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## **Capital Movements Between The European Union And Turkey Within The Integration Processes**

### **Abstract**

*The institutional model used in the integration process between the European Union (EU) and Turkey was that of establishment of a customs union under an Association Agreement. In the context of the difficulties that have occurred in the membership negotiations between the EU and Turkey, the question arises whether real economic integration between them has gone further than that achieved at the stage of a customs union. Free movement of capital, constituting one of the so-called four fundamental freedoms within the single European market, is the subject of examination in this paper. The obligations of Turkey, as an EU candidate country, in the field of free movement of capital are more demanding under the EU scheme of liberalization of capital flows than within the OECD, which is regulated by the Code of Liberalisation of Capital Movements and the Code of Liberalisation of Current Invisible Operations. Real economic integration between the EU and Turkey requires further liberalization of the free movement of capital. While Turkey encourages the inflow foreign direct investment using a generous package of incentives, the role of FDI in its economy still remains moderate.*

**Keywords:** *European Union, Turkey, integration processes, capital movements, foreign direct investment*

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## 1. Introduction

Turkey has been undergoing a long-lasting integration process with the EU, which commenced in 1963 with the signing the Association Agreement (Ankara Treaty). The next steps in the EU –Turkey relations were: Turkey's submission of an application for the membership of the EEC in 1987; establishment of a customs union between the EU and Turkey in 1996; and the EU's acceptance of Turkey's status as a candidate country for EU membership in 1999. The accession negotiations were opened in 2005, however they encountered serious political barriers and have been frozen for the last three years. The parties have signed a readmission agreement in December 2013, and aim at continuing the accession negotiations.

In the context of such a long and difficult process of political and institutional integration between the EU and Turkey, the question arises whether real economic integration between them has gone further than that achieved at the stage of a customs union. The free movement of capital, constituting one of so-called four fundamental freedoms within the single European market, is the subject of examination in this paper.

The aim of the paper is to analyze and evaluate both the legal status of capital movements between the EU and Turkey and the state of the art of real capital movements between them, with special reference to foreign direct investment stocks and flows.

The more detailed research tasks are as follows:

- to present a theoretical background for analysis of integration processes between countries at different levels of development;
- to analyze legal and economic aspects of the integration processes to date between the EU Member States and Turkey;
- to evaluate the progress in the establishment of free movement of capital between the EU Member States and Turkey;
- to examine foreign direct investment flows between the EU Member States and Turkey as well as their role in the modernization of a candidate country.

The EU, UNCTAD, OECD and CEIC statistical data bases are used to analyze and evaluate capital movements between the EU and Turkey.

## **2. Theoretical background for analysis of integration processes between countries at different levels of development**

An analysis of the integration processes between the EU and Turkey can be based on the theoretical findings and postulates formulated to date in the economic literature. These include:

- economic integration between independent countries should be treated as a long-term process, usually embracing several stages (free trade area, customs union, common market, economic and monetary union) (Balassa 1961, Molle 1995, Pelkmans 1997),
- a logical scheme of achievement of the integration stages should be respected, i.e. trade liberalization should precede the liberalization of capital movements (Molle 1995),
- capital movements in the form of foreign direct investment cannot thrive or develop intensively without a certain level of trade flows between countries (Molle, Morsink 1992),
- integrating countries are expected to be at a similar level of economic development in order to facilitate the integration process,
- if countries at different levels of development decide to integrate, an adjustment period is required and a compensation mechanism for weaker partners should be activated, i.e. a socio-economic policy with special financial funds (Molle 1995, Nienhaus 1987).

The integration processes between the EU and Turkey should be perceived of as integration between countries at different levels of development, although the differences between them have been diminishing. In such a case both legal and real integration require time and effort on both sides. Cost-benefit analyses at each stage of the integration process shows that a weaker partner needs some transition periods to establish the free movement of goods, services and capital, as well as to fulfill other requirements connected with common policies such as environmental protection and competition policies. The stronger partners usually expect some transition period related to the free movement of workers, and some experiences indicate that some additional measures may also need to be undertaken temporarily to protect other segments of their market. At the end of the transition period the stronger partners gain access to the market of a weaker partner and vice versa. The net result depends on their competitive advantages.

### **3. Legal and economic aspects of the integration processes to date between the EU Member States and Turkey**

Turkey applied for associate membership in the European Economic Community (EEC) in 1959, at a time when the EEC included only six member states. The EEC suggested the establishment of an association, which would be treated as a preliminary stage of integration, leading to Turkey's accession in the future (Nas 2008, p. 142, Aksu 2012, pp. 6-7). Hence, at the very beginning of the integration process the long-term aim of mutual relations was clearly defined.

The legal and economic integration processes started with entry into force of the Association Agreement in 1964, which proclaimed (Article 2) that a customs union would be progressively established between the EEC and Turkey over a period of 12 years. According to the additional Protocol, which was signed in 1970 and entered into force in 1973, the transitional period was prolonged for up to 22 years (Additional Protocol 1972). The full customs union was achieved via some gradual adjustments. Turkey was to eliminate custom duties on 55 percent of its imports from the EEC, mainly manufactures, over the period of 12 years, and for remaining manufactures over the period of 22 years. The EEC commitments included removing its restrictions on all Turkish industrial goods, except textile and petroleum products, and the granting of preferential duties by the EEC on the majority of Turkish agricultural exports to the EEC. These EEC commitments were fulfilled in 1973 and 1987 respectively (Nas 2008, pp.142-145, Aksu, p. 7). In January 1996, Turkey entered into the customs union with the Community on the basis of the Association Council Decision 1/95 (Rapoport 2011, pp.175-176). This decision secured Turkey's alignment with the EU customs policy. The institutional framework of the association was completed with a new joint committee dealing with technical aspects of the customs union.

The economic consequences of the establishment of the customs union are assessed quite positively. Both short-term static welfare effects and long-term dynamic effects seem to appear. Trade creation and trade diversion effects are confirmed by research on the dynamics and structure of Turkey's trade with the EU. An increase in Turkey's trade volume with the EU has taken place, as well as the diversification of both exports and imports. (Nas pp.146-150). The data presented in the Graph No 1 shows that Turkey's total trade volume was growing slightly during the first years after the entry into force of the customs union. A more rapid increase in the total trade volume has been observed since 2003, with the exception of years 2009-2010, when the global financial crisis occurred. Export to and import from the EU showed the same tendencies (see Graph No 2). It is worth noting that Turkey's

export to the EU increased 5.3 times in the years 1996-2013, and import from the EU grew 4 times in the same period. The net current account of Turkey amounted, however, to -29.4 billion USD in 2013 (CEIC data and own calculations).

At the beginning of the customs union, the EU as a whole was the dominating trade partner of Turkey, which is confirmed by the EU shares in Turkey's total export and import (see Graph 3). In 1996 these shares amounted to 51.5% and 53.2% respectively. The EU share in Turkey's total export was growing in subsequent years and amounted to 57.9% in 2004. Since then, it can be observed that the EU share in Turkey's total export has been decreasing. The EU accounted for only 41.5% of Turkey's export in 2013, i.e. 10 percentage points less than in 1996. The EU share in Turkey's total import was decreasing throughout the whole analyzed period. This share amounted to 49.3% in 2004 and 36.7% in 2013. In comparison to the beginning of the customs union, this share diminished by 16.5 percentage points (CEIC data and own calculations). The EU as a whole remains, nevertheless, Turkey's biggest trading partner while Turkey continues to be the EU's sixth largest partner in foreign trade (EC 2013, pp. 4-5).

The data cited above shows that Turkey being a member of the EU customs union has differentiated the directions of its trade flows and led to the development of its trade relations with third countries. At least three factors seem to influence these processes. Firstly, the creation of the customs union with the EU requires Turkey's adjustments to the EU FTA's and gives it opportunities to diversify its trade relations.<sup>1</sup> Secondly, the WTO membership of both partners has had an impact on the weighted average tariff rates used after entering the customs union into life. These rates amounted to 5.48% before and 4.65% after the creation of the customs union. This means that the WTO members also benefited from the customs union between the EU and Turkey (Raport 2011, p.193). Although it has been pointed out that Turkey is the subject of WTO disputes, lower trade barriers under the WTO rules enable it to develop foreign trade. Thirdly, the decrease in the EU's share in Turkey's total trade in the years 2008-2013 might have been related to the consequences of the global financial crisis, which were acute for some EU Member States.

The specific type of the association model, including a customs union instead of a free trade area, which was implemented in the relations between the EU and Turkey was expected to help in the future accession negotiations.

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<sup>1</sup> Turkey has concluded 19 preferential agreements with the EU partners, of which 11 is now in force (Raport 2011, p. 183).

However this model, chosen in the 1960s, could not absorb new integration aspects occurring over time and it is evaluated rather critically in the context of the accession negotiations (Rapoport 2011, pp.194-195).

#### **4. Accession negotiations between the EU and Turkey – achievements and obstacles**

Following the adoption by the European Commission of the European Strategy for Turkey in 1998, in 1999 the European Council gave Turkey the status of a candidate country for EU membership. This was treated as a groundbreaking event for Turkey-EU relations (Aksu, p. 12-13; Joseph, p.174-175). Turkey was assessed to have fulfilled the Copenhagen criteria and the accession negotiations were officially launched on 20 October 2005. The Negotiating Framework provided for 2014 as the earliest possible date for accession, but the negotiation process was treated as ‘open-ended’ and without any guarantees (Hakura 2006, p. 11). The screening process, as the first phase of the negotiations, was completed on 13 October 2006.

The initial optimism about the new opening in Turkey-EU relations was also based on some changes in Turkish politics and in its economy. Turkey adopted several reform packages in order to fulfil the EU obligations related to the democratisation of different aspects of life. Turkey also improved its position in the world economy, moving from the 26<sup>th</sup> position to 16<sup>th</sup> in a group of the largest economies in the world by 2011. The years between 2002-2012 were perceived as ‘... *transformative years in Turkey’s history in terms of political, economic and social developments.*’ (Aksu 2012, p.13). Despite these achievements however, serious political obstacles appeared and the relations between Turkey and the EU became almost frozen. The reasons for this were: the Cyprus issue, human rights violations, problems with the current judicial system in Turkey, and anti-Turkish sentiments in Europe (Aksu 2012, p.15). The reluctance of some European societies towards the prospects of Turkish membership of the EU might be explained, on the one hand, by cultural and religious differences between both partners, and on the other hand by socio-economic factors. The latter were connected with the free movement of people, agricultural subsidies, and structural policy. The Negotiating Framework specified that these issues may be subject to long-term restrictions or permanent derogations, which would be a controversial solution (Hakura 2006, p. 14), as Turkey is against these derogations. In this context a more general question arises if such a flexibility mechanism introduced by the EU in

relations with a future members does not undermine the key legal principle of non-discrimination and equality of all the EU Member States (Inglis 2011, pp.1-28).

According to the Ministry of Foreign Affairs of the Republic of Turkey, the results of the negotiations to date between the Turkey and the EU are as follows (Turkey –EU Relations, <http://www.mfa.gov.tr>):

- 13 chapters<sup>2</sup> have been opened to negotiations so far, and one of them has been provisionally closed (25-‘Science and Research’),
- The negotiations on 8 chapters<sup>3</sup> cannot be opened at present as a result of the EU Council decision of December 2006, on the ground that Turkey is not undertaking its obligations stemming from the Additional Protocol to the Ankara Agreement in its entirety (Turkey’s position with respect to the Greek Cypriot Administration),
- No more chapters can be provisionally closed – the justification is as above
- In 2007, France blocked the opening of the negotiations on five chapters; however, the blockage on chapter 22 was lifted,<sup>4</sup>
- In 2009, the Greek Cypriot Administration unilaterally stated that it would block the opening of six chapters.<sup>5</sup>

According to the European Commission’s progress report on the negotiations with Turkey, the opening of the negotiations on the chapter 22 is an important step towards overcoming the three-year stalemate in these negotiations (EC 2013). The document points out some progress as far as fulfilment of the political criteria is concerned. Turkey has adopted both the judicial reform and the democratisation packages in 2013. Nevertheless, further progress is held back by various persisting factors. The main political obstacle seems to be the implementation of the Additional Protocol to the Association Agreement and related to the *Cyprus issue*. At the same time, an assessment of the fulfilment of the economic criteria shows that Turkey is a functioning market economy and it would be able to cope with the competitive pressure and market forces within the EU in the medium term. The implementation of some structural reforms, however, should be accelerated.

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<sup>2</sup> These include among others: chapter 4-‘Free Movements of Capital’.

<sup>3</sup> These are: ‘1- Free Movement of Goods’, ‘3-Right of Establishment and Freedom to Provide Services’, ‘9-Financial Services’, ‘11- Agriculture and Rural Development’, ‘13-Fisheries’, ‘14-Transport Policy’, ‘29-Customs Union’ and ‘30-External Services’.

<sup>4</sup> It is ‘22-Regional Policy and Coordination of Structural Funds’.

<sup>5</sup> Among others it is: ‘2-Freedom of Movement of Workers’.

As above mentioned facts and opinions show, serious barriers have appeared in the course of the membership negotiations between the EU and Turkey, and completing the negotiations will be rather a difficult and long-lasting task.

### **5. Progress in the establishment of the free movement of capital between the EU and Turkey**

The free movement of capital is a constitutive element of the common market, and a candidate country must undertake the necessary measures in order to achieve the required liberalization level. Turkey, as a member of the OECD from 1961 and a candidate country for membership of the EU, is expected to liberalize capital movements in its relations with other Member States.

The OCED members should respect the Code of Liberalisation of Capital Movements and the Code of Liberalisation of Current Invisible Operations. These Codes constitute legally binding rules and are implemented through 'peer pressure'. Policy reviews and assessments and examinations of countries are used as methods of putting pressure on the Member States (OECD, <http://www.oecd.org>). One important aspect of implementing the OECD Codes is 'benchmarking', which gives countries a type of guidance and support in the field of their own financial liberalization (OECD 2002).

The implementation of the provisions of the Code of Liberalisation of Capital Movements is not unconditional. An OECD member has the right to:

- lodge reservations relating to the obligations resulting from the Code (Article 2b),
- introduce clauses of derogations if economic and financial conditions justify such a course (Article 7),
- use exceptions to the principle of non-discrimination because of being part of a special customs or monetary system (Article 10),
- withdraw from the Code by transmitting a notice in writing to the Secretary-General of the Organisation (Article 22).

Turkey has introduced financial liberalization gradually over the course of its OECD membership. Historically, the main step in the financial liberalization process was the abolition of the limitations and controls imposed on interest rates and foreign currency transactions at the beginning of the 1980s (Ekinci 2006, pp. 21-24; Takim 2010, p.528-529). In 1982, the Capital Market Law was enacted in Turkey in order to regulate the Turkish capital market, and within this scheme the Capital Market Board was established. In 1986, the Istanbul Stock Exchange (ISE) was established and government



bonds and securities exchange markets started functioning. The Turkish Central Bank initiated open market transactions in 1987. Resolution No 32 of the Council of Ministers, enacted in 1989, introduced full liberalization of capital movements and thus the process related to the liberalization of foreign currency operations and capital movements was concluded (Takim 2010, p.528-529). Turkey became integrated into global financial markets as a result of these legislative processes by 1991 (Ekinci 2006, p.22).

Foreign direct investment, treated as one of the types of capital movements, was also liberalized by Turkey incrementally in the years 1954-2003. As a result, Turkish legal regulations offer basic guarantees for foreign investors, i.e. a freedom of investing in Turkey, a national treatment. i.e. equal treatment with local investors, no restrictions on the share of foreign partners, and a guarantee against expropriation or nationalisation without proper compensation (Ekinci 2006, pp.22-23).

The above presented state of legal regulations in Turkey concerning capital movements would imply that this country is fully adjusted to the rules of free capital movement, not only within the OECD but also within the EU. However, the list of reservations lodged within the OECD Codes includes a relatively high number of derogations from its provisions. These include reservations related to direct investment, to some operations in real estate, in securities on capital and money markets, some operations in negotiable instruments and non-securitised claims, some operations in collective investment securities, credits granted by non-residents to residents and vice versa, some credits and loans granted by residents to non-residents, and the operation of deposit accounts (OECD 2011, pp. 132-135).

In its *Turkey 2013 Progress Report*, the European Commission evaluates the current state of liberalization processes in this country concerning the *Free movement of capital* as not satisfactory enough, although some progress has been observed recently (EC 2013, pp. 26-27). The main objections of the EU are related to:

- Turkey's legislative framework on the **acquisition of real estate by foreigners**, which is not in line with Article 63 of the Treaty of Functioning of the European Union. The EC states: '*Arrangements for real estate acquisition remain non-transparent, not aligned with the acquis and restrictive of rights of a number of Member States nationals*' (EC 2013, p. 27); Greek, Bulgarian and Cypriot citizens are subject to specific restrictions;
- **sector restrictions on foreign ownership** in Turkey; some restrictions continue to exist in radio and TV broadcasting, transport, education, and electricity generation and distribution;

- the **fight against money laundering and terrorist financing**; although Turkey adopted the Law on Prevention of Financing of Terrorism and a relevant implementing regulation in 2013, the new Law does not address all the shortcomings identified by Financial Action Task Force; as a result, Turkey is still on the list of *jurisdictions with strategic anti-money laundering/counter-terrorist financing deficiencies*. It is pointed out that while the new Law gives the legal basis for freezing terrorists' assets, nevertheless Turkey's activities remain limited in this field.

The European Commission takes note of some progress as regards payment systems. A new Law was introduced regulating settlements systems in securities and payments, and electronic money. Implementation regulations will be adopted within a year, hence, it is concluded that the current legislative framework needs to be aligned with the *acquis*.

The evaluation of the liberalization processes in the field of free capital movements between the EU and Turkey shows that adjustments are still required. A sensitive issue is the acquisition of real estate in Turkey by non-residents, which is determined by both economic and political factors. The obligations arising from Turkey's preparation for membership of the EU seem to be more demanding than those related to its membership of the OECD.

## **6. Foreign direct investment flows between the European Union and Turkey as a candidate country**

The main factors influencing the scale of FDI flows into Turkey are related to its advantages, which are: economic growth, market size, labour costs, strategic geographical location, an investment climate determined by a generous incentive policy, and customs union with the EU.

As indicated above, Turkey encourages FDI inflows into its economy using a generous package of incentives. Implementation of the incentive policy is based on the national treatment rule, which means that incentives are available to both domestic and foreign investors alike. The new incentive package entered into force in 2012 includes VAT and customs duty exemptions, employer social security contribution exemptions, corporate or personal income tax concessions and land grants and interest–rate subsidies to investment projects. The eligibility of incentives depends on region, sector and size criteria, which are quite commonly used by less developed recipient countries (OECD 2012, p.55, Investment Incentives Turkey, [www.incentives.gov.tr](http://www.incentives.gov.tr)).

Benefits for investors locating their investment in the least developed regions amount up to 45% of initial investment costs, and up to 25% in the more developed regions. Additionally, in the case of investment in the least developed regions employer and employee social security contributions and personal income tax will be exempted for 10 years. Sector differentiation of incentives is relatively low. However, some 'priority' sectors receive stronger incentives, irrespective of regional location. These are: tourism, mining, railroad and maritime transport, pharmaceuticals, defence and education. Moreover, newly defined 'strategic' sectors will receive additional benefits. These are sectors where Turkey's dependence on imports is the highest. Finally, incentives are differentiated by investment size. The largest investment projects, with initial costs above TL 50 million, are granted additional tax concessions (OECD 2012, Investment Incentives Turkey, [www.incentives.gov.tr](http://www.incentives.gov.tr)).

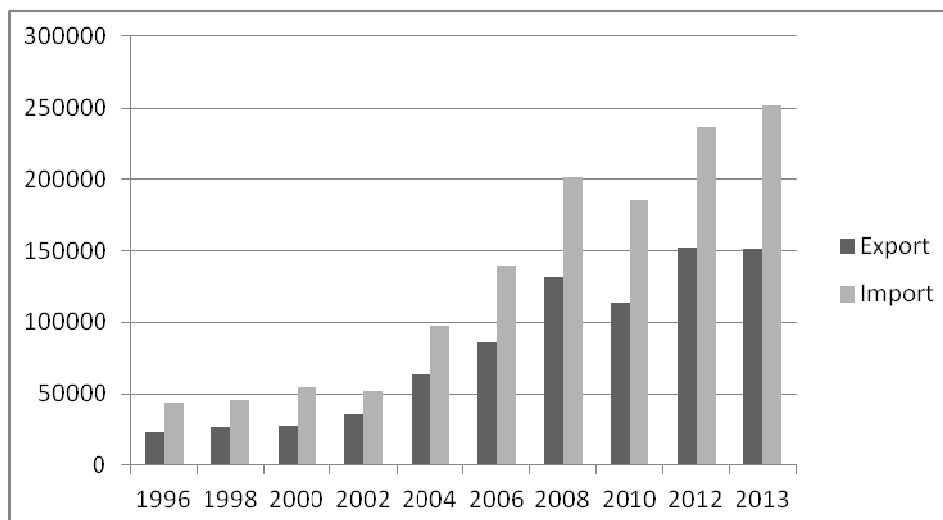
The strength of the particular internal factors mentioned above could be subject to dispute. However, FDI inflows are dependent on global and regional factors as well. Graph No 5 presents the trends in FDI flows into and out of Turkey in the years 1990-2012. This data shows that at the beginning of the functioning of the customs union with the EU there were no rapid changes in FDI inflows into Turkey. The inflows soared a decade later, i.e. in 2005-2007, similar to the trends in global FDI inflows. The global financial crisis drastically reduced both the global FDI inflows and FDI inflows into Turkey. The latter declined more than by a half. The recovery of the global FDI flows is a rather slow and bumpy road (UNCTAD 2013). In 2012 Turkey received USD 12 billion, i.e. USD 10 billion less than in the record year 2007, but still almost five times more than in 2004. Positive decisions taken by foreign investors to invest in Turkey in the years 2005-2012 might have been influenced by the structural reforms undertaken in Turkey and by incentive regimes, which were modified in 2004, 2005 and 2009. However, FDI flows are more sensitive to the global economic and political situation than trade flows. Hence, Turkey and other countries have experienced a deep decline in FDI inflows. Almost 71% of FDI located in Turkey comes from the EU and is characterized by a strong high-technology component (EC 2013, p.5). FDI outflows from Turkey are limited as far as their scale is concerned, but they have been growing in recent years. Turkey remains a net importer of capital in the form of FDI.

The relative importance of FDI in Turkey's economy is still moderate. FDI inward stocks amounted to USD 140 billion and constituted 18.1% of Turkey's GDP in 2011. FDI outward stocks amounted to USD 26 billion and 3.4% of its GDP. FDI inflows as a percentage of GDP confirms that Turkey relies mainly on internal factors in its development. This measure amounted to 2.1% in 2011 (OECD 2013).

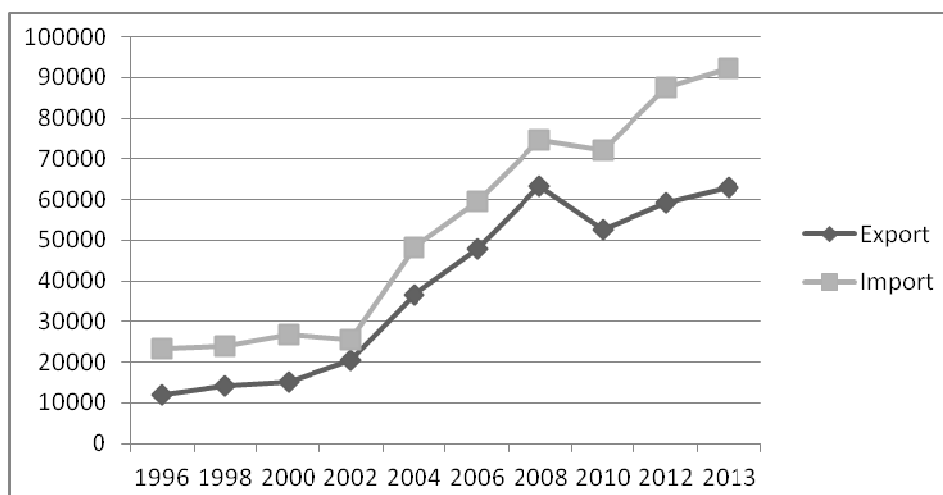
In the context of the above cited data it is difficult to state definitely if investment creation and diversion effects within the customs union occurred in the case of Turkey.

## **7. Conclusions**

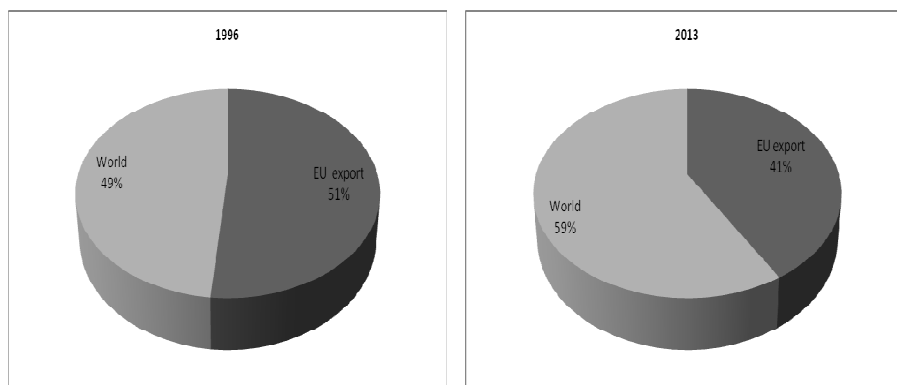
1. The integration processes to date between the EU and Turkey were conducted unconventionally, by using the institutional model of establishment of a customs union under an Association Agreement. Despite the earlier expectations, it has not helped much in the membership negotiations.
2. A specific feature of the EU-Turkey membership negotiations is the occurrence of serious political obstacles. These seem to be much stronger than they were in the previous enlargements.
3. Acceptance of permanent derogations related to some sensitive areas under the future EU-Turkey membership agreement, as proposed by the EU, could break the rules of non-discrimination and the equality of all EU Member States, which might constitute serious legal and political problems.
4. The case of Turkey, as well as the experiences from last three enlargements, seem to confirm that integration processes between countries at different levels of development cause economic problems, although benefits have also been achieved by all the partners. The EU Member States should be determined to offer assistance on an appropriate scale for a weaker candidate country.
5. The obligations of Turkey as a candidate country in the field of free movement of capital are more demanding under the EU scheme of liberalization of capital flows than within the OECD, regulated by its Codes.
6. Real economic integration between the negotiating parties has not gone further than that achieved at the stage of customs union. The free movement of capital requires further liberalization processes.
7. Turkey encourages foreign direct investment inflows using a generous package of incentives. However, the role of FDI in its economy still remains moderate.

**Graph 1. Turkey's total export and import , USD Million, 1996-2013**

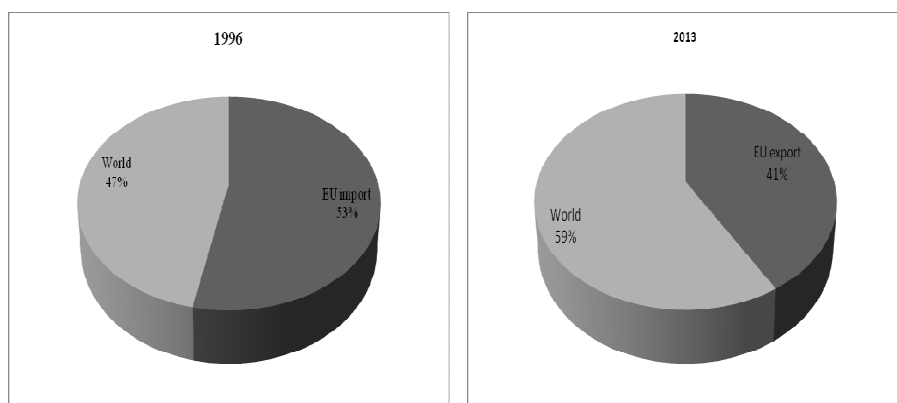
Source, CEIC data basis and own elaboration.

**Graph 2. Turkey's export to and import from the EU27, USD Million, 1996-2013**

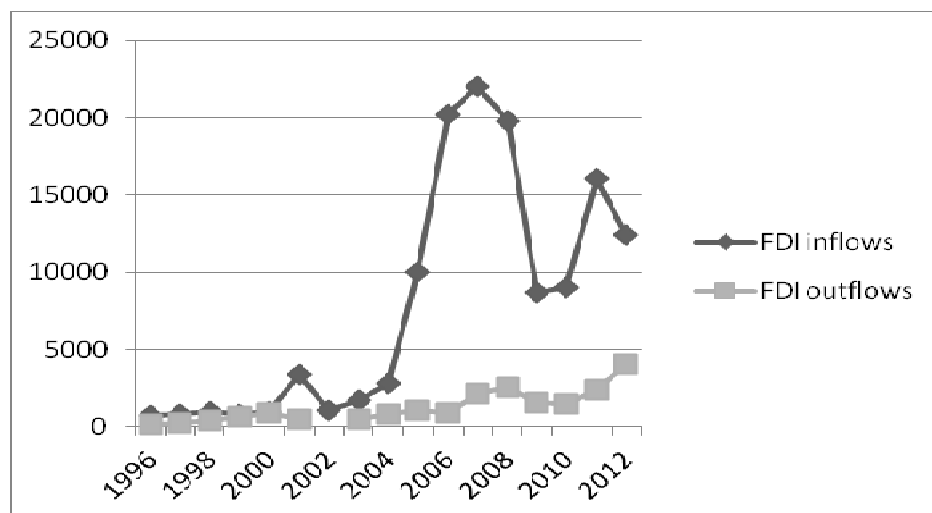
Source, CEIC data basis and own elaboration.

**Graph 3. The EU's shares in Turkey's total export - 1996, 2013 (in %)**

Source: CEIC data base and own calculations.

**Graph 4. The EU's shares in Turkey's total import - 1996, 2013 (in %)**

Source: CEIC data base and own calculations.

**Graph 5. Foreign direct investment flows into and out of Turkey, USD Million, 1996-2012**

Source: UNCTAD data base and own elaboration.

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## Streszczenie

### PRZEPIŁYWY KAPITAŁOWE MIĘDZY UNIĄ EUROPEJSKĄ A TURCJĄ W PROCESIE INTEGRACJI

*W procesie integracji między Unią Europejską a Turcją wykorzystany został instytucjonalny model, zakładający utworzenie unii celnej w ramach umowy o stowarzyszeniu. W kontekście trudności, jakie wystąpiły w trakcie negocjacji o członkostwo Turcji w UE, pojawia się pytanie, czy realna integracja gospodarcza między tymi partnerami wykroczyła poza poziom osiągnięty na etapie unii celnej. Przedmiotem artykułu jest swobodny przepływ kapitału, stanowiący kluczową swobodę w ramach jednolitego rynku europejskiego. Zobowiązania Turcji w zakresie swobodnego przepływu kapitału są bardziej daleko idące w ramach wymagań obowiązujących w UE, niż w ramach członkostwa w OECD, regulowanych tzw. Kodeksami. Rzeczywista integracja ekonomiczna między UE a Turcją wymaga dalszej liberalizacji przepływów kapitałowych. Turcja zachęca bezpośrednich inwestorów zagranicznych do inwestowania, wykorzystując hojny pakiet zachęt. Rola bezpośrednich inwestycji zagranicznych w gospodarce Turcji pozostaje jednak umiarkowana.*

**Słowa kluczowe:** Unia Europejska, Turcja, procesy integracji, przepływy kapitałowe, bezpośrednie inwestycje zagraniczne