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TURKEY'S RECENT TRADE AND FOREIGN DIRECT INVESTMENT PERFORMANCE

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Abstract

This paper analyzes the changes in the structure of trade as well as the developments in the capital account of Turkey since mid-1990s and discusses the possible composition of trade flows and Turkey's attractiveness for international capital inflows in the near future. Analysis of the long-term performance of Turkish exports and imports reveals that the efforts to increase exports were successful only to a certain degree. The country's large trade deficit with the rest of the world accumulates over time and frequently ends up with a crisis which automatically reduces the trade deficit by reducing the imports. Since 2001 the transformation of exports from the low-tech products to medium-tech and to a certain degree high-tech products has taken place. While this transformation helped bring the trade deficit with the EU down, it contributed to the widening of trade deficit vis-à-vis the Asian countries and oil exporters.

The initiation of the EU accession talks in 2005 invigorated the expectations for a more rapid and consistent implementation of the rules and regulations that ensure a level playing field for all companies, domestic and foreign, alike. The EU accession process enabled Turkey to attract record levels of FDI inflows. Almost all of the FDI inflows over the last four years have been composed of mergers and acquisitions, and directed mostly to service sectors and the real estate. From a longer term growth perspective Turkey needs to attract greenfield investments, especially in the manufacturing industries. In order to put Turkey in international producers' networks the current investment environment should further be improved by the implementation of long-delayed microeconomic structural reforms as well as judicial and legal reforms.

Keywords: Turkey, European Union, Foreign Trade, Current Account, Capital Account.

JEL Codes: F4, F14.

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I. Introduction

Over the last decade there have been significant changes in Turkey's external economic relations. The process of integration of the Turkish economy into the world economy has gained momentum following the Customs Union with the EU in 1996, the economic crisis of 2001 and the EU's decision to start accession talks with Turkey in December 2004. Current figures on foreign trade, foreign direct investments and other capital flows prove the case.

Both internal and external factors contributed to accelerating integration of the Turkish economy with the world economy. Thanks to the persistence in the implementation of macroeconomic and structural reforms, Turkish economy recovered rather quickly after the 2001 economic crisis. The increased confidence in Turkey's ability to sustain economic reforms led to a surge in capital inflows. While the increased domestic demand has been the domestic pull factor behind the faster growth performance, the availability of abundant foreign capital since 2003 has been the external push factor behind it.

The best way to characterize the Turkish growth experience since 2002 is to emphasize that Turkish growth is domestic demand (consumption and investment) driven. However, the rapid expansion of the domestic demand during this period implies that domestic savings was insufficient to finance the ever expanding domestic investment. When domestic savings are not sufficient the only alternative left to finance the expanding domestic demand is the foreign savings.

Actually, this basic characteristic of the Turkish economic growth has been observed since 1980s. Turkey's growth episodes over the last three decades are almost always financed by capital inflows. This was also the case in the post-2002 era. The availability of abundant international capital ready to flow into emerging markets and therefore Turkey led to the real appreciation of the Turkish Lira since 2002. This in turn further fueled the demand for imports, worsening the current account deficit. In addition, the secular upward trend in the international price of oil and other raw materials since 2003 contributed to the rapid deterioration of the current account balance, as the two thirds of the country's imports are raw materials and other intermediate goods.

The improvements in business environment, thanks to the bold reform agenda adopted in this period and with the EU decision to start membership negotiations with Turkey at the end of 2004, increased Turkey's attractiveness as a destination for global savings glut. The benign external conditions helped Turkey change the composition of the financing of its current account deficit toward the type of capital inflows that contributes less to the foreign debt accumulation. Since 2003, the shares of long-term capital inflows, non-debt creating capital inflows and non-bank private sector borrowing from abroad have increased in total capital inflows.

The cumulative portfolio investment of foreigners which was below US\$ 10 billion at the beginning of 2003 has exceeded US\$ 100 billion as of 2007. As of November 2008 the external debt stock of the private sector has reached US\$ 196.2

billion, US\$ 145 billion of which has long term maturity. Likewise, the foreign direct investment inflows (including real estate purchases by foreigners) continued to increase in 2007 and reached US\$ 22 billion. FDI performance of Turkey, has significantly improved since 2005. In 2006, Turkey was ranked the fifth among the emerging markets in terms of attracting FDI inflows. Total FDI inflows during 2005-2007 added up to US\$ 52 billion while the total FDI stock as of the end of 2007 reached US\$ 155 billion.

In addition to the rapid economic growth process after the 2001 economic crisis, the Chinese accession to the WTO in December 2001 help fueled the Turkish imports by making cheaper products available. Another critical factor behind the rapid increase in Turkish imports has been the real appreciation of the Lira since the end of 2001. More than 50% real appreciation of the Lira between 2002 and 2006 was in part a result of the success of the stabilization program that has been in effect since early 2001 as well as the benign conditions in international capital markets.

Despite the appreciation of the Lira, Turkish exports quadrupled since 2000, reaching USD 135 billion on an annual basis. This stellar performance of exporters was in part made possible by huge productivity gains in the manufacturing industry after the crisis as well as the appreciation of the euro against the dollar. While the EU accounts for more than 60% of Turkey's exports, its share in Turkish imports is less than one-half. Importing raw materials from East Asia and other parts of the world in dollar terms, Turkish exporters have been able to keep the costs of production under control.

In section II we review the changes in the Turkish trade regime since 1980s, followed by a detailed analysis of the integration of the Turkish economy with the world markets in section III. In section IV we focus on the trade performance since the 2001 economic crisis and the changes in the prices and composition of Turkish imports and exports. Section V is devoted to the analysis of Turkey's FDI performance. Section VI concludes the chapter.

II. Turkish Trade Regime since 1980s

The liberalization of foreign trade in Turkey started after the structural reforms in 1980 following the severe balance of payment crisis in the late 1970s. In the early years of the program (1980-1983) exports were encouraged through various direct and indirect measures such as export tax rebates, preferential export credits, foreign exchange allocations and the duty-free access to imports. During this period, the total subsidy rate received by manufactured goods exporters reached 20-23 percent of export value (Milanovic, 1986).

Elimination of import barriers gained momentum after 1984. First, quantitative restrictions were rapidly phased out (Togan 1994), and a large number of commodities were allowed to be imported without any prior permission. Second, there were significant reductions in tariff rates, especially on imports of intermediate and capital goods in the late 1980s and early 1990s. Though tariffs on certain goods (for example, consumer goods) were increased temporarily after the elimination of quantitative restrictions, this

did not lead to an increase in overall nominal protection rates, because imports of the goods in these categories were severely restricted before 1984. The output-weighted average nominal tariff rate for the manufacturing industry declined to 40 percent in 1990 and to 20.7 percent in 1994 from 76.9 percent in 1984,

The most important change in the trade regime of Turkey in the 1990s was initiated by the customs union between the EU and Turkey which came into effect on January 1st of 1996. The customs union was one of the steps that had been foreseen in the 1963 Ankara Agreement between the European Union and Turkey before Turkey was expected to become a full member.

Customs Union (CU) constituted an important step in Turkey's efforts to join the European Union. The Ankara Association Agreement in 1963 established the institutions of the Association and started the first phase of the Customs Union. Additional Protocol (1970) initiated the 2nd phase of the Customs Union. The European Countries eliminated all duties and other restrictive regulations of commerce with respect to all the trade in industrial products and processed agricultural products. Turkey in return had an adaptation period of 12 years to meet its obligations stemming from the CU and a transition period of 22 years for its sensitive industrial products. The decision 1/95 of the EC-Turkey Association Council Customs Union introduced the final phase in which Turkey also reduced its tariffs.

The CU assumes the adoption of a common customs policy and thus common tariffs against third countries. According to the provisions of the Turkey-EU Customs Union Decision No. 1/95, Turkey adopts the Free Trade Agreements (FTAs) signed by the EU, whether the country signs a FTA with Turkey or not. Non-completion of the FTAs by the countries that sign such agreements with the Union created trade distortions for Turkey.

The problem will be more severe in the case of FTAs of EU with South Korea and ASEAN. As in previous cases if Turkey cannot sign FTAs when the EU concludes negotiations with them, some sectors such as textile, electronics and motor vehicles will face serious competitiveness pressures.¹

Nearly 12 years after the Customs Union, EU has a stable share of around 50% in Turkey's foreign trade. The CU is important for Turkey's production structure, since 85% of total imports are intermediary and investment goods. The biggest increase in imports from the EU is in consumer products. The share of consumer goods rose to 15.1% in 2007 from 7.3% in 1994, while the share of intermediate goods has remained almost constant at around 63% and the share of investment goods decreased to 21.4% from 29.3% in the same period.

The share of investment goods in total exports from Turkey to the EU rose to 14% in 2007 from 2.9% in 1994, and the share of intermediate goods rose from 32.5% to

¹ At the time when the article is written, the negotiations were not finalised

38.7%, while the share of consumer goods declined to 47.1% from 64.6% in the same period.

The figures show the changes in the structure of Turkey's foreign trade after the CU. However, Customs Union has also been a strong proof of the capacity of Turkey to cope with competitive pressures and market forces within the European Union. It has also increased Turkey's resilience against global turmoil. The East Asian and Russian crisis of the 1990s and the global recession that has started in 2008 would have affected Turkey much more in the absence of CU.

The Customs Union is far more comprehensive when compared with other forms of associations such as Free Trade Agreements or Preferential Trade Agreements. As the membership process goes by it will include services sectors, public procurement and agriculture.

Turkish economy's performance after joining the CU provides insights for its future performance as it intensifies Turkey's integration with the EU and the rest of the world. Traditionally, Turkey has had strong trade relations with Europe. Between 1999 and 2003, trade with the EU-25 accounted for 53 percent of Turkey's exports and 51 percent of imports. Defining Europe to include countries that became members in 2004, and Bulgaria and Romania that joined in 2007, Europe's share of Turkish exports and imports in 2004 was 59 percent and 53 percent, respectively. With 49 percent share in imports at the end of 2005, EU continued to be the most important trade partner for Turkey, despite the rapid increase in imports from China in the 2000s. The Chinese share in imports rose to 7.8% in 2007 from 2.2% in 2001.

As a result of the Customs Union, there was a small decline in import tax revenues as Turkey lowered tariffs for imports from the EU. According to calculations reported in Togan (1997), the unweighted average tariff for the manufacturing industry decreased from 13.5 percent in 1995 to 3.6 percent in 1996. Import tariff revenues fell from 2.8 percent of total tax revenues in 1995 to an average of 1.1 percent over the period 2001–05. The decline in tax revenues, however, is too small to be blamed for the large budget deficits.

Increased competition in the form of higher imports from the EU forced productivity improvements in the manufacturing industry. Before the CU came into force some sectors such as automotive, durable home appliances, electrical machinery, and equipment had continued to receive protection behind high tariff barriers despite the import liberalization process that started a decade ago. Despite this fact, productivity growth was higher in import-competing sectors compared to export-oriented and non-traded goods sectors (See Ozler and Yilmaz, 2009)

The track record of the Turkish manufacturing industry in response to the CU has been better than expected, especially when one considers that Turkey received very little financial support from the EU to help ease the adjustment burden. As shown by Taymaz and Yilmaz (2007), even though the total factor productivity in the manufacturing

industry did not increase much between 1996 and 2000, the productivity in those sectors that experienced significant increases in import penetration rates rose substantially.

The CU agreement with the EU did not have much impact on Turkish exports in the first five years. The compounded annual growth rate of exports between 1996 and 2001 was 6.2% compared to 14.3% growth rate between 1980 and 1995. The EU had already removed tariffs on imports from Turkey long before the CU went into effect. In addition, despite the CU, the EU continued to reserve the right to impose antidumping duties on Turkish exports to the EU as well as keeping technical (regulation) barriers. Coupled with the appreciation of the lira, it is therefore not surprising that Turkish exports did not surge to the EU countries immediately after the CU.

The impact of the CU on Turkish exports was realized with a long delay, only after the 2001 crisis. The depreciation of the Turkish Lira and the contraction in domestic demand that followed the economic crisis of February 2001 forced domestic producers to search for export markets. Export revenues increased by only 12.6 percent in 2001. Exports continued to grow even after the domestic market resumed growth in 2002 and 2003 at a rate higher than the period prior to the crisis. Exports grew by 15 percent in 2002, 31 and 34 percent in 2003 and 2004, respectively and by 16 percent in 2005 and 2006. Better-than-expected export performance in 2002 and 2003 was achieved despite a 25 percent real appreciation, and even nominal appreciation, of the Turkish lira during this period. This remarkable export performance is in part due to the newly acquired competitiveness of the Turkish manufacturing industries that was forced by the increased competition after Turkey joined the CU.

In order to analyze the welfare implications of the CU agreement one should go beyond an evaluation of the effects of trade policy measures. Aside from trade-related implications the CU agreement foresaw changes in the commercial policy as well. As emphasized by Zahariadis (2002), the CU agreement also incorporates a number of “deep integration elements.” These include the harmonization of Turkey’s competition policy legislation to that of the EU, the adoption of the Community’s commercial policy towards third countries (the free trade agreements with all the EU’s preferential partners which worked against Turkey), and of the EU *Acquis* regarding the standardization of industrial products and consumer rights.

The welfare effects of the CU on the Turkish economy have been analyzed by several studies. Using a fully fledged computable general equilibrium model of Turkey, Harrison, Rutherford and Tarr (1996) show that as a result of the CU Turkish welfare would increase between 1 and 1.5 percent of GDP. De Santis (2001) develop a similar CGE model on Turkey and show that the CU agreement did not have trade diversion effects. Furthermore, De Santis also showed that while the urban households welfare decline by -0.5% equivalent of their income, that of the rural household increase by 2.3%. Overall, the aggregate welfare increases by 0.6% as a result of the CU agreement.

While these models are static in nature, it is possible to incorporate some form of dynamics into these models, via investment and capital stock. Zahariadis (2002) looked at the effects of deep integration following the completion of the EU-Turkey customs union

by focusing on technical barriers to trade (standards harmonization), as well as barriers emerging from border formalities and related procedures, and found that gains from deep integration are found to be smaller than tariff related ones. However, he concludes with a caveat that the estimated gains could be biased downwards because the multi-sector, multi-region CGE model used in the analysis does not take into account efficiency gains that would emerge as a result of the adoption of EU standards by Turkish domestic producers.

Based on the welfare analyses of the effects of the CU on Turkish economy, It would not be wrong to conclude that Turkey performed quite well under the CU agreement since it stood against the competitive pressure from the EU, while it continued to increase its exports in a renewed product mix. Overall we can say that the Customs Union has been beneficial for Turkey. Finally, the Customs Union did not lead to the increased trade deficit with the EU as the critics of the agreement foresaw. The share of the EU in Turkey's foreign trade deficit decreased from 57.6 % in 1996 to 13% in 2007.

III. Accelerated Integration to World Markets

There were four main episodes of the globalization of the Turkish Economy. Before, 1980, the economy was characterized by heavy protection. The liberalization in foreign trade after 1980's was followed by the liberalization of capital movements in August 1989. The ratio of exports to GDP more than tripled while the ratio of imports to GDP increased more than twice in the 1980-2007 period. The integration process gained momentum after the Customs Union decision with the EU in 1996 and once again after the 2001 crisis which is followed by macroeconomic stability and sustained growth in the 2002-2007 period. As a ratio of GDP, imports and exports rose to 24% and 16% in 2002-2007 period, respectively, and the ratio of trade volume has reached to 40% from less than 10% before 1980 (Table 1). The compounded annual rate of change in imports has been slightly higher than in exports, 27%, and 24.4% respectively.

Table 1. External Trade since 1970s

	1970-79	1980-1995	1996-2001	2002-2007
Trade Balance (billion \$)	-2.0	-6.0	-18.8	-38.7
Exports/ Imports (%)	47.3	64.0	59.7	65.0
Imports / GDP (%)	6.8	15.8	20.8	24.4
Exports / GDP (%)	3.0	10.2	12.3	15.8
(X-M) / GDP (%)	-3.8	-5.6	-8.5	-8.6
(X+M) / GDP (%)	9.7	26.0	33.0	40.1
Imports - annual compounded rate of change (%)	20.5	10.6	-1.0	27.0
Exports - annual compounded rate of change (%)	16.1	14.3	6.2	24.4

Source: Turkstat and authors' calculations.

On the imports front, after the implementation of the Customs Union in 1996, the penetration of imports from the EU increased from 17% to 22%.. China's accession to the

WTO in September 2001 led to an even more dramatic change in the structure of Turkey's imports. Total imports (over a 12-month period) surpassed USD 207 billion in November 2008. The share of imports from East Asia, and especially from China, increased dramatically to 7.8% in the post-2001 period, at the expense of the EU. Besides the Customs Union and China's accession to the WTO, the real appreciation of the Lira since the end of 2001 has been the third critical factor behind the rapid increase in Turkish imports over the last decade. Monthly CPI based exchange rate index published by the CBRT, shows that Turkish Lira appreciated by 66% in real terms from the end of 2001 to August 2008, when it reached its climax.

The rapid increase in imports was not the only major development in Turkey's trade relations with the rest of the world. Despite the appreciation of the Lira, Turkish exports quadrupled since 2000, reaching USD 134 billion (over a 12-month period) in November 2008.

The liberalization of foreign trade, affected both imports and exports similarly. Although both exports and imports have increased sharply and the ratios of exports and imports to GDP have gone up, the export/import ratio has stayed almost the same, showing that all the efforts to increase exports fell short of making the trade balance narrower. Although exports increased at record levels, the coverage ratio had been at a decreasing trend in the post 2001 period, putting shade on the export success.

Figure 1. Export/Import Ratio (1950-2007)



The macroeconomic stabilization program and the accompanying structural reforms that were put into effect after the 2001 crisis have been instrumental in restraining wild fluctuations of the economic variables. The import coverage ratio of exports also smoothed out. After reaching 75.7% in 2001, the export/import ratio steadily declined since then to 61.3% by 2006 before increasing slightly to 63.1%. Compared to the unstable period of 1996-2001, the average export/import ratio during the 2002-07 period has increased slightly to 66.5%.

Recent studies such as Kaminski and Ng (2007) and Aysan and Hacıhasanoglu (2007) have specifically pointed out the acceleration in Turkish exports since 2001. While exports in value terms have increased by an annual average rate of % 21.5%, the rate of increase for imports has been 19.5%.

Yükseler and Türkan (2006), on the other hand, have pointed out the underlying weaknesses in the production and foreign trade structure during the post-2001 period. They have characterized the transformation of the Turkish industry and foreign trade as a process of internationalization, increased import dependence and increased trade with Asian countries. They have pointed out the increasing ratio of imports to production and imports to supply in manufacturing industries and called it as increased import dependence. Although the level of exports has increased, imports have also increased and a closer look at sectors reveals that there has been an increase in intra-industry trade. According to these authors, while leading to high growth rates for exports, intensification of intra-industry trade falls short of creating a substantial positive impact on value-added and employment. The authors call this process as internationalization. Together with the appreciation of TL, the tightening competitiveness conditions have forced the exporters to “buy from Asia and sell to European markets”. Drawing attention to the increasing share of Asian countries in imports, the authors suggest that this process would have important repercussions on the future production model, price level and employment structure.

IV. The determinants of foreign trade performance since 2001

Analysis of the long-term performance of Turkish exports and imports, reveals that the efforts to increase exports were successful only to a certain degree. Being not rich in natural resources, physical capital or human capital resources the country tends to give trade deficit with the rest of the world. The trade deficit accumulates over time and frequently ends up with a crisis which automatically reduces the trade deficit by reducing the import bill. However, as the economy recovers, imports start to rise again. The success in increasing exports marks the extent and duration of the correction in trade deficit. In each case, trade deficit starts to rise again as the increase in exports could not be sustained. The measures taken to increase exports stimulate the transformation of the production structure and product mix. That transformation also coincides with a longer-term transformation of production activity away from agricultural sector and towards industry and services sectors.

In this section we will analyze the main contributors to Turkey’s foreign trade performance in the period after the 2001 crisis. The transformation of the manufacturing i output from low-tech products towards medium- and high-tech products has helped reduce the trade deficit with the EU, at the expense of widening trade deficit vis-à-vis the Asian countries.

Having achieved the transformation from agriculture to industry in the 1980s, Turkey was not in a position to benefit from hikes in agriculture and food prices. The country was no more a cheap labor country, so that its competitiveness in low-tech

manufacturing goods eroded against the labor abundant East Asian countries. This process accelerated after China's accession to the EU. The expiration of China's textile quotas to the US and the EU had also affected Turkey's export performance in this product group. As a reaction to the harsh competition from China and India, Turkey tended towards higher technology products.

We can figure out four main characteristics of the performance in exports and imports.

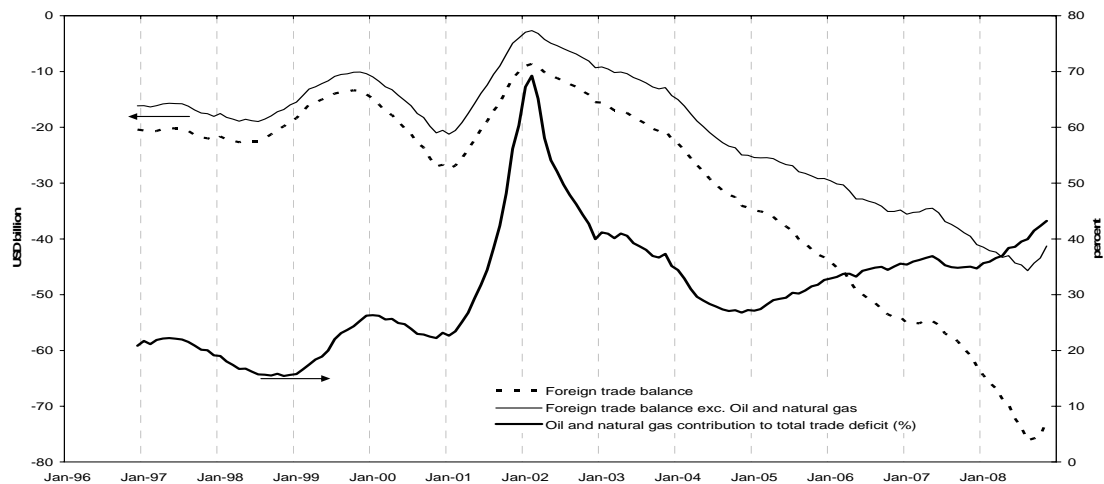
1. The oil bill put an extra burden on trade balance.
2. Turkey benefited well from the secular change in the Euro/US Dollar parity in favor of the Euro.
3. International price movements were not favorable for Turkish product mix.
4. The process of shifting towards more technology intensive product mix was slow and lost momentum lately.

Below, we will analyze each of these characteristics in detail.

4.1 Oil prices

Turkey is not particularly rich in terms of raw materials, and the energy intensity of production in Turkey is ever increasing. Turkey's dependence on oil and natural gas is high. The raw oil imports volume is almost constant. The total amount varies between 22,750 thousand tons and 24,000 thousands tons. However, the total import bill has increased rapidly after 2005. By 2006, the oil price has tripled the average level in 1996-2001. Oil prices continued to rise rapidly in the first half of 2008 and reached five times of its level in the 1996-2001 period.

Figure 2. Trade Deficit and Energy Imports



Natural gas is used heavily as a primary energy source in heating and in industry. As the price of natural gas moves along with the oil price, increases in oil prices forcibly increases the import bill. The country is currently 72% dependent on imports for energy. The Ministry of Energy estimates this ratio to rise to 80% by the year 2020.

The contribution of oil and natural gas imports to overall trade deficit increased substantially during the 2001 economic crisis (see Figure 2). However, this upward jump is mainly a result of rapidly shrinking trade deficit during the crisis. However, the energy import bill could not be reduced as quickly as the rest of imports because as energy is key for the industry as well as households. The imported energy bill, including oil and natural gas, increased almost four folds between 2001 and 2008 to reach 31 billion dollars. The energy bill constituted 36% of total trade deficit in 2007. As the oil price continued to increase during most of 2008 the ratio increased further to 54% by November 2008. However, with the global economy facing the worst recession in decades the energy import bill is expected to fall along with the decrease in oil and natural gas prices.

In the long-term Turkey will again face increasing energy import bill because so far Turkey has not been successful in the diversification of its energy sources. Unless it diversifies its natural gas imports, it will lose bargaining power vis-a-vis Russia, its main energy supplier. As result Turkey is likely to pay higher prices for natural gas imports in the future. The trade deficit problem that is caused by high energy imports is not simply a foreign trade problem since any increase in export revenues will go to meet the energy bill. Thus, besides increasing exports of manufacturing goods, Turkey has to achieve energy supply diversification and increase the share of domestic sources. The diversification of supply is also a critical element for Turkey to become an energy corridor as well as a terminal. 75% of the crude oil and natural gas reserves of the world lie in the surrounding countries of Caspian, Europe, Middle Asia, Middle Eastern regions and Russia. According to the Ministry of Energy, Turkey has already taken on several initiatives to become an East-West Energy corridor and completed 3,368 km crude oil and 4,000 km natural gas pipelines. Turkey's completed international oil and gas projects include:

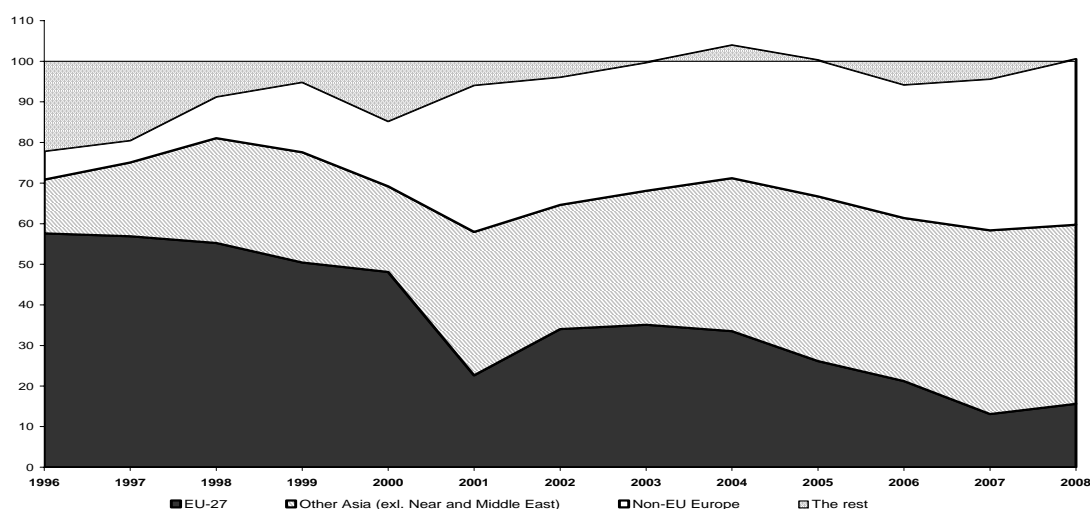
- Blue Stream Natural Gas Pipeline
- Baku-Tblisi-Ceyhan Crude Oil Pipeline
- Baku-Tblisi-Erzurum Natural Gas Pipeline
- Kirkuk-Yumurtalik Crude Oil Pipeline
- Turkey-Greece Natural Gas Pipeline

According to the Ministry of Energy, Turkey is developing several other pipeline projects including Nabucco which will transmit the Caspian and Middle East natural gas reserves to European markets. With completing these projects, Turkey will not only be able to diversify its energy supply but will also be able to generate revenue from the transmission of natural gas and oil. Furthermore, Turkey needs to develop an energy policy with the objective of making greater use of renewable energy sources to reduce the dependency on fossil oil sources and reduce its energy import bill.

4.2 The euro/dollar parity

Along with the huge productivity gains in the manufacturing industry, the appreciation of the euro against the dollar was one of the factors that contributed significantly to the stellar performance of the Turkish exports since 2001. Importing raw materials from East Asia and other parts of the world in dollar terms and exporting mostly in euro terms, Turkish exporters have been able to stay competitive in the wake of a real appreciation trend for Turkish Lira.

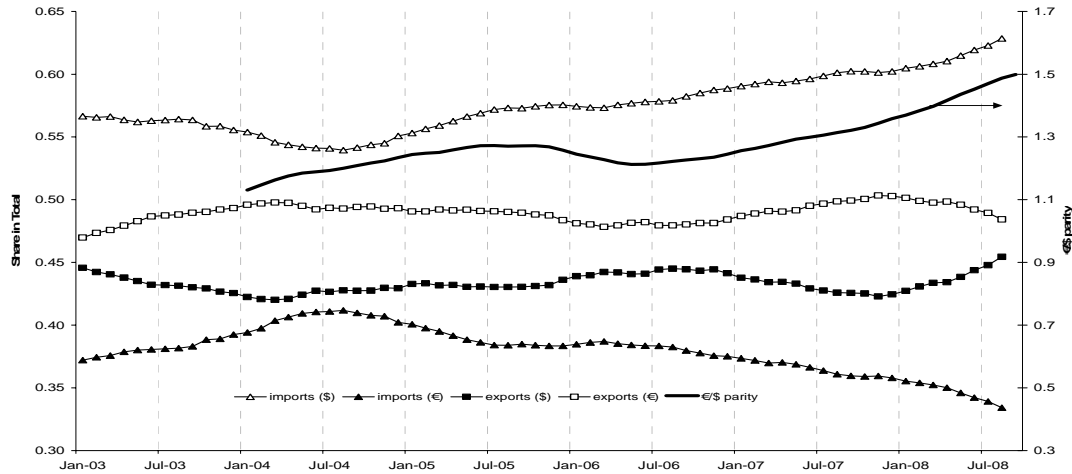
Figure 3. Major Trade Partner Groups' Contribution to Trade Deficit (%)



After the CU, the share of the EU in Turkey's total imports had been on a downward trend. The share of the EU in total imports has decreased to 40% in 2007 from 56% in 1996 while, East Asia's share has doubled to reach 20% in 2007. One can argue that under the CU agreement the share of the EU in Turkey's trade balance decreased from 57.6 % in 1996 to 13% in 2007 (Figure 3). In the meantime, excluding Middle East and Near East, Asia's contribution to total trade deficit increased from 13% in 1996 to 45 percent in 2008.

Figure 4 clearly exhibits that the importers in Turkey had been quite successful in sourcing their imports more and more from suppliers that price their products in US dollars away from euro suppliers when the euro appreciated against the dollar. The euro/dollar parity has moved from 1.131 in 2003 to 1.358 at the end of 2007. That parity change has been reflected on the origin of imports. From mid- 2004 until the end of 2007, the share of imports in dollars rose to 60% from 54% while the share of imports in euros has decreased to 36% from 41% (Figure 4).

Figure 4. Turkey's Exports and Imports - By type of currency
(% share, 12 months moving average)



4.3 The International Price Effect

As we have shown above the export performance is overestimated if denominated in US dollar terms. Although imports are largely determined by the strength of domestic demand, there has been an important effect of international price movement on exports. For a better evaluation of both exports and imports, we will look at the foreign trade performance excluding the price effect.

In the 2001-2008 period, the average annual growth rate of exports based on monthly data was 24%. The growth rate was 15.1% in terms of the quantity index and 8.3% in terms of price index.

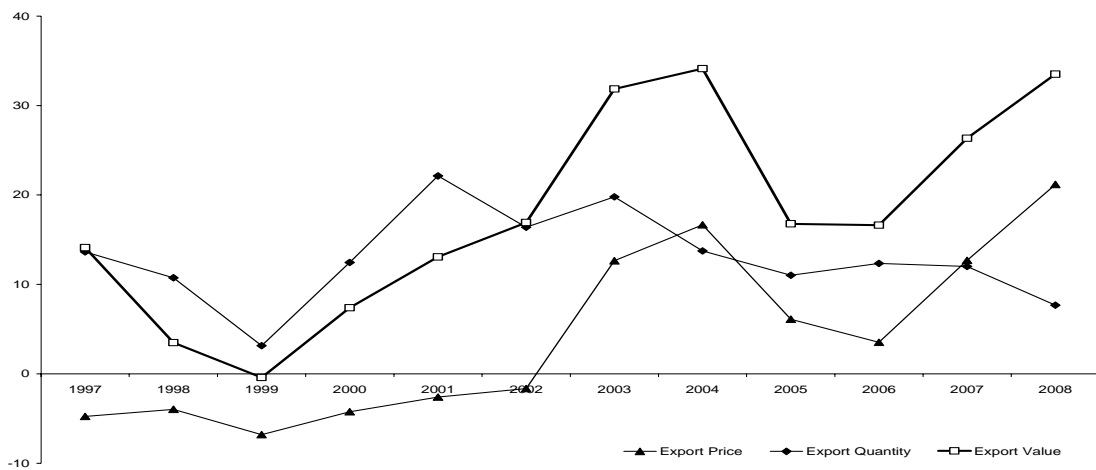
Looking at monthly data, annual rate of increase in exports started to decelerate in 2005. The trend is quite visible if the data is smoothed by taking 12 months moving average. The year-on-year growth figure started to accelerate after the second quarter of 2006, when we saw a correction in the value of TL. The strong growth performance on exports continued until the last quarter of 2008. As the recession fears intensified worldwide, Turkey's monthly exports as well as imports declined slightly in October followed by a sharp downturn in November.

However, quantity and price indices reveal a different story. The quantity index of exports has been at a decreasing trend since the beginning of 2002 with an exceptional increase for around one year starting from the first quarter of 2006. The price index on the other hand, has a very similar trend with export values. Thus, export prices acted to postpone the visibility of decreasing trend in exports.

Price effect played even a bigger role lately. Most people were astonished by the record-breaking export performance but that performance were mainly the result of merely higher prices. Starting from the second quarter of 2007, the quantity index and the

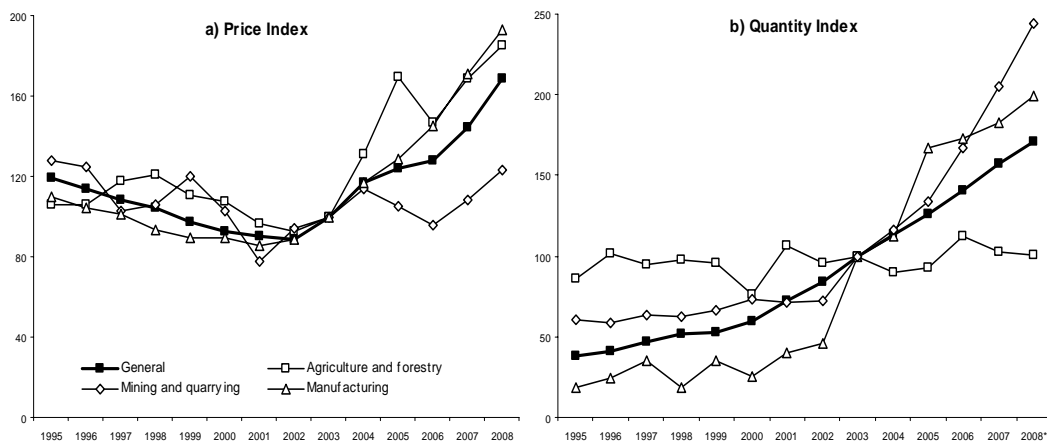
price index moved in opposite directions (Figure 5). In value terms, the rate of increase of exports accelerated to 37.4% in the third quarter of 2008 from 24.7% in the first quarter of 2007. The high level of prices supported the strong performance in exports. Growth rate in export prices index accelerated from 12.4% in the third quarter of 2007 to 24.4% in the third quarter of 2008. The growth rate in exports in quantity terms decelerated between the third quarter of 2007 and the third quarter of 2008, from 11.1% to 9.7%. Starting from the second quarter of 2008, this slowdown became more significant. The yearly increase in export quantity index came down to 9.7% in the third quarter from 19.8% in the first quarter. These figures show that the continued increase in exports can be attributable solely to the increase in export prices. After the collapse of prices in international markets in 2008, it became impossible to sustain growth in exports.

Figure 5. Turkish Exports - Value, Volume and Prices (percent change)



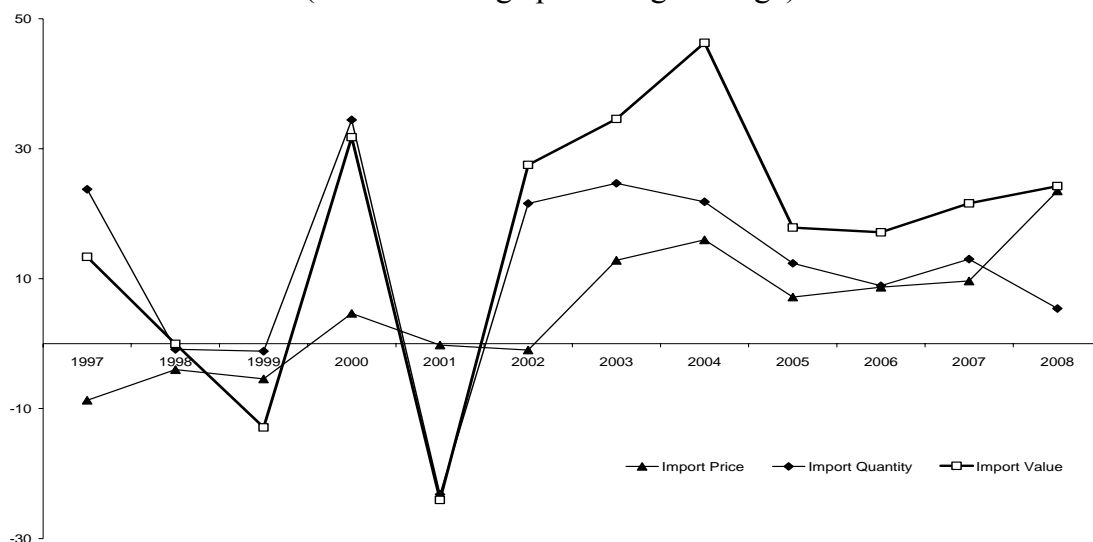
The decomposition of export performance to quantity and price effects reveals that the strong export performance is partly due to the increase in the average international price of exports. The rate of change in export quantity index has a clear downward trend since 2002. rate of increase in export quantities is at a decreasing trend.

Figure 6. Export Price and Quantity Indices



Another generally accepted success story for exports is the shift from agriculture to manufacturing industry. Decomposition of the export price and quantity indices shows that, quantity of agricultural exports started to decelerate after 2002, whereas their prices rose rapidly after 2004 (Figure 6). The agricultural goods export quantity index decreased to a level of 89.6 in the first three quarters of 2008, from 106.4 in 2002, whilst, the price index rose to 180.6 from 92.6 in the same period. Thus, Turkey continued to shift away from agricultural goods to manufacturing goods exports at a time when the price indices moved in the opposite direction. And that shift away from agriculture to manufacturing had a dampening effect on the increase of exports in value terms.

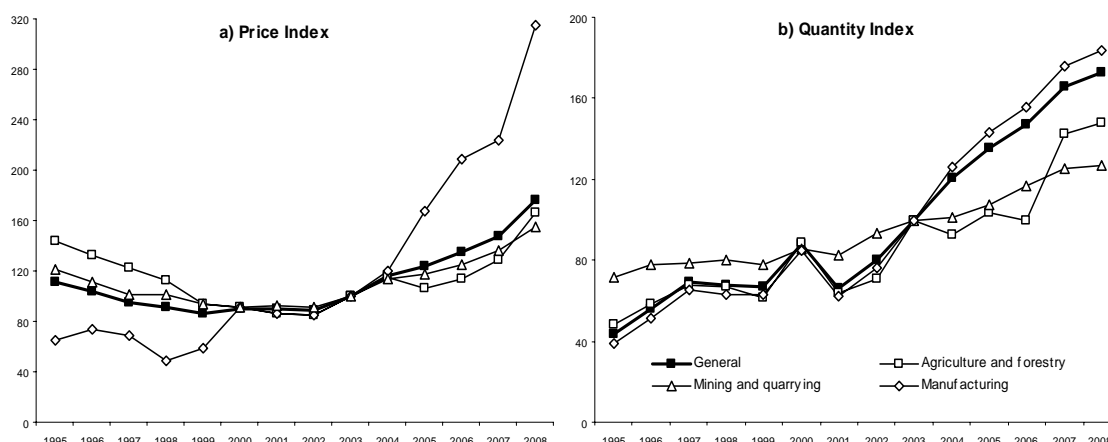
Figure 7. Imports - Value, Volume and Price
(Annual average percentage change)



A similar analysis on imports shows that, in the 2001-2008 period the average annual growth (based on monthly data) was 20.9 % in value terms (Figure 7). The growth rate in terms of quantity index was 10.8% and 9.4% in terms of price index,. In contrast with exports, import bill has moved with quantity of imports. Like exports, the price and quantity indices in 2008, have moved in sharp contrast with each other. Together with the deceleration in economic activity, import quantities started to lose momentum. The rate of increase in import quantity index decelerated from 16.2% in 2007 to 0.4% in 2008 when the third quarters of each year are considered. The price index on the other hand, rose from 7.2% to 29.2% during the same period.

Import price indices by economic activity reflect the rapid increase in oil prices (Figure 8). Prices of imported manufactured goods rose by 50% whilst the increase in prices of mining and quarrying products has been 3.5 folds. Although international price movements worked in favor of export revenues, they negatively affected imports.

Figure 8. Import Price and Quantity Indices



4.4. Technological Shift in the Composition of Exports

In the preceding sections, we have shown that although exports increased steadily, the achievement has rested mostly on export price movements and the parity changes that influenced exports and imports differently. In this section we will look at the changes in product mix to shed light on factors that go beyond prices.

2001 crisis was a crucial factor in explaining the transformation of production and foreign trade. The sharp depreciation of the TL and the fall of domestic demand forced Turkish companies towards foreign markets. This new impulse for increasing exports has also caused a radical change in the composition of exports, favoring the share of investment goods producing sectors in exports. The flipside of this process was the increase of the import dependency of the manufacturing sector, especially during the last five years. The change in the product composition of this sector (the imported input using activities increasing their share), and the appreciation of the TL were the main factors responsible for increasing import dependency.

While there was a considerable change in the product mix towards higher technology products, that shift did not contribute to the solution of problems such as high unemployment and large current account deficits. As shown below, during the last five years, manufactured goods sector created an important volume of foreign trade, but the impact of this trade on employment wasn't enough to counteract the unemployment problem.

There are few studies that analyzed the shift in the technological structure of exports. In an early study, Lall (2000) concluded that there was little evidence of an ability to shift to more dynamic products. He added that the country will not preserve the competitive advantage in low technology products since it is not a low wage economy

and thus will lose in international competition unless it shifts towards products with a higher technological content.

The same pessimistic viewpoint was repeated in more recent studies. Albaladejo (2006) pointed out the decline in the share of medium and high technology sectors and found that it difficult for the country to enhance its competitiveness unless it achieves major improvements in structural factors such as education, innovation system, and modern infrastructure..

Aysan and Hacıhasanoglu (2007) incorporated the change in the technological composition of manufacturing exports by analyzing percentage increase in sectoral export volumes.. They concluded that “Turkish exports experienced a structural change and shifted from conventional and unskilled labor intensive sectors to technology intensive sectors that required more skilled labor.” (p. 191)

Kaminski and Ng (2007) have adopted a taxonomy developed by Landsman and Stehrer (2003) to assess the technological content of Turkish exports in three categories. They found that EU oriented exports show a dramatic shift towards medium and high technology products, although low technology and unskilled labor-intensive products remain as major areas of specialization. According to these authors that shift has also led to higher wages in higher technology sectors, which in turn led to higher wages in services and unskilled labor-intensive sectors with obvious implications for their international competitiveness..

We will build our analysis on the findings of previous studies and argue that a shift from lower technology to higher technology products has started and that shift led to higher wages and employment opportunities in newly developing sectors.² But that shift could not be sustained since this depends crucially on the enhancement of the business environment. The reform motivation has started to weaken since 2006 and thus the technological shift has been short-lived.

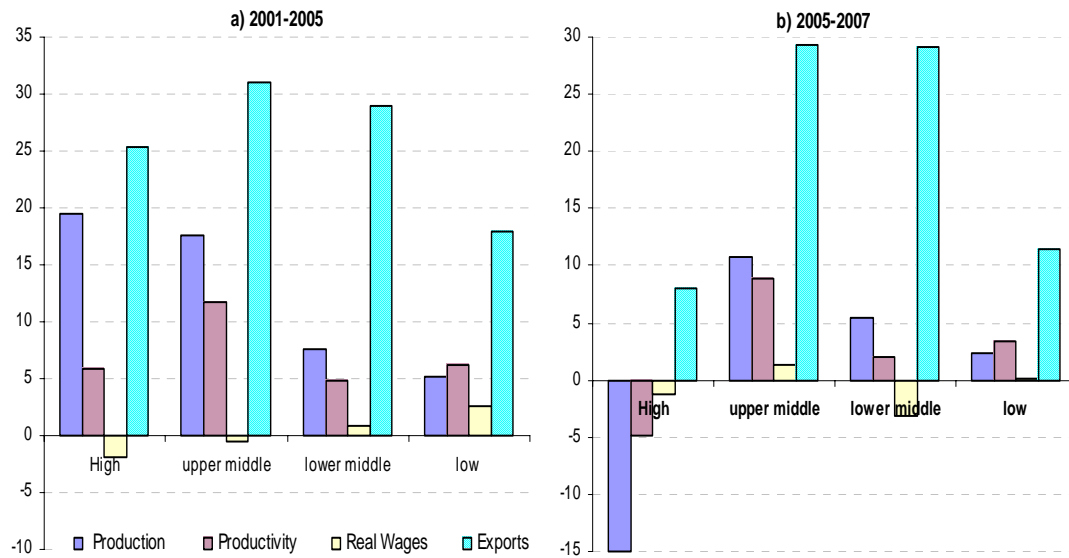
We divide the post-2001 period into two sub-periods. In the 2001-2005 period we see the positive impact of the macroeconomic stability achieved by a comprehensive stabilization program that was supported by a bold reform agenda. In this period, sectors that achieved the most rapid growth in production and exports were higher technology manufactured products. These were also the sectors that offered greater employment possibilities and higher real wages (See Figure 9)-.

The growth rates of production in these sectors followed closely their export performance and were above the average for the manufacturing sector, creating sizable employment. During the 2001-2005 period the rate of growth of production was 19.5% and 17.5% in high and upper middle technology products and only 7.5% and 5.1% in lower middle and low technology products (Figure 9). In the 2005-2007 period in the

² The sectors are grouped according to an OECD classification of manufactured goods sectors based on the intensity of technology.

high technology sectors the rate of growth of exports and production declined to 8% and 15%, respectively (See Figure 9 and Table 2).³

Figure 9. Performance of Sectors Grouped According to Technology Intensity (2001-2005 (Compounded Annual Average Change)



The high growth in production was supported by high rates of growth in productivity and exports. The increase in the production per work hour experienced during this period has shown that the increase of production was not entirely due to an increase in labor but instead reflected an increase in factor productivity under the pressure of the international competition. It is reasonable to assume that in these sectors, the changes in real wages were not a primary source of competitive advantage to boost export volume.

³ As shown by Taymaz and Yilmaz (2008), the exports and the production in the consumer electronics industry (which is classified as a high-tech industry) started to decline since 2005 as the industry has been unable to transform its production from CRT color television sets to the new LCD and plasma technology products.

Table 2. Selected Indicators of Turkish Manufacturing Industry
(Compounded Annual Percentage Change)

	1997-2007	1997-2001	2001-2005	2005-2007
Production Index				
High	4.97	2.47	19.46	-14.95
upper middle	6.58	-5.21	17.51	10.84
lower middle	3.31	-1.74	7.50	5.47
low	5.67	7.98	5.10	2.31
Productivity Per Hour Worked				
High	3.60	5.76	5.93	-4.91
upper middle	5.74	-1.32	11.69	8.80
lower middle	3.97	4.11	4.84	1.97
low	9.09	15.01	6.29	3.39
Real Wages Per Hour Worked				
High	-1.64	-1.57	-1.91	-1.22
upper middle	-0.20	-0.68	-0.47	1.30
lower middle	1.04	3.47	0.79	-3.19
low	0.44	-1.43	2.54	0.07
Exports				
High	21.35	24.58	25.30	7.99
upper middle	23.61	14.03	30.99	29.36
lower middle	19.50	6.51	28.96	29.19
low	9.27	0.28	17.89	11.46

Source: Turkstat and authors' calculations.

V. Foreign Direct Investment

Until recently Turkey was not successful in attracting FDI inflows. Before 2005, the average annual inflows of foreign direct investment Turkey received was less than one billion dollars. Furthermore, the majority of the multinational corporations establishing subsidiaries in Turkey mostly targeted the country's sizeable domestic market, rather than using their subsidiaries in Turkey as an export base.

Turkey's failure to attract large foreign investment inflows was mainly due to economic and political uncertainties surrounding the country in the 1990s and early 2000s. During this period Turkey experienced two major economic crises in 1994 and 2001 during which GDP declined by more than 5% each time. Furthermore, due to domestic political uncertainty and populist economic policies of successive governments, Turkey became quite vulnerable to external shocks such as the Russian crisis of 1998 and the Marmara earthquake that had shaken the industrial heartland of the country with substantial human losses.

However, after facing the threat of a complete systemic collapse in 2001 Turkey's political elites could produce no alternative to the policies dictated by the IMF which came to the rescue with a 19 billion dollars loan package. The structural reforms that targeted the conduct of fiscal policy and the regulation of the financial sector has been quite successful thanks to the technocratic leadership of Kemal Dervis, who served as the Minister in Charge of Economic Affairs from April 2001 to the summer of 2002. Both economic and political uncertainties subsided down with the successful implementation of structural reforms and the election of a single-party government in the November 2002 general elections and FDI inflows started to increase, albeit only slightly.

Aside from the macroeconomic and political uncertainties, foreign investors faced enormous institutional, legal and judicial obstacles. The insufficient clarity of and the lack of respect for rule of law have been the most important legal and judicial constraints. In addition, the inadequate functioning of regulatory bodies that foresaw competition in service and infrastructure industries such as telecommunications, energy and finance made entry and exit into these markets extremely difficult. Overall, with its rule of law and competition-related constraints the country's investment climate was a major drawback discouraging foreign investors away from the country.⁴

The EU's December 17, 2004 decision to begin membership negotiations with Turkey marked the turning point in FDI flows to Turkey. The EU decision helped convince international investors and multinational corporations that the future of Turkey lies with the EU (See, Sayek 2007). The EU's strong signal about the prospective EU accession of Turkey convinced the investors that the most problematic institutional, legal and judicial obstacles to FDI inflows would eventually be removed.

As a result the FDI inflows bounced. While FDI inflows amounted to less than \$1 billion before 2004(repetition) and reached only \$2.5 billion in 2004, it reached a record level of \$9.6 billion in 2005. FDI inflows continued to increase to \$20 and \$22 billion in 2006 and 2007, respectively. Despite the global financial crisis, in the first 11 month of 2008 FDI inflows stayed around \$13.8 billion (Figure 10).

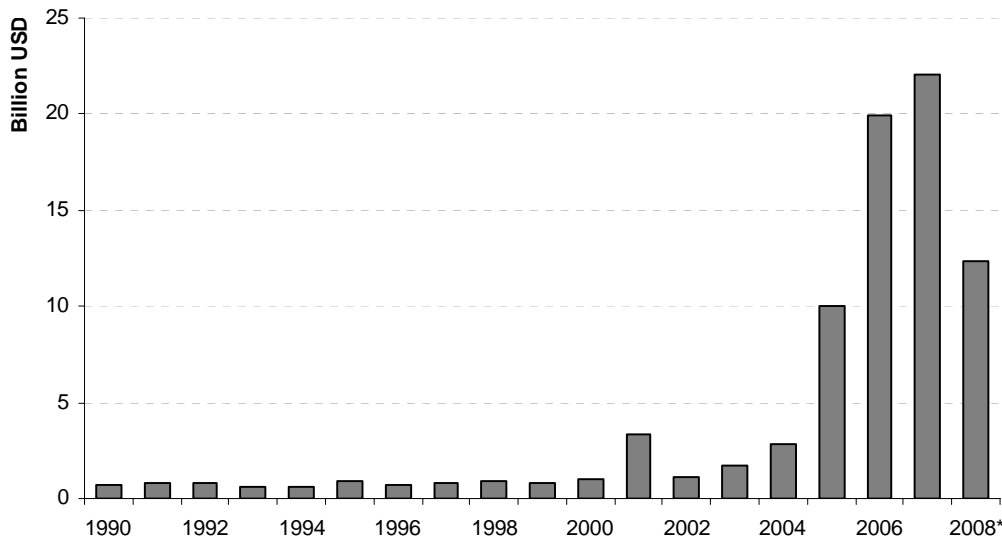
Turkey was not the only country that experienced such a jump in FDI inflows with the initiation of the EU membership negotiations. Central and Easter European countries, such as Czech Republic, Hungary and Poland as well as others, also experienced significant jumps in the FDI inflows as soon as the membership negotiations started.

Over the last 15 years, following each emerging market crisis the market values of domestic companies plunged along with the devaluation of national currencies and this made the local companies very attractive to foreign investors. The situation has been quite different for Turkey. In the three-year period following the 2001 crisis, multinational corporations preferred to stay away from taking a stake in Turkish companies, as the country risk was quite high in that period. Foreign interest in Turkish companies therefore remained exceptionally low during the period of 2001-2004. Turkish companies were saved from being acquired at very low prices by foreign investors on account of the uncertainties that hang on for some time after the crisis. All that changed

⁴ For a more detailed account of the pre-2005 investment climate in Turkey and how the EU accession will help Turkey see Dutz, Us and Yilmaz (2005).

with the EU decision to start the membership negotiations with Turkey. The interest shown in Turkish companies, and particularly the finance sector has boomed since 2005.

Figure 10. FDI Inflows to Turkey



Source: Central Bank of Republic of Turkey
 * January-September 2008.

Before going on with our analysis of FDI inflows to Turkey, let us briefly emphasize the importance of FDI for developing countries. In addition to creating new employment areas and increasing capital stock based on advanced technology, FDI can also make significant contributions to economic growth. As FDI requires technology and technological know-how, it can have a two-dimensional effect on the economy; both directly, and indirectly. As it also includes direct ownership control, it may affect growth through R&D activities, direct technology transfer, enhancement of opportunities for human resources, and productivity.

Several studies have through regression analysis shown that there is a positive relationship between economic growth and FDI.⁵ However, these findings do not mean that the relationship between FDI and economic growth is observed always; FDI does not always come with direct technology transfer. If the investment is only geared towards the domestic market, and the market is protected through various sanctions, then there may not be a technology transfer. Foreigners will prefer to use old technology in a backward market where the competition is not intense and where the educated labor supply is insufficient, and therefore technology transfer shall not be realized. Apart from direct transfer of technology, investments of multinational companies may contribute to the country's development through positive productivity spillovers to domestic companies.

⁵ Borensztein, De Gregorio, and Lee (1998) show that FDI flows have a positive impact on economic growth. They also demonstrate that not all countries benefit from FDI. Countries require a minimum stock of human capital to realize the growth effects of FDI. Zhang (1999) shows that FDI inflows helped to stimulate economic growth in several East Asian countries, whereas Gruben and McLeod (1998) show that in a sample of 18 countries, FDI had a significant impact on economic growth, especially in Latin American countries.

In addition to the impact of improvements in domestic investment climate and the beginning of EU membership negotiations, the sudden hike in FDI inflows in Turkey is also related to the increased privatization of state owned enterprises since 2005. While in the twelve years from 1990 to 2001 the state could raise only \$7.3 billion through the privatization of state owned enterprises (SOEs), over the last 7 years the privatization revenues quadrupled to reach \$28.9 billion. As the privatization process continues on track, the number of SOEs to be privatized will decrease over time and this is likely to have a direct negative impact on FDI inflows to Turkey.

A quick analysis of the data on the sectoral breakdown of FDI in Turkey reveals that with 82 % service sectors accounted for the largest share in total FDI inflows received since 2005 (Table 3). Three of the five sectors that attracted the bulk of FDI inflows are service sectors. Among these the banking and financial intermediation industry, which attracted \$28 billion, accounted for 48% of the total FDI inflows from January 2005 through November 2008.⁶ The transport, storage and telecommunications industry attracted \$11 billion, while the wholesale and retail trade industry attracted \$3.4 billion during the same period.

Table 3. Sectoral Breakdown of FDI (Million Dollars, excl. Real Estate)

Sectors	2003	2004	2005	2006	2007	2008*
Mining and Quarrying	14	73	40	122	336	122
Manufacturing Industry	448	190	785	1,866	4,210	3,196
Food products and beverages	249	78	68	608	888	973
Textiles	8	9	180	26	232	183
Chemicals and chemical prod.	9	38	174	601	1,110	86
Non-metallic minerals	0	1	53	125	770	159
Basic and fabricated metals	1	6	139	158	515	1,062
Machinery and equipment	17	6	13	54	47	153
Electrical and optical Inst.	4	2	13	53	116	108
Motor vehicles	145	27	106	63	70	63
Other Manufacturing	15	23	39	178	583	284
Electricity, gas and water	86	66	4	112	567	858
Construction	8	3	80	222	285	837
Wholesale and retail trade	92	72	68	1,166	169	1,981
Transport, storage and communications	2	639	3,285	6,696	1,116	144
Financial intermediation	51	69	4,018	6,957	11,663	5,316
Total	745	1,190	8,535	17,639	19,304	13,260

Source: Undersecretariat of Treasury

*: provisional, January-November.

⁶ In a country that experienced the 2001 economic crisis with the collapse of a large number of domestic banks, the mergers and acquisitions in the banking industry by European banks were applauded by many as a significant step to improve the domestic banking industry's soundness. However, the global financial crisis of 2008 has proven those researchers and commentators wrong. The problems in the American and European banks could easily spillover to the domestic banking industry through their subsidiaries.

Since 2005 the manufacturing sector as a whole attracted a total of \$10 billion in foreign investment, an amount equal to 17% of the total FDI inflows Turkey received during this period. While the share of manufacturing industries in FDI inflows was relatively low in 2005, it followed an increasing trend throughout the period. FDI inflows in manufacturing industries, which amounted to less than \$785 million in 2005, increased to \$1.9 billion and \$4.2 billion in 2006 and 2007, respectively. Along with the total inflows FDI in manufacturing industries declined in 2008, but the figures inclusive of November amounting to \$3.2 billion indicate that manufacturing industries fared better compared to other sectors.

Among the manufacturing industries chemicals and chemical products attracted \$2.5 billion, food products and beverages attracted \$2 billion and basic and fabricated metals attracted \$1.8 billion from January 2005 through November 2008. The automotive sector which has become the leading export sector over time has not attracted large sums of FDI inflows. This is a clear sign that most of the investment undertaken towards the development of new models and the capacity increase in this sector had been financed through retained earnings.

While in a country that runs large current account deficits all types of foreign direct investments should be preferred to foreign debt as a source of finance, greenfield investment projects should be singled out as potentially the most beneficial for the host country. Not only do they entail investment in production facilities and creating new jobs but in most cases they involve technology and know-how transfer to the host country. That is the why UNCTAD traces the number of big greenfield FDI projects a country attracts separately which provides a crude measure of the total greenfield investment a country attracts. The data from this source indicates that in 2007, 5,700 out of a total of 11,700 greenfield projects worldwide were undertaken in developing countries. A considerable portion of these investment projects were clustered in countries such as China (1176), India (682), Russia (363), Brazil (152), Singapore (240), United Arab Emirates (277), Mexico (209), Malaysia (162), Hong Kong (144), and Thailand (121), as well as the Central and Eastern European (CEE) countries listed in Table 1. Turkey however, has not been successful in attracting big greenfield investment projects from 2004 through 2007.

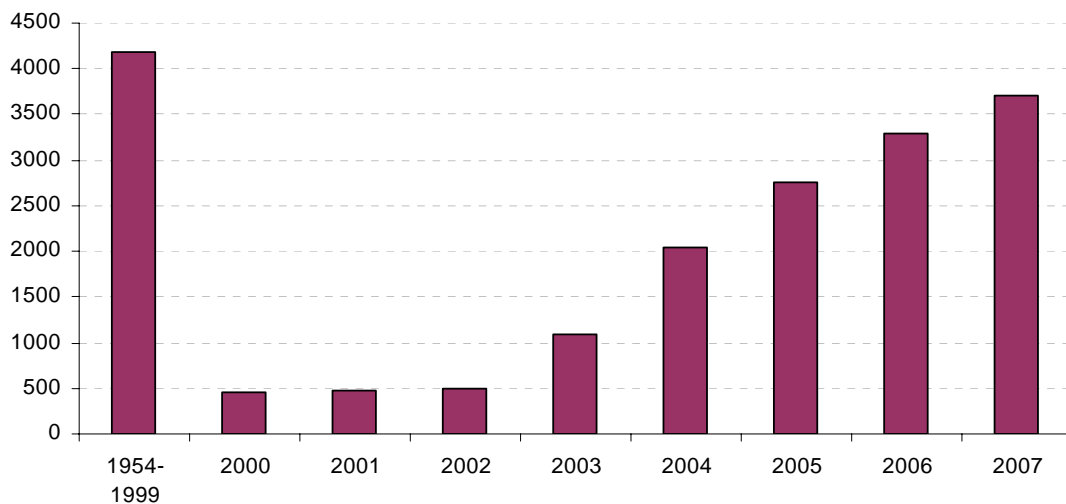
Table 4. Total Number of Greenfield FDI Projects

	2003	2004	2005	2006	2007
World	9,469	10,254	10,632	12,441	11,703
Developed Countries	4,162	4,688	5,150	6,198	6,037
Developing Countries	5,307	5,566	5,482	6,243	5,666
Turkey	71	67	73	90	93
Czech Republic	145	148	152	181	149
Hungary	218	224	212	256	219
Poland	154	240	275	350	333
Bulgaria	98	109	142	298	151
Romania	116	182	264	385	366

Source: World Investment Report, 2008.

The data on the number of newly established foreign-owned corporations collected by the Undersecretariat of Treasury does not confirm the above table at a first glance. The total number of foreign-owned companies established in Turkey between 1954 and 1999 was 4192. Furthermore, between 2000 and 2002 the number of newly established foreign-owned corporations in a year was less than 500 a year,, but increasing rapidly since 2003 and reaching more than 3700 in 2007 (Figure 11). This statistic depicts such an optimistic panorama that it is being used by many politicians in order to substantiate the view that foreign interest in Turkey has increased considerably in the recent past. However, it is not correct to use this data without complementing it with figures demonstrating the size of the foreign-affiliates.

Figure 11. Number of Newly Established Foreign-Affiliated Companies in Turkey



Source: The Undersecretariat of Treasury .

The rapid increase in the number of foreign-affiliated companies established in a given year certainly demonstrates that foreign investors' interest in Turkey is on the rise. Yet the increase observed in 2003 and 2004 was not reflected in the figures for total value of FDI inflow figures. As data given in Table 5 clearly shows, 95% of the companies established have less than USD 500,000 equity capital each and are accordingly small enterprises. However, along with the jump in FDI inflows since 2005 there has been a shift in the size distribution of companies towards more medium- and large-scale companies. Whereas the number of newly established companies with foreign capital with over USD 500,000 equity capital was 97 in 2004, this figure has increased to 118 in 2005. In 2007 this figure jumped to 325. The number of newly established foreign-owned manufacturing companies with over USD 500,000 equity capital also increased substantially from 28 in 2005 to 80 in 2007.

Table 5. Breakdown of Companies with International Capital according to Size of Equity Capital (1000 USD)

	< 50	50 - 200	200 – 500	> 500	Total
2004	1,468	462	102	97	2,129
2005	1,832	711	164	118	2,825
2006	1,976	863	241	208	3,288
2007	2,092	1,010	275	325	3,702
Manufacturing Industry					
2004	211	90	31	37	369
2005	255	131	36	28	450
2006	253	128	32	56	469
2007	243	130	47	80	500

Source: Undersecretariat of Treasury

Although high levels of FDI inflows since 2005 can be seen as a positive sign for the Turkish economy, it is not possible to conclude that Turkey has become a center of attraction for foreign investors. According to IMD (International Institute for Management Development) World Competitiveness Report, Turkey is far behind its competitors. Although a certain activity has been observed after 2003, this is mostly related to macroeconomic policies implemented after the crisis, and reforms in public finances. Macroeconomic reforms are a necessary condition for attracting FDI in the medium and long-run, but they are not sufficient. The factors that caused Turkey to lag behind its competitors should be analyzed at the institutional and microeconomic levels. Among these factors are; high taxes on labor and energy costs which constitute an important portion of the costs of production, lack of skilled labor, the system of education that is not able to raise employees commensurate with the necessities of the companies that compete worldwide, low level of R&D investments and inadequacy of the infrastructure for technological development. .

It can be observed that there has been no significant change in Turkey's position in the World Competitiveness ranking of IMD since 2001. In 2001 Turkey was ranked 48th. Despite the first wave of macroeconomic and structural reforms in the post-crisis period, over the last seven years Turkey's place in the competitiveness rankings moved between 56 in 2003 and 48 in 2007 and 2008. It is obviously encouraging to see that Turkey's place in the rankings improved since 2003, but it is still same as 2001, the crisis year. Furthermore, Turkey is far behind many of its competitors: Czech Republic ranks 28th, Slovak Republic 30th, Spain 33th, Portugal 37th, Hungary 38th, Greece 42th, and Poland 44th in the 2008 IMD World Competitiveness rankings. This poor record of Turkey is confirmed also by the Doing Business Survey of the World Bank which ranks Turkey 57th in a group 178 countries.

In an effort to evaluate the relative attractiveness of countries for foreign investors, every year A.T. Kearney prepares the FDI Confidence Index, which is based on the responses of executives from multinational corporations. After being ranked 29th in this index in 2004, Turkey moved up the ladder by 16 steps in 2005 and became the 13th ranked country in terms of the attractiveness for foreign investors. However, it could not hold on to its place and dropped to become the 20th ranking country in 2007. Since

these indices are based on personal views of experts and executives, who play key roles in the international investment world, it is not practical to say that they always reflect the actual situation. However, we are keen to stress that a medium-sized country like Turkey can not become a center of attraction for foreign direct investment without improving its position in these survey-based rankings, regardless of their shortcomings.

The establishment of the Investment Promotion and Support Agency in 2006 was an important step. The agency is expected to spearhead the efforts to attract foreign direct investment. An important contribution of the agency is to provide information to interested investors, as well as providing incentives such as the provision and development of investment sites for specific investment projects. Ultimately, the agency's functions will be further enhanced once it is given the authority to function as a one-stop shop where all bureaucratic procedures can be handled within a very short-period of time (For more on the functions of investment promotion agencies see Dutz, Us and Yilmaz, 2005).

The most important factor behind Turkey's rise in the world competitiveness league is the sustained implementation of macroeconomic policies and public finance reforms since 2001. Thus, the ratio of public debt to GDP, and the inflation rate have dropped rapidly, and high growth rates have been achieved. However, the primary reasons why Turkey's competitiveness is still at the same level as it was in 2001 are directly related to the lack of any progress in the implementation of the second-wave of structural reforms.

These reforms should have started as early as 2006 and should have included tax reforms to reduce the overwhelming indirect tax burden, which also encourages businesses to underreport their earnings and help expand the underground economy. Tax reform should also include the exemption of minimum wage earners from income tax. In addition, labor market reforms should have targeted increased flexibility of the labor market. The burden of income and social security taxes on labor costs are extraordinarily high in Turkey. To give an example, while the net minimum wage is 477 TLs in the first six months of 2009, the total cost of a minimum wage employee to his/her employer is 809 TL. The difference between the two, which is equal to 70% of the net wage a minimum wage earner takes home, is the income and social security tax burden on the employee and the employer. It is extremely high. That is why the gross minimum wage in Turkey is higher than the minimum wages in the Central and Eastern European countries (see Yilmaz 2007). While some policy actions have been promised towards lowering the cost of labor they are too little and too late to have some economic impact.⁷

In addition, the overhaul of the education system is a must if Turkey wants to attract domestic and foreign investment in the long term. There is an urgent need to expand the vocational training, as the inadequacy of technical, skilled worker supply is cited as one of the important bottlenecks in the manufacturing industry. In addition to the legal and judicial reforms that are required to ensure the rule of law the effective

⁷ For example, after pressure from various industry representatives in 2008 the government decided to lower the social security Premium by 5% , but the implementation of the decree was postponed to September 2008, but never implemented.

functioning of the already established regulatory agencies is also necessary in order to enhance competition in telecommunications, energy industries.

Table 6 lists several infrastructure related factors from IMD's World Competitiveness Yearbook that have so far adversely affected Turkey's competitiveness and provide data on these for Turkey, Poland, Czech Republic and Hungary. It reveals Turkey's weaknesses in several areas, such as education and human capital accumulation, the inadequacy of investments made in technology and internet infrastructures, and the inadequacy of R&D investments, which play a very important role in today's competitive environment. The existing gap between Turkey and its competitors, and particularly the Czech Republic and Hungary indicates that Turkey lags far behind in education, technology and R&D investments, and that it needs to undertake substantial amounts of investment in these areas as soon as possible.

Table 6. Infrastructure-related Factors Adversely Effecting Turkey's Competitiveness

	Turkey	Poland	Czech Rep.	Hungary
Share of high technology export (% , 2006)	1.50	3.81	14.10	23.99
Ratio of illiterates (% , + 15 age, 2005)	12.6	1	1	1
Pupil/teacher ratio in primary education (% , 2005)	25.80	11.66	17.53	10.61
Telecommunication investments (ratio to GDP, 2006)	0.22	0.72	0.44	0.37
Number of internet users (per 1000 population, 2007)	241	413	587	443
Electricity cost in industry (\$/kwh, 2006)	0.10	0.073	0.094	0.105
Human Development Index (2005)	0.78	0.87	0.89	0.87
Number of computers (per 1000 population, 2007)	83	260	375	306
Life expectancy at birth (2005)	71.5	75.0	76.0	73.0
R&D investments (USD per capita, 2006)	39.7	49.8	215.1	112.1

Source: IMD World Competitiveness Report, 2008

VI. Conclusions

This chapter has analyzed the changes in the structure of trade as well as the developments in capital account in Turkey since mid-1990s. Based on the analysis of the recent experience, it has focused on the possible composition of future trade flows and Turkey's attractiveness for international capital inflows. In particular, it has emphasized how Turkey can stay competitive by constantly improving its investment climate and attracting FDI, especially greenfield investment by foreigners.

Over the last decade there have been significant changes in Turkey's external trade relations with the outside world, which are marked by increased integration to world markets. The liberalization of foreign trade, affected both imports and exports similarly. Although both exports and imports have risen steadily in absolute terms and relative to GDP, the export/import ratio has stayed almost the same, showing that all the efforts to increase exports fell short of making the trade balance narrower. Furthermore,

this ratio has been on a downward trend throughout the whole period, casting a shadow on the export success.

Analysis of the long-term performance of Turkish exports and imports reveals that the efforts to increase exports were successful only to a certain degree. Not being rich in natural resources, physical capital or human capital resources, the country tends to have a sizable trade deficit with the rest of the world. The trade deficit accumulates over time and frequently ends up with a crisis which automatically reduces the trade deficit by reducing the import bill. However, as the economic activity recovers, imports start to rise again. Whether the increase in exports is sustained or not, determines the extent and the duration of the correction in trade deficit.

Since the 1980s there has been an ongoing transformation in exports from agricultural products towards manufacturing products. While this process was more or less completed in the late 1990s, another transformation process has been taking place since 2001. This time around, the transformation in exports is from the low-tech manufacturing products to medium-tech and high-tech products, which obviously is desirable for the Turkish economy. It is true that this transformation helped bring the trade deficit with the EU down, but it also contributed to the widening of trade deficit vis-à-vis the Asian countries and oil exporters.

The initiation of the EU accession talks in 2005 enabled Turkey to attract record levels of FDI inflows. However, an important shortcoming of the recent FDI inflows to Turkey has been its composition. Almost all of the FDI inflows over the last four years have been composed of mergers and acquisitions, and directed towards service sectors and real estate. From a longer term growth perspective Turkey needs to attract greenfield investments, especially in the manufacturing industries. The establishment of the Investment Promotion and Support Agency in 2006 was an important step towards a more systematic approach to attract greenfield investments, but it is not sufficient. In order to put Turkey in international producers' networks the current investment environment should further be improved by the implementation of long-delayed structural micro reforms as well as judicial and legal reforms.

The EU accession process played a critical role in attracting FDI inflows because it invigorated the expectations for a more rapid and consistent implementation of the rules and regulations that ensure a level playing field for all companies, domestic and foreign, alike. However, the rather long lull in the accession talks since the end of 2006, which is stemming mostly from political reasons than economic fundamentals, is a cause for concern for the future of global economic ties of Turkey.

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