STANBUL TECHNICAL UNIVERSITY ★ INSTITUTE OF SCIENCE AND TECHNOLOGY

THE COMPARATIVE ANALYSIS OF FOREIGN DIRECT INVESTMENTS AND PORTFOLIO INVESTMENTS, AND THEIR IMPACTS ON TURKEY

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YABANCI DOĞRUDAN YATIRIMLARIN VE PORTFÖY YATIRIMLARININ KARŞILAŞTIRMALI ANALİZİ, VE TÜRKİYE'YE ETKİLERİ

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PREFACE

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LIST OF ABBREVIATIONS

ADR	: American Depositary Receipts
CBRT	: Central Bank of Republic of Turkey
CEE	: Central and Eastern Europe
CMB	: Capital Markets Board
EMU	: European Monetary Union
FDI	: Foreign Direct Investment
FPEI	: Foreign Portfolio Equity Investment
FEAS	: Federation of Euro-Asian Stock Exchanges
GNP	: Gross National Product
GDP	: Gross Domestic Product
GDR	: Global Depositary Receipts
IFC	: International Finance Corporation
IMF	: International Monetary Fund
ISE	: İstanbul Stock Exchange
LDC	: Less Developed Countries
M&A	: Merger and Acquisition
MNC	: Multinational Corporation
S&P	: Standard and Poor's
TNC	: Transnational Corporation
UNCTAD	: United Nations Conference on Trade and Development
YASED	: Foreign Investors Association of Turkey

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SUMMARY

In our globalized world, with technological developments and removal or lessening of restrictions and controls over international trade and capital, the movements of capital started to flow all over the world. Investors direct their funds towards promising countries. Liberalization of the markets, create a good oppurtunity of an integrated single marketplace all over the world. Especially the emerging markets provide great opportunuties for institutional investors, such as pension funds, and investment funds.

Foreign investments are basically two kinds. Foreign direct investment and foreign portfolio investment. Direct investments are long-term and it includes more than the cash capital. The main motive behind the direct investment is the internationalization of production and the TNCs that shift their production towards emerging markets.

Portfolio investments are generally short-term, and aim to get high returns through portfolio diversification. Both direct investment and portfolio investment are very helpful for developing countries in need of capital for their growth. However, foreign investments sometimes expose disadvantages on developing countries.

With the increasing of the foreign investments all over the world, countries are becoming affected by these flows at different levels. Some countries benefit the foreign investment since most of them expose threats not only because of the externalities but also because of the mismanagement of the recipient economies.

Host countries prefer direct investment because of its long-term nature. In addition to cash capital, foreign direct investment provide machinery and skilled labor, management practices, know-how which increase the production volume and quality. The mobility of FDI is much slower than that of portfolio investments and it is not searching for speculative movements.

In 1970s and 1980s, direct investment flows have been realized between the developed countries of capital exporters. Because of the rush for direct investment, global inflows reached the historic high of US$ 865 billion. Developed countries attracted US$ 636 billion of FDI inflows in 1999. This is about 74 per cent of the world's total FDI inflows. China attracted US$ 40 billion in 1999, alone one forth of developing countries. Turkey ranked 54^{th} with US$ 0.8 billion in 1999.

Turkey ranked first with 255 % price index change in dollar terms in 1999. And the market capitalization reached US$ 114 billion. But the next year Turkey performed worst and Turkey was the biggest loser among emerging markets.

Although Turkey has very liberal regulations, Turkey failed to attract foreign investment both direct investment and portfolio investment. The most important reason behind that is the political and economic instability. It is necessary to have political and economic stability in order to get high shares in foreign investments. If Turkey could succeed to overcome obstacles, there would be many opportunuties ahead .

YABANCI DOĞRUDAN YATIRIMLARIN VE PORTFÖY YATIRIMLARININ KARŞILAŞTIRMALI ANALİZİ, VE TÜRKİYE'YE ETKİLERİ

ÖZET

Küreselleşen dünyamızda, teknolojik alandaki değişmeler ve uluslararası ticaret ve sermaye üzerindeki kontrollerin ve engellerin kalkması ya da azalması ile birlikte dünya çapında sermayenin dolaşımı artmaya başlamıştır. Yatırımcılar yüksek getiri vaad eden piyasalara ve yatırım alanlarına doğru yönelmektedir. Piyasaların liberalleşmesi, dünyanın tek bir entegre pazar haline gelmesi fırsatını yaratmaktadır. Özellikle gelişen pazarlar, emeklilik fonları, yatırım fonları gibi uluslararası kurumsal yatırımcılara iyi bir yatırım fırsatı sunmaktadır.

Yabancı yatırımlar temel olarak iki şekildedir. Yabancı doğrudan yatırımlar ve yabancı portföy yatırımları. Doğrudan yatırımlar uzun vadeli olup nakit sermayeden daha geniş bir konuyu içerir. Doğrudan yatırımların artmasındaki en büyük sebep üretimin uluslararası hale gelmesi ve ulus ötesi şirketlerin artan oranda yatırımlarını gelişen pazarlara kaydırmalarıdır.

Portföy yatırımları ise genellikle kısa vadeli olup, portföy çeşitlendirmesi yaparak yüksek getiri elde etmeye çalışır. Her iki yatırım şekli de büyüme için sermayeye ihtiyaç duyan gelişmekte olan ülkeler için önemli bir finansman aracıdır. Fakat her iki yabancı akımın da bazı olumsuz etkileri olabilmektedir.

Yabancı yatırımların dünya çapında artması ile birlikte, her ülke bu akımlardan farklı düzeylerde etkilenmektedir. Bazı ülkeler yabancı yatırımlardan faydalanırken bir çok ülke sadece dışsal unsurlardan kaynaklanmayan kötü yönetimi de içine alan tehditlerle karşı karşıya kalmaktadırlar. Bu nedenle ülkeler, yoğun sermaye akımlarının olumsuz etkilerini ortadan kaldıracak ve kaynakların en iyi dağılımını sağlayacak politikalar takip etmektedirler.

Yatırım çeken ülkeler açısından uzun dönemli doğrudan yatırımlar daha caziptir. Doğrudan yatırımlar ile birlikte üretimin kalitesini arttıracak teknolojik transferin yanında, know-how, yönetim ve pazarlama bilgisi gibi nakit olmayan sermaye akımları da oluşur. Ayrıca, doğrudan yatırımlar portföy yatırımlarına oranla daha yavaştır ve spekülatif kazançlar peşinde değildir.

1970'lerde ve 1980'lerde, doğrudan yatırımlar çoğunlukla gelişmiş ülkeler arasında olmuştur. 90'lı yıllarda gelişen ülkelere olan yatırımlar artmaya başlamıştır. Doğrudan yatırımdaki artış günümüzde US$ 865 milyar seviyesine ulaşmıştır. Gelişmiş ülkeler, 1999 yılında US$ 636 milyar doğrudan yatırım çekmişlerdir bu da toplam doğrudan yatırımların %74'üdür. Çin yalnız başına US $ 40 milyar yatırım

çekmiş olup bu rakam gelişen ülkelerin dörtte biri anlamına gelmektedir. Türkiye yaklaşık 1 milyar dolar rakamı ile 54. sıradadır.

Öte yandan, Türkiye 1999 yılında en iyi kazandıran hisse senedi piysası olmuştur. Pazar değeri de 114 milyar dolara ulaşmıştır. Fakat geçen sene hisse senedi çok kötü bir performans sergilemiş ve en çok kaybettiren hisse senedi piyasası olmuştur.

Türkiye yasaları itibariyle liberal bir ülke olmasına rağmen hem doğrudan yatırım hem de portföy yatırımı çekmekte zorlanmaktadır. Bunun en büyük sebebi de politik ve ekonomik istikrarsızlıktır. Türkiye'nin yabancı yatırım pastasından daha fazla pay alması için acil olarak politik ve ekonomik istikrara kavuşması gerekir. Türkiye potansiyelini daha iyi değerlendirdiği takdirde büyük fırsatlar önümüzdedir.

1. INTRODUCTION

Globalization, the technological developments and the liberalization of the economies have made great changes in the investment structure and the funds have been directed towards new promising countries all over the world regardless of their nations. The lessening of the trade barriers and the development of the coummunication means provided the investors to reach new countries which offering comparative advantages of natural sources, labour and market booms. And also globalization and liberalization of the financial systems have brought a near convergence in the structures of the economies.

Almost through the last one and a half decades, the financial markets around the world are rapidly integrating into a single marketplace, and developing countries are increasingly becoming an important player through this process. This change primarily are driven by the advances in communications and information technology, deregulation of financial markets, and the rising importance of institutional investors that are able and willing to invest all around the world. By improving the macroeconomic policies and setting up institutions and regulatory framework, the developing countries are attracting more capital flows in which seek market confidence and more stable economic environment for gaining high returns.

Particularly the Developing Countries, newly named Emerging Markets, and the Less Developed Countries (LDCs) have become new investment arenas with their transformation towards an investment-friendly environment for the foreigners that have great surpluses of funds and taking risks for great fortunes hardly achievable in their mature markets. They are attracting private capital flows by improving their macroeconomic variables and regulations about the foreign investments in which create more stable and credible markets for the investors.

Basicly there are two main flows of foreign investments which have been made in the world today. The Foreign Direct Investments (FDI) are the long-term capital flows towards the host countries and triggered by the new production cycles and they are likely more acceptable for the host countries. The main backbone of this direct investment boom is the Transnational Corporations (TNCs) or previously known as Multinational Corporations (MNCs) that invest more in volume, mainly on services and manufacturing industries all over the world. The internationalization of the production spurred the overall activities of the TNCs especially in the developing countries and economies of transition over the last decade.

Also the other form of flow, the foreign portfolio investments increased the capital flows with the decreasing levels of regulatory barriers and controls over the capital movements. And another motivation of the portfolio investment is the innovation in the financial engineering creating new instruments and approaches to portfolio theory. A great number of individual investors as well as the institutional investors (such as pension funds, life insurance companies, investment trusts and mutual funds) are increasingly seeking more returns with the development in the information technology via investing in new markets avoiding or decreasing the risks exposed before. The lower correlation of returns between the emerging markets and the mature markets offer the foreign portfolio investors to achieve considerably great benefits from diversification of the investment in the light of portfolio theory. Despite the fact that the enourmous risks, such as political, exchange rate and domestic economy risks, taken in these emerging markets, the dexterity in benefiting from the volatility have provided great earnings to portfolio investors of developed markets.

Today, the debate is continuing over both of the foreign investment flows and the discussion tries to determine the threats and dangers as well as the benefits of the foreign investments. It is argued that the foreign investments are not too much beneficial to host countries. It is not just the volume of the flows, but the speed at which such investment pours in-and can be withdrawn in cases of crisis- that present particular challenges to the economies. Maybe the most striking events, the financial crises of the last decade (1994-95 Mexican currency crises so called "tequilla" crises, and 1997 Far East Asian crisis) have brought up several questions and suspicions about capital flows.

Another item of the debate, the environmental and labor market aspects of the direct investments have created many questions among the countries which are in need of fresh capital for developing and sustainable growth. With this emerging dilemma about the FDI, it has been sought by some as a new tool for the wealthy countries to spoil the sources of the developing countries and LDCs. And the internationalizaton of the production consequently resulted in the production of dirty products in the developing countries and LDCs, and the consumption of these in wealthy nations via imports while satisfying to protect their local environment.

1.1 Objective of the Thesis

The increasing of foreign investments, both direct investment and portfolio investments have been accelerated by the internationalization of production which is a result of decreasing levels of trade barriers and the controls over the capital movements, and by tremendous leap in the technological area especially the information technology providing the markets integrate more. Today the participation of TNC activities is speeding up the process.

Two major flows of capital increased dramatically in the last two decades. The paramount changes in the global economy offering both many opportunities and dangers. This forced the countries to think again about benefits and threats of foreign investments. For example, there are many positive effects of FDI to the host countries. Host countries receive technology transfer, employment opportunities and learn new management systems and marketing strategies via FDI. The increasing volumes of production and the exports contribute the domestic economy, and lessening the tension on the balance of payments of the countries.

But also globalization poses numerous challenges for developing countries and emerging economies. One of these challenges stems from a widespread concern that as governments in developing and emerging economies move to adopt more open and market-friendly policy regimes, and act more actively to attract foreign direct investment which they see as vital for strengthening the ability of their economies to compete in global markets, they stimulate or reinforce a global process of competition among governments to attract FDI that has undesirable effects. This competition may lead governments to engage in "bidding wars" that drive up investment subsidies to exorbitant levels, and/or drive down public measures that are needed to protect the environment and/or rights and labour standards.

Today financial markets show a high degree of integration and the world markets face high capital mobility. The portfolio investments in the stocks of developed countries markets together with the stocks of emerging markets, gain more earnings than the portfolios solely composed of stocks of developed markets. While the portfolio investors benefiting much, short-term capital flows resulted in financial crises, and put pressures and adverse effects primarily on developing countries suffering significantly more in these conditions.

Before making a decision about the foreign investments, it is useful to look at the facts and figures in the world while focusing on Turkey later. Turkey started the liberalization and opened up its economy in 1980s. The liberal economic policy implementation encouraged foreign investors and caused increases in foreign direct investments. However, substantial increases occurred between 1988-1992, averaging of one billion dollars per year came to Turkey in terms of FDI. However, this trend became stagnant and even lesser while the global trends were increasingly booming in other developing economies. It is obvious that Turkey does not enjoy the global FDI flows today.

The other aspect of the foreign investment, the foreign portfolio investment mostly started to act in 1990s in Turkey. The stock and bond markets are open to foreign investors, without any restrictions on the repatriation of capital and profits. Thus, Istanbul Stock Exchange (ISE) is the main player to attract portfolio investors. The motive behind the inflows of foreign portfolio investments is the high real interest rates in Turkey because of the huge budget deficits of government spending and the volatility of stock markets reaching 5-10 % daily fluctuations, which are not rare.

The objective of this work is to analyze the development of the foreign investments in the world, to study the motives separately both in direct investment and portfolio investment. Another concern is to elaborate on the determining factors of FDI and portfolio investment, and on the implications of direct and portfolio investments. Classifying the risks in emerging markets and the instruments of portfolio investments will be our concern either. Then, the development of foreign investments in Turkey and impacts over the economic variables will be explained. Thus it will be easier to assess the Turkey in the light of foreign investments.

Also in this work, an attempt will be made to put an understanding about the foreign investments and the capital flows which giving opportunities and at the same time posing threats for the countries of investments. It is necessary to take all precautions to achieve the benefits of freer capital flows while trying to minimize the risks pose on the other.

1.2 Scope of the Thesis

In the second chapter, the general facts about the foreign investments are analyzed. The history of the capital flows in terms of debt and investments; the structures, characteristics of the world markets; and the fundamental two kinds of foreign investments are reviewed in order to understand the global trends and the real position of Turkey in this rapidly growing environment.

In the third chapter, the focus of the work is the FDI, having a long term perspective and covering other than the financial assets like know-how, licences and management skills as well as tangible assets of building, machinery and so on.

The fourth chapter primarily focuses on the portfolio investments which is the most critical issue of capital flows. The portfolio investments have great impacts on countries especially in the emerging markets and economies of transition as compared with developed markets. The portfolio choice of the investors make the funds act in other markets like emerging markets having a high degree of returns as well as risks such as volatility. The ability of a fund in maturity and volatility gives great earnings of hardly achievable in the developed markets and even compensating of the losses in the developed markets via benefiting from the negative or lower correlation of the emerging markets with the developed markets.

The main issue of this work, Turkey will be analyzed in the fifth chapter. As a developing country, Turkey has been faced with great challenges in the economic arena. High inflation rates, market imperfections, weaknesses in market mechanism, the implications of the decisions made by the policymakers, and the economic and political instability have made enormous harm over Turkey through the last three decades. So the foreign investments are vitally important for Turkey to overcome these obstacles while considering the foreign investments having dual aspects, threats as well as benefits. The most important attitude is to manage what is in hand and avoiding the damages of foreign investments mainly the portfolio ones having a short term capital flows. And also in this chapter, all aspects of foreign investments will be analyzed in order to give sound decisions about Turkey. The investments are an ongoing process, because of the endles needs of people requiring more for developing. And the people try to improve their quality of life and recieve more profits. It is evident that the ability of benefiting more will increase the degree of satisfaction of the countries.

2. MARKETS, FOREIGN INVESTMENTS AND CAPITAL FLOWS

2.1 Capital Flows

There are two main types of international capital flows: Foreign portfolio investment and foreign direct investment (FDI). Although these flows increased very much in the last two decades, these large and rapid flows are not new for the world history.

Before the World War I, net capital flows were proportionally as large as today although the complexity and volume of the interactions (gross) was then much less. Most of the flows in that period were in the form of long-term bonds, with governments, railways, mining and other commodity extraction enterprises. Because of the main government involvement in these infrastructure at that time, it could be seen that most of these loans were linked to exports and the means to service debt. However, there were many crises, but not so much frequent and severe as in today.

After the crises of the 1930s, there was a collapse in international capital flows and in the trade and the recovery started with slowly after World War II. The international capital flows has begun in the 1960s, and increased rapidly while their characteristics differing from that seen before the World War I. The maturity of loans tends to be of rather shorter duration and the bond financing becomes lesser today. Moreover, both purchases of equity and foreign direct investment play a much more important role in the international financial flows.

The postwar world has been one of open trade with diminishing tariffs and other restrictions on trade and capital movements across national boundaries. International trade in goods and services has increased much more rapidly than world output. Although the capital flows among industrial countries were already of great significance in the 1960s and 1970s, the international mobility of capital is now a worldwide phenomenon. The capital flows to developing countries have greatly increased in recent decade.

The factors determining the capital flows into the developing countries are "push" and "pull" factors. Push factors depend on the idea that basic determinants are the changes in external factors, which are adverse conditions in developing countries. Pull factors depend on the idea that basic determinants are the attractive conditions in developing countries in which the flow pours into it. Among the capital flows, foreign direct investments are determined by the pull factors, whereas portfolio investments and short-term capital flows are determined by the push factors.

With the recurring foreign exchange and banking crises in the emerging markets over the last two decades, new views has been put forward towards the international capital flows. As in the case of Asian crisis, the role of the foreign investment in the crisis has been questioned and raised many controversies. Critics, many of them in the affected regions, have charged that foreign investors were too fickle, pouring too much money in too rapidly and then taking it out at even faster pace. The deepening and the spread of the crisis might be impossible to tame and the destruction over the markets be hard and painful to recover in the following years.

Internationally integrated financial markets also mean that financial markets in emerging market countries are vulnerable to interest rate increases in industrial countries. As well, there is growing evidence that equity markets in developing countries are more correlated with those of industrial countries than would seem consistent with the underlying fundamentals. While the adoption of floating exchange rate regimes significantly mitigates these dangers, it by no means wholly eliminates them.

Not only the capital flows pose many risks while giving many advantages to the developing countries and economies in transition but also it gives impacts on developed countries. Market risks and maturity mismatches (as in the case of Korea in 1997) in one market easily may trigger crises in a region and with the domino effect the economic turmoil may cross the borders faster than ever in our globalized world economy. Financial contagion may destruct the financial markets as if the weather global storm ruins everything in front of it.

It has been considered that some initiatives can be a remedy for the crises. The deepening local markets, not just with foreign capital but also with domestic savings. To do this, it is required to develop long-term domestic sovereign debt improve risk management and control systems, to develop better mechanisms for hedging currency risks, to enhance transparency, and to develop ways for investors to differentiate different emerging markets from one another to minimize herding effects when crises break out. In the various sections that follow, these initiatives are considered more in detail.

2.2 Financial Markets

2.2.1 International Financial Markets

There are many countries that enacted regulations to allow trade by foreigners. Foreign investors who supply and demand funds can trade at these markets either domestically or internationally. The most important international markets are New York, London and Tokyo markets. The major characteristic of this markets is the minimum country risk. Markets that are developed by local financial instruments internationally other than the local market, are called "Euromarkets". Ther are two kinds of Euromarkets.

2.2.1.1 Eurocurrency Markets

Eurocurrency is the type of deposits held in a bank abroad in terms of a completely convertible currency. Majority of Eurocurrency transactions are short term and realized by US dollar. Eurodollars are dollar-denominated deposits (almost always time deposits) in banks located outside the United States. Eurocurrencies are any deposit liabilities of banks, including Eurodollars, that are denominated in currencies of the banks in which they are held. (Evans, 1992) Originally, dollar-denominated deposits not subject to U.S. banking regulations were held almost in Europe; hence, the name Eurodollars. The Eurocurrencies held outside Europe are usually called to the region such as "Asiandollar" or "Riodollar".

These markets arose in response to earlier attempts to restrict capital flows and regulate financial markets. The Euromarkets have a competetive advantage over domestic markets because Eurocurrency deposits face no reserve requirements, pay no deposit insurance, have no interest rate regulations, and pay low or no taxes.

They were off-shore markets that did not fall within the jurisdiction of any country (Schaberg, 1998).

Lending in the Eurocurrency market is relatively short-term by comparison with bond financing, but the Eurocurrency market's maturities overlap those of bonds. Eurocurrency market lending is commonly on a floating-rate basis.

2.2.1.2 Eurobond Markets

Eurobonds are the bonds issued in currencies other than those of the countries in which they are initially distributed (Evans, 1992). Some of the bonds are local ones purchased by foreign investors in developing markets; others are issued abroad mainly in New York (Yankee bonds), Tokyo (Samurai bonds), and in the Eurobond market. Borrowers in the Eurobond market includes well-known firms, governments and their agencies and international organizations.The Eurobond market offer two important adantages over issuing bonds in their own country. First, with Eurobonds, a borrower could avoid the financial disclosure rules and it means avoiding the costs of complying with the rules and the disclosure of information that a borrower might prefer to keep confidential. The second major advantage of Eurobond financing is that it offer somewhat lower interest rates than the domestic bond markets.

The trading spreads in the Eurobond market are generally low, and an efficient clearing system allows trades to be effected quickly and at low cost. Most Eurobond trades are cleared either Euroclear, located in Brussels, or Cedel, located in Luxembourg. These clearing systems do not make physical delivery of bonds to their purchasers. Ownership changes are registered electronically and the securities are left in trust under suitable arrangements.The Eurobond market is highly efficient and easily accessible to portfolio managers.

2.2.2 Developed Markets

The developed markets basicly are assesed by their market capitalization, trade volume, market depth, institutional investors, liquidity, variety of financial instruments, existence of derrivative markets and number of corparations traded. The United States, Japan and UK are the major countries possesing developed markets like New York Stock Exchange, Tokyo Stock Exchange and London Stock exchange. The most of the foreign investment take place in the developed markets, however the share of emerging markets increase more and more.

2.2.3 Regional Markets

Regional Markets are formed by countries who are geographically closed to eachother. The most early example of the regional market was Nordquote enabling to trade between the Scandinavian countries of Denmark, Finland, Norway and Sweden. Nordquote opened to trade stocks of 83 firm in 1994. But Nordquote failed to live and the next year Copenhagen, Helsinki, Oslo and Stockholm Stock Exchanges started to operate seperately.

Recent trend about the regional markets is the unification attempts between the stock markets. The single currency, disappearing of national currencies with European Monetary Union (EMU) forced the countries in the Euro-zone to integrate their financial markets more. Also Franco-German-Swiss alliance is focusing on bringing together futures and options contracts, particularly those for bonds and short-term interest rates.

There is also another tendency of integration of stock markets within various regions of the world and within federal states. This integration means that investors can buy and sell shares in those markets without restrictions and that identical securities can be issued and traded at the same price across the markets after foreign exchange adjustment. The implementation of EMU is an oppurtunity for the European countries to move towards a more integrated market. Maybe it is not possible that there will be only one market in Europe but it is obvious that there will be less markets than we have today. Today the stock exchanges are more willingly try to merge as in the case of London Stock Exchange and Frankfurt Bourse. Despite the fact that there is not a merger this time, the trend will be in that direction.

Another example of integration is that the starting of the Federation of Euro-Asian Stock Exchanges (FEAS) consisting of exchanges in 15 countries (Turkey, Israel Middle Eastern, Central Asian, and Eastern European Countries). This is an initiative of Istanbul Stock Exchange and established in May 1995. The main objective of FEAS is to encourage cross-listing and trading among member exchanges and to establish an international bond and equity market free of tax and restrictions on trade, in which the securities are denominated in U.S. dollars. Now there are 22 member stock markets of 19 countries in FEAS.

2.2.4 Emerging Markets

The term 'emerging markets' is by its nature very general and applies to a very diverse and changing cast of countries. Usually the term refers to stock markets that are developing from an incipient stage toward a more modern and eventually more mature stage (Kuczynski, 1994).However, the term is not necessarily tied to stock markets; it is simply a reflection of the pace of economic development. In other words, the term can also refer to any market in a developing economy, with the implication that all have the potential for development. A stock market might then be said to be 'emerging' if it meets at least one of two general criteria:

1. Emerging Economy Criterion.
2. Developing Stock Market Criterion.

In the past, IFC's definition of an emerging stock market was aligned only to an emerging economy criterion: if a country's GNP per capita did not exceed the World Bank's threshold for being a high income country, i.e., if a country was eligible to borrow from the World Bank, its stock market was said to be emerging.

Today, IFC is considering ways in which to officially amend its selection criteria to include emerging stock market criteria. It should allow a more comprehensive screening process by addressing some of the deficiencies that result from using only economic criteria. For example:

- US$ GNP per capita can be significantly affected by fluctuations in currency.
- Many economies develop rapidly on a GNP per capita basis, but have stock markets that retain substantial features of emerging stock markets.
- There are many qualitative features in emerging markets. Areas such as operational efficiency of stock market regulation, supervision and

enforcement, transparency and level of accounting standards are all important considerations.

For this reasons IFC accept the World Bank's classification of economies, and the economies under US$ 9360 GNP per capita level are accepted as 'emerging markets'. 155 countries are classified as emerging markets. The Economist publication, by contrast, usually lists the twenty-five countries, as countries where emerging markets are located.

Two primary forces are driving investor interest in emerging markets, the search for higher returns and opportunities for risk diversification. Emerging markets may offer valuable opportunities for diversification beyond national borders and potentially higher returns for the portfolio investors. Emerging markets vary widely, and they do not rise and fall in tandem with developed markets. A small investment could increase portfolio's diversification and reduce its overall volatility or price fluctuations. Rapid growth in emerging markets can produce impressive returns.

Compared with established markets, emerging markets offer the potential for faster economic growth, and emerging markets stocks are sometimes more reasonably priced. However, the risks of investing in these markets are substantial. The risks in these markets are: The first one is the market risk. Emerging markets historically have been more volatile than the developed markets and the value of the investment could fluctuate dramatically as the markets rise and fall. Currency risk is the risk that adverse movements in the price or one national currency vis-à-vis another will reduce the net rate of return from a foreign investment. In addition, it is called exchange rate risk. Liquidity is the quality or capability of assets to be sold quickly with little risk of loss and possessing a relatively stable price over time. Small trading volumes could result in buying and selling the securities above or below their market value. The country risk or political risk is the probability that changes in government laws or regulations will result in a lower rate of return to the investor or, in extreme case, a total loss of invested capital. Political events (a war, national elections), financial problems (rising inflation, government default), or natural disasters (an earthquake, a poor harvest) could weaken a country's economy and cause investments in that country decline.

Investors are gradually turning their attention to emerging markets, and it might be said that the reasons which explain why emerging markets are seen as attractive by investors, namely that they:

- represent a fast growing part of the world's economy;
- have delivered superior returns;
- provide further diversification of global portfolios;
- are attractively valued;
- represent huge marketplaces; and
- are underweighted in global portfolios.

For many investors, the 1990s has been the decade of 'emerging markets' in both a positive and a negative sense. The good news is that this is the decade that set records for capital inflows into developing countries and transition economies, since dubbed the emerging markets. The bed news is that emerging markets were shaked twice with crisis, first following the devaluation of the Mexican peso in 1994-95 and then in 1997-98 following a series of financial crises in Southeast Asia and Russia.

Emerging markets are important not only because their precipitous downfall sent a shudder through the economies of the rest of the world but also because they have most of the world's population and, over the next several decades, should account for the most of the world's growth in economic output. As this occurs, financial flows and institutions within those markets, and between those markets and markets in the rest of the world, inevitably will become more important.

Another characteristics of the emerging markets is the fragility of their stock markets in times of crises. While developed market crisis are less severe, both in terms of the extent of price decline and the duration of the crises, this is not so for the emerging markets. For emerging markets stock crises, prices tend to fall rapidly and steeply, but take longer to recover. And the contagion hit hard the markets in the regions than that of the developed markets.

2.2.5 Economies in Transition

After the collapse of the Soviet Union, there has been both political and economic transition in the countries of Central and Eastern Europe (CEE) and in the republics of the former Soviet Union. Transition of the economy is a multidimensional process and it is mainly divided into three categories of reform (Solomon, 1999):

1. Macroeconomic stabilization via fiscal and monetary policies;
2. Institution building to install the necessary features of a market economy, such as property rights and commercial law, an effective banking and paymants system, an adequate tax system, and a social safety net;
3. Structural reform, such as decontrolling prices, downsizing, closing, or privatizing state-owned enterprises, liberalizing foreign trade, and establishing a convertible currency.

As transition of these economies grow, their share in trade, capital flows and foreign investments are greatly increase. Amount of capital absorbed by the countries in transition has been modestly increased in 1990-1995, CEE and CIS countries recieved 15 percent of the total flow of capital to developing and transition countries.

2.3 Foreign Investments

Global trade liberalization, financial innovation, and information technology have created a new global economy in which private capital flows are dominant and governmental policy mistakes are quickly and severely penalized. Advances in communications and information technologies have been revolutionizing all the financial markets: equity, debt, credit, capital, and currency.

With the increasing of the foreign investments all over the world, countries are affected by these flows at different levels. Some countries benefit the foreign investment since most of them expose threats not only because of the externalities but also the mismanagement of the reciepent economies. So countries pursue different policies in order to remove the negative effects of intensive capital inflows and to ensure effective distribution of resources. The basic aims of these policies are the preservation of macroeconomic stability and financial discipline while benefiting much of the foreign investments.

2.3.1 Foreign Direct Investments

There are some definitions about the FDI. The basic definition, that FDI is the investment made by corporations who are located in another country than the investment is made in order to establish a new firm, getting involved to a local company by using her shares or joining with the local company by a joint venture or merger.

According to the 1993 International Monetary Fund (IMF) Balance of Payments Manual, "Direct investment is the category of international investment that reflects the objective of obtaining a lasting interest by a resident entity in one economy (the direct investor) in an enterprise (foreign direct investment enterprise) resident in another economy." The Manual goes on to say that, foreign direct investment (FDI) occurs when a foreign investor develops a long term relationship with a domestic enterprise and owns enough of the equity of the enterprise to exercise a significant degree of influence on the management of the enterprise. For statistical purposes, it has been decided that ownership of "10 percent or more of the ordinary shares or voting power (for an incorporated enterprise) or the equivalent (for an unincorporated enterprise)" constitutes a sufficient share to give the foreign investor a significant influence on the management of the enterprise. It should be noted that the IMF Manual permits some flexibility in the application of the three main criteria of the FDI definition. Therefore, for example, "if the direct investor owns less than 10 percent (or none) of the ordinary shares or voting power of the enterprise but has an effective voice in management" then his investment may be classified as a FDI.

Attitudes toward foreign direct investment have changed significantly since the early 1980s, as a result of decreasing flows of other types of foreign capital, such as commercial bank loans and foreign aid, and the increasing globalization of the world economy. Consequently, FDI has become increasingly important as a source of capital, particularly for developing and transition economies. Many countries are liberalizing their economies and implementing policy changes to participate more fully in the internationalization of production.

The crucial change with FDI has been the substantial growth since the early 1980s, even though this growth only brings us to a level roughly equal to that for the pre-World War I period. Today FDI is receiving growing attention in relation to globalization, economic development, the operating modes of multinational enterprises and international investment rules. FDI is a key ingredient of economic growth, employment, technological development and spreading of managerial and marketing skills. FDI makes host countries more fit to compete in an increasingly globalized world.

FDI does not have to be in terms of cash necessarily. It can be enter the country in terms of fixed capital, infrastructure or know-how, required to produce the planned product as well as administrative knowledge. It has a great variety of tools to invest another country.

Although there are some similiarities between FDI and portfolio investmenst like the international characteristic, it can be said that four primary distinguishing points between the two (Seyidoğlu 1993):

1. The home country investor totally controls the investment and production process in direct investments. For effective control over the investment, mostly the foreign investor determines the top management of the firm. On the contrary the portfolio investor invests in bonds or shares but never holds the right to intervene to the decisions or plans of the invested institutions. It does not mean that the right to vote in general boards is not a direct control over the management.

2. In addition to cash capital, foreign direct investor may provide machinery and skilled labour, management practices, know-how which increase the the production volume and quality. However, portfolio investor only contribute in terms cash capital.

3. Almost all of FDI has been realised by the TNCs.

4. The mobility of FDI is much slower than that of portfolio investments and it is not searching for speculative movements. The transfer of the earnings by

investment is determined by the performance and productivity of the investment, and it is also subject to the regulations of the host country.

In the light of aforementioned facts, there is no doubt that FDI is much more desirable and beneficiary particularly for developing countries and LDCs. Even FDI is more 'sticky' than the portfolio capital in times of crisis. FDI not only brings resources to reciepent countries, but it typically comes with managerial and technical expertise that can serve as powerful engines of growth over the long run. However, the portfolio investments pours into developing countries more than that of FDI flows in.

2.3.2 Foreign Portfolio Investments

Portfolio investment is the capital invested in instruments like shares, government bonds and T-bills and other instruments in the foreign capital markets by foreign investors who undertake additional risks such as political risk, exchange rate risk and information risk. The investors direct their funds on equities like stocks, bonds and other capital market instruments in order to recieve interest and dividend earnings. The portfolio investors are the ones whose stake in the companies they buy is not sufficient to give them control or influence in the running of the corporations.

Investors can either invest in foreign investment instruments that are dealt in their own country or invest in the instruments that are dealt in the foreign country that the instrument belongs to (Canlıel, 1998). There are three basic types of foreign investors, namely mutual funds, pension funds, and hedge funds, and three means by which foreign institutions invest in local stock through local markets, international placements of publicly traded depository reciepts, and local private equity.

Portfolio investments are traded internationally or traded between the markets. International transaction is the trade of the securities and bonds issued by the country in which foreign investors buy and sell these instruments in its capital markets. The intra-market transaction is the trading of these instruments in off-shore, other than the country of origin. There are two major approaches used in calculating the volume of the portfolio equity investments on stocks which is the major part of it (Howell and Cozzini, 1994):

1. The net investment amount is achieved by deducting the securities sold from the securities bought.
2. The total volume of transactions is added up regardless of the direction of the capital flow.

Another important aspect of portfolio investment is the motives of foreign investors. It can be said that there are five classes of investors: (1) *analysts* who returns by assessing and reacting to information; (2) *growth investors* who, like analysts, respond quickly to changes in information about company prospects; (3) *momentum investors* who buy what is going up and sell what is going down and thus often help to destabilize markets; (4) *index investors* who buy regardless of price or fundamentals of particular companies but instead purchase portfolios of stocks; and (5) *value investors* who respond quickly to price changes, but slowly to news about changes in fundementals.

There are several factors that determine the decisions of the portfolio investors whether they will remain in the host country and if so the duration of the investment. These factors in determining the objective of investment are very helpful for evaluating the degree of benefits and harms of capital flows which are directed towards the economies and for forseeing the indicators of the possible results ahead of investments.

3. FOREIGN DIRECT INVESTMENT (FDI)

Foreign direct investment (FDI) is defined as an investment involving a long-term relationship and reflecting a lasting interest and control of a resident entity in one economy (foreign direct investor pr parent enterprise) in an enterprise resident in an economy other than that of the foreign direct investor (FDI enterprise or affiliate enterprise or foreign affliate). (UNCTAD, 2000) FDI implies that the investor exerts a significant degree of influence on the management of the enterprise resident in the other economy.

The FDI entry into a country usually are realised by the cash transfers to host country investment. FDI does not have to be in terms of cash necessarily. Foreign investors sometimes add some of the earnings again on investment without trasfering the incomes to home country, these reinvested earnings are also considered as direct investments. FDI can enter a country in terms of fixed capital, such as machinery, to establish the technological infrastructure to produce goods. In addition to fixed capital, it also canbe in terms of intangible assets and rights such as licences and loyalties, know-how, administrative and management skills either. It is also possible that the direct investment consist of both fixed capital and intangible assets and rights (IMKB, 1994).

Foreign direct investor or an FDI enterprise of a foreign direct investor provide capital to an FDI enterprise. There are three components in FDI flows:

1. *Equity capital* is the foreign direct investor's purchase of shares of an enterprise in a country other than its own.
2. *Reinvested earnings* comprise the direct investor's share of earnings not distrubuted as dividends by affliates or earnings not remitted to the direct investor. Retained profits by affliates are reinvested.

3. *Intra-company loans* or *intra-company debt transactions* refer to short-or long-term borrowing and lending of funds between direct investors (parent enterprises) and affliate enterprises.

In 1970s and 1980s, direct investment flows mostly had been realised between the developed countries of capital exporters. FDI has been one of the defining features of the world economy over the past two decades and it continues to be a driving force of the globalization process that characterizes the modern world economy. It has grown at an unprecedented pace for more than a decade, with only a slight interruption during the recession of the early 1990s. Also there has been an upsurge in the 1990s in the flows of FDI to developing countries. More firms in more industries from more countries are expanding abroad through direct investment than ever before and all economies now compete to attract multinational enterprises. This is facilitated by the liberalization of FDI policies which are more open and market-friendly to the foreign investors.

As a result of the rush for direct investment, global inflows reached an historic high of US$ 865 billion in 1999 with an increase of 27 per cent over the previous year. This trend has been driven by the complex interaction of technological change, evolving corporate strategies towards a more global focus and major policy reform in individual countries. The past decade has witnessed an unparalled opening and modernisations of economies in all regions, encompassing deregulation, demonopolisation, privatisation and private participation in the provision of infrastructure, and the reduction and simplification of tariffs.

3.1 Transnational Corporations and FDI

Transnational corporations (TNCs) are incorporated enterprises comprising parent enterprises and their foreign affliates. A *parent enterprise* is defined as an enterprise that controls assets of other entities in countries other than its home country, usually owning a certain equity capital stake. An equity capital stake of 10 per cent or more of the ordinary shares or voting power for an incorporated enterprise, or its equivalent for an unincorporated enterprise, is normally considered as a threshold for the control of assets. A *foreign affiliate* is an incorporated or unincorporated enterprise in which an investor, who is resident in another economy, owns a stake that permits a lasting interest in the management of that enterprise. (UNCTAD, 2000)

Transnational Corporations are the major actors in the restructuring process of the new international economic system. The new structure of the internationalization of production and the TNCs' participation with FDI mainly on services and manufacturing industries have been dramatically increased in developed and also in a number of developing countries for almost the last two decades. Falling transportation and communications costs are allowing TNCs to integrate production and other corparate functions across countries in historically unprecedented ways. As FDI policies have been liberalized, innovation costs have risen and international transaction costs fallen, internalized transaction by TNCs have grown in significance. To benefit from this process many firms try to become transnational today.

Transnational corporations adopt a variety of strategies in undertaking international production. As their strategies changed over time, they adopt "deep integration" strategies as compared to independent "satellite" strategies (UNCTAD, 1999) Deep integration strategies may include the location abroad of corporate functions like research and development (R&D), marketing or accounting. It also may mean an integrated production system in which different steps of a production process are undertaken in different countries according to their relative cost and logistic advantages.

There is a recent trend almost during the last five years, M&As boom. The cross-border M&As are playing an important role in boosting FDI and becoming more common as a mode of entry for TNCs in developing countries. In a cross-border merger, the assets and operations of two firms belonging to two different countries are combined to establish a new legal entity. In a cross-border acquisition, the control of assets and operations is transfered from a local to a foreign company, the former becoming an affiliate of the latter. The country of the acquirer or purchaser is the "home country" and the country of the target or acquired firm is the "host country". In mergers, the headquarters of the new firm can be in both countries. Acquisitions can be minority (foreign interest of 10 to 49 per cent of a firm's voting shares), majority (foreign interest of 50-99 per cent), or full or outright acquisitions (foreign interest of 100 per cent).

Cross-border M&As can be classified in three: *Horizantal* M&As are conducted between competing firms in the same industry. The merging firms aim to achieve synergies and often greater market power by combining their resources. *Vertical* M&As, between firms in client-supplier or buyer-seller relationships, seek to reduce uncertainty and transaction costs as regards forward and backward linkages in the production chain, and to benefit from economies of scope. *Conglomerate* M&As, between companies in unrelated activities, seek to diversify risk and deepen economies of scope. (UNCTAD, 2000)

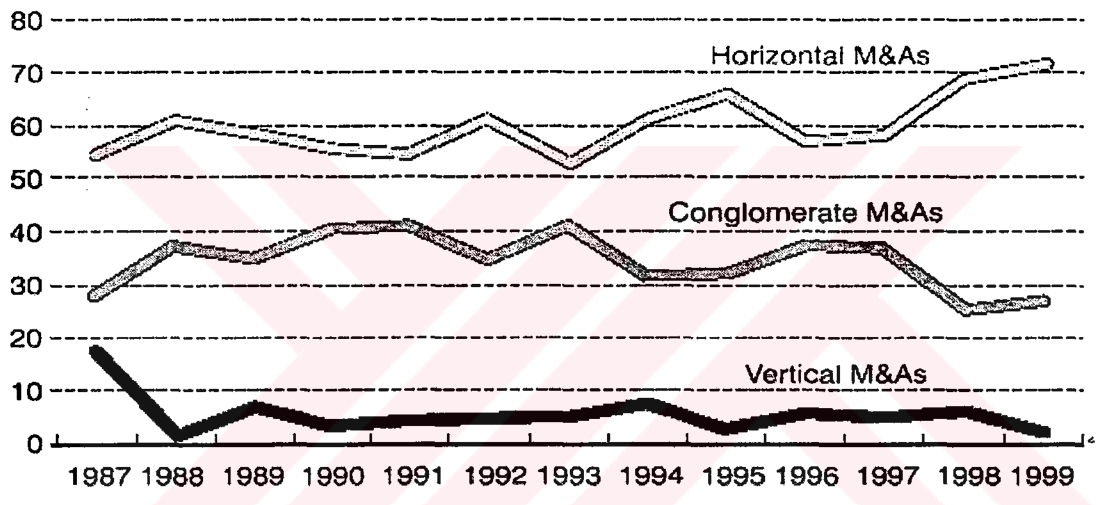

Figure 3.1 World cross-border M&As, by Type, 1987-1999
Source: UNCTAD, World Investment Report (2000)

M&As completed worldwide,between domestic and foreign firms, have grown over the past two decades, reaching $2.3 trillion in 1999. More than 24,000 deals took place. M&As worth $1 billion or more is called "mega deals". There were a number of deals, such as acquisition of Mannesman by Vodafone AirTouch with a payment of $200 billion. In 1999, 109 mega deals had been realized reaching $500.8 billion and a share of 69.6 per cent of total M&As deals.

Developed countries are main players in M&As deals. However, developing country firms are still little players in terms of acquiring firms abroad.heir share of the value of global M&A purchases reached just over 10 per cent during 1996-1997, but dropped to less than 5 per cent in the period 1998-1999. In contrast to FDI outflows, of which developing countries account for some one-tenth of the world total. The firms in developing countries prefer direct investment rather than M&As.

Firms prefer to grow via M&As rather than through organic growth, because there are two determining factors; speed and access to proprietary assets. M&As often represent the fastest means of reaching the desired goals when expanding domestically or internationally. And firms seek ways to reach strategic assets, such as R&D or technical know-how, patents, brand names, the possession of local permits and licences, and supplier or distribution networks. These assets are not available in the market, so the firms consider M&As as the best way to access ready made proprietary assets.

The driving forces of cross-border M&As affected by changes in the economic and regulatory environment especially the international economic and regulatory environment (See Figure 3.2). Changes in the economic environment greatly result in cross-border M&As. The rapid pace of technological change forced the technology leader with fierce competition. The costs and risks of innovation rise, thus firms seek ways to overcome this huge burden in innovation. Another aspect is the policies on FDIand cross-border M&As. Most countries are now trying to attract direct investment, not just by removing restrictions, but also through active promotion and by providing high standards of treatment, legal protection and guarantees. The founding of regional free trade areas also facilitate M&As in several ways. Enlarged and immediately accessible markets attract the foreign investors. And the widespread privatization and deregulation of activities, especially in service industries suc as telecomunications, transportation, power generation and financial services create a frindly environment for cross-border M&As. Privatization programmes in many developing countries and economies in transition increase the availability of domestic companies for sale.

Lastly the changes in world capital markets facilitate cross-border M&As, in a rapid pace. The liberalization of capital movements, new information technology provide instant access the globe. Liberalized financial transactions and controls over capital accounts easily increase the mobility of capital all over the world.

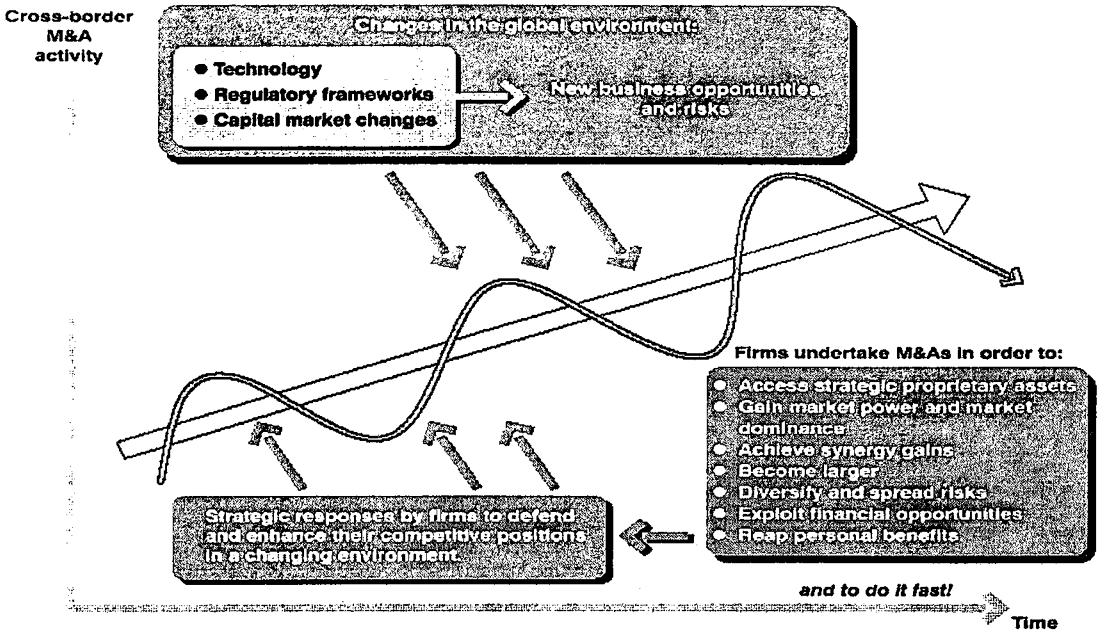

Figure 3.2 The Driving Forces of cross-border M&As
Source: UNCTAD, World Investment Report (2000)

3.2 Recent Global Trends of FDI

In 1999, global FDI inflows reached $865 billion with an increase of 27 per cent. (See Table 3.1) After the narrowing phase of 1998 FDI flows to developing countries, the recent trend accelerated to the pace of earlier growth. FDI is playing a larger and more important role in the world economy. Internationalization of the production is growing faster than other economic aggregates.

3.2.1 Global Inward and Outward Flows of FDI

Together with rapidly increasing of FDI flows, FDI stock reached $5 trillion at the end of 1999. Sales by foreign affliates, a measure of revenues generated by international production, reached $14 trillion in 1999, and their gross product reached the value of $3 trillion. Global gross product of foreign affliates is about one tenth of global GDP, compared to 5 per cent in 1982. The ratio of FDI stock to global GDP has risen from 6 per cent to 16 per cent over this period.

Table 3.1 Selected Indicators of FDI and International Production, 1982-1999 (billions of dollars and percentage)

	Value at current prices (Billion dollars)			Annual growth rate (per cent)			
Item	**1982**	**1990**	**1999**	**1991-1995**	**1996-1998**	**1998**	**1999**
FDI inflows	58	209	865	20.0	31.9	43.8	27.3
FDI outflows	37	245	800	15.7	27.0	45.6	16.4
FDI inward stock	594	1761	4772	9.4	16.2	20.1	18.8
FDI outward stock	567	1716	4759	10.7	14.5	17.6	17.1
Cross-border M&As	...	151	720	23.3	46.9	74.4	35.4
Sales of foreign affiliates	2462	5503	13564	10.4	11.5	21.6	17.8
Gross product of foreign affliates	565	1419	3045	7.1	15.3	25.4	17.1
Total assets of foreign affliates	1886	5706	17680	13.7	16.5	21.2	19.8
Exports of foreign affliates	637	1165	3167	13.9	12.7	13.8	17.9
Employment of foreign affliates (thousands)	17433	23605	40536	5.0	8.3	11.4	11.9
GDP at factor cost	10611	21473	30061	6.3	0.6	-0.9	3.0
Gross fixed capital formation	2231	4686	6058	5.9	-1.4	-2.1	-0.3
Royalties and fees receipts	9	27	65	14.2	3.9	6.3	0.5
Exports of goods and non-factor services	2041	4173	6892	9.5	1.5	-1.8	3.0

Source: UNCTAD, World Investment Report (2000)

Global sales and gross product associated with international production have increased faster than global exports and GDP during the period 1982-1999 (See Figure 3.3).There are several reasons behind the growth and deepening of international production. The liberalization of FDI regimes and perception about FDI's contribution to firm competitiveness are the principal pull and push factors.

3.2.2 Regional Trends of FDI

Developed countries attracted $636 billion in FDI inflows in 1999 (See Table 3.2). This is about 74 per cent of the world's total FDI inflows. United States and the United Kingdom lead in both inward and outward FDI. The most remarkable increase within developed countries was Sweden's 200 per cent increase over the last year's inflows. This was the result of the merger between the two pharmaceutical companies Astra (Sweden) and Zeneca (United Kingdom). FDI developments in 1999 were more than ever driven by M&As in developed world.

Flows of FDI to developing countries increased by 16 per cent in 1999. Despite the fact that there is an increase in absolute flows, their share in FDI inflows continued

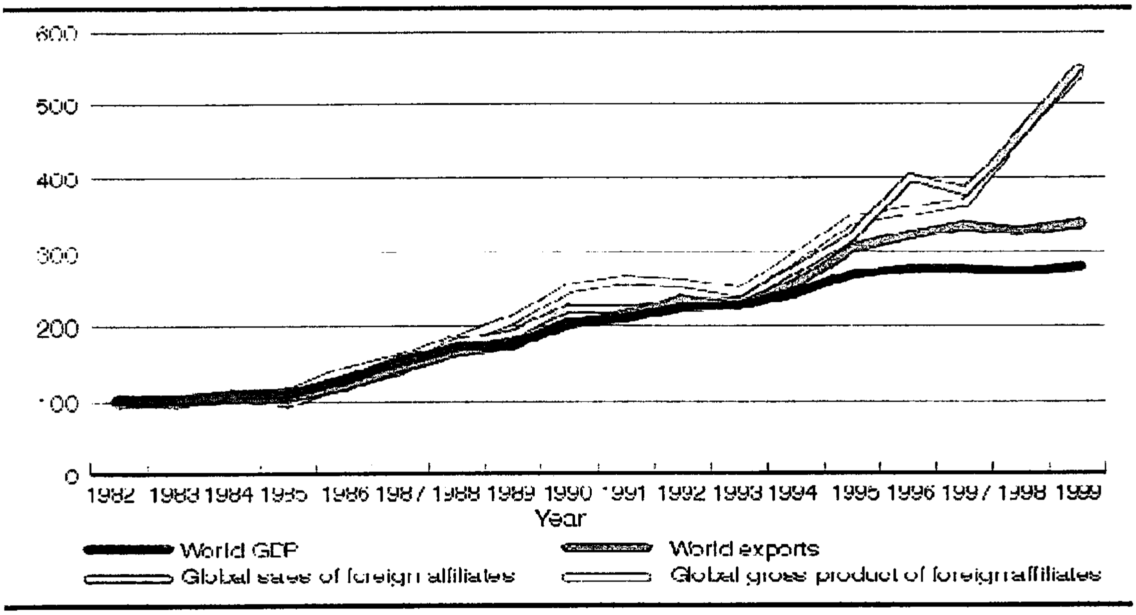

Figure 3.3 The growth of sales and gross product associated with international production, GDP and exports, 1982-1999 (Index, 1982=100)

Source:UNCTAD, World Investment Report (2000)

to decline, falling in 1999 to 24 per cent from 38 percent in 1997. Total flows to developing countries amounted to $208 billion, nearly one third of total developed countries' FDI inflows. China attracted $40 billion, alone one forth of developing countries' FDI inflows. Inflows into Africa rose by 19 per cent, from $7.5 billion to $9 billion in 1999. Recent FDI inflows to Africa have been growing faster than at the beginnig of the 1990s. This is because of the more business friendly environment created by many African Governments.

Table 3.2 FDI Inflows and Outflows, by Host Region and Economy,1997-1999 (Millions of dollars)

	FDI Inflows			**FDI Outflows**		
Host region/economy	**1997**	**1998**	**1999**	**1997**	**1998**	**1999**
World	473 052	680 082	865 487	471 906	687 111	799 928
Developed Countries	275 229	480 638	636 449	404 153	651 873	731 765
Developing Countries	178 789	179 481	207 619	64 335	33 045	65 638
Africa	6 896	7 519	8 949	1 617	648	935
Latin America and the Caribbean	69 172	73 767	90 485	15 050	9 405	27 325
Asia	101 575	96 504	105 621	47 418	22 818	37 239
Turkey	**805**	**940**	**783**	**251**	**367**	**645**
Least Developed Countries	2 524	3 715	4 527	1 047	111	386

Source: UNCTAD, World Investment Report (2000)

Table 3.3 FDI Inward and Outward Stock, by Host Region and Economy, 1998-1999 (Millions of dollars)

	FDI Inward			FDI Outward		
Host region/economy	**1995**	**1998**	**1999**	**1995**	**1998**	**1999**
World	2743391	4015258	4771981	2870624	4065798	4759333
Developed Countries	1967538	2690129	3230800	2607095	3649951	4276961
Developing Countries	739499	1240976	1438484	258265	403920	468744
Africa	66430	84372	93066	14499	16340	16974
Latin America and the Caribbean	204932	404621	485604	48165	77372	104580
Asia	461988	741311	846677	194237	308357	345206
Turkey	**5103**	**7570**	**8353**	**268**	**996**	**1641**
Least Developed Countries	16054	24286	28602	739	1574	1653

Source: UNCTAD, World Investment Report (2000)

FDI inflows to developing Asia increased by 9 per cent in 1999, reaching its record level of $106 billion. Despite the 1997-1998 financial crisis, the recovery started sooner than expected. China saw a drop of nearly 8 per cent in 1999, downing to $40 billion from nearly $44 billion (See Figure 3.4). This was a result of redirected inflows to other Asian countries, such as Republic of Korea and Singapore. And there was a slowdown of economic growth leading to weaker demand with increasing competition from neighbouring countries.

In East Asia (Hong Kong (China), the Republic of Korea; and Taiwan Province of China), FDI flows increased by nearly 80 per cent in 1999. In the Republic of Korea FDI reached another record level (it nearly doubled), over $10 billion, four times its precrisis level (1996). This is the result of more liberalized FDI policies led t o higher M&A-driven FDI growth. In South-East Asia, FDI decreased by 17 per cent in 1999. Singapore is the largest FDI recipient in this sub-reagion. Singapore attracted $7 billion with an increase of 27 per cent from the previous year. Flows to Malaysia icreased by 31 per cent and reached to $3.5 billion in 1999. Central Asia lost the FDI momentum it had enjoyed at its early stage of liberalization and reforms after collapse of Soviet Union. The share of Kazakhstan and Azerbaijan increased with oil and gas FDI inflows.

Aggregate FDI inflows to Latin America and the Caribbean continued to expand in 1999, reaching a new record of $90 billion, nearly aquarter than in 1998. A significant part of FDI flows came through M&As. The MERCUSOR countries

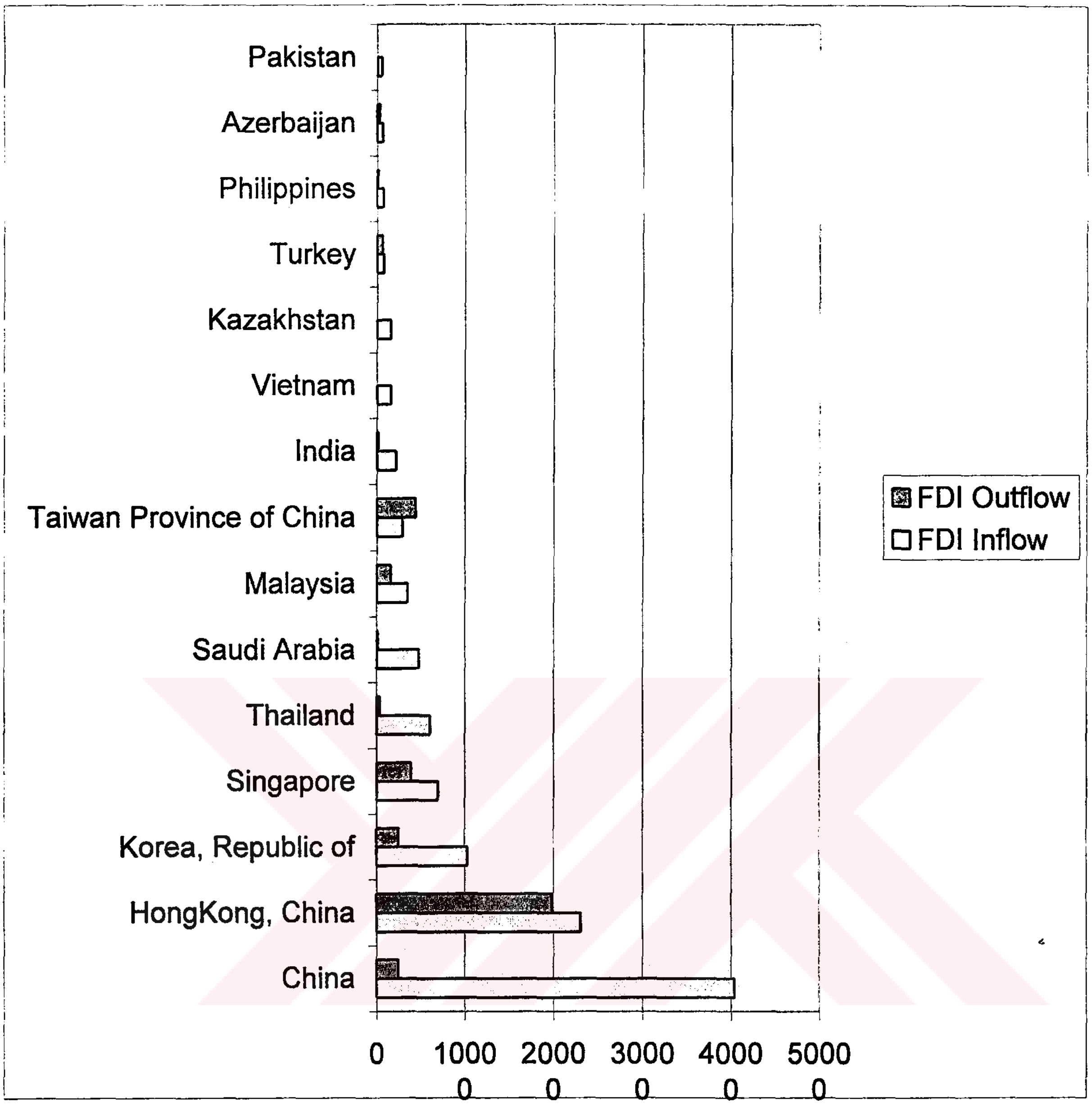

Figure 3.4 Asia and the Pacific: FDI Inflows and Outflows, Top 15 Economies, 1999 (millions of dollars), (ranked by FDI Inflows)

Source: UNCTAD, World Investment Report (2000)

(Argentina, Brazil, Paraguay and Uruguay, with Bolivia and Chile) increased their weight in total Latin American FDI inflows in 1999. despite its currency crisis in January 1999, Brazil enjoyed its leadership for 4 consecutive years, reaching $31 billion of inflows in 1999. Argentina more than tripled its 1998 level of FDI inflows, to reach $23 billion. Privatization related FDI greatly increased the inflows to Argentina.

FDI flows into Central and Eastern Europe increased for the third consecutive year. Annual inflows exceeded the amount of $20 billion. The Czech Republic, Hungary, poland and the Russian Federation continued to be leading recipients of FDI inflows. As in the case of Poland's leadership, large domestic market played a great role in attracting foreign investors.Also the privatization policies in Czech Republic increased the volume of FDI to a level of $5.1 billion in 1999. In the Russian Federation, after the dramatic fall in 1998, from $6.6 billion to $2.8 billion, FDI inflows were far from the previous record.

There is an uneven distribution of FDI flows and gaps between FDI inflows and outflows per capita between the regions. Developing countries face with more rigorous conditions at their respective shares in absolute values of world FDI inflows and outflows. (See Figure 3.5) In 1998, the value of per capita FDI inflows to developing countries as a group were about seven per cent of that for developed countries. This reflects the fact that developing countries recieve a smaller proportion of the world's FDI and yet account for the most of the world population. Also a similiar remark can be made as regards comparisions between outward FDI per capita (See Table 3.4)

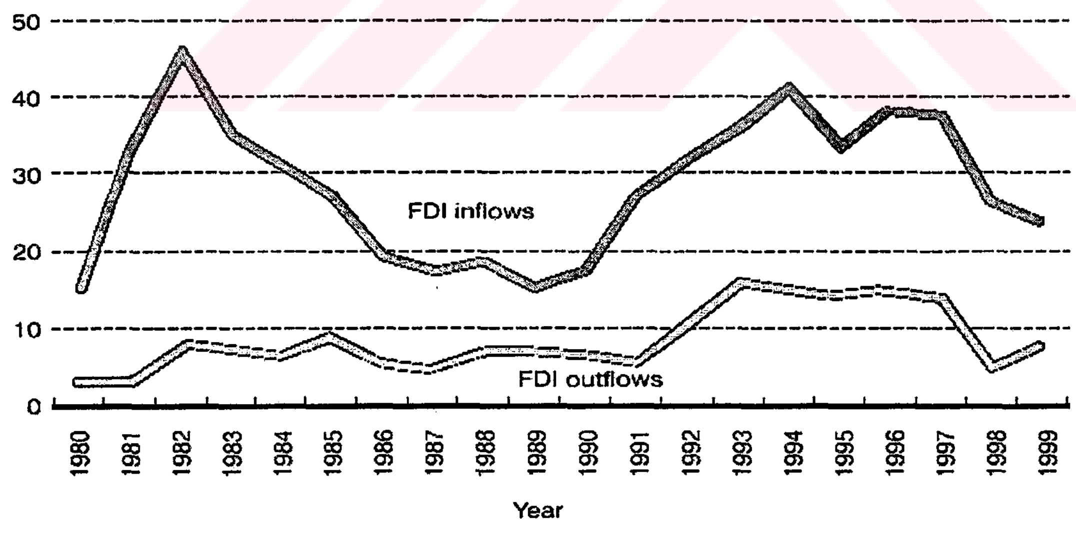

Figure 3.5 Share of developing countries in world FDI flows, 1980-1999 (Percentage)

Source: UNCTAD, FDI/TNC database

Table 3.4 Regional distribution of FDI inflows and outflows per capita, 1995-1998 (in dollars)

	Inflows				Outflows			
Region/country	**1995**	**1996**	**1997**	**1998**	**1995**	**1996**	**1997**	**1998**
Developed countries	238.6	240.3	309.3	518.3	350.4	364.0	460.2	669.5
Western Europe	317.0	300.0	350.1	614.8	457.8	530.5	623.4	1051.9
European Union	310.9	292.3	337.9	614.7	431.7	488.0	584.9	1032.1
Other Western E.	509.2	541.2	730.2	617.6	1280.0	1864.0	1826.3	1670.4
United States	220.0	283.7	402.2	706.4	344.7	277.7	404.8	485.2
Japan	0.3	1.8	25.7	25.3	180.9	186.9	206.9	191.8
Other developed c.	286.6	192.1	256.3	257.9	161.6	177.2	302.0	307.3
Developing Countries	23.8	29.8	37.4	35.4	11.7	13.01	14.1	11.1
Africa	6.1	8.5	10.8	10.9	0.7	-	2.0	0.7
Latin America and the Caribbean	69.7	96.2	140.1	144.8	16.0	15.0	32.0	31.2
Developing Europe	37.5	84.2	76.0	99.9	5.4	7.0	19.8	11.2
Asia	20.7	24.5	28.1	24.6	13.4	15.4	14.0	10.5
West Asia	-2.0	2.8	20.7	20.0	-4.1	9.7	9.3	8.1
Central Asia	21.0	28.3	42.1	41.6	-	-	-	0.1
South, East and South-East Asia	22.2	26.0	28.3	24.6	14.9	16.2	14.7	10.9
The Pacific	91.4	28.6	22.7	26.7	-0.5	0.1	3.3	3.8
Central and Eastern Europe	42.3	36.8	55.1	52.2	1.4	3.3	10.2	5.7
World	58.0	62.4	79.6	108.9	63.2	66.0	81.4	109.7

Source: UNCTAD, FDI/TNC database, World Investment Report (1999)

3.2.3 Investment Policy Developments

Because of the given importance of FDI, all countries today seek to attract more FDI and to make their policies more favourable to investors. Of the 140 changes in FDI laws in 1999, 131 liberalized conditions for foreign investors (See Table 3.5); Over 1992-1999 period, 96 per cent of the 953 policy changes favoured investors. These changes in national laws complemented by the conclusion of new bilateral investment treaties (BITs) between developing countries. There is an increasing numbers of BITs between developing countries. BITs are accompanied by double taxation treaties (DTTs). The increasing number of agreements are creating more favourable FDI regimes as well.

Table 3.5 National Regulatory Changes, 1991-1999

Item	1992	1993	1994	1995	1996	1997	1998	1999
Number of countries that introduced changes	43	57	49	64	65	76	60	63
Number of regulatory changes of which:	79	102	110	112	114	151	145	140
More favourable to FDI	79	101	108	106	98	135	136	131
Less favourable to FDI	-	1	2	6	16	16	9	9

Source: UNCTAD, World Investment Report (2000)

Note: More favourable includes changes aimed at strengthening market functioning, as well as increased incentives; less favourable includes changes aimed at increasing control as well as reducing incentives.

Changes in governments policies on FDI during 1999 strengthen the trend towards the liberalization, protection and promotion of FDI. Developing and transition economies reduced sectoral restrictions to foreign entry, or liberalized operations in industries earlier closed or restricted to FDI (See Figure 3.6). Ownership of land and real estate, employment of foreigners and foreign exchange controls reduced or removed. Legal guarantees on the protection of intellectual property rights and aginst expropriation and unfavourable changes in legislation were strengthened. Also the developing countries deregulated limitations on foreign entries. These changes aimed to strengthen competition, corporate governance, consumer and environmental protection.

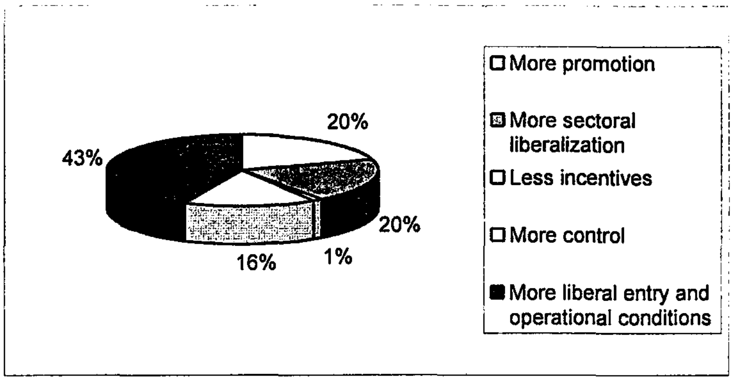

Figure 3.6 Types of changes in FDI laws and regulations, 1999

3.3 The Determining Factors of FDI in Host Countries

It is widely agreed that FDI takes place when three sets of determining factors exist simultaneously (UNCTAD, 1998):

1. The presence of ownership-specific competitive advantages in a TNC;
2. The presence of locational advantages in a host country; and
3. The presence of superior commercial benefits in intra-firm as against an arm's-length relationship between investor and recipent.

The ownership-specific advantages (e.g. proprietary technology) of a firm can compensate for the additional costs of establishing production facilities in a foreign environment and overcome the firm's disadvantages vis-a-vis local firms. The ownership-specific advantages of the firm should be combined with the locational advantages of host countries (e.g. large markets or lower costs of resources or superior infrastructure). And the firm finds greater benefits in exploiting both ownership-specific and locational advantages by internalization, i.e. through FDI rather than arm's-length transactions. There may be several reasons for this case. Markets for assets or production inputs (technology, knowledge or management) may be imperfect, if they exist at all, aand may involve significant transaction costs or time-lags. Additionally, it may be in a firm's interest to retain exclusive rights to assets (e.g. knowledge) which confer upon it a significant competitive advantage (e.g. monopoly rents).

The first and third conditions are firm-specific determinants of FDI, and the second is location-specific and has an important influence on a host country's inflows of FDI. If only the first condition is met, firms will rely on exports, licensing or the sale of patents to service aforeign market. If the third condition is added to the first, FDI becomes the preferred mode of servicing foreign markets, but only in the presence of location-specific advantages. Within the all three condotions for FDI to occur, locational determinants are the only ones that host governments can influence directly.

It is necessary to understand how TNCs choose investment locations for giving differences in FDI inflows. There are many discussions and negotiations on international investment frameworks (bilateral, regional and multilateral) which gather momentum and raise questions about establishing agreements for the location of FDI and activities of TNCs .

While the world economy becomes more open to international business transactions, countries compete increasingly for FDI, not only by improving their policies and economic determinants, but also implementing pro-active facilitation measures that go beyond policy liberalization. Direct investment abroad is a complex venture. FDI involves a long-term commitment to a business in a foreign country as distinct from trade, licensing or portfolio investment.FDI involves the engagement of considerable assets and resources that need to be coordinated and managed across countries and to satisfy the principal requirements of successful investment, such as sustainable profitability and acceptable risk/profitability ratios.

There are basically four elements of investment affecting the importance of different location-specific determinants. First, the motive for investment (e.g. resource-seeking or market-seeking FDI) (See Table 3.6), secondly the type of investment (e.g. new or sequential FDI),third aspect is the sector of investment (e.g. services or manufacturing) and lastly the size of investors (small and medium-sized TNCs or large TNCs). As the economic environment evolves over time, the relative importance of different determinants also change.The host country determinants that explain FDI changes as the structures of its domestic economy and of the international economy evolves. However, the location-specific determinants remain constant.

Host countries whose policies are most conducive to TNC activities offer good chances of attracting FDI. However, the firms also see locational determinants in their interaction with ownership-specific and internationalization advantages in the broader context of their corporate strategies. These strategies aim pursuing oligopolistic competition, and matching competitor's actions or looking for distinct sources of competitive advantage. In the context of different strategies, the same motive and the corresponding host country determinants can acquire different meanings. For example, the market seeking motive can translate, in the case of one TNC, into need to enter new markets to increase the benefits arising from multiplant operations; in the case of another TNC, it can translate into desire to acquire market power; and for another TNC, it can aim at diversifying markets as part of a risk-reducing strategy.

Table 3.6 Host Country Determinants of FDI

Host country determinants
1. Policy framework for FDI • economic, political and social stability • rules regarding entry and operations • standards of treatment of foreign affiliates • policies on functioning and structure of markets (especially competition and M&A policies • international agreements on FDI • privatization policy • trade policy and coherence of FDI and trade policies • tax policy 2. Economic determinants 3. Business facilitation • investment promotion • investment incentives • hassle costs (*related to corruption*, administrative efficiency, etc.) • social amenities (bilingual schools, quality of life, etc.) • after-investment services

Type of FDI classified by motives of TNCs	Principal economic determinants in host countries
A. Market seeking	- market size and per capita - market growth - access to regional and global markets - country-specific consumer preferences - structure of markets
B. Resource/asset seeking	- raw materials - low-cost unskilled labour - skilled labour - technological, innovatory and other created assets (brand names), including as embodied in individuals, firms and clusters - physical infrastructure (ports, roads, power, telecommunication)
C.Efficiency-seeking	- cost of resources and assets listed under B, adjusted for productivity for labour resources - other input costs, e.g. transport and communication costs to/from and within host economy and costs of other intermediate products - membership of a regional integration agreement conducive to the establishment of regional corporate networks

Source: UNCTAD, World Investment Report (1998)

3.3.1 Attractiveness for Foreign Investment in Developing Countries

Foreign investment play an important role in the economic growth of developing countries that need capital for their needs. It is important for the developing countries to attract more foreign investment. Developing countries have to influence the investor's choice or decision about making an investments in their country.

There are many differing aspects for every investor whose decisions vary according to their needs in investment. To explain the investor's concerns over investment , surveys are a good process to give recommendations to the host countries. Investors surveys consistently include five broad categories of concern in the developing countries and the economies in transition: (Moran, 1998)

1. Cultural factors (worker motivation, absenteesim, alcoholism, cultural preparation,etc.);
2. Labor regulations (flexibility in hiring and laying off workers);
3. Responsiveness of the surrounding economy in providing supporting goods and services;
4. Credibility of public-sector commitments about taxes, infrastructure, and other regulatory issues (often extending beyond the probable duration of any given government); and
5. Institutional base of commercial law (case law or common law) to provide precedent when disputes arise.

For explaining the factors above, some examples can be given for clarifying the objective of the foreign investor. In tropical or siesta environments, worker's motivation might change, and investors might worry about alcholism, absenteeism, and lack of a work ethic in the former communist states. The procedure to hire and lay off workers, the worker unions and the degree of supervision of workers give ideas to investor about labor regulations. Nearness to the supporting goods and services is that the availability of components in Far East for an electronic/computer investment or establishing an investment in oil-rich regions for petrochemical complexes. Input prices for feed-stock and local utilities to provision of infrastructure in investment determine the credibility of host government promises. And also interpretations of commercial law to independence and reliability of the judicial system itself explain the institutional factors in commercial law.

There is a more broad survey about the foreign investment. According to a survey conducted in 1992, there are 12 major criteria which an investor seeks in deciding to make an investment in a foreign country (USIA, 1992). These are:

1) Macroeconomic Policy Framework: Macroeconomic Policy Management has a large impact on foreign investor confidence in the host country, as countries that are economically well-managed are less likely to experience turbulent economic performance, which may excercise a negative impact on profitability for both local and foreign owned firms. Economic volatility raises uncertainty for investors.

Foreign investors respond to economic uncertainty in countries where thay have already invested by diminishing the size of their investment or by withdrawing from the country altogether. In countries where they are not exposed, foreign investors will not risk their capital until the economic situation becomes more stable. The most important aspect of macroeconomic policy stability centers on a low, predictable rate of inflation.

2) Currency Risk: The exchange rate of local currency in relation to major currencies (such as euro, dollar) directly affects the costs and profits of the foreign capital firms which evaluate their financial results on a consolidated global basis against the major currencies. Since a foreign capital firm makes an investment denominated in local currency, the risk of currency depreciation affects the value of financial assets after taxes as well as its earnings and profit expressed in major currencies.

Appropriate exchange-rate policy adjusts the value of the local currency on a steady, predictable basis, which contributes to economic stability and investors confidence. The exchange rate of the currency is important for the foreign capital firms which want to export from the host country as well as for the countries themselves, which seek to generate export earnings. Local currency that is overvalued hurts exports from the local country, because such exports are more expensive than exports from competing countries.

3) Labor Force: In the globalizing economy, foreign investors seek for arbitrage from many respects. The commodity is human labor and the price is wages. Wage arbitrage moves the production and jobs from high-wage labor market to another where the labor is much cheaper. The producers thus reduce their costs and enhance profits by arbitraging wage differences, and usually selling their finished products back into the high-wage markets (Greider, 1998)

However, foreign investors examine the quality of the local labor force because they must recruit their potential employees from that labor force. In many industries, particularly industries that use a high amount of labor to create a finished product, foreign investors seek to establish plants in developing countries to take advantage of their lower wage rates. It is important to note that pay scales are not the only determinant of the attractiveness of the labor force. Foreign investors also look at the quality of education in the host country, because better educated workers will be easier to train and will reach their peak output sooner than workers who are not well educated. Another factor in labor–force productivity is the degree of worker absenteesim. The costs and productivity of labor are key ingredients in the product competitiveness in the international market place.

4) Local Market Characteristics: The single most important factor centered on the attractiveness of the host country as a market for the products or services of foreign investors. The size of the local market, the relative wealth and purchasing power of the population and growth potential of these variables, as well as the economy as a whole, comprise the most basic criteria that foreign investors use to decide if a potential site merits further consideration. The country's natural resources and its geographic location are also important for foreign investor.

5) Market Access: Local laws and regulations that grant or do not restrict a firm's access to local markets may enhance its earnings potential and profitability. Countries where the state exerts a large degree of control over economic activity and restricts the private sector's freedom to conduct besiness are not attractive to potential investors.

6) Protection of Intellectual Property Rights: Intellectual property refers to a company's ownership of the intangible as well as tangible products of its own.

These include its manufacturing processes, software, and marketing techniques. In the major industrialized countries, a company's ownership rights are protected through the use of patents, copyrights, trademarks, protection of trade secrets and other laws covering proprietary technical data. Given that a significant proportion of their assets consists of intangibles, the protection of intellectual property is a high priority for foreign capital firms, particularly in dynamic industries such as telecommunications, where technology is a major competitive weapon in the development of new products and markets.

7) Capital Repatriaton: Investors focus on the regulations affecting their ability to take invested capital and profits out of the host country. Foreign capital firms can transfer profits to parent company through dividends, interest payments, royalties or technical assistence payments. In addition, foreign capital firms may wish to sell some of the holdings of the local company. Countries which restrict these activities have less attractive investment climates for foreign investors than countries which allow free movement of capital and profits.

8) Trade Policies: These policies affect the cost and ease or difficulty of moving imports into and exports out of the host countries. The cost of imported products is affected by the applicable tariff rate as well as by the local currency exchange rate. Import costs are important for manufacturers who use imported inputs in producing a finished product. Tariff rates that are higher compared to those in other countries raise the cost of a finished product of a foreign capital firm Since cost is a crucial factor in the competitiveness of exports in international markets, high tariffs make countries unattractive to foreign investors. Licensing procedures also affect the ability to export goods out of the host country. Many countries require exporters to go through several steps before they can ship their products. Fees may also be charged for exporters to obtain the necessary licences and permits. These requirements may increase costs and delay the appearence of the finished products at the market and therefore higher costs and delays make host countries less attractive and less competitive.

9) Government Regulation: The regulatory climate, a term used to describe how government regulations affect besiness operations, may have a very significant impact on operating efficiency and cost and therefore on firms' profitability and

competitiveness. An attractive regulatory climate is an important aspect in the investment decision. It is important to note that some degree of government regulation is essential in protecting the interests of producers and consumers and thereby ensuring the integrity and smooth functioning of th emarketplace. However, from the standpoint of foreign investors, too much regulation can create distortions that raise costs and cause markets and firms to function less efficiently. For example, many governments have labor laws designed to protect workers' jobs by making it difficult for firms to dismiss workers despite changing market conditions. Other laws may dictate wage rates for workers or may require firms to provide a host of benefits. These laws may raise costs for foreign investors.

On the other hand, policies and regulations discourage potential investors. Policies may dictate interest rates or designate priority sectors where available capital should be invested. Governments may create numerous procedures for getting foreign investments approved or establish bureaucratic requirements or restrictions that may hamper investor's ability to move their capital or profits into and out of the country quickly. Again, investors seek flexibility to enable them to respond too rapidly changing market conditions. Regulations that hamper firms' flexiblility thus serve as a deterrent to investment. Restrictions on firm's activities, such as when governments reserve specific sectors for state-owned enterprises, have the same effect.

10) Tax Rates and Incentives: A key factor in the investment decision involves how taxation affects a firm's normal operating environment. Excessive tax burdens on investments and profits will discourage the foreign investors from investing in a prospective host country. The tax burden involves not only tax rates, but the tax treatment of dividends, royalties, remittances, and other transactions between local subsidiaries and their parent companies. To improve their attractiveness relative to competing countries, many countries offer packages of tax and other incentives for foreign investors. These incentive programs may be helpful for host countries in attracting foreign investment.

11) Political Stability: This is the fundemantal aspect of the investment decision. Investors simply will not risk their capital in an environment that is percieved as unstable, because the risk of losing their investment will be percieved as too high.

Stable political environment give investors confidence that laws and regulations governing their investment and the markets in which they operate, will remain basically the same over the long term. This confidence is important, because when capital is risked in a direct investment, a long-term time horizon is usually required for the investment to generate the expected profits. Aside from the characteristics of the political regimes, the attitudes of government officials, labor leaders, and private sector leaders in the host countries also affect perceptions of the host country's stability and attractiveness as a site for foreign investment.

12) Infrastructure/Support Services: A host country's physical resources suc as roads, ports, airports, telecommunications networks and facilities, availability and cost of energy, have a great impact upon the cost and efficiency of production and transportation of products. Countries must strive to keep these resources modern and detect-free in order to maximize their attractiveness for foreign investment. Regardless of how well a country may rate in terms of investment criteria, one with poor infrastructure may have difficulties in capturing a significant amount of foreign investment.

Infrastructure also consists of the services necessary to support manufacturing operations. Thses services include those provided by law, insurance, and accounting firms; commercial and investment banks; and transportation facilities via air, sea, and land. Raw materials and other manufacturing inputs must be available in sufficient quantities and at competitive prices. Stable, secure relationships with local suppliers are also important. Strong local service and supply companies both benefit from and contribute to attract foreign investment.

The all these factors mentioned above determine how a country is attractive for foreign investment. The high levels of investment friendly factors easily affect the foreign investor's choice.

3.4 FDI and Development

Most developing countries today consider FDI as an important resource for their development. However, it is almost impossible to measure the economic effects of FDI with precision. It is widely belived that FDI is a source for reaching sustainable development in developing countries which are in need of fresh capital. Because of their lack of capital, human or natural resources, and technology, developing countries have difficulties in providing better living conditions for their citizens.

That is simply how FDI will tend to improve economic performance in the host country on the following grounds (Dyker, 1999):

1. It will generally helps the host economy to integrate into the global economy.
2. It will increase the aggregate rate of investment.
3. It will generate transfers of hard technology - the technology of process and product.
4. It will generate transfers of soft technology - the technology of management, organization, sourcing and marketing.
5. It will tend to induce patterns of networking and subcontracting with other firms in the host country which are conducive to a general increase in levels of technology and productivity.

Developing countries try to attract foreign investors for increasing the growth of its industrial capital stock, its industrial output and experience at every level while foreign investor aims to maximize its profits or returns on expertise and management. It can be said that sucessfull foreign investments may give benefits in the following terms (Akan, 1999):

- It helps in the transfer of technology and skills;
- It provides management and training of local managers;
- It can help in the training of workers and the creation of indigenous skills in administration, marketing, and other business techniques;
- In appropriate forms and with appropriate safeguards, it can contribute to the growth of local entrepreneurship;
- It may, by changing the market structure, contribute to more vigorous competition;
- It helps in establishing contacts with overseas banks, capital markets, markets for products, sales organizations and other institutions and it opens a previously closed society to world-wide influences;

- It may also contribute indirectly to filling the savings and foreign exchange gaps by contributing to tax revenue;
- It may create, directly and indirectly, employment opportunities;
- It may raise domestic wages, or improve the terms of trade.

But there are also many opposing considerations about foreign direct investment. It may provide too few, or wrong kind of resources and assets and fail to adjust to localized capabilities and needs. The incentives made by host governments may create anti-competitive practices, leading to an unacceptable degree of market concentration. It also can limit the upgrading of indigenious resources and capabilities by restricting local production to low value-added activities and importing the major proportion of higher value-added intermediate products. Lower taxes paid to host governments may restrict the growth of GDP and decrease the tax revenues. The imbalances between the exports and imports of FDI firms may put pressures on the balance of payments of developing countries. And also it may cause political, social and cultural unrest or divisiveness by the introduction of unacceptable values (e.g. labour practices, environmental considerations, etc.) and by the direct interference of foreign companies in the political system.

4. FOREIGN PORTFOLIO INVESTMENTS

Liberalization of the financial markets enabled people to invest in the international markets much more easily than before. Diversification and higher returns are the main factors in promoting international investments. Today the developed countries are generally net exporters of capital whereas the emerging market countries are the net importers. Following their financial liberalization, emerging markets have shown a remarkable growth in recet years. Because of higher returns, international investors are too eager to invest in emerging markets. This lead to a rapid incease in international capital flows.

Portfolio investment is the capital invested in instruments like shares, government bonds and T-bills and other instruments in the foreign capital markets by foreign investors who undertake additional risks such as political risk, exchange rate risk and information risk. The investors direct their funds on equities like stocks, bonds and other capital market instruments in order to recieve interest and dividend earnings. The portfolio investors are the ones whose stake in the companies they buy is not sufficient to give them control or influence in the running of the corporations.

Portfolio investment is motivated primarily a search for immediate financial gain and the time horizon is also short term. This short term orientation may make these investment flows quite volatile at times and may contribute to the emergence of crisis. Unlike FDI, portfolio investment is fully mobile at low cost. Because of their volatility, portfolio investments can cause drastic distruptions in private capital flows during crisis which may then spill over into the real sector since such investments are a significant source of productive resources, especially for developing countries.

4.1 Classification of Risks for Foreign Investors

Risk means uncertainty about future rates of return and is usually defined as the probability of obtaining a return less than expected from an investment. The probability of changes in earnings of international investments represent the total risk. Total investment risk varies according to sector, region, financial instrument and investor's choices. There are three major risks in international investments (IMKB, 1993) :

- Global risk
- Country risk
- Micro-economic risk

With a theoretical approach towards the risk, total risk has two main sources:

- Systematic risk
- Unsystematic risk

Systematic risk is a non-diversifiable risk that affect each assets in a market, so it is also called market risk. It is not affected from the own dynamics of the financial organization that it belongs to but from some factors such as war, stagnation, high interest rates, etc. It is not possible to avoid from the systematic risk with portfolio diversification. In other terms the risk that can not be eliminated through portfolio diversification is said to be systematic risk, and it is the risk that is common to all assets in the market. Even for a global portfolio, there will be a systematic risk, that of the global factors. The sources of the systematic risk are the changes in the political, economic and social environment.

Unsystematic risk is totally because of the company or the institution that the assets belongs to. It has no relation with the market. Thus, unsystematic risk depends totally on the financial, industrial and managerial power of the company. Even sometimes, other companies in the same sector, are not affected from the same kind of treatment. Unsystematic risk can be eliminated through portfolio diversification, and it is the risk that is not common to all assets. There are the sources of the unsystematic risk and unsystematic risk can be decreased by a well-diversification.

Unsystematic risk is the total amount of the risks of the country and the firm. Inefficient management of a firm cause a firm failure which can be defined as an unsystematic risk. But the impact of the global oil crisis over a firm can be defined as systematic risk. Country and global risks affect each investment at different levels. It depends on the country risk and micro-economic risk of the investment.

4.1.1 Global Risk

All events that affect comprehensively the world markets at the same time period, constitute the global risk. Today international financial markets increasingly integrate more with each other. The full integration of the markets increases the level of global risk. The Gulf Crisis, or the Global Oil Crisis are the best examples of global risk.

The best indicator of global risk, is the flactuations of incomes of international financial instruments or the supply and demand situation of the substantial commodities widely traded in international markets. The increase in oil prices easily put pressures on the price of the manufactured goods.

Although there is no way of making a risk-free investment; miltinational corporations might minimize their risk by investing in different regions and different sectors through portfolio diversification. However even with best diversification, a global will exist in all investments.

4.1.2 Country Risk

The country risk, which is very different from the global risk, includes various risks such as financial risk of that country, exchange rate system, allocation of resources, debt service capacity and market indicators. The country risk accepted, as a systematic risk for a local investment will become an unsystematic risk in a global portfolio. There are four factors in determining the country risk (Shapiro, 1991):

1. Fiscal Risk: It is the ratio of budget deficit over to gross national product.
2. Controlled Exchange Rate System: Tight currency controls and threat of depreciation of the currency are major factors causing the foreign investors flee host country.
3. Inefficient Government Spending: The growth with foreign debt increases the possibility of subsidizing consumption other than efficient investments. This increases the level of country risk seriously.

4. Country Resources: Lack or inefficient use of natural, financial and human resources increases the risk of a country.

And also there is another risk determining criteria made by Euromoney (IMKB, 1994):

1. Analytic Indicators: Three economic ratios. Debt service/exports, balance of payments/gross national product and foreign debt/gross national product.
2. Credit Indicators: Payment records and new payment service plans are examined to determine general credibility of a country.
3. Market Indicators: Providing the liquidity with entry into bond markets, short-term financial assets acquisition, and sustaining this liquidity in secondary markets are examined.

Besides the above mentioned factors, the monetary authorities and their turnover rate are quite important indicators to portfolio investors. The higher the turnover rate, the higher the risk to invest in that country.

4.1.3 Micro-economic Risk

The microeconomic risk includes the financial risks of the companies. Micro-economic risks are alway non-systematic, whether in a local or international market. Basically, investors focus on the analysis of sector and firm in which investment will be made. After determining the country of investment, investor tries to select the appropriate firms for investment. Financial ratios are the best tool to determine the firm's capabilities. In evaluating the return of a portfolio investment in international markets, the investor is faced with several risks different than the risks of investing in the home country. These risks mainly include market risk and foreign exchange risk. Market risk can be defined as variability of returns associated with fluctuations in the overall market, specifically the local market in which the investment commitment is being made. Foreign exchange risk is a risk of variability in investment returns associated with changes in exchange rates. Foreign exchange risk is encountered whenever one makes a foreign investment (Stanley,1995).

4.2 Factors Affecting Portfolio Investments

International investors aim to benefit from the high-returns and arbitrage oppurtunuties in emerging markets. Providing this, they include emerging market securities in their portfolios through diversification motive. The underpriced securities in emerging markets provide promising returns for international investors. Before entering an emerging market, investors are very sensitive to the structure of the market. They analyze political stability, legal framework and liberalization policies related with economic arena.

4.2.1 Political Stability

The political stability is very important for foreign investors when they are about to decide whether to invest or not. Political structure represent the country risk of the investment. The political problems and instability create uncertainties and suspicions in the minds of investors. It is obvious that investors seek comfortable investment areas in which decrease the level of risk exposed. The changes in the economic environment due to political considerations affect foreign investors negatively. High rates of taxes, restrictions on investment structure, controls over profit transfers make investors reluctant to invest in such a country and investors shifts their investment towards more investment-friendly countries.

4.2.2 Legal and Regulatory Factors

Constructing and reinforcing the regulatory framework is essential for emerging markets to attract foreign investors and reduce systematic risk. Free markets are more efficient than the markets under government contol. So developing countries had been liberalized their economies to attract more foreign investors. Government had changed from economic actors to economic regulators.

Developing countries are changing more legal infrastructure in conforming to that of developed countries. Removal of the restrictions over financial institutions's operations in a market, plays a substantial role to integration of all markets in the world. Investors are most concerned with protection of property rights and transparency. Transparency and openness in economic activities create more comfortable markets for foreign investors and the efficiency of a market increasingly develops with predetermined rules and regulations. There are some factors in reaching an efficient market; these are conformity with developed markets, cunducting high standards in accounting, derrivative instruments, dissemination of information to public, preventing manipulative and insider trading acts, etc.

4.2.3 Liberalization of Economic Policies

With changing economic structure towards a more integrated market, net private capital flows to developing countries increased in the last decade. Internationally integrated markets increased the capital flows from mature markets to emerging markets and the volume of the transactions. Removal of currency and capital controls, liberalization of the financial markets and privatization efforts are vital for market efficiency and liquidity. Increased portfolio flows to emerging markets provide overall integration of fonancial markets in the long-run.

The degree of currency controls in a market determines the exchange rate risk in a country. Hardships in capital transfers and rapid depreciation of currency put pressures on investors. Developing countries are removing all barriers in capital movements in and out of their country. For an efficient market, governments liberalize their financial markets providing financial deepening and liquidty to attract more foreign investor. Both removing the restrictions over capital and privatization provide fully liberal financial markets. Governments delegate its role in economic arena to market mechanism. Privatization efforts in making increased productive investment provide competition and efficiency in market while providing financial deepening and liquidty in capital markets. Lessening of trade barriers and low tariffs open market towards outside competition. And foreign investors decide to invest in these markets.

4.3 Instruments for Portfolio Investments

Globalization requires efficient communication technology and dismantling of regulatory constraints. These tendencies in world wide investment environments have encouraged international investing in recent years. Foreign investors use very different financial instruments in channeling their investments all over the world.

There are a large variety of mechanisms through which portfolio flows are channeled into emerging markets. The principal mechanisms are American Depositary Reciepts (ADR) and Global Depositary Reciepts (GDR), country funds, venture capital funds, convertible bonds and bonds with equity warrants. Countries may prefer to direct portfolio flows through specific mechanisms in order to protect their markets from externally exposed impacts.

4.3.1 American Depositary Reciepts (ADR) and Global Depositary Reciepts (GDR)

Depository reciepts are securities tradable in an investor's home country that represent a given number of shares of companies underlying stock trades abroad. Depositary reciepts are usually listed on in internationally recognized exchange (Price,1994).

ADRs are negotiable certificates that certify that the holder owns shares of a foreign company that are on deposit in the company's home market. It is generally created by the deposit of the securities of a non-US company with a custodian bank in the country of incorporation of the issuing company. ADRs overcome many of the investment restrictions, transaction costs, and informational problems associated with investing in foreign securities (Bekaert, 2000). ADRs are US dollar denominated and are traded in the same way, as are the securities of US companies. The holder entitle to the same rights and advantages as owners of the underlying securities in the home country. Several variations have developed over time to meet more specialized demands in different markets. GDR is something like ADR, the difference is issuence takes place more than one market and at the same time in international markets Also there are International Depositary Reciepts (IDRs), Continental Depositary Reciepts (CDRs) and European Depositary Reciepts (EDRs) (Vurgun, 1994).

ADRs lower the cost of trading non-US companies' securities. The depositary provides both settlement and clearance services. In addition, a major advantage of ADRs for investor is that dividends are paid promptly and in US dollars. These advantages provide an incentive for investors in US capital markets to invest in the equity of emerging markets via ADRs.

Table 4.1 General Benefits of Depository Receipts

For Issuer	For Investors
• Issuer sharpens image of the firm with entering U.S. financial market • Issuer expands and diversifies shareholder's composition • ADR prices can be arranged with other competitor firms • Local stock prices may increase with global demand and transactions • Issuer's shares increase its marketability with liquidity	• Institutional investors who were only limited to invest in U.S. securities, have the ability of diversification with ADR • Foreign investors have the ability to change shares into ADR in terms of U.S. dollars • Investors have the ability to reach U.S. settlement and custody system • Stock prices offered in terms of dollars and dividens are paid in dollars

4.3.2 Country Funds

There are ways to invest indirectly through investment funds internationally. A closed-end fund is an investment that buys stocks in the market; in turn shares of the closed-end fund are listed on some national market and are traded at a price determined by the supply and demand for fund. Closed-end funds differ from open-end funds in the sense that they are never liquidated and the number of shares of the fund remains fixed.(Solnik,1996)

A closed-end country fund is an investment company that invests in a portfolio of assets in aforeign country (e.g., an emerging market) and issues a fixed number of shares domestically (e.g., in the United States). Each fund provides two distinct market-determined prices. The country fund's share price quoted on the market where it trades, and its net asset value determined by the prices of the underlying shares traded on the foreign market. (Bekaert, 2000) Investors invest in country funds for two benefits. First, they offer a simple way to access the local market of the fund and benefit from international diversification as they are just managed portfolios specializing in the stocks of a specific country. In addition, country funds, approved by local government, are a way to overcome foreign investment restrictions. Foreign investment restriction is the second motive for the creation and use of some of these country funds. Overall emerging market country funds are most often closed-end funds, while regional and global emerging market funds are often open-end funds.

Introduction of country funds drives up the prices of local companies and reduces the cost of capital. The country fund essentially renders the local market partially integrated with global markets. Country funds can also provide indirect benefits to emerging markets by applying pressure for improvement of disclosure and accounting standards, as well as greater transparency.

4.4 Portfolio Investments in Emerging Markets

Substantial flows of foreign portfolio equity investment to emerging markets is a recent phenomenon dating only from the early 1990s. Two major factors lie behind the rise in foreign portfolio equity investment flows into emerging markets: the liberalization and globalization of financial markets and the concentration of substantial financial resources in the hands of institutional investors. Investments into emerging markets have been facilitated by the rapid provision of market information made possible by improvements in communications technology and the willingness of portfolio equity investors to bear greater risks in the expectation of reaping higher returns in these new and fast growing markets. The higher returns have been made possible by the sustained superior growth performance of emerging markets in comparison to that of developed economies during 1990s. Stock market capitalization in emerging markets has also grown much faster than that in developed countries.

However, as in the case of FDI flows, portfolio equity investment flows have remained skewed towards a small group of mostly upper middle-income emerging markets with impressive growth performances and prospects. This is not surprising. For many large institutional investors, it is more attractive to invest in more mature emerging markets that tend to have relatively large market capitalization and provide high liquidity levels, relatively fast and reliable settlement systems and a generally more developed market infrastructure.

In the light of vastly increased volume of foreign portfolio equity investment flows to emerging markets , the impact of these flows on host-country economies is likely to be significant. Although such investments can make an important contribution to the financing of equity capital of local companies, concerns have been expressed by host countries particularly as regards the volatility of these flows and their effect on exchange rates.

In 1993, net flows to emerging countries tripled, reaching US$ 51 billion, from the previous year. However, the level of these flows fell in the two subsequent years in response to the Mexican peso crisis, with US$ 35.2 and 36.1 billion, in 1994 and 1995 respectively. But it recovered in 1996, reaching US$ 49.2 billion.Unfortunately, Asian Crisis and Russian Moratorium in the next two years, decreased net flows of equity portfolios down to US$ 15 billion in 1998. In 1999, equity flows increased by 77 per cent to be reach US$ 27.6 billion.

World total market capitalization was US$ 36 trillion in 1999, with an increase of some 13 per cent from the previous year. Developed markets accounted for 91 per cent of total market capitalization with US$ 32.9 trillion, while emerging markets had only US$ 3 trillion (See Figure 4.1). There is an uneven distribution of market capitalization. It is in favor of developed markets, for example the United States had almost half of the world market capitalization (See Table 4.2).

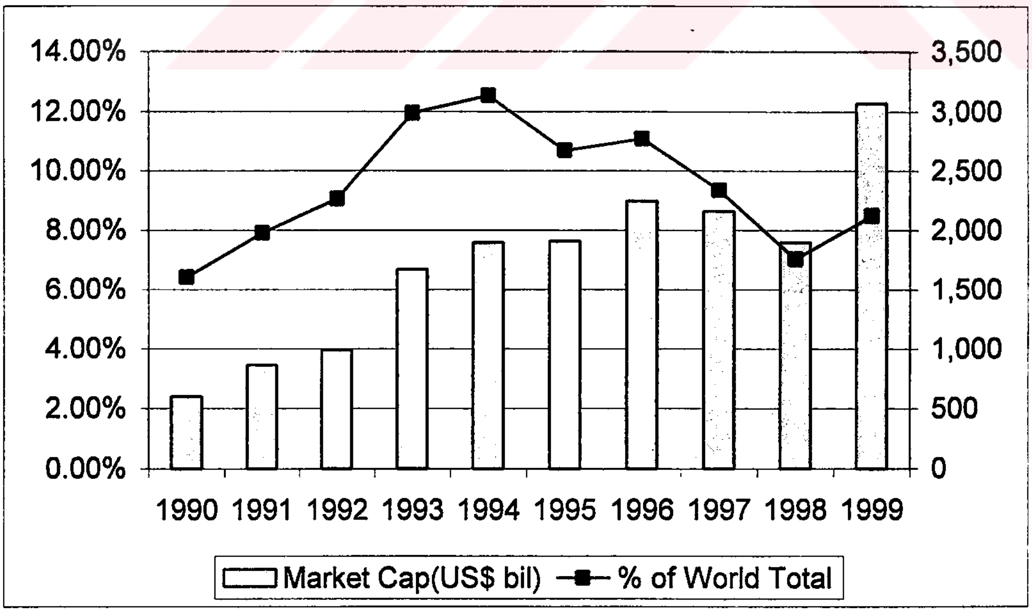

Figure 4.1 Emerging Markets'Share of World Market Cap, 1990-1999
Source: S&P (2000)

Growth in capitalization in emerging markets over the last decade first increased remarkably from 6 per cent to 12.5 per cent in the first half of last decade peaking in 1994, but later its share decreased to 8.5 per cent; total capitalization grew from US$ 604 billion in 1990 to US$ 3 trillion in 1999 (See Figure 4.1) (S&P, 2000).

As of end of 1999, emerging markets represent 85 % of the world's population, but only 22 % of its GNP and 8.3 % of the world's stock market capitalization. That 155 countries are classified as emerging markets with US$ 9,360 or less per capita GNP, whereas 51 countries as developed, totalling 206 markets worldwide. The average GNP per capita of emerging markets is US$ 1,246 against US$ 25,480 GNP per capita in developed markets.

Emerging stock markets posted strong positive returns in 1999, ending the Asian market crisis that rippled through developing equity markets in 1997 and 1998. The S&P/IFCI Composite Index surged 63.5 % in dollar terms. In 1999, Turkey ranked first with 255.6 %, price index change in dollar terms. (See Table 4.3) Russia (242.6 %), Malta (177.6 %), Zimbabwe (150.3 %) and Finland (136 %) followed Turkey. It is evident that emerging markets performed well in 1999. There were very little developed country among the top 20 market performers.

At regional basis, European shares gained best returns, S&P/IFCI Europe Index climbed 80.3%. Other regions, posted equally notable returns. The S&P/IFCI regional index for Asia gained 70.5 % in 1999, while its Latin america and Middle East/Africa counterparts rose 56.9 % and 49.1 %, respectively.

Table 4.2 World Rankings of Market Market Capitalization, Value Traded, and Number of Domestic Companies, 1999

Rank	Market	Total Market Cap (US$ millions)	Rank	Market	Total Value Traded (US$ millions)	Rank	Market	Number of Listed Domestic Companies
1	U.S.	16,635,114	**1**	U.S.	18,574,100	**1**	U.S.	7,651
2	Japan	4,546,937	**2**	Japan	1,849,228	**2**	India	5,863
3	U.K.	2,933,280	**3**	U.K.	1,377,859	**3**	Romania	5,825
4	France	1,475,457	**4**	Germany	1,357,841	**4**	Canada	3,767
5	Germany	1,432,190	**5**	Netherlands	941,804	**5**	Japan	2,470
6	Canada	800,914	**6**	Taiwan	910,016	**6**	U.K.	1,945
7	Italy	728,273	**7**	France	769,951	**7**	Australia	1,217
8	Netherlands	695,209	**8**	Spain	744,315	**8**	Egypt	1,032
9	Switzerland	693,127	**9**	Korea	733,591	**9**	France	968
10	Hong Kong	609,090	**10**	Switzerland	538,955	**10**	China	950
11	Spain	431,668	**11**	Italy	536,475	**11**	Germany	933
12	Australia	427,683	**12**	China	377,099	**12**	Bulgaria	860
13	Taiwan	375,991	**13**	Canada	364,625	**13**	Slovakia	845
14	Sweden	373,278	**14**	Hong Kong	244,886	**14**	Pakistan	765
15	Finland	349,409	**15**	Sweden	238,237	**15**	Malaysia	757
16	China	330,703	**16**	Greece	188,722	**16**	Korea	725
17	Korea	308,534	**17**	India	122,247	**17**	Spain	718
18	South Africa	262,478	**18**	Finland	111,585	**18**	Hong Kong	695
19	Brazil	227,962	**19**	Australia	105,999	**19**	South Africa	668
20	Greece	204,213	**20**	Singapore	97,985	**20**	Israel	644
26	**Turkey**	**112,716**	**22**	**Turkey**	**81,277**	**29**	**Turkey**	**285**

Source: S&P, Emerging Stock Markets Factbook (2000)

In developed markets, NASDAQ 100 performed well with 85.6 %, while S&P 500 just rose 19.5 %. Equities in developed European markets also performed well with the FTSE-100, CAC-40, and DAX indices climbing 14.1 %, 36.2 %, and 23.9 %, respectively in dollar terms. Also Japan's Nikkei 225, climbed 50.7 % in 1999.

Table 4.3 World Stock Market Performance, 1999 (Ranked by % Change in Price Indices in US$)

Rank	Market	%Change in Price Index	Rank	Market	%Change in Price Index
1	**Turkey**	**255.6**	**26**	Saudi Arabia	42.3
2	Russia	242.6	**27**	Pakistan	39.9
3	Malta	177.6	**28**	China	38.2
4	Zimbabwe	150.3	**29**	Iceland	37.9
5	Finland	136.0	**30**	France	36.2
6	Cyprus	132.8	**31**	Costa Rica	35.5
7	Korea	110.4	**32**	Chile	35.4
8	Indonesia	99.1	**33**	Argentina	33.4
9	India	81.5	**34**	Canada	32.6
10	Mexico	79.6	**35**	Iran	29.8
11	Brazil	67.0	**36**	Norway	28.2
12	Greece	66.1	**37**	Luxembourg	24.2
13	Hong Kong	64.6	**38**	Germany	23.9
14	Singapore	58.7	**39**	Poland	22.3
15	South Africa	56.1	**40**	Peru	21.0
16	Israel	55.7	**41**	Armenia	20.4
17	Sweden	54.9	**42**	Ukraine	20.2
18	West Bank	52.7	**43**	Australia	19.5
19	Taiwan	51.5	**44**	United States	19.5
20	Japan	50.7	**45**	Tunisia	16.8
21	Nepal	47.1	**46**	Egypt	15.7
22	Thailand	47.1	**47**	Hungary	15.2
23	Botswana	45.6	**48**	United Kingdom	14.1
24	Malaysia	43.6	**49**	Netherlands	12.5
25	Estonia	42.3	**50**	Italy	9.9

Source: S&P, Emerging Markets Factbook (2000)

Also Turkey gained momentum with IMF/World Bank loan package and invitation to become a European Union candidate and ranked first in 1999. However, Turkey was among volatile markets with its high turnover rate. (See Table 4.4)

Table 4.4 Stock Market Turnover of Some Selected Countries, 1999

Rank	Market	Turnover Ratio (%)
1	Macedonia	348.3
2	Korea	346.7
3	Pakistan	340.1
5	Spain	178.5
7	China	134.2
9	U.S.	123.5
10	**Turkey**	**111.1**
11	Germany	107.5
13	Hungary	94.9
15	Norway	90.2
16	Thailand	89.2
20	Switzerland	78.0
22	Sweden	73.1
24	Portugal	63.0
25	France	62.4
28	Canada	54.2

Another indicator of capital flows is the net capital flows to emerging markets. In 1999, emerging market asset prices saw strong increases, as fundamentals in many countries improved and the domestic and external financing situation of most emerging markets continued to recover from the crisis of Asia, Russia, and Brazil between mid-1997 and early 1999. Net private flows increased with the momentum of portfolio investments of US$ 23.3 billion and negative bank loans. (See Table 4.5)

Table 4.5 Net Private Capital Flows to Emerging Markets, 1996-1999 (US$ billion)

	1996	1997	1998	1999
Total net private capital flows	215.9	147	75.1	80.5
Net foreign direct investment	113.2	138.6	143.3	149.8
Net portfolio investment	77.8	52.9	8.5	23.3
Bank loans and other	24.9	-44.0	-76.7	-92.5

Source: IMF, World Economic and Financial Survey, 2000

5. THE IMPACTS OF FOREIGN INVESTMENTS ON TURKEY

The history of foreign investments goes back to the 19th century in Turkey. Capital flows started in 19th centry while direct investments mainly started in 1950s with 6224 numbered Foreign Investment Law. The most remarkable period was 1980s, witnessing great changes in economic area. The economic liberalization started, and the volume of capital flows both direct investment and portfolio investments increased year to year.

Today the degree of openness of Turkish economy; i.e., the environment in which capital transactions take place, is very much liberal and legal framework of foreign investment established well. However, Turkey failed to attract foreign investments, especially direct investment which has long-term perspective. Even after the first half of the 1990s, Turkey suffered from economic and political instability. And Turkey faced with economic crises which have both domestic and global roots. Now the bank credits are the most dominant form of the capital flow in Turkey and that the Turkish financial markets are quite well integrated with the world financial markets. Even though the magnitude as well as the direction of the flows depend on the measures used, capital flows are not of significant importance in Turkey, compared to that of Latin America and Asian countries.

5.1 The History of Capital Markets in Turkey

Turkish securities market have their roots in the second half of the 19th century with the development of the Dersaadet Tahvil Borsası (Dersaadet Securities Exchange) in 1866. Common shares in international markets were traded by telegram. In the 1890s, Istanbul's Securities Exchange was among the leading exchanges in Europe. In 1985, the Istanbul Stock Exchange was second only to the London Stock Exchange in terms of transaction volume. (Yuce, 1996) The name was changed as "Istanbul Esham ve Tahvilat Borsası" in 1906 and a new security law was passed that imposed new regulations and prohibited foreigners from becoming members of the exchange. The operational principals of today's ISE were put by the regulations that were enacted in 1922. The name ISE was given by Decree No 1447 enacted in 1929 which also regulated the trade of bonds, shares and foreign exchange.

In the first years of the Republic, foreign exchange transactions took place as well however after the 1929 World Depression, tight restrictions were put on the foreign exchange transactions which made it meaningless. The ISE was moved to Ankara in 1938 but came back to Istanbul in 1941. For the next 40 years the Exchange remained insignificant and was limited only to the trading of corporate bonds on an over-the-counter market, in particular those issued by Turkish investment and development banks for sound industrial projects. The stock market generated little interest domestically and internationally.(Özden, 1996)

In 1980s Turkey suffered from Banker Crisis and lost confidence on capital markets. The Central Bank had no control over the bankers. Anyone could become a banker and offer notes with high interest rates. In 1981 the crisis broke out, damaged Turkish economy. The primary cause of "the bankers event" was the hyperinflation (80-90 %) of that period. Hyperinflation caused the interest earned on the certificates and bonds to be negative in terms of real earnings. The crisis caused the government to prepare and pass the Capital Market Law on July 28, 1981. Capital Market Board was established as the primary regulatory and supervisory authority of the security exchange.

5.2 Istanbul Stock Exchange (ISE)

In October 1983, the government issued a decree concerning the operation of a security exchange. The Istanbul Stock Exchange was established on January 1, 1986. The new exchange is a semi-autonomous organization whose opeartions are controlled by a Capital Markets Board (CMB). In 1986 the CMB introduced some regulations about auditing, reporting and subsequently about financial statements and reports.

In 1989 the Foreign Exchange Regime was amended by the Decree No.32 enabling residents to invest in Turkish securities and residents to invest in foreign securities.

In addition to the stock market, the first secondary bonds market was formed at the ISE in June1991, to provide investors with well-orginised environment in which to trade corporate and government bonds and treasury bills. It also increased the depth and efficiency of the secondary market. In 1991, the volume of the bonds and T-bills started with US$ 312 million, reached US$ 83.8 billion at the end of 1999, and US$ 206 billion at third quarter of 2000 (See Figure 5.1). The Repurchase and Reverse Repurchase Market was opened in 1993 and reached a trade of US$ 4.8 billion in its first year. The volume in 1999 reached US$ 589 billion, and US$ 656 billion at third quarter of 2000.

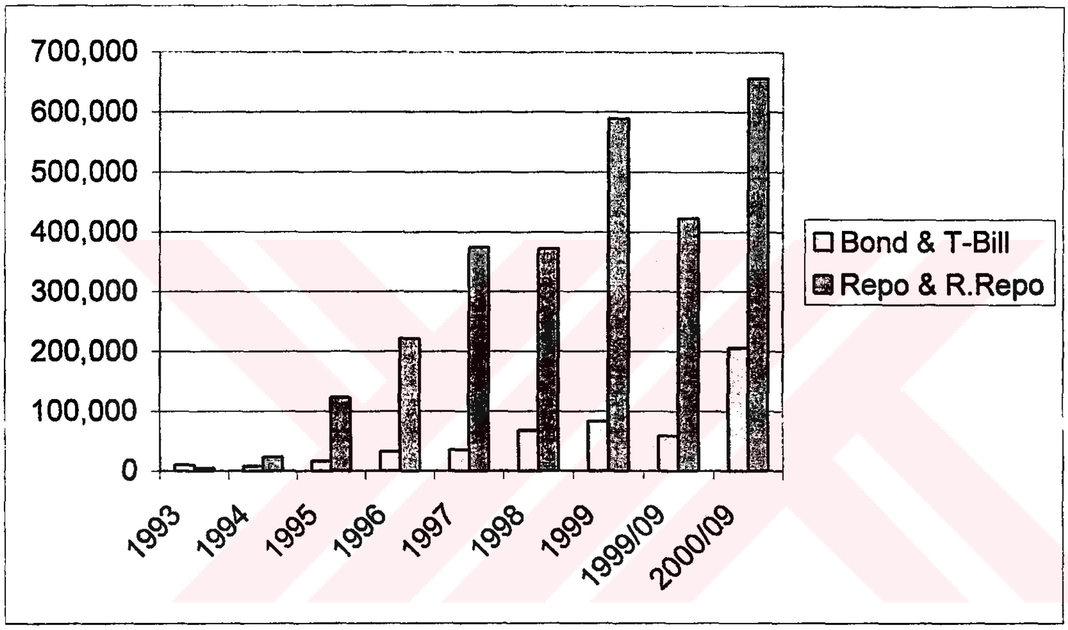

Figure 5.1 ISE Annual Bond & T-bill and Repurchase & Reverse Repurchase Markets Trade Volume, 1993-2000/09 (US$ million)

Following a fast development period after its establishment, the ISE has become an internationally recognized stock exchange in Europe and in the world. The ISE is recignized as a 'Designated Offshore securities Market' by the US Securities and Exchange Commision' and as an appropriate foreign investment market for private and institutional Japanese investors by the Japan Securities Dealers Association. Also the ISE presides over the Federation of Euro-Asian Stock Exchanges (FEAS), which brings together 22 member exchanges from 19 countries in the Euro-Asian region. The FEAS aims to encourage cooperation among members in order to promote integration to list and trade stocks commonly. The ISE is a full member of the 'Federation Internationale des Bourses de Valeurs' (FIBV), the 'International Society of Securities Administrators' (ISSA), the 'International Securities Market Association' (ISMA), and the 'European Capital Markets Institute' (ECMI), and the World economic Forum (WEF).

In 1990s the ISE developed with a rapid growth. Daily average trading volume surged to US$ 356 million, an increase of 25 per cent from the previous year. (See Table 5.1) The ISE National Index made a strong comeback in 1999, closing the year with a surge of 242 per cent. Turkey ranked first among the world exchanges with its tremendous return. However, Turkey performed worst in 2000, and the National Index collapsed down to 817.49 at the end of the year.

Table 5.1 Statistical Comparison of ISE, 1995-1999

Category	**1995**	**1996**	**1997**	**1998**	**1999**
Companies Traded	205	228	258	277	285
Market Capitalization (US$ millions)	20,781	30,792	61,879	33,975	114,270
Total Volume (US$ millions)	52,356	37,737	58,103	70,395	84,033
Average Daily Volume (US$ millions)	208.6	152.8	230.6	283.9	356.1
Index	382.6	534.0	962.0	484.0	1654.0
Market P/E ratio	9.2	12.2	24.4	8.8	24.95
Turnover Ratio	2.52	1.23	1.6	3.4	0.74
Dividend Yield (%)	3.6	2.9	1.6	3.4	0.72

Source: ISE, Annual Report (1999)

The ISE market capitalization reached US$ 114 billion at the end of 1999. But the next year the total market capitalization was some US$ 69 billion at the end of 2000 (See Figure 5.2). There are currently 298 companies traded on the ISE, 14 new companies joined in the last year. Despite its market performance in last decade, only a quarter of the 500 largest industrial companies are on the ISE list. The ISE has the potential for doubling the market capitalization with new entries.

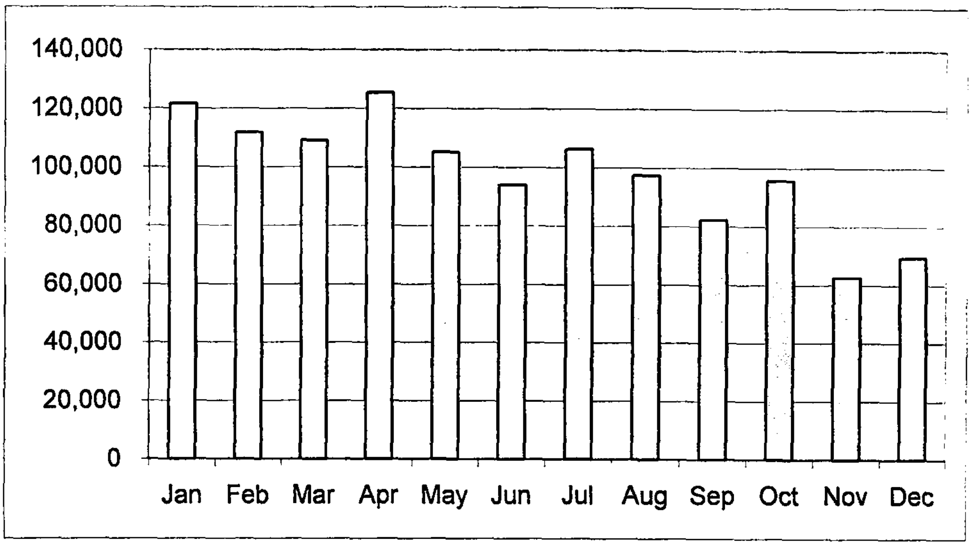

Figure 5.2 Monthly Market Capitalization of ISE, 2000

5.3 Capital Flows to Turkey

After the economic liberalization during the 1980s and the removal of restrictions on capital movements with Decree No. 32, issued in 1989, the Turkish capital markets have become very attractive to foreign investors. The capital movements started with the opening of ISE in 1986 and with regulations in 1989 foreign capital flowed to various instruments in Turkey. The opening of the Bonds and Bills Market, and the Repo-Reverse Repo Market in 1991 and 1993 respectively, increased the volume of foreign capital flows. After the Gulf War, the growth rate resumed to rise and reached its peak in 1993 with a net flow of US$ 3917 million. (See Table 5.2). In 1994, the portfolio inflows slowed down due to the domestic political instability and the financial crises both in Turkey and in Mexico. After the April 5 Crisis in 1994, new regulations regarding the exchange rates and open positions and information regarding this matter were enacted. According to new regulations, the exchange rates are determined freely by the market however the difference between buying and selling rates cannot exceed 3 per cent.

Despite these measures Turkey failed to attract foreign investors within two consecutive years,and the net capital flows were just US$ 570 million, almost one eigth of 1993 flow figure. In 1997 the flows recovered some, but the Asian and Russian crises in 1997-1998 turned out to be a crash in Turkish economy. Foreign capital fleed Turkey and US$ 6711 million net capital returned back to mature markets. In 1999, foreign capital flows reached US$ 3429 million with Stock Market boom in ISE. But again banking crisis made sufferings in economy and almost US$ 7 billion foreign capital fleed Turkey in December 2000.

Table 5.2 Net Capital Flows to Turkey 1992-1999 (US$ million)

Item	1992	1993	1994	1995	1996	1997	1998	1999
Direct Investment	779	622	559	772	612	554	573	138
Portfolio Investment	2,411	3,917	1,158	1,724	570	1,634	-6,711	3,429
Other Long-Term Capital	-938	1,370	-784	-79	1,636	4,788	3,985	345
Other Short-Term Capital	1,396	3,054	-5,127	2,305	5,945	1,761	2,601	759

Source: CBRT (1999)

5.4 Foreign Portfolio Equity Investments in ISE

Turkey has one of the most liberal foreign exchange regimes in the world, with a fully convertible currency as well as a policy that allows foreign institutional and individual investments in securities listed on the ISE since 1989. There are no restrictions on foreign portfolio investors trading in the Turkish securities markets. Decree No. 32 passed in August 1989, removed all restrictions on overseas institutional and individual investment in securities listed on the Istanbul Stock Exchange. The Turkish stock and bond markets are open to foreign investors, without any restrictions on the repatriation of capital and profits. Decree No. 32 also allows Turkish citizens to buy foreign securities.

The liberal market regulations provided that foreign investors more eager to invest in Turkey. In 1995, foreign investors had invested US$ 2 billion in the ISE stocks (See Table 5.3). In 1996, foreign investment rose by 59 per cent from tthe previous year to reach US$ 3,085 million. Asian Crisis affected some but the increase continued. However Russian Crisis hit harder than the previous one and foreign investment decreased to US$ 3,700 million. After sufferings of Asian and Russian crises, Turkish Stock Market boomed especially in the fourth quarter of 1999,the ISE National Index made a strong comeback closing the year with a surge of 242 per cent. Turkey ranked first among the world exchanges with its tremendous return. Daily average trading volume rose to over US$ 500 and US$ 900 million in the last two months of the year respectively. This trend continued with the average daily trading volume, reaching US$ 2.3 billion in the firs month of 2000. However, this momentum disappeared gradually and the foreign investment decreased to half, to the level before the market boom and December Banking Crisis increased the outflow of foreign investment.

Table 5.3 Equity Investments by Foreign Investors (US$ Million)

	1995	1996	1997	1998	1999	2000
January	---	2.457	4.655	5.718	3.429	14.597
February	---	2.849	4.564	5.296	5.196	13.362
March	---	3.029	3.997	5.373	5.554	12.734
April	---	2.736	3.577	6.864	6.741	15.046
May	---	2.489	3.793	5.765	5.853	11.390
June	---	2.965	4.456	6.095	5.555	11.338
July	---	2.671	4.728	6.589	6.603	11.999
August	---	2.551	4.938	3.845	5.555	11.188
September	---	2.790	5.970	3.200	7.001	9.503
October	---	2.926	5.881	3.068	7.362	10.645
November	---	3.165	5.465	3.668	8.920	8.079
December	1.936	3.085	6.018	3.700	15.358	7.404

Source: ISE, 2000 (Stock Market Transactions Realized on Behalf and Account of Foreign Banks/Brokerage Houses or Individuals)

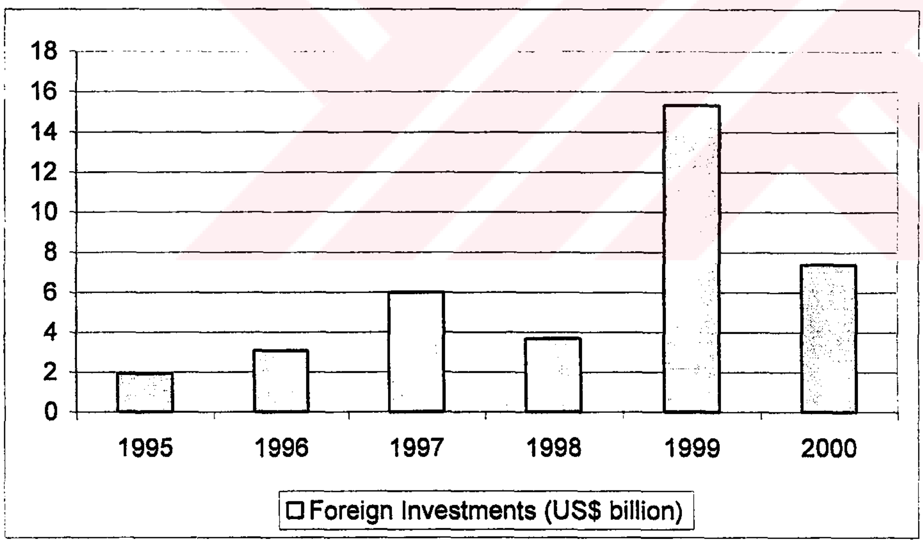

Figure 5.3 Total Equity Investment by Foreign Investors, 1995-2000
Source: ISE, Annual Reports

Foreign investors accounted for almost 10 per cent of total trading volume.(See Figure 5.4). In 1997, this ratio was 7.9 per cent. Forein investment share in total traded volume increased to reach 10 per cent in 1999. For the period of first 9 months in 2000, this ratio was about 10.3 percent.

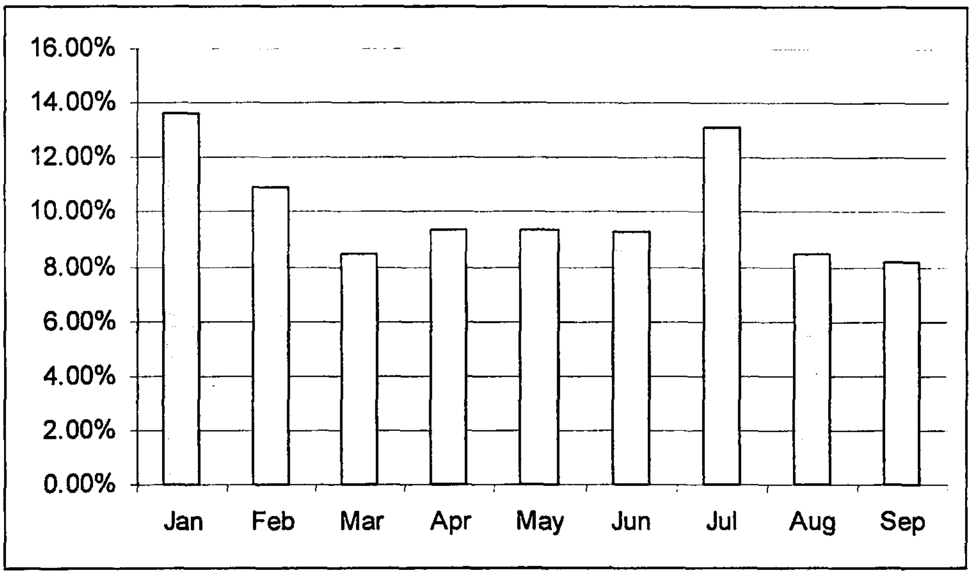

Figure 5.4 The Share of Foreign Investors in Total Trading Volume of ISE, 2000
Source: ISE, Monthly Reports (2000)

5.5 Recent Trends in FPEI in ISE

Foreign investors mainly sell and purchase National-30 Index stocks. It is evident that the National-30 Index stocks determines the trend of National-100 (See Figure5.5).

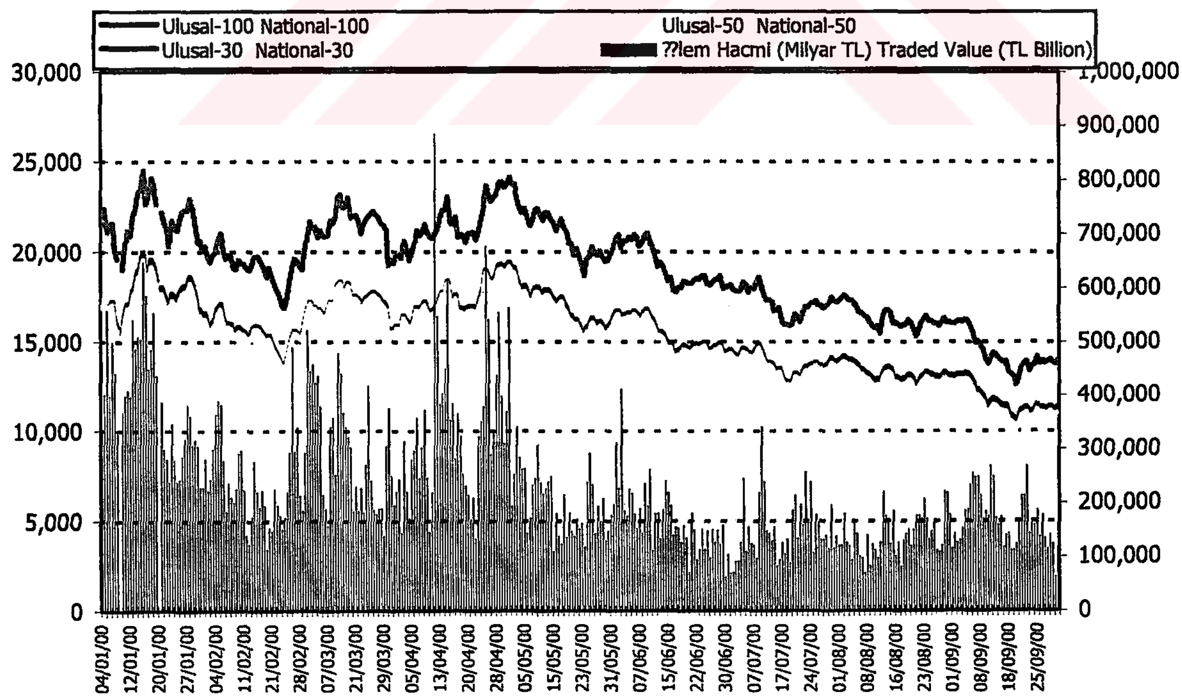

Figure 5.5 ISE Price Indices

Source: ISE, Monthly Report (2000/09)

In November, 2000 foreign investors almost made 85 per cent of their total trading in National-30 Index stocks. Foreign investors also more concerned about banking, holding and energy stocks because of high market capitalizations of these firms. In December, despite the banking crisis they continued to buy banking sector stocks except Yapi ve Kredi Bank. They were US$ 29 million out of Yapi ve Kredi Bank (See Table 5.4 and Figure 5.6). İş Bankası (C), Garanti Bankası and Akbank were favorite stocks of foreign investors in December. Total purchases of US$ 714,018,753 were less than the total sells of US$ 827,055,139, so net flows reached US$ -113,036,386 in December,2000.

Table 5.4 Top 10 Stocks of Foreign Investors' Transactions, December 2000

Stock	**Purchase (US$)**	**Sell (US$)**	**NetValue (US$)**	**Percent of total value (%)**
YAPI VE KREDİ BANK.	79,084,579	108,208,536	-29,123,957	12.16
İŞ BANKASI (C)	104,727,605	78,008,489	+26,719,116	11.85
GARANTİ BANKASI	49,460,763	90,048,151	+40,587,388	9.05
TURKCELL	56,167,783	54,543,772	+1,624,011	7.19
AKBANK	62,455,188	31,709,395	+30,745,793	6.11
VESTEL	39,839,062	51,454,209	-11,615,147	5.93
KOÇ HOLDİNG	26,431,413	47,917,845	-21,486,432	4.82
DOĞAN YAYIN HOL.	27,618,488	27,639,590	-21,102	3.58
SABANCI HOLDİNG	22,582,306	31,714,777	-9,132,471	3.52
TÜPRAŞ	21,949,568	27,515,127	-5,565,559	3.21
Total	**714,018,753**	**827,055,139**	**-113,036,386**	**67.86**

Source: ISE, Monthly Bulletin, December 2000

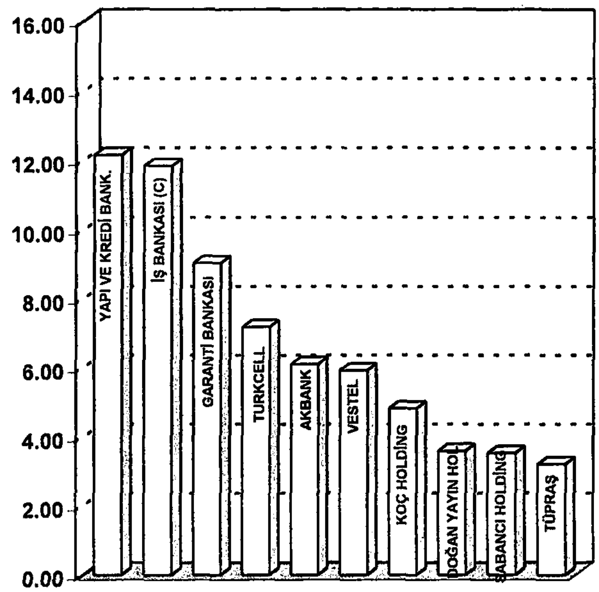

Figure 5.6 Top 10 Stocks of Foreign Investors' Transactions, December 2000

5.6 Foreign Direct Investment in Turkey

5.6.1 History of Foreign Investment in Turkey

The history of FDI inflows to Turkey is very smiliar to the history of internationalization of the production in the world economy and it goes back to the 19th century. There has been a substantial inflow of FDI to Ottoman economy in those years particularly in railway construction and in some services sectors like banking and insurance as in many developing and less developed countries.

This has changed during the first years of modern Turkish Republic, and the inherited foreign debt from Ottoman time caused deep suspicions about foreign investments. The years 1923-1929 became a period of institutional change, westernisation and reconstruction with industrialization of the economy. And a policy of inward looking import substitution strategy within a mixed economy adopted.

In January 18, 1954, Turkey enacted Law 6224, the Encouragement of Foreign Investment, which designed as a liberal law of its time. The articles of law was throughly liberal compared to similiar laws in other countries. Foreign investment were permitted in all areas which are open to the Turkish private sector. Foreign firms were equally treated with domestic firms and there were no heavy restrictions on the transfer of profits and shares. As a result of this encouragement law in 1954, there has been a considerable rise in FDI inflows to Turkey in the first years, but it became stagnant further. Later, this law was used as a law discouraging foreign investors due to the suspicios attitude.

Simply, foreign direct investment in Turkey can be divided into three periods: pre-1980, 1980-1990 and post-1990 periods. There was very little foreign investment came into Turkey prior to 1980, 24 January austerity package. Between 1954 and 1980, Turkey attracted just a little value of foreign investment as US$ 228 millon value with small numbers of investments made mainly in automotive, pharmaceutical, foodstuff and petrolum sectors. Almost all of this investment was made by three oil companies, three tire companies, and some foodstuff,chemical and machinery firms (Arıman, 2000).

The 1980s and 1990s have been a period of rapid change in Turkey, with remarkable economic development, high rates of growth and industrialization. Over the last two decades, the Turkish economy has opened up to international competition with the removal of barriers to foreign trade and encouragement of foreign investment and multinational companies.

After the liberalisation efforts following the 24 January Decree in 1980, foreign investment gradually began to flow into Turkey. By this economic liberalisation program, Law 6224 remained as the basic legal framework of FDI. After the comprehensive liberalisation of the foreign trade regime in Turkey, radical changes were introduced in the legislation pertaining to FDI by the Framework Decree on Foreign Capital.

With this liberalisation period, foreign investment gradually began toflow into Turkey, and in the second half of 1980s the acceleration of foreign investment increased. In 1987, the inflow figure exceeded US$ 200 million in a single year, reaching US$ 239 million (See Table 5.5). Later, in 1988 and 1989, this figure doubled, and finally reached US$ 1 billion at the end of 1990.

Foreign capital legislation was further liberalized with the Capital Framework Decree 2789 of March 20, 1992. In addition to previous one, certain sectors such as tourism, mining and petroleum were subject to specific laws affect foreign investors. However, this decree had some restrictions like investments with foreign share capital exceeding US$ 150 million required the approval by council of ministers. Until 1994, new investments coming to Turkey for the first time accounted for near to half of the 1980s to reach the one billion dollar level in 1990. Following the 1994 economic crisis, the ratio of new investments fell sharply but the total inflow recovered the next year.

In 25 August 1995, foreign capital framework decree have been extremely simplified with procedures and conditions to do investment in Turkey. The restrictions on prior approval of investments over US$ 150 million and license, know-how, technical assistance had been removed.

With this amendment, Turkish Foreign Investment Law became a very open investment regime. This regime welcomed equal rights and obligations to foreign and local investors alike, posed no limitations in equity participation ratios and no restrictions on sectors that could be penetrated and assured free transfer of profits, fees and royalties as well as repatriation of capital.

To increase the foreign direct investment, Turkey signed bilateral agreements with countries. Protection and Promotion of Investment Agreements have been signed with 57 countries and 36 of them has entered into force. Avoidance of Double Taxation Agreements with 42 countries have been signed and came into force (DPT, 2000).

Table 5.5 The Structure of Foreign Direct Investments in Turkey (1980-2000)

Years	Foreign Investment Permitted (Million US$)	Total Permitted Investment Amount of Foreign Firms (Billion TL) (Accumulated)	Number of Firms (Accumulated)	Total Capital of Firms (Billion TL) (Accumulated)	Inflow (Million US$)
1980	97.00	76.87	78	28,390	35
1981	337.51	72.16	109	47,400	141
1982	167.00	218.14	147	100,196	103
1983	102.74	199.22	166	147,109	87
1984	271.36	312.28	235	254,775	162
1985	234.49	1,168.16	408	464,981	158
1986	364.00	3,099.74	619	707,164	170
1987	655.24	3,179.53	836	960,035	239
1988	820.52	5,468.27	1,172	1,597,103	488
1989	1,511.94	9,507.35	1,525	4,847,832	855
1990	1,861.16	18,249.28	1,856	7,943,775	1005
1991	1,967.26	15,893.98	2,123	13,101,036	1041
1992	1,819.96	17,976.36	2,330	23,441,214	1242
1993	2,063.39	70,136.27	2,554	36,737,050	1016
1994	1,477.61	37,202.36	2,830	62,449,964	830
1995	2,938.32	328,447.82	3,161	113,013,790	1127
1996	3,836.97	1,250,652.13	3,582	235,971,182	964
1997	1,678.20	624,461.10	4,068	458,968,459	1032
1998	1,646.77	1,016,653.54	4,533	823,560,55	976
1999	1,700.52	1,599,520.36	4,950	1,446,502,79	817
2000	3,059.90	7,883,004.85	5,328	3,063,464	1307*
TOTAL	**28,600.27**	**12,885,500**			**13,795**

Source: Undersecretariat of Tresuary, *As of October

Another important point about foreign investment of Turkey, is the increasing levels of capital outflows from Turkey to other countries. Until the half of the 1990s, the outflows were low in figures and the net flows remained high as compared with inflows. In 1996, the outflows have doubled, reaching US$ 325 million (See Table 5.6). And in 1999, it doubled again to US$ 685 million. With this increase in outflows the net foreign direct investment realization fell sharply to US$ 138 million. Now, Turkey is facing the danger of being a net exporter of foreign capital. Despite its very open foreign investment regime, the outcome of this regime have not been so satisfactory. Turkey is in difficulty to attract more foreign investments while domestic investors are trying to invest in other countries in which provide more appropriate conditions and incentives for foreign investors. The stagnation of foreign investment put pressures on the Turkish economy. It is obvious that Turkey has a low profile investment arena for new foreign investors. The average one billion foreign investment accounted for the old investors remaining in Turkey.

Table 5.6 Foreign Direct Investment in Turkey (Million US$)

Years	Inflow Realization	Outflow Realization	Net Realization
1982	103	48	55
1983	87	41	46
1984	162	49	113
1985	158	59	99
1986	170	45	125
1987	171	65	106
1988	387	33	354
1989	738	75	663
1990	789	76	713
1991	910	127	783
1992	913	134	779
1993	797	175	622
1994	637	78	559
1995	935	163	772
1996	937	325	612
1997	873	319	554
1998	982	409	573
1999	823	685	138
2000	1307*	---	---

Source: CBRT, *As of October

5.6.2 Turkey and Other Developing Countries

Today, Turkey has been unable to attract sufficient amounts of foreign investment as compared with other developing countries. In the early days of 1990s, Turkey was amongst the top 10 FDI recipient developing countries with its US$ 0.8 billion of inflow while Mexico was the leading country of its US$ 4.7 billion in 1991. (Table) China performed a remarkable leap in the last decade and reached the figure of US$ 37 billion and US$ 40.4 respectively in 1997 and 1999. Also Mexico and Argentina which have similiar economic structures to Turkey have recieved US$ 11 billion and US$ 23.2 billion respectively in 1999 (See Table 5.7). This example could give an idea about the smallness of FDI inflows directed to Turkey and weakness of Turkey in attracting foreign investors.

Table 5.7 FDI flows to the top 10 recipient developing countries (billions of dollars)

	1991		**1994**		**1997**
Mexico	4.7	China	33.8	China	37.0
China	4.3	Mexico	11.0	Brazil	15.8
Malaysia	1.0	Malaysia	4.3	Mexico	8.1
Argentina	2.4	Peru	3.1	Indonesia	5.8
Thailand	2.0	Brazil	3.1	Poland	4.5
Venezuella	1.9	Argentina	3.1	Malaysia	4.1
Indonesia	1.5	Indonesia	2.1	Argentina	3.8
Hungary	1.5	Nigeria	1.9	Chile	3.5
Brazil	1.1	Poland	1.9	India	3.1
Turkey	**0.8**	Chile	1.8	Venezuella	2.9
Share of top 10 in FDI to all developing countries (percentage)	74.2		76.1		72.3

Source: Global Development Finance, World Bank (1998)

The main reasons for Turkey' instability to attract more foreign investments are high and chronic inflation and political instability. Instability in political and economic arena leads international investors to postpone their investment decisions in Turkey. However, the regulations on foreign direct investment have liberal provisions, the uncertainties over the political and economic life put suspicions on foreign investors. Firms that have invested in Turkey in the past continue to invest because the large internal market, while newcomers are reluctant to come for beginning an investment. Despite its geographical position and liberal foreign investment law, Turkey attracted less foreign investment than other developing countries, such as Poland, Hungary, Angola, Kazakhstan, Egypt, Romania, Morocco, Malta and so many more (See Table 5.8). Turkey attracted just 0.1 % of total FDI flows and 0.4% of FDI flows to developing countries in 1999. While Turkey was amongst the top ten recipient country in the early years of 1990s, it could not sustain its position and it has performed under many developing countries in last years.

Another problem for Turkey is very low per capita investment figures. It is evident that Turkey does not enjoy the benefits of foreign investments while other developing countries enjoy more respectively (See Table 5.9). Many countries attract more foreign investment and provide their sustainable growth with this investment figures. Turkey just attracted US$ 12 per capita while other developing countries having the joy of foreign investments such as Ireland, Argentina, Malta, Czech Republic. Ireland, Malta, Argentina, Czech Republic attracted 380,167, 52, 42 times more as of Turkey.

Table 5.8 FDI Inflows of Some Selected Countries (1995-1999) (billions of dollar)

Rank	Country	Rank in 1995	1995	1997	1998	1999
1	United States	1	60.2	105.5	186.3	275.5
2	United Kingdom	3	29.9	33.2	63.7	82.2
3	Sweden	5	13.7	11.0	19.6	60.0
4	China	2	38.0	44.2	43.8	40.4
5	France	4	20.1	23.2	29.5	39.1
7	Brazil	15	4.9	18.7	28.5	31.4
8	Germany	10	9.0	11.1	21.2	26.8
9	Canada	7	11.1	11.8	21.7	25.1
10	Argentina	18	3.9	8.8	6.5	23.2
11	Ireland	-	1.4	2.7	8.6	18.8
16	Korea, Rep. of	47	0.1	3.1	5.2	10.3
18	Chile	21	3.0	5.2	4.6	9.2
19	Poland	23	2.6	4.9	6.4	7.5
25	Czech Rep.	-	2.6	1.3	2.7	5.1
38	Hungary	-	4.5	2.2	2.0	2.0
39	Angola	-	0.5	0.4	1.1	1.8
41	Vietnam	-	2.3	2.8	2.0	1.6
42	Kazakhstan	-	1.0	1.3	1.2	1.6
43	Egypt	39	1	0.9	1.1	1.5
46	Croatia	-	0.1	0.5	0.9	1.4
49	Bolivia	-	0.4	0.9	1.0	1.0
50	Romania	44	0.4	1.2	2.0	1.0
52	Morocco	45	0.3	1.1	0.4	0.9
53	Malta	-	0.2	0.2	0.3	0.8
54	**Turkey**	**38**	**1.0**	**0.8**	**0.9**	**0.8**

Source: UNCTAD, YASED

Table 5.9 Per Capita FDI of Some Selected Countries in 1999

Countries	Rank in 1999	Population (millions)	Per capita FDI (US $)	As many times as of Turkey
Argentina	10	37	625	x 52
Ireland	11	4	4575	x 380
Chile	18	15	615	x 50
Poland	19	39	190	x 16
Czech Rep.	25	10	510	x 42
Angola	39	12	150	x 12
Vietnam	41	78	21	x 1.7
Kazakhstan	42	15	106	x 9
Egypt	39	62	24	x 2
Croatia	46	4.5	310	x 26
Dominican Rp.	48	8	175	x 15
Bolivia	49	8	125	x 10
Romania	50	22.5	44	x 4
Morocco	52	28	32	x 3
Malta	53	0.4	2000	x 167
Turkey	54	65	12	

Source: UNCTAD, YASED

Despite very optimistic speculations about attractiveness of Turkey's high potential of US$ 25-30 billion in a year, Turkey failed to realize these projections. In the US government's 10 Big Emerging Markets (BEM) strategy developed for the new decade, it was envisaged that 10 most important developing countries will reach the level of Europe or of Japan in their foreign economic relations with the US in the year 2000 and by the year 2010 these countries's share will exceed the total volume of Europe and Japan combined. Turkey ranks second only to China among these developing countries. Unfortunately, Turkey is the only country failing to attract that amount of projections in the 10 BEM strategy, while other countries performed well. If Turkey succeed in recieving the same pattern of China and Brazil, it has an ability of attracting US$ 30-40 billion in a year. (Ariman, 2000,22) But today Turkey is very much far from this projections because of its instability of political and economic structure, and its conduct of mismanagement in all areas of life in which resulted in failure of bad governance. The failed privatisation efforts and high rates of inflation fuelled economic instability. Additionally, inadequate protection of intellectual property rights, in particular copyrights and trademarks, non-tariff barriers, price controls, delays in the dispensation of justice due to deficiencies in the justice system and similiar factors all make the investment environment less attractive.

The Bill on the Constitutional Amendment to introduce local and international arbitration in connection with settlement of disputes arising from concession commitments and contracts related to public services passed by the Turkish National Grand Assembly on August 13, 1999. This may change the foreign investor's decisions in the long run, especially in Build-Operate-Transfer (BOT), Transfer of Operational Rights (TOR) and Thermal Power Plant (TPP) projects of Turkey.

Also the stand-by agreement with IMF in 1999, created more credible economic environment in Turkey. If the stabilization program succeeds in decreasing the high level of inflation and budget deficits, it will provide more stable economic and political life and Turkish economy would have a chance to recover and grow steadily and rapidly. These measures might pave the way for new foreign investors which seek stable investment areas while providing already present investors' capacity increases or extra investments.

5.7 The Structure of FDI by Sector in Turkey

Manufacturing, agriculture, services and mining are four main sectors in which foreign investment in Turkey is realized. The sectoral distribution of foreign capital can be seen from Table 5.10 . At the end of 1980, 92 % of total permitted foreign capital was in the manufacturing sector, and only 8 % was in the services sector. At the end of 1990, 65 % of total permitted foreign capital was in the manufacturing sector, 28 % was in the services sector. The negligible rest was in agricultural and mining sectors. It can be seen that while the share of the manufacturing sector has been decreasing, the share of services sector has increased rapidly over the same period. In 1987, services sector became first in share with 52 % of total foreign capital .

At the end of 1999, 66 % of total permitted foreign capital was in the manufacturing sector, 32 % was in the services sector. Services sector made its remarkable jump with a share of 81 per cent while manufacturing had only 16 per cent. However, the next year the course had changed and manufacturing sector reached 52 per cent. The second leap had been realized previous year and services sector had 61 per cent while manufacturing sector had 36 per cent of total permitted foreign capital.

Manufacturing and services are the two sectors which have attracted most of the foreign capital coming to Turkey since 1954. Therefore developments in these sectors are important. Services sectors showed a rapid increase especially after 1987 almost catching up with the manufacturing sector.

There are ten main sub-sectors in manufacturing and three main sub-sectors in services. Automotive, food manufacturing, chemical products, electrical machinery, electronics, beverages and tobacco, textile and clothing, plastics and cement are the main sub-sectors in manufacturing. Automative and its side industries had accounted for 11.82 percent of total FDI . Trade, banking and other financial services, and communication are the main services sub-sectors. Communication, banking and other financial services, and trade constitute 16, 11, 8 per cent of total FDI .

Table 5.10 Classification of Foreign Investment Approvals by Sector (millions of dollars)

Years	Manufacturing	%	Agriculture	%	Mining	%	Services	%	Total	Ihflow
1980	88.76	91.51%	0.00	0.00%	0.00	0.00%	8.24	8.49%	97.00	35
1981	246.54	73.05%	0.86	0.25%	0.98	0.29%	89.13	26.41%	337.51	141
1982	98.54	59.01%	1.06	0.63%	1.97	1.18%	65.43	39.18%	167.00	103
1983	88.93	86.56%	0.03	0.03%	0.02	0.02%	13.76	13.39%	102.74	87
1984	185.92	68.51%	5.93	2.19%	0.25	0.09%	79.26	29.21%	271.36	162
1985	142.89	60.94%	6.37	2.72%	4.26	1.82%	80.97	34.53%	234.49	158
1986	193.47	53.15%	16.86	4.63%	0.86	0.24%	152.81	41.98%	364.00	170
1987	293.91	44.86%	13.00	1.98%	1.25	0.19%	347.08	52.97%	655.24	239
1988	490.68	59.80%	27.35	3.33%	5.62	0.68%	296.87	36.18%	820.52	488
1989	950.13	62.84%	9.36	0.62%	11.86	0.78%	540.59	35.75%	1,511.94	855
1990	1214.06	65.23%	65.56	3.52%	47.09	2.53%	534.45	28.72%	1,861.16	1,005
1991	1095.48	55.69%	22.41	1.14%	39.82	2.02%	809.55	41.15%	1,967.26	1,041
1992	1274.28	70.02%	33.59	1.85%	18.96	1.04%	493.13	27.10%	1,819.96	1,242
1993	1568.59	76.02%	21.05	1.02%	11.37	0.55%	462.38	22.41%	2,063.39	1,016
1994	1107.29	74.94%	28.27	1.91%	6.20	0.42%	335.85	22.73%	1,477.61	830
1995	1,996.48	67.95%	31.74	1.08%	60.62	2.06%	849.48	28.91%	2,938.32	1,127
1996	640.59	16.70%	64.10	1.67%	8.54	0.22%	3,123.74	81.41%	3,836.97	964
1997	871.81	51.95%	12.22	0.73%	26.70	1.59%	767.47	45.73%	1,678.20	1032
1998	1,018.29	61.81%	5.75	0.35%	13.73	0.83%	609.67	37.01%	1,647.44	976
1999	1,123.22	66.05%	17.19	1.01%	6.76	0.40%	553.40	32.54%	1,700.57	817
2000*	1,115.20	36.45%	59.74	1.95%	6.32	0.21%	1,878.64	61.40%	3,059.90	1307*
Total	15,805.06	55.24%	442.44	1.50%	273.18	1.04%	12,091.91	42.26%	28,612.59	13,795

Source: Undersecretariat of Treasury, *As of October

5.8 The Pattern of FDI by Country of Origin in Turkey

In order to analyze the source of origin of investments in Turkey, breakdown of foreign capital and number of firms according to regions is given in (Table 5.11) . As is clearly observed in Table , there is an indisputable dominance of OECD countries as FDI is concerned in Turkey. Almost 86 per cent of foreign capital directed to Turkey is sourced by OECD countries, especially European Union countries. Germany had the first place with 951 firms, covering 18 % of total number of foreign capital firms.

Table 5.11 Breakdown of Foreign Capital According to Home Country Groups

Regions	Number of Firms	Present Foreign Capital (million TL)	Percentage in total foreign capital
OECD Countries	3,208	1,428,064,765	86.16 %
European Union	2,525	1,117,474,773	67.42 %
Other OECD Countries	683	310,589,992	18.74 %
Islamic Countries	1,010	39,915,247	2.41 %
Middle East Countries	901	29,132,586	1,76 %
Northern Africa	55	7,482,825	0.45 %
Other Islamic Countries	54	3,299,836	0.20 %
Eastern European Countries	401	16,862,572	1.02 %
Other E. E. Countries	76	11,556,588	0.70 %
Commonwealth of Independent States	325	5,305,984	0.32 %
Other Countries	715	172,532,786	10.41 %
South Asian	113	8,677,234	0.52 %
Other	602	163,855,552	9.89 %
GRAND TOTAL	**5,334**	**1,657,375,370**	**100.00 %**

Source: Undersecretariat of Treasury

In terms of stock of capital invested, Netherlands had the first place with TL 416 trillion, then Germany had the second place with TL 188 trillion at the end of 2000. In terms of total breakdown of authorized FDI, France had the first place with US$ 5,397 million, while Germany had second place with US$ 3,684 million and Netherlands had third place with US$ 3,635 million. Although this ranking changed by years, generally the same countries placed among the top five (See Table 5.12) Previous year the ranking is France, Germany, the United States, and Netherlands respectively. Netherlands increased its ranking with US$ 695 million investment last

Table 5.12 Breakdown of Authorized FDI According to Home Countries (1980-2000) (millions of dollar)

COUNTRIES	1980-84	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	TOTAL
FRANCE	43.08	14.92	8.31	33.11	43.71	233.42	669.06	249.18	353.75	223.15	255.29	476.05	2,370.35	103.94	135.50	146.72	37.77	5,397.31
GERMANY	144.66	22.49	45.26	105.58	101.61	130.95	145.88	196.41	202.46	145.37	223.46	392.13	226.47	281.59	329.89	407.31	582.97	3,684.49
NETHERLANDS	39.28	8.70	2.40	20.40	68.30	149.21	34.11	280.30	272.90	179.42	194.02	559.32	338.61	206.11	352.05	234.57	695.98	3,635.68
U.S.A.	268.20	21.71	24.53	61.07	129.75	137.49	127.84	460.87	197.55	248.34	158.32	231.37	179.44	174.48	297.20	292.51	296.07	3,306.74
SWITZERLAND	233.34	20.01	53.29	82.52	115.49	167.22	127.74	109.08	203.51	136.11	54.29	327.75	156.84	50.28	101.58	50.89	35.43	2,025.37
U. KINGDOM	28.73	26.49	22.83	102.61	129.65	280.72	286.41	80.82	109.34	120.49	47.42	161.37	164.80	122.25	44.43	88.40	166.99	1,983.75
ITALY	22.40	0.10	4.83	6.09	40.58	74.20	65.86	180.66	119.66	419.29	164.00	98.57	43.24	124.50	128.69	95.22	271.70	1,859.59
JAPAN	0.05	3.45	2.63	111.53	69.18	73.78	102.71	54.59	36.60	237.06	125.92	283.84	21.14	126.68	17.54	13.85	192.12	1,472.67
BELGIUM	13.99	0.16	17.12	4.50	3.85	29.85	18.07	8.27	20.00	21.10	13.43	36.20	70.18	7.61	17.82	23.41	71.75	377.31
S. ARABIA	4.95	4.36	75.77	7.27	17.32	11.05	4.63	43.95	34.07	15.08	8.44	11.81	8.98	10.11	17.14	14.47	9.09	298.49
S. KOREA	0.00	0.00	0.20	1.65	0.48	1.01	17.25	0.94	10.29	93.30	0.53	15.94	30.99	17.88	2.51	13.62	91.29	297.88
CANADA	7.52	0.00	5.54	0.58	9.76	6.21	2.24	51.26	22.63	58.31	37.37	41.33	1.42	0.38	12.86	1.91	2.42	261.74
BAHRAIN	3.33	6.00	0.95	0.04	1.07	0.58	4.35	6.92	49.70	25.92	11.95	6.44	18.44	4.46	25.16	0.00	0.00	165.31
SWEDEN	0.66	0.85	1.03	6.88	3.97	12.01	15.65	13.96	14.39	6.25	8.70	11.84	22.09	7.52	19.42	6.88	8.73	160.83
AUSTRIA	2.82	0.16	0.90	1.06	4.85	8.15	6.53	8.36	8.83	5.55	3.59	32.92	11.20	8.42	6.10	16.41	29.39	155.24
DENMARK	21.36	6.90	4.67	2.05	0.58	31.64	15.76	4.73	3.66	5.21	8.57	3.63	0.44	13.68	4.15	11.28	10.5	148.81
SINGAPOUR	0.00	0.00	0.00	0.00	0.05	29.73	25.83	9.67	14.07	15.03	1.32	18.13	6.17	8.35	0.00	0.16	2.79	131.30
PANAMA	0.89	0.67	20.36	2.06	16.10	3.73	3.02	1.74	2.55	3.58	2.11	17.53	0.13	0.00	0.67	0.00	50.67	125.81
IRAN	12.59	2.78	7.09	8.03	11.17	12.07	5.48	3.23	8.95	5.80	3.96	5.63	5.35	9.58	5.00	1.58	2.14	110.43
I.F.C.	4.46	0.00	0.00	2.13	0.70	5.86	8.57	6.09	10.47	1.70	20.98	9.76	7.30	3.62	3.36	0.03	0.33	85.36
SYRIA	4.42	1.70	1.71	2.65	5.53	4.21	11.13	3.56	0.99	2.69	1.69	1.49	10.47	4.58	0.72	1.87	0.51	59.96
U. A. E.	16.06	0.00	4.64	1.03	3.14	3.68	6.04	8.04	0.32	3.39	0.31	0.23	0.60	0.58	0.31	0.17	0.00	48.53
OTHER COUNTRIES	102.82	93.04	59.94	92.40	43.68	105.17	157.00	184.63	123.27	91.25	131.94	195.04	142.32	391.60	123.70	279.26	501.28	2,818.34
TOTAL	975.61	234.49	364.00	655.24	820.52	1,511.94	1,861.16	1,967.26	1,819.96	2,063.39	1,477.61	2,938.32	3,836.97	1,678.20	1,645.80	1,700.52	3,059.90	28,610.90

year. And the ranking changed as France, Germany, Netherlands and the United States. Netherlands generally placed among top five countries. As an example, Unilever originated from Netherlands was among the first foreign companies to invest in the Turkish market. It entered the market in 1951. France is one of the leading FDI countries with its investments in automative, cement, communication and trasportation.

6. CONCLUSION

Technological developments and the internationalization of production provided direct investment opportunities in developing countries. Today foreign investors are more eager to invest in these markets because of their higher growth potentials. We witness great changes and rapid transformations with financial liberalization especially in the emerging markets. The liberalization causes a huge flow of capital through these markets and great changes in their economic systems. It is inevitable to reverse back these flows. It is obvious that rational and cautious measures can increase the benefits of a country from these flows.

Turkey's experience during the last two decade shows that liberalization of capital flows needed to start after macroeconomic stability and financial discipline has been achieved. Because, short-term capital flows are very volatile and they are very sensitive to crisis. Country risk is the most important factor for the foreign investor, furthermore investors are reluctant to behold high risks while investing in emerging markets and seek the best portfolio choice. Because of high country risk, Turkey is a very volatile stock market, and foreign portfolio investors are reluctant to invest or very short-term in investment in Turkish securities markets. Therefore, the market deepening, and high market capitalization may change volatile structure of the capital markets and provide a more secure market both for foreigners and for domestic investors.

Countries follow different policies in order to attract foreign investments and prevent the negative effects of rapid capital flows. Although Turkey has very liberal regulations, it fails to attract foreign investors especially the direct investors. Today, Turkey's share in FDI is just 0.1% of total inflows. Because, political and economic instability increase Turkey' country risk in the light of foreign investors. Turkey should give an impetus to privatization and sustain economic and political stability in order to enjoy the foreign investments. It is not a delusion to reach prosperous days after implementing sound decisions.

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