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# Structural Transformation of the Turkish Industry & the Role of Regional Integration

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# Agenda

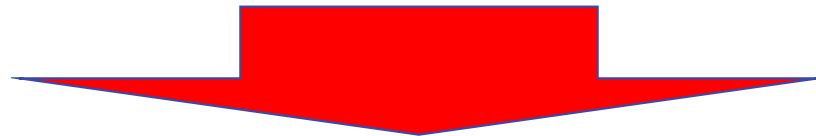
- The on-going structural changes in the Turkish industry
- Emerging risks and sustainability of the growth process
  - current account deficit
  - unemployment
  - creative destruction
- Towards a brand new agenda
  - adjustment management
  - risk management
  - raising competitiveness
- Building capacity & the role of TEPAV – Economic Policy Research Institute
- Some thoughts on Regional Integration in the Middle East
  - a concrete example: TOBB-BIS initiative

- 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

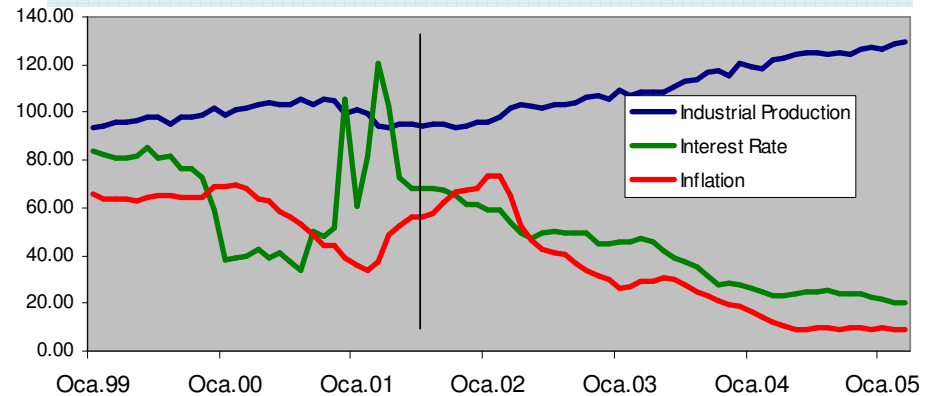


- three economic crises, internal conflict, 1999 earthquake...
- the 2001 economic crisis = GDP shrank by 10%

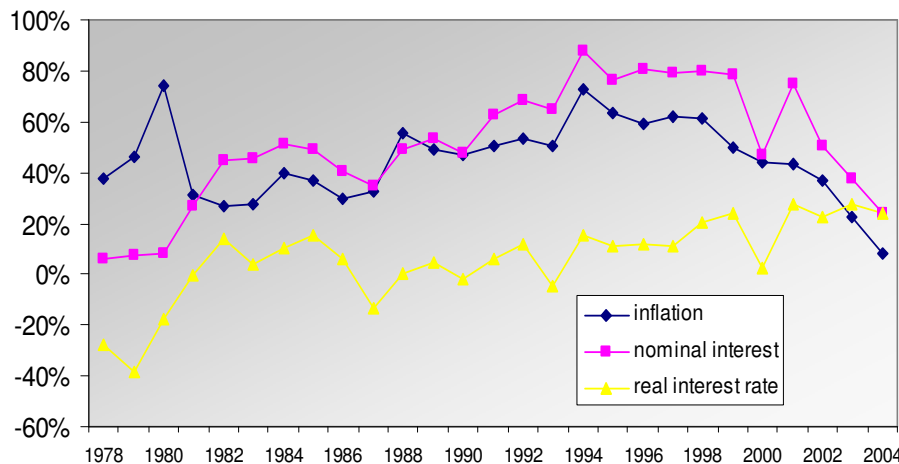
# “Every crisis brings both opportunities and risks” A new process after 2001?

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

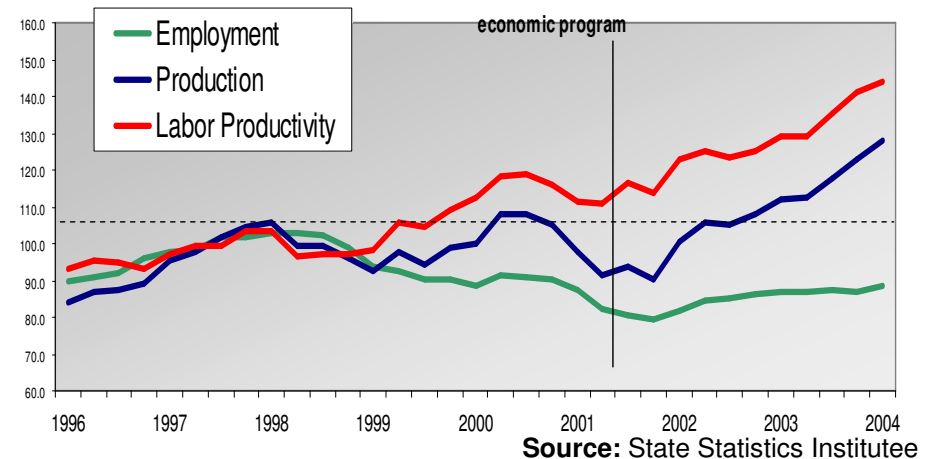
Non-inflationary growth (1999-2005)



Inflation and Interest Rates



Productivity and Employment Trends



# 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)

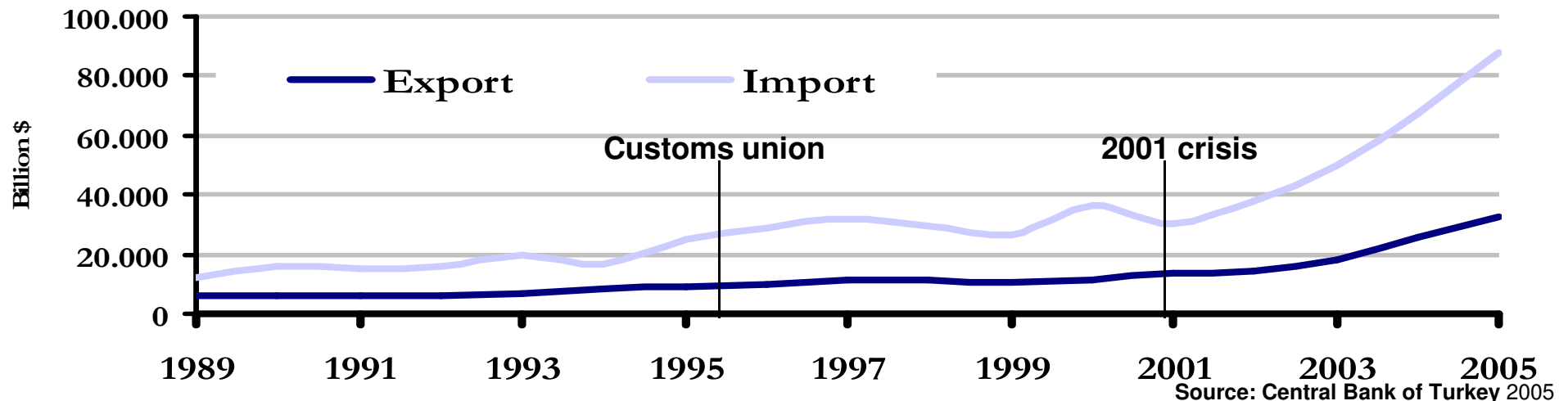
- Reflections on the industry
  - The story on competitiveness
  - Integration into the EU economy
    - New trends, new risks



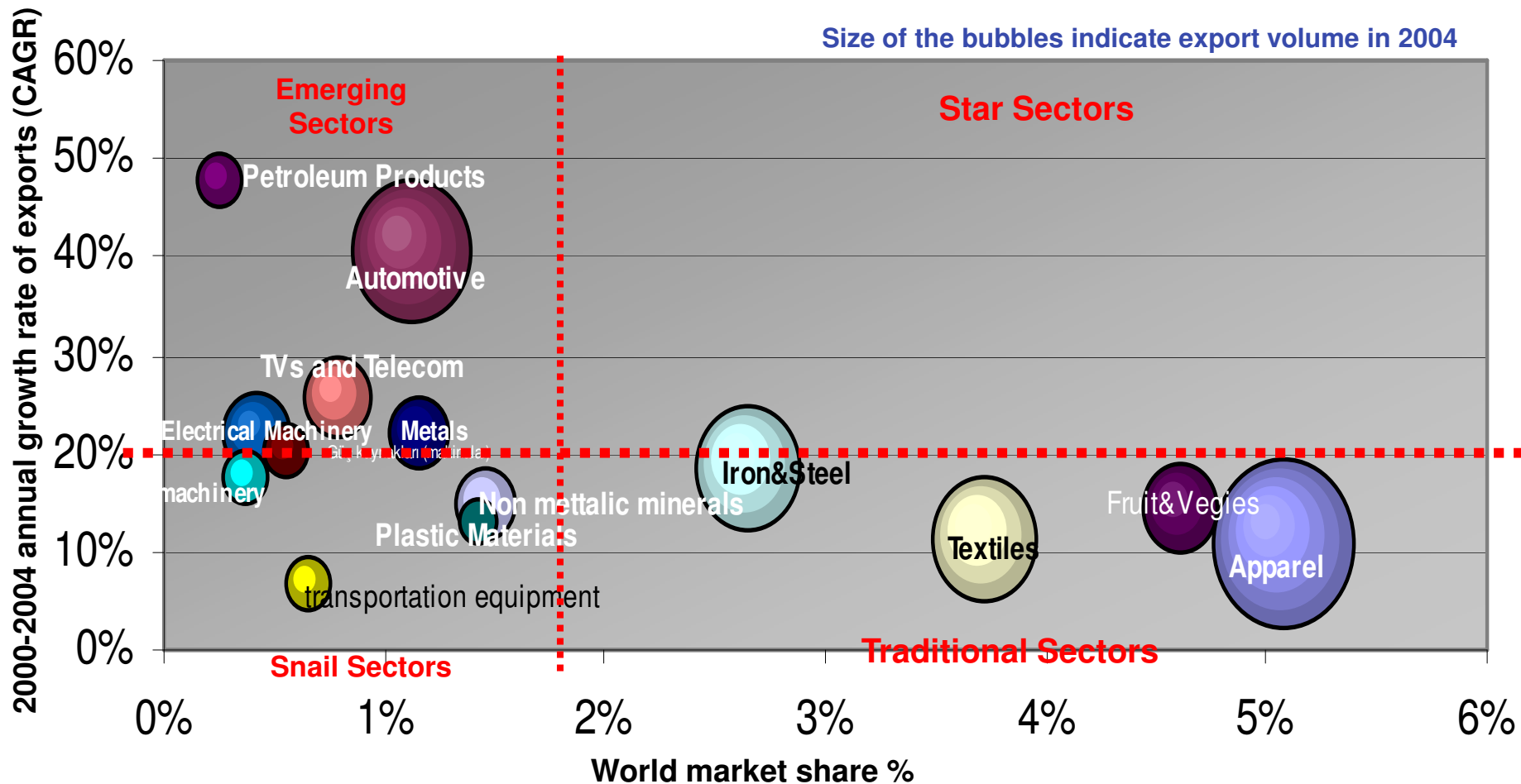
# The new game: Integration into the global economy

- 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

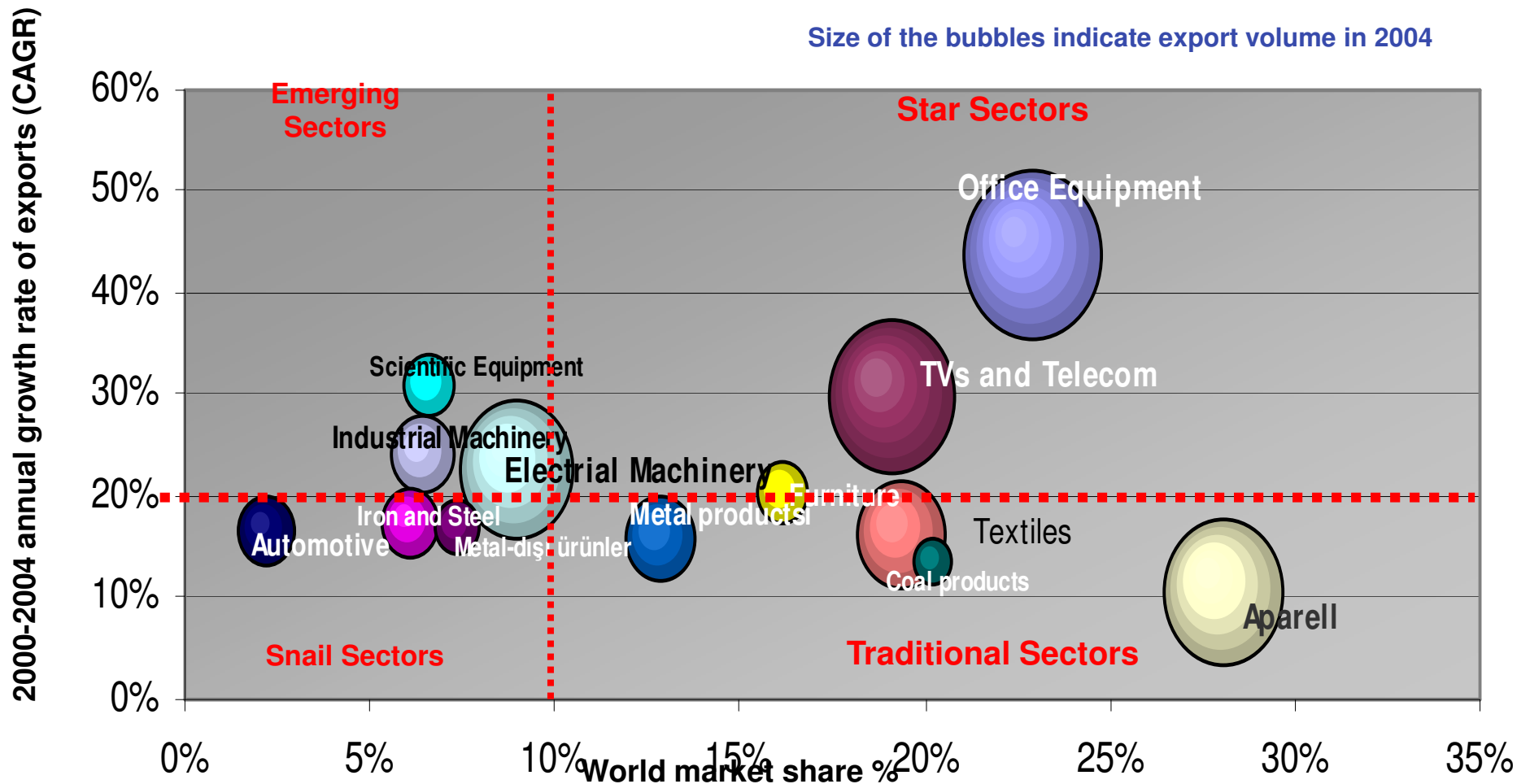
Import and Export of Intermediate Inputs, 1989-2005, billion \$



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



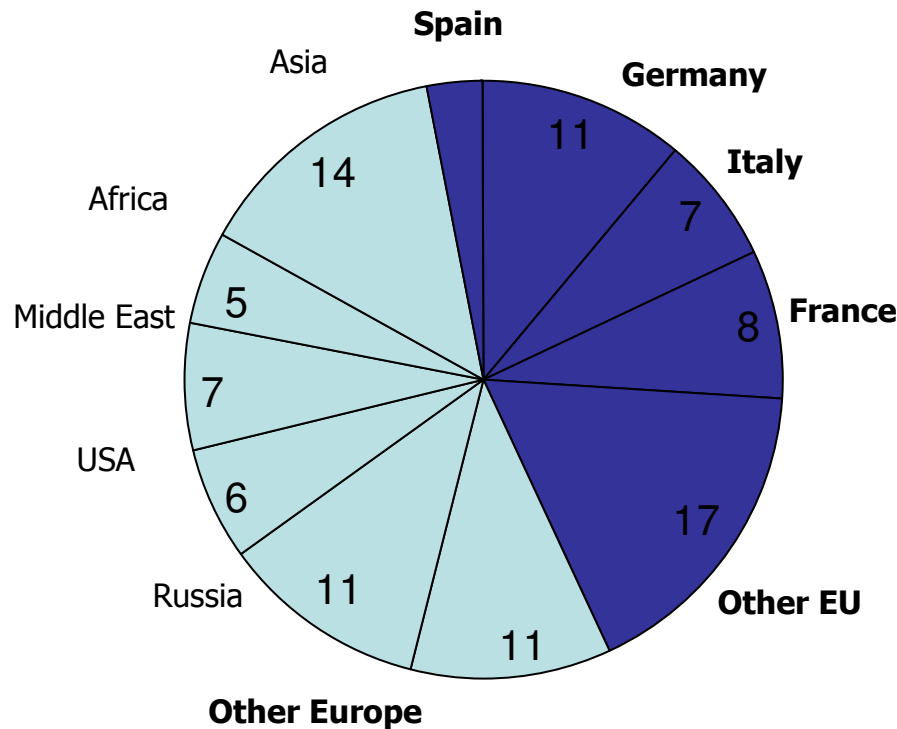
... challenging because China does not only mean cheap labor



# The EU is Turkey's largest trade partner

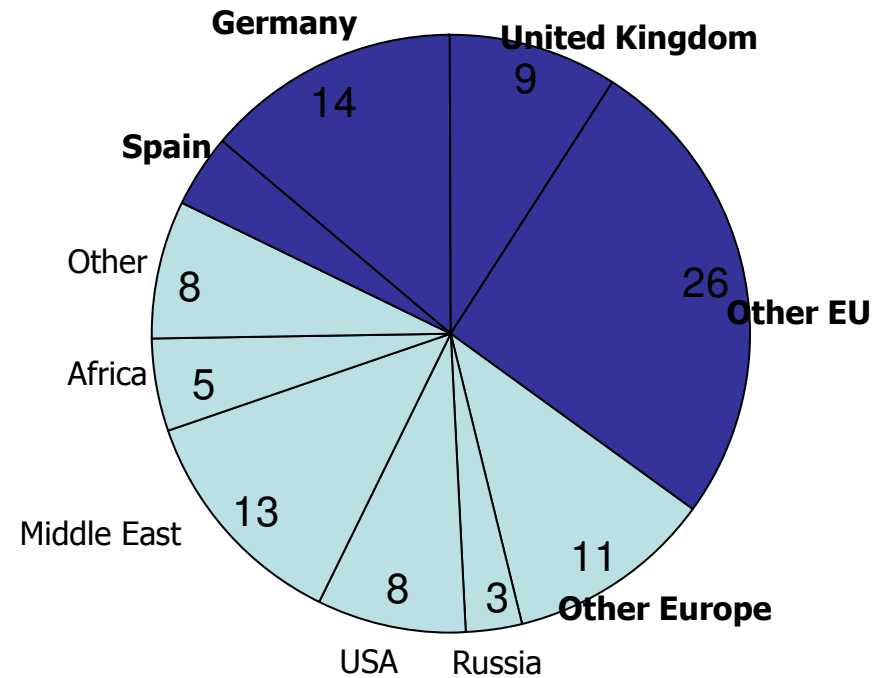
## Imports

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



## Exports

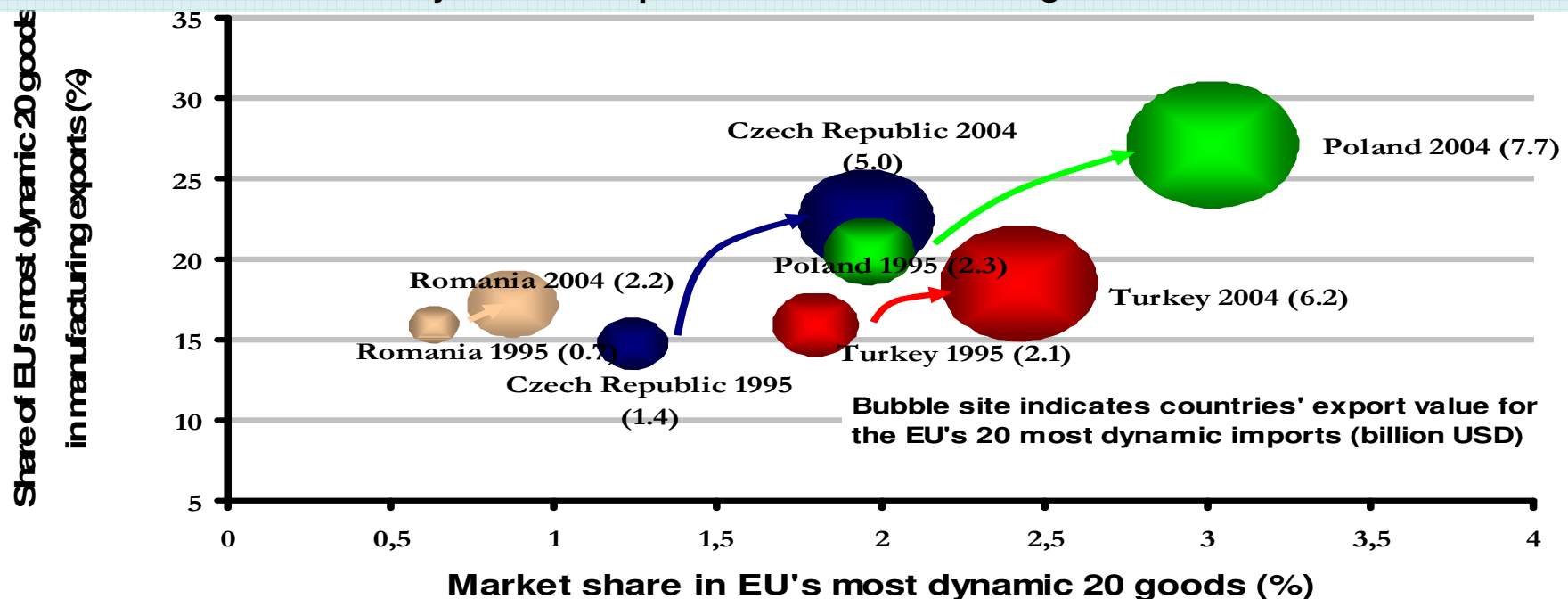
Total USD 73 billion, 2005, (52% EU share)



# 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**

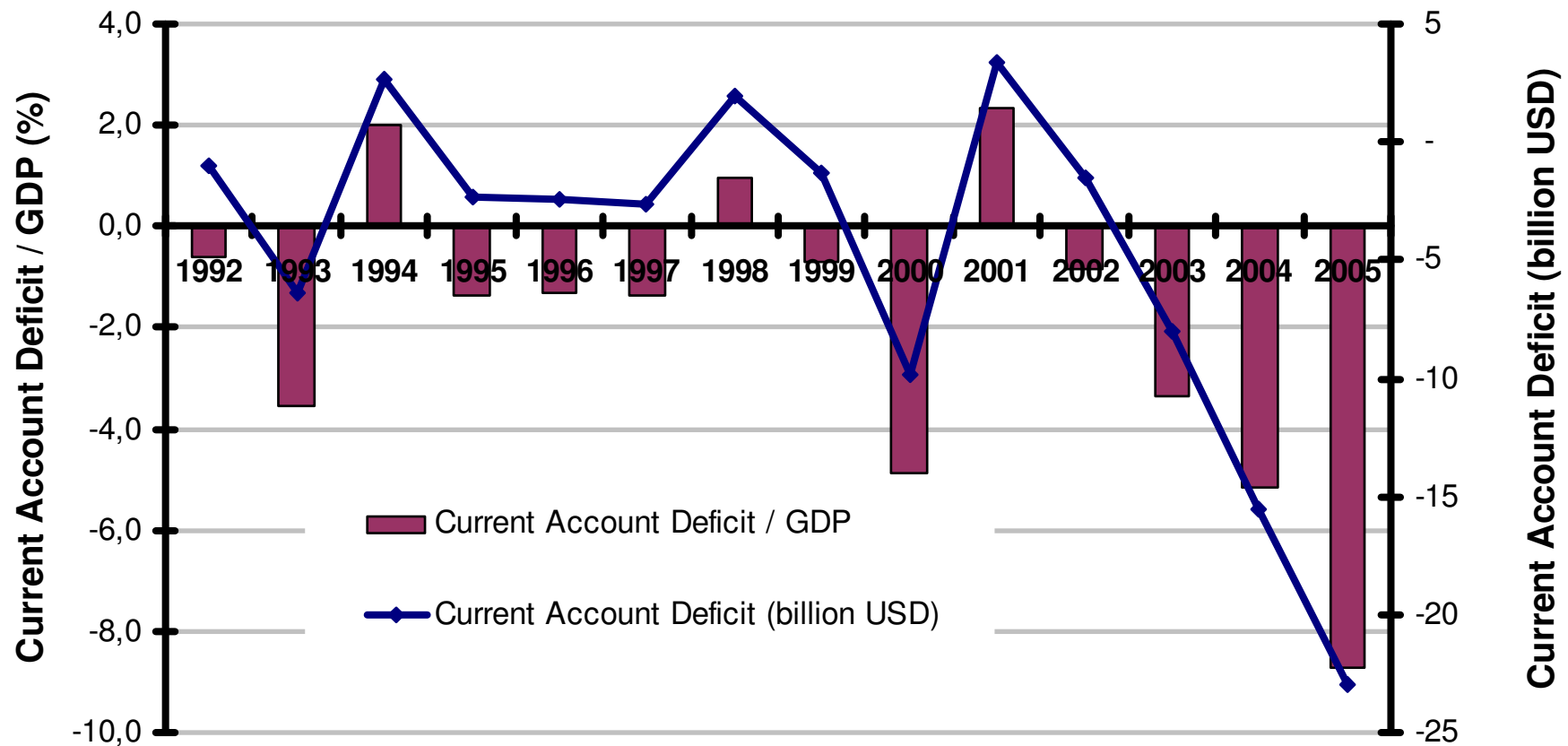
- **Employment Trends**

- *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<br>(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>Ttobacco products</i>                             | 0%                            | 0.093             |

Source: State Statistics Institute



## 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

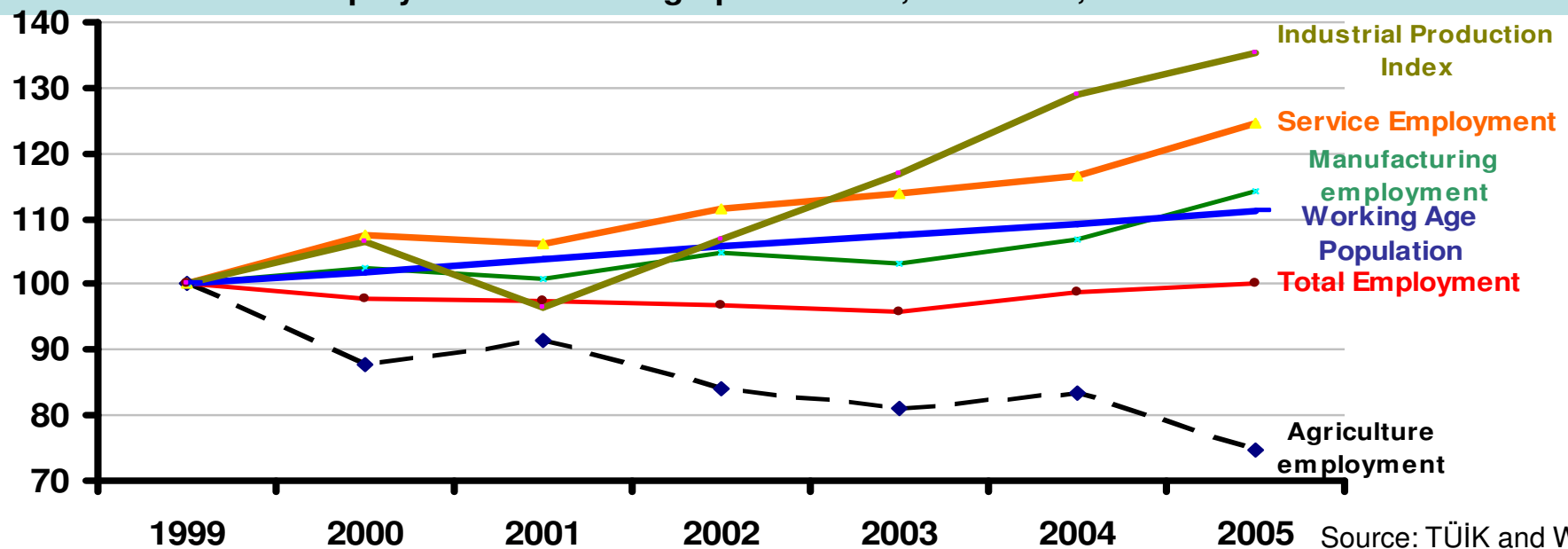
### Textile and Apparel Exports to EU-15 Countries: Turkey and China

|        | 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                                      |

# 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*

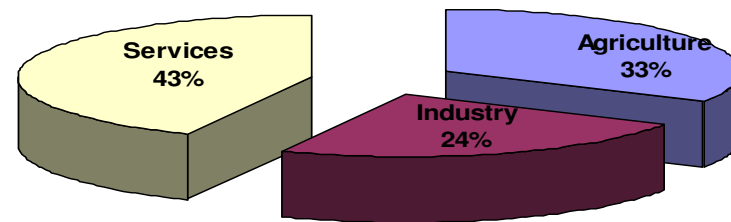
Sectoral Employment and Demographic Trends, 1999-2005, 1999 indexed to 100



# 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<br>Greece   | 1986<br>Portugal | 1986<br>Spain | 2001<br>Greece  | 2001<br>Portugal | 2001<br>Spain |
| Agriculture | 31               | 22               | 16            | 16              | 12               | 6             |
| Industry    | 29               | 34               | 32            | 23              | 35               | 31            |
| Services    | 40               | 44               | 52            | 63              | 53               | 61            |

Source: World Development Indicators

# Is Creative Destruction in place?

## Closer look at the companies closing down

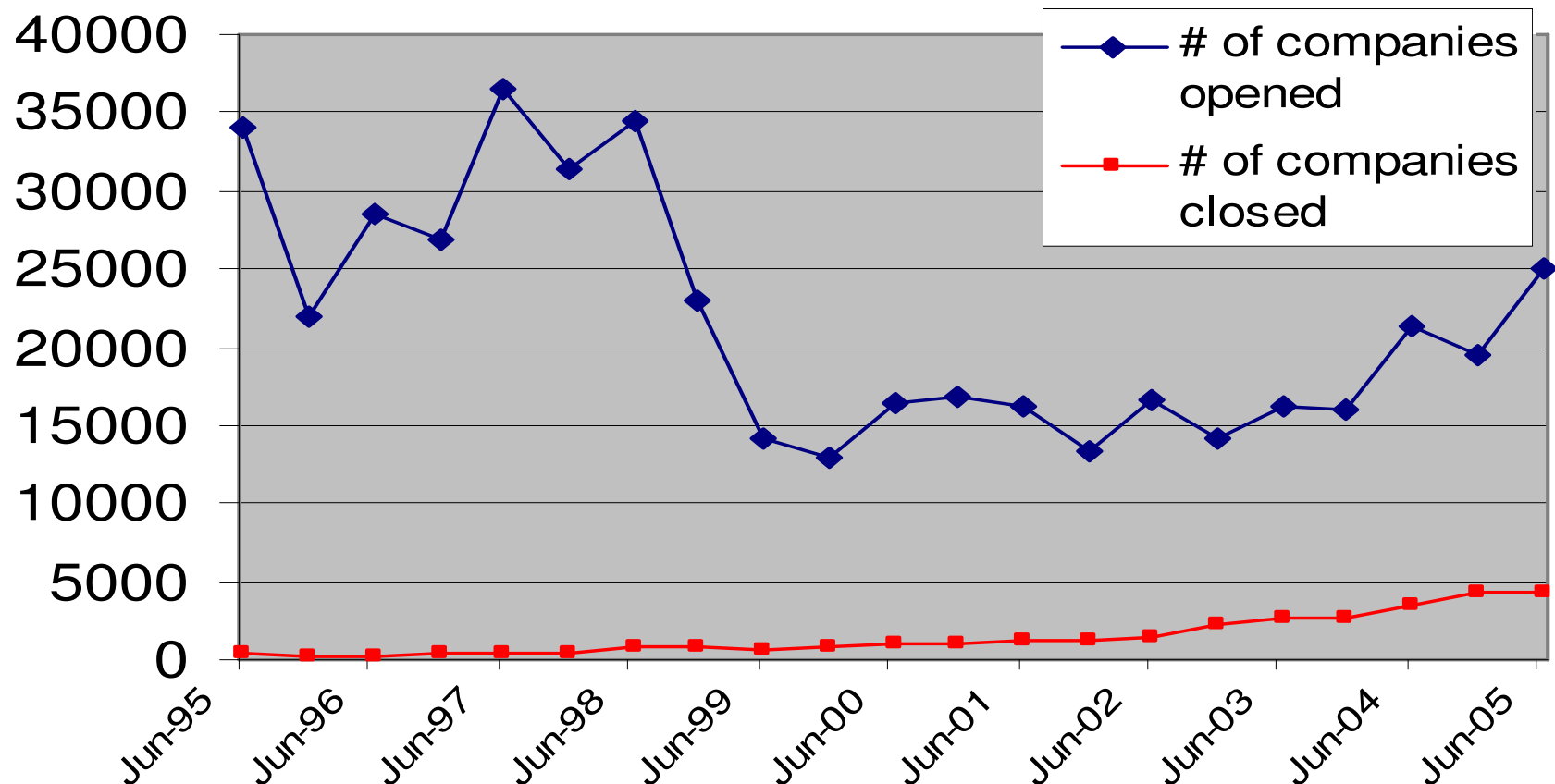
- Floating exchange rate as a sweeping mechanism?
  - ➔ As a mechanism to break the inertia
  - ➔ As an igniting mechanism for creative destruction?

1995-2005 Number of Companies Closed Down



# Is Creative Destruction in place (2) ?

1995-2005 Number of Companies Started and Closed Down



## ■ 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



# Towards a new industrial strategy for Turkey: SPO-TEPAV document

- 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*)

# TOBB-BIS Industry for Peace Initiative

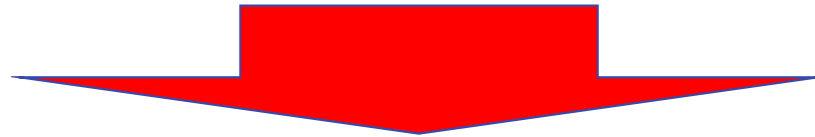
- Job creation will be highly critical for stability and peace
- Solution lies in industrial development



- Manufacturing base as well as the capacity to promote such activities is very limited
  - **First-best option:** Building overall capacity, build industrial infrastructure, improve investment climate (*takes a long time but the need is urgent...*)
  - **Second-best option:** Mobilizing Industrial Parks as instruments for job creation and economic growth (*can be done in short term if there is a strong dialogue mechanism*)

# Why Industrial Parks for Growth?

- Clustering is useful
- Governments cannot deliver adequate services everywhere equally and efficiently



- Second-Best Solution: Certain areas can be designated as more equal (i.e. superior infrastructure, faster permits & licenses)
- Investment Climate at the local level can be improved via PPPs

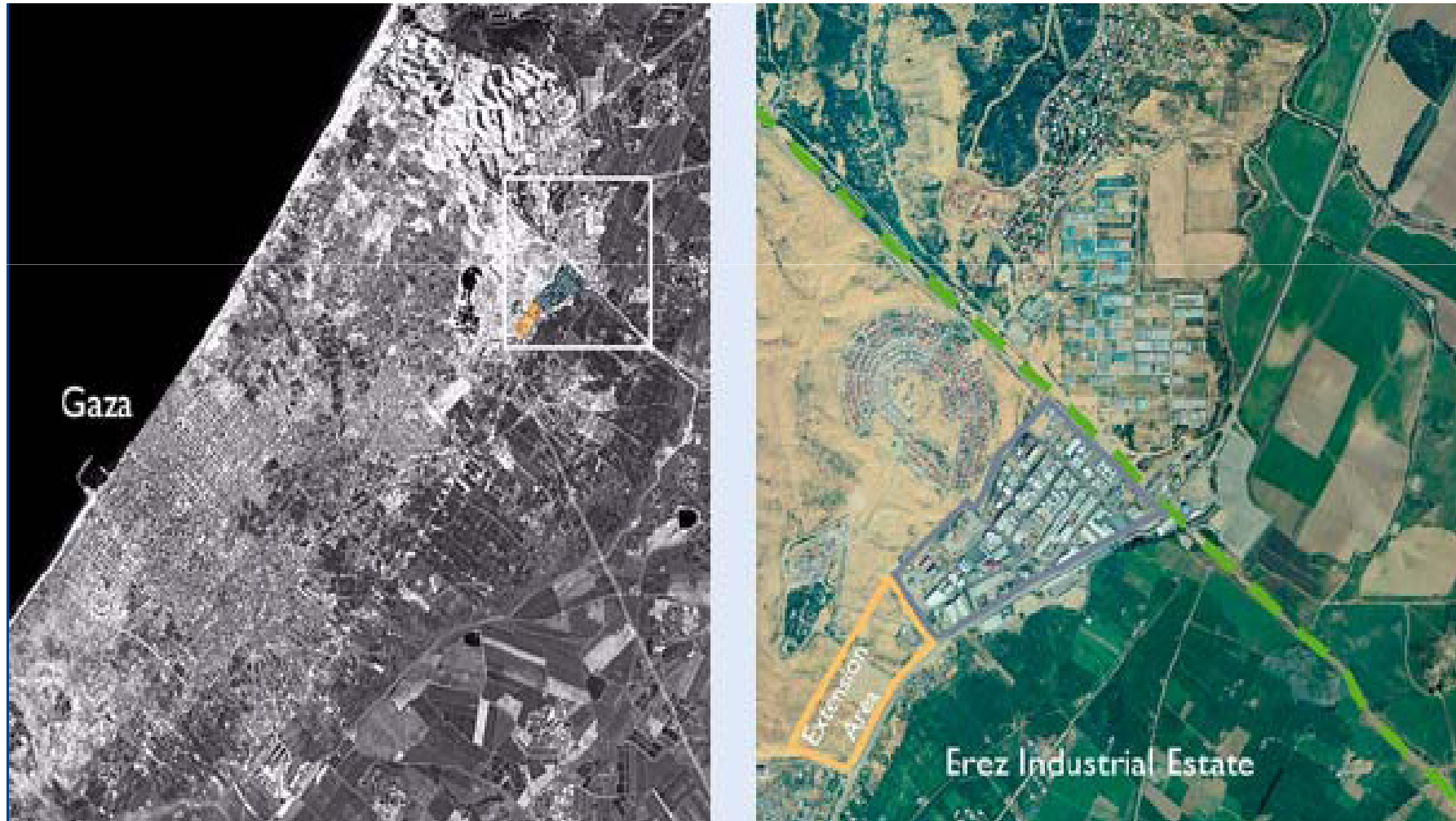
# Turkey's Experience in a Nutshell

- 200+ Organized Industrial Zones, 70 fully operational
- Started as a urban development tool in the 1960s, with a loan from the World Bank
- **Private-public partnerships were facilitated through the local chambers**
- Evolved over time to obtain regulatory oversight
- The Law on OIZs was enacted in 2000

# TOBB's Estate Project in Gaza

- We started with the most difficult area
- Idea came at one of the Ankara Forum meetings
  - Forum first started as a network of businessmen for cooperation
  - A concrete project was needed to monitor and test the words of politicians
- An opportunity to leverage the know-how of Turkish Chambers in:
  - public-private dialogue
  - Industrial park management
  - Doing business under extraordinary circumstances
- A microcosm of all political and economic problems

# Palestinian Industrial Free Zone





# A Unique & Exemplary Project

- It is not an ordinary business project.
  - requires effective coordination among the two not-so-friendly sides – PA and Israel
  - private-public dialogue is key throughout the entire process
- But, it is still a business project.
  - If we want it to be sustainable, it must generate profits. Under appropriate security conditions.
  - If there's fresh air for the investors, business prospects don't seem too bad (especially, given the resources ready to flow into the region and generous FTAs.)

Thank you

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