DEVELOPMENT AND DETERMINANTS OF FOREIGN DIRECT INVESTMENT IN TURKEY: A COMPARATIVE ANALYSIS WITH THE EU COUNTRIES

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ABSTRACT

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The main purpose of this study is to investigate the nature of FDI inflows into the economy of Turkey, to analyze its development and various economic determinants, which govern its levels and performances. For this purpose, we have firstly to examine exact reasons for comparably low level of FDI in Turkey and secondly compare determinants of FDI in other EU Members & Candidates in order to discover essential steps to be taken. For this purpose, an FDI development analysis is made in the second chapter, and a comparative analysis between Turkey and EU Members & Candidates is completed in the third chapter. The research indicates that political and economic instability, weakness of legal framework, insufficient administration system, and corruption have been the major problems that prevent favorable investment climate, thus, attracting large amount of foreign direct investment. The lack of transparency in the financial statements and resistance to adopt the international accounting standards stand as the most important impediments in the microeconomic scope. The increasing FDI by 2005 is considered to be closely linked with the European Union process of Turkey and the well functioning privatization program.

ÖZET

TÜRKİYE'DE DOĞRUDAN YABANCI YATIRIMIN GELİŞİMİ VE ETKENLERİ: AVRUPA BİRLİĞİ ÜLKELERİYLE KARŞILAŞTIRMALI ANALİZİ

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Bu tez Türkiye'de doğrudan yabancı yatırımın etkenlerini ve gelişmesini araştırmaktadır. Bu nedenle öncelikle Türkiye'deki yetersiz doğrudan yabancı sermayenin nedenleri üzerinde ikinci olarak da bu faktörlerin AB üye ve adaylarında yabancı sermaye etkenleriyle karşılaştırılması üzerinde durulmuştur. Karşılaştırmalı vaka araştırması bulgularına dayanarak yapılan analiz, Türkiye'de siyasi ve ekonomik istikrarsızlığın, yasal mevzuatın, idari prosedürlerin ve yolsuzluğun yabancı yatırımcılar için uygun bir yatırım ortamı yaratmaya yönelik önemli engeller olduğunu göstermiştir. Ayrıca, mali tablolardaki şeffaflık sorunu ve uluslararası muhasebe yönetmeliğininin uygulanmaması; şirketler bazında yabancı yatırımlar için önemli engel teşkil etmektedir. 2005 yılı itibariyle Türkiye'de artan doğrudan yabancı sermaye Avrupa Birliği ile geliştirilen ilişkilere ve iyi işleyen özelleştirme programına bağlanmıştır.

Contents:

Abbreviations

FDI (Foreign Direct Investment)

MNEs (Multinational Enterprises)

OECD (Organization for Economic Cooperation and Development)

UN (United Nations)

UNCTAD (United Nations Conference on Trade and Development)

IMF (International Monetary Fund)

EU (European Union)

CU (Customs Union)

WTO (World Trade Organization)

BDDK (Turkish Banking Regulation and Supervision Agency)

TUSIAD (Turkish Industrialists’ and Businessmen’s Association)

YASED (Foreign Investors Association Turkey)

DEIK (Foreign Economic Relations Board)

USD (United States Dollar)

TL (Turkish Lira)

GDP (Gross Domestic Product)

CEEs (Central and Eastern European Countries)

IMD (International Institute for Management Development)

TUBITAK (The Scientific and Technical Research Council of Turkey)

GDFI (General Directorate of Foreign Investment Turkey)

M&A (Mergers and Acquisitons)

ICI (Istanbul Chamber of Industry)

CHAPTER 1

Introduction

Foreign direct investment (hereinafter FDI) has been the major vehicle for multinational enterprises in the last two decades to establish and expand business operations all over the world, particularly to the places that provide competitive advantages. On the other hand, foreign investment has contributed to economic development of emerging countries with its great input to their capital and technology level.

The main purpose of this study is to investigate the nature of FDI inflows into the economy of Turkey, to analyze its development and various economic determinants, which govern its levels and performances. For this purpose, we have firstly to examine exact reasons for comparably low level of FDI in Turkey and secondly compare determinants of FDI in other EU Members & Candidates in order to discover essential steps to be taken. For this purpose, an FDI development analysis is made in the second chapter, and a comparative analysis between Turkey and EU Members & Candidates is completed in the third chapter by addressing the following questions:

1- What are the economic determinants & impediments of FDI and how do they explain the developing foreign direct investment in Turkey?

2- What does the comparative analysis with the EU Members & Candidates indicate for Turkey's future performance in attracting sustainable Foreign Direct Investment?

Finally, in the light of our results, we made some policy suggestions related with the FDI policy in Turkey.

In this study; Turkey is taken as a basis because Turkey failed to attract FDI between 1980-2003 and is found to be successful in this area in the last two years due to betterment of investment conditions and starting of accession negotiations with the European Union. According to UNCTAD World Investment Report 2004, Turkey has been 35th in attracting FDI throughout the world; whereas she was ranked as 57th by 2003. Thus, Turkey has been successful to become aware and improve the negative features of its investment climate. This two dimensional nature puts Turkey in a unique position when analyzing impediments of FDI.

The research indicates that political and economic instability, weakness of legal framework, insufficient administration system, and corruption have been the major problems that prevent favorable investment climate, thus, attracting large amount of foreign direct investment. The lack of transparency in the financial statements and resistance to adopt the international accounting standards stand as the most important impediments in the microeconomic scope. The increasing FDI by 2005 is considered to be closely linked with the European Union process of Turkey and the well functioning privatization program. Thus, the ongoing negotiations with the European Union is found to be a helpful factor to eliminate traditional impediments by imposing regulations, therefore stabilizing and enhancing the investment environment. Comparative areas with the EU Members and Candidates will include key factors for the FDI inflow; such as purchasing power parity, labor costs, productivity, education, trade openness and demographic dynamism. The main aim of this kind of a research is to address the key areas that Turkey needs to develop in order to attract sustainable FDI inflow throughout the next decade.

The structure of the thesis is the following. The second chapter, namely, *Development & Determinants of FDI in Turkey*, gives insight into FDI inflows in Turkey starting from 1980s. A detailed information on the nature of the Turkish economy, FDI inflow into different sectors, the source countries of FDI will be explored. The well known theories on Foreign Direct Investment such as Internalization, Eclectic Theory and Product Life Cycle Theory are going to be explained and linked with the Turkish case throughout the chapter. The determinants of FDI and the historic impediments will be analyzed in detail. Privatization and significant increase in the sales of state enterprises will be separately discussed as an important factor that contributes to the increasing FDI inflow in Turkey. Moreover, practical examples from the corporate life are going to be provided in the context of impediments to FDI.

Chapter three, *A Comparative Analysis of Turkey & EU Members & Candidates*, presents an in depth comparison of Turkey and similar emerging economies of one or two decades ago, such as Poland, Czech Republic and Hungary and other comparable EU countries which have been successful in attracting foreign direct investment. The main aim of this kind of a comparison is to address the gap between Turkey and its competitors on key factors affecting the FDI inflow. Finally, the Conclusion chapter attempts to summarize the main findings of our case study and offers a recommendation section for Turkey to attract FDI throughout the accession negotiation process with the European Union.

CHAPTER 2

Development of Foreign Direct Investment in Turkey & Determinants of FDI

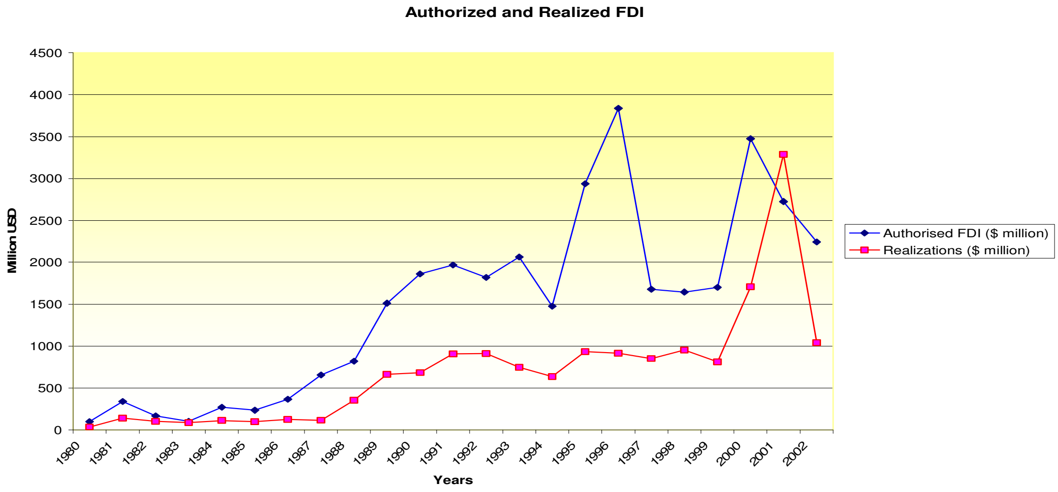
If Turkey is to start a convergence process with the European Union by its new Economic Program launched in 2001, its growth rates will have to stay around 5–7 % range which is achieved in last couple of years. As Dervis puts it, the past experience shows that Turkey is lacking of domestic savings to finance investment to keep growth at this level (Stabilizing Stabilization, 2004). In fact, many EU members and candidates have faced with the problem of financing huge need of new capital which can not be obtained by domestic savings. Foreign direct investment here emerges as the best solution to finance the huge growth rates and current account deficit as this type of capital can not be typically pulled back at short term; and therefore, does not lead to potential for crisis.

"For a country like Turkey, with a limited technology base and lack of domestic savings, FDI inflows are desirable" (Dervis, Stabilizing Stabilization, p.6). After the economic liberalization program coming into force in 1980s, international trade became important part of the economy. This sudden improvement in the international trade can also be explained by the Customs Union Agreement with the European Union signed in 1996 which implied an elimination of tariff and non tariff barriers on industrial goods and forced Turkey to adopt the Common External Tariff (CET) against third country imports. However, integration with the world economy through FDI has been low compared to the other developing countries. The Customs Union had a very limited impact on FDI inflow since 1996. This could have resulted from the Turkish governments' failure to facilitate the large interest shown by investors and to convert them into real investment because of many factors such as macroeconomic instability and 'non-friendly' FDI legislation (Hadjit -Browne, 2005).

2.1 Development of Foreign Direct Investment

Although the legal framework preparations for the Foreign Direct Investment were already started in 1950s, the degree of openness of the Turkish economy has changed radically in the recent decades. According to the report of Melek Us (2001), the director of foreign investment department in Turkey, the cumulative FDI until 1980 was only USD 220 million. The liberalization program adopted in 1980s aimed to minimize state intervention, establishing a free market economy and incorporating the Turkish economy with the global economy. Thus, with the liberalization program, Turkey has gradually abandoned the inward oriented strategy and accepted free market reforms, thus shifting into export oriented economic liberalization.

As the below chart displays, the annual FDI flows in Turkey grew rapidly by the mid 1980s, reaching $ 1 billion in 1990. However Us notes in the same report that the global FDI inflows has reached its peak on 1990s, USD 1 quadrillion in average. Thus, the increase of FDI inflow in Turkey at 1990s can be closely connected with the increase of global foreign investment.



Source: Turkish Treasury, data as of June 2003

According to the above data, the FDI inflows were just 0.44 % of GDP in Turkey between 1995-2000. This statistic ranked Turkey on the 81st place out of 91 among developing and transition countries where FDI inflow was 2 % of GDP in average. Despite of emphasizing Turkey's high FDI potential, Turkey has been ranked as an under performing country as it was the case with the World Investment Report in 2003. In the European Commission's progress report in 2000, Turkey's poor inward FDI performance was emphasized as a barrier to economic development and integration. Besides all these factors the yearly FDI attraction potential of Turkey was US$ 35 billion according to the World Investment Report in 2002.

As shown in the above chart, in 1995, the year that the Customs Union agreement was signed and in 1996, where agreement came into force, approved and realized FDI flows show quite big differences. The main reason was that investors' perceptions of the opportunities of investing in Turkey did not meet the reality of the situation. Therefore most of the authorized investment projects were not realized in 1990s (Loewendahl&Ertugal, 2001). In other words, the above chart indicates that the former governments were unable to facilitate the large interest shown by foreign investors.

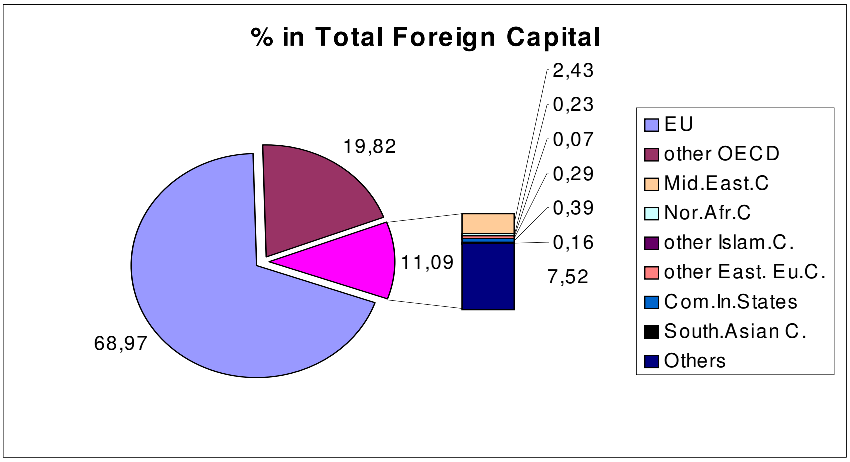
After settling on USD 800 - 1,000 million range throughout the late 1990s, the FDI inflow has significantly increased as of 2004 and 2005. According to UNCTAD World Investment Report 2004, Turkey has been 35th in attracting FDI throughout the world with an FDI amount of \$2,733 bn; whereas she was ranked as 57th by 2003 with an FDI amount of \$ 1,753 bn. Turkey showed improvement in 2004, but 2005 had been revolutionary. Even though the official numbers are not announced yet for the year ended 2005, it is predicted that the FDI amount has reached over \$ 20 bn already (Erdikler, Foreign Investors' Association Report, 2005). Even though the determinants of the increasing FDI will be analyzed later in the study we believe that the improving economy should be explored at this point as being one of the most important determinants of FDI attraction. Today, Turkish economy performs better compared to last decade as the last stand-by agreement with the IMF and the regulations of EU Economic Criteria are carried out decisively into the economy. The main macroeconomic indicators provide confidence and stability. As of 2004, GDP grew by 9.9 % which makes Turkey OECD's fastest growing country, leaving China behind. Debt to GNP ratio stands at 67 % at the year end 2005; which seems to be in line with the Maastricht Criteria, 60 %.

The European Commission Report, European Economy (2004, p.100), states that stabilization of the economy has continued along 2003 and 2004 in Turkey. The main forces of the stabilization have been pointed as investment and private consumption. The inflation rate was below the target of 10 % achieved by strict fiscal policy and declining domestic demand. It is pointed by the European Union that Turkey has made progress in improving the functioning of markets and in strengthening the institutional framework for a fully functioning market economy. However, macroeconomic stability and predictability are not found sufficient yet to achieve sustainable growth rates throughout the next decade (http://europa.eu.int, 2005).

The last overview of the Turkish economy is stated as the following in the Seventh Review under the Stand-By Agreement by IMF:

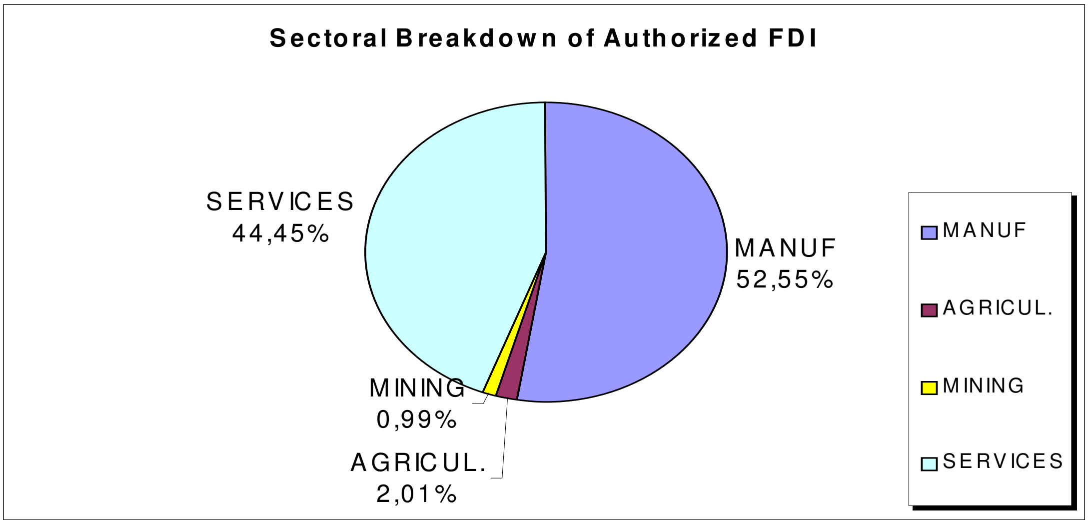
> Successful macroeconomic management delivered an impressive economic performance in 2003. Fortunately, policy credibility that was established last year, as well as favourable political developments and positive global financial market conditions, shielded Turkey from adverse market reaction and gave time for fiscal, policy to be adjusted. The challenge of this final year of the program is to maintain macroeconomic policies firmly on track and to move decisively on a comprehensive program of structural reforms to safeguard and advance the recent achievements. (IMF, 2004)

As it is shown in the figure below, the main source of FDI inflows in Turkey is the EU Members. For the 1980–2002 period, France, Germany and the Netherlands were the chief investors in Turkey. They were followed by the United States, the UK and Italy. In terms of the number of companies, EU companies are yet again in the first position. As of June 2003, Germany is the leading country with 1,084 companies, followed by the Netherlands, UK and France (Economist Intelligence Unit, 2004). However, the foreign interest from the non EU members has increased significantly as of 2005. Oger Telecom of Saudi Arabia bought 55% of Turk Telecom for $ 6.65 billion. The negotiations with the investors from Dubai are still ongoing. The project includes building of Dubai Towers in Istanbul worth $ 5 billion.



Source: Turkish Treasury, data as of June 2003

The distribution of FDI permits by sector indicates that between 1980 and 2002, the manufacturing sector attracted the most, with a share of 52.55 percent, followed by services (44.45 percent), agriculture (2.01 percent) and mining (0.99 percent) (Turkish Treasury, 2005). In terms of sub-sectors, the automotive and auto-parts sub-sector are the ones that received most of the FDI permits.



Source: Turkish Treasury, data as of March 2005

2.1.1 FDI Theories & FDI in Turkey

A number of theories have been developed to explain the models of the FDI and activities of multinational enterprises during the last couple of decades. Well accepted, three of them are reviewed in this section briefly, with the purpose of providing appropriate knowledge over those known theories. Furthermore, even though the literature lacks of matching the FDI theories and the pattern of FDI in Turkey, these theories are linked with the Turkish case with the aim of explaining the FDI inflow from certain industries. What we have found is that the theories themselves are not sufficient to enlighten the whole pattern FDI inflow in Turkey; however they are useful in bringing an explanation to some aspects of foreign direct investment.

Theories discussed in the following pages are internalization theory, Dunning's eclectic theory which seeks an explanation of multinational enterprises activities, and the product life cycle one which is originally known as a trade theory but also used to explain FDI and multinational enterprises' activities too.

Internalization Theory

The hypothesis of the internalization theory is that MNEs seek alternative ways to set up value-added activities outside the national market and those multinational enterprises take investment decision whenever they see that operating across national boundaries is beneficial and exceeds home market operation advantages (Dunning, 1993).

Buckley&Casson (cited by Seymour, 1987, p 34) suggest that four main factors relevant to the internalization decision;

- Industry specific factors, relating to the nature of the product and the structure of the external market
- Region specific factors, relating to the geographical and social characteristics of the regions linked by market
- Nation specific factors, relating to the political and fiscal relations between the nation concerned
- Firm specific factors, which reflect the ability of the management to organize an internal market

Griffin and Pustay (2002) contributes to the theorem that impediments and costs for transactions are the main factors in firms' decisions to operate across national boundaries. By focusing non-transferable factors of competitive advantages, the internalization theory tries to explain why MNEs undertake FDI instead of choosing easier and less risky arrangements such as contracts or licensing. Firms are reluctant to transfer their assets to other firms which might be a competitor in the future by using knowledge of the contracting firm. By setting their own operations in foreign markets, rather than licensing, firms are able to exploit their knowledge across borders while maintaining control and realizing a longer and safer return on investment (Rugman & Wr1ight, 1999).

In today's world, the companies that invest much more to the research and development are the ones that avoid giving licenses easily. So these companies internalize their operations abroad. In the Turkish example, the pharmaceutical companies that are coming from the developed countries are investing and establishing their production centers throughout the Turkey instead of giving their licenses to the local companies to produce 'generic' medicaments. Given the insufficient spending to the R&D and differences in the health regulations with the EU, the huge pharmaceutical companies such as GlaxoSmithKline, Pfizer and Roche tend to build their own operations in Turkey in order to protect the reputation of their brand and to prevent misuse of its proprietary technology. Thus, in line with the internalization theory these companies do not leave the control to the local pharmaceutical firms.

Eclectic Theory

The eclectic theory groups a number of explanations which can be classified either as ownership-specific advantages (O), location-specific advantages (L), and internalization advantages (I) (Harrison et al 2000). In deciding whether to undertake FDI, a firm must have developed firm specific characteristics that enable it to be competitive in the market. Dunning (1993) adds that the capability and willingness of MNEs to operate in foreign markets depend on their possessing specific assets. Such assets are referred as ownership specific advantages (O), because they are unique to that particular firm. Those assets are not only tangible such as natural endowments, capital etc. but also intangible assets such as technology, information and managerial skills.

By location specific advantages (L), Dunning indicates the advantages that rise from using resource endowments or assets that are tied to a particular foreign location and that a firm finds valuable to combine with its own unique assets.

The 'I' internalization factor in the OLI paradigm explains why a firm would choose to serve a foreign market through FDI rather than pursue alternatives modes without ownership of foreign equity (Oxelheim et al 2001). As mentioned in the internalization theory to establish the internal control is crucial for multinational companies to protect brand reputation (Griffin&Pustay, 2002).

In the Turkish case, the foreign direct investment of global audit & corporate finance companies such as PricewaterhouseCoopers and KPMG can be explained by the eclectic theory. Managerial skills of these companies, such as its high level finance experts (ownership-specific advantages) stand as an important factor that shape their investment decisions. These companies recruit outstanding graduates throughout the world, therefore transferring know how between the different zones is not a huge issue for them. Turkey's feature as an emerging economy, bridging between the EU and the Middle Eastern Countries determines the region of their investment (location specific advantages). As the 'trust' is the most important issue for the reputation of the audit firms, instead of giving the royalty rights to the local finance companies, these firms internalize their activities and run the enterprises by themselves (internalization factor).

Product Life Cycle Theory

Product life cycle theory, which originated in the marketing field to describe the evolution of marketing strategies as a product matures, is a theory of international trade (Griffin&Pustay 2002). Despite this theory's primary focus on international trade, the theory is also applied to explain FDI. Vernon argues that usually the same firms that pioneer a product in their home markets undertake FDI to manufacture a product for consumption in foreign markets (Hill, 2003). The theory of international product life cycle states that first, firms start by exporting their production to foreign markets then invest across national boundaries as product moves through its life cycle (Wild; 2003). This action contains three product stages; the new, maturing and the standardized.

In the first stage, the product is not standardized. That is mainly because the innovation requires great research and development investment and qualified labor, and on the other hand demands for the product is unknown, the product would be first designed and manufactured in home market which is highly industrialized and provides sources for innovation. Thus, manufacturing costs are at the highest level due to non-standardized production and the continued use of highly skilled labor (Czinkota et al 1999). High production costs bring high prices for the product and it attracts mainly high income groups as customers (Tayeb, 2000). In this first stage of the product, the innovator company enjoys monopolistic advantages in the market. At the later stage of the cycle, the product is exported to the other markets, which show similarities in market structure and demand patterns, by having advantages of a combination of innovation and production facilities offered by home market (Dunning, 1993).

When production expands, it becomes more standardized and this brings less need for highly skilled labor. As a result, production costs start to decline. At the same time, demand for the product from the other markets increases which enables the innovator company to invest in foreign markets (Harrison et al 2000). In this stage of the product, competitors come into the market with the same or similar products which put pressure on the prices and profit margins therefore the production costs become more important for the firms. Vernon (cited by Czinkota et al 1999) argues that the firm has to take a critical decision in this stage of the product. The first one is to lose market share against companies which have low-cost production facilities, and the second is to invest abroad where competitive advantages of factor costs exist.

In the last stage, the product is totally standardized. There are no needs for skilled labor and much research and development with the automation of the manufacturing process which forces the firms to manufacture where competitive advantage of factors' is the highest (Czinkota et al 1999).

This theory helps to explain why products once manufactured in developed countries, produced at lower cost in developing countries and then are exported back to the original producing countries (Harrison et al 2000). Product life cycle theory is applicable for technology based products. Other products such as resource based or services are not easy to categorize by stages of maturity (Czinkota et al 1999).

Through last decade, the automotive sector in Turkey has become a leading sector in the manufacturing industry. Moreover, it is one of the few sectors in which Turkey has become a global production location. From 16 automotive companies in Turkey which manufacture various vehicles from passenger cars, busses, pickups, mini and midi busses, 11 businesses are foreign origin. Three Asian companies Toyota, Hyundai and Honda received investment incentives from the Turkish governments and have established joint ventures with Turkish firms. The other EU based firms that invest in Turkey are Fiat (Joint Venture), Ford (Joint venture), MAN (Joint Venture) and Mercedes Benz (www.deik.org.tr). Capital partnerships between Tofas- Fiat, Oyak – Renault, Ford – Otosan, Toyota and the recent capital increases in their Turkish plants reveals the full integration of Turkey into the strategic market expansion plans for foreign firms. In our opinion, this progress in the automotive sector can be explained by the product life cycle theory. The countries that started car production have realized the competitive advantages in the emerging economies such as Turkey. Thus, the production process has shifted to Turkey and the other developing countries with relatively low production costs in order to generate high profits.

2.1.2 Turkey & Key Location Factors of Host Country

MNEs assess many factors before they take investment decision in a particular country. Investment decisions are determined after analyzing many factors that would affect the business. UNCTAD Trade and Development Board's report points that three factors are important to determine where the MNE invest: the policies of host countries (including the core regulatory framework for FDI), the proactive measures countries adopt to promote and facilitate investment, and the characteristics of their economies (UNCTAD 1999).

Throughout the last couple of decades, with globalization and especially the changing attitudes of former communist countries to achieve market economy, developing countries are in competition to attract more FDI inflows by setting attractive policies for the world's biggest MNEs (Hill, 2003). However, government policies still might be both promoting and restricting. Some governments set up attractive policies to have more FDI inflows into country with the purpose of finding sources to boost the economy, whereas other governments put some controls on FDI inflows with the intent of protecting domestic industries, firms or national sovereignty and autonomy. FDI policies of host countries are also related to trade, privatization, macro economics and competition policies (UNCTAD, 1999).

UNCTAD's (2003) report stresses that business facilitation measures include investment promotions, after investment services, incentives and improvements in amenities. Fiscal and financial incentives are also attractive for MNEs even though they are considered later than the other determinants settled.

According to the UNCTAD investment reports, economic factors assert themselves as location determinants. They are shown as principal motives for investing abroad and named as: resource seeking, efficiency seeking, asset seeking and market seeking.

Resource Seekers

MNEs can have opportunities by investing abroad to acquire particular and specific resources at a lower cost. This penetration aims to be more profitable and competitive in the markets by using these cheap or efficient resources. Most output of affiliates is exported mainly to the developed countries. Dunning (1993) classifies resource seekers into three parts as explained below.

The first kind of resource seeking is for physical resources. Producers and manufacturing enterprises undertake FDI in order to minimize cost and to secure supply sources. MNEs, especially whose products need complimentary inputs, try to reach resources such as minerals, raw materials and agricultural products. For industries such as mining and petroleum, access to resources is crucial (Harrison et al 2000).

The second kind of resource that companies may see as an opportunity is cheap and skilled labor (Czinkota et al 1999). MNEs seek investment opportunities in countries with low labor cost and skilled or semi-skilled labor potential by setting up or acquiring subsidiaries with the purpose of low production cost. The third type of resource seeking FDI is to acquire technology, management or marketing know-how and organizational skills. Companies from developing countries such as Asian MNEs particularly try to form alliances with developed countries' firms in order to obtain know-how (Dunning, 1993). The analysis in section 3.2 shows that the labor costs in Turkey are much higher than that of Central Eastern and European Countries. Nevertheless, Turkey overwhelms in labor productivity rankings which is a positive indicator for foreign investors.

Efficiency Seekers (Vertical Multinationals)

Having benefits of economies of scale and scope and with the purpose of risk diversification, existing market seeking or resource seeking investments may be governed together to gain optimum efficiency from the investment. The purpose of efficiency seeking is, in brief, to use different factor endowments and market structures with common or similar production facilities in few locations and to supply to multiple markets. However, the firm must be producing standardized products and involved in globally accepted production processes. Dunning (1993) classifies efficiency seeking FDI as two kinds; the first uses advantages of availability and cost of factor endowments in different countries. The optimum efficiency can be reached by investing capital, technology and information intensive activities in developed countries and investing labor and natural resources intensive activities in developing countries. The second kind is made in similar economic structures and income levels and is designed to take advantages of the economies of scale and scope (Dunning 1993).

Hadjit and Browne (2005) define Turkey as a suitable location for efficiency seeking FDI. The argument is supported by the example of EU–Turkey Customs Union, which is a crucial sign for efficiency-seeking FDI. For the Asian or Middle Eastern firms which want to access the European market, Turkey might become an export base to the rest of the EU. Bevan and Estrin (2000) have found that the prospect of future EU membership of candidate countries made them more attractive for efficiency-seeking FDI because of the establishment of regional corporate networks.

The strategic assets or capability seekers

Dunning (1993) notes that MNEs seek to build strategic assets such as new technology or distribution networks by investing in other companies abroad that specialize in certain aspects of production. This occurs when a company collaborates with another one to prevent competitor's operation, merges with one of its foreign rivals to strengthen their joint capabilities, acquires a group of suppliers to get the market for a certain raw material, seek access over distribution outlets, acquire a firm that produces a complementary range of goods or services, join forces with a local company that is in a better position to secure contracts from the host government. Companies look for these opportunities to protect themselves or to build a better position in the market. The expected benefits might include gaining access to new markets via the foreign party involved (distribution networks and/or government contracts), creating synergies and economies in R&D, production and marketing, or acquiring a range of tangible or intangible assets through the acquisition of a foreign company that compliments the MNE's current offerings.

The tobacco market in Turkey is huge and maintains big potential for foreign investors. As of 2003, Philip Morris International (PMI), who had a 39% market share announced that it was interested in the acquisition of TEKEL, the Turkish State Liquor and Tobacco Monopoly, which had 35 % market share. In spite of this fact, TEKEL was standing as a strategic opportunity for PMI to grow further in the market. The Competition Authority (CA) declared that PMI's acquisition of TEKEL may bring future liability to the company as this would mean an establishment of a clear monopoly in the market and could pave way to abuse of the leading position. To prevent this situation, CA recommended TEKEL to avoid 'block sales' and proposed TEKEL to get divided into 4 companies before going to the auction process. Thus, CA prevented PMI to buy TEKEL as a block, so the Company did not bid through the privatization process. This example gives an insight on the attitude of the foreign investors to acquire strategic assets in Turkey and also summarizes the approach of Turkish superior authorities against unfair competition emerging through foreign direct investment.

Market Seekers (Horizontal Multinationals)

So far, national market size and the population income have been important determinants for FDI. MNEs invest into foreign markets to find new customers for their goods and services. If the managers notice that their product is unique and can dominate the new market then they may seek to take advantages of this opportunity. Dunning (1993) states that apart from market size and growth potential, there are four main reasons about why companies take market-seeking investments decisions. The first one is following suppliers or customers. The second reason is to adapt to local tastes (both the product itself and business operation) which would prevent weaknesses against local companies' products. The other reason emerges when serving a local market from adjacent facilities is cheaper than supplying from distance. It is for sure that manufacturing goods which do not need specific production facilities and which are expensive to transport should be produced in or around the targeted market. The last, but not the least, reason pointed by Dunning (1993) is to have a physical presence in the leading markets served by its competitors. This type of investment is mostly made by large sized MNEs that operate in the oligopoly sectors such as oil and semi-conductors. At this point it should be noted that, the purchasing power of the people is the real determinant in a huge market. As it will be discussed in Section 3.1, despite of its huge population, Turkey has to take decisive steps to enhance its purchasing power parity compared to EU Members.

2.2 Determinants of FDI in Turkey

This section discusses the main determinants of Foreign Direct Investment in Turkey and throughout the world. According to an in depth research conducted by PricewaterhouseCoopers (2002) the main determinants of foreign direct investment can be summarized under economic determinants, FDI enabling environment and political and institutional determinants. The *economic determinants* include economic liberalism (tariff and non tariff barriers, privatization policies, foreign exchange policy, taxation), performance of the economy (GDP growth, inflation, internal and external debt), FDI track record and the telecommunications infrastructure. *FDI enabling environment* indicates investment promotion, investment facilitation, incentives, corruption and administration costs and post-deal services. *Political and institutional determinants* include political system, government's attitude to the foreign direct investment, tensions among socio-economic groups, judicial system and dispute settlement, rules of entry and operation, policies of functioning and structure of markets (competition policy, mergers & acquisitions, labor markets), international agreements on FDI, coherence of FDI and trade policies, cultural factors and quality of life (PricewaterhouseCoopers, 2002, Doing Business in Turkey).

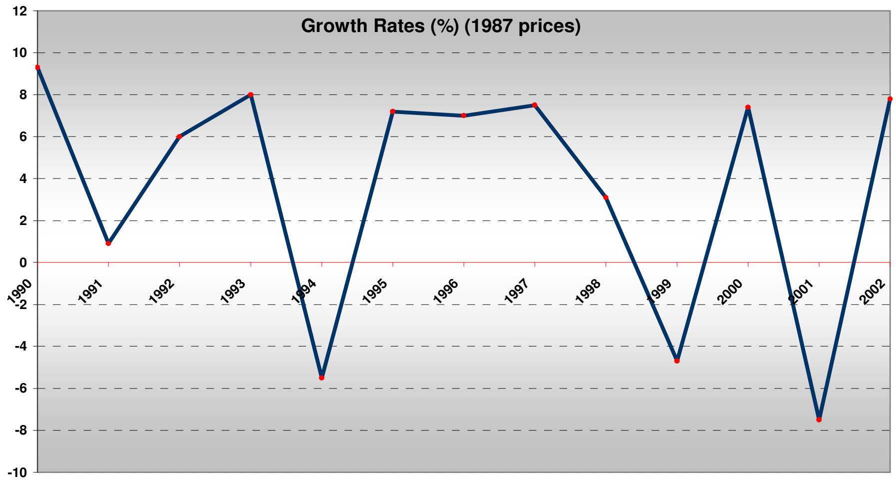
Through this section we will start by discussing the performance of the Turkish economy, as it emerges as the most important economic impediment to FDI. The other significant determinants that will be discussed are; the political stability, corruption, administration procedures, legal framework and tax system. In fact, the increasing FDI in Turkey as of 2004 and 2005 are linked to the betterment of these impediments that are described at the end of each subsection. OECD Economic Survey (2002) on Turkey supports the findings of this research, as the survey stresses that chronic macroeconomic instability, a fragmented political system, a cumbersome bureaucracy and legal environment for businesses combine to make Turkey as an unattractive place for foreign investors compared to other countries at similar development levels. In the same survey, FDI potential of Turkey is linked with EU candidacy or membership and the increasing privatization process. Throughout the third chapter, the key factors that have crucial impact of the FDI inflow in Turkey are going to be compared with that of EU countries.

2.2.1 Turkish Economy & Economic Impediments to FDI

The Turkish economy has long been suffering from an exceptional degree of macroeconomic instability characterized by especially hyperinflation and sharp swings in the business climate. Turkey experienced serious economic crises throughout the last decade that resulted with IMF oriented stabilization programs. The underlying reasons for the crisis were hided over the previous decade, particularly a fragile banking system, weakness in the structural fiscal adjustment as well as, the external crisis that directly affected Turkish economy (OECD, 2002). Moreover, up until 2003, Turkey was one of the several major economies in the world that continued to struggle with a high inflation rate.

The World Bank Report states that “macroeconomic instability has played an important role, among many factors, in Turkey's inability to realize its full growth potential. Cross-country comparisons and analytical work suggest that countries that grew faster than Turkey did so in part because they achieved a greater degree of macroeconomic stability, accumulated physical capital faster, invested more in human capital, and did more to improve government effectiveness and the business climate” (World Bank, 2003, p.16). The macroeconomic and structural policy challenges which Turkey experienced in the last decade include a substantial public debt burden, high inflation, banking sector difficulties, and extensive state involvement in the economy.

The key problem triggering the economic instabilization has been the public sector debt, which rose from 25 % in 1990s to the 90 % as of 2001. The collapse of exchange rate and surge in the public sector debt by recapitalizing the de facto bankrupt state banks in 2001 have led to increase of public debt / GDP ratio. The new economic program adopted after the crisis in 2001 was based on radical fiscal retrenchment to pull down public debt. Thus, the fluctuations in annual growth rates in the last two decades have improved in last couple of years by these tight fiscal policies. Average growth rate between 1983 and 1993 has been 5.0 % whereas it was 2.7 % in the period between 1993 and 2003 (www.worldbank.org, 2005). This rate is not low compared to OECD countries' average growth rate which was c.a 2.1% in 1992-1997 and 2.7 % in 1997-2002. However, the growth rates have been negative in the periods of financial crises. To give an example, GDP growth rate was 2.8 % in average between 1992-1997 whereas it was negative (-0.6%) between 1997 and 2002 (www.oecd.org 2003). As of Turkey and EU set out the beginning of accession negotiations in 2005, the foundations exist for continued stable and rapid growth. Therefore, fiscal policy now generates a sizeable primary surplus which stands at 6.5 % as of 2004, structural reforms pave way to decrease in government expenditures and social policies ensure that inequalities do not undermine the social cohesion (Dervis, 2004). Finally the growth rate, which is one of the most important determinants for FDI inflow, is increased to 9.9 % in 2004, and over 5 % in 2005.



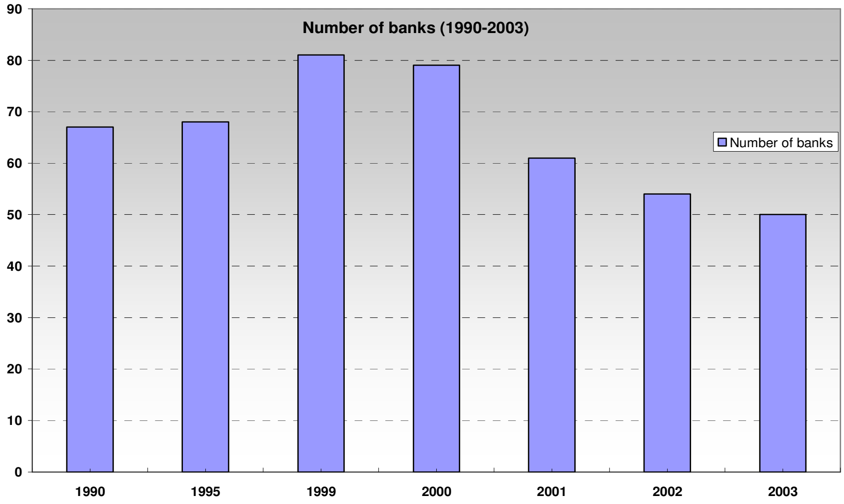
Source: State Institute of Statistics 2003

The inner structure of the economy had been another important reason for the failure of attempts to stabilize the economy throughout the last decade. State involvement has always been at high levels and state-owned enterprises often enjoyed monopoly status in strategic sectors such as telecommunications. As the result of the populist policies, the public sector employed excessive workers with low productivity and thus, affording high wage costs.

As mentioned above, over the last decade, Turkey experienced several financial crises. By the end of 1993, increasing current account deficit and debt resulted with governments changing policies towards a low interest rate with high depreciation. The first exchange rate decline was 13 % which destroyed the banks' balance sheets. In April, devaluation of Turkish Lira was around 65 percent; which resulted with foreign capital flow-out. The interest rates jumped up overnight and the economy has faced with a massive recession (OECD, 2002).

Following the 1994 crisis, with the effects of the Asian crisis in 1997 and the Russian crisis in 1998, the economy again experienced a deep recession and high interest rates which prompted the government to agree on another Stand-By with IMF in 1999. On 20 February 2001, a political problem between the Prime Minister and the President, just before a major Treasury auction, has triggered the deepest financial crisis of Turkey. Overnight rates jumped to unprecedented levels of 6200%, the Turkish Lira depreciated 40% in ten days and the Central Bank reserves lost 5.36 billion USD in a week (Uygur, 2001).

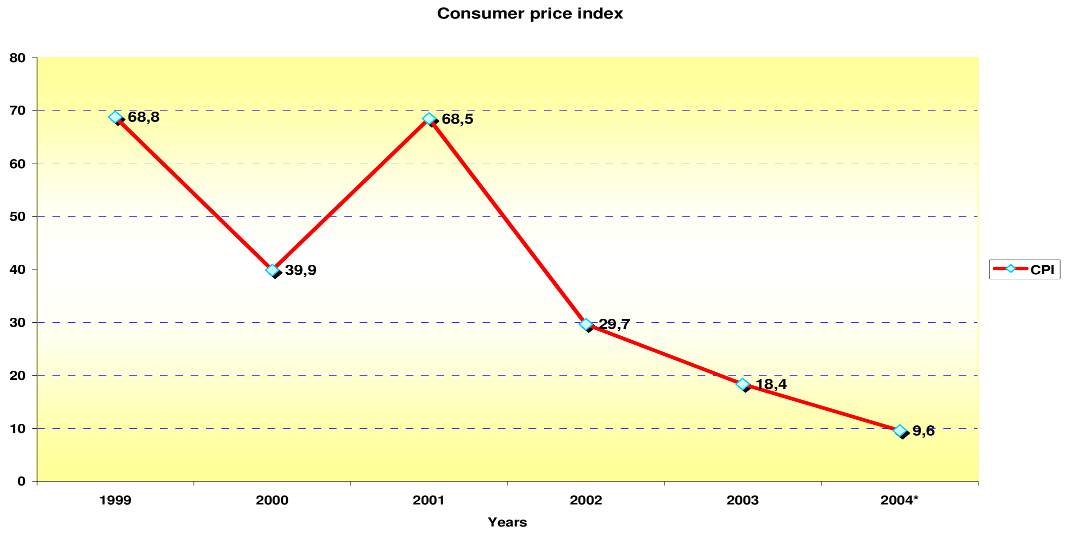
The fragile banking system has been the breaking point, especially at the time that the economy was hit by crises. The weak banking system led the economic program, supported by the IMF stand-by agreement, to end up with twin crises, which resulted in a credit crunch and severe decline in the banking sector in 2001. As Dervis explains (2004), what led to the 2001 crisis was the coming together of a banking crisis, which forced the state to recognize its contingent liabilities in the banking sector, with a risky attempt to disinflate by using a nominal anchor exchange rate policy. The problems in the banking sector arouse from small and fragmented banking structure, dominance of state banks in total banking sector, weak asset quality, extreme exposure and fragility towards market risk, lack of transparency, inadequate internal control systems, risk management and corporate governance. In response to the severe banking crises, the government has taken a number of serious reform actions supported by the World Bank and the IMF. A number of insolvent private banks were taken over, recapitalized, restructured or sold. The public banks have been restructured and some of them are put into privatization portfolio. The cost of the clean up has been huge for Turkish economy, it was accounted around 30% of the GDP.



Source: Banks Association of Turkey 2003

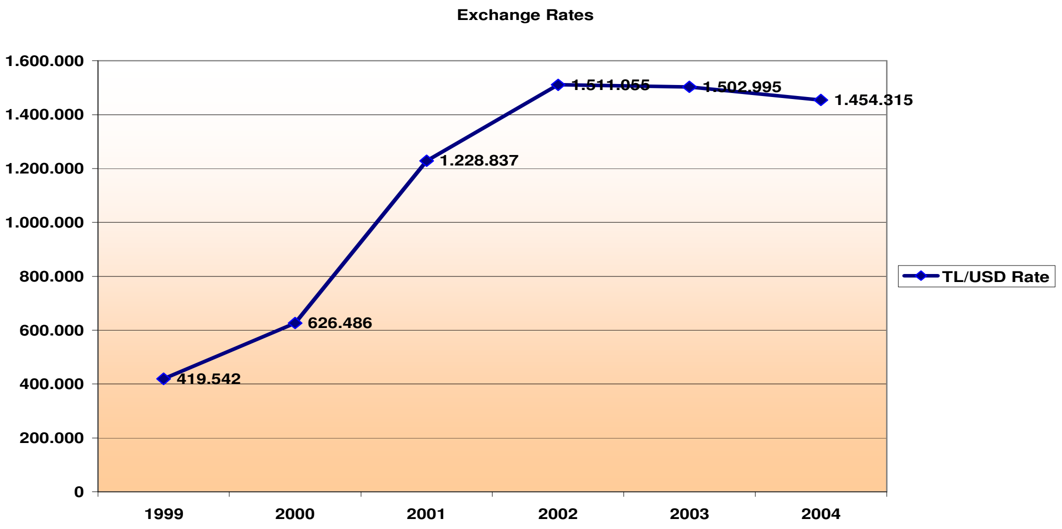
Since the calendar with the EU negotiations is announced by the European Commission on December 17, 2004, the banking sector recovers; thanks to the increasing FDI inflow into the financial services. Fortis Bank of Belgium acquired 89.34% of Disbank shares for $1.14 billion. Another important transaction during 2004 was the acquisition of the indirect ownership of the financial holding company of Turk Ekonomi Bankasi (TEB), TEB Mali Yatirimlar, by BNP Paribas for $217 million. Currently, Deutsche Bank is negotiating with Finansbank for a potential acquisition. Thus, the increasing confidence on the relations between EU – Turkey and recent banking regulations put into force has encouraged foreign investors to invest at Turkish banking sector.

As it is the case with Turkey, chronic inflation had been the main difficulty for the other developing countries throughout the transition period. Throughout 1990s; the inflation averaged about 70 % and until 2003, Turkey has remained as the only major economy that suffered from inflation. As of 2004, Turkey has succeeded to pull the rates down to 12 %, and the inflation rates decreased below to 8 % as of December 31, 2005.



Source: Turkish Treasury 2005

More than a decade, instable economy and high inflation rates have led to high interest rates and weakness of the Turkish Lira. The consequent devaluation has resulted with Lira becoming one of the worthless currencies in the global economy. The below graph indicates the depreciation of Turkish Lira against US Dollar. As of January 1, 2005, six zeroes were deleted from Turkish currency and New Turkish Lira became the new currency unit. The main purpose of removing zeros was eliminating the operational and technical problems arising from the use of figures with multiple zeros. However this operation has coupled with the success of driving inflation down to single digit numbers. Thus, the new Turkish Lira became a symbol of Turkey's determination to drive down the inflation and attain price stability.



Source: Turkish Treasury 2004

High inflation rates led to a sharp rise in interest rates which created a serious obstacle for foreign and domestic investors. It became more profitable for investors to place their money towards guaranteed high yields without risk rather than entering into the more unpredictable environment of the market (Turan, 2002). Currently the nominal interest rates in Turkey stand around 14 % which is well above the Maastricht Criteria and the EU Average, which is 3.5 %.

World Bank has emphasised the importance of the government programs in fighting against economic weakness and noted that;

> Countries that introduced economic reforms in general and in particular geared toward FDI such as Brazil, Mexico, Korea and Thailand, witnessed sustained increases in FDI inflows in the post-crisis period. The FDI plays a strategic role beyond recovery from crisis. Competition pressures from foreign firms can promote product innovation, the overall diffusion of new technology, investment in new plants and sales growth. Increased FDI can play a crucial role in broader corporate restructuring through exposure to advanced organizational and managerial skills. (World Bank, 2003)

Stability in the economy is one of the first factors that foreign investors assess before taking investment decisions. Instability discourages investors as uncertainties in the future put the investment in a more risky position. Research conducted by TUSIAD&YASED (2004) points Turkey as in the 13th position among 16 emerging economies in terms of providing stable general macroeconomic conditions.

The above description on economic instability might explain why Turkey lagged behind the other emerging markets in terms of attracting FDI inflows. However, as it is explained above, the recovery of Turkish economy has already started. On December 14, 2004, the IMF and Turkey signed a new agreement worth $10 billion for three years starting from 2005. The official start of accession negotiations with the EU on October 3, 2005 brings much more confidence. For the year 2006, the Central Bank of Turkey targets 4.7 % inflation rate. In fact when CPI target is analyzed for last couple of years, we can not criticize Central Bank as being optimistic. The Central Bank fixed a target of end-year CPI (Consumer Price Index) 12 percent in 2004 and 9 percent in 2005. Turkey reached the target for 2003 and 2004 as the end-year CPI was respectively for those years 18.4 and 9.32 percent. Thus, Turkey showed it was catching up with Bulgaria and Romania, where the inflation rate was 6 and 9.3 percent in 2004. Low inflation that is achieved in last couple of years brings certainty concerning the possible scenarios of the economy's future and imparts confidence in the ability of foreign investors to repatriate earnings. However Turkey now is encouraged to maintain a stability-oriented economic policy in order to convert the current positive dynamics into sustained economic development (Hadjit-Browne, 2005). The below figure summarizes the macroeconomic policy achievements since 2001, the launch of new economic program.

Table 1. Macroeconomic policy achievements

	2001	2002	2003	2004*
GNP per capita (€)	2360	2770	3000	3290
GDP growth (%)	-7.5	7.8	5.8	>5.0
Inflation (CPI annual, %)	68.5	29.7	18.4	12.0
Real effective exchange rate (CPI, end 2003=100)	82.4	91.8	100	
Central Bank reserves ($ billion)	18.741	26.725	33.639	
Bank regulatory capital to risk weighted assets (%)	15.3	25.3	31.8	
Net public debt/ GNP (%)	90.9	78.6	70.5	67.7
Primary surplus/GNP	5.5	4.0	6.5	6.5
PSBR/GNP	-21.1	-12.3	-9.3	-6.8
Spreads on Turkish dollar Eurobonds (basis points)	707	693	309	
Average real interest on domestic debt, ex-ante	35,5	30,3	28,6	11,2
Unemployment (%)	8.4	10.3	10.5	
Current account (%of GDP)	3.4	-1.5	-2.9	-3.5 to-4.0

* Economic Programme magnitudes
Sources: Eurostat, IMF Staff Report, IFS, Turkish Treasury and Central Bank estimates.

2.2.2 Political Stability

Foreign direct investment is an activity based on future prospects of the return of investment and the confidence in the host country that should be foreseeable for investors. A common strategy that foreign investors adapt to their investment is the minimization of the risk regarding their return on investment. Thus, political stability is an important part of the investment decision process which secures the future of the operation from the risks, caused by political problems in the host country.

The survey (K.Chan & E.Gemayel, 2004) shows that over 50 % senior executives of the large MNEs believe that government regulations, political and social disturbance, currency and financial risks are the major risks that bear on their investment decision. The survey concludes that these politic, economic and financial risks have more impact on investment decision compared to other factors such as intellectual property rights, safety problem and security threats. While political stability is one of the important factors to offer an attractive investment climate with its effect on both economic and social issues, it has been one of the major obstacles for Turkey in having FDI flows.

Very often change of governments throughout the last decade has caused political uncertainties in Turkey. In the last 13 years, Turkey had experienced 13 governments (www.tbmm.gov.tr, 2005). The rapid change of the governments may be the similar problem in the other developing countries; however, in Turkey; each change of government has applied significant modifications in the personnel structure and brought different attitudes within the state mechanism. From the eye of investors, Turkey is considered to have a highly volatile political and economic system prone to sudden policy changes (DEIK, 2001).

Continual formations of coalition governments through 1990's have been major reason for political instability. Weak governments were incapable to take courageous decisions and policies and even less capable of implementing the decisions taken. The populist policies of coalitions ended up with short term cabinets and large public debts with excessive public expenditures.

The tradition of each government assigning their own bureaucrats to the different levels of administrative organs had created fear for existing bureaucrats to lose their positions which paved way to bureaucratic inefficiency. Starting in the 1970s, large sections of the bureaucracy became politicized. This cycle created an administration system that had been dealing with personal issues and interests instead of formulating and carrying out major policies. Thus, policies made in these periods were devised in an inappropriate way without judging needs or measuring potential outcomes. This might be shown as a main reason that policies and business environment became very unpredictable (Turan, 2002).

Political instability triggers other impediments to create favourable business environment. The economic restructuring programs, eliminating corruption and insufficient bureaucracy can succeed only if the political environment is stable and decisive in application; and only if politicians execute the necessary reforms and policies.

Similar to its economy, Turkey's political landscape has improved in last several years. With the adoption of many reforms in line with EU's Copenhagen Criteria; there has been considerable improvement in human rights and independence of judicial system. The prospect of future membership offers foreign investors a guarantee of democratization in Turkey. Through the increasing FDI in the last two years, the argument of today's government has become that EU membership would anchor Turkey in the West, strengthen it as a firewall against terrorism, and help make it a model of democracy for the Muslim world

2.2.3 Administrative Procedures

Administrative procedures might be another discouraging factor for investors if the procedures are cumbersome, time consuming, and expensive. If the other conditions are the same; easy and cheap operation process could be a main determinant of investment decision. Excessive regulations can lead to substantial delays and costs to firms that may decide to locate elsewhere. Morisset & Neso (2002) state that administrative procedures which vary from country to country depend on the structural factors such as political system, transparency in the government and economy, the corruption level, the legal system and the public sector wage policy.

In evaluating the performance of Turkey in terms of attracting FDI inflows, the cost and the time of administrative procedures were observed as the longest process compared to the other EU countries, including less developed ones. The main problem was the lack of entity that manages all necessary procedures regarding foreign investors. There have been so many procedures for investors to apply and deal with; such as registration papers, required approval and work permits. Not only the starting point but also during the operations, such detailed procedures have been burdensome for foreign investors as well as domestic investors.

The study (Morisset&Neso, 2002) conducted among 32 developing and less developed countries proves the failure of Turkey in providing a pleasant investment climate in terms of administrative procedures. The study provides the figures from 2001 and it assumes a standardized firm with the following main characteristics; it performs general industrial or commercial activities, it operates in the largest city by population, it is exempt from industry-specific requirements, it does participate in foreign trade, it employs expatriates and a total of 20-50 employees, it purchases or leases state land, it is connected to 10 phone lines and uses on average 100 kW of electricity during peak hours, and it is a limited liability company with a initial capital of US$10,000.

The procedure is divided into three parts as the first group is entry approvals, the second is access to land, site development and utility connections; and the last one is considered operational requirements. Results proved that the number of procedures in the second category is the highest one in Turkey as 125 procedures are required to access land, site development and utilities. In terms of entry approvals procedures, Turkey ranked the second after Bulgaria with 22 procedures before the start of the operation.

The longest delay is also found in Turkey with 1,106 business days -121 days for entry and 985 days for the second category- to complete the whole process. The most important delays arise from land purchasing from the state and site development procedures, especially permits and inspections from local authorities that appears relatively inefficient in processing investors' requests. The administrative cost for foreign investors in Turkey has also proved to be one of the highest among 32 countries that are examined in the study.

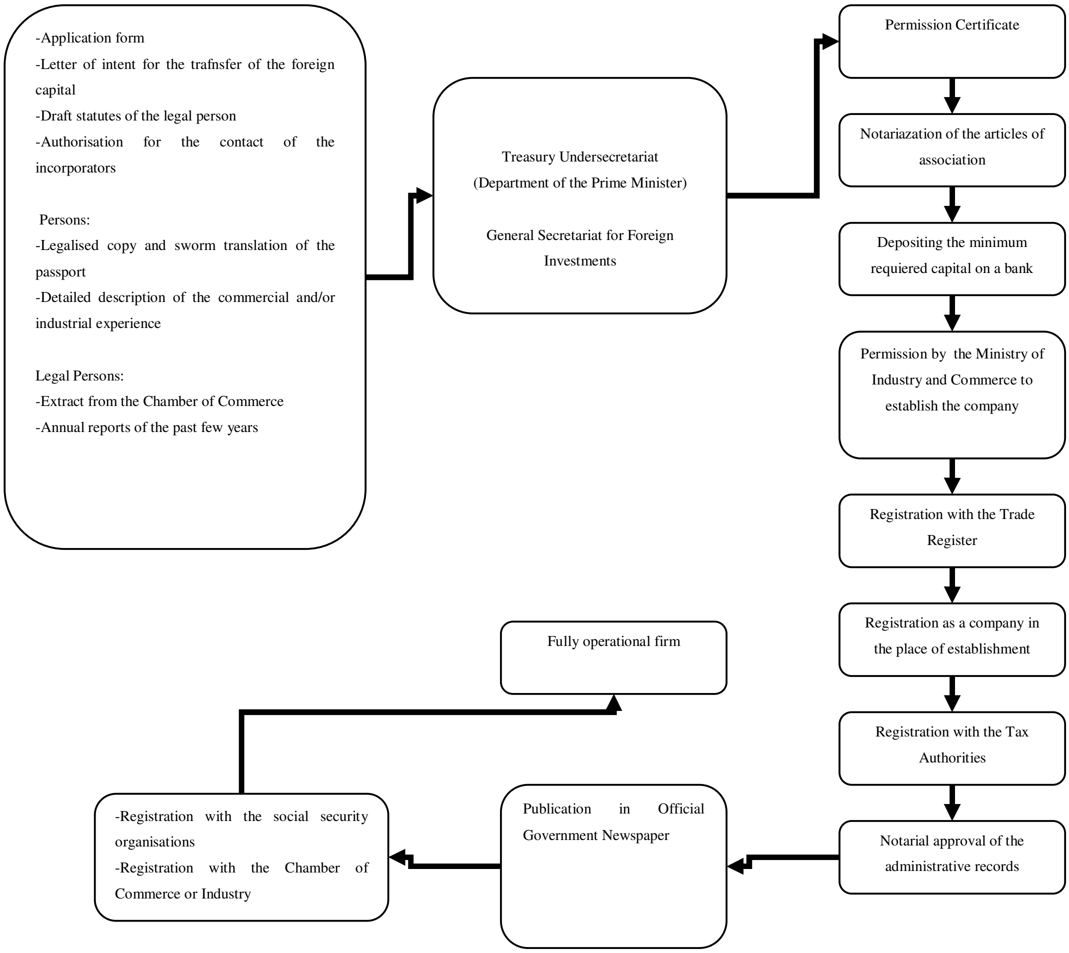
An important attempt for betterment of the long administrative procedures has been the new FDI law enacted in 2003. By this new law, international standards and rights of investors are improved by guarantee of transfers, access to real estate, international arbitration and employment of expatriates. Besides this new law, government has established Coordination Committee for the Improvement of Investment Climate (YOIKK) in 2004. This body was formed to remove administrative and regulatory barriers for foreign investors. The objective of this Law, stated by Turkish Treasury, is;

> to encourage foreign direct investments; to protect the rights of foreign investors; to define investment and investor in line with international standards; to establish a notification-based system for foreign direct investments rather than screening and approval; and thus regulate the principles to increase foreign direct investments through established policies.(http://www.treasury.gov.tr, 2003)

However, Turkey is having difficulties to implement the rules. The most recent example to administrative procedures can be given from Hyundai investment. In 2004, Hyundai top management has declared that they would like to invest and build factory in Turkey and employ 3,000 people (which exceeds 20,000 employers with the emergence of supplier industries). However as the authorities delayed the allocation of building plot for Hyundai, the management decided to invest in the Czech Republic which offered high incentives such as investment tax credit and free land.

A necessary pre condition to remove administrative barriers is that social goals for foreign direct investment should be clearly defined and widely shared by society. This would increase the probability that discretion is used in a way that enhances social welfare and that deviant behavior becomes socially unacceptable. Only then it will be possible to rely on the discretion of politicians and public sector employees. More recent research conducted by ACIEP (The Advisory Committee on International Economic Policy, 2003) presents 13 procedures were required to start a business in Turkey, taking 53 days and costing US $1,222.

A number of formalities that must be followed in starting process of the business are illustrated below.



Source: http://www.solidine.com, 2005

As shown in the chart, foreign investors have to deal with a number of different bodies that pave way to delays and the costs. The inefficiency of state institutions and the corruption in different levels of the government organs increase the loss of time and other informal costs. This control, combined with lack of accountability and transparency, paves way to a widespread corruption (Fias 2001, cited by Erdilek 2003). Thus, in our opinion, there exists a close linkage between administrative procedures and corruption. As the procedures become more complicated and lengthy, the tendency for corruption increases. The next section deals with the nature of corruption and recommends solutions in order to remove the related obstacles for foreign investors.

2.2.4 Corruption

The proper functioning of EU regulations on the Turkish legal environment for the foreign investors hugely relies upon the back tracking of the corruption. As Lou explains, "corruption is a behaviour in any institutions that violates formally defined role obligations in search of private gains" (Lou, 2002, p.113). Such role obligations may be defined in national level codes, governmental regulations, and organizational level ethic codes for subunits or individual employee. Putting the EU acquis on the rule of books is meaningless if it is not properly enforced because of the widespread corruption.

The Global Competition Report of the World Economic Forum places Turkey at 35th position among 59 countries in the overall propensity for illegal payments for carrying out business activities (DEIK, 2001). Similarly, in the 2001 Corruption Perception Index by Transparency International; Turkey was ranked 54th country out of 91, together with Egypt and El Salvador behind to its competitors like Czech Republic, Poland, Hungary, Brazil, and Mexico (Lou, 2002).

The main places where corruption is thought to be severely spread are: customs, public procurement, public banks, as well as the other areas such as taxation, the municipalities, the courts, and the implementation of incentive schemes. The main effects of corruption can be summarized as follows;

- Lower efficiency in the public sector
- Increase in public expenditures
- Reduced government credibility
- Barrier to competition
- Increase of the country risk (Senatalar B. 2002, p.66)

For the foreign investors, a growing economy needs a bureaucracy that enforces laws and regulations in a way that allows market to work. As Turkey still seems backward in corruption index despite of the EU process, several solutions can be projected. Gross and Steinherr (2004) provide a simple model of the extent of autonomy in decision-making bureaucrats that is consistent with minimizing corruption and the social objective of efficiency. The model suggests that better education and better pay for civil servants are the keys to success. Better educated officials can be given more leeway to interpret decisions because they are also less likely to use discretion for their own personal advantage as their prospects outside the public sector would also be tarnished by corruption.

Experiences from Corporate Life

The interviews held by Mr. Husnu Dincsoy, PricewaterhouseCoopers Turkey - Advisory Partner, has shown that the potential foreign investors mostly complain on the lack of transparency of the financial statements in Turkey. Thus, even though the International Financial and Accounting Standards (IFRS) are embedded to the legislation in 2003, the implementation process should accelerate. Moreover, the new Commercial Code foresees that every enterprise *must* be audited by an international accounting firm, starting from 01.01.2007. 'These developments will clearly attract the attention of foreign investors' Mr. Dincsoy says. The unregistered economy which paves the way to unfair competition and the extending periods to take work permit are the other issues that foreign investors criticize. Mr. Dincsoy, who has international experience as an advisor to privatization projects, gives the example of Ireland, which is well known as being supportive for foreign investors in every sense. By establishing Irish Development Agency, Ireland has overcome most of the bureaucratic difficulties in attracting FDI. Lack of intellectual property rights and lack of qualified labor force are the other criticized issues. In order to contribute to the self financing foreign investors, tax incentives could be offered. Our conversation ends by giving the Russia example, where foreign investors earn high profits, but tend to exit from the market because of economic and political corruption.

2.2.5 Privatization

Privatization is analyzed under a separate section throughout the study as it has become one of the most important determinants of FDI in Turkey starting from 2004. Accordingly with the IMF Stabilization Program, Turkey has accelerated the sales of its state enterprises which has attracted an important amount of FDI. Moreover, Turkey foresees to continue with this massive privatization as of 2006. For 2006, Turkish Privatization Administration includes TEDAS (Turkish Electricity Distribution Inc.), Turkish Airlines and state owned banks such as Vakıfbank and Ziraat Bank to its privatization portfolio.

Since the start of globalization in the world economy, privatization has taken its place in many countries' economic strategy agenda. The success of some emerging markets attracting large amount of FDI inflows has been influenced by their privatization programs in this period. For most of the Central and East European region, the FDI has been closely tied with privatization, with the sales of state assets to multinational companies (http://www.undp.org.tr, 2002).

In Turkey, since the beginning of sales assets to the multinational companies in 1985, the privatization is mostly seen as a tool to increase government revenues rather than a structural change, and therefore the impacts of this process was limited in short term. Furthermore, since the acceleration of the privatization process in 2004, Turkey is criticized for selling its strategic assets to the foreign investors. This argument can be disproved in several ways. First of all, a transparent privatization process would be a good sign for foreign investors to invest in Turkey. Secondly, if Turkey has accepted to implement the free market system, then it has to fulfill its obligations. The government should pull itself off from the economy and should act as a controller as it is the regular case in a free market. However we defend that government shall continue to remain effective in health, education services and judicial system.

A total of 91 M&As took place in Turkey in 2004, in 67 of which the transaction value was disclosed to amount to a total of $2.5 billion. This demonstrates an 82% increase over the 2003 level, which was US$1.4 billion -excluding the Aria-Aycell merger, whose transaction value was not publicly revealed (PricewaterhouseCoopers, M&A Research, 2005). The most important transaction among the 2004 M&As was the privatization of the vehicle inspection station services at $613.5 million, where the servicing rights were sold to the Akfen-Dogus-Tuvsud consortium by the Privatization Administration. Another important transaction during 2004 was the acquisition of the indirect ownership of the financial holding company of Turk Ekonomi Bankasi (TEB), TEB Mali Yatirimlar, by BNP Paribas for $217 million.

In 2004, the top 10 M&A transactions, which accounted for 75% of the total disclosed transaction value, indicated that energy, tourism and mining were at the top of foreign investors' agendas. While 2004 was a year in which foreign investors preferred to wait and see for the developments regarding the outcome and the sustainability of structural reforms promised by the government, 2005 has proved almost revolutionary in M&A activities.

Oger Telecom of Saudi Arabia bought 55% of Turk Telekom for $6.65 billion; Koc Financial Services paid US$ 2.6 billion for a 57.42% equity stake in the fifth largest retail bank in Turkey, Yapi Kredi; and Fortis Bank of Belgium acquired 89.34% of Disbank shares for $1.14 billion. Another big deal in 2005 was between Sekerbank and Dutch Radobank, where Radobank paid $92 million for 36.5% ownership in Sekerbank. In September 2005, Koc Holding A.S & Shell Co. paid US$ 4.14 billion to TUPRAS In October 2005, the country’s biggest state owned producer of flat steel, Eregli Iron&Steel Works Co., has sold to OYAK with a bid of US$ 2.77 billion. It is recently publicly announced that OYAK has established partnership with French Arcelor, in order to run Erdemir. In December 2005, the third biggest GSM company, Telsim, is sold to British Vodafone Group Plc. with a bid of US$ 4.55. The following chart summarizes the 2005 privatization projects in Turkey.

2005 Sales Agreements

Company	***mn USD***
Turk Telekom	6.550
Telsim	4.550
Galataport	4.300
Tupras	4.140
Ataturk Airport	3.000
Erdemir	2.770
Vakıfbank Arz	1.270
Mersin Port	755
Uzan Cement Factories	944.5
Vehicle Inspection Stations	613.5
Star TV	306.5

Source: Turkish Privatization Administration

And the chart below which is based on Turkish Privatization Administration data, empirically indicates the fluctuations in privatization policies since 1980s and shows the increasing privatization in Turkey as of 2005.

Privatization Figures for Turkey

Years	***mn USD***
1985-88	28.6
1989	131.2
1990	486
1991	243.8
1992	422.9
1993	565.5
1994	411.8
1995	514.6
1996	292
1997	465.5
1998	1019.7
1999	38.3
2000	2716.5
2001	119.8
2002	536.5
2003	177
2004	1267.2
2005	16900.3

Source: Turkish Privatization Administration

2.2.6 Tax System and Inflation Accounting

Tax system is one of the determinants of FDI that is related to policy framework of the host country. Throughout the last decade, Turkey has applied some fiscal incentives in order to reduce tax burden for foreign investors. However, the main problem regarding tax system in Turkey has been the practice of taxing paper profits that result solely from inflation, rather than reflecting any realizable economic gain (ACIEP, 2003). High inflation throughout the last two decades and waiting to apply inflation accounting system until the beginning of 2004 have resulted inflationary profits on tax base and corporate taxes have been paid without excluding inflationary profits.

In their last report, Tusiad & Yased (2004) reported that taxes are high in Turkey compared to the other emerging markets. Because Turkey has recently realized how important taxes and incentives are for foreign firms; following amendments in tax laws have been enacted;

- Inflation accounting is introduced
- Payments and collections for a particular amount of money are done through bank transfers to eliminate the unrecorded economy

The fund levy, which was 10% on the corporate tax and dividend withholding tax, has been eliminated.

Similar to Tusiad & Yased report, the research conducted by Deik (2001) stresses that in practice; Turkey has become the country with the highest level of corporate taxes among emerging markets. The corporate tax rate on profits is standing at 33-35%. In November 2005, it is publicly announced by the Turkish Ministry of Economics that the Corporate Tax rates are going to be lowered to 20% in 2006 which may create further incentives for foreign investors (Hurriyet, Nov 30, 2005).

Volatility of the tax environment and unstable tax system are the other weak points as those two-volatility and instability- have been the major obstacles in creating attractive business environment. The chart below compares Turkey's tax rate status with the CEEs as of 2002.

COMPARATIVE TAX RATES (%)					
	Czech Republic	***Hungary***	***Poland***	***Ireland***	***Turkey***
Corporate Taxes	31	18	28	10/12.5/20/25	33
Local Tax	-	2	-	-	-
VAT	22	25	22	20	18

Source:PricewaterhouseCoopers,WorldwideSummaries,CorporateTaxes,2002

2.2.7 Concluding Remarks

The main determinants of the FDI inflow and the major impediments that prevent potential FDI inflows into Turkey were discussed in this chapter. Findings of research show that Turkey had failed to provide two main determinants of FDI throughout the last decade; the first one is policy framework (i.e. performance of the economy, political stability, privatization strategy, tax policy) and the second; business facilitation (i.e. administrative procedures, corruption). Our research shows that there have been improvement in the impediments of FDI since 2003, thanks to the IMF backed stabilization program and the reforms parallel with the EU process. Below you can find a chart for summary indicating the determinants of FDI. The biggest improvement is observed in the privatization process, which became an important tool to attract huge amounts of FDI.

Determinants of FDI	
I. Policy Framework for FDI ▪ Economic, politic and social stability ▪ Rules regarding entry and operations ▪ Standards of treatment of foreign affiliates ▪ Functioning policies and structure of markets ▪ International trade and investment agreements ▪ Privatization policy ▪ Trade policy and coherence of FDI and trade policies ▪ Tax policy	***II. Economic Determinants*** *Market Seeking* ▪ Market size ▪ Market growth ▪ Access to regional and global markets ▪ Country specific consumer preferences ▪ Structure of markets *Resource Seeking* ▪ Raw materials ▪ Low cost unskilled and semi-skilled labor *Efficiency Seeking* ▪ Cost of resources and assets listed above, adjusted for productivity for labor resources
III. Business Facilitation ▪ Investment promotion ▪ Investment incentives ▪ Social amenities ▪ After investment services	▪ Other input costs; e.g. transport and communication costs to/from and within host country and costs of other intermediate products *Asset Seeking* ▪ Build new technology and distribution networks ▪ Physical infrastructure

Source: World Investment Report (UNCTAD 2003) and Dunning(1993)

CHAPTER 3

Comparison of Turkey with the EU Members

The second chapter has analyzed the main determinants and impediments to FDI in Turkey. The analysis shows that there has been improvement in the investment climate through last two years due to the IMF backed stabilization program and the improving relations with the EU. At this point it would be beneficial to make comparison of the certain economic determinants of Turkey with the EU members & candidates. The following comparison aims to provide the readers an insight about the impacts of membership or candidate status on FDI inflows, the status of key competitors of Turkey in attracting FDI and the areas that Turkey needs to improve to attract sustainable FDI inflow. The comparative analysis will include key factors such as purchasing power parity, labor costs, labor productivity, education, trade openness and demographic dynamics.

Although they have a different economic background from Turkey, the CEEs represent fierce competition for Turkey in attracting FDI, the main competitors being Poland, the Czech Republic and Hungary. For the 1998–2003 periods, net inflows of FDI amounted to less than one percent of GDP in Turkey while they reached six percent for Bulgaria, three percent for Romania and 4.3 percent for the group formed by Hungary, the Czech Republic and Poland.

FDI in Turkey and CEEs 2001-2004, mn USD

	2001	**2002**	**2003**	**2004**	**FDI(% of GDP)***
Turkey	3,268	1,063	1,753	2,733	2.3 %
Czech Republic	5,641	6,483	2,901	4,483	8.6 %
Hungary	3,938	2,964	2,182	4,167	4.7 %
Poland	5,714	4,131	4,123	6,159	3.1 %

Source: UNCTAD, World Investment Report, 2005

As it is seen from the figure above, Turkey has been less successful in attracting FDI relative to its size of economy and population. The key reasons of low FDI inflow are discussed in the previous chapter and this chapter will give the readers an insight about the status of key determinants in Turkey and the recent EU members & candidates.

3.1 Growth & Purchasing Power Parity

As discussed in the second chapter, performance of the economy is one of the most important economic determinants for the FDI inflow (Loewendhal, 2001). Certainly, the growth rates stand as the crucial indicator for the performance of the economy. The below figure summarizes the growth rates in the last decade and compares the performances of Poland, Portugal and Turkey. Thus, when compared to its competitors, Turkey has experienced volatile growth rates which had been a negative sign for the foreign investors. When analyzing Poland, one can observe that since the start of accession negotiations in 1998, the growth rates show an increasing tendency. Thus, it may be an important indicator for Turkey that the official start of accession negotiations in October 2005 may be a positive sign for the future growth rates.

Source: Eurostat.

To give a broader insight to the readers, we will provide a comparison of purchasing power parity between Turkey and the new EU entrants below. The below research indicates that in 2003, Turkey's nominal capita per income is at 12 % of the 2003 EU -15 average and at 25% of PPP adjusted per capita income of the EU-15 (Oztrak, 2004). Another useful dimension of PPP comparison is that Turkey's domestic market size is usually discussed as one of the attractive reasons to have direct investment in Turkey. In his research, Bosut (1999) describes Turkey as a large and growing domestic market for the foreign investors. Its proximity to the emerging markets in the Middle East and Central Asia, as well as its cultural ties with certain countries, creates lucrative business opportunities. However, as the purchasing power of the people is low compared to the EU-15 and the recent EU entrants, the 'big domestic market' argument will totally be ineffective.

	PPP (€)		Nominal (€)	
	2003	Average (1998-2003)	2003	Average (1998-2003)
EU-15	€23,270	€21,700	€24,320	€22,677
New EU-10	€11,300	€10,675	€7,854	€6,722
Poland	€9,860	€9,043	€4,850	€4,687
Bulgaria	€6,280	€5,503	€2,260	€1,807
Romania	€6,350	€5,582	€2,320	€1,966
Turkey	€5,750	€5,662	€3,000	€2,805
	PPP (EU=100)		**Nominal (EU=100)**	
	2003	Average (1998-2003)	2003	Average (1998-2003)
EU-15	100	100	100	100
New EU-10	48.6	47.2	32.3	29.5
Poland	42.4	41.6	19.9	20.6
Bulgaria	27.0	25.3	9.3	7.9
Romania	27.3	25.1	9.5	8.5
Turkey	24.7	26.2	12.3	12.4

Sources: EUROSTAT, New Cronos.

Turning to individual comparisons and including Romania and Bulgaria which are listed for accession to the EU in 2007, Turkey's nominal per capita income in 2003 was about 62 % that of Poland but was actually 29 % higher than Romania's and 33 % higher than Bulgaria's. When we consider that these comparisons take place at the time of their accession and Turkey is considered about a decade before the accession, we can easily conclude that if Turkey continues with its current growth rate, the numbers and the results of the analysis can change rapidly. However, for today, we may conclude that the argument of big domestic market for the foreign investors is not a genuine one as the purchasing power of people in Turkey is even less than that of the future members, i.e. Romania and Bulgaria.

3.2 Labor Costs & Productivity & Education

The labor issue (i.e. labor costs, productivity and skilled labor) is another important determinant in attracting FDI. In the below research of Loewendhal (2001); Turkey has an employment cost around $ 7.958 per labor, while Czech Republic and Poland stand highly competitive compared to Turkey. This huge cost difference arises because of high tax burden on wages and salaries in Turkey. Thus, labor costs tend to stand as an important impediment in front of foreign investors in Turkey compared to the new EU entrants; until the burden of foreign investors regarding legal deductions on salaries and wages are reduced.

Labor Costs in Manufacturing,1991-95 (US$)	
Country	**Labor Costs**
Turkey	7.958
Hungary	2.777
Czech Republic	1.876
Poland	1.714
Greece	15.899
Ireland	25.414
Romania	1.190

Despite of the above facts on labor costs, labor productivity is equally important for the foreign investors in a host country. The most recent comparative research on the issue is completed in 2000 which is summarized below. The table; 'Sectoral Gross Value Added per person Employed' shows that Turkish labor productivity is close to that of Czech Republic, Hungary and Poland. Thus, productivity in services, construction, and even in industry is high in Turkey when compared to the new entrants of the EU. The situation looks even more favourable to Turkish industry when productivity levels are compared to Romania and Bulgaria; the two remaining candidate countries beside Turkey. The comparisons show that Turkish economy is not only more developed in terms of productivity than the economies of Romania and Bulgaria but that Turkish productivity outside agriculture is close to or higher than what we observe in the new EU entrants (Oztrak, 2004). The high productivity levels might even improve with the demographic trend and be a source for more rapid income growth through the accession negotiation process. Thus, if we combine our analysis with the above findings; we can conclude that the labor costs are high in Turkey compared to that of new EU entrants; however Turkey is prevailing in labor productivity, which is a significant positive indication for the foreign investors.

Sectoral Gross Value Per Person Employed(Euros)

	Agriculture	Industry	Construction	Services	Total
Bulgaria	€4,289	€3,696	€3,176	€4,292	€4,073
Czech Rep.	€9,707	€12,391	€8,867	€12,060	€11,739
Hungary	€7,629	€11,962	€8,566	€12,090	€11,531
Poland	€2,093	€11,841	€12,049	€13,511	€10,874
Romania	€1,149	€5,779	€6,224	€7,466	€4,188
Turkey	€4,577	€13,523	€8,508	€15,657	€10,890

Source: Eurostat, (cited by Oztrak, Relative Income Growth and Convergence, 2004)

The general overview is that Turkey has a relatively skilled labor force which puts it in a competitive position among the other emerging markets. Dervis (2004) discusses that in terms of investing on human capital, Turkey starts from a very weak point. From the figures below, it is apparent that Turkey is investing relatively little in education, with the exception of Greece, which is taken into the comparison because of the proximity fact. The two new member countries Poland and Hungary seem to invest more in education, i.e. almost 1.5 times more than Turkey. When we look at the percentage of adult population with upper secondary education, only Portugal is performing worse than Turkey. It is not surprising though, as Portugal is currently facing with a hard time in competition through the internal market after the enlargement.

	Total expenditure on education as % of GDP	% of adult population with upper secondary education
Turkey	3. 91	24.3
Poland	5.31	45.9
Portugal	5.69	19.8
Greece	3. 86	51.4
Hungary	5.15	70.2

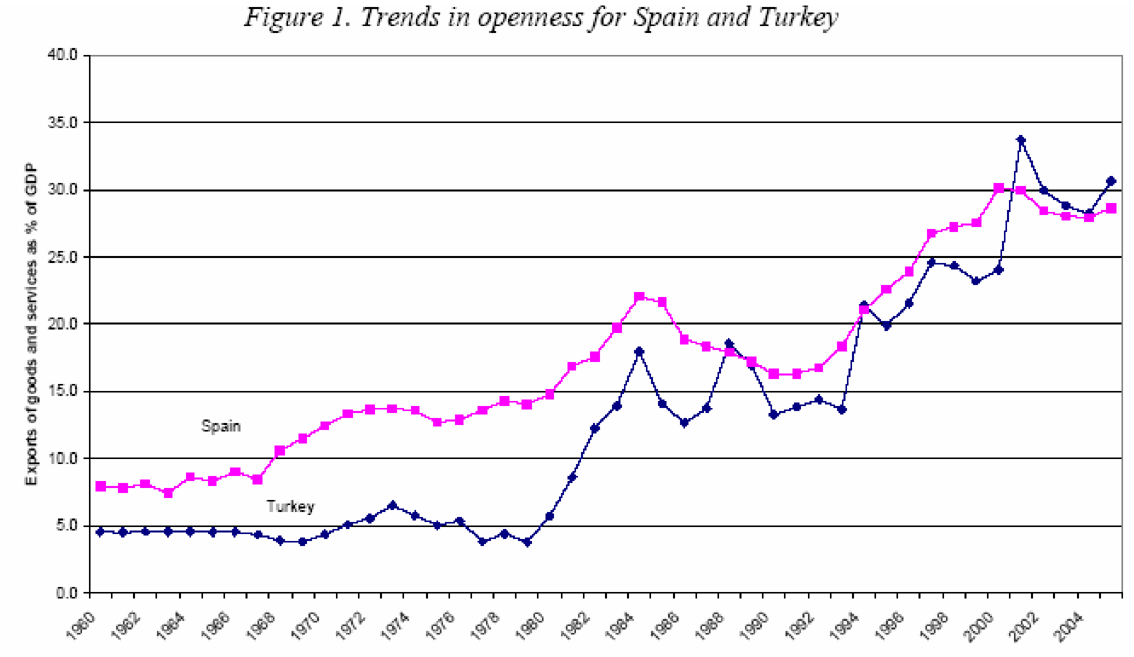
Source: OECD (cited by Dervis, Stabilizing Stabilization, 2004)

Even though Turkey has spent relatively low to the education so far, the 2006 Budget is promising. Accordingly; the share of expenditure on education will be 9.5 % of the GDP as of 2006 which might be a positive indicator for the foreign investors. However, today's facts indicate that Turkey lags behind its competitors in investing human capital.

3.3 Trade Openness

The trade openness is another crucial issue that foreign investors evaluate in a country. The openness of trade would encourage foreign investors to establish an export base in the host country. Moreover, greater openness brings fiercer competition which paves the way to higher quality. Until 1980, Turkey was a closed economy. Exports accounted for 5 % of GDP much less than Franco's Spain of the time (Gros, Oztrak 2004). The reforms of 1980 included the abolition of subsidies and price controls, more flexible exchange and interest rates. As it is analyzed form the graph below, Turkey's export amounts gradually increased to 30% of GDP as of 2004. The most important reason for this increase is the Customs Union Agreement going into effect in 1996. Under the Customs Union Agreement both import and export regimes have been made consistent with the EU regulations (http://www.seeurope.net, 2005). Thus, Turkey has already adopted a considerable amount of relevant Community legislation. Today's export figures are even close to Spain, which has been part of the internal market for more than 10 years. Spain is taken as an example because of its similarity in trade openness with Turkey. Spain was very closed in 1980 it was ranked among 17th among 21 OECD Countries (Deutschebank Research Report, 2003). Its accession to the EU in 1986 triggered a wave of trade liberalization. Since 1980, despite of the improvement in the trade openness of Turkey, exports to the EU account for 15 % of GDP compared to 20% in Poland, which is the least open country among the new entrants.

The Customs Union Agreement between Turkey and EU eliminates all customs duties and equivalent charges to industrial imports from the EU, as well as all quantitative restrictions. However according to a research conducted by INRA (Institute National pour la Recherche Agricole) for the European Commission in 2003, EU is one of the worlds most open market to imports of agricultural products from third countries and especially from developing ones. Thus, if the parties could extent the scope of the agreement to the agricultural products, Turkey's trade openness degree would further improve compared to the current EU members. "While Germany, Belgium and Netherlands were among the most open countries in 2005, we expect that emerging markets like Korea, China and Turkey will have overtaken them by 2020" (Neuhaus, Deutchebank Research, 2003, p.1).

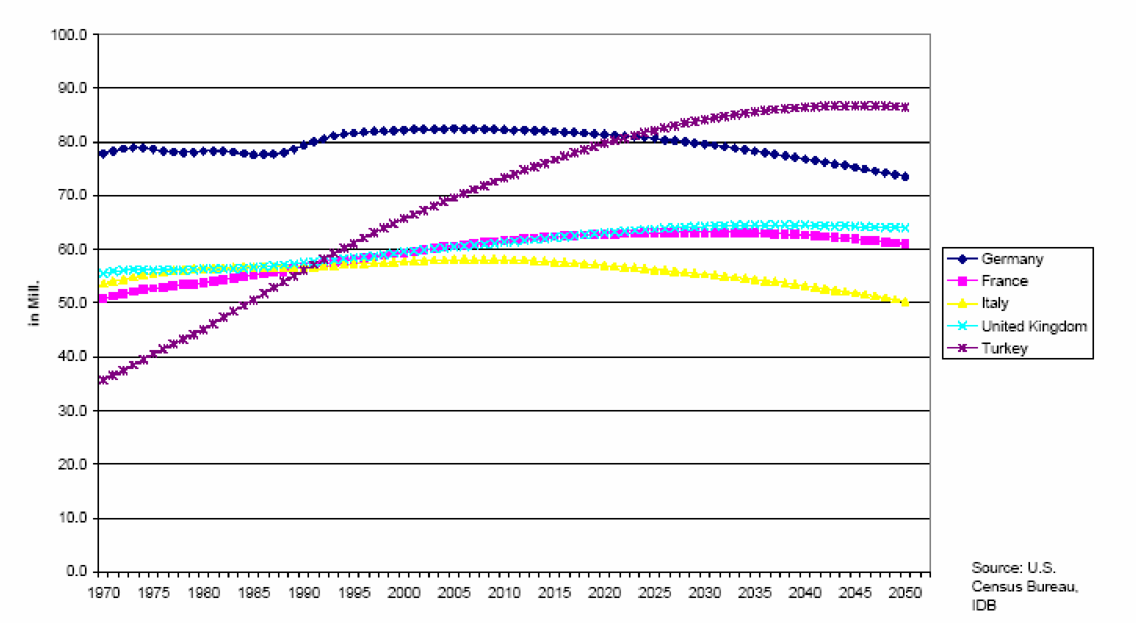


Source: Eurostat (cited by Daniel Gros, Economic Aspects of Turkey's Membership, 2005)

3.4 Demographic Dynamics

Last, but not least, FDI inflow is parallel with the demographic dynamics in the host country. The investors would like to obtain the necessary labor force for the production in the host country rather than bringing blue collar workers from abroad. Moreover, with their different recruiting processes from the local companies, the MNEs usually try to choose most of its white collar employees from the host country. In contrast to its competitors, namely EU members, Turkey's population is still growing but the rate of increase has slowed considerably compared to last decades. According to the ministry of national education, the population increase ratio has begun to fall. However currently, 37.3 million people are still making up 57% of the population belong to 0-24 age group (http://www.meb.gov.tr, 2002). The figure below compares Turkey's demographic dynamics with the 'old Europe' (Gros, 2004). From the figure we can analyze that old Europe has been stagnating or growing rather slowly for the last several decades. On the other hand, Turkish population has doubled during the same time.

Projections indicate that Turkey's population growth rate will be moderate in forthcoming 25 years, however compared to Italy and Germany; Turkey remains much more dynamic than other member countries. The Turkish population in working age has grown rapidly in last decade, which is a clear source of labor force for the forthcoming FDI. If Turkey can increase its employment level as well, it will have a clearly strong advantage over the richest members of the EU in the demographic area.



Source: US Census Bureau (cited by Daniel Gros, Economic Aspects of Turkey's Membership, 2005)

In order to provide a comprehensive comparison; there exists a detailed competitiveness ranking between EU Members and candidates below. The research, which is presented at World Economic Forum in 2003, indicates that Turkey is performing far better in the key areas than the future members in 2007, namely Romania and Bulgaria. However, compared to the recent EU entrants, Turkey has to improve on several issues such as Research & Development (R&D), financial services and sustainable development. Although the average share of R&D in GDP increased from 0.4% in 1994 to 0.6% during 1998-2000 -- considering the average between 2.5 % - 3 % in developed countries (Tusaid & Yased, 2004) --, it is not a sufficient share to boost innovation in the country. It is advised in the OECD

Economic Surveys that "if Turkey wishes to upgrade its production base and move toward a more high-tech economy, both business and government need to invest in R&D, develop new products and gain access to technologies being developed abroad." (OECD, 2001, p.32). Implementation of tax incentives to the techno parks and corporate tax postponement for R&D would help to betterment of the conditions. The improvement of financial services in Turkey is observed since 2003, which is proved by the increasing foreign investors in the sector. Currently 15 % of the financial services sector is dominated by the foreign investors, which had been below 5 % as at September 2004 (PricewaterhouseCoopers, M & A Research, 2005). However this ratio is even less than that of Czech Republic and Bulgaria; where the foreign investors dominate 90% of the market.

Competitiveness Ranking for recent EU Members & Candidates

	Final index		Sub-indexes							
Country	Rank	Score	Information society	Innovation and R&D	Liberalisation	Network industries	Financial services	Enterprise	Social inclusion	Sustainable development
Estonia	1	4.64	4.92	3.82	4.40	4.98	5.43	4.90	4.2	4.44
Slovenia	2	4.36	4.38	3.92	4.06	5.21	4.69	3.76	4.24	4.60
Latvia	3	4.34	3.62	3.86	4.44	4.35	4.84	4.87	4.47	4.29
Malta	4	4.2	4.42	2.99	4.03	4.81	5.27	4.0	4.83	3.24
Czech. Rep	5	4.16	3.62	3.34	4.01	5.19	4.03	4.18	4.40	4.48
Hungary	6	4.12	3.24	3.47	4.10	4.57	4.87	4.41	4.19	4.09
Lithuania	7	4.05	3.36	3.57	4.10	4.51	4.67	4.38	3.69	4.17
Slovak Rep.	8	3.89	3.29	3.34	3.84	4.50	4.39	3.43	3.83	4.53
Poland	9	3.68	2.95	3.53	3.75	4.0	4.26	3.56	3.42	3.99
Turkey	10	3.45	2.61	2.72	3.68	4.01	3.99	3.84	3.45	3.33
Romania	11	3.35	2.91	2.88	3.04	3.48	3.77	3.65	3.74	3.33
Bulgaria	12	3.25	2.66	2.94	3.26	3.54	3.64	3.81	3.07	3.06
EU average		4.97	4.61	4.41	4.69	5.81	5.52	4.74	4.81	5.16

Source: World Economic Forum, (cited by Oztrak, Relative Income Growth and Convergence,2004)

CHAPTER 4

Recommendations & Conclusion

4.1 Recommendations

Turkey has already started to take steps in enhancing quality business environment and improvement in foreign direct investment climate. The following recommendations will be helpful to achieve higher FDI levels:

- Support for effective Information Technologies Systems and innovation shall be provided

- Accelerated privatization should be maintained, the Privatization Administration shall continue its operations with its privatization portfolio

- Increase education levels for all segments of the society

- Current economic program shall be followed with IMF as it is a strong economic anchor

- Business facilitation issues should be improved. Establishing a single official body to deal with burdensome administrative procedures would also remove corruption as well

- Transparency should be provided in companies' financial statements; related legal actions shall be taken against the companies that resist adapting international accounting standards

- Facilitating the investment process is not sufficient by itself. Turkey has to promote its business climate abroad. Thus, an effective public relations organization should be established (i.e. a semi-autonomous Investment Promotion Agency)

- Decisive policies should continue through the negotiation process with the EU and political and economic reforms must be put in practice as the European Union will stand as a strong political anchor in the near future

4.2 Concluding Remarks

The figures show that in spite of its huge potential, Turkey is a country which lags behind other comparable economies in terms of FDI. This study aims to analyze the development and determinants of FDI in Turkey, as well as main impediments that paved way to the low inward investment during the last two decades. For this purpose, a comparison of the key determinants of FDI with the EU Members and candidates are presented.

The analysis at the beginning of the study shows that EU Member States are the main source of FDI inflow in Turkey. Manufacturing industry attracts most of the FDI which is followed by the service sector. The target of Turkey to become a full member of the EU makes it a suitable location especially for the efficiency-seeking FDI.

The political and economic instability, cumbersome bureaucracy, wide spread corruption, unregistered economy, failure in implementing policies such as privatization, and inappropriate tax system have been the main obstacles to create favourable investment climate for foreign investors. Among with the impediments, the betterment of the conditions are also explained in detail. The Turkish economy has become more robust and flexible to shocks as a result of the reforms introduced under IMF backed economic programmes since 2001. Furthermore, Turkey has made a major advance by achieving the Copenhagen political criteria which were so problematic to implement in previous years and was given October 2005 as a date to start the EU accession negotiations. This is seen as a strong signal for foreign investors of the stabilization of Turkey. With the introduction of the new FDI law in 2003 and policy regulations, a more favorable investment climate is achieved, purified from lengthy administrative procedures. The announcement of a significant decrease in corporate tax rates as of 2005 indicates that importance of the foreign capital is realized by Turkish politicians.

Our analytic comparison with the EU members & candidates indicate that Turkey is disadvantageous on some key determinants of FDI inflow such as labor costs, education and purchasing power parity. However the determinants are improving rapidly such as trade openness. Moreover, converting the determinants to one's advantage relies on Turkey's performance as it is the case with the demographic dynamism. The Competitiveness Ranking of the World Economic Forum shows that Turkey is performing far better than the future EU members, Romania and Bulgaria, but needs to take decisive steps to catch recent EU entrants to become competitive in attracting FDI.

Our recommendations point out that; it is now time to accelerate the pace of privatization in strategic sectors as this would reduce the political interference in business and therefore stimulate foreign investors' interest in the Turkish market. However as with the privatizations of Turk Telecom and Tupras, protests by employees and legal challenges may cause delays to the government's ambitious privatization projects.

As it has been the case in Central and Eastern European Countries recently, it is widely accepted that the foreign investors foresee the prospect of future EU membership as a guarantee and tool for stability. To give an example, the Eurostat Report in 1997 (cited by TUSIAD,2004) shows that FDI inflows in Ireland are doubled in the first five years following the accession and also in Portugal, FDI doubled each year at the period between 1987-1989; just one year after becoming full member. Spain's figures also show similar increase in FDI inflows after membership (Loewendahl&Ertugal, 2001). However the prospect of its future membership could reinforce the FDI potential of Turkey only on the condition that it follows its commitment to carry out economic and democratic reforms in order to achieve sustained stability.

Combining the two main chapters and analysis, the result of the study indicates that even though the FDI has enormously increased in 2004 and 2005, the increase is mostly due to the immense privatization program followed by the current government and improvement of the relations with the European Union. However unlike the other enlargements, EU accession negotiations with Turkey are an open-ended and not guaranteed beforehand. Moreover, the possibility of permanent safeguard clauses for the movements of Turkish people could imply a second-class membership for Turkey and can be considered as unacceptable in the future. Finally, France and Austria has announced that they would like to consult their citizens' opinion on Turkish membership by referendum. Thus, the process of negotiating Turkey's membership is long and unsteady. In our opinion, Turkey shall not link its future FDI inflow projections to its relations with the European Union. Instead; Turkey should try to close the gaps between herself and the current EU Members to achieve a sustainable FDI inflow throughout the next decade.

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