Chapter 12
EU–Turkey Customs Union and Bilateral Foreign Direct Investment Flows

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ABSTRACT
Main aim of this text is presentation of the effects of customs union between the European Union and turkey on bilateral FDI flows in light of the theory of linkages between economic integration and FDI flows. First section of the text is a survey of main theoretical links between economic integration and FDI flows. Second section focuses on the history and scope of the customs union. Third and fourth sections are empirical and are devoted to presentation of the results of analysis of FDI inflows to the European Union and turkey, including main trends and impact of the economic integration. According to the results of the conducted research, FDI inflow to both sides of the agreement increased substantially. Intraregional FDI flows grew since the formation of the union which may be attributed to the positive impact of reduction of trade barriers and access to enlarged markets as well as linked changes in the turkey’s legislation. FDI inflow from the third countries also increased.

INTRODUCTION
Establishment of the European Union (EU)-Turkey Customs Union (EUTCU) in 1996 was another and, for the time being, last step in proceeding economic integration between the two sides involved. Apart from the most often considered impact of the economic integration (e.g., customs union) on trade flows, effects of this process can also be analyzed in terms of one of the main categories of capital flows (i.e., foreign direct investment (FDI)), even though this issue lies outside the main scope of the agreement. The value and structure of FDI inflows (i.e., flows of FDI to a particular country) is an important issue for a given economy due to their impact on availability of capital and other effects linked with entry of foreign companies. Hence, this issue should be regarded as one of the significant factors of the economic

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development and be analyzed in more detail. The main purpose of this chapter is presentation of the
effects of customs union between the EU and Turkey on bilateral FDI flows in light of the theory of
linkages between economic integration and FDI flows.

The first section of the chapter is a survey of main theoretical links between economic integration and
FDI flows, including such areas as reduction of trade barriers, creation of customs union (particularly
important in context of this text), access to enlarged markets, provisions regarding investment liberaliza-
tion and protection, and long-term integration effects (such as changes in the dynamics of the economic
growth). Second section will include short description of the EU-Turkey Customs Union. Aspects covered
will be history of the agreement and selected aspects of covered bilateral economic relations, above all
regulations regarding free circulation of goods and their implementation. Third section will be devoted
to FDI flows trends in the EU and Turkey. Analysis will cover topics such as the volume and dynamics
of FDI inflows, main investment partners, and sectors. The fourth section will focus on results of analysis
of the EUTCU’s impact on bilateral FDI flows conducted with regard to the theoretical links between
economic integration and this type of capital flows. The fifth and final section will be discussion and
conclusions, including possible future developments in the EU-Turkey economic relationship and their
impact on FDI flows – the most significant topic discussed will be the widely debated Transatlantic
Trade and Investment Partnership.

BACKGROUND

Economic Integration: Main Concepts

Economic integration is a process with a profound impact on the world’s economic system. The global
number of various types of economic integration blocs is very high as there are nearly 400 such agree-
ments, labeled together by the World Trade Organization (WTO) as regional trade agreements (RTAs)
(World Trade Organization, 2014). This group includes various types of agreements such as free trade
agreements, customs unions and economic integration agreements, which differ in their scope as well
as number of countries involved. This obviously hinders formulating any sound theories regarding the
impact of these blocs, including the ones about links between their creation and FDI flows.

However, despite their high heterogeneity it is possible to list the theoretical effects of economic in-
tegration on the FDI flows by considering the main consequences for the bloc’s economies. This section
will focus on such effects, especially the ones linked with intraregional FDI flows (another category, FDI
inflows to RTA members from non-member countries, will be also be presented but it is less important in
the context of this text’s subject). The first part of the section will be devoted to most important concepts
linked with the effects of economic integration, especially changes in the trade flows.

Establishment of the RTA, which involves liberalization of international trade inside the bloc by
reduction of various barriers, has a profound impact on flows of goods and services. Two main effects
discussed in the extant literature as key results of the customs union (free trade agreement with com-
mon foreign trade policy) are labeled as ‘trade creation’ and ‘trade diversion’ (Viner, 1950; Balassa,
1973). Both occur as a result of trade liberalization inside the bloc and remaining limitations in trade
with non-member countries. Trade creation is an increase in intraregional trade flows (resulting from the
replacement of domestic production by less expensive products from other member countries), whereas