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Analysis of Turkish Economy

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MANAGERIAL IMPLICATIONS

In general, **Turkey is in long-term projections an attractive investment target for foreign companies**. It has proven growth potential, relatively young population, huge energy and infrastructure projects, logistically and strategically preferred location, established trade relations and a ruling party showing commitment to international cooperation. In addition to its domestic market potential, Turkey has a good position to act as a manufacturing and service base from which to supply European, Central Asian and Middle Eastern markets, as a source of raw and processed materials, and as a pool of human resources. As Turkish lira and stocks have recently lost value, **there may be some good acquisition targets in Turkey**.

However, the SWOT analysis below shows that **not all aspects in Turkey are close to perfect**. Particularly, the short-term development in Turkey is expected to be far from stable, and things may get worse if the global financial crisis provides even more turbulence. It is a modest wish that this report helps executives to understand the unique opportunities and specific threats of Turkey's economy both in short- and long-term. The SWOT-analysis may also be used as a general tool to position Turkish companies and resources in a global value network, as companies operating in Turkey are affected by these environment-specific factors.

Table 1 SWOT-analysis of Turkish economy

Strengths: young and large population, relatively high GDP per household, increased resilience against external shocks, reforms related to investment attractiveness, tourism, number of key industries	**Weaknesses**: current account deficit, lack of domestic savings, unemployment, unregistered economy, narrow tax base, low economic development, poor infrastructure, distracting power struggle, lack of structural reforms, high interest rate policy leading to problems of Turkish companies, inflation, low labour force participation, low labour productivity, heavy taxation, volatility of Turkish lira, corruption, regulatory environment, R&D environment, lack of private sector R&D, lack of respect to IPR, dependence on foreign energy, high electricity prices, regional disparities, labour productivity, bureaucracy, corruption, customs procedures
Opportunities: population and labour force growth, long-term economic growth projections, market potential, taxation and social security reforms, devaluation of lira, public-private partnerships in infrastructure projects, R&D incentive packages, improving IPR protection, infrastructure projects, geostrategic location for energy and transportation and manufacturing, development of close markets, indigenous energy sources, regional development outside Marmara Region, privatisation processes, potential from wider tax base	**Threats**: global financial crisis, dependency of state finance on one-off receipts, dependency on FDI, education, health services, pensions, domestic energy crisis, deteriorating physical infrastructure, devaluation of lira, trade disputes with Russia, power struggle

POLICY RECOMMENDATIONS

Turkey's concern must be business environment rather than inflation. Focus on business environment improves the ability of Turkish companies to engage in global networks and improve their position within these networks. Much advertised focus on high-tech innovations is quite narrow-oriented approach for which Turkish companies may not even have capacity. Therefore more realistic, environment-specific catching-up strategies should be introduced in Turkey based on productivity gains in the current key sectors. **Turkey needs an EU-anchor**. The statement does not take an opinion whether Turkey should or should not enter the Union. However, an EU-anchor certainly helps to focus on economic and other reforms which improve the competitiveness of the country in the long-term. If the short-term oriented economic policy continues, the country fails in seizing the momentum for long-term growth. This is also valid for the non-governmental decision-makers in Turkey, as the whole country should now push for the reforms which have potential to improve the quality of life for all interest groups in the long-term. These measures consist of investments in infrastructure (both physical and institutional) and reforms related to taxation, regional development, education and unemployment, which all are wished to provide new boost and excitement for Turkish economy. The figures indicating that education expenditure is decreasing prove that Turkey is currently on a wrong track.

Turkey needs to widen its formal economy. One idea to widen the size of the formal economy and to improve Turkey's service sector is to *introduce* ***drastic tax deductions for the use of services***. This would encourage people to buy from registered service providers. Although this might be a zero-sum game in the short-term, it might have huge impact on longer-term with the change of culture towards taxation and the competitiveness of Turkey's service sector.

EU needs a Turkey-anchor. The statement does not suggest that the EU should necessarily take Turkey as a member. However, the EU should work on making the Union popular in Turkey and to be perceived as a wanted partner (like everywhere else) in order to encourage reforms in Turkey. This includes keeping up the made promises and more understandable marketing of the benefits which the EU provides. This is the only way to have the kind of candidate as standing on the wish list of the EU. The middle class who has elected the AK Party to the parliament may turn into other parties if they are severely hit by the global financial crisis. As the large parties in opposition are currently to large extent involved in anti-EU rhetoric, the change in the power may lead to change in the possibilities of the EU, as well. As the global financial crisis is also resulting from foreign speculation, it is easily justified by the competing powers that the engagement in foreign trade and capital made Turkey vulnerable to external shocks and thus gives solid backing for anti-EU opinions. Thus, **the EU needs to work on getting wider support in Turkey** just in case it one day wants the country to access the Union – as a result of European hunger for energy and labour force, for instance.

SUGGESTIONS FOR FURTHER STUDIES

Despite the market size and evident growth potential of Turkey and its close markets, ***there is practically no objective economic monitoring available free of charge***. This kind of information is needed in order to increase the availability of reliable economic information on Turkey and the Black Sea Rim Economies.

More research is also needed *why companies are attracted to invest in Turkey*. This kind of research is needed in order to attract more foreign investments in Turkey. This should also find the basis of how much of investments is dependent on the IMF and EU-related target anchors and high interest rates, and how much of foreign investments could be facilitated with different political approaches.

Turkey is also an interesting case for innovation studies, as it seems to have a genuine wish to become a world-class player in high technology but seems to lack the needed infrastructure. ***Lessons from other innovation systems*** should be given for Turkish decision-makers in order to help developing its innovation and R&D environment. Evidently, innovations are one way to improve the network position of Turkish companies but surely not the only one. Just like IMF should not copy and paste the guidelines for economic policy from one country to another, Turkey should not blindly follow the innovation-oriented policies of advanced industrialised countries. Therefore, **more research is needed on the ways how Turkish companies have become successful and comparative data is needed also from other countries at the similar level of economic development**. For instance, many Russian companies are operating under similar conditions in which the business environment does support companies operating *neither in the low cost production nor in high technology* but they must find their own position in the global networks somewhere in between.

Russia is also otherwise interesting neighbouring country for Turkey. In fact, there are many things which are common to both Turkey and Finland, and possibly other neighbouring countries of Russia. Meaningful, comparative research fields could be easily found from areas such as *energy sector, construction industry, transportation* and *customs procedures* where Finnish companies share similar concerns with Turkish companies.

The research findings also prove **the importance of analysing Turkish economy further**. As this is only a brief and general analysis of Turkish economy, more resources should be allocated in the related, more detailed research projects. Particularly, the ***managerial perspective should be improved*** as the current literature on Turkish economy is mostly based on statistical analysis. Reports based on quantitative economic data may lead to biased results, and research projects with qualitative research orientation could have more to give for the development of Turkey and for companies operating in Turkey.

CONTENTS

1 INTRODUCTION

It is widely noted that Turkey is an interesting business environment, which has plenty of opportunities to provide for foreign companies. Despite the positive development of Turkish economy since 2001 economic crisis, Finnish firms among many other foreign companies have been busy investing in China and Russia, and thus not completely utilised the opportunities which Turkey provides.

In order to tackle the above-mentioned problem, the report at hand was decided to be written a couple of years ago. The report was finally written in 2008 and published in November 2008 but the dramatic changes in the business environment during the writing process have changed the scope of the report for a couple of times. This is also why Turkish economy is referred as a "*döner ekonomi*" [1] – a revolving economy at the title of this report.

The author of this report visited experts in Turkey in March 2008, just a couple of days before the closure case of the governing AK Party got started. Once it was more or less in the background and the business environment started to slowly gain more confidence, the global economy was hit by the daily flow of bad news from the Wall Street, and Turkey's economy was again experiencing a shock to some extent. As a result of this turbulence, the report has a long-term approach which takes into account the news analysis from 2008 but aims at analysing Turkey's business environment beyond these short-term effects[2]. This is done in order to provide foreign investors, policymakers and the academia a reliable picture on long-term competitiveness of the Turkey's business environment. This view in mind, it must be noted that in many instance a shortcut has been taken in the analysis, as a 360-degree (*döner*) view is impossible to undertake in this type of a short report.

However, in a tight package, *the research aims at increasing the awareness of opportunities and threats in Turkey's business environment among foreign companies in general and Finnish firms in particular. It aims at providing reliable information on Turkish economy and analysing its development until the near future.*

[1] The connotation to probably the most well-known meal in the Turkish cuisine, *döner kebab*, is also used here to provoke the discussion of the international brand of Turkey, and should not be considered as a denigration of Turkishness.

[2] However, a great deal of the report concerns the analysis of the current business environment of Turkey, as it defines the basis for the future oriented SWOT-analysis.

2 TURKISH BUSINESS ENVIRONMENT IN A GLOBAL COMPARISON

In the following, Table 2 provides a snapshot of Turkish economy in an international comparison. It highlights the large surface area and huge population which comprise of close to 15% of the calculated EU-27+Turkey figure. But the table also reveals how Turkish economy is lagging behind in economic terms when it comes to GDP which is less than 4% of EU-27 +Turkey. Figures in foreign trade, foreign investments and R&D spending are relatively even worse than GDP. They expose the underdevelopment of Turkish economy but emphasise the huge potential which Turkey has if its economic figures are catching-up *per capita* figures of the European Union member countries.

Table 2 Turkey in figures and international comparison 2007

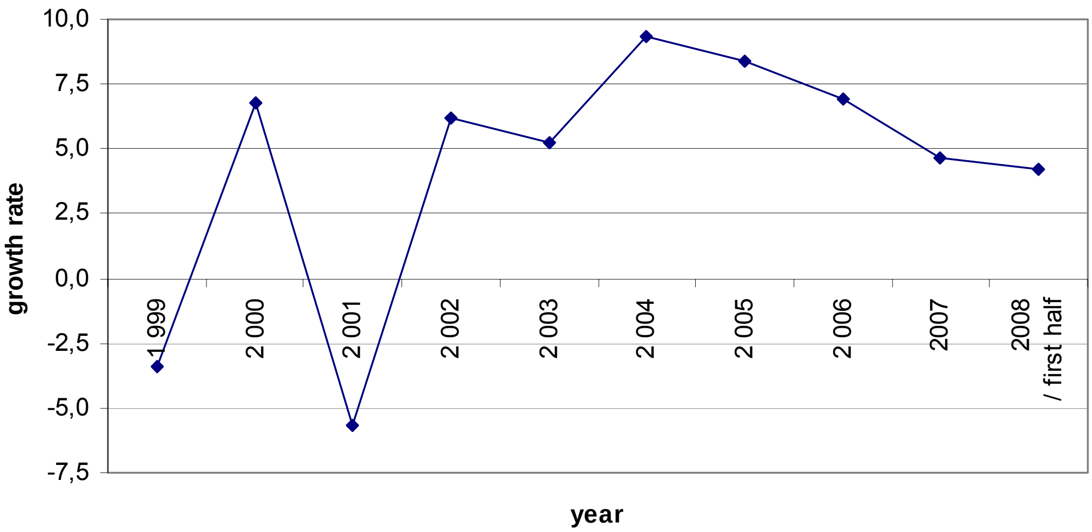
	Turkey	Share of EU-27 +Turkey	Finland	Germany	Russia
Surface area, km^2	781 000	15.3%	338 000	357 000	17 075 000
Population	70 600 000	14.3%	5 300 000	82 300 000	140 200 000
GDP, US$ mln	657 000	3.7%	246 000	3 297 000	1 291 000
GDP per capita, US$ mln	9 300	24 900*	46 400	40 100	9 200
GNI per capita, PPP adjusted, US$ mln	12 100	29 400*	35 300	33 800	14 400
Inflation (consumer prices)	8.8%	2.4%	2.5%	2.2%	11.9%
Unemployment rate	8.5%	7.1%*	6.9%	8.6%	6.1%
R&D expenditure, EUR mln **	2 400	1.1%	6 000	58 800	8 500
R&D expenditure, % of GDP **	0.5%	1.7%*	3.3%	2.4%	0.9%
Exports, US$ mln	107 154	2.1%	89 656	1 326 521	355 177
Imports, US$ mln	169 987	2.6%	81 145	1 059 439	223 059
Current account, % of GDP	-5.0%	0.5%*	4.6%	4.6%	6.1%
Inward FDI flow, US$ mln	22 000	2.7%***	8 000	51 000	52 000
Inward FDI stock, US$ mln	146 000	2.1%***	85 000	630 000	324 000
Outward FDI flow, US$ mln	2 000	0.2%***	9 000	167 000	46 000
Outward FDI stock, US$ mln	12 000	0.2%***	113 000	1 236 000	255 000

* EU-27 average
** Calculated by using the data from year 2006
*** Calculated by using the data from year 2006 for Ireland
Sources: National and European Statistics, UNCTAD (2008), World Bank (2008c), author's calculations

Economic growth: When there is a discussion whether Turkey should become a member of the Union or not, more often the argumentation is based on the figures of economy rather than those related to population.

Turkey has already experienced 26 consecutive quarters of economic growth with an average growth rate above most OECD countries. The consecutive growth quarters have helped Turkey to catch up with the EU average only slowly in PPP-terms. Whereas EU-27 citizen was on average 2.8 times richer than a Turk in 2001, the current difference stands at 2.4. Turks are only slightly richer than the poorest nations in the EU, Bulgaria and Romania. However, Turkey's GDP per household[3] is greater than per capita figure on relative terms which may be more relevant indicator of economic development for many industries (such as household appliances).

Figure 1 Economic growth rate in Turkey at constant prices, 1999–2008/H1

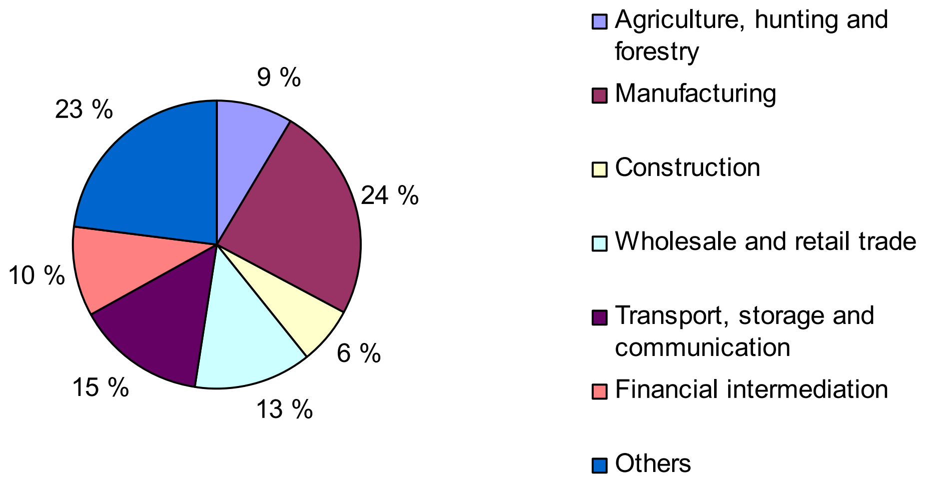


Source: Turkstat (2008)

During past couple of years, real estate, renting and business activities, and financial intermediation have grown in double-digits. Last year, the largest decline was seen in agriculture (incl. hunting and forestry) which plummeted 7.2%. Consequently, its share in Turkey's economy has contracted from 12.1% to 8.6% in only one decade.

[3] There is no recent data available to make precise calculations.

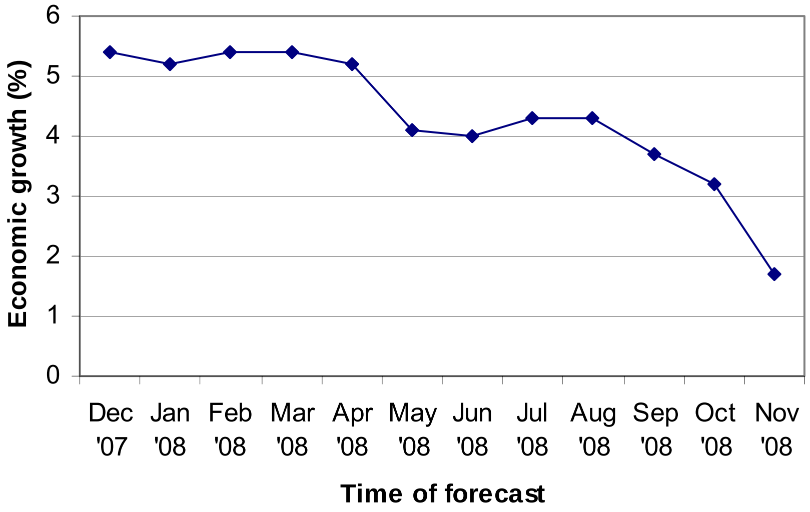
Figure 2 Turkey's GDP by economic activity in 2007



Source: Turkstat (2008)

Despite the bright history, **Turkey's economic growth seems currently far from stable in the short-term**. Both 2007 and 2008 have already "been lost" to political struggles and global turmoil, and 2009 is again a year with important elections. The most recent shock faced by Turkey started on March 14th when the Supreme Court of Appeals Chief Prosecutor opened a closure case against the ruling AK Party. Consequently, the economic growth has slowed down to the lowest level since the beginning of 2002, and the political turbulence has also caused deviation in different growth projections. For instance, the Economist Intelligence Unit (EIU) has been forced to revise its forecast for Turkey's 2009 economic growth drastically during one year from 5.4% (in December 2007) to 1.7% (in November 2008). This indicates that investment decisions should neither be based on the historical data nor the forecasts based on historical data, as the short-term changes are fast at the current economic situation.

Figure 3 Forecasts for economic growth in Turkey in 2009



Source: EIU (2007–2008)

Impact of global financial crisis on Turkish economy: The global financial crisis, which first was not to hit Turkey at all, has arrived in Turkey. The crisis which seemed to be only problems of main export markets have all ingredients to turn into a domestic tragedy.

The cough in export markets has already led to down-scaling the production in car industry, and it will definitely have impact on the economic growth of Turkey. The problems abroad have also affected tremendously the global capital flows, and a substantial amount of money has escaped the emerging economies. Turkey has been suffering from this development as well, and with its huge current account deficit, this may lead to further problems in the country. Turkish lira already lost 40% of its value against US dollar in October 2008.

These kinds of problems affect soon the real economy when companies suffer from lack of capital and gloomy economic scenarios. Lay-offs are probable, when companies seek productivity gains, which again have well-known impact on domestic consumption and further on to the real economy. This all may have impact on the governing AK Party which has already lost its support in the recent polls. This may encourage the party to take undertake short-term oriented policy before the local elections in 2009, and thus the financial crisis is about to postpone long-term-oriented structural reforms.

However, there may also be good news in financial crisis, which means that the global financial crisis does not have to mean a domestic tragedy. Particularly, the depreciation of lira is good news for labour-intensive, non-energy-intensive export companies in Turkey. These sectors may be able to benefit from the crisis more than other sectors in the long run. Thus, financial crisis affects companies differently, and *more company-specific analysis* is a must.

The closure case led also to an immediate reaction of the international credit rating agency Standard & Poor's which downgraded its outlook for Turkey's creditworthiness from stable to poor. Eventually, Turkey's Constitutional Court voted for not closing the party and following the calming political environment the credit rating was again raised. However, the desires for structural reforms were repeated by the agency (Today's Zaman 2.8.2008).

Although the closure case showed some specific features of Turkish political environment which may be difficult for foreign companies to comprehend, Turkish Economy Minister Mehmet Simsek may be right by stating that seven years ago similar case would have shot up interest rates to 7,000 percent overnight (Today's Zaman 22.3.2008). Similarly, the **Turkey's economy has recently proved its resilience against external shocks** amid the Georgian crisis and the financial crisis, although the final impact may remain to be seen.

Regardless of short-term corrections and slow catching up process, **the long-term economic growth estimates look promising** to Turkey. According to World Bank (2008d), Turkey is now in a better position to achieve catching up as it has undertaken reforms with longer payback horizon. The fourth middle-term programme of the State Planning Organisation (DPT 2007) is similarly optimistic and has a vision of Turkey's transformation into an information society with a high level of competitiveness and employment creation capacity. Towards this goal, the DPT plans that Turkey's economy will grow by 5% in 2009 and by 5.5% and 6% in the following two years.

Although these plans seem challenging to achieve as the economy has suffered from the closure case and global uncertainty, **Turkish economy is expected to grow faster than Russia in the next decade** and even to surpass the growth rate of India by 2015 (OECD & FAO 2008). According to the report, Turkey's economic growth rate will average 5.5% during 2010-2017. In fact, Zafer Caglayan, Minister of Industry and Commerce, has announced that Turkey aims at ranking the top 10 economies (currently 17th) in the world by 2023, when the country celebrates the 100th anniversary of the republic (Today's Zaman 16.6.2008). In another bold statement, Economy Minister Mehmet Simsek has announced that Turkey will experience sustained economic growth until 2040 (Today's Zaman 14.6.2008).

Power struggle in Turkey: The closure case of the governing AK Party was just another show in the power struggle in Turkey. Particularly, it shows the large role of the military in securing the secular state. It must be remembered that the closure case was not unique in Turkey in the sense that political parties have been closed before. Closing a party which has majority in the parliament is still obscure for a foreigner.

The military operates in Turkey with huge resources. The budget is estimated at close to 5% of GDP, the greatest share in NATO, and in 1996 Turkey approved a military budget of US$ 150 billion until 2030. Turkish army is considered to have 200,000 soldiers and 55,000 pro-government village guards against the estimated 4,000–5,000 Kurdish terrorists. To some extent large military forces are justified as Turkey is a country 7th most affected by terror incidents. Turkey witnessed over twice more terror incidents in the Q2/2008 than Israel, for instance. Some of these terror attacks have however been claimed to have links to the Ergenekon gang with claimed links to Turkey's military forces.

The political struggle not only distracts the government from important reforms but also provides it a perfect camouflage to avoid important but difficult questions. The need to concentrate on real issues has been urged by people in key positions both in Turkey (Today's Zaman 2.6.2008) and in the EU (2008a). The resolution of the closure case may have provided opportunity for the party to avoid populist actions, as it provided a warning not only to the party but its voters, too. Moreover, experts think that the closure case may have left the party incapacitated to take populist actions, as the AK Party "is in the governmental position not because it is supported by a majority of the nation but because the state allows it" (Today's Zaman 1.8.2008).

In 2008, the Turkish news has not only been filled with the closure case and the constant stream of bombings but also by corruption allegations and the Ergenekon-case. The tensions between the government and the military in addition to other internal security problems allocates resources to the armed services over investment in competitiveness-related cost items, such as infrastructure and education Fortunately, the Prime Minister has understood at least in rhetoric that confidence and stability are the key factors to bring positive expectations boosting production, exports and employment (Today's Zaman 23.9.2008). There are also some hopes that the newly appointed Chief of Turkey's Supreme Military Council, General Ilker Basbug would be able to ease the tensions between the secular forces and the government (EIU 2008; Oxford Business Group 2008a) but it remains to be seen what the future holds.

Inflation: The declining, one-digit inflation has been one of the major successes of Turkey since the economic crisis of 2000–2001. Now **inflation is again proving to be a problem to some extent**, as Turkey's Central Bank (2008) has had to raise the range for its inflation target for year 2009 from 5.9% to 9.3%, and the mid-term target to 5.4% for mid-2011. As a result, Turkey has fallen far behind the economic criteria for eligibility to join the EU.

Turkey's Central Bank (2008) has put the blame on hiking inflation on global surge of food and energy prices which have contributed 64% to annual CPI inflation. This is due to food and energy expenditure accounting for an important share of income – above OECD average (OECD & FAO 2008). However, it also proves how vulnerable the country remains for supply shocks. Partially, inflation has been a result of monetary policy, as high real interest rates have continued to attract capital inflows and thus kept lira appreciating, undermining labour-intensive industry of the country (OECD 2008). Inflation is also highly dependent on the pricing power of energy and service companies resulting from imperfect competition (OECD 2008). Although the central bank cannot be solely blamed on high inflation rates, analysts have agreed that the development in 2008 has hurt confidence in the bank's reliability (Today's Zaman 6.8.2008), which makes it difficult to reach the inflation targets set for the coming years. Also the government should not be left without blame as more actions for domestic energy and food production could have eased down the inflationary pressures in the home front.

Budget: Currently, Turkey is again running budget surplus. The reason for poor performance in 2007 was partly caused by the general elections which postponed privatisation processes and increased public spending. In fact, the fiscal consolidation has recently been managed with privatisations, as well as cuts in public capital spending and less on rationalisation of expenditure (OECD 2008). This creates pressure on Turkey as it should be able to meet the challenges of education, health services, pensions, and energy and physical infrastructures (OECD 2008). The stability of the state finance is not so stable when the budget surplus is largely based on one-off receipts (EIU 2008).

Budget constraints have limited new investments since the mid-1990s (OECD 2008), and more should be invested in order to sustaining the economic growth of past few years (World Bank 2008d). The government, however, still remains cautious of not overspending money, and have kept tight fiscal policy under the uncertainty caused by the global financial crisis, as investments require either domestic savings, or FDI inflow or foreign debt. Particularly, the expenditure on gross fixed capital formation (GFCF) indicated a sharp decline in the confidence in the second quarter of 2008 (EIU 2008). The decrease in GFCF was even sharper in public sector which followed decreasing figures in government spending (EIU 2008) despite the demands for public investments.

Interest rates: There is also debate in Turkey in which direction the interest rates should be modified. The global financial crisis has resulted in pressures of increasing the interest rates in order to attract foreign investors amid global uncertainty to finance its current account deficit. High interest rates are problematic for domestic companies but for multinational companies the interest rates are set at the global credit markets, and therefore provide competitive edge for them against indigenous firms. However, high interest may impact also foreign companies in Turkey if their local customers encounter financial problems. Lower interest rates might give further boost for consumption and investments but might leave the country in ruins with the escape of speculative hot money. The Governor of the Central Bank has said that interest rates will decline in Turkey only if inflationary pressures give in (Today's Zaman 24.9.2008).

Turkey's high interest rate policy is considered very expensive for Turkish tax payers. It has been calculated that more than US$ 300 billion was paid to foreigners as a result of high interest in 10 years after 1999. This money could have been and should be better invested in the future (Today's Zaman 13.7.2008).

Need for structural reforms: Already financial crises of November 2000 and February 2001 revealed the need for deep-rooted structural reforms. Some of these reforms such as commitment to fiscal discipline and tight monetary policies were undertaken successfully. However, **Turkey has failed significantly in fighting against unemployment and current account deficit**. These deep-seated structural problems may have drastic outcomes in case the global liquidity causes problems in financing the current account deficit. This is very relevant in the aftermath of the subprime-crisis, which may have influence on the consumption in the main export markets of Turkey and thus lead to further problems in terms of unemployment. (USAK 2008.)

Business association TÜSIAD worried already before the political turmoil, in early March 2008, about Turkey's macroeconomic data, particularly inflation and unemployment. It demanded the government to speed up efforts on structural reforms and warned that the domestic market is contracting and the economic growth will slow down if the government does not come up with a new plan to fight unemployment. TÜSIAD long supported the pro-business, pro-EU AKP government since it came to power in 2002 but on the 2nd term it has frequently expressed concerns that the government is not paying enough attention to the economy and the EU process. (YASED 2008.)

Population and labour force: Turkey has a population of 70.6 million, of which half is aged less than 28.3 years. Approximately 70% of Turkey's population is living in cities and some 18% of population is living in Istanbul, which is a city of 12.6 million inhabitants. In addition, some 3.7 million Turks were residing overseas at the end of 2006 of which more than 80% were living in Western Europe[4]. As a result, Turkey is ranked among the top emigrant-sending countries in the world (World Bank 2008c).

Turkey has major impact on the population and labour force projections of the EU. Given that Turkey is a member of the EU by 2020, it is expected to host 13.8% of the Union's population (Economist Intelligence Unit 2006). And it is not only relative to developed countries which shows the young population of Turkey tempting, the same applies against Ukraine, Romania and Bulgaria, for instance.

Table 3 Population and labour force trends in Turkey and selected countries, 2007–2020

	Population trend			Labour force trend		
	2007 (thousand people)	2020 (thousand people)	Change 2007–2020 (%)	2007 (thousand people)	2020 (thousand people)	Change 2007–2020 (%)
Turkey	75 161	86 774	15,5	27 876	32 989	18,3
Germany	82 729	82 283	-0,5	41 379	40 322	-2,6
Russia	141 900	133 101	-6,2	73 368	65 430	-10,8

Source: Laborsta (2007), author's calculations

Table 4 Changes in the labour force in Turkey by age class, in 2007–2020

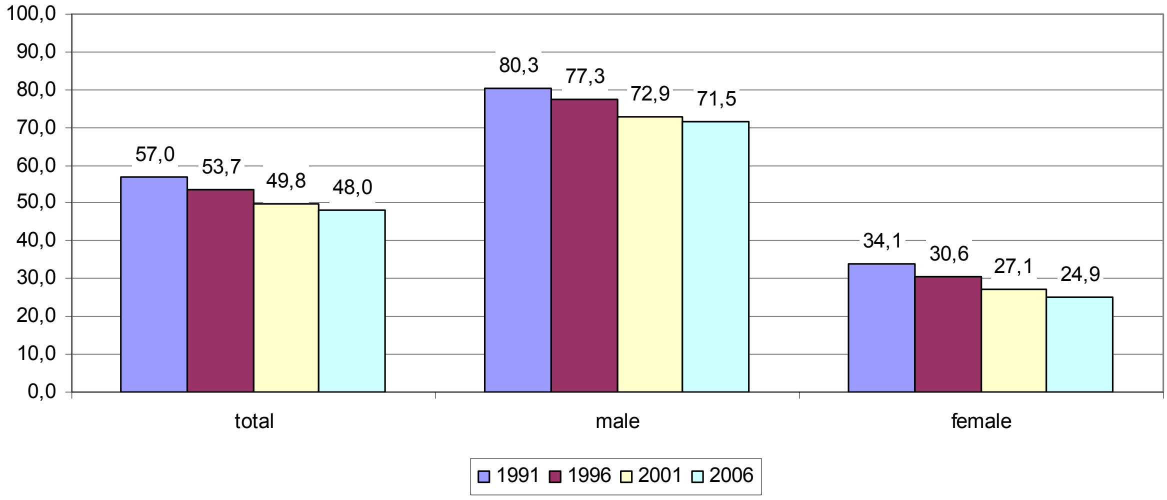
Age class	2007 (thousand people)	2020 (thousand people)	Change 2007–2020 (%)	Share of labour force 2007 (%)	Share of labour force 2020 (%)	Change 2007–2020 (percentage points)
15–19	2 547	2 604	2,2	9,1	7,9	-1,2
20–24	3 997	4 240	6,1	14,3	12,9	-1,5
25–29	4 063	4 088	0,6	14,6	12,4	-2,2
30–34	3 875	3 944	1,8	13,9	12,0	-1,9
35–39	3 436	3 996	16,3	12,3	12,1	-0,2
40–44	3 024	3 867	27,9	10,8	11,7	0,9
45–49	2 510	3 424	36,4	9,0	10,4	1,4
50–54	1 751	2 530	44,5	6,3	7,7	1,4
55–59	1 155	1 882	62,9	4,1	5,7	1,6
60–64	622	1 065	71,2	2,2	3,2	1,0
65+	896	1 351	50,8	3,2	4,1	0,9

Source: Laborsta (2007), author's calculations

[4] This figure was published in a report "Turkish Workforce Abroad" prepared by the Foreign Affairs and External Labor Services General Directorate.

By entering the EU, Turkey would make the Union also younger. Turkey's old-age dependency ratio is estimated at only 13% in 2020 compared to one-third in the EU (Economist Intelligence Unit 2006).

Figure 4 Labour force participation rate (%), 1991-2006



Source: Turkstat (2008)

Turkey suffers from relatively low labour force participation rate (70.5% in EU-27) which has even dropped since 1990s. The low labour force participation rate is partly due to large share of unregistered business in the economy. In fact, the barriers to formal employment are one of the key issues of Turkey, which prevent it achieving its full potential. As the costs of employers for minimum wage employees are too high in the formal sector, they rather remain unregistered. (OECD 2008.) It is considered that the government has not yet put enough emphasis on fighting against the unregistered economy. Particularly, education programmes to fight against the decreasing female labour force participation is on the wish list. Currently, Turkey's participation rate of women[5] (25 %) is far below European standards (57 %). (USAK 2008.) In addition, cutting the labour market regulations should move more people into the formal economy.

[5] Although these figures indicate the traditional division of roles between men and women in Turkey, there are some highly ranked women in Turkish business such as Güler Sabanci (CEO of Turkey's second largest conglomerate, Sabanci Group) and Arzuhan Dogan Yalcindag (Chairwoman of the most influential business men in Turkey, TÜSIAD). Güler Sabanci was recently named as the ninth most powerful woman in business globally by Fortune (2008).

Despite low labour force participation and recent hikes in economic growth, unemployment has remained high in Turkey under the phenomenon "*jobless growth*". The reasons for this have been explained to vary from excessive regulatory framework and tax burden to problems stemming from IMF programme, which causes currency appreciation and contraction of exports in labour intensive sectors such as textiles, clothing and food processing in addition to problems in agricultural sector. However, partially the phenomenon can be explained by *4 million (mostly under-employed) agricultural workers shifting to industry, construction and services sectors since 2001*[6].

Even more concerning is the high unemployment among the young (aged 15–24 years) people, which has jumped from 13% in 2000 to close to 20% in 2007. The scale of the problem is significant, as there are 500,000–700,000 new workers entering the labour market annually. If the DPT plans hold true, there will be 1.3 million new jobs created in 2009–2011, which is simply not enough to fight against unemployment, particularly among the young (currently about 20% remain unemployed). This may lead to flow of young Turks abroad when the economic conditions get better in host countries, which would lead to Turkey losing the most prospective productive potential it has for the future economic growth (World Bank 2008d). Another concern for the governing AK Party is the rise of *revolutionary forces*, as the young unemployed masses have been active in shaping the political scene in the world history.

In addition to problems within the labour force participation and unemployment rates, Turkey's labour productivity is poor. Turkey's labour productivity per person is forecasted to be only 45 % of EU-27 in 2008. The figure has slightly increased from the estimated 40 % in 2000 but it remains as an important problem yet to be solved. (Eurostat data in USAK 2008.) This makes it difficult for the country to compete in labour-intensive manufacturing sectors as the wages are simultaneously hiking in two-digit figures.

Unregistered economy: According to the Labour and Social Security Ministry, almost half of Turkey's employees remain unregistered. The best situation is in Marmara region where the share of unregistered employment stands above 40 percent compared with close to 70 percent in Eastern Anatolia. (Today's Zaman 9.6.2008.) The unregistered business makes tax collection problematic and according to the data revealed by the Ministry of Finance, government officials were able to collect

[6] Author's calculations based on the data provided by the EU (2008d).

approximately 70% of all taxes due in early 2008 (Today’s Zaman 25.6.2008). The problems are deeply-rooted as a vast majority of people in Turkey do not trust in the country’s taxation system (Today’s Zaman 13.10.2008).

If Turkey manages to get rid of its unregistered business, it might revise its GDP figures massively. Although the country has tackled the problem, it is continuously finding the task challenging. For instance, between October 2005 and December 2007 inspections carried out by the Social Security Control managed to register about 60,000 previously unregistered workers. This figure is inconsequential, as Turkstat estimates that there are closer to 12 million people in Turkey with no social security. A report by the Social Security Control Officers’ Association claims that the loss of the state from the unregistered economy has already reached billions of dollars but the current number of official social security inspectors only totals less than 500. (Today’s Zaman 24.6.2008.)

Simultaneously, the EU is funding a project for registering all sheep and goats in Turkey. It is estimated that altogether 32 million animals will get identifying rings attached during the project, costing approximately EUR 1 per animal. Although this may seem inconsequential, the report by the Turkish Union of Agricultural Chambers has revealed that 25% of Turkey’s meat production remains unregulated (Today’s Zaman 21.7.2008), which means a market of approximately US$ 5 billion.

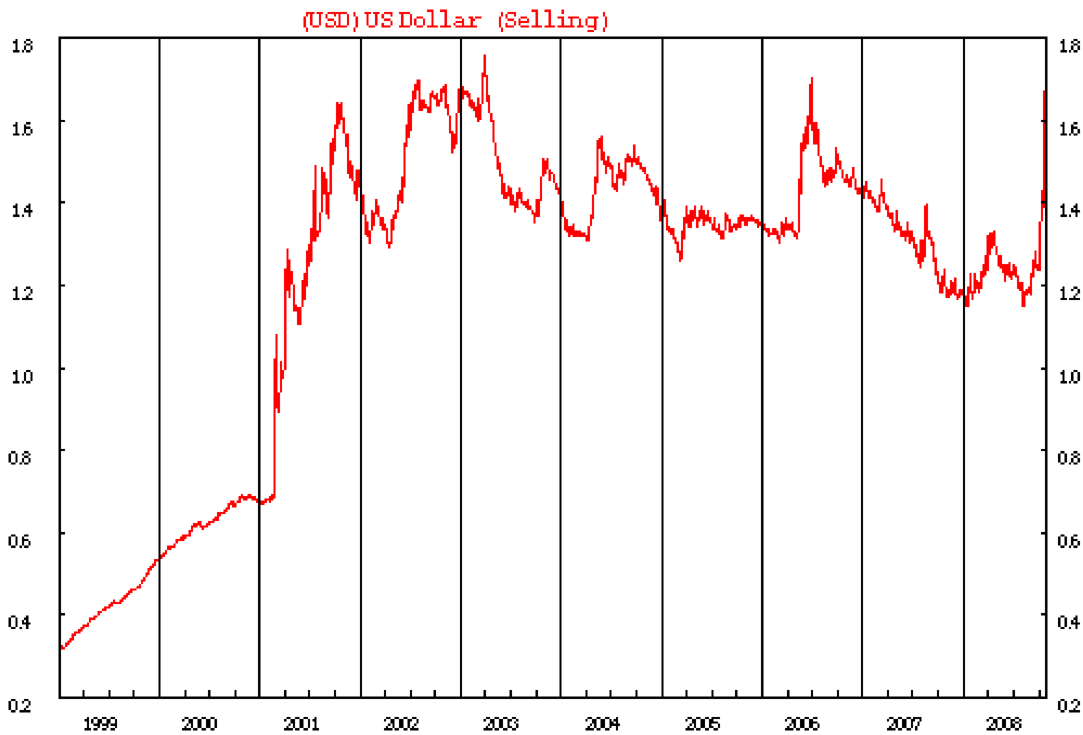
Taxation: Unregistered labour force may be partially simultaneously *a cause for* and *a result of* heavy taxation. According to the Ministry of Finance Income Policies Headquarters, Turkey had the highest tax burden on income among 30 OECD countries in 2007 with 42.7% tax burden on average annual salary. Since then, reforms have dropped Turkey’s ranking but it is still among the top tax collectors. Surprisingly, Turkey, ranking currently 8th, still has higher tax burden on wages than Finland, for instance. (Today’s Zaman 24.4.2008.)

Currently, the Finance Ministry is preparing changes to taxation policy. New measures target also tax fraud. Simultaneously, there are also discussions whether the highest income tax percentage should be reduced from 35% to 25% (Today’s Zaman 19.9.2008.) However, the Prime Minister Erdogan has stated that there will be no tax cuts before more economic activities are brought under taxation (Today’s Zaman 23.9.2008), and no reduction in income tax should be expected in 2009 (Today’s Zaman 9.10.2008).

In fact, public debt has made tax cuts difficult for long and this still remains the case despite of improving situation on GDP basis (Today's Zaman 17.7.2008). The small taxation base also cuts down the financial resources to invest in key public services such as infrastructure and irrigation (OECD 2008).

Overvaluation and depreciation of lira: In January 2005, six zeros were cut from the currency, and the currency has since then, and until the beginning of 2009, been called "new lira". Until very recently, Turkish lira was considered overvalued as a result of the high interest rate policy of the Central Bank. In October 2008, the lira however lost approximately 40% of its value against US dollar. The recent devaluation of lira has been good news for export-oriented, non-energy intensive industries. Although the overvalued lira has now lost its value, even the exporters have criticised the rapidity of the change (Kutlay 2008).

Figure 5 Development of Turkish lira's exchange rate against US dollar, 1999-October 2008



Source: Turkey's Central Bank (2008)

If lira was fixed in euro or dollar, it would make Turkish economy more predictable for foreign companies. However, the exchange rate stabilisation programme of 1999 was an experiment which triggered by political dispute ended up in one of the deepest crisis in Turkish economic history in February 2001 (OECD 2008).

Also weak lira policy of the post-2001 helped to correct price competitiveness but postponed the needed reforms on industrial level. Therefore, the monetary policy can be seen to have a large role in the structural transformation of Turkish industries. In real terms the Lira was pushed up by capital inflows since 2001-crisis, which eased the pressure on inflation but brought up challenges in cost-competitiveness in international markets for many industries (OECD 2008).

The artificially strong lira is unsustainable, as it leaves the country vulnerable for external shocks. The strength of lira is affecting companies differently depending on their target market and the role in the global value chain. For instance, it is more difficult for the lower technology, labour intensive industries to face the challenges of strong lira policy (Yilmaz & Gönenc 2008).

Competitiveness: Turkey has been performing quite well in increasing its business climate and competitiveness since the crisis of 2001. However, it is still performing relatively badly in different competitiveness rankings leading to vulnerability in the economic development front.

Table 5 Turkey's business environment rankings in international indexes 2008

Index	Ranking	Author's notes
Global Competitiveness Index (World Economic Forum)	63/134	losing 10 ranks from 2007
World Competitiveness Yearbook (IMD)	48/55	
Corruption Perception Index (Transparency International)	58/180	1st among countries in South Eastern Europe and Central Asia
Doing Business Ranking (World Bank)	59/181	
Index of economic freedom (The Heritage Foundation)*	83/157	improving trend since 2003
Best Countries for Business (Forbes)	41/121	
Knowledge Economy Index (World Bank)	52/132	improving 12 ranks from 2007
Country Credit Rating (Institutional Investor)	70/177	

* data from year 2007

Although Turkey declared anti-corruption a priority prior to 2006, Transparency International (2008) and the EU (2008d) highlight that there have been neither notable changes in legislation for greater transparency nor a comprehensive strategy for the fight against corruption in the past two years.

The government has also otherwise been distracted from reforms needed to enhance the competitiveness of the country. Therefore, also the Economy Minister Simsek wishes that the next agreement with IMF should focus on increasing Turkey's competitive power in order to "enter a process that will ensure a permanent drop in inflation" (Today's Zaman 13.9.2008), and this view has also been echoed by Turkey's businessmen stating that the programme needs to take the reality of the real sector into account (Today's Zaman 14.8.2008). Other problems stem from the regulatory environment which is a key element for private sector and employment growth (World Bank 2008a).

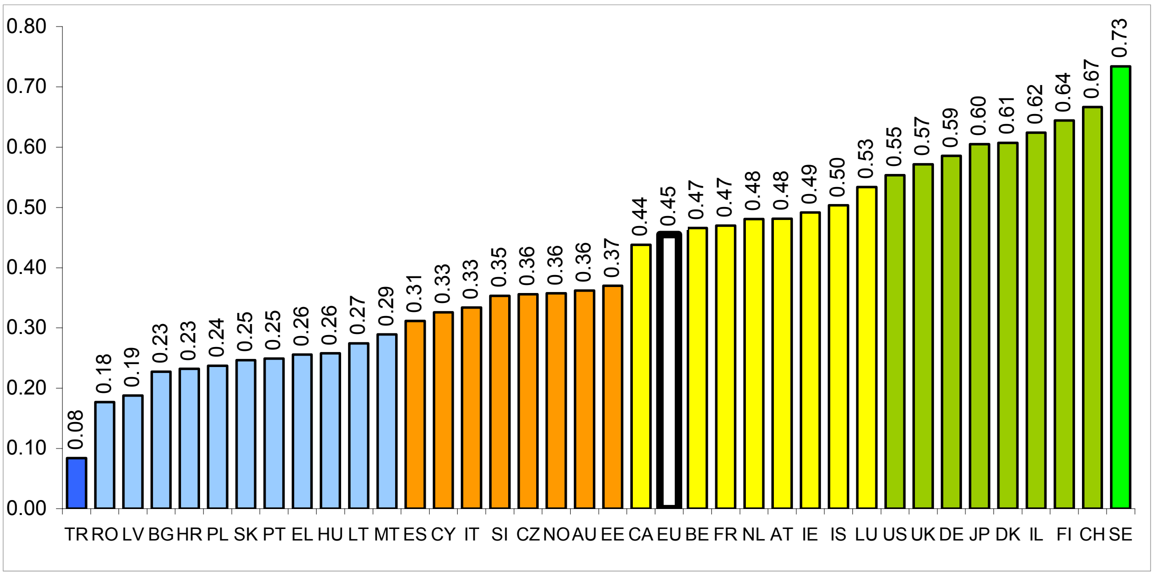
The State Planning Organisation (DPT) has published its plans on how to improve Turkey's competitiveness. These measures include: private sector participation in infrastructure projects, securing long-term energy supply security and to prevent power outages, and boosting R&D activities.

Innovation policy: As Turkey's main economic sectors remain mostly low-tech and labour-intensive and are continued to face heavy competition from lower-wage competitors. Therefore, Turkey needs to raise productivity and innovation in these sectors to maintain competitiveness and to attract FDI (OECD 2008b).

In spring 2008, a law on R&D promotion was passed in Turkey. The new law gives incentives through land allocation, taxation and other financial instruments. The law was introduced to make Turkey more attractive for R&D-intensive FDI in which Turkey has earlier failed. For example, the R&D Magazine (2008) estimates that Turkey will attract less than US$ 40 million R&D funding from abroad in 2008. The rest 99% of R&D funding is estimated to origin from local industry (70%) and government (29%) with a steady increase in industrial funding in the past. Perhaps, a recent acquisition of a Turkish pharmaceutical company, Yeni Ilac by Spanish Recordati is a sign of changes in that respect.

The fact that Turkish companies do not take advantage of foreign technology hinders their growth (World Bank 2008d). Although Turkey has improved its performance in the World Bank's Knowledge Economy Index, it is still far away of being an information society. In order to improve the situation, The State Planning Organization (DPT) has allocated some US$ 300,000 for feasibility studies on "making Turkey the information technology base of the European Union" (Today's Zaman 13.8.2008). Despite the state's willingness to see Turkey in the group of high-tech innovating countries, some experts do not think that it is possible and not even beneficial for the economy in short run. The difficulties are highlighted in the European Innovation Scoreboard in which Turkey has recently moved further away from the EU average (EU 2008b). In fact, **Turkish companies could be better of by finding their own position in the global value networks instead of solely repeating the high-tech innovation mantra of more advanced economies**.

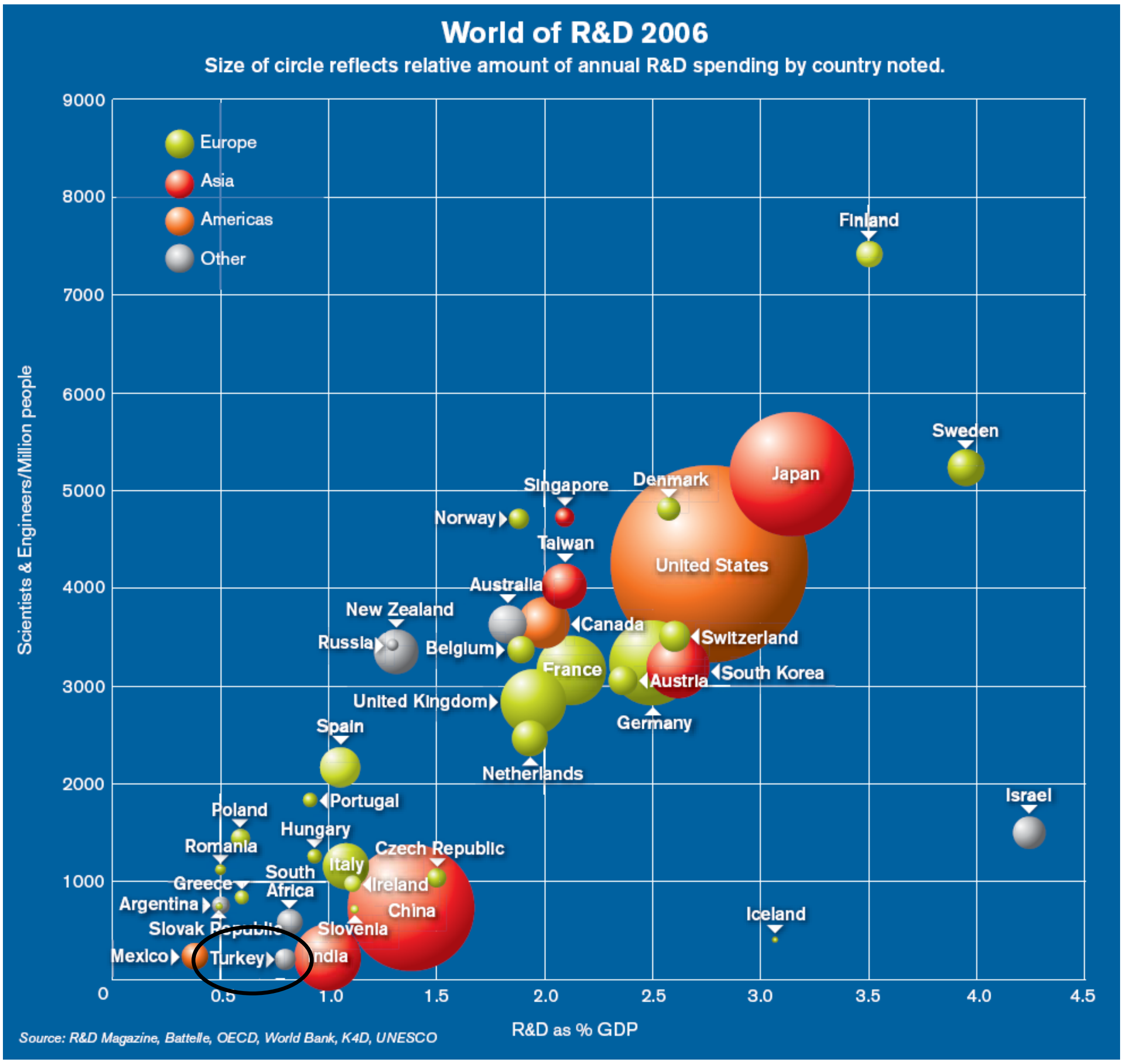
Figure 6 European Innovation Scoreboard 2007



Source: EU (2008b)

Turkey spends 25th most money on R&D activities in the world and increased R&D spending second fastest after China during 2003–2005 (Investment Advisory Council for Turkey 2008). However, in order to make R&D spending parallel with its size of the economy (17th), it should increase the spending 2.5 times. The share of R&D researchers of total employment (0.3%) also still falls far behind the figures of Finland (2.2%). The increase in R&D spending has mostly been a result of available public funds highlighting the problems of the Turkey's R&D environment. (R&D Magazine 2007.)

Figure 7 Turkey's R&D expenditure and number of R&D workers in an international comparison

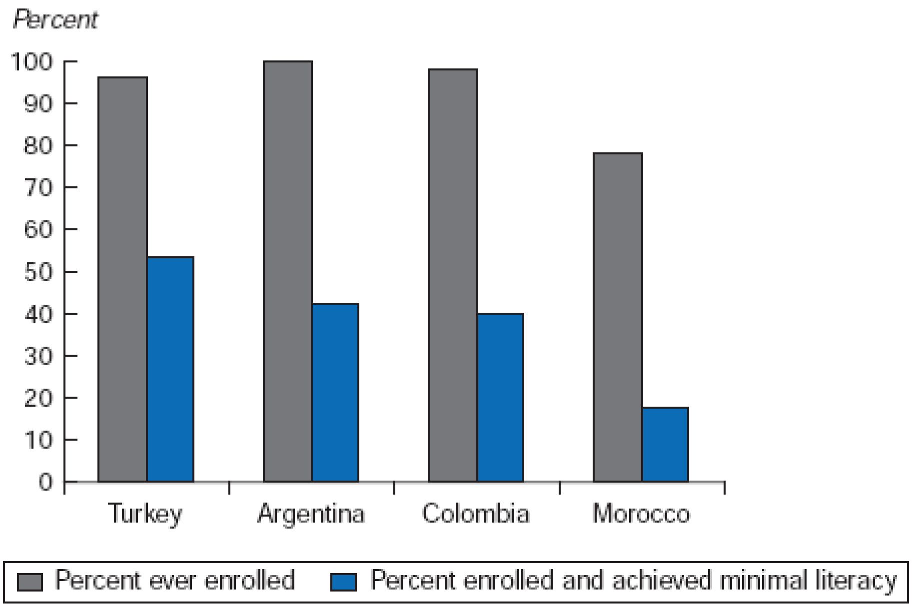


Source: R&D Magazine (2007)

According to the EU sources (EU 2008c), the three largest R&D spending companies (Koc, Ford Otomotiv, Aselsan Electronic Industries) in Turkey make it to top 1000 non-EU spenders. In the EU-level, these companies would be positioned as 297th, 335th and 377th, respectively. In comparison, 16 companies from Finland are ranked among top 370. In fact, Turkey spends less money on R&D than Finland despite their more than 10-time difference in the size of population and two times larger economy.

Problems of school system: The challenges of Turkey becoming "an information society" and "the IT base of Europe" are highlighted in the country's educational system. Only a small portion of workforce are able to absorb international best practices, and the unmet supply and demand of educational system and labour market further confirm the gap of the school system to meet the needs of the economy. The companies require mostly semi-skilled workers, but only one fourth of the working age population has attended a degree after the lower secondary education. Moreover, the money spent on primary and secondary education is estimated at only some 20–30% from EU-average in PPP-terms. (OECD 2008.) The most recent figures on GDP also revealed that education expenditure was experiencing sharpest decline (-2.3%) out of all sub-sectors of GDP in the first half of 2008.

Figure 8 A half of Turkish school children fail to meet OECD reading standards on fourth grade



Source: World Bank (2008b)

The poor results can be seen already among the fourth graders where only half of the students are able to pass standardised OECD tests. Although in the Figure 8 Turkey seems to be performing well against Argentina, Colombia and Morocco, in an international comparison the results are nothing to be proud of. Consequently, only a small proportion of the population in Turkey is matching the needs of top Turkish universities. These problems have also been highlighted in the EU's recent Progress Report on Turkey (EU 2008d).

Drawbacks in education and literacy, the lack of necessary infrastructure and technological capacity, also hinder the diffusion of future technologies in Turkey. For instance, targeted drug delivery, improved diagnostic and surgical techniques, and quantum cryptography are considered to be technologies which are expected to be mastered by 2020 in Eastern Europe and Russia but not in Turkey. Additionally, there are technologies such as tissue engineering and wearable computers which are about to make Turkey even more peripheral compared to the industrialised countries if things will not change. (Silberglitt et al. 2006.) However, these problems have also been addressed in Turkey (Investment Advisory Council for Turkey 2008) and some progress should be expected in the near future.

Intellectual property rights: One of the reasons for Turkey's weak performance in innovation scoreboard may also stem from its poor record in intellectual property rights (IPR). The Office of the United States Trade Representative (USTR) removed Turkey earlier this year from its priority watch list where it monitors deficiencies in the protection of IPR. Turkey was lowered to Watch List in 2008 "due to notable progress on copyright enforcement, including an increased number of raids against copyright pirates and seizures of pirated goods, impositions of deterrent-level penalties by the courts, improved pharmaceutical protection, and increased cooperation between law enforcement authorities and the private sector" (USTR 2008). Although this is of particular importance for the country to be able to attract FDI, there are still huge problems in Turkey regarding the IPR. According to Tahir Uysal[7], 40% of Turks think that people who sell counterfeited products should not be punished (Today's Zaman 27.6.2008).

Transportation infrastructure: The competitiveness rankings also highlight the need for infrastructure investments in Turkey, particularly in the areas of energy, communications and transport (OECD 2008). OECD (2008) does not give high credit to the transport infrastructure in Turkey, as they claim roads to suffer from local congestion and deteriorating quality. Railway density is lower per capita than in any of the EU countries iced with old infrastructure. Together with high petrol prices, poor infrastructure has made it very expensive to transport goods to and from Turkey. According to the Foreign Trade Minister Tüzmen, logistical costs account for some 20% of the total costs of an exported item (Today's Zaman 23.9.2008).

[7] President of International Investors Association (YASED)

There are only 80 cars in Turkey per 1,000 inhabitants with a rate even far beyond the lowest ranking EU country, Romania (149 per 1000). However, things are developing rapidly in Turkey. The amount of goods vehicles (lorries, road tractors, vans and pick-ups) have grown more rapidly in Turkey (165%) than in any EU country. Moreover, Turkey's motorway growth rate has been almost as high as that of Ireland, who has recorded the highest growth figure in the EU. (Eurostat 2007a.)

In January 1999, it was reported that investment permission has been taken from the State Planning Organization (DPT) for the project described as "Fast Train" which will construct two- way railway lines between big cities of Istanbul and Ankara, which would decrease the transportation between Istanbul and Ankara by railway to 4.5 hours (HRI 2008). Almost a decade later, the transportation takes 7 hours (DPT 2007) but there is some light at the end of the train tunnel as Turkey's Ministry of Transportation has once again announced a decision to renew the railway system (Today's Zaman 14.8.2008). The high-speed train project between Ankara and Istanbul and Ankara-Konya should be finalised in 2008 (Investment Advisory Council for Turkey 2008). As a part of the modernisation process of the transport infrastructure, also the country's 2,000 km highway network with 72 maintenance stations are expected to be privatised before the end of 2008.

One of the most interesting railroad projects is however the plans for having a railroad connection from Europe to China via Turkey, resembling the traditional Silk Road. Turkey has been claimed to have finished already 80% of its work on the project (Today's Zaman 18.5.2008). If the plans are implemented in full scale, this may shift the balance of economic power in Europe southwards and eventually closer to Turkey. Therefore also Northern European companies should follow closely the infrastructural development in the South.

3 TURKEY'S EXTERNAL ECONOMIC RELATIONS

3.1 Foreign trade partners and structure

Since 2000, Turkey's export growth has outperformed the export growth of all new EU member states (World Bank 2008d). In fact, the increase in Turkish exports is a good indicator of Turkey's increasing competitiveness in the world market. But as seen in chapter 2, the relative competitiveness of Turkey is still poor. The State Planning Organisation (DPT) is expecting exports to increase moderately in the near future compared to previous growth rates. In the period of 2009–2011, the DPT expects exports to increase 10% on average compared to previous growth figures closer to 20%. Similarly, imports are expected to grow less rapidly but the estimated growth rate of 9% is still not enough to avoid the widening deficit in current account. Moreover, these figures will definitely be updated as a result of global financial crisis.

Although the export figures from September 2008 still look promising, the full impact of the crisis is yet to be seen in the coming months and years. However, the estimates that Turkish exporters were not to be affected by the crisis due to small dependence on the US market (Today's Zaman 22.9.2008) was a signage of huge misunderstanding on the global aftermath of the sub-prime crisis. In fact, Turkish companies may be hit dramatically if global funding becomes less available as the country has large external financing requirements (EIU 2008). Although the country seems unlikely to tip into recession, the Turkish economy may be more vulnerable than it looks (Economist 2008). Lehman Brothers also warned that Turkey is heavily relying on global capital market and is therefore vulnerable to future shifts in global economy (Today's Zaman 29.8.2008), a reference which was just a month later valid for the one who warned.

According to Economy Minister Simsek **the main problems of Turkey's economy is its mushrooming current account deficit** (Today's Zaman 15.7.2008) **and the lack of sufficient savings** (Today's Zaman 8.10.2008). In fact, Turkey is one of the worst performing countries in the world in terms of current account deficit and the absolute deficit has only worsened despite its much advertised post-2001 crisis reforms. Relatively, the balance of foreign trade has remained more stable (Table 6).

Table 6 Turkey's foreign trade ($US mln), 2001-2007

	2001	2002	2003	2004	2005	2006	2007
Imports	41 400	51 600	69 300	97 500	116 800	139 600	170 100
Exports	31 300	36 100	47 300	63 200	73 500	85 500	107 300
Balance of foreign trade	-10 100	-15 500	-22 100	-34 400	-43 300	-54 000	-62 800
Exports per imports	75.7%	69.9%	68.1%	64.8%	62.9%	61.3%	63.1%

Source: Turkstat (2008)

In the first half of 2008, Turkey's current account deficit hiked another 41%. Two-thirds of the growth in imports is made up by energy, metals, and mechanical and electrical products combined with vehicles. Chronic current account deficit needs financing increasingly, and it has made the economy vulnerable to shifts in external conditions (OECD 2008), such as the global credit crunch. For instance, Rifat Hisarciklioglu[8] has calculated that in 2008 Turkey needs US$ 45 billion to avoid economic crisis (Today's Zaman 14.5.2008). The World Bank estimates that Turkey needs $130 billion of financing in 2009 and it expects that Turkey will be able to make it (Hürriyet 12.11.2008). This fact is a cause for high real interest rates by increasing its risk premium in credit ratings (OECD 2008). Naturally, the recent drop in global energy prices helps Turkey's current account. However, as Turkey has witnessed very low import elasticity in energy sector, a significant devaluation of lira is expected to cause worsening of the current account, leading to loss of competitiveness, increasing debt ratios and thus putting further pressures on inflation. In addition, Turkish non-financial companies with mostly lira denominated revenues owe US$ 130 billion to foreign companies (Today's Zaman 19.9.2008). This creates another risk for the economy, particularly if lira loses more of its value.

Also the public debt has upward pressures. In 2007, Turkey was able to finance its current account deficit from FDI and portfolio investments but the most recent figures indicate that Turkey has to rely on its foreign reserves and foreign borrowings to cover the deficit in 2008. However, Turkey has US$ 80 billion of foreign reserves[9] (Turkey's Central Bank 2008) which helps its position remarkably. Otherwise, Turkey does not have many instruments to reverse the situation caused by the global crisis (Kutlay 2008).

[8] President of Turkish Union of Chambers of Commodity Exchanges (TOBB)
[9] As of September 2008

Despite the warnings of the experts, the Government and particularly the Prime Minister Erdogan is confident about Turkey's economy saying that Turkey is likely to be the country least affected by the global financial crisis (Today's Zaman 3.10.2008). Although FDI inflows offset 53% of Turkey's current account deficit in 2007, with portfolio investments covering only 9% Turkey had to rely massively on external borrowing.

The State Minister Tüzmen has demanded that "Turkey must pursue trade focusing on high price, high quality and high technology" (Today's Zaman 9.10.2008). In fact, to some extent Turkish exporters have started to export more innovative and higher quality products (OECD 2008, World Bank 2008d). For instance, machinery and equipment exports from Turkey have increased by US$ 6.5 billion since 2001. The problematic situation is however caused by simultaneously hiking imports in the same industries.

Table 7 Breakdown of Turkey's foreign trade in selected economic activities, 2007

	Share of exports	Share of imports
Motor vehicles and trailers	16.5%	11.3%
Manufacture of basic metals	10.8%	11.2%
Wearing apparel	10.0%	0.6%
Textiles	9,3%	2.5%
Manufacture of machinery and equipment	7.2%	10.8%
Coke, petroleum products and nuclear fuel	6.9%	6.1%
Food products and beverages	5.1%	1.6%
Agriculture and forestry	4.0%	2.6%
Chemicals and chemical products	3.5%	12.3%
Crude petroleum and natural gas	0.0%	13.7%
Others	26.7%	27.3%

Source: Turkstat (2008)

Table 8 Absolute growth in foreign trade in selected economic activities, 2001–2007

Exports	US$ mln		Imports	US$ mln
Motor vehicles and trailers	14 400		Manufacture of basic metals	19 500
Manufacture of basic metals	9 400		Chemicals and chemical products	16 800
Manufacture of machinery and equipment	6 500		Crude petroleum and natural gas	15 700
Wearing apparel	6 400		Motor vehicles and trailers	12 900
Textiles	5 900		Manufacture of machinery and equipment	12 200
Coke, petroleum products and nuclear fuel	4 500		Coke, petroleum products and nuclear fuel	7 700

Source: Turkstat (2008), author's calculations

The EU remains to be the single most important trading partner for Turkey, although its share has declined in imports following the increase in the price of energy, which is mostly imported from non-EU countries. As Turkey is the 7th most important trading partner of the EU (EU 2008d), this indicates that economically Turkey is more dependent on the EU than vice versa.

The proactive foreign policy of Turkey with Middle Eastern countries has improved the trade volume with the Middle Eastern and Asian countries, as their share has increased from 17% of Turkey's total volume in 2000 to 24% in 2007 (USAK 2008). Simultaneously, the share of top 5 main export countries has dropped from 50% to 36%. This shift may now help Turkey to be less vulnerable for the global crisis.

Table 9 Turkey's main foreign trade partners 2007

	1.	2.	3.	4.	5.
Exports	Germany	UK	Italy	France	Russia
	11.3%	8.0%	7.0%	5.6%	4.4%
Imports	Russia	Germany	China	Italy	USA
	13.8%	10.3%	7.8%	5.9%	4.8%
Total	Germany	Russia	Italy	China	UK
	10.6%	10.2%	6.3%	5.1%	5.1%

Source: Turkstat (2008), author's calculations

The trade relations of Turkey with Russia are more or less controversial, particularly after the Georgian crises tightened the tensions between the two countries. Although Russia and Turkey are among each other's most important trade partners – mostly due to energy trade – Russia exposed strict measures in its borders against Turkish traders earlier this year. In addition to these non-tariff barriers, there are also high customs taxes introduced for Turkish traders which is considered to put them in a disadvantageous position in the Russian market.

Table 10 Absolute growth in foreign trade by countries, 2001–2007

Exports	US$ mln		Imports	US$ mln
Germany	6 600		Russia	20 100
United Kingdom	6 500		China	12 300
Italy	5 100		Germany	12 200
France	4 100		Italy	6 500
Russia	3 800		Iran	5 800

Source: Turkstat (2008), author's calculations

Luggage trade between Turkey and Russia shows that some exporters are able to benefit from unregistered foreign trade. Although the importance of luggage trade between the two countries has diminished since peak years of 1990s, it has recently the value of luggage trade is estimated to stand close to US$ 650 million (Lasiad 2008).

In addition to structural problems, the rising price of oil and raw materials has contributed to the deterioration of current account in Turkey (USAK 2008). Although the decreasing price of energy[10] on the world market should have eased down its impact on current account, it remains vital for the Turkish economy particularly if lira loses more of its value. Therefore, in the next chapter a closer look is taken on Turkey's trade in energy.

Customs union with EU countries and on-going negotiations: Already in September 1963**,** the Ankara Agreement was signed to take Turkey to European Customs Union and finally to full EEC membership. However, little progress was made on the matters during the following decades, and it was only in 1987 when Turkey applied for full EEC membership. One remarkable step was taken in 1995 when the Association Council made a decision on the Customs Union. In 1999, the EU-Helsinki Council decided on the candidate country status of Turkey. The negotiations were officially started in 2005, and since then the European Commission has annually published critical reports on Turkey's accession progress indicating the suspicious minds of the EU member countries towards Turkey's membership. (EurActiv 2008.)

After a couple of years of slow progress, there has recently been more news regarding Turkey's EU negotiations. Anyway, the Turkish businesses do not expect the country to enter the Union before 2015 with a quarter of companies believing that it will never happen. Partially the survey results are due to problems in the EU's information activities. Despite these negative sentiments, most of Turkish companies believe that the EU membership would be good news for country's long-term competitiveness. (EurActiv 2008.)

Moreover, positive impact is also expected from the European Bank for Reconstruction and Development (EBRD), which is about to start operations in Turkey. It is also considered as a major step towards the membership in the European Union. EBRD investments would promote growth of small businesses and support privatisation, particularly outside the urban regions.

Some progress is definitely needed, as otherwise also Turkey becomes more suspicious towards the EU. Without concrete progress, the EU fails in showing its benefits. One of the controversial issues occurred in 2008 when Turkey's GDP figures were revised up by one-third as a result of move bringing the economic data compilation in line with the EU standards. This made people more sceptical towards the EU, as many felt that GDP increased – but only on paper as their standard of living was not affected at all (Anima 2008).

[10] It has been calculated that a US$ 10 decline in the oil price should improve the current account balance by US$ 500 million (Today's Zaman 29.8.2008).

3.2 Energy reserves and trade in energy[11]

As Turkey is able to cover only 30% of its total energy demand by domestic production (OECD 2008), its current account deficit has heavily been influenced by skyrocketing energy prices. Economy Minister Simsek has provided data that the energy imports of US$ 34 billion would have been US$ 13 billion, if they had been calculated in 2002 prices (Today's Zaman 19.6.2008). Thus, mid-term increase in energy prices has caused Turkey an annual bill of more than US$ 20 billion, which is equivalent of annual inflow of FDI. According to Turkstat (2008), imports of crude petroleum increased further by 56% in the first half of 2008 over the same period in 2007, despite the -1.5% decline in tonnage imports. As a result of the hike in the price of energy, oil and other fuels altogether account already 22% of Turkey's imports.

By August 2008, Turkey had witnessed 50% increase in natural gas prices in only eight months. The record-high prices on energy imports has also put pressure on electricity prices in Turkey, as more than half of Turkey's electricity production depends on natural gas and the electricity prices have hiked at the same pace with natural gas. As a respond to increasing energy prices, Turkey's Energy Market Regulatory Agency (EPDK) has increased the price of electricity three times in 2008 which has made Turkish electricity among the most expensive in the world (IEA 2008) suffering energy-intensive industries in particular.

Similarly, the data of International Energy Agency (IEA 2008) and GTZ (2008) show that petrol prices in Turkey are among the highest in the world. This is very much due to high taxation of gasoline in Turkey. The share of taxes in the petrol prices in Turkey stands at the level of 60%, which is close to European average, and therefore it is more likely to find the objects for blame somewhere else. In fact, Turkey's Competition Board started its investigations for the claimed price fixing of fuel distribution companies in July 2008.

[11] There is more energy-related information in chapter 4.1.

Table 11 Turkey's energy balance sheet in international comparison 2006

	Turkey	as of EU-27 + Turkey	Finland	Germany	Russia
Electricity					
Production kWh bln	168	4.7% (2005)	78	592	904
Consumption, kWh bln (2005)	129 (2005)	4.3% (2005)	81 (2005)	545 (2005)	779 (2005)
Exports, kWh bln	2	0.6% (2005)	3	65	23 (2005)
Imports, kWh bln	1	0,2 % (2005)	14	48	10 (2005)
Annual average consumption growth (2000–2005)	5.9%	2.0%*	1.4%	1.5%	2.1%
Oil					
** Production, barrels/day	43 950	1.5%	8 950	151 330	9 676 570
Consumption, barrels/day	669 400	4.3%	224 420	2 664 880	2 919 520
Exports, barrels/day	0 (2004)	0.0% (2004)	0 (2004)	22 330 (2004)	5 211 140 (2004)
Imports, barrels/day	482 490 (2004)	3.7% (2004)	215 930 (2004)	2 218 030 (2004)	83 950 (2004)
*** Oil reserves, mln barrels	300	1.9%	0	367	60 000
Annual average consumption growth (2000–2006)	1.0%	0.3%*	0.9%	-0.9%	2.0%
Natural gas					
Production, cubic feet bln	32 (2007)	0.4%	0 (2007)	634 (2007)	23 046 (2007)
Consumption, cubic feet bln	1 292 (2007)	5.5%	162 (2007)	3 441 (2007)	16 746 (2007)
Exports, cubic feet bln	1 (2007)	0.0% (2007)	0 (2007)	432 (2007)	8 377 (2007)
Imports, cubic feet bln	1 265 (2007)	6.4%	162 (2007)	3 120 (2007)	2 059 (2007)
*** Gas reserves, cubic feet bln	300	0.2%	0	9 000	1 680 000
Annual average consumption growth (2000–2007)	14.5%	2.1%* (2000-2006)	1.6%	1.2%	2.3%

* EU-27 average
** Preliminary data including crude oil, natural gas plant liquids, other liquids, and refinery processing gain
*** Oil & Gas Journal estimate for January 1, 2007

Source: Energy Information Administration 2008, author's calculations

Russia's role has only got stronger as the main crude oil exporter to Turkey since 2005 when oil import and trade was liberalised in the country. Although the total imports have declined by 0.1 million tons to 23.4 million tons in 2007, Russia's share has simultaneously increased from 29% to 40%.

Table 12 Sources of Turkey's crude oil (in million tons)

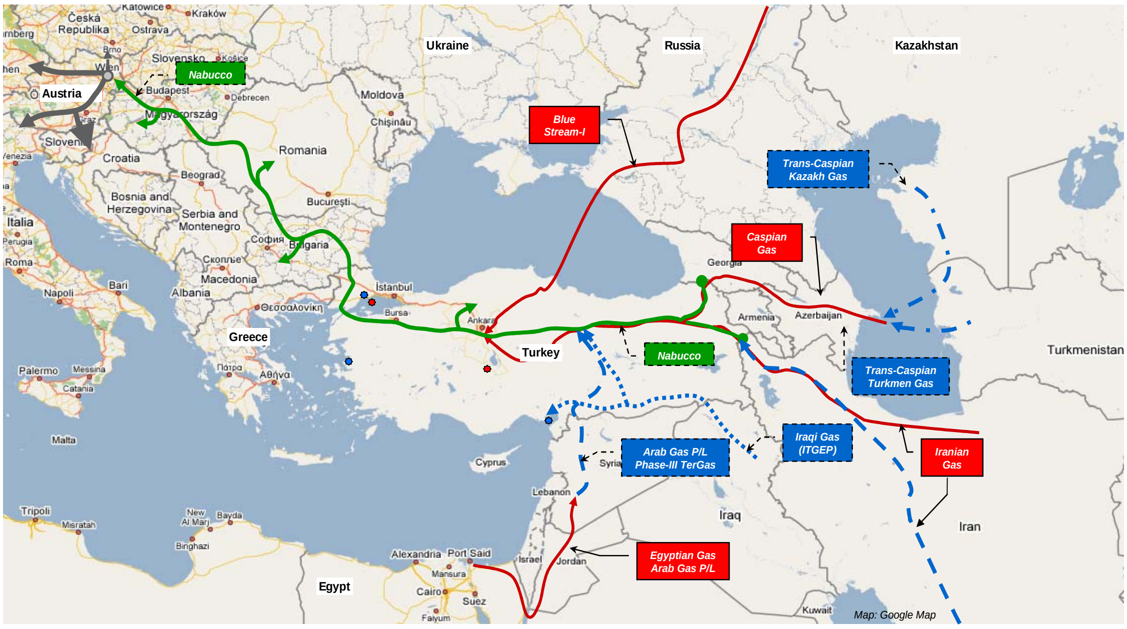
	2005	%	2006	%	2007	%
Russia	6,8	28,9	6,7	27,6	9,3	39,7
Iran	6,9	29,4	8,8	36,2	8,9	38,0
Libya	4,5	19,1	4,4	18,1	0,3	1,3
Saudi Arabia	3,5	14,9	3,4	14,0	3,3	14,1
Iraq	0,9	3,8	0,5	2,1	0,9	3,8
Italy	0,0	0,0	0,3	1,2	0,4	1,7
Syria	0,3	1,3	0	0,0	0,2	0,9
Others	0,6	2,6	0,2	0,8	0,1	0,4
Total	**23,5**	**100,0**	**24,3**	**100,0**	**23,4**	**100,0**

Source: Today's Zaman 30.7.2008; Energy and Natural Resources Ministry and Tüpras

Despite of Turkey's efforts to diversify its energy sources, it has been analysed that with the current trend Turkey's dependence on Russian gas may get as high as 80% in the coming years (Today's Zaman 26.4.2008). Already now Turkey imports 63% of its natural gas from Russia, 17% from Iran and the rest from Azerbaijan, Algeria and Nigeria. As half of Turkey's power plants are currently operating by natural gas, disturbance in both Russian and Iranian gas deliveries has tremendous impact on Turkey. To take more important role in the Iranian gas sector, Turkey's state-owned petroleum company TPAO will explore gas in South Pars field in Iran which will then be piped to Turkey. Greater participation by Turkish side is needed because last three winters have proved incapacity of Iran to be a reliable gas distributor (Oxford Business Group 2008b). This naturally causes political tensions between Turkey and the United States. But Turkey is politically in a difficult position as its contract with Russia on annual flow of 6 billion cubic metres of natural gas will expire in 2011 and something has to be done in order to avoid power outages. The question of Central Asian energy is also otherwise highly political where Russia has high stakes, too.

One of the most interesting projects within the area is the Nabucco pipeline project. The project consists of a gas pipeline connecting the natural gas fields in Azerbaijan, Turkmenistan, Kazakhstan, and even Egypt, Russia, Iran and Iraq via Turkey, Bulgaria, Romania, Hungary with Austria and further on with the European gas markets. The pipeline is scheduled to start operating in 2013, and the project aims at achieving the maximum capacity (31 billion cubic metres of gas annually) by 2018. The 3,300 kilometre long pipeline is estimated to cost approximately US$ 10 billion and has currently Austrian OMV, Turkish Botas, Hungarian MOL, Romanian Transgaz, Bulgarian Bulgargaz, and German RWE as stakeholders. (Nabucco 2008.)

Figure 9 Nabucco pipeline route with existing and possible supply routes



Source: Nabucco (2008)

The project is considered to be crucial for Europe's energy security. Currently, only 42% of the consumption in the EU is covered from sources within the Union. The imported natural gas comes mostly from Russia, Norway and Algeria. However, the consumption of energy and the share of natural gas as a primary energy source are anticipated to increase in the EU with simultaneous decline in the indigenous production. Therefore, Europe has to increase the share of imported natural gas, which may be up to 80% of natural gas consumption in 2030. Nabucco's studies indicate that in 2020 volumes between 25–30 billion cubic metres of natural gas annual flow from the Caspian region and the Middle East is needed to cover the anticipated shifts in supply and demand. (Nabucco 2008.) Although demand side looks promising, an analysis by Istanbul Analytics (2008) has indicated that it is not so clear whether Nabucco will get all the gas supplied at the level of its capacity, as there are also competing natural gas projects in Central Asia with legally binding agreements to supply gas to other pipelines. This fear has also activated Andris Piebalgs, the EU Energy Commissioner, who aims at intergovernmental deals to be signed by January 2009 (New Europe 2008).

Simultaneously, Turkey is trying to become less depended on natural gas in its own power generation by shifting its reliance onto alternative energy. Turkey has started developing its wind energy production but the capacity still stands at 42 megawatts. Although it is expected to be increased to 475 MW by the end of the year and 5,000 MW by 2013 (Today's Zaman 9.7.2008), it remains nominal in the near future. Energy Minister Güler instead expects 15,000 MW (equivalent with six nuclear plants and one-third of current capacity) of wind energy installed in the coming years necessitating investments worth US$ 15–20 billion (Oxford Business Group 2008c; Today's Zaman 20.7.2008). Moreover, Turkey has Europe's largest reserves of geothermal resources, and Güler has promised that these 9th largest resources in the world will soon be available for investors.

The surge in the energy prices and domestic consumption has also made Turkey to take a closer look at its own energy sources in oil and gas fields. In fact with current price levels, Turkey's hard-to-extract oil reserves have become interesting for the first time in history. As Turkey needs crucially its own energy sources, it has recently started exploring natural gas and oil in the Black Sea Region. For instance, Turkish Petroleum Corporation (TPAO) has started more exploration projects during the last four years than it had launched since its establishment in 1954. The drillings with foreign companies have provided promising results, as the TPAO project jointly taken with British Petroleum (BP) found enough oil to meet Turkey's domestic demand for 40 years, *ceteris paribus*. The Energy Minister Hilmi Güler expects that these results will allow the country to meet 71% of its oil demand with own resources by 2023 which is substantial when compared with the current annual figure of 9% (Today's Zaman 29.7.2008). This would have also tremendous impact on balancing the current account. Cheaper and more reliable energy would also improve the competitiveness of many industries in Turkey (World Bank 2008d).

Russian energy: Good news for Turkey is that also the EU is concerned of its dependence on Russian energy supplies. As Europe's vulnerability has increased in terms of interruptions in energy supplies, it has been suggested that Turkey should use its energy card to get most out of the EU by emphasising its geo-strategic location. The crisis in Georgia in August 2008 put the question high on the agenda, and it may have improved Turkey's position in the regional energy game. The Georgian crisis also indicated how vulnerable the transport corridors from the Central Asia are. This encourages Europe to have several options for securing its goods and energy deliveries. Turkey has wished to become a regional energy hub which Nabucco project may enable. But on the other hand explosion on the BTC pipeline has put concerns on its reliability as well.

There have been interesting developments which has brought also Russia in the Nabucco scene. Partially due to political issues and the rest due to economic backing, Turkey and Russia have had discussion at the state-level to include Russia in the Nabucco natural gas pipeline. This may be crucial for Turkey if it finds out that Nabucco does not get enough gas without Russian participation.

The battle between the pipelines is also changing according to the cost estimates which seem to vary quite frequently. In august 2008, the price tag for South Stream was revised up by one-third, leaving Nabucco almost half-priced compared to its competing project. This may also increase the economic attractiveness of Nabucco from Russian perspective.

With energy demand increasing 8–9% annually, experts agree that **Turkey will face energy crisis point around year 2015**. As the electricity consumption is increasing by only 1% on average in Europe, this makes Turkey more vulnerable for increasing price of energy. Luckily, also the decision-makers in Turkey have realised the situation. To avoid the shortages in energy supply, the **Energy Ministry is expecting US$ 130 billion in investments by 2020** (Today's Zaman 12.6.2008), and is therefore opening tenders for the building of first nuclear power plants. The government plans include 5,000 MW of nuclear power by 2020 (Nuclear Energy Agency 2007).

There are currently no nuclear power plants in Turkey although *nuclear energy* is considered as a way to meet the energy needs without further damaging the current account. Feasibility studies for the first nuclear power plant have been written already since 1965 (Nuclear Energy Agency 2008) but the project has been postponed ever since. However, in 2008 a tender for the first nuclear power plant was undertaken. But just when Turkey tries to become less reliable on Russian energy, *the sole bidder for the tender was a Russian company*, Atomstroyexport[12] in consortium with Inter RAO UES[12] and a Turkish partner, Ciner Group (Rosatom 2008). At the pretender stage, there was more interest shown in the power plant project but the global financial crisis among other possible reasons scared a number of companies away from the expensive project.

3.3 Foreign direct investment partners and structure[13]

Since saving in Turkey falls short of investment, the country has always tried to obtain sources to finance the debt. It is generally accepted that foreign direct investments are a good way to finance the debt as it leaves the country less vulnerable for external shocks. (USAK 2008.) Turkey has put substantial effort in making it more attractive for foreign investors. As a result, institutions such as Turkey Investment Support and Promotion Agency (ISPAT), regional development agencies and investment support agencies, and an investment portal (Invest in Turkey) have been established. The importance of these institutions is emphasised by the Prime Minister Erdogan for whom the ISPAT directly reports.

In fact, Turkey has received significant results in attracting FDI. The inflow figures also outweigh the outflow figures, as foreign investments from Turkey have remained rather insignificant on a macro level. In 2007, Turkey made a record in FDI inflow figures, and the AK Party has been very proud of the recent FDI figures which have mushroomed more than tenfold since they took the political responsibility in the country.

According to USAK (2008) the most important factor influencing the growth of inward FDI flows, at the level of higher than world average, has been the start of EU negotiations which has contributed to the stability and confidence of Turkey in the eyes of foreign investors. In addition, the “global liquidity conditions” have been suitable for Turkey, as international investors have shown remarkable interest in emerging economies in general.

[12] Both Atomstroyexport and Inter RAO UES are under the control of a Russian state corporation, Rosatom.
[13] There is more information about structural FDI flows in chapter 4.1.

Although Turkey's FDI inward stock as of GDP remains below world average, foreign investors are already losing interest in the country. Turkey was able to attract 23rd most FDI in the world in 2007 which is no longer in relation to its size in the world economy (UNCTAD 2008), and it is 6 ranks below its position in 2006. This indicates that the record year was more due to increasing M&A activities globally rather than Turkey's individual effort. Also the most recent A.T. Kearney (2008) survey results shows that Turkey has moved down to the 20th place (13th in 2005) on the FDI confidence index indicating that Turkey has become less attractive country in the list of world FDI destinations. Therefore, no one should expect the recent development to continue on a similar pattern without disruptions.

Table 13 Development of foreign investment flows 1990-2007

	1990-2000 annual average	2005	2006	2007	reference value
FDI outward flow	227	1 064	924	2 106	12 210 total stock
FDI inward flow	791	10 031	19 989	22 029	145 556 total stock
FDI inward flow as of GFCF	1.9%	9.9%	16.9%	15.6%	14.8% world average
FDI inward stock as of GDP	..	..	16.6%	22.2%	27.9% world average

Source: UNCTAD 2008

Previously, low levels of inward FDI were explained by political, economic and exchange rate instability as well as a historical fear and suspicion of foreign economic presence (Erdal & Tatoglu, 2002; Erkilek, 2003). These reasons seem not to be disappeared anywhere despite the recent hike in IFDI. Recent political turbulence partially affected capital flow to and from Turkey. The Istanbul Stock Exchange lost remarkably in value, in addition to depreciation of Turkish lira against US dollar. Immediately after the decision was announced, the stock market rallied and lira appreciated against dollar, showing the positive reaction from the capital markets. Also the ISPAT admitted that a number of large scale investment projects were postponed due to the closure case (Today's Zaman 1.8.2008) and after the closure case more similar news have followed the global uncertainty (Today's Zaman 18.9.2008).

There are also some positive aspects found in the foreign investor behaviour. Whereas during the closure case the share of foreign investments in the Istanbul Stock Exchange dropped from 72% to 69%, the 2001 crisis dropped the share from 60% to 40%. It is also again one indication on greater confidence on Turkey in the long-term compared to the negative investor sentiment in the short-term.

YASED Chairman Tahir Uysal estimated in April that FDI inflows to Turkey will be cut to around US$ 15–20 billion this year (Today's Zaman 16.4.2008) and has repeated his estimation also later (Today's Zaman 16.9.2008). YASED survey published earlier this year showed that it is not only the political turmoil to blame for unwillingness to invest in Turkey. The Association published a survey result before the closure case and it already indicated that foreign companies were not so convinced about the Turkish economy (Today's Zaman 4.5.2008), and in September more than half of the companies thought that the economy will only worsen in the short term despite being optimistic in the middle and longer terms (Today's Zaman 17.9.2008).

The news above is indeed very worrying for Turkey's economy. Despite the recent growth in inward FDI, the country needs to attract more FDI in order to finance its mushrooming current account deficit, which has aroused concerns due to the close linkage between current account deficit and balance of payment problems. The need for FDI is crucial as its share of financial account has shot up from 15% in 2004 to 55% in only three years. Similarly, the need for other investments (long-term external borrowings of the private sector and banks) has indicated upward pressure, particularly when inflows of FDI and portfolio investments prove to be on a declining trend.

In June 2008, DPT estimated that in 2011, the FDI inflows will make a record of US$ 23.6 billion (Today's Zaman 30.6.2008). But already in following month, the Economy Minister Simsek said that the annual flow will decline from the original target by $US 4 billion to between US$ 12–14 billion (Today's Zaman 15.7.2008). The uncertainty about Turkey's near future can also be seen in the willingness of foreign companies to transfer profits from Turkey instead of reinvesting them in the market. Between January 2003 and July 2008, foreign companies transferred close to half of the money they had invested during the given period. On the other hand, this also shows how operations in Turkey have been used to finance unprofitable businesses elsewhere. For instance, banking sector is a good case example.

Table 14 Turkey's balance of payments 2004–2008, in US$ million

	2004	2005	2006	2007
CURRENT ACCOUNT	**-14.4**	**-22.1**	**-31.9**	**-37.6**
Foreign Trade Balance	-22.7	-33.0	-40.9	-46.7
Total Exports of Goods	68.5	78.4	93.6	115.3
Total Imports of Goods	-91.3	-111.4	-134.6	-162.0
Balance of Services	12.8	15.3	13.8	13.9
Balance of Income	-5.6	-5.9	-6.7	-6.9
Current Transfers	1.1	1.5	1.9	2.2
CAPITAL & FINANCIAL ACCOUNT	**13.4**	**20.3**	**32.1**	**36.5**
Foreign Direct Investments	2.0	9.0	19.0	19.9
Portfolio Investments	8.0	13.4	7.4	0.7
Other Investments	4.2	15.8	11.8	23.9
Reserve Assets	-0.8	-17.8	-6.1	-8.0
NET ERRORS & OMISSIONS	**1.0**	**1.8**	**-0.2**	**1.1**

Source: Turkey's Central Bank (2008)

It is notable that some 70% of investments have been in the form of mergers and acquisitions with a lack of greenfield and infrastructural investments. Another problem is that Turkey has attracted very little of manufacturing investments. The problem with foreign investments in financial intermediation, transport and communications is their one-time nature, which does not help transfer of technology, expansion of tax base or job creation, and thus sustainability of current account deficit. (USAK 2008.)

Table 15 Main foreign investor countries by FDI flow in 2002–2007

1.	**2.**	**3.**	**4.**	**5.**
Netherlands	Belgium	United Arab Emirates	Greece	France
21.4%	16.0%	10.9%	9.9%	9.4%

Source: Turkey's Undersecreteriat of Treasury (2008), author's calculations

The Netherlands is the main source of FDI in Turkey in terms of FDI inflow during 2002–2007. In 2007, the transfer by ING for shares of Oyakbank and the transfer by Eureko for the shares of Garanti Insurance&Pension made the Netherlands again number 1 investor in 2007. However, approximately US$ 4.7 billion of the FDI flow from the Netherlands during 2002–2007 is due to transfer of capital through the Netherlands by Vodafone (UK) for the acquisition of Telsim. Similarly, many US companies transfer money to Turkey via the Netherlands and therefore the USA's share in FDI statistics may be underestimated.

As the Dutch investments, also Belgian, Greek and French investments have recently been mainly in finance sector. The two major Belgian deals are between Disbank and Fortis Bank[14] in 2005 and between Denizbank and Dexia Bank in 2006. Greece is on the list because of the acquisition of Finansbank by the National Bank of Greece[15] in 2006–2007. Similarly, transfer of funds from France for the partial acquisition of Garanti Bank by GE Consumer Finance and acquisition of publicly owned Basak Sigorta by French insurer Groupama were the largest FDI deals originating from France in 2005 and 2006, respectively. The United Arab Emirates is similarly on top of the list as a result of one large-scale M&A deal – the annual instalments for Türk Telekom's privatisation deal in 2005 and 2006.

On-going privatisation program: Privatisation has been one of the driving forces of recent hikes in FDI inflow. Turkey has gathered altogether some US$ 13 billion by selling its state-owned assets to foreign investors since 1989. Before the AK Party took the power in Turkey, the state had privatised US$ 1.4 billion to foreigners. Since then foreign companies have participated in the privatisation processes in greater activity and acquired assets worth US$ 11.7 billion. (Turkey's Privatization Administration 2008.)

One of the most interesting privatisation projects are in the energy sector where number of power plants and distribution companies will be privatised. Currently, electricity generation, transmission, distribution and retail sales are dominated by state-owned entities. The first tenders have already been recently concluded and more tenders are expected in the near future, as the state is under pressure not only to raise funds but also to increase efficiency in the energy sector. There are also state-owned companies in the privatisation portfolio in the following sectors: maritime transportation, food, mining, petrochemicals, textile, transportation, banking and ports. (Turkey's Privatization Administration 2008.)

In 2008, also Turkish national lottery (Milli Piyango) should be privatised according to original plans. Together with privatisation of country's highways and sugar processing plants, privatisation projects are expected to bring some US$ 10 billion to the Turkish Treasury.

[14] As a result of liquidity crisis of Fortis Bank, BNP Paribas acquired the Turkish business of Fortis among other operations in October 2008 (Today's Zaman 8.10.2008).

[15] In September 2008, the National Bank of Greece announced another remarkable investment in the Turkey's financial sector as they acquired Fiba Holding for US$ 700 million (Today's Zaman 27.9.2008). The acquisition indicates that even amid global financial crisis, the international confidence on Turkish financial sector is high.

Due to huge impact of single large deals on FDI statistics, the number of investing companies gives to some extent a better picture on the sources of FDI in Turkey. The share of foreign companies originating from EU-27 has remained relatively stable at around 60% which shows that investments outside Europe are also important to Turkey despite the dominating role of the EU. For instance, the number of Chinese-owned companies in Turkey increased from 102 to 300 during 2002–2007. Although the investment figures still appear to be rather small, attention should be paid on the development[16]. Chinese companies have paid interest particularly in the automobile sector, and earlier this year Chery, China's largest automobile company, announced its plans to produce cars in Turkey on their way to European markets. Interestingly, a Chinese nuclear company has also expressed interest in Turkey's nuclear power plant projects.

Table 16 Foreign direct investments inflow by source country, 1954–2007

Country	1954-2001 (Cumulative)	2002	2003	2004	2005	2006	2007	1954-2007 Total
EU Countries (27)	**2,624**	**227**	**466**	**1,042**	**1,626**	**2,045**	**2,118**	**10,148**
Germany	885	63	148	377	494	579	579	3,125
The Netherlands	432	45	69	140	199	274	260	1,419
The United Kingdom	325	37	67	132	329	478	463	1,831
Other European Countries	982	82	182	393	604	714	816	3,773
Other European Countries (Excluding EU)	**558**	**47**	**141**	**280**	**344**	**387**	**506**	**2,263**
African Countries	**73**	**15**	**30**	**41**	**58**	**43**	**49**	**309**
North America	**326**	**41**	**57**	**104**	**112**	**145**	**169**	**954**
U.S.A.	304	37	48	93	99	118	135	834
Canada	22	4	9	11	13	27	34	120
Central-South America and Caribbean	**40**	**2**	**5**	**13**	**14**	**10**	**21**	**105**
Near and Middle Eastern Countries	**970**	**109**	**269**	**368**	**398**	**431**	**527**	**3,072**
Azerbaijan	83	13	39	55	59	83	121	453
Iraq	138	27	41	51	60	79	115	511
Iran	298	27	108	128	126	115	108	910
Other	451	42	81	134	153	154	183	1,198
Other Asian Countries	**302**	**38**	**110**	**160**	**172**	**171**	**277**	**1,230**
China	88	14	44	58	33	21	42	300
South Korea	48	2	15	16	17	12	24	134
Other	166	22	51	86	122	138	211	796
Other Countries	**56**	**10**	**13**	**31**	**26**	**56**	**35**	**227**
Total	**4,949**	**489**	**1,091**	**2,039**	**2,750**	**3,288**	**3,702**	**18,308**

Source: Turkey's Undersecreteriat of Treasury (2008)

[16] Further analysis of Chinese foreign investments e.g. Kaartemo (2007)

3.4 Tourism in Turkey

In addition to foreign direct investments, tourism inflow is an important financer of Turkey's financial accounts. The international tourism receipts of US$ 18.5 billion are relatively very high and equivalent with annual FDI inflow figures covering one third of current account deficit. Tourism receipts are also equivalent with 3% of Turkey's GDP. Moreover, Turkey's tourism industry has grown very rapidly during the past two decades.

Table 17 Turkey's tourism flows 2007

	Turkey	as of EU27+ Turkey (2005)	Finland (2005)	Germany	Russia (2006)
International tourist arrivals	22 200 000	5,5 %*	3 140 000	24 400 000	20 199 000
Average annual growth					
- 1990-2000	7.2%	..	..	1.1%	..
- 2000-2005	16.2%	..	3.0%	2.5%	..
International tourism receipts, $US mln	18 487	5.8%	1 757	36 029	9 607 (2007)
Receipts per arrival, $US	833	..	590	1 477	378

* EU-27 is calculated by using 2004 data for Lithuania and Portugal.
Source: World Tourism Organization (2008), author's calculations

In 2008, Turkey expects some 26 million to visit Turkey indicating 15% rise from 2007 (Today's Zaman 7.7.2008). The effects can also be seen reflected in the increasing tourism revenues. According to the estimations of the DPT, tourism revenues are to remain on the growth path (Today's Zaman 30.6.2008).

Also Turkey's Ministry of Culture and Tourism (2007) has high expectations for the future development of the country's tourism industry. It aims at becoming "*a world brand in tourism and a major destination in the list of the top five countries receiving the highest number of tourists and highest tourism revenues by 2023*". This is a bold vision for Turkey which is currently ranked 52nd in Tourism Competitiveness Index (World Economic Forum 2008). The country is currently ranked 10th in tourism revenues and collects less than half the tourism revenues of China (US$ 42 billion) at the 5th place (World Tourism Organization 2008). As all top 9 countries ahead of Turkey have been growing faster for the past couple of years, the feasibility of the tourism strategy may easily be questioned.

Some experts think that Turkey's tourism data is very much biased, and does not show the true potential of Turkey's tourism sector. This may be due to usage of official data which does not include estimates on unregistered economy. For instance, Istanbul was only recently ranked as top 3 European city after Florence and Rome in a US travel magazine survey, despite of being ranked 23rd most expensive city in the world.

However, the global financial crisis may hit Turkey's tourism sector hard. Particularly, the economic situation of middle class in Russia and Germany are highly relevant for Turkey, as most of the tourists to Antalya originate from Russia (26%) and Germany (25%) (Today's Zaman 7.8.2008). On the other hand, Turkey's main tourist resorts are relatively inexpensive for tourists and becoming even less expensive with depreciating lira. This all may end up in Turkey being the winner in the global tourism markets (TDN 2008).

4 KEY INDUSTRIES AND REGIONS FOR FOREIGN COMPANIES IN TURKEY

The sectoral breakdown of foreign direct investments to Turkey has resembled the global development during the past few years. Financial intermediation has long been the sector attracting most FDI in Turkey, as well as in the rest of the world. In 2007, financial intermediation continued on a steady growth path. Also manufacturing sector recorded remarkable increase in FDI inflow.

Table 18 Foreign direct investment inflow by sector 2007

	Sector	FDI inflow, US$ mln	Share	Growth (2006–2007), US$ mln
1	Financial intermediation	11 409	59.5%	4407
2	Manufacturing	4 199	21.9%	2346
3	Transport, storage and communication	1 119	5.8%	-5505
4	Real estate, renting and business activities	905	4.7%	817
5	Electricity, gas and water supply	555	2.9%	443
6	Mining and quarrying	341	1.8%	216
7	Construction	260	1.4%	-181
8	Wholesale and retail trade	181	0.9%	-983
9	Health and social work	178	0.9%	..
10	Hotels and restaurants	26	0.1%	..
	Other	17	0.1%	..
	TOTAL	**19 190**	**100.0%**	**1373**

Source: Turkey’s Undersecreteriat of Treasury (2008)

Although manufacturing sector indicated increasing foreign interest in 2007 its share of FDI inflows since 2002 is only 15.9%. Its low share has raised concerns in Turkey. It also explains Turkey’s poor performance in fighting against unemployment and current account deficit. Moreover, with the exception of car manufacturing, FDI inflows have mainly (>70%) been targeted in domestic market-oriented activities. (OECD 2008.)

In the 2000s, car manufacturing, consumer durables, industrial machinery, chemicals and steel production have been labelled as “well performing sectors” in Turkey by OECD (2008) as they have done consistently well along most determinants of competitiveness. As these sectors are among the most capital- and imported-input intensive, they gained from the decline of costs during the appreciation periods of lira. Manufacturing of electronic goods, furniture, plastics and food products have instead had more volatile performance. Textile and clothing industry is labelled as “squeezed activities”, as many firms with low-skilled labour have failed in improving productivity. (OECD 2008.)

4.1 Key industries

Finance sector: Much as a result of the state intervention and the following structural reforms of Turkey's finance sector after 2001-crisis, Turkish banks have not severed badly from the global credit crunch. Prior to 2000 and 2001 crises there existed even banks with no formal credit evaluation and risk assessment techniques. The foreign investments in the banking sector have contributed to the system and increased the number and variability of financial instruments. (USAK 2008.)

In 2007, all the over US$ 1 billion foreign direct investments in Turkey were in the banking sector. US-based Citibank acquired Akbank for US$ 3.1 billion, ING Bank acquired Oyakbank for 2.7 billion and the National Bank of Greece paid US$ 2.3 billion for Finansbank (General Directorate of Foreign Investment 2008). In 2006, there was one even larger acquisition when Belgian Dexia Bank acquired Denizbank for US$ 3.2 billion (General Directorate of Foreign Investment 2008). Moreover, foreign banks have continued their acquisitions in 2008, which further strengthens their role in the country's finance sector. The list of foreign banks features companies such as BNP Paribas, Unicredito, Rabobank and Citibank. Although 45% of Turkish banking sector is owned by foreigners (EU 2008d), the share of foreign-owned companies is even higher in the insurance sector.

M&As are used as an entry mode as no new banking licenses have been recently issued by the state officials. Turkish government has promised that all state-owned banks will be privatised by November 2010 (Today's Zaman 28.7.2008). In reality, there remain only three public banks, which cover some 30% of the banking sector in terms of asset size. It is expected that Halk Bank, which is 75% owned by the state, is going to be privatised soon but currently the privatisation process waits for more optimistic investor sentiment.

On average, the growth of financial intermediation services has outpaced the average economic growth during the past decade. Consequently, banks populate the list of Turkish companies in Forbes Global 2000 ranking. The largest bank, Is Bankasi[17] is ranked 371st on the list, and is followed by Akbank (384th), Garanti Bank (405th), Halk Bank (873rd), and Vakif (909th). Altogether there are 14 Turkish companies ranked on the list.

[17] Is Bankasi is the 86th largest bank in the world up from 102nd place in 2007 list.

Only four banks of Turkey's 50 banks have headquarters outside Istanbul. This can also be seen in their orientation towards urban regions. As a result, **more than half of the population is estimated to remain outside the formal banking system** which creates huge potential for banks in Turkey (Oxford Business Group 2008d). The conventional saving behaviour of Turkish savers is still considered hindering the development of Turkish financial sector. Whereas in the EU bank assets per capita reach 79.000 euros, the corresponding figure in Turkey stands only around 3.700 euros. As most of savers use informal channels instead of investing in the financial sector, banks can not allocate resources properly. However, there has been dramatic increase in the total assets of Turkish banking sector which signals the changing behavioural patterns of the Turks. (USAK 2008.)

Telecommunications sector: According to statistics provided by the Interpromedya research group, the communications technology market grew by 24% in 2007. As a result, the list of largest (in net sales) technology companies in Turkey is heavily populated by telecommunication companies with top 5 firms representing the sector. These companies are Turk Telekom, Turkcell (TeliaSonera owns 37% of shares), Vodafone, Avea and Genpa in descending order. According to the Finance Ministry, Turk Telekom is also the largest corporate taxpayer in the country (Today's Zaman 15.5.2008). Turkcell is instead ranked as the best company in Turkey in terms of market value, according to Forbes list.

The sector hosted some major mergers and acquisitions in 2006. British[18] Vodafone paid US$ 4.7 billion for Telsim, which was the highest inflow of the year. In addition, Oger Telecom's US$ 1.5 billion deal with Turk Telekom was the fourth largest FDI transaction in 2006. The sector is about to attract some attention also in November 2008 when 3G tender is about to take place again. Last year only Turkcell submitted a bit and therefore the license was cancelled.

[18] In FDI statistics, the FDI inflow is hosted by the Netherlands.

According to Turk Telekom, the number of internet subscribers exceeded 5 million earlier this year (Today's Zaman 22.4.2008). Although it resembles that more Turks are online, it also indicates that the market has huge potential with still low penetration rate[19].

Prices in telecommunication sector in Turkey are among the highest in the OECD while the quality is relatively poor among the area (World Bank 2006). Partly, this is due to heavy taxation, as taxes applied to mobile telecommunications cover 58% of costs – three times higher in Turkey than developing nation's average.

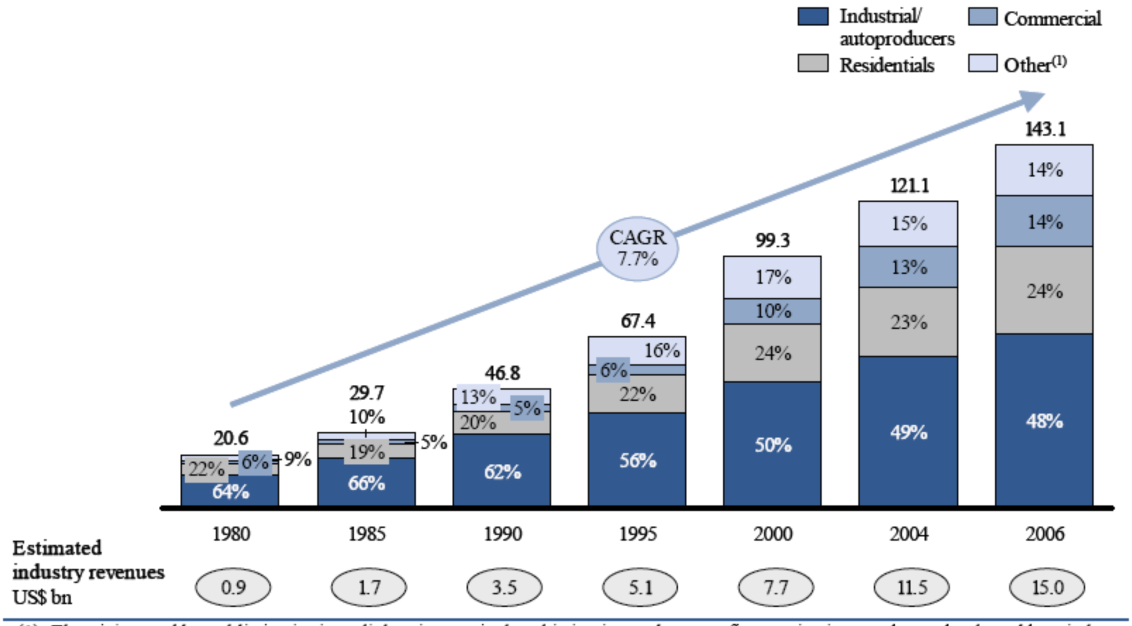
Energy: The energy sector looks very promising in Turkey, as the demand for electricity has grown by annual average level of 7.7% since 1980. However, it is still far below EU-average, and remains three times below Spanish per capita demand despite of similar climatic conditions. As a result, the gross demand is anticipated to grow with an *annual rate* of 7.7% until 2020[20]. It would still lead Turkey's per capita consumption below the current electricity consumption of EU average (Turkey's Privatization Administration 2008). This provides business opportunities in power generation, distribution, and related activities. In fact, Turkey's electricity market is altogether already worth more than US$ 15 billion, and with growth projections and rising energy prices, the market is forecasted to grow faster than the GDP. Only in 2007, 34 privately owned power plants were opened (Investment Advisory Council for Turkey 2008).

Consequently, the energy sector has witnessed foreign interest during the past year. However, the activities could have been even more, and some sources have suggested that the foreign interest has been hit by the global financial crisis and the politic turmoil in Turkey. The largest acquisition deal this year has been the purchase of Baskent Dogalgaz by the Global Yatırım Holding & ABN-AMRO Consortium for US$ 1.6 billion (Deloitte 2008).

[19] With larger household size, the *penetration rate per household* is, however, relatively higher than when measured on per capita-terms compared with more advanced economies.

[20] In comparison, Finland's recent energy and climate strategy anticipated that electricity demand will grow altogether 10% by 2020 (from 90 TWh to 98 TWh).

Figure 10 Electricity consumption by customer group 1980–2006, in TWh



(1) Electricity used by public institutions, lightening, agricultural irrigation and non profit organizations such as schools and hospitals

Source: Turkey's Privatization Administration (2008) from the data of TEDAS and TEIAS

The bidding process for the block sale of the Baskent Electricity Distribution Corporation ended in July 2008, and saw the highest bid coming from Turkish-Austrian joint venture at US$ 1.2 billion. Since then, the Austrian OMV has continued its active role in the Turkish energy sector and announced in August that it will construct, together with its partners[21], a US$ 650 million natural gas energy plant in Samsun, close to the Blue Stream delivery point (Scandoil 2008).

Simultaneously, there was a block sale organised for Sakarya Electricity Distribution Corporation which ended up in the win of Turkish-Czech joint venture for US$ 600 million. And only a month later Gaz de France acquired Izmit gas distribution company in north-western Turkey with a US$ 500 million deal, and one month further Turkish groups Alsim Alarko and Kiler acquired privatised power grids which enabled Turkey to raise again more than US$ 500 million.

In the petroleum front, Russian oil giant Lukoil announced in July its agreement to buy Turkish gas distributor Akpet for US$ 500 million. In addition to Lukoil, also Gulf countries have expressed their interest in Turkish fuel market (Today's Zaman 22.4.2008).

[21] Among these partners was Lehman Brothers which went bankrupt only a month after the announcement.

Turkey has also been able to attract interest in the field of renewable energy, as French energy company, Perfect Wind, has announced to have plans for investments worth US$ 2 billion in near future (Today's Zaman 27.8.2008).

The energy sector thus indicates that **foreign investors have not totally been distracted by short-term tensions but are confident in the market development in the longer term**. This is good news for Turkey, as it seems to lack domestic financing to avoid energy crisis.

Textiles: Turkey is famous for its textile sector. According to Ekrem Akyigit, Chairman of the United Brands Association (BMD), ready-wear retailing accounts for 7.8% of the national income, 16.3% of industrial production, 11.4% of total employment and 24.6% of total exports (Today's Zaman 25.4.2008). These figures particularly show the importance of textile sector in Turkey's foreign trade. In fact, Turkey is currently ranked second after China as a textile and ready-to-wear supplier to the EU. In 2007, the textile imports of the EU countries from Turkey increased again by 6.5% to US$ 17 billion, covering 16.1% of all textile and apparel imports to the Union. However, the EU's removal of quotas imposed on Chinese products will tense the competition in the EU market.

There have been statements in the media that Turkey is no longer favourable for textile production (Today's Zaman 14.4.2008). Although Turkey benefits from its favourable logistical location (representing 5% of total costs), the increase in labour costs (12–20% of total) and energy costs (10% of total) has caused Turkish textile factories to move up to higher end brands and into quality- and marketing-based competition. This shift can also be seen in the unit prices of EU imports from Turkey. Whereas the EU countries' average unit price in textile and apparel imports decreased by 2.6% in 2007, imports from Turkey had average unit price increased by 2.8% (OECD 2008). In fact, Turkish companies have already been able to build up a couple of international brands in textile sector, such as Collins and Mavi Jeans.

Vehicle industry: Turkey's vehicle industry is perhaps the most well-known of its manufacturing industry sectors. Turkey is aiming at moving up from the 14th place to 10th in the number of cars produced annually by 2012. Currently, factories in the country produce some 1.1 billion vehicles but the aim is to have annual production of 2 billion cars in four years. This is mostly in the hands of foreign companies which have shown increasing interest in Turkish automotive sector. The largest producers can be listed as Ford Otosan, Oyak Renault, Tofas-Fiat and Toyota. Nearly two thirds of the production is exported and mostly targeted in the EU market. (IGEME 2007c.) For instance, recently Malaysian carmaker Proton announced its plans of aiming at European markets via Turkey, following the example of Japanese, South Korean and Chinese car companies (Today's Zaman 3.5.2008).

The economic slowdown in the European market, target for 90% of Turkey's automobile exports, has hit Turkish car industry. Consequently, the production targets have been downgraded. In October 2008, exports dropped by nearly 30% (Hürriyet 12.11.2008). As a result of these difficulties, the most recent data on industrial production has shown negative growth figures (EIU 2008).

The tractor sector in Turkey has revitalised after the announcement that Turkey will scrap 700,000 tractors which are over 20 years old. As a result, more than 30 foreign tractor companies have invested in the country. (Today's Zaman 28.8.2008.)

Turkey has also made efforts in attracting ship building deals in luxury yachts. There have been promising results from the industrial zone near Istanbul which has become in just a few years an important production place for commercial ships and luxury yachts (OECD 2008). Currently, there are 260 registered yacht manufacturers and they have increased their yacht and boat export activities but the figures remain rather insignificant at US$ 150 million (IGEME 2007d), although foreign billionaires such as Roman Abramovich have placed orders for Turkish yachts.

Household appliances: As in the vehicle industry, the Turkish household appliances sector has its roots back in 1950s when first Turkish-made refrigerator was produced under the brand Arcelik (IGEME 2007b). Nowadays, Arcelik is the 7th largest company in Turkey. The sector has also other large companies such as Aletleri (21st) and Vestel (30th). (ISO 2008.) Also international companies have established production lines in Turkey, such as Ariston, Bosch, Indesit, Merloni, Philco and Siemens. There are also nearly 500 firms supplying parts and components to the 7 million refrigerators, 5 million washing machines, and 2 million ovens produced in Turkey, and of which two thirds exported annually (IGEME 2007b).

Construction: Construction sector is in the middle of crisis in Turkey. Although the growth of construction has been declining drastically since 2007, the sector is one of the most interesting sectors in Turkey in the long-term. It covers some 6% of Turkey's GDP and working population. Furthermore, there is great potential for future growth if the mortgage system becomes fully operational, as housing loans are then expected to double annually from US$ 30 billion in 2007.

In addition to construction projects in Turkey, Turkish construction companies are among the most internationalised companies in the country. In fact, 22 Turkish contractors[22] are listed by the Engineering News Record (2007) in the Top 225 International Contractors ranking. Out of these companies, Enka (44th), Renaissance (61st), Gama (64th), Tekfen (69th), Yüksel (85th) and Baytur (94th) make even the top 100 ranking with all moving up in the list from previous year.

Turkish construction companies are particularly active in neighbouring countries, and have, for instance, taken up 75% of all construction projects in Azerbaijan. Traditionally, Turkish construction companies have also been active in Russia where they have undertaken projects worth over US$ 25 billion. However, recently Turkish construction business has encountered problems there, as two Turkish companies, namely Enka and Gama, have been accused that they had provided support to the separatist Chechen movement (Today's Zaman 29.5.2008). Moreover, the rapid decline in the price of energy has put pressure on Russian construction sector, and almost half of the projects undertaken by Turkish construction companies are under the risk of suspension (Hürriyet 16.10.2008). Earlier this year Italian Barbetti acquired 30% of a Turkish cement company Cimko, which is valued at US$ 1.3 billion.

Mining and minerals: In 2007, some 23 foreign companies were involved in mining in Turkey, including Inmet, Cominco Mining, Tuprag Metal and Turk Maadin Sirketi. In June 2008, Finnish Ruukki Group agreed to acquire chrome ore and ferrochrome production assets of Kermas Group for US$ 300 million. In fact, Turkey is one of the major chromium sources of the world and it possesses two thirds of world reserves in boron, an essential plant nutrient. Recently, also marble mining has become one of the most dynamic sub-sectors. (IGEME 2007a)

[22] That is third most in the world after USA (51) and China (49), and two times more than the next European country, Italy, with 11 companies.

There are about 4,400 mineral deposits, excluding oil and coal deposits, in Turkey (IGEME 2007a). In 2007, Turkey was the 11th largest producer of raw steel with an annual output of 26 million tons (2% of world total). The steel industry is very important for Turkey's external economy as the sector represents 12% of Turkey's total exports.

Food and beverages sector: The global boom in mergers and acquisitions in the food and beverages sector is expected to affect Turkey as well in the coming years (General Directorate of Foreign Investment 2007). It has been stated that if necessary precautions are not taken, Turkey has to import 170,000 tons of meat in 2015 (Today's Zaman 21.7.2008). However, the previously discussed level of unregistered business may cause difficulties for foreign food producers in Turkey. For instance, only 30% of produced milk is provided by registered producers. Also otherwise, World Bank (2008d) has noted about the problems in food sector, as the lack of modernisation causes problems in food safety across the food chain.

One of the advertised sectors is fish farming, which might provide opportunities for foreign companies. "…there is no other business in Turkey which has larger potential than fish farming and that there is no other business whose potential has gone so unnoticed."[23] The sector has been primarily hindered by bureaucratic obstacles but it is expected that when Turkish producers and exporters have adapted to international norms, their share in the world fish market grows (IGEME 2007f).

ICT: Software industry has grown in the beginning of the 2000s faster in Turkey than in the USA and the EU. There are some 1,300 software companies in Turkey but the value of exports lies insignificantly at US$ 15 million. Thus, largest software companies are mainly targeted in the domestic market. These companies include Meteksan, Microsoft, KocSistem and Siemens Business Services. (IGEME 2007e.)

According to statistics provided by the Interpromedya research group ICT industry reached US$ 26 billion in value, and ADSL subscriptions are expected to exceed 6 million by the end of 2008 (Today's Zaman 2.7.2008). This will also naturally boost online shopping in Turkey. Currently, only 2.5 million Turks are engaged in e-commerce.

[23] Oguz Satici, Chairman of Turkish Exporters Assembly – TIM (Today's Zaman 2.8.2008)

Forestry: The first plantations of fast growing eucalyptus trees were made in Turkey already in 1930s. The most attractive locations for fast growing plantations in Turkey are Blacksea and Marmara regions. More information on the potential of fast growing trees can be found in Ayan and Sivacioglu (2006). Opportunities in forestry are tempting as there are no paper factories in the country (Finpro 2007).

4.2 Major foreign and domestic companies

Table 19 Top 10 companies in Turkey according to production-based sales

Rank	Company	Industry	Region	Production-based sales, US$ mln
1	Tüpras	Energy	Marmara	14 800
2	Ford Otosan	Vehicle industry	Marmara	5 000
3	EÜAS	Energy	Central Anatolia	3 700
4	Oyak Renault	Vehicle industry	Marmara	3 300
5	Toyota Otomotiv Sanayi	Vehicle industry	Marmara	3 200
6	Erdemir	Metal industry	Central Anatolia	3 200
7	Arcelik	Household appliances	Marmara	3 100
8	Tofas	Vehicle industry	Marmara	2 500
9	Aygaz	Energy	Marmara	2 200
10	ICDAS	Metal industry	Marmara	1 900

Source: ISO (2008)

Turkey’s economy is very much in the hands of its largest companies. The 500 largest companies account for 50% of Turkey’s production-based sales and their share in total gross value added created is closer to 60%. Even more shocking is the role of 50 largest companies, covering for 25% of production-based sales in the country. Although the production-based sales showed increasing trend in 2007, the President of the Istanbul Chamber of Industry (ISO) claims that the increase is only virtual and was achieved at the expenses of risks in currency and inflation. (Today’s Zaman 24.7.2008.) Largest Turkish companies are heavily backed by foreign capital, as 143 companies i.e. 30% of top 500 companies in Turkey have foreigners as shareholders either totally owned or as a partner. The largest companies are mainly privately run, and in top 10 only Eüas is a public company. In fact, there are only 15 public companies in top 500 list (ISO 2008), and all top 10 exporters in Turkey are private.

Although these top 500 companies mark high in sales, they employ only 12% of the industrial labour force reflecting high capital intensity. These firms have not therefore been affected by the competitive squeezes stemming from currency appreciation and low-cost competition. In fact, currency appreciation in the past has provided them possibility to improve international presence via investing in foreign assets. (OECD 2008.) The SMEs are more troubled with limited access to finance and know-how[24] (EU 2008d).

Keeping the above in mind, it is not surprising that despite of the recent backlashes in the economy, Turkey's largest companies were able to make profit in the first half of 2008. Their overall growth rate was 4.4% in real prices. The most profitable company in Turkey is the Turkish Petroleum Refineries Corporation (Tüpras), which was acquired by Koc Holding in 2005 for US$ 4.1 billion. Since the acquisition, the company has now held the position for three years. Koc Holding also owns partially Ford Automotive, which came third in profits and number one in exports. Koc Holding is the largest conglomerate in Turkey, and the only Turkish company which has made it to the Fortune Global 500 list ranking 186th. It is a stakeholder in altogether 5 companies in the list of top 10 Turkish companies. In addition to Tüpras and Ford Automotive they have invested in Arcelik, Tofas and Aygaz. The second most profitable company in 2007 was Erdemir, which was acquired by the Turkish Army-linked OYAK[25] a couple of years ago.

[24] The Investment Advisory Council for Turkey (2008) claims that studies for clustering of SMEs have already been started which should lead to increasing international competitiveness of Turkish SMEs.

[25] OYAK (Armed Forces Pension Fund) holding is one of the largest transnational Turkish companies. It was established a year after the military coup d'état in 1961. Currently, the Fund incorporates sixty companies active in finance, manufacturing and services, employing more than 34.000 workers (OYAK 2007) and nourishing some 500,000 soldiers (Cuesta 2007). According to some experts, OYAK is currently the 3rd largest holding in Turkey (Today's Zaman 29.4.2008).

4.3 Regional characteristics

Turkey is divided geographically into seven regions, which are further divided into provinces. There are huge differences among these regions and provinces[26]. With development, people and production become concentrated in some parts of countries, called "leading" areas. For instance, population density varies from 11 (Tunceli) to 2,420 (Istanbul) persons per square kilometre between provinces, and similar differences apply to business opportunities within Turkey. Economic density grows in these parts – Marmara in Turkey, for example – while income in places economically distant – such as south-eastern Anatolia in the east – can lag far behind (World Bank 2008c). However, it must be remembered that **Turkey is much more than Istanbul**, and a closer look is needed on the regional characteristics of Turkey.

The World Bank (2008c) estimates that GDP per capita in Turkish urban areas is two to three times higher than the corresponding figure in rural areas of the country. Although it generally appears that the spatial disparities in income slow or stop at per capita incomes between US$10,000 and US$15,000, there has not yet been evidence of convergence in per capita income (World Bank 2008d).

The problems of "long distance and wrong density" could be solved by spatially connective infrastructure, such as interregional highways, railroads and improved telecommunications. Currently, Turkey's lagging eastern areas have 44% of the land but only 6% of national motorways. Similarly, the asphalt road coverage is 40 % that of the leading regions. (World Bank 2008c.)

The huge differences between regions are also widely addressed in Turkey. For instance, TÜSIAD sees that regional differences are hindering economic growth in Turkey, and demand more effective actions from the government in the field of transportation, health care, education, energy and communications. Their plans also include regional innovation centres but these are only effective when local people are educated. (Today's Zaman 4.9.2008.) In fact, the delaying of agreement with IMF has enabled the government to increase public spending, and to speed up investments in the less developed regions (EIU 2008).

[26] However, the lack of Turkish data at regional level causes difficulties in systematic analysis of regional development in Turkey. The problem has also been cited by Eurostat (2007b).

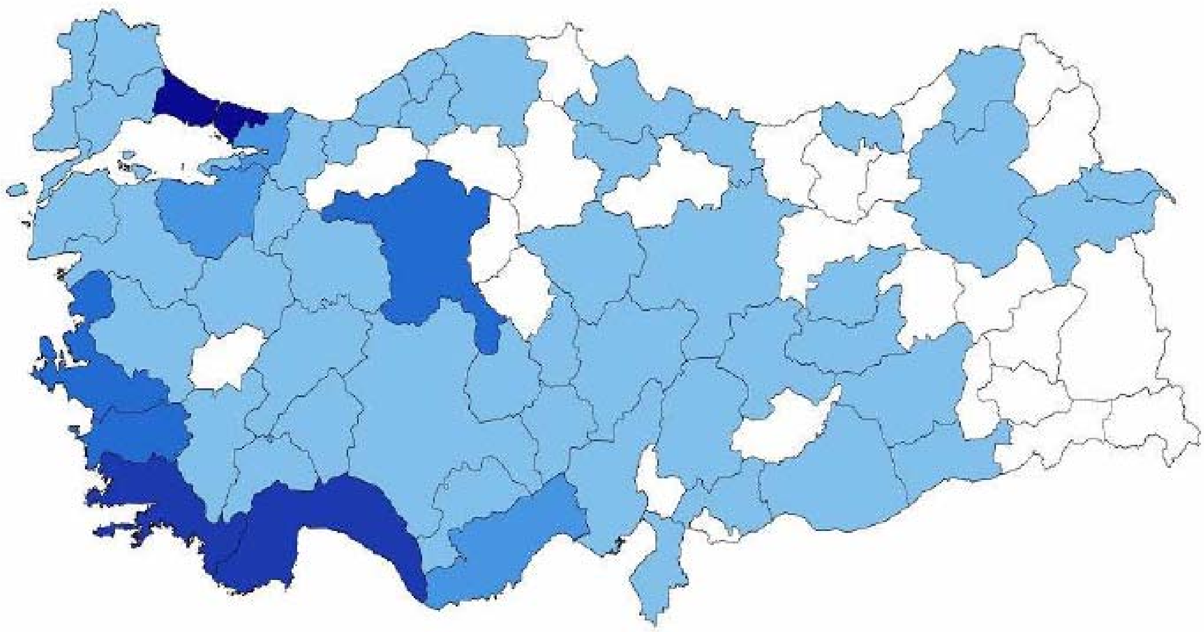
Table 20 Regional distribution of FDI inflows and foreign-owned companies in Turkey*

Region	FDI inflow, US$ mln	Share	Number of companies	Share
Marmara	17 944	94.0%	10 643	55.7%
Central Anatolia	609	3.2%	1 224	6.4%
Aegean	362	1.9%	2 573	13.5%
Mediterranean	175	0.9%	2 750	14.4%
Black Sea	..	..	..	..
South Eastern Anatolia	..	..	..	..
Eastern Anatolia	1	0.0%	..	..
Total	**19 092**	**100.0%**	**17 190**	**90.0%**

*The data is compiled at the provincial level with US$ 2.6 million of investments and 1,118 companies labelled under "other provinces". Therefore, the data does not reveal FDI inflows in two regions, no companies in three regions and total figures are not equal with US$ 19,094 million of FDI and 18,308 as the number of companies.
Source: General Directorate of Foreign Investments (2008)

The disparities can also be seen in the spatial distribution of foreign companies. A half of the foreign companies are located in Istanbul province and more than 60% in Marmara region. In addition to Marmara, also Mediterranean, Aegean and Central Anatolia has significant number of foreign companies, whereas other regions are largely neglected by foreign companies, at least what comes to their direct investments.

Figure 11 Regional distribution of foreign-owned companies established in 2007



Source: General Directorate of Foreign Investments (2008)

Because of higher agglomeration economies and lower transport costs, areas near Istanbul and Izmir may be better suited for integrating with Europe. The more distant areas of eastern and south-eastern Anatolia and the Black Sea have a GDP per capita about half that of the western areas. The disparities persist despite government efforts to spread economic mass toward the east. Meanwhile, public investments in social services help lagging areas, while fiscal incentives for firms to locate in those areas seem ineffective. (World Bank 2008c.)

Table 21 Foreign trade performance by regions*

Region	exports, US$ mln	Share	imports, US$ mln	Share
Marmara	78 843	73.5%	128 145	75.4%
Central Anatolia	6 763	6.3%	19 438	11.4%
Aegean	10 301	9.6%	9 476	5.6%
Mediterranean	4 367	4.1%	6 504	3.8%
Black Sea	2 506	2.3%	2 811	1.7%
South Eastern Anatolia	3 236	3.0%	2 716	1.6%
Eastern Anatolia	595	0.6%	198	0.1%
Total	**107 082**	**99.4%**	**169 289**	**99.5%**

*The data is compiled at the provincial level with US$ 661 million of exports and US$ 774 million labelled under “ambiguous”. Therefore, the total figures are not equal with US$ 107,272 million of exports and US$ 170,063 million of imports.
Source: Turkstat (2008)

Disparities are also highlighted in foreign trade performance of Turkish regions. The development from 2002 is indicating that the dominating role of Marmara Region in foreign trade has not proven significant changes, as its share has changed by only a couple of percentage points. Ankara in Central Anatolia is lagging behind other major provinces in exports, whereas both Bursa and Kocaeli in Marmara region show solid performance in international activity measured both in exports and imports.

A special case in foreign trade is the system of free zones in Turkey. They are considered to be mainly tax havens and have not been that important in terms of competitiveness of the economy. Altogether the 21 free zones account only few percents of Turkey’s exports. However, in 2009 there should be a new legislation concerning the free zones making them more attractive (Today’s Zaman 13.8.2008), and companies interested in business opportunities in Turkey should bear this in mind.

Marmara: Istanbul's industrial and commercial activities cover 28% and 25% of Turkey's economic output (Today's Zaman 7.4.2008). Istanbul has been the top destination for foreign companies, and it hosts more than half of foreign companies in turkey. Moreover, it attracted 94% of total FDI inflow in 2007. Almost 40% of foreign companies operate in wholesale and retail trade, a fifth of the companies operate in manufacturing sector and some 10% of them operate in real estate, renting and business activities sector. Many investment opportunities in Istanbul are however becoming relatively expensive in Istanbul, and thus direct investments flow elsewhere in the country. Also the population growth has made the infrastructure (incl. drinkable water) insufficient by many means which is hindering the attractiveness of Istanbul as an investment destination.

Mediterranean: In Mediterranean region companies are concentrated in wholesale and retail trade (24%), real estate, renting and business activities (17%), hotels and restaurants (16%) and construction sectors (16%) in parallel with the vibrant tourism sector. Mediterranean Region is a destination for 2,750 foreign companies which is second most after Marmara Region. However, in terms of FDI inflow it attracted only US$ 175 million (0.9% of Turkey) in 2007. In the future, the region is expected by experts to attract further FDI. Particularly, the region is expected to benefit from the BTC-pipeline, and the development is estimated to bring more foreign investments, as the region is about to become a "world wide energy region" (Investment Advisory Council for Turkey 2008).

Aegean: In the Aegean region, an intensive activity of the foreign-owned companies is observed in manufacturing and tourism sectors. Foreign companies have mainly invested in wholesale and retail trade, and manufacturing sector. Izmir is one of the top destinations for foreign companies in Turkey, as 1,120 companies have started operations in Izmir Province by 2007 recording nearly US$ 300 million in annual FDI inflows. Mugla Province hosts 1,123 foreign companies but in 2007 it attracted foreign investments only worth US$ 3 million.

Central Anatolia: In the Central Anatolian region foreign companies are mainly engaged in wholesale and retail trade sector and manufacturing sector. Ankara is the second largest city in Turkey. Recent development has changed Ankara from being a city of officers, trade and agriculture to an industrial city. Machinery and metal industry with the influence of defence industry[27] has a significant place in the industry of Ankara, having 40% of the industrial foundations. Other fast growing sectors in Ankara include construction, furniture and textile. (ASO 2008.)

Black Sea: Majority of the people earn their living from the land in the Black Sea Region. The main industries are related to steel, thermal power, coal production, copper production, sugar, paper, sulphuric acid, vegetable oil, tea, hazelnut shelling and hazelnut products, fish flour and cigarettes in various parts of the region.

Eastern Anatolia: Erzurum is a capital of Erzurum Province, the largest province in the Eastern Anatolia. Erzurum is rich about rivers, which may have in the future more importance economically than what they currently have. The future shows whether Coruh Stream, Oltu Stream, Tortum Stream and Hinis Stream become as significant as North Stream and Blue Stream, when the region becomes more dependent on water as a natural resource.

Southeastern Anatolia: There have been many different programmes to improve the living standards in the troubled Southeast already since the 1960s (World Bank 2008d). In May 2008, the Turkish government promised again close to US$ 20 billion in 2008–2012 to regional GAP project improving social, infrastructural, institutional and economic development in Southeastern Anatolia.

The GAP Region supplies 50% of Turkey's cotton production, and the region is also otherwise not that remote as it seems in the statistics. One of Turkey's largest harbour, most of the trade centres in Middle-East, and the Turkey’s largest international cargo airport are in proximity which can make Southeastern Anatolia a preferred location for a foreign investor in long-term. Moreover, the public-funded infrastructural projects and incentive packages increase the attractiveness of the region in the short-term.

[27] The largest defense company is Tusas Aerospace Industries (TAI), which is a Turkish-American joint venture. Foundation of Strengthening Turkish Army has a 1.9% direct share in the company.

5 FINNISH COMPANIES IN TURKEY

Previously it has been found out that Finnish companies have entered Turkish market being attracted by large and growing economy, large population, logistically attractive location, and low cost level (Wilén 2005). Particularly, Finnish companies have been happy about the market development and overall internationalisation of the economy. In 2007, it was found out that Turkey’s business environment was comparable to that of Poland’s in 2005. The largest problems were found in bureaucracy, price competition, cultural differences, customs procedures, level of infrastructure and economic policy environment. (Finland’s Central Chamber of Commerce 2007.)

However, the view of Turkey’s development has not previously been asked from Finnish companies and therefore more future-oriented survey was made as a part of the research. The survey results are described in detail in chapter 5.2 but the following list describes the main research findings from the survey:

- Even for most (75%) Finnish companies who are active in Turkey, Turkish market remain relatively unimportant (less than 5% of turnover).
- 21% of companies expect that Turkey’s share of turnover will increase by 2 or more percentage points until 2015.
- **Market size, regional development outside Istanbul, and energy projects have most positive impact on profitability** of Finnish companies in Turkey.
- Finnish companies consider that **market size, privatisation processes and regional development outside Turkey will develop more positively than other factors until 2015**.
- **Bureaucracy, customs procedures, corruption, unfair competition from grey market and competition overall** have remained as factors which are considered to affect profitability of Finnish companies most negatively in Turkey and they are even **expected to worsen until 2015**.
- Availability of raw materials and labour productivity are only factors which are considered to affect profitability negatively but improving until 2015.
- Finnish companies view Turkey’s innovation and R&D environment affecting negatively their profitability, and are not expecting to see positive development until 2015.

5.1 Turkey's external economic relations with Finland

Finnish exports to Turkey have soared by nearly 70% during 2000s. Moreover, according to Finland's minister for foreign trade and development Paavo Väyrynen "business ties between Finland and Turkey are even stronger than what the trade figures indicate" (Turkish Daily News October 3, 2007).

Finland's trade with Turkey is concentrated on trade in machinery and transport equipment. Although Finland's exports to Turkey have diminished in the product group since 2000, the product group's share of Finland's imports from Turkey has increased from 20% to nearly 40%. Large share of this product group is due to increased imports of road vehicles (€ 90 million) from Turkey. Other product groups marking high import figures are metalliferous ores and metal scrap (€ 68 million) and articles of apparel and clothing accessories (€ 68 million). Finland exports mainly paper, paperboard and related articles (€ 163 million), telecommunications and sound recording equipment (€ 159 million) and machinery for special industries (€ 67 million). (National Board of Customs in Finland 2008.)

Table 22 Finland's trade with Turkey in selected product groups 2000–2007

Product group	Finland's exports to Turkey				Finland's imports from Turkey			
	2007 € mln	2007 share	growth 2000–2007 € mln	share change 2000–2007	2007 € mln	2007 share	growth 2000–2007 € mln	share change 2000–2007
Machinery, transport equipment	337	50.3%	-122	-19.3%	146	38.6%	125	18.6%
Basic manufactures	249	37.2%	108	15.8%	59	15.6%	36	-6.0%
Chemicals and related products	36	5.4%	6	0.9%	9	2.4%	5	-1.4%
Inedible crude materials, except fuels	32	4.7%	15	2.2%	71	18.9%	55	3.3%
Miscellaneous manufactured articles	13	1.9%	1	0.1%	78	20.6%	45	-10.5%
Others	3	0.5%	2	0.3%	15	3.9%	6	-3.9%
TOTAL	**669**	**100.0%**	**273**	**0.0%**	**377**	**100.0%**	**10**	**0.0%**

Source: National Board of Customs in Finland (2008)

Although the operations of Finnish companies have been relatively small in Turkey, year 2006 showed remarkable growth in FDI outflow, number of employees and turnover of subsidiaries and branches of Finnish companies in Turkey. Also the announcement of Finnair for starting direct flights between Helsinki and Istanbul in March 2009, and the recent decision of Turkish Airlines to increase the number of direct flights between the two cities indicate that there is faith in positive development of the economic relations of Finland and Turkey.

Table 23 Finnish companies in Turkey 2000-2007

	2000	2001	2002	2003	2004	2005	2006	2007
FDI from Finland, € mln	7	-23	4	39	28	27	165	59
Number of employees	892	667	427	426	430	445	2 432	..
Turnover, € mln	518	205	328	380	508	730	1 002	..

Source: Bank of Finland 2008

The leading sectors for Finnish export and investment in Turkey, include telecommunication services, electric power systems, natural gas transmission and related activities, telecommunications equipment, architecture, civil engineering, construction, building materials, plastics, agriculture and food industry, automotive parts and equipment, medical equipment and technologies, and forestry (Yavan 2008).

Small inflows of Finnish capital into Turkey are partly due to bad reputation of Turkey in Finland. This is partly due to Finnish media's reporting, as only catastrophes make it to the evening news, such as the attack against Turkish Embassy in Helsinki. But it is not only the Finnish media to blame. Just taking a look at the BBC top news on Turkey during the past year shows where the image comes from: Turkish attacks against Kurds, terrorist attacks in Turkey, headscarf reforms, limits on freedom of speech, accusations against the ruling party. Partly, the image is external to the government's actions but much controversial news is at least by-products of national politics.

Also Finnish companies may remember the problems of Nokia and TeliaSonera in Turkey. Nokia has had problems of receiving money from the Uzan family's Telsim worth US$ 1.7 billion despite the court's order in 2002 (Pervilä 2004). TeliaSonera had instead problems in buying Turkcell shares from the Cukurova family (Pervilä 2005).

Perhaps the most acknowledged Turkish company in Finland is a television maker Vestel. The company acquired the famous Finnish brand of Finlux in 2006, and has since then operated the marketing of Finlux from Finland. This is a good example how Turkish companies are taking part in the globalisation and learning about branding with the help of foreign experts. It also provides an example how Finnish companies could, instead of closing all operations, move their production to Turkey where production costs are lower.

5.2 Finnish view on Turkey's business environment

In order to find a view of Finnish companies on Turkey's business environment a survey was sent via email to 181 Finnish companies active in Turkey[28]. Altogether 28 companies responded during 5–24th September 2008 which gives the response rate of 15.5%. Moreover, 27 companies informed that they do not have currently operations in Turkey on a scale that they could give responses. This indicates that the effective response rate is higher, and can therefore be considered as a quite reliable snapshot of Finnish companies active in Turkey.

The survey was responded by a varying set of companies arranged by size (turnover), length of experience in Turkey, relative importance of Turkish market (share of turnover) and mode of operations.

Most of the companies who participated in the survey have been active in Turkey already in the 1990s, which provides them a broader scope to view the current status of the business environment. Most of the companies have, for instance, experienced the crisis in 2001.

[28] The list of companies was received from the Finnish Exporters Database provided by Finpro.

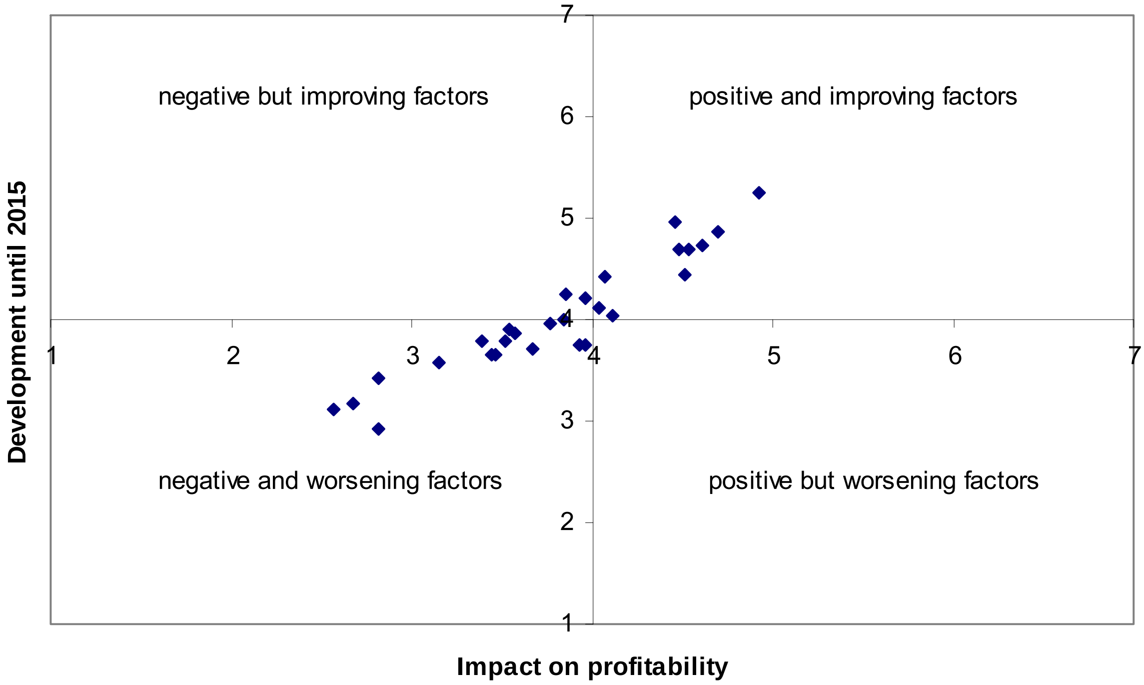
Table 24 Characteristics of the companies who participated in the survey

Size	turnover	number of companies
large	> € 50 million	6 (21%)
medium-sized	≤ € 50 million	8 (29%)
small	≤ € 10 million	7 (25%)
micro	≤ € 2 million	4 (14%)
not available		3 (11%)
Experience of Turkey	year of establishment	number of companies
long	-1990	7 (25%)
medium	1990-2001	13 (46%)
short	2002-	7 (25%)
not available		1 (4%)
Importance of Turkey 2008	share of turnover	number of companies
relatively unimportant	< 5%	21 (75%)
relatively important	≥ 5%	7 (25%)
Importance of Turkey 2015	share of turnover	number of companies
relatively unimportant	< 5%	17 (61%)
relatively important	≥ 5%	10 (36%)
not available		1 (4%)
Mode of operations		number of companies
agents		15 (54%)
exporters		13 (46%)

The 2008 figures may have some resemblance to short-term fears but the future was taken long enough to analyse the long-term prospects. Most of the factors asked are considered as negative and worsening from the perspective of profitability but this may not tell the whole picture about the Turkey's business environment, as it may be caused by survey design.

As Figure 12 shows further, most of the responses of Finnish companies saw positive factors developing to a positive direction and negative factors to a negative direction. This may also be partly a result of the questionnaire design. However, there are also factors in the "negative but improving"-corner which indicates that all responses do not follow the pattern above. These factors are now analysed in more detail instead of "positive but worsening"-corner in which no factors belong to. Also the factor "innovation and R&D environment" was considered to stay stable until 2015, and therefore is not described in the following. This view is sad considering Turkey's efforts on modernising its economy, as currently *Finnish companies on average view Turkey's innovation and R&D environment affecting negatively their profitability*.

Figure 12 The view of Finnish companies on Turkey's business environment and its development until 2015 from the perspective of profitability



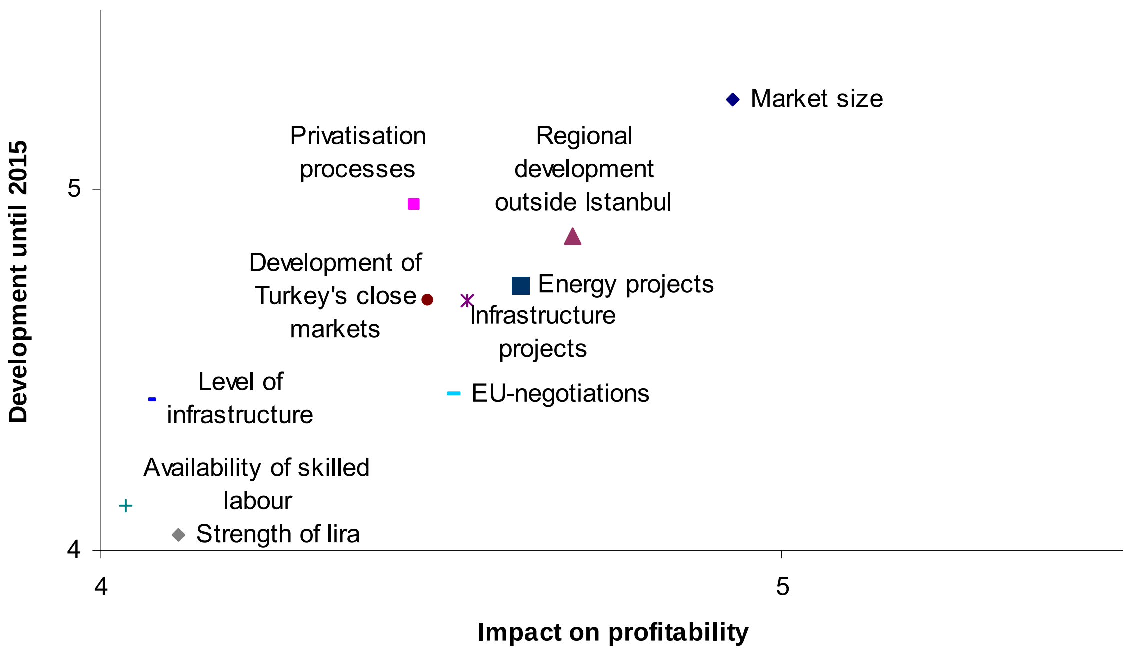
Positive and improving factors: The survey indicated that there are many factors which affect profitability of Finnish companies positively in Turkey. All positively affecting factors were also optimistically considered improving until year 2015 (Figure 13).

Companies who participated in the survey saw market size (4.9), regional development outside Istanbul (4.7), and energy projects (4.6) having the most impact on their profitability on a scale 1–7.

Market size (5.3) is also considered to develop better than other factors. The companies view also privatisation processes (5.0) and regional development outside Istanbul (4.9) leading to more profitable results in the future.

In many instances Turkey is marketed as a springboard to its close markets. This is to some extent also facilitated by Finnish companies, as for instance TeliaSonera subsidiary Turkcell has expanded outside Turkish borders. In July 2008, it signed an agreement to acquire 80% share of the Belarusian telecommunications company BeST for US$ 500 million.

Figure 13 Positive and improving factors from the perspective of profitability



Negative but improving factors: Only two factors were considered affecting profitability negatively but improving until year 2015. These factors are availability of raw materials and labour productivity.

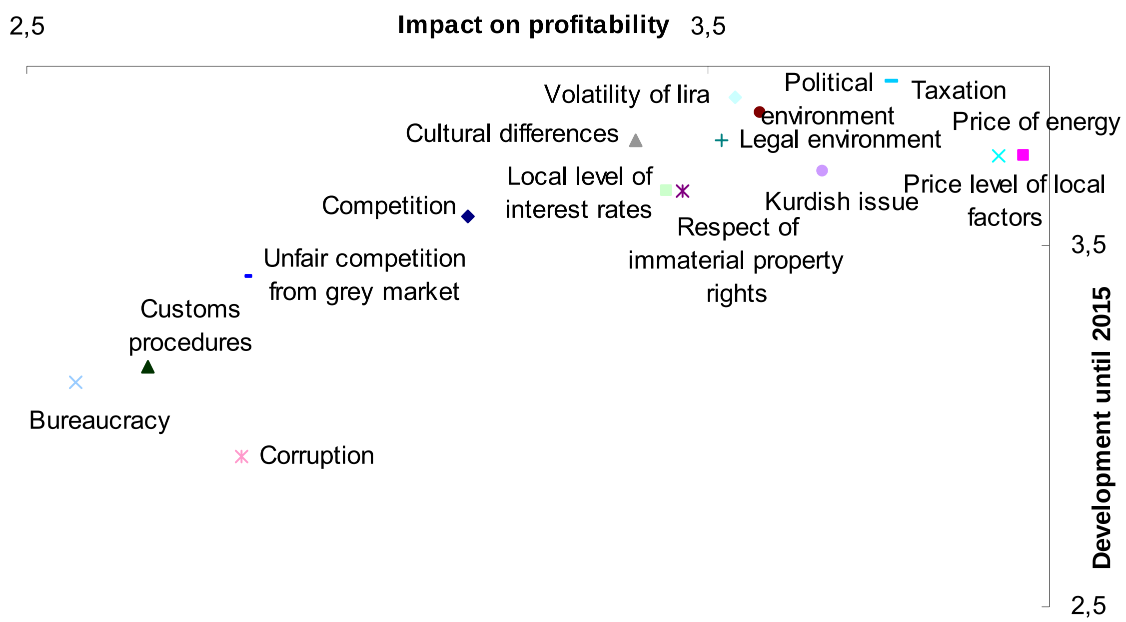
Particularly companies were concerned on the availability of raw materials. This may however be more global concern and due to limitations of the questionnaire, Turkey's relative position can not be further analysed. However, labour productivity is very Turkey-centric, and the view on positive development may encourage investments in the labour-intensive sectors of the country.

Figure 14 Negative but improving factors from the perspective of profitability

Negative and worsening factors: Most of the factors asked in the survey were considered by the respondents as affecting their profitability negatively and worsening until year 2015. These factors are shown in Figure 15.

Although the political environment, legal environment and Kurdish issue make it to the headlines, for Finnish companies these factors seem to have only a minor negative impact on their profitability. Similarly, price of energy seems not to be problematic for Finnish companies. This may be very much related to the type of their activities in Turkey. Finnish companies are instead more affected by bureaucracy (2.6), customs procedures (2.7), corruption (2.8), unfair competition from grey market (2.8) and overall competition (3.1).

Figure 15 Negative and worsening factors from the perspective of profitability



Differences according to size: There were no major differences stemming from the size of the companies and the way they perceived the impact of environment-specific factors on profitability of their business operations in Turkey. Micro-sized companies were found to have more difficulties with competition (2.3 vs. 3.1), level of infrastructure (3.3 vs. 4.1), and local interest rates (2.0 vs. 3.4) than companies on average. On the other hand, they perceived the impact of the development of Turkey's near market slightly more important (5.3 vs. 4.5) than companies on average. Large companies, instead, perceived the availability of raw materials having positive impact on their profitability whereas rest of the companies perceived it to have negative impact (4.7 vs. 3.9).

Considering the development of Turkey's business environment, companies were more or less agreeing throughout size categories. Only major differences[29] were found among micro companies who saw the price of energy developing more negatively (2.7 vs. 3.8) and cultural differences (5.0 vs. 3.8) developing more positively than companies on average.

Despite these differences, *no correlation was found with the size of a company and the way in which environment-specific factors were perceived*.

Differences according to longer presence in Turkey's market: Surprisingly, when companies were arranged by the start of their operations there was even less variance between companies.

Differences according to share of Turkish business: Similarly, when companies were organised by share of Turkish business on turnover there was less variance between companies than according to the size of the company.

[29] A variance of 0.80 from the average is reported here as a major difference.

6 CONCLUDING REMARKS

All in all, it is easy to agree with OECD-report (2008): Turkey is in a difficult position as it should "preserve a rigorous fiscal policy stance, while both improving the quality and cost-efficiency of key public services and developing the country's infrastructure, and simultaneously reduce the most distorting aspects of the Turkish tax system".

Considering Turkish economy from the perspective of foreign companies we should not, however, forget the positive development in Turkey before and beyond the 2000–2001 crises. The development has made Turkey the sixth largest economy in Europe and more resilient against external shocks. Many experts on Turkish economy, including those from the OECD (Gönenc 2008), admit that there are grounds for optimism in long-term modernisation of the economy. Also the labour force potential is huge considering positive demographic projections and the size of population outside the formal labour market. Finnish companies also see particular potential in market growth, privatisation processes and regional development outside Istanbul.

In general, the results of the company survey presented in this report highlight the negative sentiments towards Turkey's business environment among Finnish companies. However, the recent news from Turkey regarding the expanding businesses of large Finnish companies, such as Uponor, Componenta, Huhtamäki, Outokumpu, Ruukki and TeliaSonera prove that these companies have faith in the future development of Turkey. This report gives some background why companies should have faith in Turkish economy but also reveals the major weaknesses of the economy. However, the development of the *döner ekonomi* affects companies differently, and therefore **all companies should allocate resources on analysing the long-term business opportunities in Turkey from their own perspective**. The research findings represented here are only to provide a shortcut for more detailed analysis.

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