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ABSTRACT

Global foreign direct investment (henceforth FDI) flows have resumed growth in 2004. Favourable conditions for FDI flows continued in 2005, leading a growth from $648 billion in 2004 to $916 billion (WIR 2006). It is forecasted by the Economist Intelligence Unit (2006) that the global FDI inflows in 2006 will exceed the $1trn mark (WIR 2006). The upsurge in global FDI flows has mainly spurred by the expansion of cross-border mergers and acquisitions (M&As) as an alternative mode of entry to greenfield FDI. This essay surveys the different possible impacts of the two modes of FDI and the diverse effects of the shift of FDI towards the services sector on host developing countries' economies. The study is further developed by examining the short-term outcomes of the new form of FDI on the Turkish economy.

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I. Introduction

Global foreign direct investment (henceforth FDI) flows have resumed growth in 2004. Favourable conditions for FDI flows continued in 2005, leading a growth from $648 billion in 2004 to $916 billion (WIR 2006). It is forecasted by the Economist Intelligence Unit (2006) that the global FDI inflows in 2006 will exceed the $1trn mark (WIR 2006).

The upsurge in global FDI flows has mainly spurred by the expansion of cross-border mergers and acquisitions (M&As) as an alternative mode of entry to greenfield FDI. The share of M&As in total FDI flows reached to 78 percent in 2005. Moreover, there was a 48 percent increase in the value of completed worldwide cross-border deals in the first half of 2006 compared to the same period of 2005 (WIR 2006; WIP 2006).

There has been a change also in the sectoral distribution of FDI, which shifted more towards the services sector, which has become the largest and fastest-growing sector in the global economy during the last two decades due to the noteworthy enhancement in its capacity in providing global output and generating employment. The most important reason behind the upsurge in services FDI is the fact that, because many services are non-tradable in nature, serving foreign markets has necessitated FDI to this sector. Regarding the share of cross-border M&As in services FDI, in both developed and developing countries, more than half of all cross-border M&As have took place in the services sector during the last three years.

In line with the global patterns, FDI flows to Turkey, which have been on a record-breaking upward trend, have also occurred in the form of cross-border M&As and the most attractive sector has been the services sector. The share of services sector in FDI inflows boosted dramatically from 39 percent in 2003 to 93 percent in 2006.

This qualitative change in FDI flows has accompanied with various concerns among both many scholars and policy makers about the developmental effect of FDI. What makes the issue important is the fact that cross-border M&As and greenfield investment cannot be considered as perfect substitutes, since the former is a mere transfer of ownership from domestic firms to foreign enterprises whereas the latter requires establishing new plants and

generating new employment at entry. The magnitude of the developmental effects of services FDI manifests itself in the non-tradability problem, particularly when the significance of export growth for a sustainable economic growth is taken into account. Therefore, although the volume of FDI is important, its composition across entry modes and sectors is also of great importance for a thorough evaluation.

This essay surveys the different possible impacts of the two modes of FDI and the diverse effects of the shift of FDI towards the services sector on host developing countries' economies. The study is further developed by examining the short-term outcomes of the new form of FDI on the Turkish economy.

The paper is organised as follows: the second section outlines the global trends. In the third section a comparison of developmental effects of greenfield foreign investment and FDI through M&As on host developing country economies are evaluated. The change in the sectoral distribution of FDI towards the physically non-tradable services sector and its impact on host countries is assessed in the fourth section. In the fifth section, a case study of Turkey is conducted and some policy suggestions are put forward. The sixth section finally concludes.

II. General Trends in Global FDI Flows

II.1. Global Trends: Mounting FDI Flows

2004 was an important year for global FDI flows. Following large declines in their value in 2001, 2002 and 2003, FDI flows rose in 2004 for the first time in four years. Favourable conditions for FDI flows continued in 2005, leading a growth from $648 billion in 2004 to $916 billion (WIR 2006). It is forecasted by the Economist Intelligence Unit (2006) that the global FDI inflows in 2006 will increase a further 22 percent, and this will be the first time since 2000 that global inflows surpass the $1trn mark.

FDI flows to developing countries also rose considerably, 57 percent and 22 percent in 2004 and 2005 respectively. These growth rates were largely spurred by the so-called 'emerging markets'. However, forecasts for 2006 – a mere 2.8 percent increase – are not that

promising due the fact that privatisation prospects will tail off in many leading emerging markets, hence dampen the inflows (WIP 2006).

At the regional level, in 2005, West Asia and Africa saw a significant rise of 85 percent and 78 percent respectively. These striking growth rates were mostly driven by rising corporate profits and high commodity prices in Africa, where FDI has concentrated mainly in countries rich in natural resources, particularly fuel and minerals (UNCTAD 2005). Whereas in West Asia strong economic growth, production increase due to high commodity prices, expected further high prices of oil and gas, continued liberalization efforts such as privatization of services were the factors stimulating FDI. Growth rate of FDI inflows to South, East and South-East Asia was modest, a rise of 20 percent. In several countries in the region (e.g. Malaysia and China), FDI has been in the form of greenfield investment designed to link these low-cost locations to international production networks for production of labour-intensive manufactures for global markets. A number of countries in the region also attract high value-added and knowledge-intensive activities by leading TNCs. In Latin America and the Caribbean, on the other hand, FDI flows increased only by 3 percent mostly due to the recent policy changes that make these countries less welcoming to FDI (WIR 2006).

II.2. Change in Entry Mode of FDI Inflows: Cross-Border M&As Take the Lead

These dramatic growth rates of FDI flows is largely spurred by M&As which started to pick up in 2004.[1] In 2005, while greenfield projects were falling, there was an enormous rise in both the value and number of cross-border M&As reaching to $716 billion and to 6,134 respectively. Increasing numbers of mega-deals (each worth more than $1 billion in transaction value), which was stimulated by the recovery of stock markets, were behind this rise. For example, there were 141 such deals and their total value was $454 billion, accounting for 63 percent of the total value of cross-border M&As. Moreover, the value of completed cross-border deals worldwide surged to $435 billion in the first half of 2006, a 48

[1] In practice, world M&As have been predominantly driven by acquisitions. Cross-border mergers usually represent a small share in cross-border M&As (Calderon, Loayza and Serven, 2002). Moreover, in reality, "one company shall buy another and, as part of the deal's terms, allow the target firm to proclaim that the transaction is a merger of equals, even if it is technically an acquisition" (UNCTAD, 2005 p.2). It is important to note that there are further distinctions also between 'mergers' and 'acquisitions'. However, it is beyond the scope of the current study. Thus I usually refer to acquisitions even though I use the abbreviation 'M&As'.

percent increase over the same period of 2005. This increase, however, was mainly concentrated in the developed world (WIR 2006; WIP 2006).

II.3.Changing Sectoral Distribution of FDI

Looking at the sectoral distribution of FDI, services sector witnessed a dramatic increase in both FDI flows and stock in the past 15 years. Regarding the share of cross-border M&As in services FDI, in both developed and developing countries, more than half of all cross-border M&As have took place in the services sector during the last three years. However, the difference between 2004 and 2005 was that the primary sector appeared to be an important part of FDI flows in 2005. M&A sales and purchases in this sector rose more than sixfold. FDI in mining was largely responsible for this recent growth of FDI in the sector. Nonetheless, primary sector M&As mostly take place in developed countries while in developing regions, where there is a rather restrictive regulatory environment, FDI to this sector occurred through greenfield investments. The growth in FDI in manufacturing (apart from the industries related to primary products), on the other hand, was noticeably less than FDI in services (WIR 2006).

Table 1: Estimated World Inward FDI Stock by Sector, 1990 and 2004 (million $)

	1990			2004			
	Developed Countries	Developing Countries	World	Developed Countries	Developing Countries	Southeast Europe&CIS	World
Primary Sector	139.563	23.715	163.278	268.171	151.632	20.725	440.529
Manufacturing Sector	586.379	144.372	730.750	2.406.127	613.559	20.448	3.040.135
Services Sector	716.554	151.589	868.133	4.624.699	1.224.356	34.286	5.883.341

Source: UNCTAD (2006)

Table 2: Estimated World Inward FDI Flows by Sector (million $)

	1989-1991			2002-2004			
	Developed Countries	Developing Countries	World	Developed Countries	Developing Countries	Southeast Europe&CIS	World
Primary Sector	9.103	3.340	12.443	36.398	16.328	4.909	57.635
Manufacturing Sector	47.693	16.453	64.147	93.337	84.957	6.648	184.943
Services Sector	83.607	11.302	94.909	336.513	92.418	7.243	436.174

Source: UNCTAD (2006)

More specifically, in 2005, oil and gas, utilities, banking and real estate were the leading industries in terms of inward FDI, reflecting that the present FDI growth is led by a few specific industries. The petroleum, finance and telecommunication industries accounted

for more than one third of the total value of M&A deals and they were closely followed by real estate (WIR 2006).

II.4. Driving Forces Stimulating the Recent Developments in FDI Flows

The global environment for FDI improved considerably in recent years. The increase in global FDI flows was mainly driven by a combination of several factors. First, world real GDP growth was 5.3% in 2004, 4.8% in 2005 and is forecasted to be 5.2% in 2006 (WIP 2006). This continued economic growth has been the most important factor at the macroeconomic level. Apart from the accelerating economic growth in the US and in other OECD countries, most emerging markets have witnessed solid growth, with China's economy continuing to lead the group with exceptionally high rates. This also helped to drive up commodity prices – which in turn fuelled strong growth in many other emerging markets and stimulated FDI in countries that are rich in natural resources.

Second, managing international business systems in an integrated manner has become even easier due to technological developments. Third, further liberalization of FDI regimes and new incentives to foreign investors offered in many countries created new opportunities for companies to expand. Fourth, rising corporate profits and improved balance sheets together with favourable conditions in financial and stock markets also gave rise to FDI flows. Fifth, sharper competition among firms made it necessary for multinationals to seek for new opportunities in different locations. Finally, the rising amounts of financial flows to collective investment institutions (e.g. private equity funds, hedge funds), a rather new and special form of finance industry, led massive cross-border investments by these funds (WIR 2006).

III. Greenfield FDI vs. Cross-Border Mergers and Acquisitions: What are the Impacts On Host Developing Countries?

III.1. How do the Multinational Firms Determine their Optimal Modes of Entry?

The expansion of FDI through cross-border M&As is highly associated with the emergence of a knowledge-based economy and the increasing liberalisation of markets. In such a global business environment knowledge-based assets and skills are crucial for

competitiveness, making asset-seeking FDI increasingly important. Among the two modes of FDI entry, only M&As can be used to access assets embodied in firms. Moreover, increased competitive pressures fuelled by strong market liberalisation, require firms to access assets or restructure rapidly and consolidate their operations in strategic response to competitors' actions. Accordingly, the greenfield option is often discarded as an entry mode, at least at the early stage of corporate decision-making, since speed has become an important factor (WIR 2000).

According to Nocke and Yeaple (2004) since cross-border M&As and greenfield FDI are not perfect substitutes for both multinational enterprises (MNEs) and host country policy makers, not only the volume of FDI but also its composition across modes are important. Therefore they developed an assignment theory to analyze the volume and composition of FDI. The results of their model indicate that efficiency of MNEs, host country's level of development, factor price differences between home and host countries, and existence of key firm-specific assets in host countries all play a role in determining the composition of FDI.

In more detail, the predictions of their model indicate that: first, firms engaging in greenfield FDI are, on average, more efficient than those engaging in cross-border acquisitions. Greenfield FDI requires building a new plant in the foreign country and such expenditure is meaningful only if the gains from relocating production are high enough. Hence, only satisfactorily productive firms will engage in greenfield FDI, whereas the market for corporate assets allows even relatively inefficient firms to take advantage of complementarities. Second, greenfield FDI and cross-border acquisitions co-exist, but as factor price differences peter out, almost all FDI takes the form of cross-border acquisitions. This is mostly because, the vanishing factor price differences in previously low-cost locations become no longer exploitable, whereas cross-border M&As not only exist because of factor price differences but also because of host country firm-specific assets.

Eicher and Kang (2005), in addition, examine multinational's entry behaviour into foreign markets as a function of market size, market structure, FDI fixed costs, tariffs and transport costs. According to their model, FDI fixed costs, tariffs and transport costs are critical not only in deciding whether to engage in FDI or trade, they also affect the acquisition choice. As FDI fixed costs rise, the profitability of greenfield investment diminishes and multinational corporations (MNCs) turn to acquisition. In case of low competition intensity in

the host country, acquisition increase in monopoly profits and market size especially if trade and greenfield FDI can be used as "threats" to reduce the acquisition price. Market size is important because only in large markets it is optimal for a MNC to acquire a local firm and become a monopoly supplier, since in small markets a MNC is unable to recover the acquisition price or marginal production costs. This is in line with the findings of Hill et al. (1990), that is the existence of large monopoly rents favours acquisition over greenfield FDI.

Nevertheless, free trade and proximity to the MNC's foreign production site exclude greenfield FDI as a potential entry mode, regardless of market size or fixed costs. No matter whether trade is free or transport costs are negligible, sufficiently large markets always attract an MNC to purchase the local firm, not only to become a monopoly producer, but also because trade is a powerful threat that lowers the acquisition price.

As the competition intensity in the host country increases, however, the MNC's marginal cost advantage can drive out the domestic firm. This diminishes the importance of market size since even in small markets MNC – whose entry behaviour becomes more aggressive – may capture the entire market to generate adequate demand to cover fixed costs. This in turn increases the acquisition threat, lowers the acquisition threshold market size and allows for acquisition even in small markets in case of high fixed costs.

III.2. Does the Mode of Entry Matter for Development?

So far, the factors affecting the decision-making process prove to be clear enough to understand the MNCs' motivations. Now the point is to take account the rising concerns over M&As and to analyze the positive and negative effects of this changing entry mode of FDI on host developing country economies.

Given the ever increasing importance of M&As in total FDI flows, developing host countries have started to be cautious about the developmental effects of this type of FDI. The most common view rising among many scholars and developing country governments is that FDI through M&As, unlike greenfield FDI, have little or no positive impacts on the most important determinants of economic growth such as external financial resources, investment generation, technology upgrading, employment creation, and export competitiveness. The above-mentioned study conducted by Nocke and Yeaple (2004) is indeed inline with these

views. The results of the model demonstrate that greenfield FDI is superior to cross-border M&As since it involves the creation of new plants, best foreign firms, and a large number of workers.

Before analyzing the effects of the two different types of FDI on the aforementioned determinants of the economic development, it is important to point out a widely debated issue regarding the growth effect of FDI. While the theoretical literature (WIR, 1999) [2] points out that FDI may boost economic growth via increased financial resources and investment, and technology spillovers, the empirical literature (Li and Liu, 2004; de Mello, Jr, 1999; Desai, Foley and James R. Hines Jr, 2005; and Borensztein, de Gregorio and Lee, 1998) raises high contention about the relevance of these impacts. The problem arises mostly because greenfield investment and FDI through M&As are noticeably different in their motivations and their impacts on growth. While for instance, the former affects growth via increased physical investment, the latter is expected to do so via enhanced productivity growth. In fact, the increasing share of M&As in total FDI is probably the most important factor behind weakening empirical relationship between FDI, investment, and growth. For example, the process of public enterprise privatization which generally accounts for the bulk of the M&As in many developing countries usually does not lead to a significant increase in total investment, especially when governments use the provided funds to finance their servicing debts. Therefore, realizing and analyzing distinctions between the two types of entry mode becomes crucial.

For instance, Calderon, Loayza, and Serven (2002) examined the dynamic relations and systematic differences between the two components of FDI flows – greenfield FDI and M&As – regarding their respective relationship with investment and growth in destination economies. The results indicate that growth tends to precede and produce positive impact on greenfield FDI but gets no feedback from the latter in both developed and developing countries. For M&As, on the other hand, the results were similar to those for greenfield investment for developed countries, whereas there was no statistically significant relationship between economic growth and M&As for the sample of developing countries.

[2] See also the references in WIR (1999)

These results suggest that establishing a reasonable relationship between economic growth and FDI depends on a large variety of factors. For instance there may be the problem of bi-directional causality problem, or – as mentioned before – a one shot nature of privatization process in many developing countries may not lead to a significant increase in total investment. Accordingly, in the following section I will elaborate the different impacts of both greenfield investment and M&As on the most important determinants of economic growth, denoting a particular attention on acquisition-related FDI.

III.2.1. Current Account of the Balance of Payments

One of the most important concerns rising over mounting M&As is related to its possible negative impacts on the current account of the balance of payments of host developing countries. The balance of payments effect of FDI is the result of its impact on the real exchange, on exports, on import dependency and on investment income payments.

First, since a foreign merger or acquisition typically places resources in the hands of the local owners of a firm immediately, if a transaction is large, it may create greater pressure on the domestic currency than a greenfield investment of the same volume, leading to currency appreciation. Privatizations involving foreign buyers are a typical case in which the exchange rate may be affected by such sudden inflows. The negative effect of large capital inflows on the local currency indeed can be reduced through intervention by the monetary authorities. However, in some specific cases the possibility of putting this option into practice might be limited (WIR 2000).

Appreciation of the exchange rate of the national currency in turn reduces the competitiveness of exports, thus leading to the reduction of investment in export industries. Moreover, not only export competitiveness is negatively affected in the case currency appreciation, but typically there is considerable increase in imports. The ordinary outcome of this process is that substantial increase in exports is more than compensated by an even more significant increase in imports, exacerbating the current account deficit (WIR 2000).

The effect of FDI on current account of the balance of payments becomes further complicated when the impact of profit repatriation and transfer pricing is included. This effect actually differs according to the mode of entry: outflows of earnings are likely to begin sooner

with M&As than with greenfield FDI. However, this is only a short-term effect, since transfer pricing will also start in greenfield projects over the long run. In Thailand, for instance, the average rate of repatriated profits for FDI projects as a percentage of the accumulated stock of foreign capital over 1975-91 was 9.2%, almost exactly equal to the average international interest rate over the same period (Jansen, 1995). There are also cases such as some Latin American countries, in which annual profit remittances of acquired firms exceed the M&A-related FDI inflows. A recent report published by UNCTAD, in addition, shows that in a number of African countries profit remittances have in recent years exceeded total FDI inflows, sometimes by many times over (UNCTAD, 2005).

Consequently, since FDI through M&As is more likely to create a dutch-disease effect in host countries, greenfield FDI appears to be superior to the former, particularly when the importance of exports in maintaining a strong economic growth is taken into account.

III.2.2. Investment

Although there is no distinctive relation between investment and growth, the strong influence of capital accumulation on the latter is widely approved (Rodrik, 1997 and Akyuz, 2006). This power of investment comes from its ability to generate income since it is a dynamic component of effective demand. More importantly, it also expands productive capacity and has strong complementarities with other elements of growth, particularly technological progress and productivity growth (Akyuz, 2006).

The recent upsurge in FDI flows has contributed not so much to an acceleration of capital formation and growth. Although the share of FDI as a proportion of GDP has more than tripled in recent years compared to 1980s, the proportion of world GDP allocated to investment has fallen by 2.5 percent. The gap was even larger for developing countries which experienced a fivefold increase in the FDI/GDP ratio (Akyuz, 2006). These unfavourable developments in FDI-investment relation were partly the result of the changing nature of FDI flows: While greenfield FDI takes the form of a direct addition to host country production facilities, FDI in the form of acquisition of existing public or private assets, though changes in ownership which is accompanied by increased productivity may encourage further investment, appears to have no direct contribution to domestic capital formation.

The usual assessment of the contribution of FDI to total investment in a host country is demonstrated by $I \equiv I_d + I_f$ where I_d is domestic investment and I_f is thought of as FDI. Since M&As are mere transfers of existing assets from domestic to foreign firms, all FDI cannot be considered as investments in real sense. Although the impact of the two modes of FDI on investment is an empirical issue, this distinction cannot be found in FDI statistics yet. However, there are country cases in which the effects of the both types of FDI can be analysed. In Latin America, for instance, most of the acquisitions of domestic firms were almost akin to portfolio investment hence not leading to any increase in the physical capital of the host countries. There were also many cases where the acquired companies were not in need of modernizing as they were already operating with highly modern technologies (Agosin and Machado, 2005).

Moreover, it is often argued that although FDI through M&As may displace domestic firms, this negative effective can be compensated by backward and forward linkages established by foreign firms. These linkages are expected to be stronger in the case of M&As than greenfield investment since acquired companies have existing local linkages and acquirers are likely to continue to rely on these local suppliers as long as the suppliers are competitive with alternative sources (WIR 2006). However, it should be stressed that although linkages are a necessary factor for crowding-in, their sufficiency is questionable, particularly when a possible 'dutch disease' syndrome, which may substantially reduce competitiveness of local producers against international ones, is taken into account.

Therefore, it appears that greenfield investment which directly contributes to host country production facilities at entry is more favourable for a positive relation between FDI and capital formation than FDI through M&As. However, this judgment is only valid in the short-tem, because the longer term relation between FDI and capital formation would depend on the behaviour of the domestic firms (remaining domestic firms in the case of M&As).

In fact, the results of a recent empirical examination of the crowding in/out effects of FDI (without a distinction between the two modes) for twelve developing countries in three developing regions (Asia, Africa and Latin America) for the period 1971-2000 conducted by Agosin and Machado (2005) indicate that in all regions, FDI has, at best, left domestic

investment unchanged, and that there are several sub-periods for specific regions, particularly in Latin America, where FDI displaces domestic investment.

Therefore the relationship gets more intricate in the long-term. However, a related argument on the relationship between FDI through M&As and capital formation, that is those who sell their companies will use the proceeds for new investments, may be helpful for an analysis. The argument is not wholly approved because such a positive effect on sellers is likely to be weak, since TNCs are far superior to domestic firms in technological, organisational, managerial and marketing skills. In addition, sellers may well prefer using proceeds for purchasing financial assets (at home or abroad) rather than investing in the real sector, particularly if there are certain deficiencies in the domestic sector such as the existence of low value-added. Conversely, in the case of FDI inflows to a domestic market via greenfield investment, local producers seem more likely to fight to survive even at the cost of very low profits, since they would not have large sums of money at their hands to prefer to give up.

III.2.3. Employment

Concerns over FDI through M&As also arise regarding the negative impact of this type of foreign investment on employment generation. Greenfield investment necessarily creates new employment at entry, whereas FDI through M&As does not generate employment when it first enters a country, "for the obvious reason that no new production capacity is created in a merger or an acquisition" (WIR 2000, p.xxiv). In fact, it may lead to lay-offs depending on different motivations of acquirers and different characteristics of acquired companies. Generally, in market-seeking and strategic-asset-seeking M&As, unlike in efficiency seeking M&As, employment is not expected to decrease. However, in market-seeking FDI, employment generation is constrained by the amount of investment which increases in market size of a host country. Therefore, export-oriented FDI appears to be more powerful in employment generation since the market becomes much larger. Consequently, as will be discussed in more detail in the subsection IV.1, recently-increased cross-border M&As in non-tradable services sector, does not seem to have as strong job creation potential as FDI in export-oriented manufacturing sector.

Furthermore, regarding the effects that vary according to characteristics of the acquired firms, employment is very likely to decrease in acquired firms with poor technology

and management or with substantial excess capacity, since rationalization, enhancing efficiency, and reducing excess capacity are vital for TNCs in order to ensure competitiveness (WIR 2000). Moreover, the aim of eliminating duplication also leads to some lay-offs in firms which carry any synergies with acquiring firms. For example, M&As in the world automotive industry during the 1990s have been followed by cuts in employment despite an increase in output (WIR 2000). Furthermore, M&As in the financial-service industries have also led to lay-offs. In Brazil, for instance, the acquisition of local banks by foreign firms resulted in significant lay-offs (Vidotto (1999) as cited in WIR, 2000).

Finally, unemployment may hit export-oriented manufacturing sector particularly hard because of loss of competitiveness due to currency appreciation stimulated by large inflows via FDI through M&As.

III.2.4. Technology

One of the most important developmental impacts of FDI is undeniably its high potential for technology transfer to and technology diffusion in developing countries. There are a number of reasons why FDI may be the cheapest and most feasible way of technology transfer. For instance, the latest and most valuable technologies are not generally available on licence. Furthermore, even the mature technologies that are available by licensing may not be implemented efficiently by many firms in host developing countries. Moreover, FDI may also play an important role in updating technologies quickly, which is important for countries that lack the ability to improve and innovate on imported technologies (WIR 2000).

Regarding the possible spillover effects from FDI, positive spillover effects from foreign affiliates to a host economy may occur through different channels such as encouraging local firms to improve technological capabilities via competition threat and stimulating technology spillovers to vertically linked firms and service providers through cooperation between affiliates and local suppliers and customers (WIR 2000).

Thus, since FDI through M&As involves working with an existing facility and a greenfield investment setting up a new one, the former is less likely to transfer new or better technologies or skills than the latter, at least at the time of entry. However, the spillover effects occur via highly modern technologies are very limited, if none, particularly when the initial technology gap between host and home countries is significantly large (Aslanoglu

(2000) as cited in WIR, 2006). This finding in turn reflect that cross-border M&As which start with older technologies are not always less desirable. For instance, technologies in an acquired firm may be better adapted to local environment or have a stronger learning base that allows them to be used more efficiently.

Yet, there are other risks such as TNCs may restrict the access of particular affiliates to technology, in order to minimize inter-affiliate competition. What is more, it may lead directly to the reduction or closure of local production or functional activities (e.g. R&D capabilities), or to their relocation in line with the acquirer TNC's global corporate strategies. Greenfield FDI, on the other hand, does not directly reduce the technological or other assets and capabilities in a host economy (WIR 2000).

Moreover, the preferred degree of technology transfer may also be used by a TNC for reducing the acquisition price. Matto, Olarreaga and Saggi (2004) examine the preferences of a foreign firm over the two modes of FDI in the presence of costly technology transfer. The authors show how the extend to which a host country can secure the technology-related benefits of FDI is likely to depend on the mode of entry of foreign firms. First, a foreign firm goes for full acquisition because if it fully acquires a domestic firm it can internalize the benefits of technology transfer. Second, the higher the degree of technology transfer the lower the profits of a non-acquired firm. Accordingly, through its preference of technology transfer, the foreign firm can make it less attractive for a domestic firm to be a competitor thus lowering the price at which acquisition occur.

Nevertheless, the nature of the host economy, the activity concerned and the motivation of the investor will all make a difference to the technology transfer and upgrading that occur. For instance the more export-oriented the activity in question, the stronger and faster will the transfers be. Therefore, once again, it can be said that the significant rise in both the value and the number of deals of cross-border M&As in the non-tradable services sector may negatively affect the technology transfer potential of FDI, particularly for hard technologies.

III.3. Can FDI through M&As Generate Further Greenfield Investment over the Long-Term

Given the excessive growth rates of M&As, there are concerns that part of the international production-related assets and activities will be transferred from domestic firms to TNCs, rather than making an addition to host countries' output, employment and value-added. However, whether this concern is warranted depends largely on the relationship between greenfield investment and M&As. Because, "the shift may itself contribute to a growth in host countries' production capabilities over time due to possible sequential FDI aimed at expanding acquired production facilities" (WIR 2006, p.10).

Calderon, Loayza, and Serven (2002) examined the link between the components of FDI flows – Greenfield and M&A – in a large cross-country time-series data set. The question that the authors tried to answer is that since the bulk of the M&A boom was due to privatization of public assets and this will sooner or later come to an end, what will be the future prospects of FDI to developing countries?

Estimating bivariate vector autoregressions in a pooled cross-country, time-series setting for the period 1987-99 and for samples of 21 industrial and 61 developing countries, the authors found that an expansion of M&A is indeed followed by an increase in greenfield FDI. Therefore, if the experience of the 1990s and late 1980s is a good predictor for the future, FDI flows will not dry-up after the privatization process has stopped. Conversely, rise in M&As may well give way to rising greenfield investment.

The emergence of such an option in turn may improve the circumstances discussed above. For instance, privatizations often lead to lay-offs after the change of ownership. This was the case in privatization of Latin American electric power generation and distribution by the Spanish firm Endesa (ECLAC (2000) as cited in WIR, 2000); the acquisition of Manila Water Works by two TNCs in 1997 (PSI (2000) as cited in WIR, 2000); and the privatizations of telecommunication services in several developing countries and countries in transition (WIR 2000). However, once the initial adjustment after privatization has been made, employment might well increase in the case of increasing sequential investments due to rising demand stimulated by lower post-acquisition prices for products of privatized enterprises. In the Czech Republic, Hungary and Poland, for example, after downsizing, considerable new

investments took place which lift employment to either its previous level or higher levels (WIR 2000).

IV. Change in Sectoral Composition of FDI Flows: Shift of FDI towards Services

Services sector has appeared to be the largest and fastest-growing sector in the global economy during the last two decades, as its capacity in providing global output and generating employment has been increasing remarkably. The share of services in world transactions has also been an upward trend. Accordingly, there has been a marked shift of global FDI away from manufacturing sector towards services sector. Services accounted for about 60 percent of the global stock of inward FDI in 2002 – a dramatic increase compared to less than half in 1990 and only one quarter in 1970s (WIR 2004).

In fact, the first attempt to introduce trade in services came from the United States at the General Agreement on Tariffs and Trade (GATT) ministerial meeting of November 1982. It was thought that restructuring service activities in line with comparative advantage, as in the case of goods, would expand the sales and profits of the US private-sector service providers. However, the attempt failed, because the European Community was not interested and developing countries opposed the move due to their concern that it would not provide significant gains for them since it was developed countries that possess major comparative advantages in services. In addition, developing countries that considered services to be very important to the development process and so wanted to build their own service industries also feared that the issue of foreign direct investment would be indirectly included. However, although U.S. was not able to get more than a few references to services trade in the Tokyo Round agreements, its efforts led the services finally be included in the negotiations in the Uruguay Round (Banga, 2005).

Today, developing countries take considerable steps to deregulate their service industries and liberalize their FDI policies, because the traditional view that services FDI does not provide the most important benefits expected of manufacturing FDI (i.e. advanced technologies, access to export markets or linkages to local enterprises) has changed. Moreover, a more efficient and productive service sector created via soft technologies (i.e.

organisational, managerial, information processing and other skills and knowledge) brought by service TNCs is considered by host developing countries crucial for overall competitiveness of their economies. Accordingly, services FDI has grown more rapidly than FDI in other sectors. It was in services that most M&As took place, helping to shift the composition of FDI towards the services sector. This shift is in line with the growing importance of services in GDP[3] on the one hand, and the limited tradability[4] of many services on the other. Given that only one tenth of world services output enters international trade due to the non-tradable nature of many services, FDI stands as the only way of serving foreign markets.

IV.1. What Drives the Expansion of FDI in Services

Theoretically, services FDI is studied under two main frameworks. While some studies (i.e. Chanda (1997), Schroath and Korth (1988), Gray and Gray (1981) as cite in Banga, 2005) have used theories that are applicable for FDI in goods, others (i.e. Helpman (1984), Markusen et al (1996) as cited in Banga, 2005) have applied trade theories to service FDI.

Of the various theories put forward to explain FDI, one of the most important ones is Dunning's eclectic paradigm of international production, which demonstrates that the extent, pattern and growth of value added activities by TNCs depend on their competitive advantages, that are ownership, locational and internalization advantages, relative to local firms (Dunning 1981).

Rugman and Verbeke (1992) put forward locational advantages in case of service corporations such that a firm can successfully undertake direct investment abroad if it possesses some asset advantages, such as property rights to management, marketing and product innovation, exclusive or favoured access to input and product markets and access to technology and information.

However, enterprises would engage in foreign production if there are some immobile factor endowments or other locational advantages in host countries, which they can combine

[3] The share of services reached 72% of GDP in developed and 52% in developing countries in 2001.
[4] Services accounted for a mere 20% of world exports in 2002.

with their spatially transferable advantages. In the case of services, important locational determinants are input costs, infrastructural provisions, government regulations, size and character of local market, economies of being close to suppliers, customers, competitors, etc (Banga, 2005).

But mere ownership of assets and locational advantages are not considered to be a sufficient condition for FDI. In order firms to carry out FDI successfully, being able to internalise their ownership advantages becomes crucial. Incentive for internalization arises from "the need to avoid search and negotiation costs, to avoid costs of enforcing property rights, to protect the quality of intermediate products, control sale and supply conditions and to avoid or exploit government intervention" (Banga, 2005 p.24). Therefore, without the advantages of internalization, FDI might be replaced by exports or licensing.

So it can be said that the recent expansion of TNCs activities in services FDI is promoted by the all three competitive advantages since TNCs in services sector, like in other sectors, have significant ownership advantages as they are superior to their local competitors in access to capital, technology, knowledge and managerial skills. Regarding locational advantages, the recent liberalisation of services FDI regimes in many countries has done much to attract TNCs. Internalization advantages on the other hand emerge in ownership-specific advantages that are based on proprietary knowledge on which profits can be maximized through internalization.

Alternatively, in some studies it is argued that FDI in services can be explained by the theory of international trade except that it has to be clarified why FDI rather than trade is preferred in order to obtain the potential profit. Accordingly, as in the case of across-the-border production of goods in order to exploit better, cheaper but non-tradable inputs, the non-tradability issue of services necessitates FDI. Many services are integrated under knowledge capital and their distribution necessitates the existence of people with appropriate skills in the host country, who require FDI in order to be transferred.

Apart from the theoretical explanation of TNCs' increasing tendency to engage in service FDI, in practice, increased competitive pressures in service markets, especially in home developed countries that have pushed firms to seek markets abroad, together with growing markets for services, rising service intensity of the production of goods, the spread of

information and communication technologies, ongoing privatization projects and liberalization of FDI policies in many developing countries all have led to the shift of FDI towards services.

IV.2. Impact of Service FDI on Host Developing Countries' Economies

The most widely-concerned impact of services FDI in host developing countries is its potential for deteriorating those countries' balance of payment situations as services FDI, most of which enter host countries through M&As[5], injects substantial amounts of financial resources into host economies. In developing countries, for instance, the stock of services FDI rose from an estimated $150 billion in 1990 to an estimated $1.3 trillion in 2004 (WIR 2006). In some service industries, particularly the infrastructure services there are massive capital requirements and they are rapidly growing.[6]

However, although huge service FDI-related capital injections by TNCs are important for many developing countries, there is an increasing concern that large proportion of services FDI is domestic market-seeking, and hence does not contribute directly to foreign exchange earnings but, it does lead to external payments in the form of repatriated profits, interest and in some cases equipment imports fuelled by overvalued exchange rates generated by service FDI through M&As. For example, profit remittances reached to 35 percent of the total income of services foreign affiliates of United States TNCs in 2002 and 53 percent of the total income of services foreign affiliates of Japanese TNCs in 2001. As discussed above, there are cases where such payments outweighed the initial capital inflows. Such developments in turn lead to net foreign-exchange losses. In times of crisis, moreover, service TNCs, which are more footloose than manufacturing TNCs due to lower fixed costs, can accelerate transfers abroad and so exacerbate crises (WIR, 2004).

Furthermore, services FDI does not only emerge in infrastructure services, but there are substantial investments also in sectors such as real estate and financial services. Consequently, concerns are increasing apace since reliance on such a domestic-market-

[5] Services TNCs' expansion into host countries has often occurred through M&As. The share of services in cross-border M&A sales was even higher in developing (64%) than in developed countries (57%) during the period 1987-2003 (WIR 2004).

[6] In electricity for example, projections for 2001-2030 suggest that investment needs will be around $5 trillion in developing countries and $1 trillion in transition economies (International Energy Agency 2003).

oriented growth model cannot be sustained over the long term. These concerns and predictions are indeed accurate, especially when the current situation in some developing countries is compared with the victorious development experiences of countries such as China, South Korea and Taiwan which followed a successful export-oriented growth model. The sustainability of mostly domestic-market-oriented services FDI then becomes questionable since it is not certain whether the source of foreign exchange in host countries will still be available in the longer term, particularly when investors those invest in real estate begin to collect their rents and foreign affiliates of TNCs start to transfer their profits to their parent firms in home countries. Unfortunately, there is no certain answer to this question since it should not be an exaggeration to state that foreign exchange reserve conditions in such host countries is mostly depend on the global financial environment.

Another problematic issue about services FDI is that employment creation potential of services FDI is much lower than FDI in manufacturing, particularly when it occurs through M&As. It was discussed earlier that the short-term impact of FDI through M&As on employment is generally negative as companies are restructured and rationalized. However, what is problematic about the issue is that even in the long-run and in spite of the traditional connection of services sector with a large human element, services FDI does not create as much employment per dollar invested as manufacturing FDI. For instance, in the case of US outward FDI, on average $136,000 of FDI stock generated one job in 2001. The corresponding figure for stock in financial affiliates was $656,000 and for stock in holdings, $21 million. What is more, if foreign service providers in developing countries rely heavily on expatriate personnel due to high-skilled labour requirement, this may also negatively affect both domestic employment levels and improvement of local skills (WIR 2004).

The case of India, which is the most successful developing country in attracting service sector TNCs, is probably the best example for employment effect of service FDI.

Table 3: Industrial Distribution of Total Workforce in India

	1951	1961	1972-73	1977-78	1983	1987-88	1993-94	1999-2000
Agriculture	74.6	76.2	73.9	71	68.6	65	64.7	59.9
Mining&Quarrying	0.4	0.5	0.4	0.4	0.6	0.7	0.7	0.6
Manufacturing	8.2	8.6	8.8	10.2	10.7	11.1	10.5	11
Services	16.8	14.7	16.9	18.4	20.1	23.2	24.1	28.5

Source: Banga (2005)

Service sector in India now contributes around 51 percent of GDP and 24 percent of total trade. However, this rising share of services in both GDP and trade has not been matched with a similar share of services in total employment. In fact, as demonstrated in Table 3, the rise in the share of services in employment has been much slower than the decline in the share of agriculture in total employment.

IV.3. Tradability Revolution in Services: Offshoring of Corporate Service Functions

Much have been changed since the earliest attempt to explain how trade in services is different from trade in goods made by Hill (1977), who argued that "goods and services belong to different logical categories." Hill's point was that producers cannot accumulate a stock or inventory of services. Thus, services are required to be consumed as they are produced, unlike goods that can be produced and then stored.

New information and communication technologies (ICTs) have generated remarkable improvements in tradability of the information-centred set of services. The use of ICT allows knowledge to be codified, standardized and digitized, which solves the problem of non-transportability and non-storability for many services. Accordingly, producing some services in different locations in order to take advantage of cost, quality or economies of scale and consuming them in other localities either simultaneously (e.g. call centres) or at a different time (e.g. data entry, software development) become possible. This leads both to outsourcing within countries and to off-shoring to locations abroad (WIR 2004).

There is a wide range of services that are already being exported, varying from simple low-value added data processing to sophisticated financial analyses, software programmes and architectural designs. Indeed the balance-of-payments data of some countries already reveal the tradability revolution in services. The United States, for instance, reported that share of services in country's global imports rose from 11 percent in 1992 to 13 percent in 2002. Meanwhile some countries, particularly the US, India, and Ireland reported export share growth in 'other business services' and 'computer and information services' (WIR 2004).

FDI plays an important role in offshoring. TNCs increasingly invest in export-oriented services. The main categories of such projects are back-office services (shared service centres), front-office functions (call/contact centres), regional headquarters and IT services. However, the majority of offshored services are still concentrated in a few countries with Ireland, India, Canada and Israel dominating the list. This reflects the fact that low wages, per se, do not explain wholly the pattern of offshoring in services activities which have distinctive requirements such as infrastructure quality (e.g. reliable telecommunications and power supply) and highly-skilled labour (WIR 2004). Nevertheless, rising labour costs, improving business environment in some other countries and competitive pressures have led many other countries to emerge as potential destinations. For example, China, Malaysia and Singapore follow India in Asia. Hungary, Czech Republic and Poland appear to be the most attractive host countries especially for European TNCs. Brazil leads in Latin America and United Arab Emirates (Dubai) and Hong Kong (China) were successful countries in catching the attention of regional headquarters (A.T. Kearney 2004 cited in WIR 2004).

Consequently, offshore outsourcing of business processes is expected to reach to $24 billion in 2007, which was only $1.3 billion in 2002 (WIR 2004). Such an expansion together with increasing developments in ICTs seem likely to lower the concerns particularly of which is related to service FDI's negative effects on host developing countries balance of payment situations. Nonetheless, given the low sunk costs and short time needed to implement an FDI project in such services, developing countries will be required not only to offer several advantages to TNCs in order to be able to catch up with the first movers, but also to continuously upgrade their infrastructure and labour force qualities in order to avoid successful companies to move on to other locations as the competitive situation changes.

V. Trends, Patterns and Characteristics of FDI in Turkey: Are There any Parallels?

FDI inflows to Turkey, the second largest recipient of FDI in the West Asia region, have reached over USD 17 billion in 2006 (CBRT). Such high rates of FDI inflows are in fact fairly new for the country where FDI inflows amounted to only USD 19 billion between 1980 and 2003. The reason behind this dramatic increase in FDI inflows, parallel to global trend, was the current government's increased attempts to attract more FDI via privatizing state-

owned enterprises, further liberalizing the domestic market, and enforcing the new FDI law in 2004. More importantly, the European Union's decision to start negotiations with Turkey has changed the attitude of foreign investors, who previously considered the country risky and did not prefer to invest in the market in spite of the crisis of 2001 that drastically reduced the market values of many domestic firms along with the devaluation of the Turkish Lira.

Consequently, starting from 2003, there has been a noticeable increase in foreign interest towards the Turkish companies, and the finance sector in particular. While FDI inflows amounted to less than 1 percent of the GDP before, it reached record levels of USD 17 billion constituting 2.8 percent of GDP in 2006. Prospects for 2007 are also optimistic: FDI inflows are expected to reach USD 10 billion due to acquisitions and privatizations that could not be concluded in 2006 (Undersecretariat of Treasury).

V.1. Great Levels of Cross-border M&As

Most FDI enters the country through M&As. This pattern is actually in line with the global trends. As Table 4 below demonstrates, the share of cross-border M&As in total FDI inflows continuously increased in both developed and developing countries during the period of 2003-2005.

Table 4: Global Trends in FDI through Cross-Border M&As (Million $)

	FDI Inflows			Cross-border M&As Sales		
	2003	**2004**	**2005**	**2003**	**2004**	**2005**
World	557 869	710 755	916 227	296 988	380 598	716 302
Developed Countries	358 539	396 145	542 312	244 426	315 851	598 350
Developing Countries	175 138	275 032	334 285	40 166	54 700	100 633
South-East Europe and CIS	24 192	39 577	39 679	12 395	10 047	17 318

Source: UNCTAD (2006)

Following the global trend, in fact rather later than many other developing countries, Turkey has also experienced large-scale acquisitions mainly in the services sector. Telecommunications and financial sectors in particular saw substantial increase in FDI through cross-border M&As. This upsurge in FDI flows into Turkey is appreciated as a major

achievement particularly in the political arena. However, it should be stressed that foreign investment inflows that is mostly associated with privatizations and M&As, does not signify that Turkey's benefits are at utmost levels, especially when the previously-explained impacts of the two modes of FDI on the economies of developing host countries are carefully considered.

In this respect, given the importance of greenfield FDI in development, Turkey has not been successful in attracting greenfield investments. When compared with Czech Republic, Hungary, Poland, Bulgaria and Romania as potential competitors of Turkey, the number of greenfield projects in Turkey was, at best, less than half of the figure achieved by these competitor countries.[7] Table 5 evidently demonstrates this dramatic difference.

Table 5: Number of Greenfield Projects in Turkey: Comparison with the potential competitors

	2002	**2003**	**2004**	**2005**
Turkey	45	69	66	62
Czech Rep.	94	141	137	127
Bulgaria	77	97	110	130
Hungary	210	214	212	173
Poland	91	155	230	234
Romania	112	117	171	235

Source: UNCTAD (2005)

Moreover, when the total number of newly-established foreign-invested companies reported by the Undersecretariat of Treasury is evaluated, there is another dominating trend in FDI in Turkey. According to data, the cumulative number of foreign companies established between 1954 and 1999 is only 4159 whereas there were 8923 foreign-invested companies established in just four years, that is during the period 2003-2006. However, although the rapid increase in the number of new established companies signals a climbing foreign interest

[7] The number of greenfield projects in 2005 was also much higher than Turkey in Russia (377), Brazil (258), Singapore (173), United Arab Emirates (156), Mexico (154), Malaysia (125), Hong Kong (122), Thailand (121) and Korea (100), not to mention China (1529) and India (685).
(World Investment Report 2006)

in Turkey, it is clearly demonstrated in Table 6 that 95 percent of these companies were relatively small enterprises with less than USD 500,000 equity capital.

Table 6: Breakdown of newly-established foreign firms regarding their amount of capital

	<$50.000	$50.000-200.000	$200.000 – 500.000	> $500.000	Total
2004	1.468	462	102	97	2.129
2005	1.862	733	162	122	2.825
2006*	1.728	730	189	169	2.816
Manufacturing Industry					
2004	211	90	31	37	369
2005	259	132	36	29	456
2006*	212	95	24	45	376

Source: Undersecretariat of Treasury *: Temporary Data, January-October 2006

It can be said that these small enterprises are relatively less effective in generating new production and employment opportunities, directly or indirectly. The number of newly-established foreign-invested companies with over USD 500,000 equity capital, on the other hand was 122 in 2005, and has increased to merely 169 in 2006.

V.2. Services Sector Takes the Biggest Share in FDI

As Table 7 demonstrates, the services sector has got the biggest share in FDI in Turkey. The share of services sector in FDI inflows boosted dramatically from 39 percent in 2003 to 93 percent in 2006. Further, the modest share of manufacturing sector in FDI inflows can also be seen in the table. Manufacturing sector which constituted 60 percent of FDI inflows in 2003, have lost its importance in the following years and its share in FDI have plunged dramatically to 16.5 percent, to 9.3 percent and to 6 percent in 2004, 2005 and 2006 respectively.

Table 7: Sectoral Distribution of FDI in Turkey (million $)

Sectors	**2003**	**2004**	**2005**	**2006***
Mining and Quarrying	14	75	40	77
Manufacturing Industry	448	214	789	871
Food Products and Beverages	*249*	*78*	*68*	*232*
Textile Products	*8*	*14*	*183*	*14*
Chemicals and Chemical Products	*9*	*39*	*174*	*304*
Machines and Equipments Production	*17*	*8*	*13*	*22*
Electrically Operated Optical Devices Production	*4*	*2*	*13*	*39*
Motor Vehicles	*145*	*35*	*106*	*70*
Furniture Production	*2*	*0*	*4*	*3*
Other Manufacturing	*14*	*38*	*228*	--
Power, Gas and Water	86	69	4	60
Construction	8	23	107	373
Wholesale and Retail Commerce	92	103	67	1433
Hotels and Restaurants	4	1	42	15
Transport, Communications and Storage Services	2	639	3250	4768
Intermediary Financial Institutions	51	69	4016	5892
Real Estate	6	3	29	25
Education Services	0	0	17	--
Health Services	23	53	74	178
Other Social Services	10	36	86	88
Services Total	**282**	**996**	**7692**	**12832**
Total	744	1285	8521	13780

Source: Undersecretariat of Treasury

*: Temporary Data – January-October 2006

The trend can also be seen in the above-mentioned Undersecretariat of Treasury's data on the newly-established foreign-invested companies, which is demonstrated in Table 8 below.

Table 8: Sectoral Distribution of FDI in Turkey (by number of firms)

Sectors	**2002**	**2003**	**2004**	**2005**	**2006***
Agriculture, Hunting, Forestry and Fishery	4	29	31	40	31
Mining and Quarrying	18	12	33	49	32
Manufacturing Industry	83	268	368	456	376
Food Products and Beverages	*9*	*18*	*51*	*43*	*34*
Textile Products	*12*	*64*	*60*	*79*	*44*
Chemicals and Chemical Products	*6*	*29*	*46*	*41*	*36*
Machines and Equipments Production	*7*	*21*	*25*	*31*	*38*
Motor Vehicles	*7*	*17*	*18*	*20*	*14*
Other Manufacturing	*42*	*119*	*168*	*242*	*210*
Power, Gas and Water	5	7	15	12	31
Construction	21	29	137	348	362
Wholesale and Retail Commerce	207	433	911	809	740
Hotels and Restaurants	44	59	78	184	194
Transport, Communications and Storage Services	44	96	219	262	248
Real Estate and Business Activities	38	89	236	525	605
Other Social Services	34	86	92	194	197
Total	498	1108	2120	2879	2816

Source: Undersecretariat of Treasury

*: Temporary Data – January-October 2006

As it can noticeably seen in the table, among the 9421 foreign-invested firms established after the financial crisis of 2001, only 1551 of them was in manufacturing sector, whereas the corresponding figure for services sector was 7594. This spectacular increase in the number of foreign firms operating in the services sector, indeed arose in 2004, augmented in the subsequent two years and reached 6402 between 2004 and 2006. The unsuccessful performance of the manufacturing sector in attracting FDI further deteriorates, when the size of equity capital of foreign firms established in the sector is considered. The number of foreign firms with over USD 500,000 equity capital was 39, 29, and 45 in 2004, 2005 and 2006 respectively.

Although the dramatic increase in FDI towards services is a global phenomenon, the mounting concerns about services FDI through M&As should not be neglected given the

possible aforementioned negative impacts of such foreign flows on developing host economies. Accordingly, despite the trend is fairly new for the country, a tentative analysis of the magnitude of the effects of this recent change in FDI flows on Turkish economy can make a contribution to ongoing arguments on the issue.

V.3. Evaluation of the Short-Term Impacts of the New Form of FDI on the Economy

V.3.1. Balance of Payments and Current Account Balance

On average, 82 percent of foreign capital inflows to Turkey consisted of debt-creating components in the period 2002-2004. This ratio has substantially decreased to 62 percent and 50 percent in 2005 and 2006 respectively (ISS, 2006). FDI inflows, which dramatically increased from USD 6.8 billion in 2004 to over USD 17 billion, is an important contributing factor in this improvement in the balance of payment situation of the country. Moreover, mounting FDI inflows has also played a significant role in lessening the proportion of foreign capital that is assigned for current account deficit.

Although these positive effects of FDI on Turkish balance of payment situation should not be neglected, a more detailed evaluation of other effects of the former on the latter via considering the changes in the country's real exchange rate, exports and import dependency is also essential. First, the rapid appreciation of Turkish Lira has partly resulted from the upsurge in cross-border M&As as the dominant entry mode of FDI. This effect is particularly warranted in case of large transactions. Hence, recent privatizations of state-owned enterprises and large scale acquisitions in the telecommunication and the banking sectors justify that the large scale M&A deals were one of the main reasons behind the appreciation of the Lira.

The appreciation of the exchange rate of Turkish Lira in turn has reduced the competitiveness of exports, particularly for labour-intensive sectors such as the textiles and clothing industry, and has made imported goods and services cheaper.

Table 9: Current Account of the Balance of Payments, 2000-2006

BALANCE OF PAYMENTS								
	(Million $)	2000	2001	2002	2003	2004	2005	2006*
A-	CURRENT ACCOUNT	-9821	3392	-1524	-8036	-15604	-23157	-29915
1.	Exports f.o.b.	30721	34373	40124	51206	67047	76949	76566
2.	Imports f.o.b.	-52680	-38106	-47407	-65216	-90925	-109875	-115605
	Balance on Goods	-21959	-3733	-7283	-14010	-23878	-32926	-34319
3.	Services: Credit	19454	15199	14025	17945	22928	25849	22033
4.	Service: Debit	-8088	-6067	-6146	-7441	-10144	-11883	-10307
	Balance on Goods and Services	-10593	5399	596	-3506	-11094	-18960	-22593
5.	Income: Credit	2836	2753	2486	2246	2651	3684	4231
6.	Income: Debit	-6838	-7753	-7042	-7803	-8288	-9349	-9988
	Balance on Goods, Services and Income	-14595	399	-3960	-9063	-16731	-24625	-5757
7.	Current Transfers	4774	2993	2436	1027	1127	1468	1556

Source: CBRT
*: Temporary data, January-November 2006

Imports were also driven by easier access to credit encouraged by high levels of capital inflows. There has been a dramatic increase of 62.5 percent in total domestic demand for imported goods and services after the crisis of 2001 (OECD, 2006). Moreover, augmentation of imports occurred not only in consumer goods and services but also production goods and services, leading the import content of exports to reach very high levels. Consequently, although exports have not decreased but rather increased, this rise in exports has been more than compensated by even more increase in imports. Finally, all these developments together unsurprisingly exacerbated the current account deficit, which has reached the record levels of USD 29 billion in 2006 (CBRT).[8]

Another important factor that fuels the current account deficit to record levels is the fact that the services which attract the lion share of FDI is non-tradable in nature thus does not lead any foreign exchange earnings. Although there is growing improvements in ICTs that allow trade in many services, FDI to this sector is still market-oriented in Turkey. Table 10 below, is prepared to compare Turkey with some selected developing countries that are relatively successful in attracting export-oriented services FDI.

[8] Temporary data – January-November 2006

Table 10: Export-Oriented FDI Projects in Selected Countries – 2003 (number)

	Call Centres	Shared Service Centres	IT Services	Regional Headquarters
World	513	139	632	565
Developed Countries	279	48	293	339
Developing Countries	203	72	315	209
China	30	4	60	38
India	60	43	118	7
Hong Kong, China	2	--	14	37
Korea, Rep. of	5	--	5	6
Malaysia	16	6	8	17
Philippines	12	1	9	4
Singapore	16	8	35	36
Taiwan	4	--	9	4
Thailand	2	2	7	8
Czech Republic	9	6	5	--
Hungary	11	7	4	4
Poland	3	5	4	3
Turkey	2	--	2	1

Source: UNCTAD 2004

According to Table 10, export-oriented services FDI is still concentrated in East and South-East Asia, while three countries from Central Eastern Europe (Hungary, Czech Republic and Poland) have taken considerable steps. Turkey on the other hand has a long way to be able to take the advantage of advances in ICTs in order to catch up with the first movers, and make service FDI's effect on balance of payments positive.

Finally, an examination of the direct investment credit/debit entries of the current account of the balance of payments reveals that profit transfers from foreign affiliates in Turkey to their parent companies has increased from USD 279 million in 2000, to over USD 1 billion in 2006. However, this increase cannot be considered substantial, since the net inflows in 2006, for instance, was over USD 17 billion. The debit account, on the other hand, has been on a declining trend, falling from USD 368 million in 2000 to USD 203 million in 2006.

Portfolio investment account's credit and debit entries, on the other hand, illustrate that both incomes and expenditures have been rising mostly at a similar rate, though the latter exceeds the former by 50 percent to 80 percent in every year since 2000.

Table 11: Balance of Payments, Investment Income Balance

BALANCE OF PAYMENTS	2000	2001	2002	2003	2004	2005	2006*
INVESTMENT INCOME BALANCE	**-4002**	**-5000**	**-4556**	**-5557**	**-5637**	**-5665**	**-5757**
Credit	2836	2753	2486	2246	2651	3684	4231
Debit	-6838	-7753	-7042	-7803	-8288	-9349	-9988
Direct Investments	**89**	**52**	**-89**	**-405**	**-796**	**-734**	**-799**
Credit	368	361	293	203	244	277	203
Debit	-279	-309	-382	-608	-1040	-1011	-1002
Portfolio Investments	**-434**	**-694**	**-835**	**-1207**	**-1195**	**-924**	-509
Credit	1300	1253	1409	1409	1710	2402	2731
Debit	-1734	-1947	-2244	-2616	-2905	-3326	-3240
Other Investment	**-3657**	**-4358**	**-3632**	**-3945**	**-3646**	**-4007**	-4449
Interest Income	1168	1139	784	634	697	1005	1297
Interest Expenditure	-4825	-5497	-4416	-4579	-4343	-5012	-5746
Long Term	-3785	-4271	-4052	-4271	-3947	-4459	-5035
Monetary Authority	-806	-1203	-1160	-1274	-1098	-1049	-793
General Government	-1291	-1406	-1397	-1556	-1609	-1765	-1716
Banks	-312	-253	-169	-110	-103	-257	-561
Other Sectors	-1376	-1409	-1326	-1331	-1137	-1388	-1965
Short Term	-1040	-1226	-364	-308	-396	-553	-711

Source: CBRT

*: Temporary data, January-November 2006

V.3.2. Employment

After the 2001 crisis, Turkey has entered a period of recovery driven by the surge in capital inflows. FDI inflows have also started to increase after 2001, first gradually until 2004 and then dramatically in 2005 and 2006. However, neither growth averaging over 7 per cent during 2002-2006 nor the accelerating FDI inflows have resulted in significant improvements in unemployment rates. There is no publicly announced or published data on the employment levels of the foreign companies operating in Turkey. However, what Table 10 indicates is that in spite of ascending FDI inflows, unemployment rate, which increased from 8.4 percent in 2001 to 10.3 percent in 2002, has only stabilized around 10 percent level.

Table 12: FDI Inflows and Unemployment Level in Turkey

Year	FDI Inflows (million $)	Unemployment Level (%)
2000	982	6.5
2001	3 352	8.4
2002	1 137	10.3
2003	1 752	10.5
2004	2 883	10.3
2005	9 793	10.3
2006*	18 135	9.8

Source: TURKSTAT
*: Temporary data, January-October 2006

This sluggish growth pattern of employment, demonstrated in Table 11, may be partly related to the fact that, in general acquisition-related FDI, unlike greenfield FDI, does not generate employment at entry. Looking at Table 12 and given the rise in the total workforce from 23,078 million in 2000 to 25,148 million in 2006[9] (TURKSTAT), only 64 percent of them was provided with new employment.

[9] Temporary data, January-October 2006

Table 13: Employed People by Economic Activity (1000 people)

	Agriculture	Industry	Construction	Services	Total
2001	8.089	3.774	1.110	8.551	21.524
2002	7.458	3.954	9.58	8.984	21.354
2003	7.165	3.846	965	9.171	21.147
2004	7.400	3.988	1.029	9.374	21.791
2005	6.493	4.281	1.171	10.101	22.046
2006*	6.488	4.277	1.336	10.759	22.860

Source: TURKSTAT *: Temporary Data January-June 2006

Nevertheless, because most FDI in Turkey is domestic market-seeking services FDI, employment levels at least have not been on a decreasing trend. One inference can be that part of the labour released from agriculture were employed in the services sector. However, the importance of export-oriented FDI in employment creation should once again be emphasized. Accordingly, it can be said that the currency appreciation fuelled by large cross-border M&A deals also negatively affected the export-oriented manufacturing sector's potential in increasing employment levels.[10]

Finally, appreciation in the national currency that has fuelled imports has possibly had a negative indirect effect on employment through weakening the local linkages between firms, both domestic and foreign.

V.4. Future Prospects and Policy Implications

Recent developments signal that FDI through cross-border M&As will be dominant in the short-term. For the medium-term, if the positive effects of the talks carried out with the EU are not vanished and the availability of economic and political stability is assured, foreign investors' interest particularly in infrastructure and services sector will presumably continue. Nonetheless, these developments per se seem not likely to serve for sustainable economic development in the longer term.

[10] Indeed, given the high levels of informal employment in many labour-intensive industries (i.e. textiles and clothing industry) and that these industries are mainly hit by the currency appreciation and witnessed significant lay-offs, it is very likely that unemployment rates are actually higher than the official rates.

The sky-rocketing current account deficit, for instance, has led serious concerns to arise among many economists and policy makers.[11] Although there are optimists who argue that rise in current account deficit is an ordinary phenomenon in catching-up economies and deficits fuelled by high private sector investment are tolerable since these investments will ultimately result in increase in exports earnings, this might not be the likely outcome given the overvaluation of Turkish lira and the shift of FDI towards services sector, which will negatively affect Turkey's export capacity.

Therefore, a crucial long-term FDI objective of Turkey should be attracting greenfield investments in order to encourage production, particularly for the *international markets*. A study by Yilmaz (2006) conducted for YASED, propose that the feasible strategy should be increasing the share of greenfield investment in total FDI inflows to 25 percent for the period 2006-2010 – since realistically, FDI inflows will be in the form of cross-border M&As during that period – and to 75 percent for 2011-2015.

However, as it is widely-agreed, given the emergence of China and India on the global competition arena with extremely low labour costs, it is no more likely for a medium-income country like Turkey to build its global competitiveness on low labour costs. Indeed, when the export performances of the labour-intensive textile and clothing industry and the relatively more modern capital intensive automobile manufacturing industry are compared, the latter has appeared to maintain its competitiveness via increased productivity even under the circumstance of real exchange appreciation (DTM, OECD, 2006).

Hence, in order for Turkey to improve its competitiveness, faster productivity growth in traditional sectors and reallocation of resources towards more modern sectors are vital. Accordingly, targeted FDI projects should also be the ones that can guide the country's industries to adopt more advanced technologies. According to YASED (2006), for instance,

[11] Aslanoglu (2006), for instance, provides an interesting relationship between previously recorded high levels of current account deficit and subsequent economic crises in Turkey. Accordingly, the highest current account deficits were experienced in 1977, 1979, 1993, and 2000. These years were immediately followed by the 1978 crisis, the military coup of 1980, the 1994 crisis, and the severe crisis of 2001 respectively. This information indicates that the recent record breaking level of current account deficit should be taken in serious consideration.

two promising rapidly expanding sectors of the world economy, which Turkey should devote more effort to attract FDI in, are electronics and informatics sectors.

The electronics sector, which has been increasingly becoming the part of the international production networks, requires high-speed product innovation due to the rapid changes in the world demand. Thus, success in attracting FDI in the electronics sector necessitates high innovative capabilities and investment in R&D. In view of that, given the fact that the majority of the companies operating in this sector are small or medium scale enterprises and so are less likely to compete globally, the suggestion of establishing partnerships between domestic companies put forward by Yilmaz (2006) may promote FDI into this sector in line with its increased strength and competitiveness.

The informatics sector, yet again with its high technology and innovation requirements, is another key sector which Turkey has to catch a strong growth trend over the long term. According to YASED (2006), when the lack of necessary capital and knowledge accumulation is taken into account, attracting FDI into this sector can play a significant role for closing the existing technology gap.

However, catching the attention of technology-intensive greenfield FDI as well as attracting previously described export-oriented offshored services, which is expected to rise twenty-fold in 2007, is unfortunately not an easy process for Turkey. The requirements for a better performance in building up an image as a country providing a suitable production and R&D environment are multi-faceted.

First, Turkey suffers from the shortage of trained workforce. Education has long been neglected by the authorities as an important factor to achieve a sustainable economic development. Both the attendance levels to secondary and tertiary schooling and the quality of education are very low. Comparison of the education levels of the workforce in Turkey with its closer competitor countries reveals the toughness of the competition. As it is demonstrated in Table 13, 20 percent of the Turkey's active workforce is high school or vocational school graduates, whereas this ratio is 78 percent in Czech Republic, 65 percent in Hungary and 72

percent in Poland. The ratio is higher than Turkey's also in other CEE countries such as Slovakia, Romania, and Bulgaria.

Table 14: Education Level of the Workforce in Turkey

	Higher Education (%)		Secondary Edu. (%)	
	1995	**2001**	**1995**	**2001**
Turkey*	..	10.5	...	20
Czech Rep.	10.5	11.6	76.9	78.1
Hungary	14.3	16.5	60.5	65.2
Poland	13.8	12.9	64.7	71.8
Bulgaria	18.8	23.3	51.2	55
Romania	12.9	9.1	48.9	57.1
Slovakia	..	11.5	37.6	79.6
Slovenia	14.7	16.6	59.8	62.3

Source: World Development Indicators, 2005, *: 2004 data for Turkey

Table 13 indeed reflects the fact that severe scarcity exists in qualified high school graduated employees, which is in line with low attendance levels in vocational technical schools. Students mainly prefer to enter a university, since they consider being a university graduate as a way of finding a job in the formal sector whereas high school graduation is seen to result in being stuck in the informal sector. Therefore, given the high informal employment rates in the economy, and that the table above show employees in the formal sector, students' point of view proves to be right. Paradoxically, formal sector firms report that they face a shortage of good quality mid-level staff, that is vocational and technical high school graduates (OECD, 2006). This paradox then underscores the low quality of education in non-selective high schools.

Therefore, one of the most important features of a feasible strategy for benefiting from the recent surge in FDI flows is improving the quality of education through a more equitable resource allocation between selective and non-selective schools[12] and continuously up-skilling of the future labour force via, for instance, extensive introduction of information technologies across schools. Furthermore, since the outcome of such improvements can be materialized in

[12] It is reported by OECD (2006) that public resources are not distributed evenly between selective and non-selective schools. A partial analysis conducted by the institution reveals the fact that selective schools receive at least twice more funding per pupil than the non-selective schools.

the skill level of the workforce only in the long-term, there is also an urgent need to upgrade the skills of the existing labour force.

South Korea, where ICTs were developed and spread rapidly, provides a good illustration of a successful strategy of a rapid catching up with the high-skilled labour requirement of the new knowledge-based economy. During the economic crisis of 1997, many people lost their jobs in South Korea. The government took an immediate action to overcome the problem and opened ICT courses for ten million citizens, providing the one fifth of the population with internet and PC training. As a result, unemployed people with their new skills and knowledge returned to the labour market by finding new jobs (Reynolds and Jin-Kyu, 2004).

Second, since the existence and the persistence of a large informal sector affect the educational preferences of the future's workforce, it is imperative to accomplish a formalization strategy in order to prevent students from believing that being a vocational or technical high school graduate would cause them to be trapped in the informal sector with no future benefits. Moreover, immediate and widespread formalization together with regulatory simplifications should also be targeted in order to promote more firms to enter the economy. According to the Doing Business database which measures regulatory costs of starting and carrying out a business in 175 countries, Turkey is ranked 91st in the general measurement. However, when a more micro-level judgement is made, Turkey falls further behind of 145 countries regarding the difficulty in hiring/firing employees indexes and the rigidity of employment index. Similarly, Turkey is ranked 51st among 61 countries in IMD World Competitiveness Scoreboard 2006, measured by the existence of a stable and predictable legislative environment; quality, speed and transparency in government administration; relationship between wage levels, productivity and taxation; investment in education, especially at the secondary level, and in the life-long training of the labour force; and of the traditional and technological infrastructure.

This low performance of Turkey in international rankings indicates that Turkey has yet more to do in order for being able to more competitive in providing a better business environment for particularly foreign firms. This is indeed inline with the recent survey on Turkish economy reported by the OECD in 2006. According to the report, apart from the

abovementioned educational reforms, there is also a need for extensive reforms in easing complex regulations in the product and labour markets. The Organisation proposes that, since the corporate tax rate has recently been pushed down from 30% to 20%, the most important target should be easing the labour market regulations (i.e. rigidities in temporary employment rules, requirement for enterprises employing more than fifty workers to hire 6% of their workforce from socially-assisted groups) and reducing the taxes on labour income and the legal minimum wage which create a serious obstacle for firms in further formal employment generation. It is also proposed that the legal minimum wage should be varied among regions according to differing cost of living, and among sectors and firms vis-a-vis their productivity levels.

These suggestions are partly approved when the need for attracting greenfield FDI, which has a strong potential in employment creation, is taken into account. It is indeed true that the tax wedge on labour is the highest in Turkey compared to other OECD countries and the legal minimum wage in Turkey is higher than many other developing countries (OECD 2006). Nevertheless, since the social responsibilities of the state, particularly under the current fiscal austerity that targets achieving a 6.5 percent of primary budget surplus (excluding interests) cannot be ignored, differentiating the legal minimum wage across regions is probably a more practicable option. A similar application can also be carried out in lowering the taxes on labour income: the tax rate can be decreased in proportional to further employment creation of firms, thereby reducing the cost of employing an extra worker formally. This method may both serve as a tool for accomplishing the task of formalization in the domestic sector and for attracting large-scale greenfield investment since the more workers is employed by the firm the less tax is paid per worker. However, for a better application to domestic firms, incentives should be valid even in the case of increases in small scales, given the high numbers of small and medium enterprises in the economy.

Third, the long-term FDI strategy of attracting FDI in high-potential sectors requires good quality of infrastructure at reasonable costs. High energy prices and large energy taxes together with various administrative weaknesses limit Turkey’s potential in attracting more TNCs to invest in the country. For instance the highest electricity price applied to industry is in Turkey when compared to other twenty-five countries in the OECD. Moreover, telecommunication tariffs in terms of both telephone and mobile phone charges are among the

highest in the OECD countries (OECD, 2006). These high infrastructure utility bills thus represent an important obstacle for firms to increase productivity and competitiveness and it is argued by OECD (2006) that energy and telecommunication costs should be reduced via encouraging further competition in these sectors.

However, it should be pointed out that the energy sector regulations and privatization process in this sector has always been complex and painful in many countries including the developed ones such as the UK (OIES and PESD). A recent example of unpredictability of the privatization process in Turkey is the government's decision to postpone the bids of TEDAS for the electricity distribution to an indefinite future date (OIB). It is most probably the upcoming general elections in November that put pressure on the government's decision making process regarding the privatization of the electricity distribution. Therefore, liberalizing and increasing competitiveness of the energy sector is not an easy task, particularly when the pressures from particular groups and the citizens in general are taken into consideration.

Finally, regarding the need for more investment in R&D and information technologies, Turkey unfortunately lags behind many countries in number of researchers, number of patents and the share of R&D and IT and communications spending in GDP. The ratio of R&D spending to GDP in the European Union, for instance, is 2 percent on average, whereas the corresponding figure for Turkey is only 0.5 percent (TUSIAD). Although there is a limited number of projects conducted by TUBITAK, KOSGEB, TUSIAD and some universities and some financial incentives for investments in high-technology projects provided by TTGV, capital scarcity stands as the major bottleneck.

Therefore, given the financing constraints, more effort should be devoted to benefit from the recent surge in internationalisation of R&D by TNCs (WIR 2005). A striking data provided by UNCTAD (2005) shows that R&D spending of foreign affiliates in Turkey has in fact declined by 4.2 percent between 1997 and 2003. The corresponding figure for Hungary, Czech Republic and Poland was an increase of 40.7, 25.8 and 8.8 percents respectively, stressing again the importance of quality and favourable costs in infrastructure and advancements in human resources. Indeed, a very important weakness of Turkey in attracting

R&D-oriented FDI is the lack of governmental initiatives to support R&D investments along with a feasible institutional framework. Promoting improvements in the existing R&D centers as well as the new establishment projects together with creating linkages between these knowledge institutions and production enterprises are extremely necessary for building a favourable environment for FDI in high-tech industries.

VI. Conclusion

FDI inflows as the most important form of non-debt-creating capital inflows certainly have beneficial effects on developing host countries' economies. However, the increasing dominance of M&As as an entry mode of FDI and the shift of foreign investment towards the services sector raise doubts on the effects of the new form of FDI on the most important components of sustainable economic growth.

The impact of greenfield investment on employment, investment, export competitiveness and the balance of payments situations of host countries appears to be more favourable compared to the effects of FDI through M&As. First, since a foreign merger or acquisition typically places resources in the hands of the local owners of a firm immediately, if a transaction is large, it may create greater pressure on the domestic currency than a greenfield investment of the same volume, leading to currency appreciation. Privatizations involving foreign buyers are a typical case in which the exchange rate may be affected by such sudden inflows. Second, appreciation of the exchange rate of the national currency results in deterioration of the competitiveness of exports, mainly in the labour-intensive sectors, and significant increases in imports in host countries. Third, the impact of greenfield FDI on domestic capital formation appears to be more positive than acquisition-related FDI's, yet only in the short run, since the former takes the form of a direct addition to host country production facilities whereas the latter presents a mere transfer of ownership. In the longer run, the effect is largely determined by the crowding in/out effects of FDI. Fourth, greenfield investment necessarily creates new employment at entry, whereas FDI through M&As does not generate employment when it first enters a country, because new production capacities are not created at entry.

Furthermore, increasing liberalisation of trade in many services necessitates FDI towards the services sector due to the non-tradable nature of most services. Yet again, because services FDI is usually domestic market-oriented, it does not promote foreign-exchange earnings. Further, it does not generate as much employment per dollar invested as export-oriented manufacturing FDI. Nevertheless, advancements in ICTs increasingly lead more services to be traded across the boards, which in turn encourages offshoring of export-oriented services. However, developing countries has much to do, such as continuously upgrading their technological base and upskilling the labour force in order to attract export-oriented services FDI.

The evaluation of the short-term effects of the above-mentioned qualitative and sectoral change in FDI to Turkey confirm that the recent upsurge in FDI does not signify that Turkey's benefits from increased FDI are at the maximum levels: The overvaluation of Turkish Lira, which has deteriorated the export competitiveness of particularly the labour-intensive traditional sectors and has fuelled imports, was partly the result of large acquisition deals. Moreover, services sector FDI has been mainly domestic market-oriented hence has not led to increase in foreign exchange earnings. Therefore, Turkey, like other developing countries, has to attract greenfield investment in export-oriented sectors for achieving a sustainable economic growth.

However, sharp competition in the international markets requires that the targeted FDI should also be the one which can be helpful in technology upgrading in host countries' industries. Yet, such a target in turn entails a feasible strategy composed of an education reform for the future's labour force, continuous upskilling of the existing workforce, producing incentives for R&D investments and creating and maintaining a better business environment via easing business-doing regulations.

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