the largest investor country accounting for 29.6 per cent of the total investment. It is followed by the Netherlands which covers 27.1 per cent. The share of the US is only 7 per cent in total FDI stock of Czech Republic. As in Czech Republic, Germany is also the leader investor country accounting 24 per cent of total FDI stock in Hungary. The US has an important share by a 14 per cent presence in Hungary. Other EU countries are accounting the rest of the FDI stock in Hungary. In recent years there has been an influx of Japanese investors to Hungary, which is a unique for the other countries in the region. In Poland, Dutch investors held the largest stocks, followed by German and the US. At the end of 1999, more than half of foreign direct investment in Poland was held by these countries: the Netherlands (22 per cent), Germany (20 per cent) and the United States (9 per cent).

As a conclusion, it is evident that the EU accession process have created enhanced credibility in the CEECs thereby eliminating the economic and political risks that might deter the foreign companies' entry into these markets. Moreover, the new environment of commitment to liberal policies with gradual adoption the EU acquis and improved market access enabled the transition economies to attract foreign direct investment to the region and

¹³⁴ OECD (2001), Reviews of Foreign Direct Investment - Czech Republic, 2001, p.12

¹³⁵ op-cit

¹³⁶ EUROSTAT (2002), Foreign Direct Investment in Candidate Countries: Sector and Country Composition, Statistics in Focus: Economy and Finance, p.6

increased their exports to developed countries. In that respect, accession process have played a significant role in terms of liberalisation, private sector development and establishment of macroeconomic stabilisation, which are flourishing the investment environment for foreign investments.

4. TURKEY'S ECONOMIC INTEGRATION PROCESS WITH THE EUROPEAN UNION AND THE CASE FOR FOREIGN DIRECT INVESTMENT

4.1 An Evaluation of Turkey's Competitive Position with Respect to Determinant Motives of FDI

Despite its strong potential, Turkey has not benefited very much from increased FDI flows under globalisation. During early 1970s the total FDI stock of Turkey was only \$ 300 million and up until 1980 the average annual inflow of FDI was around \$ 90 million. From 1980 onwards, a steady increase was observed due to the implementation of a liberal export oriented regime. In the period 1981-1988 the annual average flow of FDI into Turkey was \$ 125 million¹³⁷. In 1990s, there was a tremendous increase in FDI flows to Turkey and from 1995-2000 the average FDI flows were \$767 million net per year, equivalent to about 0,4 per cent of GDP. This percentage places Turkey 81st out of 91 developing and transition countries, where on average the annual inward FDI ratio to GDP is only about 2 per cent¹³⁸. Turkey's annual net FDI inflows have stagnated at the levels of the late 1980s, while worldwide FDI no less than quadrupled over the last decade.

On the basis of past experience, Turkey is not a preferred investment location, which implies that investors consider the investment environment as not sufficiently attractive when compared to what other countries (especially developing countries) offer. However, it is generally accepted by most of the international institutions that Turkey has many advantages to offer foreign investors: a domestic market of nearly 70 million people, proximity to the huge markets of Europe, the Eurasia and Former Soviet Republics, the Middle East and North Africa, low labour costs, a well-educated managerial class, well-operated telecommunications networks, and modern infrastructure. Foreign investors can freely move capital goods, capital, profits, and dividends in and out of the country, and have the same rights, exemptions, and privileges as Turkish investors¹³⁹. In other words, as Balasubramanyam states the advantages introduced by Turkey to foreign investors are much too generous¹⁴⁰.

¹³⁷ Balasubramanyam, V.N. (1995), "Foreign Direct Investment in Turkey", in Balasubramanyam, V.N. and Togan, S. ed(s), *The Economy of Turkey Since Liberalisation*, MacMillian Press Ltd., pp.114-115

¹³⁸ Foreign Investment Advisory Service (FIAS) (2001a), *Turkey: Administrative Barriers to Investment*, June 2001, p.ix

¹³⁹ Loewendahl, Henry and Loewendahl-Ertugal, Ebru (2001), "Turkey's Performance in Attracting Foreign Direct Investment", ENERPI working papers no:8, p.15

¹⁴⁰ Balasubramanyam (1995), pp.112-130

One thing is clear when consider the advantages for FDI of Turkey and its under-performance over the decades, Turkey represents a paradox in case of FDI. This part of the chapter 4, therefore, aims to analyse this paradox through evaluating the locational advantages and disadvantages of Turkey that influence the motives for foreign direct investment (based on the explanations in chapter 2.3.). In order to make a sound assessment Turkey will be compared with those of Spain, Portugal and Greece as EU member countries and Hungary, Poland and Czech Republic as candidate countries in the eve to EU accession (FDI performance of these countries are discussed in chapter 3) . In evaluating Turkey’s advantages and disadvantages by making a comparison with these countries is important to reveal the effects of economic integration with EU which will be discussed in the following part of this chapter.

Table 16: Main Economic Indicators of Spain, Portugal, Greece, Czech Republic, Hungary, Poland and Turkey

Country	Average GDP Growth		Size of GDP in 2002	GDP per Capita		Population in 2002 (millions)
	1980-1990	1990-2001		\$	\$ (PPP)	
Spain	3.1	2.7	649.8	14,430	20,700	41.2
Portugal	3.2	2.7	121.3	10,840	18,000	9.9
Greece	0.9	2.4	132.8	11,660	19,000	10.5
Poland	2.2	4.5	187.7	4,570	9,500	38.7
Hungary	1.3	1.9	65.8	5,280	13,300	10.1
Czech Rep.	1.7	1.2	69.6	5,560	15,300	10.3
Turkey	5.3	3.3	182.8	2,500	7,000	69.6

Considering the “determinant motives for FDI”, Turkey’s situation can be analysed as follows:

Turkey and Market Seeking FDI

Situated at cross-roads of Europe and Asia and a large and evolving market Turkey has many attractions to offer market seeking FDI. With its 69 million population and over \$ 200 million size of GDP, the US Department of Commerce designated Turkey as one of the ten ‘Big Emerging Markets’ along with China, India, Russia and Brazil, which are expected to offer the greatest commercial opportunities due to their high economic growth and rapidly

growing population¹⁴¹. Turkey also was singled out by the UK Government's Export Forum as being one of the twelve international markets that offered significant trade and investment opportunities for British firms¹⁴².

The motives of TNCs regarding the locational advantages of Turkey for FDI are also in accordance with aforementioned views of developed countries. Table-17 implies a survey made in 1996 on 217 multinational firms in Turkey¹⁴³. According to the table the FDI entries until that time were largely market-seeking such that, the market potential of Turkey had the highest priority attached by the firms. Similarly, geographic proximity to other markets was ranked as second, verifying the market seeking tendencies of the investments.

Entry Motives	Rank Order (%)			Total	Rank
	1	2	3		
Market Potential	74.6	23.1	-	97.6	1
Geo. Proximity to Other Markets	14.5	45.5	26.4	86.4	2
Low-Cost – Labour	16.0	38.0	25.0	79.0	3
Entry/presence of Competitor	9.1	37.7	29.9	76.6	4
Governmental Incentives	23.0	32.2	16.0	71.3	5
Low-Cost – Raw Materials	22.2	15.6	26.7	64.4	6
Import Restrictions	8.3	23.3	20.0	51.7	7
Low-Cost Technology	6.9	15.2	18.2	39.4	8
Low-Cost Semi-Fin. –Goods	3.3	6.7	26.7	36.7	9

Source: Erden, D. (1996), "A Survey of Foreign Direct Investment firms in Turkey", Boğaziçi University Press, p.39

Similarly, according to the study of Tatoğlu and Glaister¹⁴⁴ (see Table-18) on 59 wholly-owned subsidiaries and 39 joint ventures regarding the importance of host country locational determinants for foreign equity venture, it is clear that the highest rank for Turkey as a host country is the market potential.

¹⁴¹ Tatoglu, E. and Erdal, F. (2002), "Locational Determinants of FDI In an Emerging Market Economy: Evidence From Turkey", in *Multinational Business Review*, Vol.10, No.1,

¹⁴² Loewendahl, H. and Loewendahl-Ertugal, E. (2001), p.20

¹⁴³ Erden, D. (1996), "A survey of Foreign direct investment firms in Turkey", Boğaziçi University Press, p.39

¹⁴⁴ Tatoğlu, E. and Glaister, K. (2000), *Dimensions of Western Foreign Direct Investment in Turkey*, Quorum Books

Table 18: Relative Importance of Locational Influences of Turkey on Foreign Equity Venture		
Location Influences of Turkey	Rank	Mean*
Market Size	1	4.13
Repatriability of Profits	2	3.83
Growth rate of Turkish Economy	3	3.77
Government Policy toward FDI	4	3.43
Availability of Qualified Local Personnel	5	3.39
Level of Industry Competiton	6	3.29
Purchasing Power of Consumers	7	3.19
Level of Infrastructure	8	3.14
Economic Stability	9	3.12
Political Stability	10	3.05
Availability of Low Cost Inputs	11	3.04
Geographical Proximity	12	2.95
Availability of Good Quality Inputs	13	2.93
Access to Neighbouring Markets	14	2.86
International Transport and Communication Costs	15	2.61
Availability of Tax Advantages	16	2.60
Availability of Incentives	17	2.45
Degree of Unionisation	18	2.07
<i>*Note: The participants of the survey asked to evaluate the importance of locational influences from higher to minor. The Mean refers the average on a scale of 1 (= "of no imporance") to 5 (= "of major importance").</i>		
<i>Source: Tatoğlu, E. and Glaister, K. (2000), Dimensions of Western Foreign Direct Investment in Turkey, Quorum Books, p.15</i>		

Turkey and Efficiency-Resource¹⁴⁵ Seeking FDI

The locational advantages resulting from low costs of assets, raw materials, other inputs for production and intermediate goods are the main factors that affect resource seeking FDI, on the other hand, availability of skilled work force, costs of resources and assets adjusted for labour productivity, quality of inputs such as transport and intermediate goods and access to regional integration market for economies of scale are the main determinants of efficiency seeking FDI. The Turkish labour market is regarded as being productive, flexible, business-oriented and cost effective. According to a survey of Pricewaterhouse Coopers (PWC) Turkey offers “a dynamic and challenging business environment in a rapidly changing market place...The workforce is highly motivated, disciplined and trainable.”¹⁴⁶

¹⁴⁵ For practical reasons efficiency seeking and resource seeking FDI are discussed together in this part. Main reason for this is that most of the important components of resource seeking (e.g. raw materials, low costs of production etc) are also in parallel with the motives of efficiency seeking FDI.

¹⁴⁶ PricewaterhouseCoopers (1999), Doing Business and Investing in Turkey, p.26

Inexpensive labour rates make Turkey highly competitive with other emerging markets, as well as with the rest of the world. Moreover, there is an increasing emphasis on quality in especially both manufacturing and services sectors. Success of Turkish firms in quality management competitions is an important sign for this. Brisa in 1996, a tyre manufacturer; Beksa in 1996, a steel cord manufacturer; Netaş in 1996, 1997 and 1998, specialising in telecommunications and network design, Beko in 1998, white goods and tv manufacturer; Arçelik in 2000, white goods and tv manufacturer; Eczacıbaşı Vitra in 2000, a ceramic manufacturer; and Bosch Turkey in 2002 and 2003, white goods and tv manufacturer have all won European Quality Awards in recent years from European Foundation for Quality Management centred in Belgium.

Table 19: Comparison With Respect to the Key Determinants of the Efficiency-Resource Seeking FDI							
	Czech Rep.	Hungary	Greece	Poland	Portugal	Spain	Turkey
-Overall productivity-real growth (% change of real GDP per person employed)	24	5	7	10	26	25	3
-Internet costs	16	15	5	13	6	12	2
-Labour productivity (GDP per person employed per hour)	25	24	20	13	22	9	18
-Productivity in industry (related GDP per person employed in industry)	26	25	20	18	22	9	16
-Integration into regional trade blocks	13	18	11	23	7	3	14
-Investment incentives	2	12	24	20	16	8	17
-Government subsidies (as % of GDP)	29	27	5	22	13	16	8
-Quality of air transportation	11	25	23	23	22	9	8
-Energy infrastructure is efficient	9	23	25	14	26	13	20
Total	155	174	140	156	160	104	106
Score	17.2	19.3	15.5	17.3	17.7	11.5	11.7
<i>Source: Derived from International Institute for Management Development (IMD) (2003), World Competitiveness Yearbook 2003</i>							

The comparison with respect to selected nine key determinants of efficiency and resource seeking FDI from the survey of International Institute for Management Development (IMD), the score of Turkey as 11.7 is quite satisfactory (see Table-19). It scored nearly the same as Spain and seems more competitive in comparison to other countries. One thing is clear from the survey that in addition to the advantages of Turkey regarding market size, it has also important assets for foreign investor seeking efficiency in resources.

Turkey and Asset Seeking FDI

The essential feature of asset seeking FDI is the availability of qualified infrastructure and well-skilled labour that will be exploited for performing high-tech production. R&D investments are the best examples for asset seeking motives. There is a relatively sophisticated communications, transport and financial infrastructure in Turkey. The liberal structure of economy allows free movement of capital, profits and dividends with no price controls. Moreover, despite the two dramatic crises in finance sector in 2001, banking sector is quickly recovered and become competitive and technologically efficient. Legal procedures in accordance with international standards were put into practice by Banking Regulation and Supervision Agency that was established in 2000 to provide sound operation and monitor banking sector. Capital markets are also in a developing process in Turkey. Istanbul Stock Exchange (ISE), which had an average daily trading volume of \$ 285 million during the first half of 2003, provides adequate liquidity to 299 quoted stocks with a market capitalisation of around \$ 44 billion as September 2003¹⁴⁷.

Table 20: Gross Domestic Expenditure on R&D						
	Mio ECU/EUR		Mio ECU/EUR PPS at 1995 prices		of GDP %	
	1995	2000	1995	2000	1995	2000
Spain	3.624	5.719	4.390	6.129	0.81	0.94
Portugal	470	815	703	1.087	0.57	0.76
Greece	437	795	592	932	0.49	0.67
Poland	602	1.196	1.434	1.864	0.69	0.70
Hungary	250	405	520	692	0.73	0.80
Czech Rep.	403	744	989	1.385	1.01	1.33
Turkey	492	851	1.010	1.266	0.40	0.60

Source: "R&D expenditure and personnel in the Candidate Countries in 2000", Eurostat Statistics in Focus, Science and Technology Theme 9, 1-2003

¹⁴⁷ www.spk.gov.tr

Table-20 compares Turkey's performance on R&D expenditure with its competitors in EU countries and candidate countries. While Turkey increased its ratio of gross expenditure to GDP from 0.40 per cent in 1995 to 0.60 per cent in 2000, it was still lower than its competitors. As it can be seen from the table Turkey is clearly far behind Czech Republic and Spain, but just about in the same group as Portugal, Greece and Poland. It is clear that there exists a danger that Turkey will be fall behind if the technology infrastructure is not improved.

Table 21: Comparison With Respect to the Key Determinants of Asset Seeking FDI							
	Czech Rep.	Hungary	Greece	Poland	Portugal	Spain	Turkey
-Access to local capital markets is not restricted for foreign companies	12	8	5	22	18	3	2
-Competent senior managers	26	17	22	23	27	16	8
-Finance skills	28	19	22	23	26	14	9
-Qualified engineers	8	11	18	19	23	12	8
-International experience of senior managers is significant	22	17	25	24	29	26	12
-Skilled labour	11	16	26	19	28	14	13
-Labour legislation is flexible enough	12	6	19	23	27	17	5
-Information technology skills	13	22	26	22	28	23	13
-Development and application of technology	21	24	22	26	27	15	20
-Patents and copyright protection	23	16	24	20	27	11	16
-Patents productivity	15	12	26	9	14	12	23
Total	191	168	235	230	274	163	129
<i>Score</i>	<i>17.4</i>	<i>15.3</i>	<i>21.4</i>	<i>21.0</i>	<i>25.0</i>	<i>14.8</i>	<i>11.7</i>
<i>Source: Derived from International Institute for Management Development (IMD) (2003), World Competitiveness Yearbook 2003</i>							

As can be seen from the survey of IMD (see Table-21), Turkey has important advantages for the asset seeking FDI. A comparison, even they are not the only ones, with respect to the eleven key determinants of asset seeking FDI Turkey scores the highest rank considering the average score. While Turkey is considered as competitive in the field of skilled labour and competent managers, it scores low in assets regarding technology issues.

4.2. Turkey and FDI Enabling Environment

The FDI enabling environment has several components including FDI legislation and procedures, attitudes towards foreign investment, corruption and administrative costs, incentives, investment promotion and familiarity with host country.

The Turkish legal environment offers many advantages to foreign investors, including:

- A free floating exchange rate
- Full convertibility of the local currency
- Freedom from restriction on the flow of goods
- Access to European regional market through the custom Union with the EU
- Well operating 21 Free-Zones
- Liberal foreign investment legislation

It is internationally accepted that Turkey has one of the most flexible and unrestricted legal regimes governing foreign direct investment. Indeed, its recent policies towards FDI are much more liberal than those of many other developing countries which enjoy substantial amounts of FDI. The US Department of Commerce announced that Turkey's foreign investment regime is among the most liberal in OECD countries¹⁴⁸

There is no discrimination against foreign investors at any stage of an investment. Once a business entity is established and registered according to the Turkish Commercial Code, it is considered as a Turkish Company. Article 3 of the Law No.4875 on Foreign Direct Investment guarantees equal treatment of businesses no matter whether a company is domestically or foreign owned. Therefore, the foreign investment regime in Turkey provides to foreign investors all the rights and obligations afforded to local nationals.

All sectors are open for unlimited foreign investments apart from radio and broadcasting, which are restricted up to 20 per cent foreign participation, and aviation and maritime transportation, which are restricted up to 49 per cent participation of foreigners. In addition, foreigners need permission from the government to participate in mining, financial

¹⁴⁸ Loewendahl, H. and Loewendahl-Ertugal, E. (2001), p.24

services, and the petroleum sector. Foreign investors are also prohibited to engage in companies that are monopolies¹⁴⁹.

Turkey has also entered into several tax agreements which provide for exemption from double taxation. Turkey is also a contracting country of the OECD code on liberalisation of capital movements and invisible transactions. As a supporter of MAI prepared by representatives of the OECD countries, Turkey also signed “Mutual Promotion and Protection of Investment” agreements with 57 countries and “Prevention of Double Taxation Agreement” with 42 countries since 2000¹⁵⁰.

In addition, Turkey provides a range of investment incentives to foreign firms. Turkey’s incentive regime is also one of the most generous one considering other developing countries¹⁵¹. The incentive regime in 1995 brought about the “industrial belts” concept and offers a wide range of investment incentives to eliminate inter-regional imbalances and to support activities accelerating employment. 20 organised industrial zones and 18 provinces have been placed under this concept. The “industrial belts” are generally defined as provinces suitable in terms of infrastructure potentials for industrialisation¹⁵². Domestic and foreign investors are eligible for the same incentives and subject to the same procedural rules according to the equal treatment principle of foreign investment regime¹⁵³.

As mentioned above investment incentives are granted depending on which part of the country goes to. Some of the investment incentives are as follows¹⁵⁴:

- *Exemption from Custom Duties and Fund Levies*: Most of –if not all- machineries and equipments imported for the investments under an investment certificate are subject to exemption. A fund payment of 5-20 per cent must be made, however, for some of them. According to the relevant legislation to be made in “industrial belts” and priority development zones are exempt from the 5 per cent payment. Raw materials and intermediate goods are not eligible for this incentive.

¹⁴⁹ FIAS (2001a), p.19

¹⁵⁰ Dartan, M. (2003), “Turkey-EU Relations with Particular Reference to the Custom Union”, in The EU Enlargement Process and Turkey, Marmara University European Community Institute, p.298

¹⁵¹ Balasubramanyam (1995), pp 112-113

¹⁵² Türk Ekonomi Bank (1996), The New Investment Environment in Turkey, Istanbul, Intermedia, p.11

¹⁵³ Article 10 of the Law No.6224 on Encouraging Foreign Investment.

¹⁵⁴ YASED (1992), An investment Guide to Turkey, Istanbul, Citibank, pp29-42

-Investment Allowance: This allowance results in the corporate tax exemption for the investments. Depending on the location of the investment the rates of investment allowance changes between 39 per cent and 100 per cent of total fixed investment. Expenses for building, machinery, equipment, freight and installation are the eligible expenses.

-Value added Tax (VAT) Exemption from Certain Taxes, Duties and Fees: Investors who commit to realise \$ 1,000 of exports within two years upon the completion of the investment are granted exemption from the taxes, duties and fees related to;

- establishing a company
- increasing capital within the investment period
- receiving investment credits whose terms are at least one year
- registration of Inad and properties as capital in kind

-Subsidized Credit Facility: It is available for R&D projects and environment investments. For the year 1995, this facility was available for investments to be realised in priority development regions and industrial belts up 15 per cent to 25 per cent of the total fixed amount.

-Soft loans: It is granted to R&D investments, environmental investments, small and medium size enterprises and special credits. Investors can also benefit from additional tax deferrals.

-Research and Development (R&D): The corporations can defer up to 20 per cent of their annual corporate tax amounts for duration of three years provided that this sum would not exceed R&D expenditures of the corporation during the year.

-Export Incentives¹⁵⁵: Several exports incentives are available for investors in Turkey. These are exemption from various taxes, fees and duties; exemption from customs duty on raw materials and semi-product imports; and export credits through Eximbank. Most of the incentives are related with manufacturing and mining sectors.

¹⁵⁵ Regulated by the Communique OG No: 23933 dated January 14, 2000.

In recent years one thing is clear that the supply of FDI has substantially increased. Perhaps this increase has been realised in parallel with the demand for FDI. Some 20 years ago, many countries (especially developing countries) had restrictions against FDI inflows. However, today, every developing country seeks to attract FDI. Promotion for FDI is one the most recent tools of developing countries that is used to achieve national economic objectives. Countries' increasing efforts to promote their economies as investment locations complement the liberalisation trends starting since the beginning of 1980s. Such promotion efforts consist of a wide range of instruments involving building a positive image, providing information, after-investment services, targeted approaches to investors and offering various incentives¹⁵⁶. Most of the developing countries realise their promotion efforts through Investment Promotion Agencies (IPA).

By providing information and image building, IPAs in the CEECs have an important role in the substantial FDI record of these countries in the last decade. Especially, the efforts of Czech Republic, Poland and Hungary in investment promotion have a complementary factor that support their liberalisation process. Poland finalised the establishment of its IPA in 1992. The Polish Agency for Foreign Investment (PAIZ) is a joint stock company, wholly owned by the State Treasury. The main role of PAIZ is to improve the local environment for foreign investment, and ensure that potential investors have access to key players in the Polish market¹⁵⁷. Hungarian Investment and Trade Agency (HITA) can provide information and other support in foreign investment promotion and export promotion and trade consulting. It operates Hungary's foreign trade service network consisting of 38 offices in 34 countries¹⁵⁸. CzechInvest, the Czech Republic's foreign investment agency, is an autonomous agency set up by the Ministry of Industry & Trade in 1992 to promote and facilitate foreign direct investment into the Czech Republic. It offers potential investors a range of services, such as: information provision; assistance in application for investment incentives; assistance in selection of potential building plots suitable for production facilities; aid with finding suitable production facilities or joint venture partners; assistance in finding potential Czech suppliers or joint venture partners; assistance in dealing with bureaucracy at both national and local levels; organisational aid and execution of visit programmes; and post-investment care. 243

¹⁵⁶ United Nations (2000), Promoting Foreign Direct Investment in Central and Eastern Europe and the CIS, Economic Commission for Europe, Trade and Investment Guides 3, pp.12-13

¹⁵⁷ The European Bank for Reconstruction and Development (EBRD) (2001), Poland Investment Profile, p.11.

¹⁵⁸ EBRD (2001), Hungary Investment Profile, p.11.

foreign companies invested in Czech Republic have been benefited from the consultancy services of Czechinvest until today ¹⁵⁹.

In case of investment promotion, Turkey is far behind its European competitors. The efforts for investment promotion have been realised by the General Directorate of Foreign Investment (YSGM) in the Undersecretariat of Treasury, however, they have been in a minor degree. The negative image stemming from political and economic instability has covered up the potential advantages of Turkey for FDI. In addition, absence of an effective investment promotion leads to lack of information on what Turkey offers to foreign investors.

	Total FDI	Privatisation related FDI	Independent FDI	Privatisation FDI/GDP	Independent FDI/GDP
Turkey	\$ 7.6 billion	\$ 1.2 billion	\$ 6.4 billion	0.6 %	3.2 %
CEECs	\$ 36 billion	\$ 16.4 billion	\$ 19.6 billion	1.9 %	2.3 %

Source: Loewendahl, H. and Loewendahl-Ertugal, E. (2001), "Turkey's Performance in Attracting Foreign Direct Investment", ENERPI working papers no:8, p.11

The irreversibility of developing countries in the implementation of privatisation policy is an important factor that increases the favourable environment for foreign investors. Although Turkey started privatisation activities in the beginning of 1980s, the record has been unsatisfactory. Mainly due to the economic crisis of recent years along with various impediments and adverse effects of international conditions and most importantly the reluctance of governments for the implementation of a comprehensive privatisation programme, the privatisation process has been proceeding rather slowly compared with other emerging countries. As can be seen from the Table-22 the total revenue of Turkey in the period of 1988-1995 was \$ 7.6 billion. This number increase to \$ 11.2 billion in the end of 2002. While the FDI related privatisation was \$ 1.2 billion in the same period, it was only \$ 1.3 billion in the end of 2002. The progress has been unsatisfactory. However, the privatisation process is almost completed in most of the CEECs despite they just started this process in the early 1990s. In mid 1990s, large strategic companies in many sectors such as banking, telecommunication, broadcasting, transportation, chemicals. FDI played a key role in the success of CEECs (especially in Hungary, Czech Republic and Poland). Table above compares the performance of Turkey and the CEECs in attracting FDI regarding privatisation

¹⁵⁹ EBRD (2001), Czech Republic Investment Profile, p.11.

and independent from privatisation. As it can be seen, considering the privatisation related FDI the CEECs attracted three times more than Turkey in terms of GDP.

In case of country specific comparison, Table-23 compares Turkey with Hungary which has the most successful record regarding FDI. It is clear that Turkey is considerably under-performed. During the period 1991-1997, total FDI inflows to Turkey were \$ 7 billion and \$ 1.2 billion of this was FDI related with privatisation activities. The ratio of privatisation related FDI to GDP was only 0.6 per cent. However, the score of Hungary was relatively higher than Turkey. The total FDI inflows in Hungary reached to \$ 15 billion during the same period. \$ 6.4 billion of the total FDI inflows which equalled to 14 per cent of GDP was FDI related with privatisation activities in Hungary. During the period 1991-1997, Hungary performed 20 times more than Turkey with respect to privatisation related FDI. In case of independent FDI this number is 6.5 times.

Table 23: Total and Independent FDI in Turkey and Hungary between 1991-1997					
	Total FDI	Privatisation related FDI	Independent FDI	Privatisation FDI/GDP	Independent FDI/GDP
Turkey	\$ 7 billion	\$ 1.2 billion	\$ 5.8 billion	0.6 %	2.9 %
Hungary	\$ 15 billion	\$ 6.4 billion	\$ 8.6 billion	14 %	18.8 %

Source: Loewendahl, H. and Loewendahl-Ertugal, E. (2001), "Turkey's Performance in Attracting Foreign Direct Investment", ENERPI working papers no:8, p.12

Table-24 is derived from IMD survey in 2003 to evaluate the FDI enabling environment in Turkey in comparison with the competitor countries in EU. According to nine key determinant factors score of Turkey implies that, contrary to its unsuccessful FDI record, it has a favourable FDI environment. Table indicates that only the Spanish economy is far more attractive when compared to Turkey. The others, except Poland, are narrowly behind Turkey.

Table 24: FDI Enabling Environment							
	Czech Rep.	Hungary	Greece	Poland	Portugal	Spain	Turkey
Protectionism does not prevent import of foreign products	19	27	14	29	16	9	18
Foreign investors are free to acquire control in a domestic company	6	9	10	27	24	7	3
Foreign companies are not discriminated against by legislation	10	21	20	22	23	5	23
Public sector contracts are sufficiently open to foreign bidders	14	27	20	23	12	9	11
Cross border ventures can be freely negotiated with foreign partners	17	11	21	29	10	4	8
Investment incentives are attractive to foreign investors	2	12	24	20	16	8	17
National culture is open to foreign ideas	28	16	12	29	4	17	13
Ease of doing business is a competitive advantage	22	24	29	29	26	9	22
Investment Risk (Euromoney country credit-worthiness scale)	25	23	20	12	19	8	25
Total	143	170	170	220	150	76	140
Score	15,9	18,9	18,9	24,5	16,7	8,5	15,6
<i>Source: Derived from International Institute for Management Development (IMD) (2003), World Competitiveness Yearbook 2003</i>							

4.3. Turkey and Political-Institutional Environment for FDI

An indispensable pre-condition for encouraging foreign investment is to have a stable political and economic climate, and a transparent and well-functioning legal, bureaucratic and regulatory framework¹⁶⁰. Turkey is generally recognized by international investors as having a difficult investment environment due to the high level of economic and political instability.

¹⁶⁰ Loewendahl, H. and Loewendahl-Ertugal, E. (2001), p.26

A survey, covering the Foreign Investors Association (YASED)'s 278 members from various countries presents important drawbacks of investing in Turkey. The main lines drawn the survey may be summarized as follows. 51 per cent of the members asserted that high inflation and political instability is the most important problem. The second ranking problem at 15 per cent is the lack of trust in authorities, or in other words, the failure of public administration to honour pledges and contracts. Other major problems stand as high credit costs, the absence of inflation accounting and full protection of the competition¹⁶¹.

Similarly, in her comprehensive study, Erden (1996) incorporates the difficulties faced by foreign investors in Turkey. According to the Table-25, the main problem encountered by the investors is inconsistent macroeconomic environment (2.080). Difficulties related to the regulatory environment (2.710), the tax system (2.719) and absence of an inflation accounting system are the other problems faced by foreign investors.

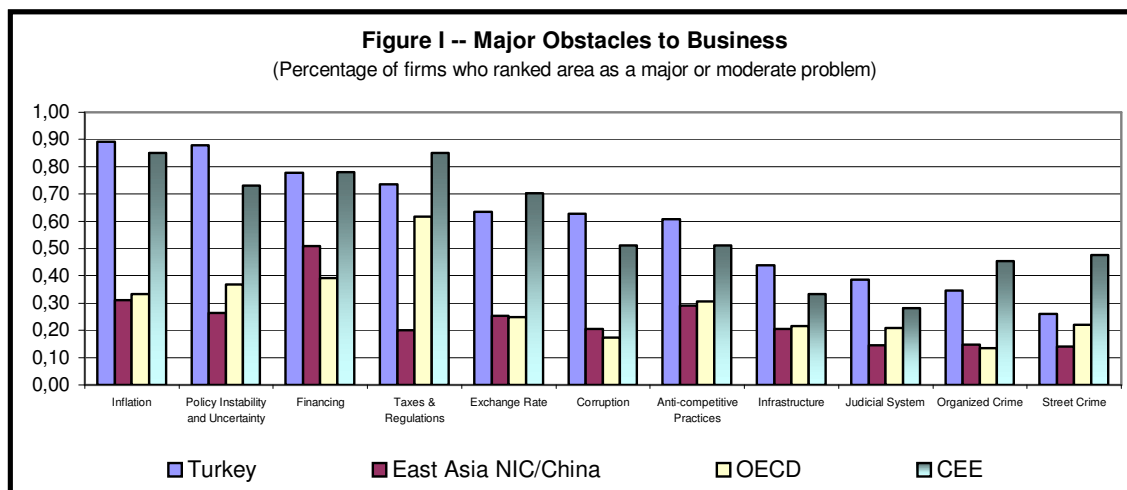
Type of Difficulty	Intensity of Difficulty
Inconsistent Macroeconomic Policy	2.080
Regulatory Environment	2.710
Tax System	2.719
Absence of Inflation Accounting	2.813
Corruption	2.871
Recognition of Patent Rights	3.210
Incentives	3.339
<i>Scale: 1=Very Serious 5=Not at all Serious</i>	
<i>Source: Erden, D. (1996), p.164</i>	

A recent perspective on investment conditions in Turkey is provided by the World Business Environment Survey (WBES) in 2000. This survey of 150 Turkish investors was conducted under World Bank assistance as part of a larger study that covered 80 countries all over the world¹⁶². Figure-I summarizes the major findings of this survey and compares Turkey to other regions. In the survey of WEBS, investors suggested that inflation and policy instability and uncertainty are the leading obstacles. High inflation in Turkey also leads to the lack of adjustment accounting, especially for taxation payments purposes. With around 75 per cent of investors are ranking financing and taxation and regulations as other major constraints to business. While the scores of OECD and East Asia/China are very low, the CEECs' records

¹⁶¹ YASED (1996), Investing in Turkey, Monthly Bulletin, January, pp.8-9

¹⁶² FIAS (2001a), pp. 4-5

are near to Turkey. Corruption seemed to be a serious problem for 63 per cent of investors, which is quite high when compared to other regions. Anti-competitive practices are another constraint which investors in Turkey found comparatively troublesome.



Source: FIAS (2001a)

In addition to the political and economic instability, as can be seen from the surveys presented above, administrative and bureaucratic rules and procedures are the other major obstacles for foreign investors that disturb political and institutional environment in Turkey. Administrative regulations are not only increase the required time for investment but they also raise the cost of doing business in Turkey. Moreover, as they are changed temporarily due to the short-lived governments, they boost the uncertainty and hamper transparency. On average, investors in Turkey reported that about 20 per cent of management time is spent dealing with government regulations and administrative requirements. This level is far beyond the ones in CEECs (8 per cent) and Latin America (4 per cent)¹⁶³. The importance of administrative barriers as having a negative effect on investment environment in Turkey is indicated by the Global Competitiveness Report of the World Economic Forum, which ranked bureaucratic “red tape” as one of the most important disadvantages of the Turkish business environment. Turkey was frequently ranked at the bottom in the areas of administrative and procedural issues and is lower than many other countries in terms of competitiveness indicators. The Report ranked Turkey 52nd among 59 countries for government bureaucracy and “red tape”.

¹⁶³ op.cit.p.4

While Turkey ranked 49th for management time spent with government bureaucracy, the Czech Republic and Hungary were 14th and 26th respectively¹⁶⁴.

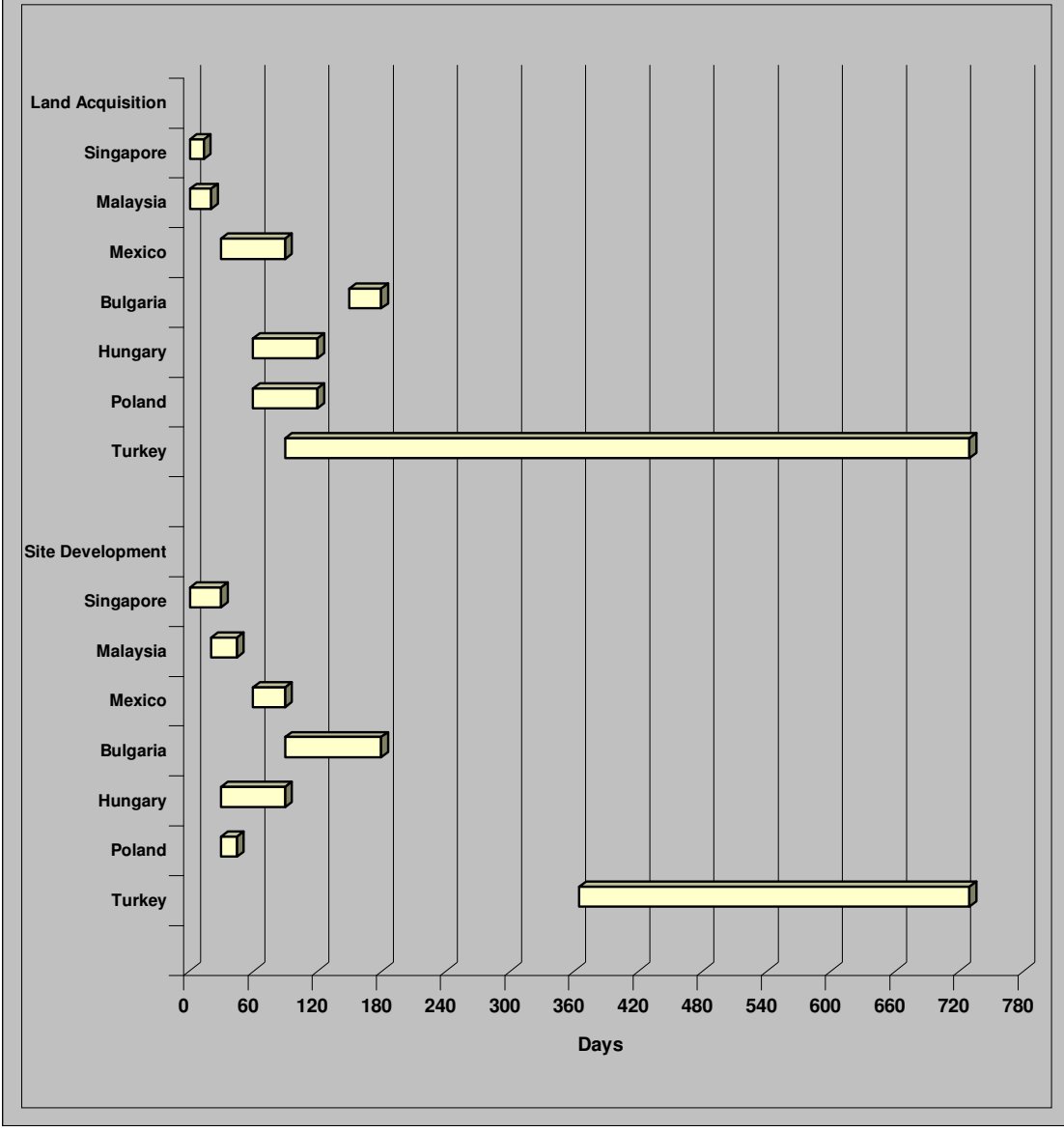
The consequences of the administrative barriers on foreign investments in Turkey were recently dealt by the study of PWC. The study estimated that the effect of Turkey's opaque business climate to be equivalent to a 36 per cent increase in the corporate tax. For Poland and these ratios are calculated as 17 per cent and 28 per cent. PWC also estimated that the cost of, or foregone, FDI in Turkey per year due to opacity is over \$ 1.8 billion, representing more than 210 per cent of actual FDI flows. Therefore, it is evident that a serious reform of administrative structure is probably to improve Turkey's business environment for investment in the same way as a high proportional tax cut. While a massive tax cut likely leads macroeconomic distortions and unaffordable fiscal losses, however, this is not the case for administrative reform. Moreover, increasing transparency in investment environment due to improvements in administrative procedures can help raise the level of competitiveness of both domestic and foreign firms operating in Turkey¹⁶⁵.

The administrative barriers on foreign investments in Turkey not only increase the cost of doing business but they also harm the competitive structure of the economy. The Figure-II and Figure-III imply that time required for administrative procedures make Turkey unattractive by comparison to other countries which compete for FDI.

¹⁶⁴ op.cit.p.2

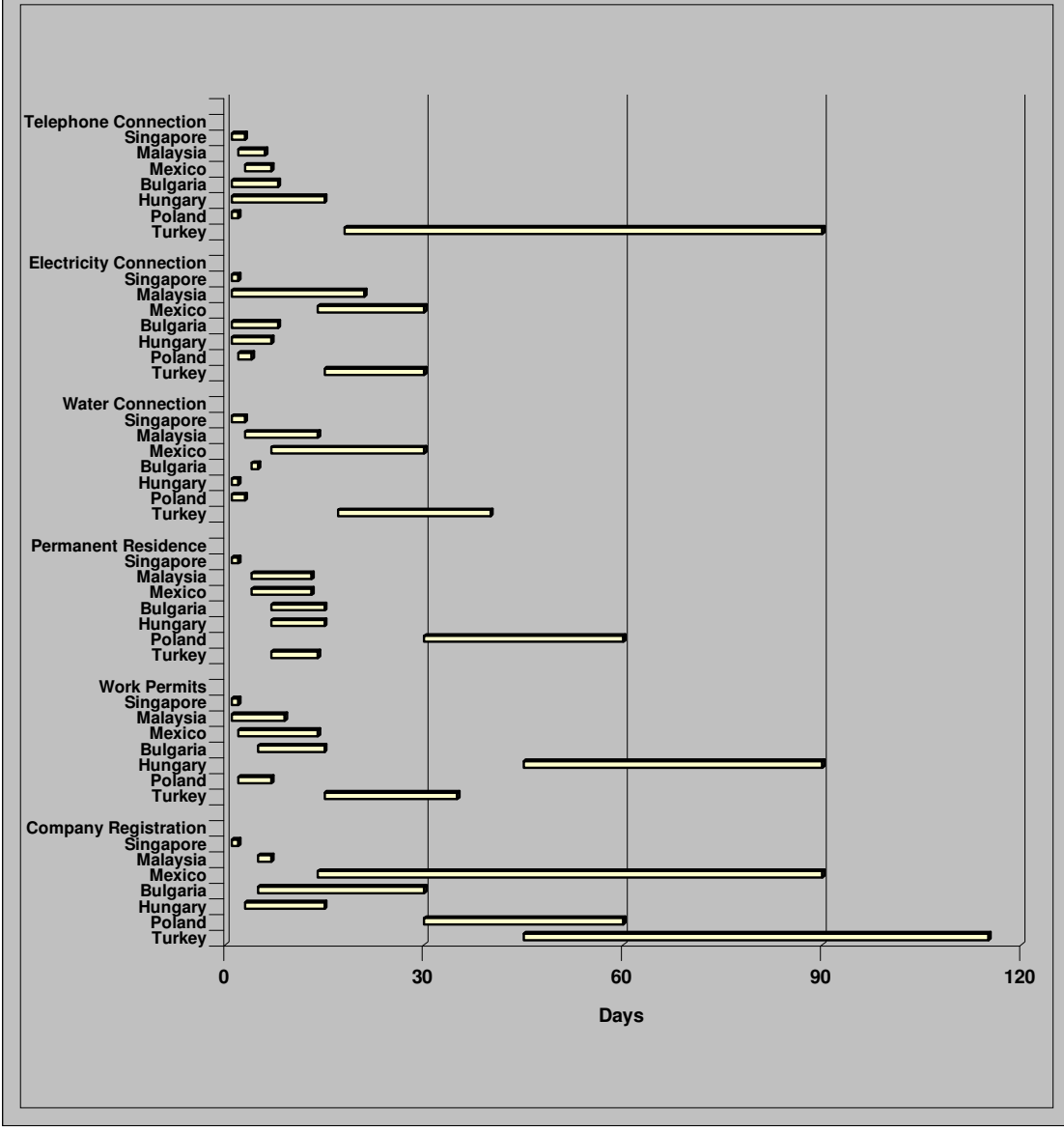
¹⁶⁵ Us, M. (2001), "Removing Administrative Barriers to FDI: Particular Case of Turkey", paper presented in OECD Global Forum on International Investment: New Horizons and Policy Challenges for Foreign Direct Investment in the 21st Century, Mexico City, 26-27 November 2001, p.3

**Figure II -- Time Required for Administrative Procedures,
Turkey and Other Comparators**
Range: Minimum to Maximum



Source: FIAS (2001a)

**Figure III -- Time Required for Administrative Procedures,
Turkey and Other Comparators**
Range: Minimum to Maximum



Source: FIAS (2001a)

It is clearly seen from the figures that establishing a business in Turkey take a lot longer than in other countries. For instance, the time and the additional costs for land acquisition and site development which are the main aspects of investment are very high when compared to the other countries. Additionally, the average time for company registration is over three to four times longer in Turkey than in most other comparator countries in the list. Therefore, one thing is clear that the delays stemming from these procedures cost investors in terms of time, money as well as the opportunity cost of starting production which increase the unattractiveness of investment environment in Turkey.

Table 26: Comparison of the Political and Institutional Environment							
	Czech Rep.	Hungary	Greece	Poland	Portugal	Spain	Turkey
Risk of political stability is very low	23	19	13	27	17	4	22
Exchange rate stability	24	25	7	1	12	14	28
Justice is fairly administered in society	27	24	18	27	28	15	23
Competition law is efficient in preventing unfair competition	21	25	24	26	26	16	19
Bribing and corruption does not exist in public	28	26	27	26	24	7	20
The public service is independent from political interference	20	22	29	27	28	9	26
Bureaucracy does not hinder business activity	22	15	28	26	25	7	24
Customs administration does not facilitate transit of goods	26	27	19	23	12	4	14
Legal framework does provide an environment that encourages the competitiveness of enterprises	22	17	25	26	26	7	24
Total	213	200	190	209	198	83	200
Score	23,7	22,2	21,1	23,2	22	9,2	22,2
<i>Source: Derived from IMD, 2003</i>							

Despite the instability in political and economic environment and the unfavourable conditions in administrative structure, Table-26, which covers the nine important determinant factors indicating political and institutional environment, implies that Turkey is narrowly around its European competitors. Only Spain is far more attractive with respect to political and institutional environment.

Table 27: Turkey's Locational Advantages for FDI	
Key Location Factors	Competitive Position
Market Seeking FDI	
Economic size	Strong
Economic growth	Strong
Population	Strong
Welfare level (per capita income)	Medium
Efficiency Seeking FDI	
Labour costs	Strong
Labour productivity	Medium
Access to regional markets	Strong
Costs of other inputs (transport)	Strong
Asset Seeking FDI	
Supply of skilled labour	Weak
R&D and innovation	Weak
Telecommunication and internet infrastructure	Medium
Qualified engineers	Weak
Quality in management	Weak
FDI enabling environment	
FDI legislation	Strong
Investment promotion	Weak
Incentives regime	Strong
Corruption	Weak
Political and institutional environment	
Political stability	Weak
Economic stability	Weak
Political certainty	Weak
Political interference	Weak
Bureaucracy and administrative structure	Weak
Justice and intellectual property rights*	Weak

**Although legislation of intellectual property rights have been enhanced after the establishment of the Custom Union in 1996, there has been still deficiencies in implementation.*

As a conclusion for this part, it can be said that Turkey competitive position is strong when compared to the potential competitor countries inside the EU and outside the EU. With its large and dynamic market, low cost labour force, favourable infrastructure and ability to access regional markets Turkey provides important advantages for market, efficiency and resource seeking FDI. Regarding its deficiencies in technology and R&D activities, availability of skilled and productive labour force, qualified engineers and well-experienced management staff, Turkey also seems unfavourable for asset seeking FDI. Due to the generous FDI legislation, FDI enabling environment is attractive for foreign investors. Although investment promotion and privatisation facilities are unfavourable, the well operating investment regime and supportive economic infrastructure (banking, capital markets etc) encourage FDI enabling environment. However, the political and economic instability and administrative barriers to investments are weakening the FDI environment. Table-27 summarizes what have been discussed in this part.

4.4. Economic Integration with European Union and FDI Performance of Turkey

Since 1950s the EU has been playing a very important role in Turkey's external economic relations. From the first years of formation the member countries have been major trading partners of Turkey and it seems that this situation will not change in the near future.

The relationship between Turkey and the European Union (at that time it was called as European Economic Community) toward an economic integration started with the Ankara Agreement, which was signed on 12 September 1963 and put into effect on 1 December 1964. The establishment of a custom union and a financial protocol were the main components of this agreement. According to the Ankara Agreement the association between Turkey and the EU was to be implemented in three stages: a preparatory stage, a transitional and a final stage. The details of the custom union between Turkey and the EU were laid down by the Additional Protocol which was entered into force in 1973. By the Additional Protocol, the preparatory stage was finalised and the association was entered into a transitory stage which took around 22 years. In 1995, it was agreed at the Association Council meeting that the custom union between Turkey and the EU was started to be implemented on 1 January 1996.

The European Helsinki Council of 1999 which granted Turkey a "candidacy status" covering an objective of full membership was also another turning point-after the custom

union- in the relations between Turkey and the EU. Turkey now focuses on to fulfil the Copenhagen criteria which sets the main conditions for the membership to the EU¹⁶⁶. However, despite the custom union with EU, due to latest instability in its economy, Turkey has not been capable to fulfil the conditions of Copenhagen economic criteria. In order to achieve macroeconomic stability a series of structural reforms in various fields of economy have been put into practice within the framework of economic programme launched in May 2001. Therefore, it can be said that after the Helsinki Summit, Turkey has entered into a transitory stage covering a structural transformation not only in the sense of politics but also in economic field.

The initial stage of flows of foreign investments in Turkey was dated back to the early 1950s and the EC member countries have been constituted the major source of FDI in Turkey until that time. The deep relations in foreign trade, geographical proximity between EU and Turkey and the large domestic market in Turkey have fostered the flows from EC countries to Turkey. The attempt started in 1963 to deepen economic relations by the establishment of a custom union was also an important asset providing a favourable environment which can attract foreign investors not only from EC but also from third countries. Similarly, the candidacy in 1999 is another attempt between two parties to accelerate the existent level of integration, provided through custom union, which can contribute to strengthening the investment environment in Turkey.

This part of the Chapter 4 focuses on the economic integration process between Turkey and the EU and tries to find out its implications on the foreign direct investment to Turkey. Economic integration with the EU and its effects on FDI in Turkey will be discussed in three stages. First covers the period from the Ankara Agreement in 1963 to the establishment of custom union in 1996. Second stage indicates the period until the Helsinki Summit where the candidacy of Turkey for EU membership was declared in 1999. Third stage focuses on the developments from 1999 until today.

¹⁶⁶ Copenhagen criteria is that applicants must have stable institutions guaranteeing democracy, the rule of law, human rights and protection for minorities, as well as functioning market economies and the capacity to cope with competitive pressures within the Union and necessary administrative structures to adopt *acquis communitaire* of the EU.

4.4.1. FDI Performance in Turkey from the Ankara Agreement to the establishment of the Custom Union

Turkey expressed its keen interest in membership to the EC just after the formation of the EC in 1957. The attempt of Turkey was encouraged by the signing of Association Agreement (Ankara Agreement) in 1963. The objective of the Ankara Agreement was to promote a constant and well-balanced intensification of trade and economic relations between parties with the aim of establishing a custom union. Moreover, the Agreement also went even further and envisaged the possibility of an eventual full membership for Turkey if and when it was able to perform the necessary obligations arising out of the Treaty establishing the Community¹⁶⁷. By this agreement Turkey was become an association member to the EC which seen as a form of partial membership, however, did not involve the right to influence the policy making of the Community. Despite the Ankara Agreement did not envisage full membership of Turkey to the EC, it institutionalised the relations between the parties. It can be considered as a stage that provided a remarkable jump in the relations between the parties and opened the possibility of Turkey's membership to the Community. Therefore, it constitutes the milestones of recent Turkish efforts to achieve the EU membership.

The Association process was divided into three stages as the preparation, the transition and the final stages by the Ankara Agreement and the Additional Protocol which was signed in 1973. The preparatory stage was to last a minimum of five years with the aim of strengthening Turkish economy by EC aid and to make Turkish economy ready for sharing the responsibilities in the transitional and final stages. The Community envisaged a financial aid programme covering 175 million ECU to assist Turkey's development in this stage. The second stage was to be a transitional period with the aim of gradually introducing a custom union. This period would involve the adoption of common external and internal tariffs and arrangements that would bring about general economic policy alignment. The Community was to eliminate custom tariffs on imports of industrial products from Turkey at once, while Turkey had to remove tariffs in stages over several years depending on the kinds of products. A second financial protocol covering 300 million ECU was envisaged in the transitory stage. The final stage would entail intensification of coordination of economic policies. The principle of the progressive setting up of the custom union over a period of 22 years is preserved in these agreements and is legally binding on both parties.

¹⁶⁷ Article 28 of Ankara Agreement

In addition to the trade agreements, the Ankara Agreement and Additional Protocol included the principles of freedom of settlement for professions, freedom to provide services, free movement of workers, stipulations about the harmonisation of tax systems, rules of competition and other economic legal regulations. With the inclusion of three of the “four freedoms” as stated in the Treaty of the EC it may be said that the sort of custom union to be established under these conditions comes nearly close to the establishment of a common market between the EC and Turkey¹⁶⁸.

In the preparatory stage, which covered the period between 1964 and the end of 1972, the EC made some tariff concessions on Turkey’s four main agricultural exports, namely tobacco, raisins, dried figs and hazelnuts¹⁶⁹, accounting for over 40 per cent of Turkey’s exports. No reciprocal concessions were required from Turkey¹⁷⁰. During this stage, the scope of the custom union between Turkey-EC was laid down by the Additional Protocol signed on 23 November 1970. By the put into effect of Additional Protocol the transition period was started. According to the Additional Protocol the custom union includes elimination of all custom duties and quantitative restrictions in trade of manufactures, alignment by Turkey on the common custom tariff (CCT), elimination of protective measures between the parties, and the treatment of matters such as right of establishment and workers’ right. The EC would abolish all custom duties and equivalent taxes on industrial imports from Turkey, with exception of certain sensitive products such as cotton yards, cotton textiles, and machine-woven carpets. Petroleum products were subject to tariff reductions within quota limits. Concerning Agricultural products, they were treated as imports from third countries and subjected to the CCT. However, the scope of custom union involves the processed agricultural products. The parties have agreed on the establishment of a system regarding the processed agricultural products in which Turkey would differentiate between agricultural and industrial components of the duties applied on these products.

With the Additional Protocol coming into effect in 1973, the Community opened its market by eliminating all custom duties and quotas for Turkish manufactured products, with exception of agricultural goods, textiles and clothing. However, Turkey was given a longer

¹⁶⁸ Kramer, H. (1996), “Turkey and the European Union: A multi dimensional relationship” in V. Mastny and R. Craig Nation (eds.) *Turkey between East and West; New challenges for a rising regional power*, Boulder, p.205

¹⁶⁹ These concessions were in the form of tariff quotas but not outright tariff cuts.

¹⁷⁰ Hine, R. (1996), “Turkey and the European Community: Regional Integration and Convergence” in Balasubramanyam, V.N. and Togan, S. ed(s), *The Economy of Turkey Since Liberalisation*, MacMillian Press Ltd., pp.142-43

period of adjustment to make reductions to the custom tariffs for imports from the EC within the framework of separate lists with different time periods, with respect to the competitiveness of the industries concerned¹⁷¹.

Although the start of the process of economic integration between Turkey-EC was quite well, the progress was not successful enough. The economic recession in 1970s due to oil crises were negatively affected both parties and led to the failure of the fulfilment of the obligations by both sides. The economic breakdown in the 1970s led to the Turkish industrialists to force the Government to abandon the idea of the custom union and to seek ways of formulating new forms of association with the EC. Moreover, the military interventions in Turkey, the Cyprus issue and the privileges granted by the EC to third countries under the General System of Preferences, Lome Convention and also under the Global Mediterranean Policy of EC were eroded the relations between the parties. By 1980s, promotion of democracy and human rights gained higher importance in the agenda of the Community. The European Community started to regard democracy and human rights issues as a sine qua non for inclusion into EC, however, Turkish leaders continued to perceive the Community as an economic entity and interpreted these issues as an internal problem. Therefore, the relations between two sides came to a standstill after the military intervention in 1980¹⁷².

On the other hand, in the second half of the 1980s the circumstances started to be changed for Turkey due to the economic reforms implemented from the beginning of the 1980s which led to a major transformation in the Turkish economy. The new export-oriented economic regime increased the importance of the custom union with EC which was the main trading partner at that time. Moreover, the western-oriented business community worried also by the declining trade opportunities from the Islamic countries in the Middle East and North Africa due to the reduction in oil prices and concerned about the impact of the EC membership of Greece, Spain and Portugal on Turkish exports. Thus, Turkey applied for full membership to the EC in 1987.

¹⁷¹ Balkır, C. (1997), "The Custom Union and Beyond" in L. Rittenberg (ed.), *The Political Economy of Turkey in the Post-Soviet Era; Going West and Looking East*, London: Praeger, p.54

¹⁷² Eralp, A. (1997), "Turkey and the European Union" in L. Rittenberg (ed.), *The Political Economy of Turkey in the Post-Soviet Era; Going West and Looking East*, London: Praeger, p.40

However, the European Community was focused on two important issues at that time. One was the accession of Spain and Portugal and the other was the establishment of single market programme in order to make operational the common market. Therefore, the application of Turkey was not approved by the EU. Instead, the European Commission suggested the reactivation of the Ankara Agreement. The dissolving of the Soviet Union and the Gulf War increased the geopolitical importance of Turkey and gave impetus the decision of the Commission. After long debates on both economic and political issues, the thirty-sixth Turkey-EC Association Council on 6 March 1995 took the decision on the custom union which would be enter into force by the 1 January 1996.

Despite the establishment process of custom union, covering the period between 1963-1996, between Turkey and EC provided an important asset for Turkish economy to attract FDI, the record of FDI in this period was relatively low. There existed various reasons for relatively low level of FDI in Turkey. One reason for this was the macroeconomic environment for investment in Turkey. Turkey adapted an import substituting industrialisation (ISI) strategy, just before the start of the process for custom union, aiming to convert the economy into a self-sufficient structure and reduce the dependency to imports in the long-run. ISI strategy requires a highly protected trade regime which constituted an obstacle for the operations of foreign firms in Turkey. Moreover, the competition in the economy was jeopardised by the high level of state ownership in the economy during this period. Despite the several changes in the governments in this period both leftist and rightist governments favoured the role of state enterprises in the Turkish economy. The public sector accounted for 60 per cent of national investment, owned about 40 per cent of manufacturing enterprises and dominated nearly whole of the sectors such as banking, energy, mining, telecommunication etc. even after the liberalisation strategy in the beginning of 1980s¹⁷³.

More importantly, just after the preparatory period in 1960s, the transition period was hampered by the unfavourable economic conditions of the world economy. Economic recession starting from the beginning of 1970s due to the oil crisis negatively affected the economies of both Turkey and EC. In addition to the economic difficulties, the existence of political debates between parties stemming from the military coups and Cyprus problem were also disturbed the requirements of the establishment of a custom union. Therefore, all these

¹⁷³ Balasubramanyam (1996), p.118

resulted in a reluctance for the creation of a custom union between the parties and made unoperational the Ankara Agreement.

In the beginning of 1980s, Turkey started to promote a liberal economic regime and adapted an export-oriented economic strategy. Due to the favourable macroeconomic conditions in the world economy in the early 1980s, the liberal shift in the Turkish economy produced an impressive growth in exports. The volume of exports which was 2.9 billion \$ in 1980 reached to 21.9 billion \$ at the end of 1995 and the ratio of exports also increased from 4.2 per cent to 12.8 per cent in the same period. Furthermore, the radical change in the economic regime was also transformed the structure of the exports. While the share of agriculture was 70 per cent during the period 1963-1980, it has fallen around 20 per cent in 1988 and 9.9 per cent at the end of 1995. Meanwhile, the share of industrial goods has almost quadrupled between 1963 and 1995 and increased from 17.9 per cent to 88.2 per cent. Moreover, Turkey has achieved a considerable progress in the share of textile and clothing. The share of textiles in total exports has reached to 27 per cent in the end of 1980s. The share of EC in the Turkish exports was 48 per cent between the period 1960-1980. Despite the economic boom of Turkey in the 1980s, the share of EC was decreased to 44 per cent due to the increase in the share of oil exporter countries. However, the exports to EC started to increase in the beginning of 1990s and reached over 50 per cent during the period 1990-1995. This implies that the export pattern of Turkey is considerably EC oriented from the early attempts of the creation of a custom union between the parties. By the adoption of a export-oriented economic regime, therefore, trade with EC countries has become more important for Turkey. Additionally, the economy was much more open when compared with at the time of the Association Agreement and the competitiveness of Turkish economy with EC was in progress from the early years of 1980s. Therefore, the development of economic relations and acceleration of economic integration between Turkey and EC was considered as an advantage of Turkey by the governments in the late 1980s. This was the main reason behind the application of Turkey for the full membership to the EC in 1987.

However, the radical economic transformation in Turkish economy resulted in high digits chronic inflation and exchange rate fluctuations causing macroeconomic instability in the late 1980s. The economic crisis in 1994 was the peak of the imbalances resulting from the instability in the economy. In the political side, the relations between Turkey and EC was entered into a new era from the beginning of 1980s. As it is mentioned above, democracy and

human rights issues became fundamental for EC. This resulted in a structural change in the relations between the parties and Turkey was started to be criticised by EC for having an unfavourable democratic environment. The frozen of fourth Financial Protocol due to Greek Veto¹⁷⁴, the decision of European Parliament suspending the Joint Parliamentary Commission¹⁷⁵, and the annulment of negotiations for the free movement of Turkish workers boosted the stagnancy in the custom union issue between the parties. All these developments in the Turkey-EC relations led to a lack of confidence. In this context, Turkish application for full membership was not welcomed by the EC and in its report for Turkey European Commission suggested reactivation of Ankara Agreement instead of full membership. Despite this decision of the Commission, the confidence in the relations between the parties could not be rebuilt.

Therefore, it may be argued that the objective for the establishment of a custom union between Turkey and EC by the Ankara Agreement was not an asset for Turkey to attract more foreign investments in the pre-custom union period. The lack of intention stemming from the both sides to make operational the requirements of a custom union due to the reasons mentioned above was also considered by the foreign investors. This can be understood from the record of foreign investments in Turkey in this period.

As for the period between 1963-1979, the total FDI stock of Turkey was 228.1 million \$. The annual average of net FDI inflows in this period were only 12.1 million \$. Between 1963 and 1979, there was a gradual increase in realised FDI inflows except in 1974 and 1979. In 1974 and 1979 there was a decrease in FDI inflows. In other words, the existing FDI was withdrawn from Turkey. The amount was 7.7 million \$ and 6.4 million \$, respectively. The reason of the decline in 1974 could be the Cyprus problem and the start of US embargo. In 1979, because of increase oil prices, FDI inflows decreased not only in Turkey but also all over the world. In 1964, there was a sudden increase in FDI inflows compared to previous years. The reason of the increase could be spreading of democratic movement through Turkey after establishing a democratic constitution. This democratic climate in Turkey may have attracted FDI inflows. When the sectoral distribution of FDI inflows were considered between

¹⁷⁴ The amount of fourth Financial Protocol is 600 million Euro/Ecu which covers 375 million Euro/Ecu grants and 275 million Euro/Ecu European Investment Bank credits.

¹⁷⁵ Joint Parliamentary Commission was established on the basis of the Turkey-EC Association Decision dated 27 July 2003. Joint Parliamentary Commission is composed of by the members of the Parliaments from both sides in the same number. Main task of the Commission is to discuss the issues based on the Association decision that provide the execution of the custom union.

1963 and 1979, the manufacturing sector attracted a large share of FDI inflows. Especially, chemicals, transportation and vehicles, electrical machinery equipment attracted large share as a sub-sector of the manufacturing. The service sector was the second leading sector which attracted FDI inflows.

Table 28: Realised FDI Inflows, 1963-1979 (in millions USD)			
Year	Annual FDI Inflow	Cumulative FDI Inflow	FDI Inflows/GNP (%)
1963	4.5	27.2	0,04
1964	11.9	39.1	0,1
1965	11.6	50.7	0,09
1966	9.7	60.4	0,06
1967	9.0	69.4	0,05
1968	13.9	83.3	0,08
1969	13.2	96.5	0,07
1970	9.0	105.5	0,05
1971	11.7	117.2	0,07
1972	12.8	130.0	0,06
1973	67.3	197.3	0,24
1974	-7.7	189.6	-0,02
1975	15.1	204.7	0,03
1976	8.9	213.6	0,02
1977	9.2	222.8	0,02
1978	11.7	234.5	0,02
1979	-6.4	228.1	0,08
1963-79 (yearly average)	12.1	-	-
<i>Source: Undersecretariat for Treasury, DG for Foreign Investment; www.treasury.gov.tr</i>			

In the period between 1963 and 1979, the Turkish manufacturing sector absorbed 85.9 per cent of total FDI inflows. However, the level of FDI in manufacturing sector was in a continuous fall. While the share of FDI inflows were around 90 per cent, it was decreased to 80 per cent in 1979. The shares of agriculture and mining in total FDI remained stable until 1979. On the other hand, the share of services in total FDI inflows increased rapidly in the 1963-1979 period.

Table 29: Source Country Distribution of FDI Stocks, 1950-1979 (in million \$)						
Source Country	1950-1974		1975		1979	
	Realised FDI	Country share in realised FDI (%)	Realised FDI	Country share in realised FDI (%)	Realised FDI	Country share in realised FDI (%)
Austria	1.61	1.17	67	1.43	34.26	0.15
Belgium	0.85	0.62	19.22	3.57	67.41	0.36
Canada	2.35	1.7	51	2.34	51	2.03
Denmark	1.98	1.44	47.16	4.07	24.8	1.58
Finland	-	-	-	-	61.96	1.38
France	5.63	4.08	43.68	11.11	44.9	16.92
Germany	19.72	14.29	46.61	15.01	46.59	15.34
Israel	0.01	0.01	0	-	-	-
Italy	15.82	11.47	42.7	13.28	40.24	10.23
Japan	-	-	40	3.67	40	0.75
Kuwait	-	-	40	2.98	60.64	2.57
Netherlands	16.67	11.79	66.31	5.63	25	4.24
Sweden	0.64	0.46	22.53	0.23	63.86	0.22
Switzerland	14.64	10.61	56.48	11.36	43.92	10.02
UK	6.1	4.42	41.37	2.86	47.64	3.23
US	33.28	24.12	28.85	18.19	13.39	12.84
Venezuela	-	-	100	0.21	-	-
Unified	19.06	13.82	41.66	4.08	38.75	18.14
TOTAL	137.96	100	40.19	100	40.19	100

Source: Undersecretariat for Treasury, DG for Foreign Investment; www.treasury.gov.tr

In the 1950-74 period the US had the largest share in total FDI flows. The US was followed by respectively, Germany, the Netherlands, Italy and Switzerland. These countries had 50 per cent of the total FDI inflows. When we came to 1979, the order changed and France had the largest share in total FDI inflows. It was followed by Germany, the US, Italy and Switzerland, respectively as can be seen from the Table-29. Therefore, it can be observed that the share of EC countries were become more than the share of the US after the mid-1970s.

It may be concluded from the record in the period between 1963-1979 that Turkey could not succeed in attracting a large amount of foreign investment. Due to the high level of protection in the economy, the TNCs in that period were oriented towards the domestic market and achieved to export small shares of their total sales. In other words, FDI in Turkey during this period was focused on the import-substituting industries. During 1970s, instead of integrating itself with the world economy on the basis of international division of labour and mutually beneficial trade, the Turkish economy preferred to largely isolate itself from the forces of international competition. Thus, state intervention and bureaucratic interference in

the economy was extreme, and the role of markets almost non-existent during 1970s. It must be stated here that, before 1980, Turkey did not have an explicit and well-defined FDI policy and the bureaucracy was not willing to implement FDI policy for industrialisation. Obviously, the Turkish economy could not attract notable FDI, up to 1980. Moreover, the detrimental effects of oil crises in the economy, the political uncertainties resulting from the short-term coalition governments and the Cyprus problem increased the macroeconomic instability in the Turkish economy. After mid-1970s, Turkey became known as one of the riskiest host-countries in the world for foreign investors.¹⁷⁶

As for the period between 1980-1995, the Turkish economy was achieved a transformation by the radical economic policy changes introduced by the 24 January Stabilisation Program in 1980. By the program, external economic relations were re-structured through liberalised policies and an export-led growth policy was adopted. Imports were liberalised and considerable incentives on exporting firms became operational, together with some measures, such as, reshaping and reducing the state economic enterprise' investments especially in the manufacturing sector and encouraging the private sector investments. One of the aims of the program was to boost production by employing idle capacities in the manufacturing sector and in order to do this, large amounts of foreign exchange inflows were needed. This policy orientation created additional incentives for foreign direct investments¹⁷⁷. These incentives, applicable not only for foreign investors but also for domestic ones, have been in two types. The incentives during the establishment of the investment can be considered in the first category. Credits subsidised by the state, tax exemptions in certain developing areas, and state aids to expenditures on infrastructure are the basic types of incentives for the first category. The second category of incentives are the incentives granted after the investment. Tax credits to legal persons, allowances on insurance premium expenditures of the employer, low interest credits by private banks and exemptions from real estate taxes are the best examples of the second category¹⁷⁸.

The surge for the foreign investments in order to achieve the objectives of the new economic transformation during 1980s brought the initiatives for the liberalisation of

¹⁷⁶ Erdilek, A. (1986), "Turkey's new open door policy of direct foreign investment: A critical analysis of problems and prospects", METU Studies in Developments, 13 (1-2), pp. 171-72

¹⁷⁷ Aklan, N.A. (1997) "Türkiye'de Yabancı Sermaye Yatırımları", Dış Ticaret Dergisi, Sayı:6, Yıl:2, Temmuz 1997, p.28

¹⁷⁸ YASED (1992), p.29-30

investment environment in Turkey. Firstly, the restrictions regarding the foreign ownership of real estate were abolished in 1984. According to the new regulation, legal persons as well as real persons could acquire real estate at any time. In other words, the former conditions on these acquisitions were no longer in effect so that 100 per cent foreign capital could buy real estates, establish subsidiaries and operate as the representatives of foreign firms.

Secondly, by the Communiqué concerning the Foreign Capital Framework Decree in 1986, the transfer of profits and dividends applied to the foreign investor's shares was made possible without any restrictions after taxation¹⁷⁹. More importantly, the approval mechanism for foreign investment applications was eased. The authorities in various institutions such as Ministry of Finance, Trade and Industry and Technology and the Council of Ministers for approval were transferred to the General Directorate of Foreign Investment under the Undersecretary for Treasury and Foreign Trade¹⁸⁰ as the sole responsible body for the approvals of investment applications under 500 million \$. The applications exceeding 500 million \$ relayed subject to the Council of Ministers' approval. This was an important attempt to reduce the delays in approval mechanism resulting from bureaucracy.

The ever-increasing need for external resources in the liberalisation period during 1980s, convinced the government on the need to attract short-term capital flows as well. Accordingly, 32nd Decree issued under the Law concerning the Protections of the Value of Turkish Lira in 1989, abolished the quantitative restrictions on capital transfers and the foreigners' trade in domestic capital market was permitted¹⁸¹.

In addition to the legal arrangements the government also adopted new policies such as privatisation, free trade zones (FTZ) and build-operate-transfer (BOT) model in order to attract foreign investments. Privatisation of state enterprises provided foreign investors important advantages because most of them were monopolies in their respective markets and offered a direct entry to a market with a secured mass of consumers to the foreign investors. However, there is no evidence to support this claim due to the failure of government in privatisation policy.

¹⁷⁹ Before these regulation there were restrictions on the profit and dividend transfers especially when the share of foreign participation exceeds 50 per cent.

¹⁸⁰ Now it is Undersecretariat for Treasury.

¹⁸¹ Aklan, N.A. (1997), p.28

The Law on the establishment of FTZ was approved by the Turkish parliament in June 1985. By the Law main objectives of the Turkish government were to encourage export-oriented production, technology transfer, employment creation and foreign investments. In addition to the specific commercial and financial incentives to the investors, the FTZs aim to keep bureaucracy to a minimum degree with a single authority in charge of the administration the free zones. Apart from acquiring operation licences from the Undersecretariat of the State Planning Organisation, all other permits relating to the use of the land and the construction and use of premises is under the authority of this Zone Directorate. This aims at vastly reducing red tape and devolving as much control as possible into the hands of the free zone entrepreneurs themselves. Revenues generated once a company is operating in a free zone can be repatriated or transferred into Turkey tax free. Moreover, favourable credit rate were available from banks within the free zones and a no strike agreement were provided for ten years after production begins. Currently, there are 21 FTZs in different regions of Turkey.

BOT model was put into practice by the government in 1984 in order to eliminate substantial costs of infrastructural investments, through benefiting from the financial and technological advantages of private sector and foreign capital. According to the model, the government guarantees buying the products or service output of the investments at a certain price over a certain period and the investor is responsible for the establishment of the investment. The concerned establishment is to be operated until all liabilities paid off and the investor realises the target percentage of profit over its capital. At the end of the specified period, the establishment is to be returned to the state for free of charge. Birecik Dam and hydro-electric production plant, UNI-MAR natural gas conversion plant, İzmit industrial and domestic water distribution plant and İstanbul Esenyurt natural gas conversion plant are some of the examples to BOT practices¹⁸².

As can be seen from the Table-30, FDI figures for the period after 1980 are higher than from the period between 1963-1979 (see Table-30). The cumulative performance of four years following 1980 exceeded the aggregate inflows between 1963-1979. In fact, despite the higher levels compared to the past, FDI inflows did not increase substantially until 1986. This was mainly stemmed from the political uncertainties of early 1980s following military intervention.

¹⁸² YASED (1996), p.4

Table 30: FDI Inflows in Turkey; 1980-1995 (millions \$)					
Years	FDI Permits	Realised Inflow	Cumulative FDI Inflows	Cumulative Number of Firms	FDI Inflows/GNP (%)
1980	97	35	263	78	0,14
1981	337	141	404	109	0,47
1982	167	103	507	147	0,26
1983	102	87	594	166	0,17
1984	271	162	756	235	0,46
1985	234	158	914	408	0,35
1986	364	170	1,084	619	0,48
1987	655	239	1,323	836	0,76
1988	820	488	1,811	1,172	0,91
1989	1,511	855	2,666	1,525	1,41
1990	1,861	1,005	3,671	1,856	1,23
1991	1,967	1,041	4,712	2,123	1,31
1992	1,819	1,242	5,954	2,330	1,15
1993	2,063	1,016	6,970	2,554	1,21
1994	1,477	830	7,800	2,830	0,48
1995	2,938	1,127	8,927	3,161	0,55
1980-95 (average)	1,042	551.4	-	-	-

Source: Undersecretariat for Treasury, DG for Foreign Investment; www.treasury.gov.tr

Together with the Foreign Capital Framework Decree and the related Communiqué issued in 1986, which considerably eased the approval process and the profit and dividend transfers as mention above, FDI flows increased steadily until they reached 1 billion \$ in 1990 and remained around that level for a few years. Also, the ratio of FDI inflows to the GNP was reached over 1 per cent for the first time in this period. The surge in Mergers and Acquisitions in the world also accounted for the breakthrough in the late 1980s. Especially, due to the effects of single market in EC, most companies in European markets aimed to prepare themselves the intense competition. The strategic objective of finding strong partners or alternatively, acquiring the potential rivals were gained an increasing trend in international level too. Turkish leading companies such as Koç, Sabancı and Eczacıbaşı (Danonesa, Toyatosa, Arçelik LG, Koç Allianz, Eczacıbaşı-Schwarzkopf are the examples of some of the partnerships) established partnerships with giant foreign corporations due to the same considerations at that period.

Although this increasing trend in FDI inflows was exhibiting a success compared to the previous period, it clearly not satisfactory when considers the inflows to the EU member countries and the CEECs throughout the same period (see Table-13 and Table-14). Since

then, the average actual FDI inflow into Turkey has been around 1 billion \$ per year – a performance which might not be regarded as too bad within itself but considering that the total volume of foreign investment in the world has no less than quadrupled over the last decade, is extremely insufficient and goes to show how much catching-up Turkey has to do with the rest of the world. It is also interesting to note that nearly 50 per cent of all the foreign capital permits given out by the Undersecretariat for Treasury turn into actual foreign capital inflows into Turkey during 1980-1995 period (551 million \$ realised vs. 1 billion \$ approved). This clearly underlines the hesitancy and lack of trust on the part of the investors when it comes down to taking the last step and actually making the commitment.

Table 31: Sectoral Breakdown of Authorized FDI during 1980-1995

Year	Manufacturing		Agriculture		Mining		Services		Total (million \$)
	Million \$	%	Million \$	%	Million \$	%	Million \$	%	
1980	88,76	92	-	0	-	0	8,24	8	97
1981	246,54	73	0,86	0	0,98	0	89,13	26	337,51
1982	98,54	59	1,06	1	1,97	1	65,43	39	167
1983	88,93	87	0,03	0	0,02	0	13,76	13	102,74
1984	185,92	69	5,93	2	0,25	0	79,26	29	271,36
1985	142,89	61	6,37	3	4,26	2	80,97	35	234,49
1986	193,47	53	16,86	5	0,86	0	152,81	42	364
1987	293,91	45	13,00	2	1,25	0	347,08	53	655,24
1988	490,68	60	27,35	3	5,62	1	296,87	36	820,52
1989	950,13	63	9,36	1	11,69	1	540,59	36	1.511,77
1990	1.214,06	65	65,56	4	47,19	3	534,49	29	1.861,30
1991	1.095,48	56	22,41	1	39,82	2	809,55	41	1.967,26
1992	1.274,28	70	33,59	2	18,96	1	493,13	27	1.819,96
1993	1.568,59	76	21,05	1	11,37	1	462,38	22	2.063,39
1994	1.107,29	75	28,27	2	6,20	0	335,85	23	1.477,61
1995	1.996,48	68	31,74	1	60,62	2	849,48	29	2.938,32
Total	11.035,95	66,13	283,44	1,70	211,06	1,26	5.159,02	30,91	16.689,47

Source: Undersecretariat for Treasury, DG for Foreign Investment; www.treasury.gov.tr

When the sectoral composition of FDI inflows in the 1980s is considered, it is evident from the Table-31 the share of the service sector was increasing while the share of manufacturing sector was decreasing in Turkey. In 1980, the share of services was nearly 13 per cent, however, it increased to 34 per cent in 1995. During 1980-1995, the share of services was accounted around 30 per cent. In fact, the world-wide outflows on service sector increased in that period, also tourism, banking, trade as a sub-sector had the largest share in FDI inflows into Turkey. The financial liberalisation attempts of Turkey from the early 1980s attracted FDI inflows in the services sector and foreign banks started to open branches in İstanbul. Also, due to the effect of Law No:2634 for the Encouragement of Tourism

Investments, which liberalised the land and credit allocations to tourism ventures and the share of foreign ownership as high as 100 per cent without any negotiations with the government, in 1982, the share of FDI in tourism in services sector has been increased substantially and reached nearly 10 per cent during 1980-1995. Despite the decrease in manufacturing sector' share from 92 per cent to 68 per cent, it still acquired the largest share in FDI inflows in Turkey. During 1980-1995, the share of manufacturing sector was 66 per cent. Transportation vehicles, iron&steel, electrical machinery, cement&soil products, food&beverages and textile and clothing had the largest share of FDI inflows on the manufacturing sector. In the same period, the share of agriculture and mining remained low as in the previous period. However, there observed a tremendous rise in the share of these sectors. While the share of agriculture was 1.70 in 1980-1995 period, it was 1.26 for mining sector.

During 1980-1995, there was a fluctuating trend in the distribution of FDI in the context of source country and EC countries and the US were the leading countries. In the period 1980-1984, Switzerland had the largest share in total FDI, followed by the US, Germany, France. During 1984-1986, the US became the largest investor followed by Saudi Arabia, Switzerland, Germany. In fact, the banking sector had the largest share in services especially from Saudi Arabia in that period. In the period between 1987-1989, the share of the UK increased, followed by Switzerland, France, the US. The tourism sector increased its share in service sector, especially from EC countries. During 1990-1992 France had the largest share in total FDI followed by the US, the Netherlands, Germany. Between 1993-1995, the Netherlands, France, the US and Germany were leading countries, respectively. The privatisation of public sector attracted foreign capital into Turkey, especially from EC's TNCs. In the 1980s, the US share in the total FDI inflows to Turkey decreased as a result of the economic recession in the US. The reason of the increase in FDI share of the EC countries in the same period was Turkey's attempts to integrate with the EC. The share of the EC countries in the total authorised FDI in Turkey was over 60 per cent during the period 1980-1995. Coming to the 1990s, although there occurred an increase in the share of the US it was not at the level of the increase in the share of the EC, thus the ranking did not change.

Although the existence of problems in the Turkey-EC relations, Turkey's economic integration with the EC was accelerated during the period between 1980 and 1995. Starting from the beginning of 1980 the volume of Turkish exports to the EC countries and the share

of imports from EC countries were growing continuously. This was the expected consequences of the newly established economic programme of Turkey at the beginning of 1980s. The EC regional market was provided enormous opportunities to the Turkish exports in which the share of industrial goods was increasing year by year. The economic transformation in Turkey was the main reason that constituted the application of Turkey to the EC membership in 1987. Despite the EC countries welcomed the economic liberalisation, Turkey was not considered as proper enough to fulfil the membership obligations. Especially, the failure of Turkey in democracy and human right issues were seen as the main reason for that. However, the advantages of the EC with respect to the potential of the Turkish economy was constituted the basis of the decision of the EC regarding the application of Turkey for full membership. The EC offered to make operational the Ankara Agreement which would boost the economic integration between the parties by the establishment of a custom union. Therefore, this period marked by the initiatives that aim to intensify the economic relations between the parties.

Unfortunately, the initiatives taken for the establishment of an economic integration between Turkey and the EC through custom union has not flourished the foreign direct investments in Turkey. Despite the growing trend in the FDI inflows compared to the levels of 1960s and 1970s, the record of Turkey was not as satisfactory as the other developing countries during 1980-1995. The move towards economic liberalisation at the beginning of 1980s streamlined the FDI inflows but it also harmed the macroeconomic balances. The deteriorations in fiscal balances stemming from the chronic inflation negatively affected the investment environment in Turkey.

Table 32: Breakdown of Authorised FDI according to Source Countries between 1980-1995 (million \$)														
	1980-84	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1980-1995	1980-1995 (%)
France	43.08	14.92	8.31	33.11	43.71	233.42	669.06	249.18	353.75	223.15	255.29	476.05	2,603.03	15.6
US	268.2	21.71	24.53	61.07	129.75	137.49	127.84	460.87	197.55	248.34	158.32	231.37	2,067.04	12.4
Germany	144.66	22.49	45.26	105.58	101.61	130.95	145.88	196.41	202.46	145.37	223.46	392.13	1,856.26	11.1
Netherlands	39.28	8.7	2.4	20.4	68.3	149.21	34.11	280.3	272.9	179.42	194.02	559.32	1,808.36	10.8
Switzer.	233.34	20.01	53.29	82.52	115.49	167.22	127.74	109.08	203.51	136.11	54.29	327.75	1,630.35	9.8
UK	28.73	26.49	22.83	102.61	129.65	280.72	286.41	80.82	109.34	120.49	47.42	161.37	1,396.88	8.4
Italy	22.4	0.1	4.83	6.09	40.58	74.2	65.86	180.66	119.66	419.29	164	98.57	1,196.24	7.1
Japan	0.05	3.45	2.63	111.53	69.18	73.78	102.71	54.59	36.6	237.06	125.92	283.84	1,101.34	6.6
Canada	7.52	0	5.54	0.58	9.76	6.21	2.24	51.26	22.63	58.31	37.37	41.33	242.75	1.46
S.Arabia	4.95	4.36	75.77	7.27	17.32	11.05	4.63	43.95	34.07	15.08	8.44	11.81	238.7	1.43
Belgium	13.99	0.16	17.12	4.5	3.85	29.85	18.07	8.27	20	21.1	13.43	36.2	186.54	1.11
S.Korea	0	0	0.2	1.65	0.48	1.01	17.25	0.94	10.29	93.3	0.53	15.94	141.59	0.85
Bahrain	3.33	6	0.95	0.04	1.07	0.58	4.35	6.92	49.7	25.92	11.95	6.44	117.25	0.7
Singapour	0	0	0	0	0.05	29.73	25.83	9.67	14.7	15.03	1.32	18.13	114.46	0.69
Denmark	21.36	6.9	4.67	2.05	0.58	31.64	15.76	4.73	3.66	5.21	8.57	3.63	108.76	0.65
Sweden	0.66	0.85	1.03	6.88	3.97	12.01	15.65	13.96	14.39	6.25	8.7	11.84	96.19	0.58
Iran	12.59	2.78	7.09	8.03	11.17	12.07	5.48	3.23	8.95	5.8	3.96	5.63	86.78	0.52
Austria	2.82	0.16	0.9	1.06	4.85	8.15	6.53	8.36	8.83	5.55	3.59	32.92	83.72	0.51
Panama	0.89	0.67	20.36	2.06	16.1	3.73	3.02	1.74	2.55	3.58	2.11	17.53	74.34	0.45
I.F.C	4.46	0	0	2.13	0.7	5.86	8.57	6.09	10.47	1.7	20.98	9.76	70.72	0.42
U.A.E.	16.06	0	4.64	1.03	3.14	3.68	6.04	8.04	0.32	3.39	0.31	0.23	46.88	0.28
Syria	4.42	1.7	1.71	2.65	5.53	4.21	11.13	3.56	0.99	2.69	1.69	1.49	41.77	0.25
Other	102.82	93.04	59.94	92.4	43.68	105.17	157	184.63	123.27	91.25	131.94	195.04	1,380.18	8.3
Total	975.61	234.49	364	655.24	820.52	1,511.94	1,861.16	1,967.26	1,819.96	2,063.39	1,477.61	2,938.32	16,689.5	100.00

Source: Undersecretariat for Treasury, DG for Foreign Investment; www.treasury.gov.tr

4.4.2. FDI Performance in Turkey between the establishment of the Custom Union and Helsinki Summit

On 6 March 1995 the European Union and Turkey decided to strengthen their relations through the establishment of a custom union. The agreement reached by the parties involves the adoption of an Association Council decision (Decision no: 1/95) establishing the custom union, an Association Council Resolution providing for the development of institutional cooperation and political dialogue, and a Declaration by which the EU announced the dimensions of financial cooperation¹⁸³ with Turkey.

The custom union covers only the industrial and industrial content of processed agricultural products. Traditionally produced agricultural goods are outside the scope of the custom union. Concerning processed agricultural products; the parties have agreed on the establishment of a system in which Turkey would differentiate between agricultural and industrial components of the duties applied on these products, similar to the model in the Community¹⁸⁴.

The Decision 1/95 of EC-Turkey Association Council which set the legal framework of the custom union defined the obligations and the timetable for the elimination of custom duties. On the basis of the Decision Turkey is expected to fulfil certain conditions regarding the operation of custom union. First is the elimination of custom duties and charges having equivalent effect applied to the Community-manufactured products. Secondly, the elimination of quantitative restrictions or measures having equivalent effect such as the Mass Housing Fund levy should be provided. Thirdly, Turkey is expected to align itself with the CCT in relation to third countries. Fourthly, within five years alignment progressively with the preferential customs regime of the Community is expected. Fifth is the incorporation of the legal order instruments to remove technical barriers to trade. Sixth is the elimination of custom duties on processed agricultural products not under the agreed lists. Seventhly,

¹⁸³ Under the context of the unilateral declaration of the Community concerning financial cooperation, between the years 1996 and 1999, the EU announced to committed financial funds mainly from five sources: (a) 375 million Euro in terms of grants from the Community budget; (b) 376 million Euro in terms of grants from the MEDA Programme; (c) 750 million Euro in terms of European Investment Bank (EIB) credits; (d) 340 million Euro in terms of EIB credits from the new Mediterranean Policy; (e) 205 million Euro in terms of EIB credits from Euro-Med Programme. Additionally, there are one more source called as Macroeconomic assistance covering 200 million Euro. However, it is linked to the IMF approved programs and can be used if it is required.

¹⁸⁴ Bayar, A. (2000), The Effects of the Custom union on the Turkish Economy; An Econometric Analysis of the Four Years' Implementation" Economic Development Foundation Publication No: 160, April 2000, p.2

implementation of the commercial policy regulations, the Community's competition rules, protection of intellectual, industrial and commercial property rights are expected. Elimination of state aids and incentives that are incompatible with the proper functioning of the custom union are set as a final condition¹⁸⁵.

As can be seen from the content and the provisions of the Association Council Decision, the proposed economic integration goes beyond the minimum requirements of a custom union. Turkey is also having to implement a number of measures which are part of the *acquis communautaire* of the EU. According to the Turkish side the custom union is not an end itself and it would serve as a stepping stone to the realisation of the objective of full membership. In that respect, it is considered as a cornerstone in the EC-Turkey relations and would be the first step of a future political integration by making deeper the current economic relationship.

Moreover, the custom union implies fundamental changes in the structure of the Turkish economy -especially in trade policy, competition legislation and policies in property rights and state aids- and creates new opportunities and challenges. In other words, the decision of Turkey-EC Association Council to establish a custom union between Turkey and the EU was the most important development affecting Turkish economy as a whole, since the liberalisation measures in the 1980s¹⁸⁶. It is somehow a complementary move that would strengthen the liberal polices of Turkey in accordance with contemporary rules of global world. Therefore, it is an attempt that is in parallel with the economic understanding and polices of the governments since the beginning of 1980s.

On the other hand, Turkey is the only country to conclude a custom union with the EC without being a full member. Without being a member country, Turkey agreed a custom union in which it is not involved in the decision making process of the Community's foreign trade policy and it is not supported with the necessary financial mechanism that is designed in line with the full membership approach¹⁸⁷. Moreover, the EU considers the custom union agreement as a treaty in its own right, which deliberately leaves out further perspectives. In that respect, the Association Decision offers a special relationship and lack of long-term

¹⁸⁵ Balkır, C. (1997), p.59

¹⁸⁶ Economic Development Foundation (2000), p.2

¹⁸⁷ Balkır, C. (1997), p.58

membership perspective. In other words, it is an economic integration agreement in a limited sense and involves no indicators that would change the current situation in the near future.

This is an important argument when the developments at the time of the Association Decision is considered. From the beginning of the 1990s, the Eastern European countries are granted the utmost attention and their perspectives to become full members are openly discussed. However, Turkey was always excluded from the debate of enlargement¹⁸⁸. In the Madrid European Council in December 1995, just eight months after the Association Decision, European Commission was called on to submit an assessment of the candidates' applications for membership, and to prepare a detailed analysis of the eastern enlargement of the EU. Accordingly, in Luxemburg Council of 1997, two years after the Association Decision, ten Eastern European and two south-east European countries were granted as the candidate countries of the EU. In the presidency conclusions of the Luxemburg Summit the European Council declared that the EU adopted a pre-accession strategy "to enable all the applicant States of Central and Eastern Europe eventually to become members of the European Union and, to that end, to align themselves as far as possible on the Union acquis prior to accession"¹⁸⁹. Moreover, the European Council decided to begin negotiations by the mid-1998 with Southern Cyprus, Hungary, Poland, Estonia, the Czech Republic and Slovenia on the conditions for their entry into the Union and the ensuing Treaty adjustments. The conclusion of the Luxemburg Summit was unacceptable for Turkey. The EU announced a "European Strategy for Turkey" which involved lesser commitments than the pre-accession strategy for the ten Eastern European and Southern Cyprus and Turkey was put into an uncertain category different from the other applicant countries. This meant that despite 40 years of Association relations and the finalisation the custom union, the EU hesitated to assign a membership perspective for Turkey and gave first priority to the membership of the Eastern European countries and Southern Cyprus. Therefore, having no clear indicator for full membership, the Association Decision and the following developments were the second exclusion of Turkey by the EC.

During the period 1996-1999, the lack of long-term membership perspective was a fundamental factor that affected the operation of the custom union. In fact, the provision of

¹⁸⁸ Brown, J.M. (1994), "Tansu Çiller and the Question of Turkish Identity" in *World Policy Journal*, Vol.11, No:3, Fall 1994, p.58

¹⁸⁹ Council of the European Union (1997), "European Luxemburg Council Presidency Conclusions", paragraph 10, http://www.europa.eu.int/comm/enlargement/intro/index_en.htm

the Association Decision regarding the free movement of the industrial goods was functioning to a large extent, it could not be possible to argue that all the other provisions were properly applied either by the EU or Turkey. Although a completely liberal regime is being carried out in bilateral trade, real integration has still not been achieved in the preparation and application of a common external trade policy, especially in case of sensitive products, preferential trade policies, and dumping and institutional provisions. There is no sufficient progress not only on bilateral matters, but also on issues that require merely unilateral efforts such as custom codes, standardisation and dumping laws. Turkey achieved little progress in the harmonisation of state aids, implementation of property rights and public procurement. EU's failure in sustaining declared financial assistance due to the Greek veto and European Parliament's hostile attitude was boosted the lack of political dialogue between the parties¹⁹⁰.

Trade between Turkey and the EU is one of the fundamental issue of the custom union between the parties. While the EU was Turkey's largest trade partner both for exports and imports, Turkey was the one of the EU's ten trading partners in the pre-custom union period. Moreover, the level of protection on the imports of industrial goods from the EU countries should be eliminated by Turkey which was 5.9 per cent before the custom union. Thus, it would be natural that imports from the EU will increase more than exports to the EU because the EU dismantled the barriers on the industrial goods since the beginnings 1970s. In addition, a large percentage of Turkey's imports are raw materials and investment goods needed for increasing manufacturing capacity, with the potential of increasing exports of Turkey. Therefore, one of the main effects of the custom union is the expectation for an increase in the volume of trade, mainly the level of imports from the EU.

Year	General				European Union				Share of the EU (%)		
	Exports	Change (%)	Imports	Change (%)	Exports	Change (%)	Imports	Change (%)	Exports	Imports	Volume
1993	15,348	-	29,429	-	7,376	-	13,874	-	48,1	47,1	47,5
1994	18,105	18,0	23,270	-20,9	8,634	17,1	10,915	-21,3	47,7	46,9	47,2
1995	21,636	19,5	35,707	53,4	11,078	28,3	16,680	54,5	51,2	47,2	48,7
1996	23,224	7,3	43,626	22,2	11,549	4,3	23,138	37,2	49,7	53,0	51,9
1997	26,261	13,1	48,559	11,3	12,248	6,1	34,870	7,5	46,6	51,2	49,6
1998	26,974	2,7	45,921	-5,4	13,498	10,2	24,075	-3,2	50,0	52,4	51,5
1999	26,587	-1,4	40,671	-11,4	14,348	6,3	21,401	-11,1	54,0	52,6	53,2

Source: Undersecretariat of Foreign Trade, www.dtm.gov.tr

¹⁹⁰ Economic Development Foundation (2000), p.13

As can be seen from the Table-33 that trade flows were significantly increased by the entry into force of the custom union, but the dynamics of imports from the EU were much stronger than the increase in the exports to the EU as expected. While the jump in the imports from the EU was 37.2 per cent, the exports increased only 4.3 per cent. When the period between 1996-1999 is considered, however, the imports was fluctuated and the exports to the EU was in a continuous but slight increase. The Table-33 indicates that the custom union was positively affected the share of EU in Turkish foreign trade and increased the volume of trade from the level of 48 per cent to around 54 per cent.

While the custom union would directly influence the foreign exchange revenues of the government, it is expected that it would also increase the budget deficit. Considering that nearly 17 per cent of Turkey's tax revenues originate from the duties placed on imports, the expected loss amounts to 2.6 million \$ annually¹⁹¹. Turkey policy makers are convinced, however, that harmonising the structure, standards and legislative framework of the Turkish economy and bringing it in line with the EU will facilitate the inflow of foreign direct investment. Thus, they count on the positive effects, to make up for the costs arising from the loss of state revenues. The Turkish Foreign Minister Murat Karayalçın at the Association Council meeting on 6 March 1995 pointed out that "substantial increases in inflows of private direct investment will help to alleviate some of the burdens that Turkey will incur"¹⁹².

The expectation for the increase in the level of FDI inflows by the custom union motivated the government to enact a new Decree that would bring Turkey's foreign investment regime to a much more liberal point at which the formalities were reduced. In the eve of the functioning of the custom union with the EU, the government enacted the Foreign Investment Framework Decree in June 1995. By the Decree, the evaluation of all investment applications, regardless of the amount of capital, by the General Directorate of Foreign Investment was provided. Moreover, the issues such as the termination of authorisation of licenses, the expertise, the technical assistance and management agreements; the removal of the compulsory conversion requirements of foreign currency to Turkish Lira; permits to foreign investors in assuring every type of foreign credit freely; entitlement to firms and branch offices established according to Turkish Trade Law and registered with Turkish Trade

¹⁹¹ Wech, M.N. (1997), Turkey-EU After the custom Union; A re-assessment of the Relations, unpublished Master Thesis in Bilkent University Department of Political Science, 1997, p.40

¹⁹² *ibid.*

Registry as Turkish firms and branch offices; simplification of practices to obtain permission to establish branches; and finally, a reduction in the amount of paper-work required for permissions are also covered by the new Decree¹⁹³.

Years	FDI Permits	Realised Inflow	Cumulative FDI Inflows	Cumulative Number of Firms	FDI Inflows/GNP (%)
1994	1,477	830	7,800	2,830	0,90
1995	2,938	1,127	8,927	3,161	1,72
1996	3,836	964	9,891	3,582	0,50
1997	1,678	1,032	10,923	4,068	0,44
1998	1,646	976	11,899	4,533	0,46
1999	1,700	817	12,716	4,950	0,44

Source: Undersecretariat for Treasury, DG for Foreign Investment; www.treasury.gov.tr

The decision of the Association Council and the government's attempts for a more liberal environment for foreign investments increased the expectations for inflow of more FDI in the following period. As can be seen from the Table-34 that this was to a degree true for the period preceding the operation of custom union. The permits for investment by the foreign companies were reached nearly 3 billion \$ constituting a peak for all years. But the volume of actual inflows were slightly less than the half of the permits. Foreign investors were again hesitate to investment and preferred to wait and see the functioning of the custom union. In 1996, the permits were higher than 3 billion \$. However, the continuation of macroeconomic imbalances which was slightly recovered in 1995 just after the 1994 crises, the failure to take harmonisation measures required by the custom union by the both parties and the intense conflict with Greece due to the Kardak islands, a member of EU, in early 1996 were stagnated the actual inflows in 1996. At the beginning of the 1997 the world economy was entered into a turmoil due to the crises in the economies of South-East Asian countries. The recession was boosted by the crises in Russia and Latin America in 1998. Thus, the record for 1997 and 1998 were negatively affected from the instabilities in the world economy. Turkish economy was deeply deteriorated by disastrous earthquake in the Marmara region in 1999. As a result the actual FDI inflows recorded the lowest amount since 1988.

¹⁹³ YASED (1996), March, p.2

Table 35: Breakdown of Authorised FDI according to Source Countries (million \$)						
Source Country	1996	1997	1998	1999	1996-1999	Share in 1996-1999 (%)
France	2.370,35	103,94	135,5	146,72	2.756,51	31,1
Netherlands	226,47	281,5	329,8	407,31	1.245,08	14,5
Germany	338,61	206,35	352,05	234,57	1.131,58	12,8
US	179,44	174,48	297,2	292,51	943,63	10,7
UK	164,8	122,25	44,43	88,4	419,88	4,7
Italy	43,24	124,5	128,69	95,22	391,65	4,4
Switzer.	156,84	50,28	101,58	50,89	359,59	4,1
Japan	21,14	126,68	17,54	13,85	179,21	2,0
Belgium	70,18	7,61	17,82	23,41	119,02	1,4
S.Korea	30,99	17,88	2,51	13,62	65,00	0,7
Sweden	22,09	7,52	19,42	6,88	55,91	0,6
Luxemburg	10,72	1,74	9,14	30,95	52,55	0,59
Ireland	0,71	36,23	14,39	1,18	52,51	0,59
S.Arabia	8,98	11	17,14	14,47	51,59	0,58
Bahrain	18,44	4,46	25,16	0	48,06	0,54
Austria	11,2	8,42	6,1	16,41	42,13	0,47
Spain	0,8	16,07	10,64	4,2	31,71	0,35
Denmark	0,44	13,68	4,15	11,28	29,55	0,33
Iran	5,35	9,58	5	1,58	21,51	0,24
Syria	10,47	4,58	0,72	1,87	17,64	0,20
Canada	1,42	0,41	12,86	1,91	16,60	0,19
Singapour	6,17	8,35	0	0,16	14,68	0,17
I.F.C	7,3	3,62	3,36	0,03	14,31	0,16
Israel	7,39	1,53	1,63	1,31	11,86	0,13
Finland	2,84	3,05	1,56	0,21	7,66	0,08
Russia	1,2	1,99	1,56	2,64	7,39	0,08
Other	118,12	330,51	87,49	237,99	774,11	8,3
Total	3.836,70	1.678,21	1.647,44	1.700,57	8.860,92	100,00
<i>Source: Undersecretariat for Treasury, DG for Foreign Investment; www.treasury.gov.tr</i>						

During the 1996-1999 period, the EU countries were constituted nearly 70 per cent of the total FDI inflows in Turkey. The record of the US, which was around 10 per cent, remained in a limited degree and followed by Switzerland recorded only 4 per cent. France was the leading country among the EU member countries and constituting over 30 per cent of the total FDI permits during the period. The Netherlands and Germany was the other EU countries whose share's were over 10 per cent.

The period just before the Decision of Association Council in 1995 is as important as the years following the custom union in explaining the effects of the custom union on the FDI inflows. Form the Table-35 it can be observed that there was an increase in the levels of FDI

authorisations permitted to the EU (the Netherlands, France, Germany and the others) and non-EU countries (the US, Japan, Singapore, S.Korea and Canada). The motives of foreign investors to increase their investments in Turkey were highly in parallel with the finalisation process of the custom union. Therefore, it may be argued that these plans for to increase the level of investments were a kind of preparation of foreign companies to the custom union.

Year	Manufacturing		Agriculture		Mining		Services		Total (million \$)
	Million \$	%	Million \$	%	Million \$	%	Million \$	%	
1996	640,59	17	64,10	2	8,54	0	3.122,74	81	3.835,97
1997	871,81	52	12,22	1	26,70	2	767,48	46	1.678,21
1998	1.017,29	62	5,75	0	13,73	1	609,67	37	1.646,44
1999	1.123,22	66	16,19	1	6,76	0	553,40	33	1.699,57
Total	3.652,91	41	98,26	1	55,73	0,6	5.053,29	57	8.860,19

Source: Undersecretariat for Treasury, DG for Foreign Investment; www.treasury.gov.tr

When the sectoral composition of FDI inflows in the 1980s is considered, it is evident from the Table-36 that the share of the service sector was tremendously increased and it received the largest share during the period 1996-1999. The average weight of service sector in total FDI inflows which was 30 per cent between the period 1980-1995 increased to 57 per cent in the period just after the custom union. The share of manufacturing sector was 41 per cent in the same period. As in the periods before the custom union the share of agriculture and mining remained low which were around 1 per cent and 0.6 per cent respectively.

When the manufacturing sector, which is the core of the custom union, is considered the authorised foreign investments were intensified in the sectors such as automotive, food processing, textile, chemicals and paper and packing during the period 1996-1999¹⁹⁴. Especially in 1995 and 1996, the investment decisions of TOFAŞ, Renault, Toyota and Mazda considering the custom union with the EU increased the motives for the foreign investors to auto parts industry. The increase in the investments of German companies in this industry was in a considerable degree. Also, main parts of the investments in the plastic sector were supportive to the auto parts industry. The investments in the automotive industry may be considered as rationalisation and re-structuring investments for the preparation to the custom union. However, there were some other reasons behind these motives when the structure of the automotive sector is considered.

¹⁹⁴ Undersecretariat for Treasury, DG for Foreign Investment; www.treasury.gov.tr

	Auto.		Paper		Iron-steel		Food Pro.		Chemical		Textile		Tourism		Plastics		Cement		Other	
	N	R&R	N	R&R	N	R&R	N	R&R	N	R&R	N	R&R	N	R&R	N	R&R	N	R&R	N	R&R
US	1	2	-	-	1	1	3	3	-	2	-	-	-	-	-	-	-	-	3	3
Ger.	5	7	-	-	-	1	1	3	3	1	3	3	-	1	2	1	-	-	12	7
Fra.	1	3	-	-	-	-	1	1	1	-	2	2	1	-	1	1	1	1	5	4
Net.	-	1	1	3	-	-	1	6	-	1	2	2	1	-	-	-	-	-	7	7
UK	-	2	-	-	-	1	-	-	1	-	1	2	-	1	1	-	-	-	2	6
Ita.	2	2	-	-	-	-	-	-	-	1	-	1	-	-	-	-	-	-	5	4
Jap.	4	3	-	-	-	-	1	-	-	-	-	1	-	-	-	-	-	-	1	2

Source: Undersecretariat for Treasury, DG for Foreign Investment;
N: New Investments R&R: Participation, Modernisation and other

	Auto.		Paper		Iron-steel		Food Pro.		Chemical		Textile		Tourism		Plastics		Cement		Other	
	N	R&R	N	R&R	N	R&R	N	R&R	N	R&R	N	R&R	N	R&R	N	R&R	N	R&R	N	R&R
US	-	3	-	-	2	2	-	3	1	2	1	-	-	-	2	1	-	-	3	5
Ger.	4	3	1	-	-	-	1	4	3	6	8	2	2	1	2	-	-	-	14	10
Fra.	1	3	-	-	-	-	-	1	1	-	-	1	-	-	-	1	2	2	4	2
Net.	2	1	1	4	-	-	-	3	-	2	1	-	-	-	-	1	-	-	6	2
UK	-	1	1	-	-	2	-	-	1	-	3	1	3	-	-	1	-	-	2	4
Ita.	2	1	-	2	-	-	3	-	3	-	-	-	1	-	-	-	-	-	2	1
Jap.	-	1	-	-	-	-	1	-	-	-	-	-	-	-	-	-	-	-	-	1

Source: Undersecretariat for Treasury, DG for Foreign Investment;
N: New Investments R&R: Participation, Modernisation and other

There has been a structural change in the Turkish automotive industry since the beginning of the 1990s when Japanese and Turkish consortium Toyotasa decided to invest in Turkey. It was stated by the company representatives in different occasions that the motives behind the decision of Toyotasa was mainly to produce for domestic market¹⁹⁵. Therefore, the entry of Toyotasa to the Turkish automotive industry led to the re-structuring of production by the present producers. In short, in the analysis of the structural change in the automotive industry at the beginnings of 1990 the effects of competition for domestic market should not be put aside.

Due to the competitiveness of Turkish textile sector, which accounted to over 30 per cent of Turkish exports, it may be possible to argue that the custom union increased the attractiveness of the textile sector for foreign investors. While the number of the authorisations for investment were 19 in 1995, this number was 18 in 1996. These numbers

¹⁹⁵ Corporate Location (1995), p.58

were quite high with respect to the authorisations in previous years¹⁹⁶. The specialisation and cost effectiveness increases the efficiency in production. Therefore, the foreign investments in the textile sector during the period just before and after the custom union may be considered as efficiency seeking foreign investments.

With the start of the custom union food processing sector was also became attractive to the foreign investors due to the free access into the EU market. The low costs of inputs and labour¹⁹⁷ have increased the competitiveness of this sector¹⁹⁸. The US companies in this sector would try to prevent their market shares by new entries and re-structuring investments against the competition advantages of EU companies due to the custom union (see Tables 37 and 38).

Chemicals and paper and packing industries were the other sectors that increased the motives of foreign investors by the start of custom union. The consumption of paper and packing goods were low when compared to the EU countries. The custom union introduced new standardisation implications accepted by the EU on imported goods. In that respect, the demand for these goods would be increased due to the rise in the levels of exports to the EU. This constituted a locational advantage for Turkey. Therefore, despite the effect of the custom union, the inflows of foreign investments in this sector after 1995 were mainly based on the domestic dynamics of Turkey. As for the chemicals industry, it may be considered that the custom union increased the attractiveness due to the low costs in this sector when compared to the EU. It is evident that the strict environmental regulations in the EU regarding chemical industry have increased the costs of production. By the custom union adoption of environment practices of the EU would increase the production costs in Turkey regarding chemical industry, however, this would not be as high as in the EU. Thus, the increase in the foreign investment in chemical industry by the custom union may be considered due to the cost advantages of Turkey. In that respect, FDI inflows in this industry during the period just before and after the custom union would be efficiency seeking in nature.

¹⁹⁶ Hazine Müsteşarlığı Yabancı Sermaye Genel Müdürlüğü (1996), Yabancı Sermaye Raporu ,1996.

¹⁹⁷ Food processing sector in Turkey has important cost advantages with respect to costs of inputs and labour. The cost of labour is around 10 times cheaper than the EU, however, efficiency is 2-3 times lower than EU average (Suiçmez, 1997, p.34).

¹⁹⁸ İstanbul Sanayi Odası (1995), Gümrük Birliğinin İmalat Sanayi Sektörü Üzerindeki Etkileri ve Bu Sektörün Rekabet Gücü, İstanbul: İSO Yayınları

Table 39: Gross National Product Growth During the Period 1996-1999 (%)					
	1996	1997	1998	1999	1996-1999
GNP	7.1	8.3	3.9	-6.1	3,3
<i>Source: State Institute of Statistics, www.die.gov.tr</i>					

In 1996-1999 period average growth of the Turkish economy was 3.3 per cent. While the performance just after the custom union was substantial reaching around 8 per cent, 1998 and 1999 were the years that the economy was shrinking. The years between 1996-1997 were a recovery period for Turkish economy which was enormously deteriorated in 1994 crises. With the support of IMF and the Worldbank a new economic programme was put into practice that flourished the macroeconomic environment. Also, the establishment of the custom union created an impetus for trade that boosted the growth. Therefore, the signals for foreign investors coming from the Turkish economy were seemed favourable just after the custom union. However, world economy was threatened by the crises in the South-East Asian economies in 1997 and Russia and Latin American countries in 1998. Due to the reluctance of the foreign investors to invest in developing countries the share of the developing countries in world FDI inflows between 1997-1998 were decreased to 31.5 per cent which was over 35 per cent during 1990-1996. Moreover, continued strong economic growth in the US, improved economic performance in many European Union countries, and the mergers-and-acquisitions boom due to the favourable effects of single market were accelerated FDI inflows to developed countries in 1996-1998 period.¹⁹⁹. As a result, the hesitacy of the foreign investors in the developed countries due to the turmoil in the economies of the developing countries might constitute a reason for the low record of FDI inflows to Turkey despite the expectations for an increase in the FDI flows just after the custom union.

However, the level of progress in the political relations between the EU and Turkey was a more valid explanation considering the failure of the custom union in attracting FDI inflows. As it is mentioned above, the political will of the EU for the full membership of Turkey was absent in the agenda of the relations between the parties. Moreover, by putting Turkey in a different category in the Luxemburg Summit increased the tensions in the Turkish side. Following the Luxemburg Summit, Turkey suspended its political dialogue with the EU and limited its relations with EU within the frame of association relationship. This also caused an interruption in meetings at the level of Foreign Ministers in the EU-Turkish Association

¹⁹⁹ UNCTAD (1998), World Investment Report: Trends and Determinants 1998, Overview, p.9

Council²⁰⁰. The unfavourable situation of the EU-Turkey relations was a signal for the foreign investors that increases the expectations for the inefficient functioning of the custom union.

On the other hand, from the beginnings of the 1990s, the European enlargement to the east was in the agenda of the EU. This boosted the motives of the foreign companies to invest into the Eastern European countries. While the volume of FDI flows to the Eastern European Countries were substantially increased, nearly 80 per cent of these flows were originated from the EU countries (for more information see Chapter 3.2.2.4.). The EU countries adopted policies that encourages European companies investing to these countries. Especially, Germany has played a major role in supporting the economies of these countries. It specially charged some state banks or public (i.e. Hermes Credits) financial institutions to encourage the private companies prepared to invest in these countries²⁰¹. This is a good example explaining that Turkey has never had this kind of political support in the 40 years of association with the EU. Therefore, it was quite clear that with the absence of the political will the custom union would not be an engine for inflows of foreign investments into Turkey.

4.4.3. FDI Performance in Turkey during the Candidacy Period

At the Helsinki Summit of December 1999, Turkey was declared as a candidate country destined to join the European Union on the basis of same criteria as applied to the other candidate countries. The Council introduced a pre-accession strategy for Turkey, like in the other candidate countries, to stimulate and support its reforms. In that respect, the Helsinki Summit was a turning point in Turkey's relationship with the European Union which was entered into a stalemate just after the Luxemburg Summit. By clearly situated Turkey to the present enlargement process along with another twelve candidate countries with the addition of Malta, the Helsinki Summit overcame the long-lasting ambiguity over the Turkey-EU relations. In the Helsinki Summit, Turkey was granted a clear membership perspective for the first time in the 40 years of Association. The inclusion of Turkey into the similar accession partnership to those of the other candidate countries was also a clear reflection of the willingness of the European Union to provide financial and technical support to prepare Turkey for membership, as it has done with the other candidate countries.

²⁰⁰ Ministry of Foreign Affairs (2001), Turkey and the European union; An Overview, June 2001, p.21

²⁰¹ Dartan, M. (2003), p.302

The pre-accession period was legally started with the regulation for the establishment of a single framework for co-ordinating all sources for EU financial assistance to Turkey for pre-accession²⁰² and the Accession Partnership (AP) which was formally adopted by the Council on 8 March 2001. The purpose of the AP is to set out in a single framework the priority areas for further work and the financial means available to help Turkey implement these priorities and the conditions applying to that assistance. In that respect, the AP is the cornerstone of the pre-accession strategy. It identifies short and medium term priorities, intermediate objectives and conditions on which accession preparations must concentrate in the light of the political and economic criteria and the requirements for Member States to adopt, to implement and to enforce the Community Acquis²⁰³. By the initiatives for the inclusion of Turkey into the pre-accession strategy, Turkey was started to move towards accession on the same road with the other applicant countries.

After the approval of the Accession Partnership by the Council and the adoption of the Framework Regulation, the Turkish Government introduced its own National Program for the Adoption of the EU Acquis (NPAA) on March 19th, 2001. The NPAA has been produced with a careful appreciation of the short and medium term priorities as spelled out in the Accession Partnership. The NPAA set the path for the progress that would be achieved towards accession.

By the announcement of the NPAA, the most pressing aim of Turkey is the opening of accession negotiations for membership, which depends on the fulfilment of the Copenhagen political criteria. Although Turkey was a candidate country and participating in the pre-accession process, candidacy without starting negotiations keeps Turkey out of the accession process. Therefore, through its national program, politically, Turkey has committed itself to major constitutional and legal reforms, covering political reforms to fulfil Copenhagen political criteria that include the freedom of expression and the freedom of peaceful assembly, political parties, individual rights and liberties, the death penalty, the role of the national security council, the elimination of regional disparities, the strengthening of the independence of the judiciary and improving its functioning, the situation in the prisons and pre-trial detention conditions and allegations of torture²⁰⁴. The main aim of these constitutional and legal reforms is to curtail the role of the state while increasing its efficiency, and enhance

²⁰² Council Regulation (EC) No390/2001 of 26 February 2001, OJ, L 58, 28.02.2001.

²⁰³ CEC (2001), Proposal for a Council Regulation concerning the pre-accession financial assistance to Turkey, 26 April 2001, COM (2001), 260, p.2

²⁰⁴ Secretariat General for EU Affairs (2001), The National Program for the Adoption the Acquis, p.5-28

individual rights and liberties to provide greater openness in society and to strengthen the role of the civil society in the democratic process.

In the context of these constitutional and legislative reforms that reinforce and safeguard fundamental rights and freedoms, democracy, the rule of law, and the protection of and respect for minorities, as set out in the Turkey's NPAA, the death penalty has been abolished. Comprehensive legislative and administrative measures against torture and maltreatment have been put into force. The right to retrial in the light of the decisions of the European Court of Human Rights (ECtHR) has been introduced. Rules concerning conditions in prisons and detention houses have been brought in line with the norms of the European Convention of Human Rights (ECHR), and the recommendations of the European Committee for the Prevention of Torture (CPT). The state of emergency has been lifted in all provinces. Freedom of thought and expression, and the freedom of the press have been expanded. Provisions concerning associations, foundations and the right to assembly and peaceful demonstration have been advanced. Legislation has been amended to reinforce gender equality, and to protect cultural diversity and guarantee cultural rights, and to enhance the right to learn and broadcast in different languages and dialects. Legislation concerning non-Muslim communities and foreigners have been improved. The Human Rights Advisory Board, which constitutes an effective platform for dialogue between state and civil society in the area of human rights, has become operational. The advisory role of the National Security Council has been redefined.

In addition, several conventions relating to the political criteria have been signed or ratified, among which Additional Protocol No. 6 to the ECHR Concerning the Abolishing of the Death Penalty, the UN Convention on the Elimination of All Forms of Racial Discrimination, the UN Covenant on Civil and Political Rights, the UN Covenant on Economic, Social and Cultural Rights, the ILO Convention Concerning the Prohibition and Immediate Action for the Elimination of Worst Forms of Child Labour (No. 182), and the UN Convention on Prevention of All Types of Discrimination Against Women and its Optional Protocol, can be cited²⁰⁵.

²⁰⁵ Secretariat General for EU Affairs (2003), The National Program for the Adoption the Acquis, p.3

With respect to meeting the Copenhagen political criteria, the progress achieved by Turkey since the adoption of the NPAA in 2001 was substantial. By the adoption of constitutional reform packages, the fulfilment of the Copenhagen political criteria is mainly completed. However, in the regular report drafted by the European Commission at the end of 2002, the political reforms realized in Turkey recently are characterized as a fundamental, it is declared that Turkey has not yet fully met the political criteria due to the deficiencies in implementation. Accordingly, the European Council in Copenhagen on 12-13 December 2002 encourages Turkey to pursue energetically its reform process and decided that “if the European Council in December 2004, on the basis of a report and a recommendation from the Commission, decides that Turkey fulfils the Copenhagen political criteria, the EU will open negotiations without delay.²⁰⁶ In order to strengthen the harmonisation process the Council also invited the Commission to submit a proposal for a revised Accession Partnership.

While the European Copenhagen Council postponed the decision regarding Turkey to 2004, on the other hand, it took decisions of historic significance concerning its next enlargement. It was decided that ten candidate countries (Hungary, Poland, the Czech Republic, Estonia, Latvia, Lithuania, Malta, Southern Cyprus, Slovenia, Slovakia) would be members to the EU as of 1 May 2004. Concerning Bulgaria and Romania, the European Council reaffirmed the objective to welcome these two states as members in 2007.

The decisions taken at the Copenhagen European Council regarding Turkey fell short of the expectations of Turkey. The result for Turkey was only a date for date that will announce the decision of the EU for the negotiations. The decision of the EU is clearly indicates that there is not a consensus among the EU countries regarding Turkey’s membership to the EU. Therefore, this created an atmosphere that awakened the ambiguity again in the relations between Turkey and the EU.

Nothing has changed in the EU side when the Regular Report of the Commission regarding the progress in Turkey was announced in 5 November 2003. The Commission welcomed the comprehensive steps taken by the new Government, however, found the implementation of political reforms slow and uneven. Moreover, the focus of the report on the Cyprus issue was increased the tensions in the Turkish Government. Especially, the statements

²⁰⁶ Council of the European Union (2002), European Copenhagen Council Presidency Conclusions, p.5

of some European politicians and bureaucrats regarding the situation in the Cyprus were increased the doubts with respect to the unwillingness of the EU for the membership of Turkey. The remarks of Günter Verheugen, the Commissioner responsible for enlargement, was an important sign of this. Verheugen said “the lack of solution in Cyprus problem could be a great obstacle for Turkey’s EU aspirations”²⁰⁷.

Turkish economy suffered a tremendous economic decline at the time of the Helsinki Council where the Turkish candidacy for membership was accepted. The earthquake in the İzmit region substantially affected the economy and caused recession in the economy. However, even though significant improvements were observed in Turkish economy in the 1990s, the rate of growth followed an unstable course with respect to chronic and high inflation persisted in this period. Financing of high level of budget deficits through domestic borrowing led to persistence of high real interest rates and worsening of domestic debt problem. On the other hand, high real interest rates had unfavourable impact on economic activities.

It became evident that permanent reforms rather than short-term solutions could ensure the reestablishment of stability in economic activities. With this purpose, “Disinflation and Economic Stability Program” was introduced at the beginning of 2000, which was supported by the IMF as well. The major objective of the Programme was to achieve single digit inflation until the end of 2002, to decrease the real interest rates and thus provide a stable macroeconomic environment in order to improve the long-term growth potential of the country. It was basically an exchange rate based stabilisation program, which announced the value of the exchange rate basket for the first one and a half-year period. Afterwards the exchange rates were let to fluctuate within a gradually widening band. Moreover, the program set up limits on some fiscal and monetary aggregates introduced some important structural measures in the agricultural sector, the social security system and fiscal management as well as a privatisation program to achieve the fiscal targets. These went hand-in-hand with appropriate incomes policy. In this period, despite the decisive steps taken in structural reforms and monetary and fiscal policies, the delays in privatisation of the state economic enterprises, expansion in the current account deficit due to the overvaluation of the Turkish Lira and the sharp increase in energy prices stemming from the rise in oil prices and the weak structure of banking sector have led to the November crisis in 2000. In February 2001, due to a political crises in the

²⁰⁷ Sabah Gazetesi, Interview with Mr. Günter Verhegun, 13.11.2003

National Security Council meeting the economy went into crises again resulting one of the worst economic slowdown in the Turkish economy since 1945²⁰⁸.

“Strengthening the Turkish Economy; Turkey’s Transition Program” which was adopted in May 2001 aimed to eliminate immediately the crisis of confidence and instability that emerged as a result of floating exchange rate. After restructuring the confidence, for the medium term, the new Programme has aimed to ensure a stable macroeconomic environment built on the existence of a functioning competitive market economy. The programs’ overall strategy can be summarised in three steps: Firstly, to take vital measures expeditiously with the aim of diminishing the uncertainties in the financial markets; Secondly, to adopt necessary mechanisms in order to stabilise the money and the foreign exchange markets, allowing a medium-term perspective to be re-established in the economy and finally, to establish macroeconomic balances gradually to enable a sustainable growth environment starting from the second half of the 2001²⁰⁹.

Moreover, in the Transition Program, restoring consumer and investor confidence, decreasing inflation, bringing real interest rates down to sustainable levels and completing the structural reforms have been considered as the key factors to achieve high growth rates in the medium term. In order to keep the inflation and the real interest rates at low levels, permanent and substantial fiscal adjustment together with reforms in public sector has been seen as fundamental. This is also stressed as necessary to keep the public debt sustainable over the medium term. In this regard, the regulations to strengthen budget discipline and to enhance the revenue resources have been envisaged²¹⁰.

Strengthening private sector activity in Turkey’s economy is an essential element of the new economic programme. Foreign direct investment plays a particularly important role in this process, through enhancing the country’s competitiveness in a globalized market economy and thus stimulating economic growth and income generation. But so far FDI inflows have not lived up to the potential of an economy the size of Turkey’s, thus stifling domestic business and employment opportunities. The new era in the EU-Turkey relations

²⁰⁸ Central Bank of the Republic of Turkey (2002), “The Impact of Globalisation on the Turkish Economy”, May 2002, Ankara, pp 50-59

²⁰⁹ Hazine Müsteşarlığı (2001), “Strengthening the Turkish Economy; Turkey’s Transition Program”, 2001, Ankara, pp12-13

²¹⁰ Ibid., p.13

after the Helsinki Summit would provide an opportunity to Turkey to increase the level of foreign direct investments. The Government of Turkey, therefore, initiated a comprehensive reform program to streamline the investment environment and to attract more private direct domestic and foreign investment in 2001²¹¹.

The reform programme started with a comprehensive joint study of General Directorate of Foreign Investment and the Foreign Investment Advisory Service (FIAS), a joint facility of the International Finance Corporation (IFC) and the WorldBank. The study covers a diagnostic review of the foreign investment environment in Turkey. The study team interviewed with a range of foreign and domestic investors from different countries and various sectors, representatives of foreign investors such as foreign attaches, chambers of commerce and foreign investor associations, as well as accounting and law firms that work with existing and potential investors. The team also met with government officials in many different ministries and agencies²¹². Moreover, as part of the study conducted jointly by Turkey and FIAS a project that aims to find out the administrative barriers to investment in Turkey was prepared²¹³. On the basis of the findings and recommendations of these studies, the government enacted a Decree on improving the investment climate in Turkey on 11 December 2001.

In the studies regarding the investment climate in Turkey, both domestic and international investors' complaints mainly centred on cumbersome, unclear, informal and time-consuming administrative procedures, which were creating an opaque and uncertain business environment, raising initial and operational costs for investor. Besides the losses investors incurred, the cost of foregone FDI in Turkey per year due to the effect of opacity was estimated to be over \$ 1.8 billion, representing more than 210 per cent of actual FDI flows²¹⁴.

Within this framework, a three-phase strategy was designed and started to be implemented to facilitate the reform process by the government. The challenge facing the government was how to implement the reform vision in the most efficient manner that would

²¹¹ Undersecretariat of Treasury DG for Foreign Investment (2002), Investing in Turkey and Improving the Investment Climate, <http://www.investinginturkey.gov.tr/>

²¹² FIAS (2001b), Turkey: A Diagnostic Study of the Foreign Investment Environment, February 2001, p.1

²¹³ FIAS (2001a)

²¹⁴ DG for Foreign Investment (2002), Foreign Investment in Turkey-2002, p.9

streamline administrative procedures while incorporating private sector feedback on the measures to be taken. As observed by the FIAS project team there was certainly a need for the Turkish national, regional and municipal authorities to seek increased participation of the private sector in the reform process. Thus, the programme has been implemented with the involvement of various segments of interests groups. In the first stage of the strategy, a clear vision and a consistent direction for the reform were embodied in the December 2001 ministerial decree in order to demonstrate political commitment and consensus behind the reform scheme. The decree established a coordinating body, Coordination Council for the Improvement of the Investment Climate (YOIKK), with the mandate to identify and remove regulatory and administrative barriers to private investment. The first YOIKK meeting was held in March 2002, and set targets and timelines for YOIKK's nine technical committees – which are comprised of senior public and private sector decision makers on different issues relating to the investment process.

Second, a clear and precise action plan defining the priorities, the timing and responsibilities was formulated. Last but not the least, the YOIKK has been holding regular monthly meetings in order to monitor the progress made by the technical committees and the eventual changes in private investors' needs. One core dimension of the reform process has been private sector involvement in all efforts through disseminating the information and sharing the results obtained over time. This emphasis is in line with the government's conviction that joint evaluation of the needs and identification of appropriate solutions is of utmost importance for the success of the reform initiative. The YOIKK convened each month while the technical committees held several meetings to discuss existing problems and to submit necessary actions to be taken for solution to the YOIKK, concerning the following issues:

- Company registration and reporting
- Employment
- Sectoral Licenses
- Land Acquisition and Site Development
- Taxes and Incentives
- Customs and Standards
- Intellectual Property Rights
- Promotion of Investment

- Foreign Direct Investment Legislation

The Government has taken several steps in compliance with the recommendations of the technical committees. Key among these are the redesign of the company registration process; the drafting a new FDI law; and the start-up of planning for the set-up of a national investment promotion entity. Early actions taken on the basis of the recommendations of the technical committees began to have a very significant impact on the investment climate. The progress in the company registration was substantial. The procedures which previously were taking almost two and a half months and requiring excessive documentation and approvals from several authorities have been simplified and streamlined. Now the registration can be done in a day. All that is required from the investors is to fill out a standard form at one point without applying to several different authorities for necessary approvals.

Given the importance of a strong legal framework for foreign direct investment, the existing relevant legislation was reviewed to assess the needs for as well as the content of new investment legislation²¹⁵. A new foreign direct investment law has been drafted by Turkey taking into consideration international best practices and recommendations of the FIAS study assessing the foreign direct investment legislation. The objective of the Law was to have a legal framework in conformity with the most up-to-date international standards. The Law No.4875 on Direct Foreign Investment was approved by the Parliament in June 2003. With this Law, all permits granted by the General Directorate of Foreign Investment are abolished. As a result, all transactions for establishing a company with foreign capital will be the same as with local companies. Since all companies established in Turkey within the framework of the Turkish Commercial Code are accepted as Turkish companies, all duties and responsibilities are equal regardless of the nature of capital formation. It is also no longer obligatory to bring a minimum of \$50,000 in share capital and there is no minimum amount of capital required.

The main principles of Foreign Investment Policy introduced by the new Law can be classified as follows:

- National Treatment: The National Treatment, the major principle of foreign investment policy of Turkey, was emphasized in the new law.

²¹⁵ *ibid.*, p.10

- Protection against Expropriation: Principles stated in the Constitution and the Expropriation Law are stated in the new law, as in the bilateral investment agreements and other international agreements. Therefore it is clarified that expropriation cannot take place with any reason other than the above-mentioned regulations.
- Guarantee of Transfers: In the new Law, the right of free transfer of profits, dividends, proceeds from sale or liquidation of all or any part of an investment, amounts arising from license, management and similar agreements, reimbursements and interest payments arising from foreign loans, banks or special financial institutions is clearly stated.
- Access to Real Estate: Legal entities with foreign capital, established and registered under rules of Turkish Commercial Code can acquire real estate with the same principles as Turkish nationals. The principle of reciprocity is still valid for foreign real persons.
- International Arbitration: According to the new law, for the settlement of disputes arising from investment agreements subject to private law and disputes arising from conditions and contracts made with the administration under which concessions concerning public services are granted, foreign investor can apply, beside the authorised local courts, to national or international arbitration, or other means of dispute settlement, provided that the conditions in the related regulations are fulfilled and the parties agree thereon.
- Employment of Expatriates: Foreign personnel can be employed for investments in Turkey. Considering its importance to foreign investors, employment of expatriates is explicitly mentioned in this Law.
- Free transfer of profits, fees and royalties and repatriation of capital in the event of liquidation or sale are also guaranteed,
- Open field of activity: Almost all sectors which are open to the private domestic investors are open to foreign participation. Investment by foreigners in the field of real estate is restricted, and establishments in the financial, petroleum and mining sectors require special permission according to appropriate Laws.

- No limitation in participation of foreign capital, except the following sectors:
 - broadcasting where the equity participation ratio of foreign shareholders is restricted to 25per cent (Establishment and Broadcasting of Radio and Television Law No. 3984);
 - civil aviation, maritime transportation and ports where the equity participation of foreign shareholders are restricted to 49per cent (Civil Aviation Law No. 2920; Cabotage Act No 815, Turkish Commercial Code No. 6762);
 - Türk Telekom where the equity participation of foreign shareholders are restricted to 45 per cent (Telephone and Telegraph Law No. 406). Law No. 4673, which amends Law No. 406 has a provision that except a golden share all shares of the Türk Telekom has to be sold. When this is realized there will be no restriction on entry to telecommunication sector.
 - Real or legal persons may operate marinas subject to the obtention of the necessary certificate from the Ministry. However, in operations to be established by foreigners, at least one of the shareholders in such undertaking must be a real or legal person of Turkish nationality. (Law For The Encouragement Of Tourism, No: 2634)

As it is discussed in the previous chapter, Turkey at present does not have an agency with a strong and clear mandate, setup and budget to carry out effective investment promotion, including functions such as investor servicing, investment generation and policy advocacy as in the Eastern European countries. The necessity of establishing a concerted and focused investment promotion effort in order to compete effectively with comparator countries was very well perceived by the policy makers who decided to include investment promotion in the reform process. The technical committee in charge of building an investment promotion function appropriate for the needs and expectations of Turkey made substantial progress toward setting up a new entity that will be supported by both public and private sectors.

Furthermore the YOIKK efforts have borne fruitful results in several other areas such as recruitment of expatriates, sectorial licensing, customs and intellectual and industrial

property rights. A law was recently approved by the Parliament simplifying procedures and authorizing one authority for the recruitment of expatriates and the draft law on organizational restructuring of the Undersecretariat of Customs have been submitted to the Turkish Grand National Assembly to be approved. The Undersecretariat of Customs has been implementing an ambitious reform program to improve its administrative efficiency and effectiveness. The customs automated system has been rolled-out to 99 per cent of all customs offices and further enhanced to assist customs in controlling movement of goods. Important steps taken include modernizing customs laws, regulations and procedures in line with those of European Union legislation; and simplifying and harmonizing forms/documents, procedures and control techniques in-line with those internationally recommended by the World Customs.

Necessary legislation to strengthen the capacity and infrastructure of the Turkish Patent Institute has been put in force. The intent is to ensure effective implementation of the regulations on protection of intellectual and industrial property rights.

Table 40: FDI Inflows in Turkey in the Pre-Accession Period (millions \$)					
Years	FDI Permits	Realised Inflow	Cumulative FDI Inflows	Cumulative Number of Firms	FDI Inflows/GNP (%)
1999	1,700	817	12,716	4,950	0,44
2000	3,477	1,707	14,423	5,328	0,8
2001	2,725	3,288	17,711	5,841	2,2
2002	2,243	1,042	18,753	6.280	0,6
2003*	1,208	150	18,903	6,511	-
<i>* As June 2003</i>					
<i>Source: Undersecretariat for Treasury, DG for Foreign Investment; www.treasury.gov.tr</i>					

In the pre-accession period, it is observed from the Table-40 that there has been an increasing trend in both the FDI permits and inflows. In 2000, the permits reached over 3 billion \$. The major permits in 2000 were for the GSM investment by İş-Tim, Iskenderun Energy Plant, Kordsa Sabancı and Dupont, Toyotasa. While the level of the permits started to decline from the 2001, they were still over the average of the previous year. In 2001, actual inflows was recorded as 3.2 billion \$ which was a record all over the period from 1950. The reason behind the high level in inflows were the realisation of previous permits. Especially, the realisation of the investments by İş-Tim and Turkcell in telecommunication, Tototasa in automotive, HSBC in banking and finance, Abbot Labouratuvars in health were increased the

actual FDI in 2001. In the pre-accession period, yearly average of FDI inflows was over 1 billion \$ performing better compared to the previous periods.

Year	Manufacturing		Agriculture		Mining		Services		Total (million \$)
	Million \$	%	Million \$	%	Million \$	%	Million \$	%	
1999	1.123,22	66	16,19	1	6,76	0	553,40	33	1.699,57
2000	1,105.49	32	59.74	2	5.01	0	2,307.18	66	3,477.42
2001	1,244.59	46	134.38	5	29.11	1	1,317.20	48	2,725.28
2002	892.01	40	32.82	1	17.29	1	1,300.81	58	2,242.93
2003*	710.65	59	7.73	1	124.18	10	365.43	30	1,207.99
Total	5,075.96	45	250,86	2	182,35	1	5,844.02	52	11,353.19

* As June 2003

Source: Undersecretariat for Treasury, DG for Foreign Investment; www.treasury.gov.tr

When the sectoral distribution of total foreign investment permits allocated in the pre-accession period is considered, services is in first place with a share of 52 per cent, followed by the manufacturing sector with a share of 45 per cent, the agriculture sector with 2 per cent and mining sector with 1 per cent. In this period, the share of services is still over the share of manufacturing as in the custom union period.

In terms of sub-sectors, the foreign investment permits have been allocated mainly to automotive, autoparts, electronics, agribusiness, press-publishing, beverages industries in the manufacturing sector; and to banking and other financial services, commerce, telecommunication, investment finance, hotel-pensions-camping business and insurance industries in the services sector.

	2000		2001		2002	
	Million \$	%	Million \$	%	Million \$	%
EU Countries	2367,71	68,1	1804,68	66,2	1426,37	63,6
OECD Countries (Other than EU)	618,04	17,7	665,6	24,4	601,86	26,8
Middle East Countries	46,88	1,4	28,16	1,1	48,18	2,2
North African Countries	1,59	0,1	2,81	0,1	9,74	0,5
Other Countries	443,2	12,7	224,03	8,2	156,85	6,9
Total	3477,42	100	2725,28	100	2243	100

When the distribution of permits on the basis of country groups is considered, the EU countries continue their traditional dominance with a share of over 65 per cent. It is followed by OECD countries (other than the EU), Middle Eastern countries and North African

countries. Germany has the largest share of foreign investment permits during the pre-accession period. The Netherlands and the US followed Germany by the share with 13,2 per cent and 11,7 per cent in the total permits in this period. France which was the leading country in the previous periods was in the sixth rank among all the countries.

Table 43: Breakdown of Authorised FDI according to Source Countries (million \$)							
Source Country	1999	2000	2001	2002	2003*	1999-2003	Share in 1999-2003 (%)
Germany	407,3	686,84	319,31	271,99	259,92	1945,36	17,2
Netherlands	234,6	1,381.34	635,47	379,27	241,42	1490,76	13,2
US	292,5	291,3	316,06	310,75	121,56	1332,17	11,7
UK	88,4	98,15	506,53	247,66	175,83	1116,57	9,8
Japan	13,85	150,78	258,6	128,76	11,92	563,91	4,9
France	146,7	33,7	137,71	134,06	93,74	545,91	4,8
Italy	95,22	17,86	33,63	243,51	30,38	420,6	3,7
Switzer.	50,89	35,26	86,1	149,3	89,93	411,48	3,6
Panama	0	50,67	133,08	28,38	9,76	221,89	1,9
Belgium	23,41	161,79	7,98	10,08	1,2	204,46	1,8
Luxemburg	4,2	31,85	72,12	45,95	24,87	178,99	1,5
S.Korea	13,62	113,52	1,96	3,56	0,95	133,61	1,2
Spain	30,95	6,31	12,28	42,89	28,43	120,86	1,1
Denmark	11,28	10,05	69,86	4,89	4,02	100,1	0,9
S.Arabia	14,47	9,01	13,59	8,05	20,49	65,61	0,6
Other	273.18	1,777.83	121.86	233.83	93.53	2,500.23	22,1
Total	1,700.57	1,697.09	2,826.14	2,242.93	1,207.95	11,352.51	100
* As June 2003							
Source: Undersecretariat for Treasury, DG for Foreign Investment; www.treasury.gov.tr							

As can be seen from the statistics in the pre-accession period (see Table-43) that there has been an improvement in the FDI figures of Turkey since the beginnings of 2000. The candidacy to the EU and the progress achieved within the reform programme were welcomed by the foreign investors and this situation positively affected the investment decisions in Turkey. However, it is early to say that these effects have completely improved the investment environment of Turkey. Because there exists an ambiguity in the results of these two factors. As for the integration with the EU membership, Turkey's future in the EU has not been clearly identified yet. The EU member countries have not reached a consensus among themselves for the membership of Turkey. They have not persisted Turkey's integration as in

the case of CEECs. Without the start of the negotiations for the membership the ambiguity would not be declined. This situation has not provided a clear vision of Turkey in the decisions of foreign investors. As for the reform programme for the improvement of investment environment, there has been achieved some progress. The studies within the reform programme have been continuing. However, changing the existing business environment in a comprehensive fashion cannot be achieved in a short period of time. Especially, since many issues related to the investment climate in Turkey span across many parts of the bureaucracy. In many instances, this will entail closer collaboration and cooperation among different bureaucratic authorities as well as changes in the mentality and attitude of Turkish civil servants. Such changes requires some period of time.

Additionally, Turkey can still not overcome the politic and economic instability. Economy suffered two substantial crises and still in a period of recovery. The macro balances are not stable and confident as the requirements of international environment. Despite the one-party government after the 3rd November elections in 2002, there still exists questions within state and the Army about anti-secular attitude of the Justice and Development Party (AKP). Moreover, the chaotic situation of Iraq, as an external factor, may be accepted as the other factors that disturbs political stability in Turkey. All these factors have negatively affected the improvement of investment environment in Turkey.

5. CONCLUSION

As stated earlier, much of the work during this study concentrates on to find out whether there is an interaction between REI and FDI. In accordance with the huge literature in this area, one of the main results of the study was the acceptance of the existence of the positive effects of regional economic integration on foreign direct investment.

The process of European economic integration, which coincided with a considerable inflow of FDI in to the European regional market, is a clear example to illustrate the positive interaction between REI and FDI. As mention before, the attempts for the establishment of an economic integration in Europe boosted the foreign direct investment inflows into the EC, especially from the US. The countries in the EC accounted for 12.2 per cent of the world total value of US FDI abroad in the period 1957-1967 which was 5.4 per cent in the period before the formation of the EC²¹⁶.

In early years of the European regional integration FDI flows to member countries were mainly tariff jumping investments which are in accordance with the basic argument of neo-classic theory. Thus, the rise in FDI flows were mainly related with the static effects of the integration and lacked continuity. Starting from the mid-1980s, with the effect of the Single Market Program which was developed to achieve the well-functioning of the European regional market, FDI inflows to the EC seek to benefit from the competitiveness provided through Single Market Program. In this period, it is thought that the investments were affected by the expected changes in the market characteristics and the signs of the formation of an investment environment which provided efficiency in production. After 1985, the accession of new members with different levels of economic development was an important event that helps to understand the factors that lead to increase in the level of efficiency seeking foreign investments. In 1990s, it is seen that the foreign investments directed to the market have lost its importance in the integration area and firms attempting to increase their competitiveness have rather made investments based on strategic asset.

²¹⁶Yannopolous, G (1990), "Foreign Direct Investment and European Integration: The Evidence From the Formative Years of the European Community", *Journal of Common Market Studies*, 28,

While considering the interaction between REI and FDI, a special attention should be paid to the intra-regional direct investments. It is clear that with the establishment of a common market there has been a favourable investment environment for European TNCs. In accordance with the theoretical expectation that direct investment increase as soon as companies become convinced of the advantages of selecting locations within an enlarged regional market. However, the motive for European Community TNCs to invest in other member countries is not the tariff-jumping effect of integration, but the advantage of settling in optimum locations in the absence of custom duties between the member countries and of large market size.

The flows of direct investment among European Community, as discussed in the chapter 3, show that the poorer member countries like Spain, Ireland, Greece, Portugal are the net importers of foreign investment while richer countries like Germany, UK, France and the Netherlands are net exporters.

These patterns are highly illustrative of the European integration process. They indicate that there is a net flow of investment flows towards the less developed EC countries. The accession of Spain, Portugal and Greece have attracted a growing inflow of direct investment, of which most has come from the EC.

As it is clear from the conclusions of this study, European integration has affected foreign direct investments in the integrated region in two ways: first is the inflow of direct investment from third countries, mainly US, since the size of the market and trade barriers are affected by the integration and second relates to the direct investment by companies of European Community in other member countries as result of the awareness of the advantages of integration market.

This study also examines the flow FDI to Central and Eastern Europe during the Union's enlargement process. It states that the integration process has positively affected the inflow of FDI to CEECs. One of the main reason behind the high rates of inflow is the support of the EU to these countries considering the EU membership. This has constituted a very important signal for foreign investors. FDIs were played a very important role in CEECs by providing the financial resources that the transition economies were unable to provide by themselves, modernising the industry, developing the service sector and facilitating these

countries' integration into the world trade system. The Association Agreements also contributed towards deeper integration between Western and Eastern Europe.

Considering the spectacular growth in the total volume of FDI going around the world over the last decade and developing countries' rapidly increasing share in it, Turkey's performance in this field has largely been disappointing, with inflows staying much below expectations and the country's well-known potential in terms of REI.

However, the analysis in the first part of the Chapter 4 implies that Turkey's competitive position is strong when compared to the potential competitor countries inside the EU and outside the EU. With its large and dynamic market, low cost labour force, favourable infrastructure and ability to access regional markets Turkey provides important advantages for market, efficiency and resource seeking FDI. Due to the generous FDI legislation, FDI enabling environment is attractive for foreign investors. Although investment promotion and privatisation facilities are unfavourable, the well operating investment regime and supportive economic infrastructure (banking, capital markets etc) encourage FDI enabling environment.

The problem that is clearly regarded to be the most serious one by the foreign investors is economic and political instability and an overwhelming majority of the potential investors recommend the establishment of political stability in Turkey. This is regarded as the major problem and it is firmly believed by the foreign investors that once political stability is achieved and a strong, long-lived government is in power, the path economical reform and stability will have been paved, encouraging the foreign investor to come to Turkey.

After the analysis of the process of the economic integration between Turkey and the EU, it is clear that the lack of confidence in the relations of the both parties was also constitute an important obstacle on the attainment of the expected consequences of economic integration. While the integration process was hampered by the unfavourable economic conditions of the world economy starting from the beginning of 1970s, it was came to nearly an end due to the democracy and human rights issues in the 1980s. In the mid-1990s, an important step was achieved by the establishment of custom union, however, Turkey has never treated as the CEECs by the EU. In other words, custom union was considered by the highest level of integration and it is not a part of a pre-accession policy that aims to make Turkey a member country.

Therefore, the decision in Helsinki at the end of 1999 was a turning point in the relations between Turkey and the EU. It is an initiative for the first time by the EU in which the possibility of Turkish membership to the EU is clearly defined. However, the ambiguity in the relations between parties is still continuing. Turkey can not start the membership negotiations. Start of the negotiations is a political decision of the EU and the EU member countries have not reached a consensus among themselves for the membership of Turkey. They have not persisted Turkey's integration as in the case of CEECs. Without the start of the negotiations for the membership the ambiguity would not be declined.

The opening up of the negotiations will be a strong signal that Turkey will come a EU member in the near future. Assuming that the government will continue the current structural reforms with a clear focus on the improvement of the investment environment, the signalling effect of the opening of membership negotiations will be very strong. Such a decision will assure foreign investors that the Turkish economy will set on a stable economic growth path towards a foreseeable future. For Turkey, the benefit of stability ensured by the negotiations will be convincing for foreign investors to channel more investments into Turkey.

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