EU INTEGRATION PROCESS: WILL TURKEY OVERCOME THE FDI OBSTACLES?

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Abstract

This paper analyses Turkey's performance in attracting FDI and highlights the key obstacles for FDI in Turkey. When compared with its main competitor countries, which includes the group of new EU member states and other candidate countries, it can be concluded that Turkey has a very low rate of FDI inflow. It can be argued that one of the major problems behind the low performance in FDI inflows is macroeconomic instability. In this paper we will also perform an empirical analysis to examine the relationship between FDIs and macroeconomic instability in the EU new member states and the candidate countries. According to the regression results, it was found that the GDP has positive effect on FDI, whereas the external debt and current account deficit have been found to be negative. On the other hand, the results related with inflation run opposite to our expectations.

Key Words: Foreign direct investment, EU integration, determinants of FDI, panel data analysis, EU candidate countries.

Introduction

Membership of the European Union (EU) is vital not only for accessing to the single market of the EU, but also having access to the structural funds of Europe, not forgetting economic growth and political stability. To start with, EU integration processes are likely to have primarily been of political nature. Also, membership criteria require that the candidate country must have achieved a functioning market economy as well as the capacity to cope with competitive pressure and market forces within the Union (http://europa.eu.int/comm/enlargement/intro/criteria.htm). Empirical studies illustrate that many of the individual institutional reforms required for EU accession have influenced foreign direct investment (FDI) receipts positively. Therefore, membership in the EU makes a country more attractive for FDI than other countries (Bevan-Estrin and Grabbe 2001).

In May 2004, the EU expanded from fifteen to twenty-five member states. Eight countries from Central and Eastern Europe – the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia – together with the Mediterranean islands Malta and Cyprus joined the EU. Bulgaria, Romania, Croatia and Turkey are the candidate countries.

This paper analyses Turkey's performance in attracting FDI and highlights the key obstacles for FDI in Turkey. It can be argued that one of the major problems behind the low
performance in FDI inflows is macroeconomic instability. In this paper we will also perform an empirical analysis to examine the relationship between FDIs and macroeconomic instability in the EU new member states (from Central and Eastern Europe) and the candidate countries. Malta and Cyprus are excluded from the analysis due to data availability problem.

The paper will focus on three main sections. The first section clarifies economic determinants of FDI and effects of EU integration process on FDI inflows. The second section compares FDI in Turkey with the new member states of the EU and other candidate countries. In the third section the relations between FDI and macroeconomic instabilities in the new member states and candidates are empirically analyzed by using panel data regression.

1 The EU Integration Process and Possible Implications for FDI Inflows

There are a number of policies and perspectives developed to explain the level and structure of FDIs. Even though there are various factors affecting the FDIs, it can be claimed that among other factors, the most underlying one is the economic structure of a country. The policies aiming to strengthen the macroeconomic structure will highly influence the FDI. These policies could be related to market size, to the cost of investments, to the policies of openness, to the economic and political stability and to the financial health. Primarily in developing countries, the market size is an important factor to attract FDI. The economic variables such as population, GDP, GDP per capita and GDP growth rate can be used in identifying the market size. Also, another factor, which may affect FDI, is the cost of investment. Some of the other important determinants for FDI are the economic, political and financial stabilities. At this point the most important variables for the stability should be clarified, namely, the exchange rates, inflation rate, current account deficit, budget deficit and external debts. Another important determinant is the openness of a country (Basar and Tosunoglu 2005).

In the 1990s, the globalization trends throughout the world caused great changes in the strategies and policies applied in the countries in which FDIs were carried out (Banga 2003). In the globalization process, in addition to all macroeconomic determinants, regional integrations have provided great contributions to the FDI inflows. In this context, there have been unexpected and remarkable developments about the FDI in recent years. Increasing competition among developing countries to draw foreign investors and reducing bureaucratic procedures preventing significant foreign investments have had important effects upon these developments. Moreover, the developments mentioned above, have increased both the numbers of bilateral and regional agreements (Banga 2003).

Together with these improvements, membership of the EU has remarkable effects for the FDIs. EU enlargement offers some major openings into new export and financial markets for member countries. For example, after the foundation of the EU, a notable increase of intra- and inter-regional FDI flows was observed among the member countries. Ireland experienced a real FDI boom after its EU accession in the year 1973. Another success story is the accession of Spain to the EU in 1986. Before 1986, it was a closed economy, but today it is the most developed market economy in Europe. The analysis of economic impacts of the EU single market has shown that this integration process has led to a medium- and long-term increase of growth rates in the participating economies. This above average growth makes the total region more attractive, not only for domestic investors but also for foreign ones (Zakharov and Kusic 2003).
Also, political announcements about timetables for admission to the EU can increase the level of FDI, thereby improving national economic performance. In contrast, countries excluded from the EU, typically because of poor progress in the transition period will receive lower levels of FDI because their country credit ratings will be poor (Bevan and Estrin 2000).

2 The FDI Performance of Turkey and a Comparison with EU New Member States and the Candidate Countries

When compared with its main competitor countries, which includes the group of EU new member states and other candidate countries, it can be concluded that Turkey has a very low rate of FDI inflow.

Table 1: Net FDI Inflows (Current Million U.S. Dollars) (1993-2003)

<table>
<thead>
<tr>
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<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>CZECH REPUBLIC</td>
<td>654</td>
<td>878</td>
<td>2,567</td>
<td>1,435</td>
<td>1,286</td>
<td>3,700</td>
<td>6,312</td>
<td>4,987</td>
<td>5,640</td>
<td>8,496</td>
<td>2,514</td>
</tr>
<tr>
<td>ESTONIA</td>
<td>162</td>
<td>214</td>
<td>201</td>
<td>150</td>
<td>266</td>
<td>580</td>
<td>305</td>
<td>387</td>
<td>542</td>
<td>284</td>
<td>890</td>
</tr>
<tr>
<td>HUNGARY</td>
<td>2,349</td>
<td>1,144</td>
<td>4,878</td>
<td>2,362</td>
<td>2,223</td>
<td>2,084</td>
<td>2,019</td>
<td>1,694</td>
<td>2,594</td>
<td>2,862</td>
<td>2,506</td>
</tr>
<tr>
<td>LATVIA</td>
<td>45</td>
<td>214</td>
<td>179</td>
<td>381</td>
<td>521</td>
<td>356</td>
<td>347</td>
<td>410</td>
<td>163</td>
<td>253</td>
<td>299</td>
</tr>
<tr>
<td>LITHUANIA</td>
<td>30</td>
<td>31</td>
<td>72</td>
<td>152</td>
<td>354</td>
<td>925</td>
<td>486</td>
<td>378</td>
<td>445</td>
<td>712</td>
<td>179</td>
</tr>
<tr>
<td>POLAND</td>
<td>1,715</td>
<td>1,875</td>
<td>3,659</td>
<td>4,497</td>
<td>4,908</td>
<td>6,365</td>
<td>7,270</td>
<td>9,340</td>
<td>5,712</td>
<td>4,131</td>
<td>4,123</td>
</tr>
<tr>
<td>SLOVAK REPUBLIC</td>
<td>198</td>
<td>269</td>
<td>236</td>
<td>350</td>
<td>173</td>
<td>562</td>
<td>354</td>
<td>1,925</td>
<td>1,584</td>
<td>4,123</td>
<td>571</td>
</tr>
<tr>
<td>SLOVENIA</td>
<td>112</td>
<td>116</td>
<td>150</td>
<td>173</td>
<td>334</td>
<td>215</td>
<td>106</td>
<td>135</td>
<td>503</td>
<td>1,686</td>
<td>337</td>
</tr>
<tr>
<td>TURKEY</td>
<td>636</td>
<td>608</td>
<td>885</td>
<td>722</td>
<td>805</td>
<td>940</td>
<td>783</td>
<td>982</td>
<td>3,265</td>
<td>1,038</td>
<td>1,562</td>
</tr>
<tr>
<td>BULGARIA</td>
<td>40</td>
<td>105</td>
<td>90</td>
<td>109</td>
<td>504</td>
<td>537</td>
<td>818</td>
<td>1,001</td>
<td>812</td>
<td>904</td>
<td>1,419</td>
</tr>
<tr>
<td>CROATIA</td>
<td>120</td>
<td>116</td>
<td>114</td>
<td>510</td>
<td>532</td>
<td>932</td>
<td>1,467</td>
<td>1,089</td>
<td>1,558</td>
<td>1,123</td>
<td>1,998</td>
</tr>
<tr>
<td>ROMANIA</td>
<td>94</td>
<td>341</td>
<td>419</td>
<td>263</td>
<td>1,215</td>
<td>2,031</td>
<td>1,041</td>
<td>1,037</td>
<td>1,156</td>
<td>1,144</td>
<td>1,844</td>
</tr>
</tbody>
</table>

Source: World Development Indicators

Table 1 indicates that Turkey’s FDI inflows of $636 million in 1993 increased to $940 million in 1998 and it reached to $3,265 million in 2001. It can be stated that the FDI inflows between 1993 and 2000 were stable. However, the economic crisis experienced in 2001 caused a significant FDI decline in 2002. After the 2001 crisis, the amount of FDI decreased to $1,038 million in 2002. At the same period, Poland, the Czech Republic and Hungary proved to be the top three beneficiaries for inward FDI.

FDI inflows into EU new member states declined from a record $26 billion in 2002, to a low of $18 billion in 2003. This was almost entirely due to the end of privatization in the Czech Republic and Slovakia. In the rest of the other countries, the decline in FDI inflows was small (UNCTAD 2004). If we compare the amount of FDI inflows to Turkey with these countries, the FDI inflows to Poland are 4.3 times, Hungary 2.1 times and Czech Republic 3.1 times higher than Turkey. On the other hand, when compared with the other candidates, the evidence is opposite. The amount of FDI inflows to Turkey is the same as Croatia and Romania and two times more than Bulgaria.

To clarify this state of affairs, it will be helpful to bring out the economic structures of the new member states, Turkey and other candidates.
Table 2: Key Economic Indicators, 2003

<table>
<thead>
<tr>
<th></th>
<th>GDP (Current Million US $)</th>
<th>GDP Growth Annual %</th>
<th>GDP Per Capita (US $)</th>
<th>Inflation (%)</th>
<th>External Debt Total (Current Million US $)</th>
<th>Budget Balance % GDP</th>
<th>Current Account (Current US Million $)</th>
<th>Openness (Imp+Exp/GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Check Republic</td>
<td>89,715</td>
<td>3</td>
<td>8,855</td>
<td>0</td>
<td>34,629</td>
<td>-11.7</td>
<td>-5,660</td>
<td>1.2828</td>
</tr>
<tr>
<td>Estonia</td>
<td>9,082</td>
<td>5</td>
<td>6,693</td>
<td>1</td>
<td>6,972</td>
<td>3.1</td>
<td>-1,199</td>
<td>1.59</td>
</tr>
<tr>
<td>Hungary</td>
<td>82,731</td>
<td>3</td>
<td>8,398</td>
<td>5</td>
<td>45,784</td>
<td>-6.2</td>
<td>-7,210</td>
<td>1.2809</td>
</tr>
<tr>
<td>Latvia</td>
<td>11,072</td>
<td>7</td>
<td>4,716</td>
<td>3</td>
<td>8,802</td>
<td>-1.5</td>
<td>-916</td>
<td>0.9751</td>
</tr>
<tr>
<td>Lithuania</td>
<td>18,215</td>
<td>9</td>
<td>5,308</td>
<td>-1</td>
<td>8,342</td>
<td>-1.9</td>
<td>-1,278</td>
<td>1.11</td>
</tr>
<tr>
<td>Poland</td>
<td>209,562</td>
<td>4</td>
<td>5,400</td>
<td>1</td>
<td>95,219</td>
<td>-4.5</td>
<td>-4,599</td>
<td>0.7137</td>
</tr>
<tr>
<td>Slovak Republic</td>
<td>32,518</td>
<td>4</td>
<td>6,048</td>
<td>9</td>
<td>18,378</td>
<td>-3.7</td>
<td>-281</td>
<td>1.56</td>
</tr>
<tr>
<td>Slovenia</td>
<td>27,748</td>
<td>3</td>
<td>13,937</td>
<td>6</td>
<td>11,512</td>
<td>-2</td>
<td>-98</td>
<td>1.13</td>
</tr>
<tr>
<td>Turkey</td>
<td>240,375</td>
<td>6</td>
<td>3,452</td>
<td>25</td>
<td>145,662</td>
<td>-9.7</td>
<td>-7,905</td>
<td>0.5994</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>19,860</td>
<td>4</td>
<td>2,550</td>
<td>2</td>
<td>13,288</td>
<td>-0.4</td>
<td>-1,675</td>
<td>1.1629</td>
</tr>
<tr>
<td>Croatia</td>
<td>28,797</td>
<td>4</td>
<td>6,403</td>
<td>0</td>
<td>23,451</td>
<td>-4.6</td>
<td>-2,066</td>
<td>1.12</td>
</tr>
<tr>
<td>Romania</td>
<td>56,951</td>
<td>5</td>
<td>2,570</td>
<td>15</td>
<td>21,280</td>
<td>-2</td>
<td>-3,311</td>
<td>0.8035</td>
</tr>
</tbody>
</table>


When taken into consideration the overall economic policies, Turkey has many advantages in its evaluation. Firstly, compared with other countries Turkey has advantages from the respects of GDP and the growth rate of GDP that are considered as indicators of the market size. Moreover, Turkey is among the largest emerging markets in the world (Loewendahl and Loewendahl 2001). Therefore, it can be claimed that ideally Turkey should draw more FDIs. Although it had not been emphasized in the table, Turkey has many other advantages. These can be listed as: being located in a strategic location, having an educated and qualified work force, having communication and other infrastructures that are needed to meet the needs of investors, and having a lower cost of labor. Furthermore, Turkey had a liberal legal framework for FDI since 1954.

However, there are some disadvantages in the Turkish economy. Firstly, for the last twenty years, the Turkish economy has been suffering from a high inflationary environment (Yilmaz 2003). Even though various governments in office have tried to apply policies to decrease the rate of inflation, the rate of inflation is still higher than other countries. Secondly, the amount of Turkey’s external debts is another crucial problem. Indeed, the rate of the external debts to the GDP is about 60%. According to the optimistic scenario of the Undersecretariat of the Turkish Treasury, it will decrease to 50 % in 2008 (Undersecretariat of Turkish Treasury 2004). The amount of the external debts is about $145 billion and this prevents a decrease in the real interest rates to the desired levels and increases the country risk. In addition to this, high amounts of interest payments, inefficient tax collection, deficits in social security systems, insufficient privatization efforts, the problems of the public sector enterprises and undisciplined expenditures all cause budgetary deficits. Besides all these macroeconomic instabilities, the political instability can also be a key obstacle. There has been several elections in the last 15 years. These elections caused tensions on the economy. It has to be noted that the frequently changing governments have given their priorities to short run political benefits and in the long run have not been sensitive to the economic problems.
Turkey is a candidate country. It is clear that being a candidate makes Turkey attractive for FIDs because when compared with its European competitors, Turkey has many advantages. Its full membership depends on its adaptation to all the norm and standards of the EU. Being part of the EU will make Turkey attractive to the FDI.

It has to be reminded that the FDI inflows are closely related to the business environment, tax policies of the state, property rights, sectoral license, customs and standards. In this context, the legal adjustments improving the investment environment related to all these factors mentioned should be put in order. Also, these adjustments will help not only in compliance with EU acquis, but also to develop a more competitive investment environment for Turkey (Dutz-Us and Yilmaz 2003).

Since 2001, Turkey has realized important structural reforms to sustain the economic growth, to improve the investment environment and to attract more FDI inflows. Undoubtedly, the most significant of these is the Law of Foreign Direct Investment, (Law No: 4875), which was enacted in 2003. This new Law of FDI was designed to reflect the liberal approach of Turkey (http://www.treasuary.gov.tr). It constitutes the legal infrastructure of FDI. However, it is too early to evaluate the influences of the law on FDI level. It is expected that the law will positively contribute to the FDI inflows. These adaptations aiming to improve the investment environment should be strictly sustained. These continuing efforts are also vital for full membership of Turkey in the EU.

To conclude, the macroeconomic and political instabilities are the major obstacles of low volume of FDI in Turkey. If Turkey can manage to eliminate macroeconomic and political instabilities, there is no doubt that it should attract more FDI. In this context first of all, in Turkey it is necessary to control public debts; to decrease the rate of inflation and to provide macroeconomic stability. To achieve all these, the financial discipline should be ensured.

3 Methodology

Using panel regression, this paper explores whether the macroeconomic determinants of FDI affect FDI inflows in the EU new member states and candidate countries or not. The study will also help to determine the policies that can be employed for increasing the amount of FDI inflows for the candidate states. As mentioned previously, there are many factors affecting FDI. In this study, FDI inflows are analyzed by using four important variables. In this analysis, the independent variables used to explain FDI are as follows: the rate of inflation (INF), external debt (EXTD), the current account deficit (CACC) and GDP. It is expected that GDP is positively correlated with FDI inflows; however, INF, EXTD and CACC that are the components of the country risk are expected to be negatively correlated with FDI.

3.1 Sources and Description of Data

The data source for the dependent variable is the World Development Indicators (WDI) published by the World Bank. The independent variables were obtained from WDI and IMF, International Financial Statistics. The models are estimated using LIMDEB statistical software. The panel data set used in this study consists of twelve countries. The data collected were limited to the year of 1993-2003 due to data availability problem.
3.2 Model and Estimations

In the panel data analysis, two panel analytical models, Fixed Effects Model (FEM) and Random Effects Model, can be used. In some cases, FEM can produce significantly different results than REM (Ozer and Bicerli 2003). Hausman test is applied to assess whether FEM or REM is more appropriate in the panel data regression model (Chan and Gemayel 2003). In this study, Hausman test was applied and the results are presented below. According to the Hausman test, the FEM was preferred to the REM.

**Hausman test results**

Fixed vs. Random Effects (Hausman) = 24.06
(4 df, prob value = .000763)
(High (low) values of H favor FEM (REM))

In this study, we estimate fixed effects regressions with a data set from eight new member states and four candidate countries. The general form of model was formulated as follows:

\[ Y(i,t) = \alpha(i) + \beta_1 X_1(i,t) + \beta_2 X_2(i,t) + \beta_3 X_3(i,t) + \beta_4 X_4(i,t) + \epsilon(i,t) \]

Where \( Y(i,t) \) represents the value of the dependent variable, \( \beta_{(i,t)} \) and \( X_{(i,t)} \) represents independent variables and their parameters respectively. The subscript “i” indicates individual countries, while “t” shows different time periods and \( \epsilon(i,t) \) represents error component.

Table 3 shows the estimated results obtained by using panel data between 1993 and 2003 in the new member states.

| Variable | Coefficient | Standard Error | t-ratio | P[|t|>|t>| | Mean of X |
|----------|-------------|----------------|--------|-----------------|----------|
| GDP      | .3390900197E-01 | .12540545E-01  | 2.704  | .0078*          | .27405245E+11 |
| INF      | 982684.6013   | 662482.53       | 1.483  | .1405           | -335.92424 |
| EXTD     | -.4337173832E-01 | .28627644E-01  | -1.515 | .1322           | .11295616E+11 |
| CACC     | -.2235092522  | .70280928E-01   | -3.151 | .0020*          | -.11540282E+10 |
| Constant | 723265017.5   | .34874265E+09   | 2.074  | .0401           | .266914   |

Based on the results given in Table 3, the equation of our model was formulated as follows:

\[ FDI = 723265017 + 0.03391 \times GDP + 982684.6013 \times INF - 0.04337 \times EXTD - 0.22351 \times CACC \]

When the results given above are examined, it is seen that the coefficient of determination is 82.26 % and adjusted coefficient of determination is 78.28 %. The value of 0.7828 shows
that 78.28 % of changes in FDI could be explained by using explanatory variables analyzed, whereas the remaining part (21.72 %) could be explained with other variables. The F value measured as 20.67 is valid in the level of 0.000. It means that F value is significant at the level of 5 %. *

According to the regression results, it was found that the GDP variable has positive effect on FDI whereas the EXTD and CACC have negative. The results didn’t differ from what was expected. On the other hand, the results related with the variable INF run opposite to our expectations. When we look at the coefficients of the “t” values, and the levels of their meaningfulness, it can be asserted that the coefficients of the GDP and CACC are important (p<0.05), whereas those of other independent variables are not (p>0.05). That is to say those, the GDP and CACC are more effective than others. These variables seem to be endogenous in the model. Thus, due to such two way causality, we may confront an endogeneity problem. We test for endogeneity of CACC. It is not significant at the level of 5% but it is significant at the level of 10%. In order to solve this problem, we used 2SLS method and the results did not change. CACC was instrumented by budget deficit and public debt.

The model equation formulated according to the panel data analysis after including the candidate countries (Bulgaria, Romania, Croatia and Turkey) is given below

\[
FDI = 827750660.2 + 0.01035 \text{ GDP} + 574672.4618 \text{ INF} - 0.00589 \text{ EXTD} - 0.10063 \text{ CACC}
\]

\[
R^2 = 74.14 \quad \text{ADJ.}R^2 = 67.74
\]

As interpreted from the equation, the coefficient of the EXTD is increasing relatively, whereas that of the GDP was decreasing. Furthermore, adjusted coefficient of determination decreased to 67.74 % from 78.28 % after including the candidate countries into the model. This shows that other variables such as tax rates, openness, the FDI policies employed, democracy, transparency and good governance that were not included in the analysis, are also important features in the candidate countries.

In this study, there are two major underlying trends in respect of FDI flows to the new member states and candidate countries. The first is non-significance of inflation and external debt in the regression model. The second significant point is the sign of inflation. Studies have shown a negative relationship between inflation and FDI inflows. In other words, a high rate of inflation in a country affects negatively the investment environment of that country and increases the country risk. However, in the results of our analysis, the coefficient of the inflation variable was calculated as positive in both the analysis of the new member states and the analysis carried out after including the candidates. The reasons of this result can be explained by the multiplicity of the extreme data related to the inflation rates in the countries included in the survey.

Conclusions

There are a number of policies and perspectives developed to explain the level and structure of FDIs. Even though there are various factors affecting the FDIs, it can be claimed that the

* We analyzed the model with standardized data of all variables but it did not change significantly.

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economic structure of the countries is the most important and foreseen factor among the others. In the globalization process, in addition to all macroeconomic determinants, regional integrations have provided great contributions to the FDI inflows. Under these circumstances, the membership of the EU has remarkable influences for the FDIs. Therefore, membership of the EU is vital for access to European single markets, access to European structural funds, improve economic growth and political stability.

Turkey as a candidate country has better conditions from the respects of GDP and the GDP growth when compared with its European competitors. However, in Turkey, there are serious obstacles preventing the FDI inflows to Turkey. The most important of these are high rates of inflation, external debts and current account deficits. This case shows clearly how crucial the macroeconomic instability is in attracting or deterring the FDI.

The results of our analysis support this case. The regression results show that GDP has significant and positive effects on FDI inflows. On the contrary, external debts and current account deficits affect negatively the FDI inflows. For this reason, candidate countries, and Turkey in particular, need to implement some policy measures in order to attract FDI. To do so, firstly, the economic obstacles that seem to prevent full membership of the EU should be improved. The political determination on this issue should be sustained. In addition to this, Turkey must eliminate macroeconomic and political instabilities.

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