

Structural Transformation of the Turkish Economy:

The new agenda for adjustment, risk management, and competitiveness

Güven Sak

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Agenda

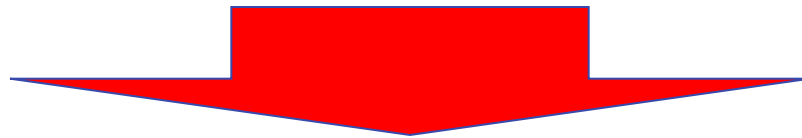
- The on-going structural changes in the Turkish economy
- Emerging risks and sustainability of the growth process
 - current account deficit
 - unemployment
 - creative destruction
- Towards a brand new agenda and the role of the EU process
 - adjustment management
 - risk management
 - raising competitiveness
- Building capacity
 - TOBB-ETÜ – Economics and Technology University
 - TEPAV – Economic Policy Research Institute

- New climate & contrasts
- What's new? What has changed?

Where do we come from?

The Turkish economy in the 1990s

- Despite huge potential, Turkish economy significantly underperformed in the 1990s:
 - boom and bust cycles in growth
 - high and chronic inflation
 - high public sector deficit
 - fiscal indiscipline
 - high levels of uncertainty (political and macroeconomic)
 - very high interest rates

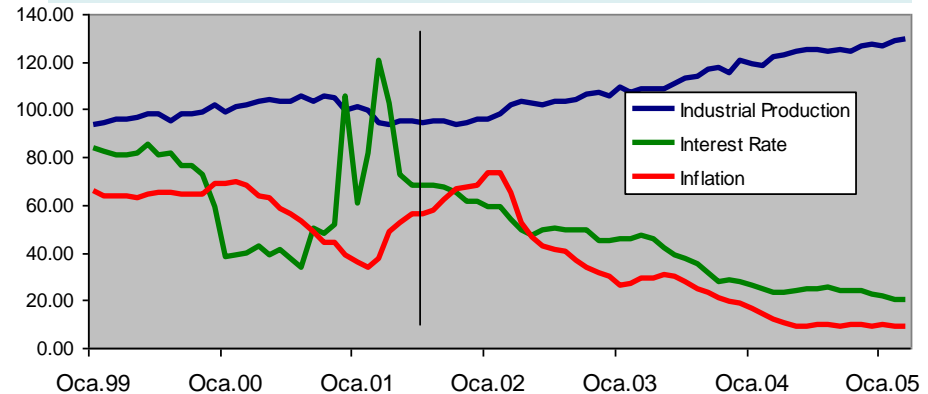


- three economic crises, internal conflict, 1999 earthquake...
- the 2001 economic crisis = GDP shrank by 10%

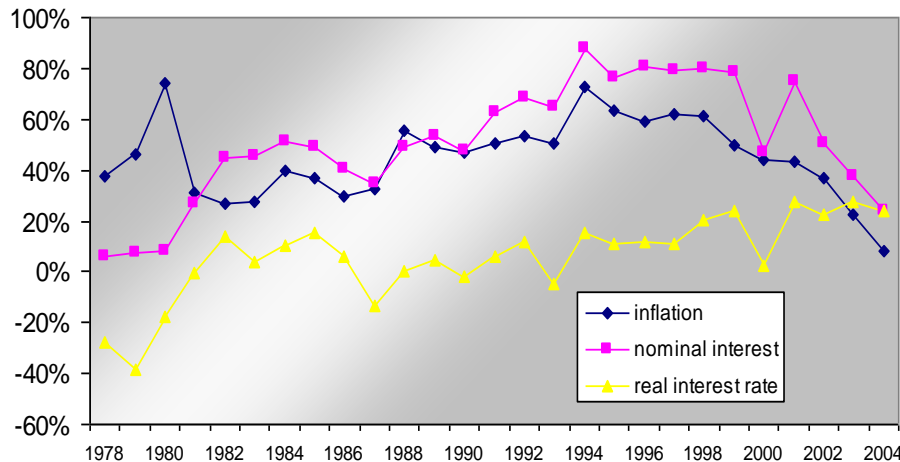
“Every crisis brings both opportunities and risks” A new process after 2001?

- Growth without inflation
- Interests rates are falling
- Productivity is rising
- No net job creation

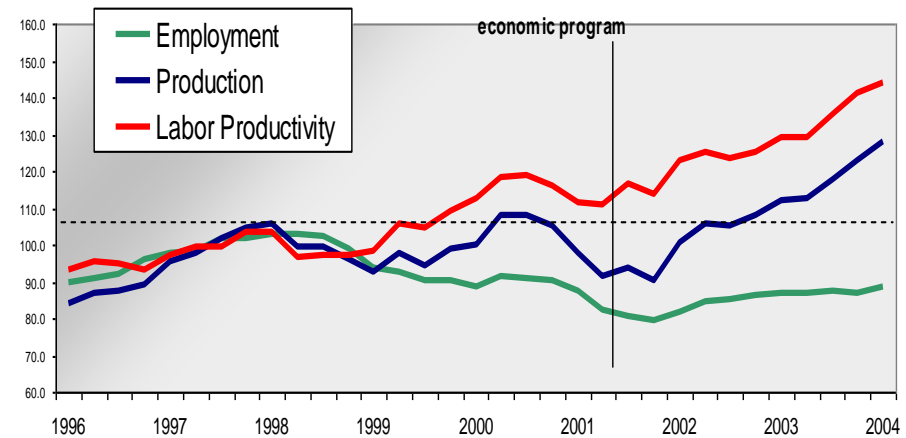
Non-inflationary growth (1999-2005)



Inflation and Interest Rates



Productivity and Employment Trends



Source: State Statistics Institute

Reforms lead to a new incentive structure

- Features of the economic program after the 2001 crisis
 - Monetary Discipline (coupled with Central Bank independence and floating exchange rate regime)
 - Fiscal Discipline
 - Public Administration Reform
 - Banking Sector Reform-Corporate Restructuring
- Results and Outcomes:
 - Impressive growth without inflation
 - Rising Productivity as the driver of growth
 - Unemployment does not decrease
 - Move from implicit to formal inflation targeting
 - Currency appreciates
 - Current account continues to deteriorate
- Of course, presence of some external factors help speed up the process (growing competition from East Asia, global liquidity etc.)

And the new incentive structure changes the rules of the game at the corporate sector

Old environment

- Competitiveness
 - need for cheap labor
 - cost and price based
 - very limited research and development
 - limited marketing
- Investment Climate:
 - High Inflation
 - Generous incentives, subsidies
 - Pegged Currency (95-01)

New environment

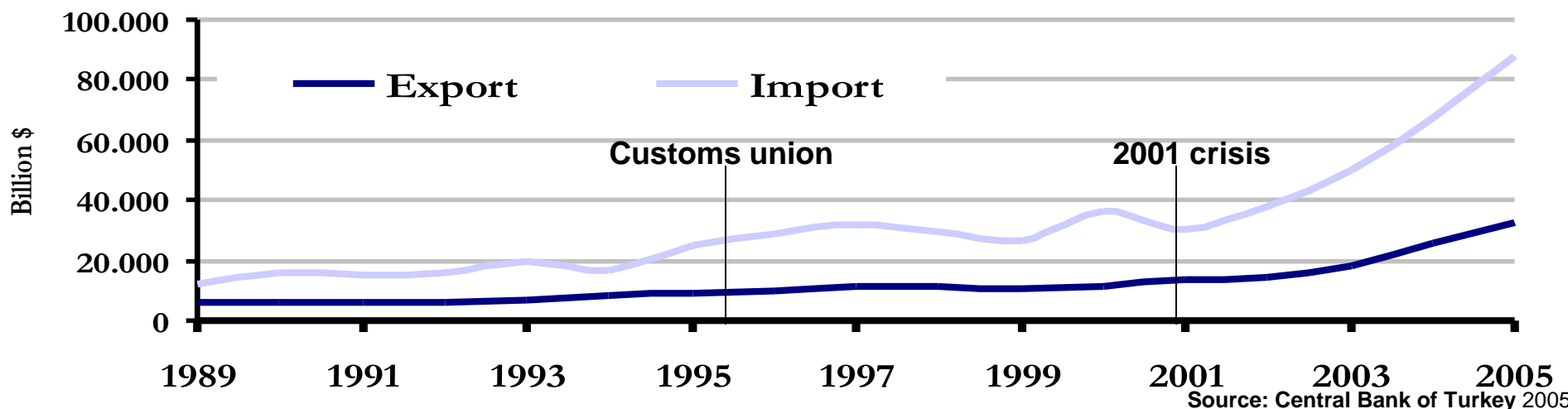
- Competitiveness:
 - need for qualified labor-force
 - quality-based
 - focus on research and development
 - marketing innovations
- Investment Climate:
 - Low inflation
 - Limited incentives, prudent banking sector
 - Floating Currency (post 2001)

- Reflections on the economy
 - The story on competitiveness
 - Integration into the EU economy
 - New trends, new risks

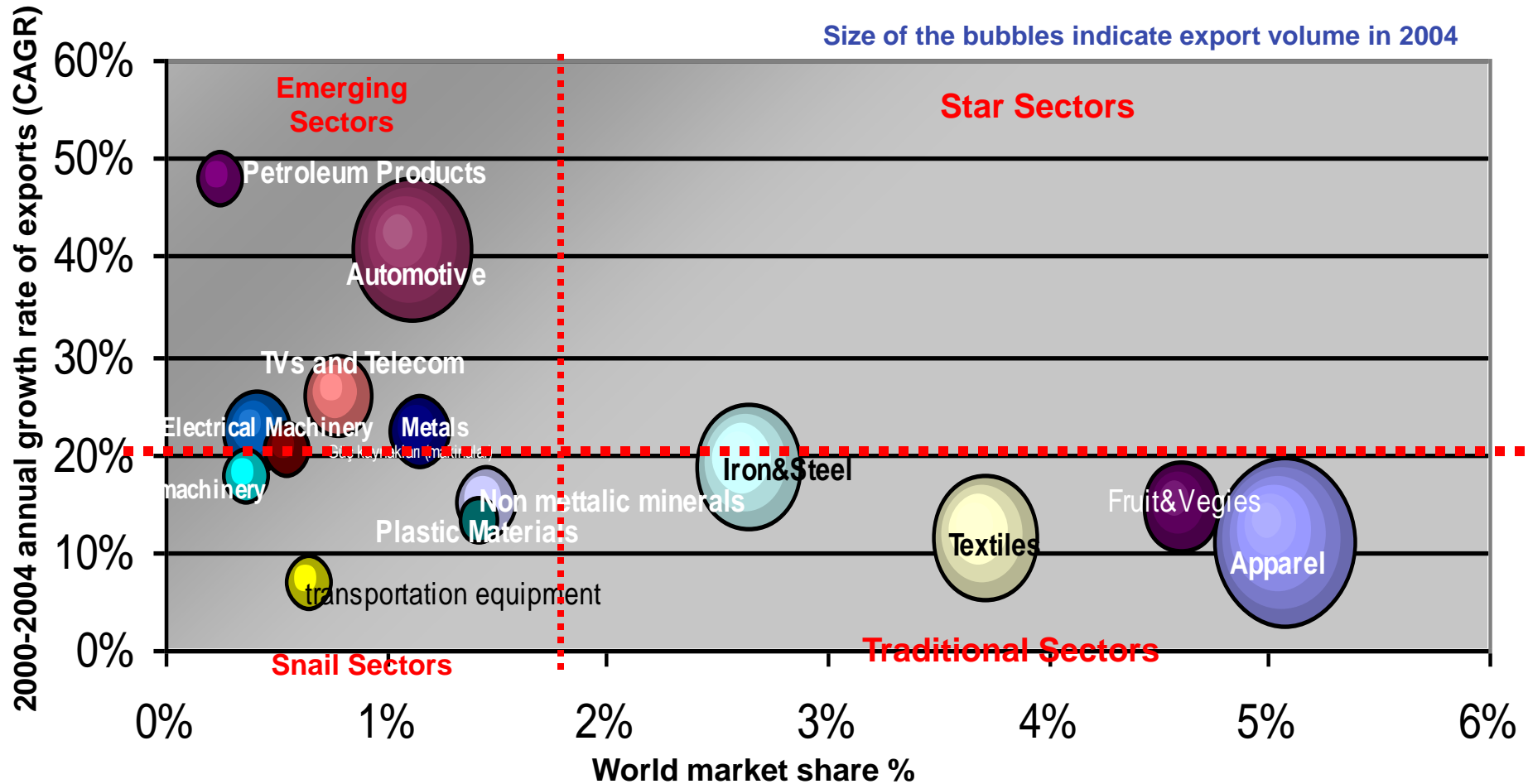
The new game: Integration into the global economy

- Growth rate of trade volume
 - 1989-2001: %8.5
 - 2002-2005: %29
- Increase in import of intermediate inputs
 - 1989-2001: %8
 - 2002-2005: %33
- Turkey in global economy
 - increasing trade of goods and services
 - increasing foreign direct investment
 - change in the sectoral composition in exports and in manufacturing value added

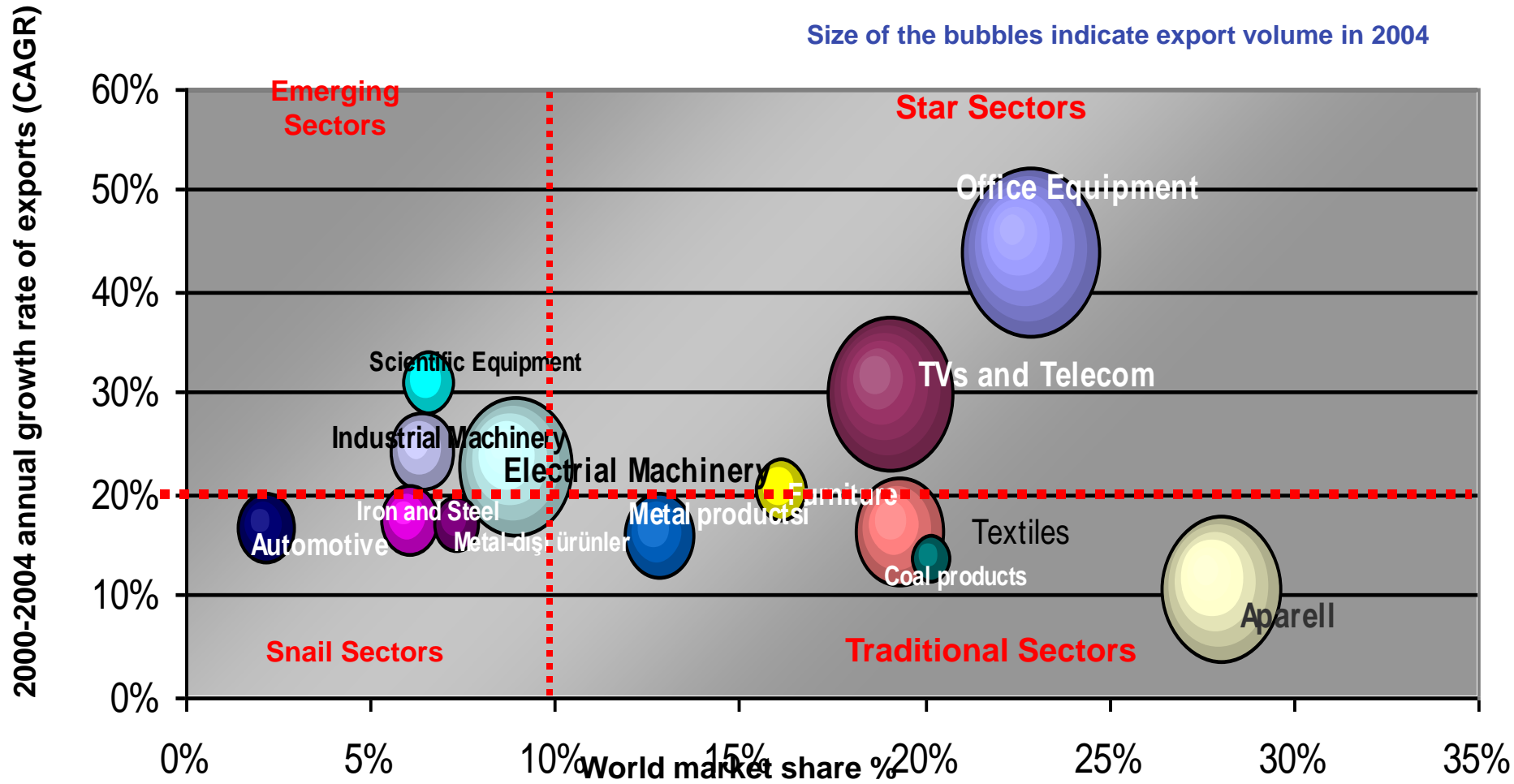
Import and Export of Intermediate Inputs, 1989-2005, billion \$



Competitiveness of Turkish Industries: Promising but also challenging...



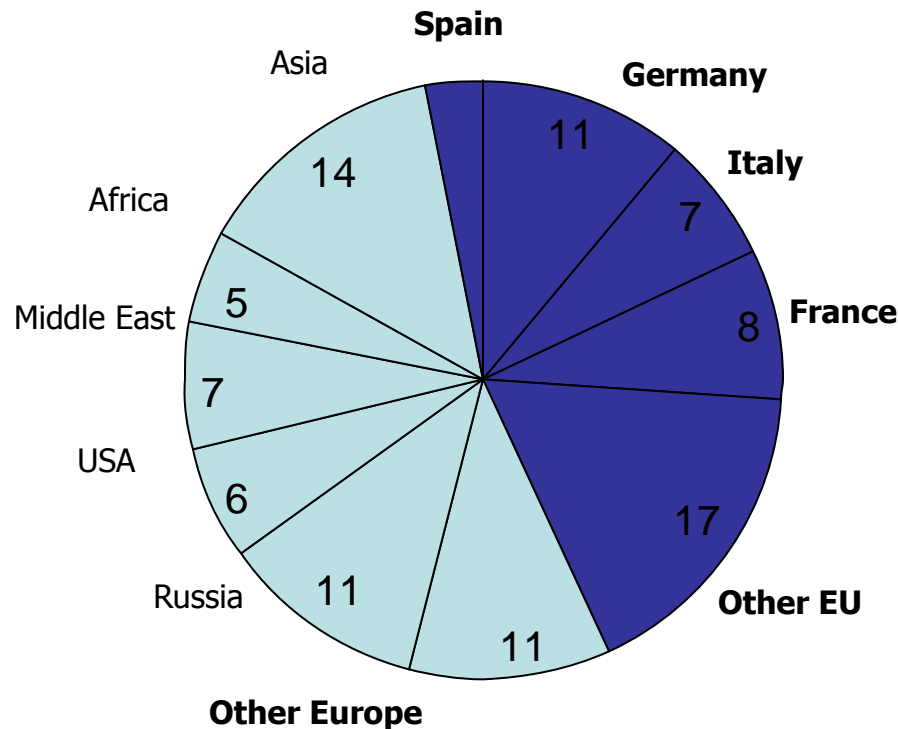
... challenging because China does not only mean cheap labor



The EU is Turkey's largest trade partner

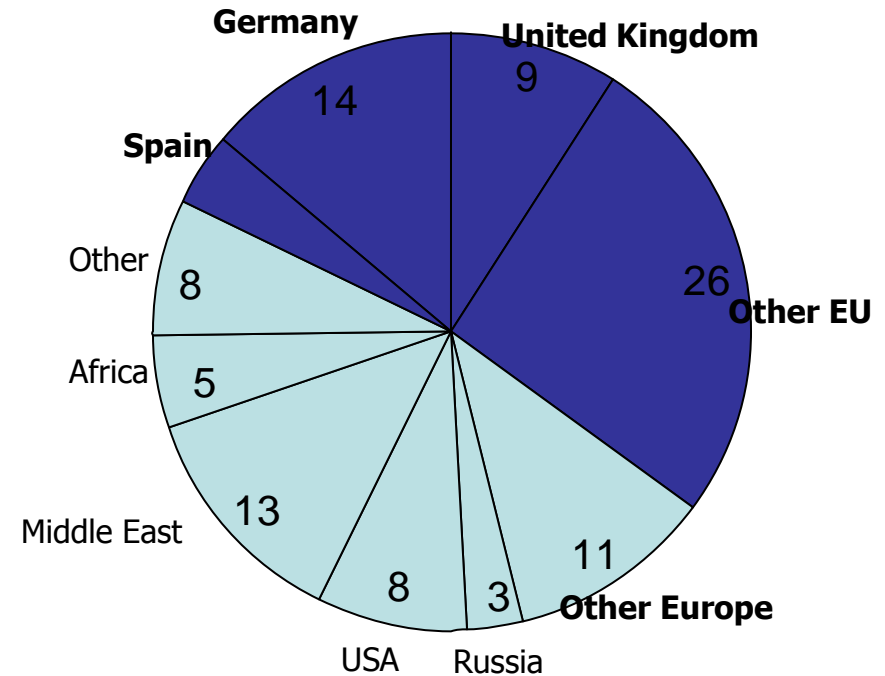
Imports

Total USD 116 billion, 2005, (42% EU share)



Exports

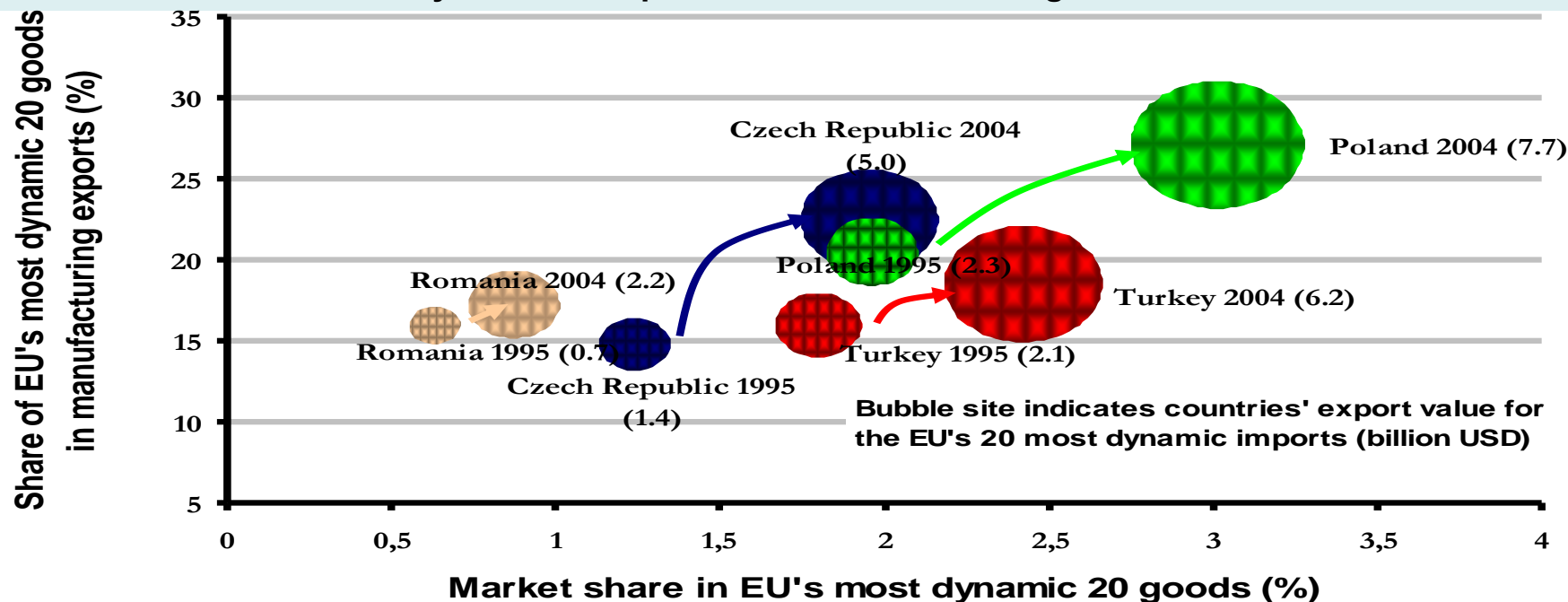
Total USD 73 billion, 2005, (52% EU share)



Fast integration into the EU: Could it be even faster?

- The share of the EU's most dynamic 20 goods in Turkey's total exports is rising. (vertical axis) This means trends in Europe increasingly change the production structure in Turkey.
- Turkey's markets share in these markets also rise, but slower than those of Czech Republic and Poland. (horizontal axis)

Market share in EU's most dynamic 20 exports and the level of integration: 1995 vs. 2004



- Emerging Risks & Sustainability of the Growth Process

- **Current account deficit and its structural components**

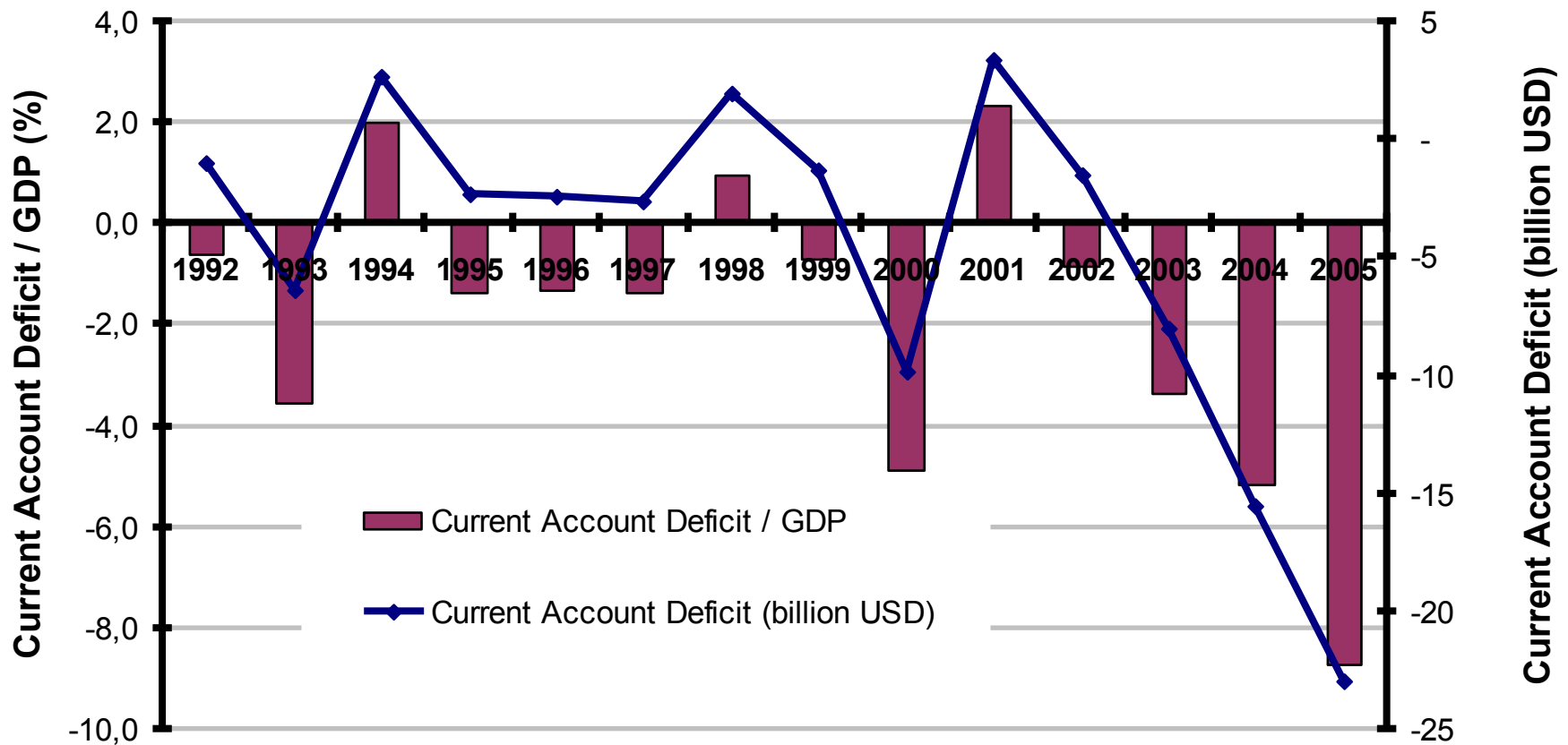
- **Employment Trends**

- *Demographic window of opportunity (or threat?)*
 - *Structural transformation across sectors: Decline in agriculture*

- **Rising creative destruction**

- *Structural transformation within sectors: Move from traditional toward modern in retail industry*

Current Account: at scary levels?



Fast growing sectors import more: Coincidence or curse? It's a fact and a serious risk generating factor

- The current account deficit seems to have a structural component and an external trigger (i.e. China), which are closely linked
- More "modern" sectors tend to be more dependent on intermediate good imports. They are also the engine of export growth.
 - Currency appreciation plays a role
 - Cheap alternatives from East Asia
 - Lack of strong local clusters in modern sectors (role of industrial policy)
- Bottom-line: Production process are getting more global, but accounts remain national; and hence vulnerabilities.

	Average Growth (2002- 2005)	Import Dependency
<i>office, accounting and computing machinery</i>	37%	0.268
<i>radio, television and communication equipment</i>	27%	0.234
<i>chemicals and chemicals products</i>	11%	0.228
<i>medical, precision and optical instruments</i>	15%	0.226
<i>Leather</i>	1%	0.151
<i>apparels</i>	-1%	0.132
<i>Textiles</i>	0%	0.13
<i>Tobacco products</i>	0%	0.093

Declining market shares in traditional sectors

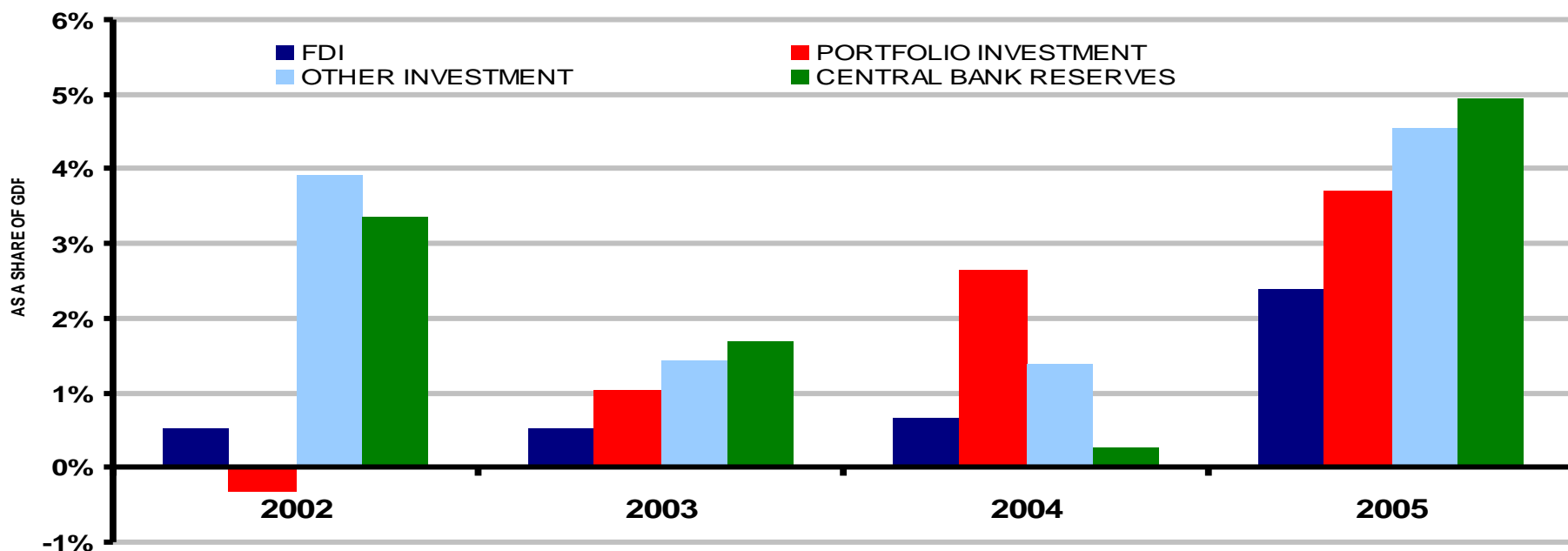
- The traditional sectors that tend to grow slower in the recent years also face rising competition from China
- The textile industry for instance, which makes up %12 of the manufacturing value added is going through hard times

Textile and Apparel Exports to EU-15 Countries: Turkey and China

	Market Share 1995	Market Share 2002	Average Growth in Market Share (1995-2002)	Market Share 2004	Average Growth in Market Share (2002-2004)
Turkey	%4,6	%6,5	%5,1	%6,9	%3,6
China	%2,9	%5,3	%9,4	%6,5	%10,9

Financial integration coupled with trade integration can mitigate risks

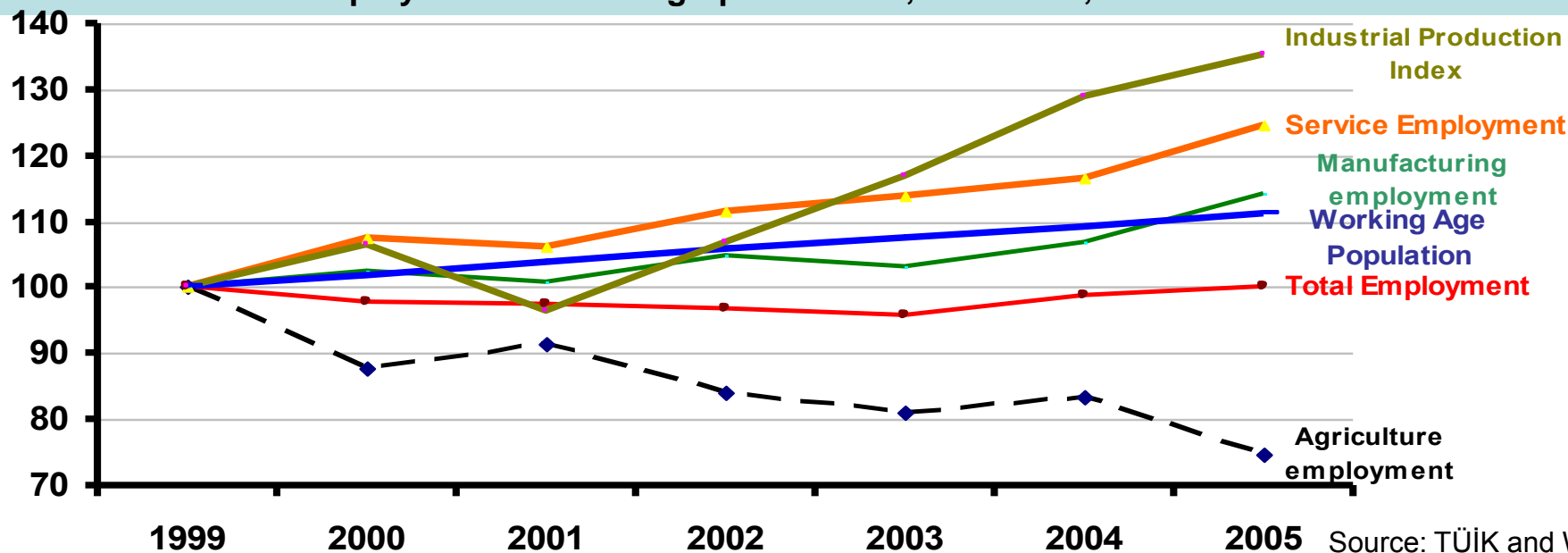
- FDI inflows increase as a result of global value chain integration
 - trade credits will increase more as a by-product
- Portfolio investments increase (ISE)
- Central bank reserves increase consistently



Recent employment trends: sometimes good is not enough

- Growth in recent years does generate jobs. But it's not enough, unemployment persists.
 - ➔ Declining share of agriculture
 - ➔ Rising working age population
 - ➔ Plus: strong competitive pressures, high tax wedges, high productivity growth
- Both trends will continue = risk generating factors*

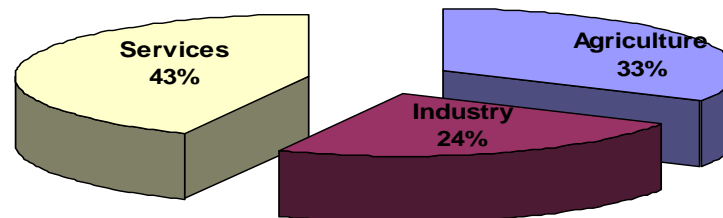
Sectoral Employment and Demographic Trends, 1999-2005, 1999 indexed to 100



Modernization inevitably leads to decline in agriculture

- EU accession process will surely accelerate transformation (plus globalization and trade liberalization)
- Turkey's total population = 70 million
 - ➔ Agriculture (33 %) = 23 million
 - ➔ Services (43 %) = 30 million
 - ➔ Industry (24 %) = 17 million

Sectoral Distribution of Employment in Turkey, 2004

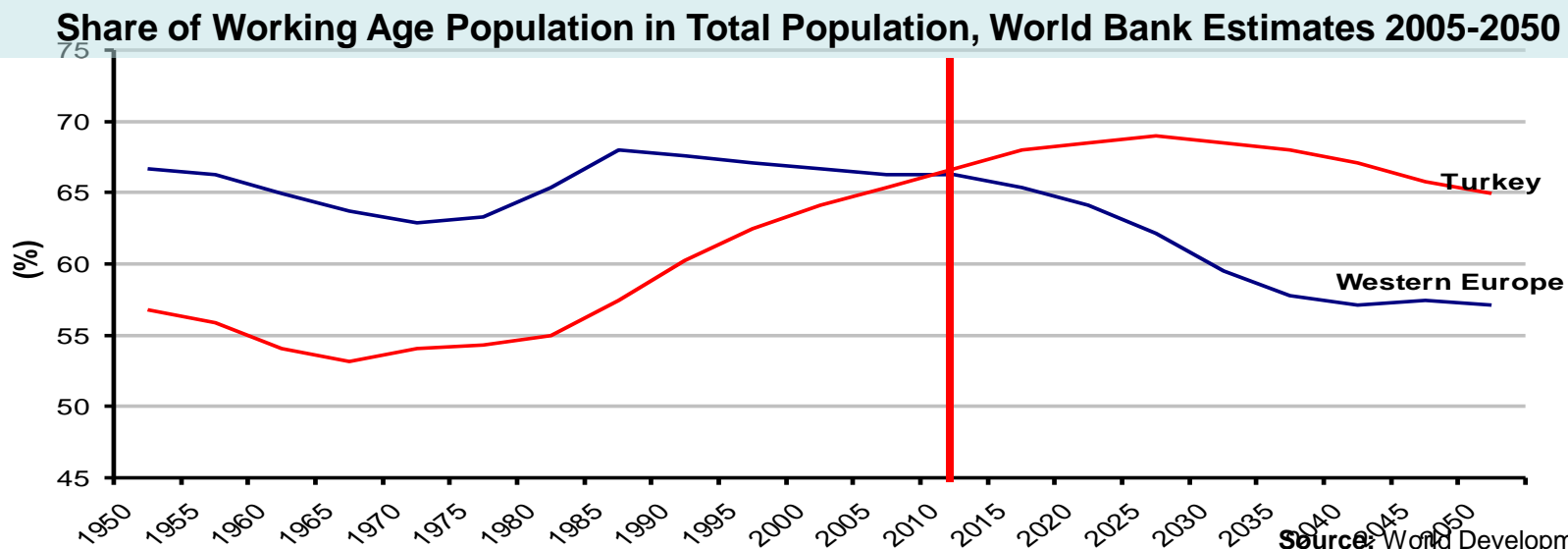


Economic Structure before and after EU accession in Greece, Portugal and Spain

	Before Accession			After Accession		
	1981 Greece	1986 Portugal	1986 Spain	2001 Greece	2001 Portugal	2001 Spain
Agriculture	31	22	16	16	12	6
Industry	29	34	32	23	35	31
Services	40	44	52	63	53	61

Demographic trends create opportunities as well as risks

- The share of working age population in the overall population in Turkey has started to increase significantly. This stands out as a very critical advantage when compared to the demographic trends of Europe.
- This ratio is at a decreasing trend for the EU countries, while it's rising in Turkey. Ratios of both EU and Turkey will be equal in 2010, and then Turkey will overtake Europe.
- Key challenges:
 - Achieving above-normal growth rates for job creation
 - Raising labor participation rates for seizing the opportunities

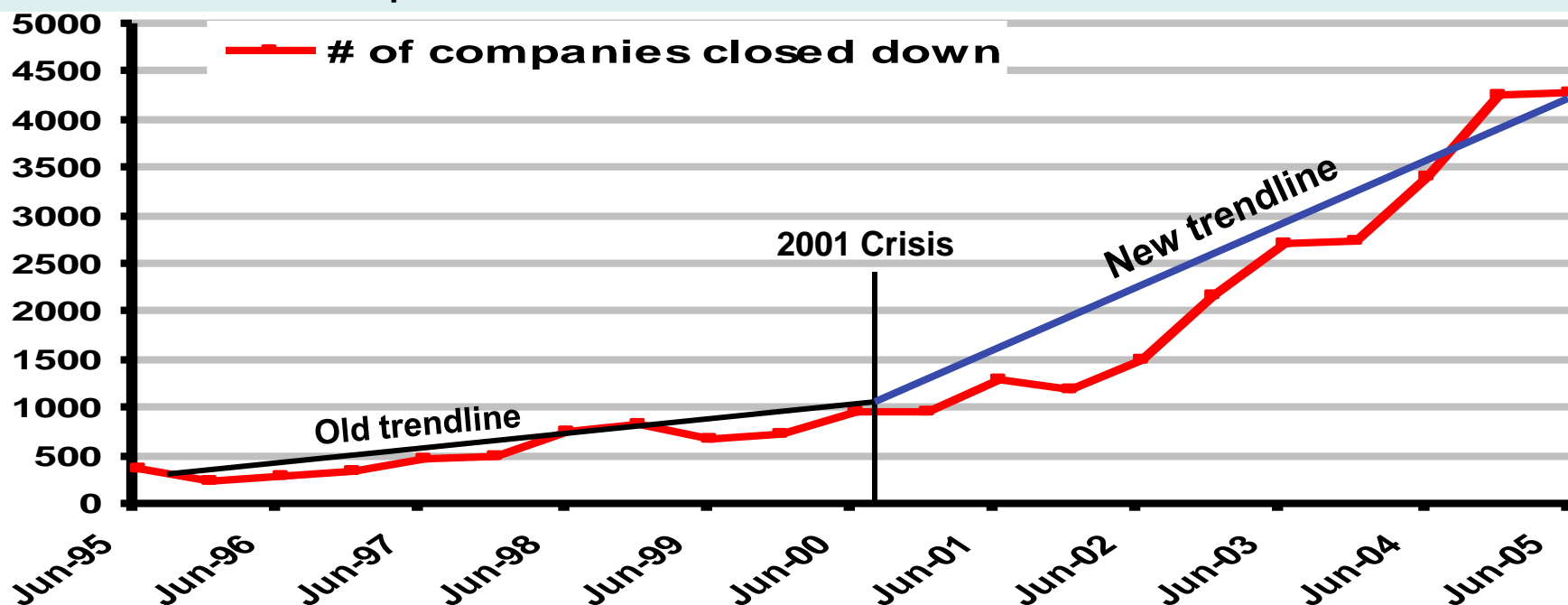


Is Creative Destruction in place?

Closer look at the companies closing down

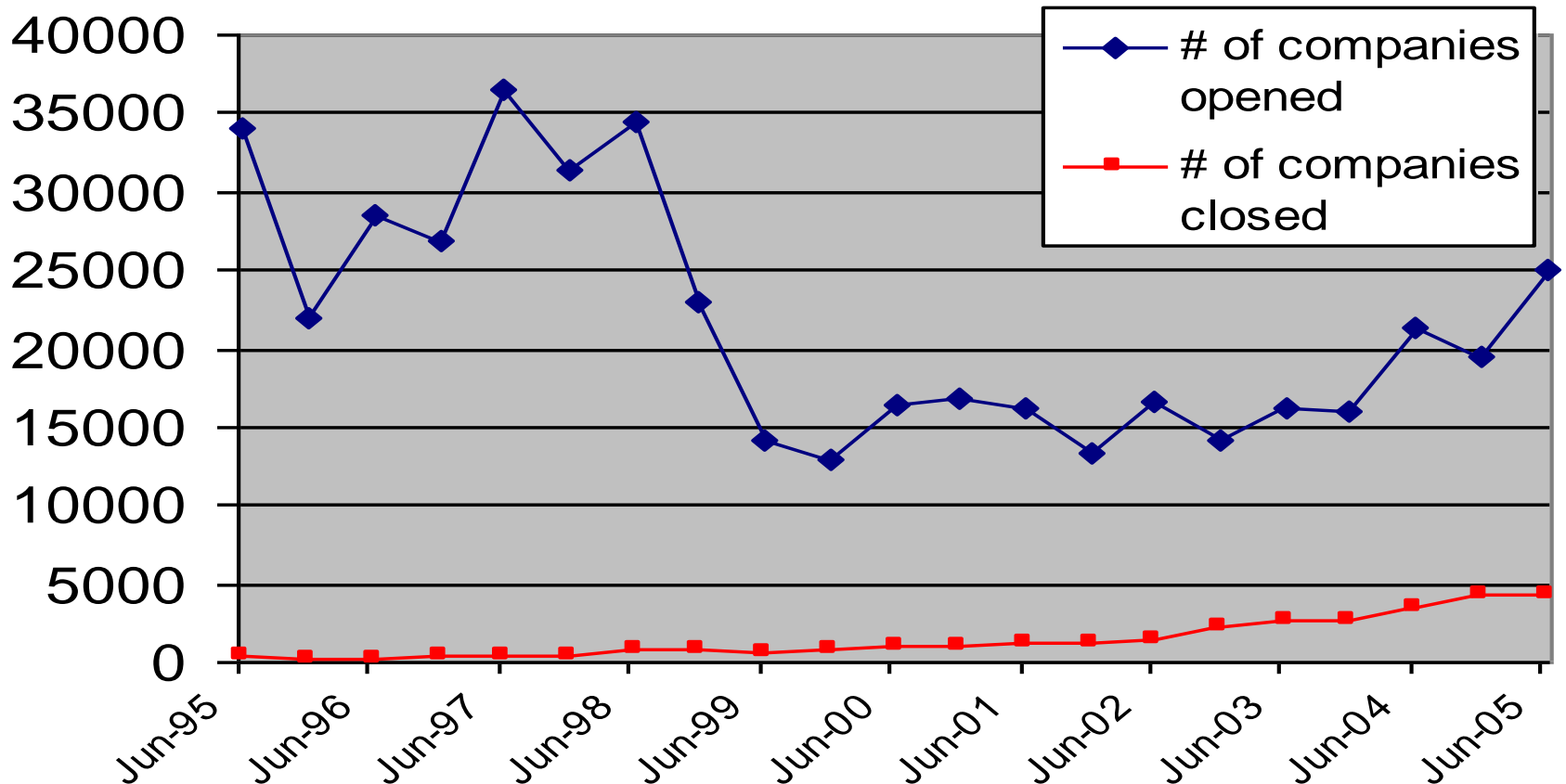
- Floating exchange rate as a sweeping mechanism?
 - As a mechanism to break the inertia
 - As an igniting mechanism for creative destruction?

1995-2005 Number of Companies Closed Down

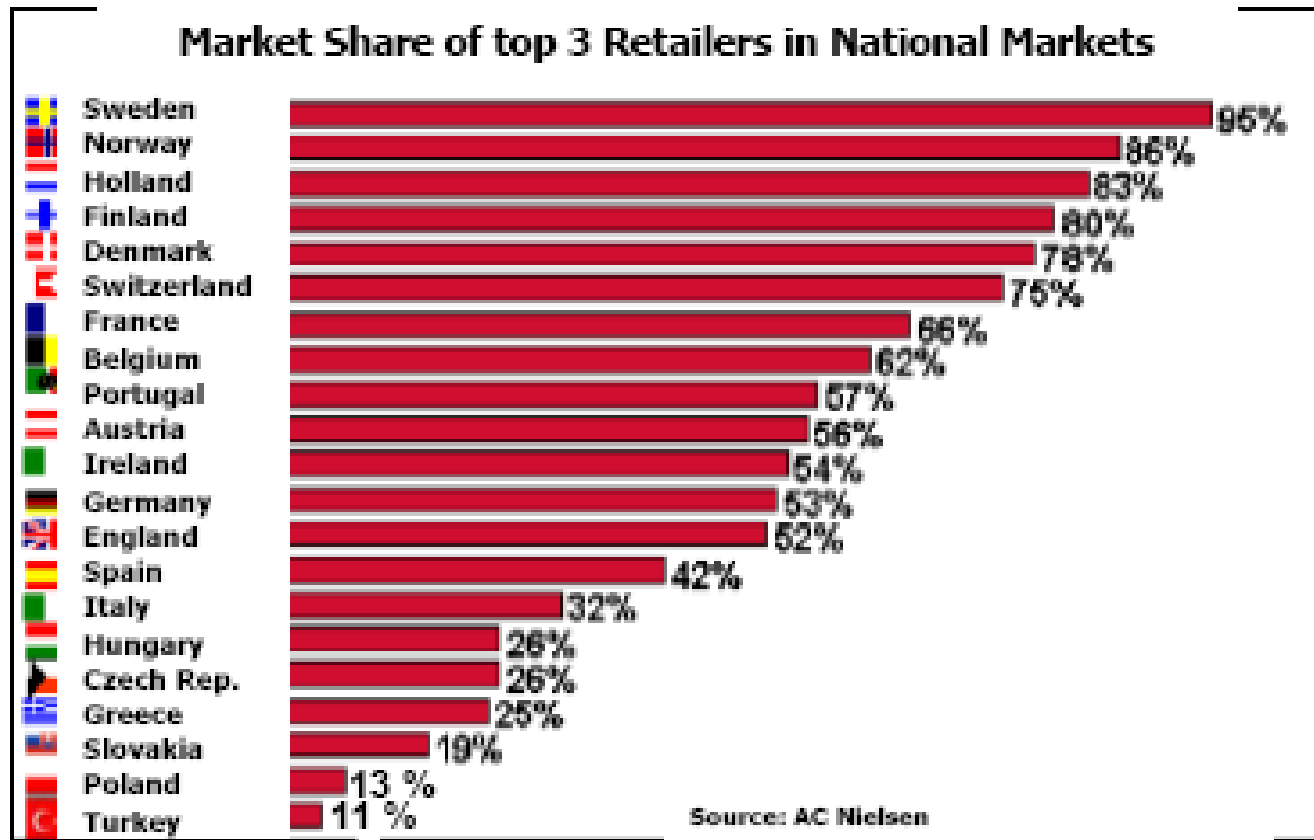


Is Creative Destruction in place (2) ?

1995-2005 Number of Companies Started and Closed Down

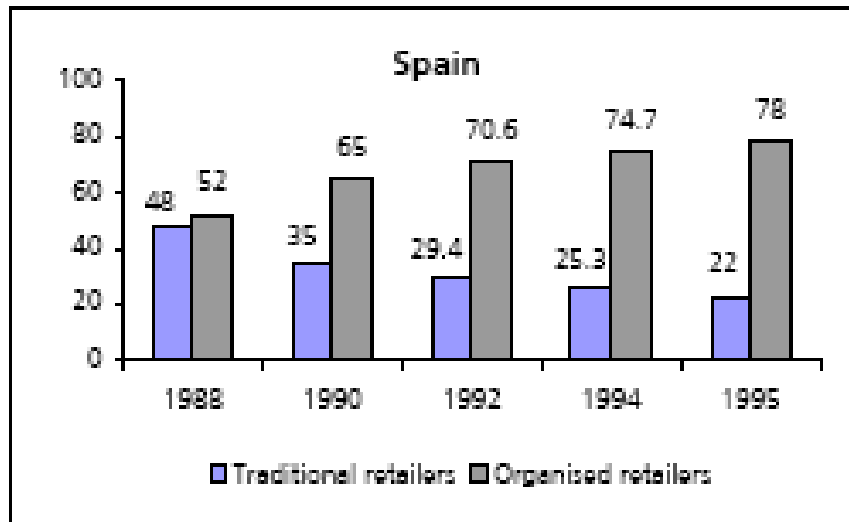


Structural Transformation of the Services Sector: An example from retailing



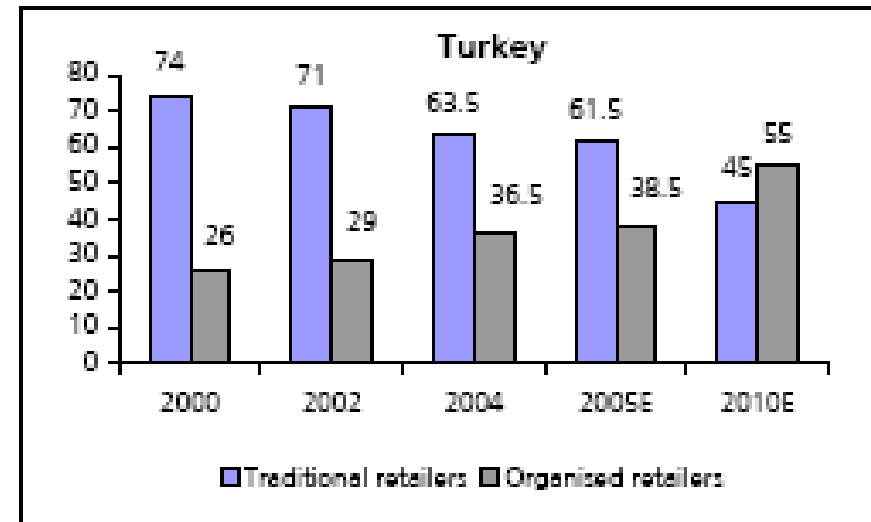
A projection for the future: Comparison of Spain and Turkey

Spain - retail market structure (1988-1995)



Source: Consumer's Co-operative Institute, Japan

Turkey - retail market structure (2000-2004)



Source: AC Nielsen

- If Turkish retail market structure is the same as in Spain by 2010, 86,000 traditional retailers would go out of business.

Winners and losers in retailing

	Winners	Losers
End-points	Organized chains	Groceries, traditional shops
Distribution	Suppliers	Wholesalers
Transportation	Logistic firms	Individual truck- owners
Production	Brand-names	Informal producers (quality??)

- Consumers are also winners because competition among organized chains drives prices down

- Towards a brand new agenda
 - Setting the priorities, implementing strategies
 - Managing the EU process
 - Building capacity

Towards a new agenda

Picture is not bad at all

- recent growth performance
- macroeconomic stability
- a new and healthy incentive structure
- global integration with also growing regional integration

However, risks are serious and require competent management

- Current account deficit
- Rising unemployment
- Creative destruction
- .. + external factors: (i.e. foreign affairs)

There is an urgent need for a new agenda

- Setting the priorities, strategic action plans, effective delivery
- Managing the EU process as a mechanism to mitigate risks
- Building the required capacity for the new environment

Setting the priorities

- We feel there should be three key areas:
 - Adjustment management
 - Risk management
 - Raising Competitiveness

- Government needs to have the capacity to
 - set the priorities
 - design strategies
 - implement effectively

- If managed wisely, EU process will be highly useful

Solving the adjustment problem and the role of the EU

- The new incentive structure came in too fast— if not managed effectively, then adjustment itself becomes a serious risk
- The corporate sector needs to adjust to the new environment
 - Modernization (Upgrading technologies, M&As)
 - Skills conversion
 - Move from informal to formal activities
- Urgent needs and the EU
 - Funds + strategy + delivery capacity

Risk management and the role of the EU

- Current account deficit
 - As the EU becomes a stronger policy anchor, FDI flows will increase (as was the case in all new EU member states)
- Unemployment and skills training (+skills conversion)
 - EU funds and framework programs can help
 - Inspiration from Korea (IT training for unemployed after the 1997 crisis) (*millions of people*)
- Creative destruction
 - EU will set the framework for the public sector reform as well as the restructuring of the services sector
 - A more efficient services sector will ease the pain resulting from creative destruction (of course, if coupled with skills training)
- Regional disparities
 - EU support programs for the Regional Development Agencies

Agenda for competitiveness and the role of the EU

- Strategic integration into the global economy
 - public-private dialogue mechanisms for right investment decisions
 - reform of the incentive system
 - foreign direct investment strategy
- Removing the barriers to investment, doing business, and productivity
 - entry and exit barriers
 - informal economy and scale problems
 - services sector restructuring and input costs
 - Fostering R&D and innovation
 - improving the quality of the workforce
 - quality standards
- Cluster Development Programs

Building capacity for the new agenda

- Can the government undertake all of this all alone?
 - Capacity problems both at the decision making and service delivery levels
 - The need for public-private dialogue mechanisms
 - Continuous feeding of the contents of the agendas
- Removing the binding constraints to effective decision making and service delivery
 - TEPAV – Economic Policy Research Institute
 - TOBB – Economics and Technology University

TEPAV – Economic Policy Research Institute

- Developing policy tools for dialogues with the government
 - Industrial Policy Document (*with State Planning Organization*)
 - Investment Climate Assessment (*with the World Bank and Treasury*)
 - Competition Environment Assessment (*with the World Bank, FIAS and Competition Authority*)
 - Higher Education Sector Project (*with the World Bank*)
- Governance of economic development
 - Decentralization studies, regional development framework (*with The Ministry of Internal Affairs and local authorities*)
 - Fiscal monitoring and transparency
- Regional Integration
 - Industry for Peace Initiative (*with TOBB*)
 - Black Sea and Central Asia Project (*with TOBB*)

Economics and Technology University

- Demographic transition started long time ago
 - Skills conversion requirement as severe as skills training
- Training for the much needed skills
 - All students working closely with the industry
 - Businessmen who can do business globally
 - Multiple languages, interdisciplinary education
 - Engineers who can innovate
 - intense university-industry collaboration
 - Civil servants who can analyze & design policy
 - Master in public policy program (Harvard and SAIS)
 - Case study based education for the region
 - Extensive focus on networking
- Sectoral Research Institutes

thank you

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