Turkey, the challenges of the biggest European market

EUROPE

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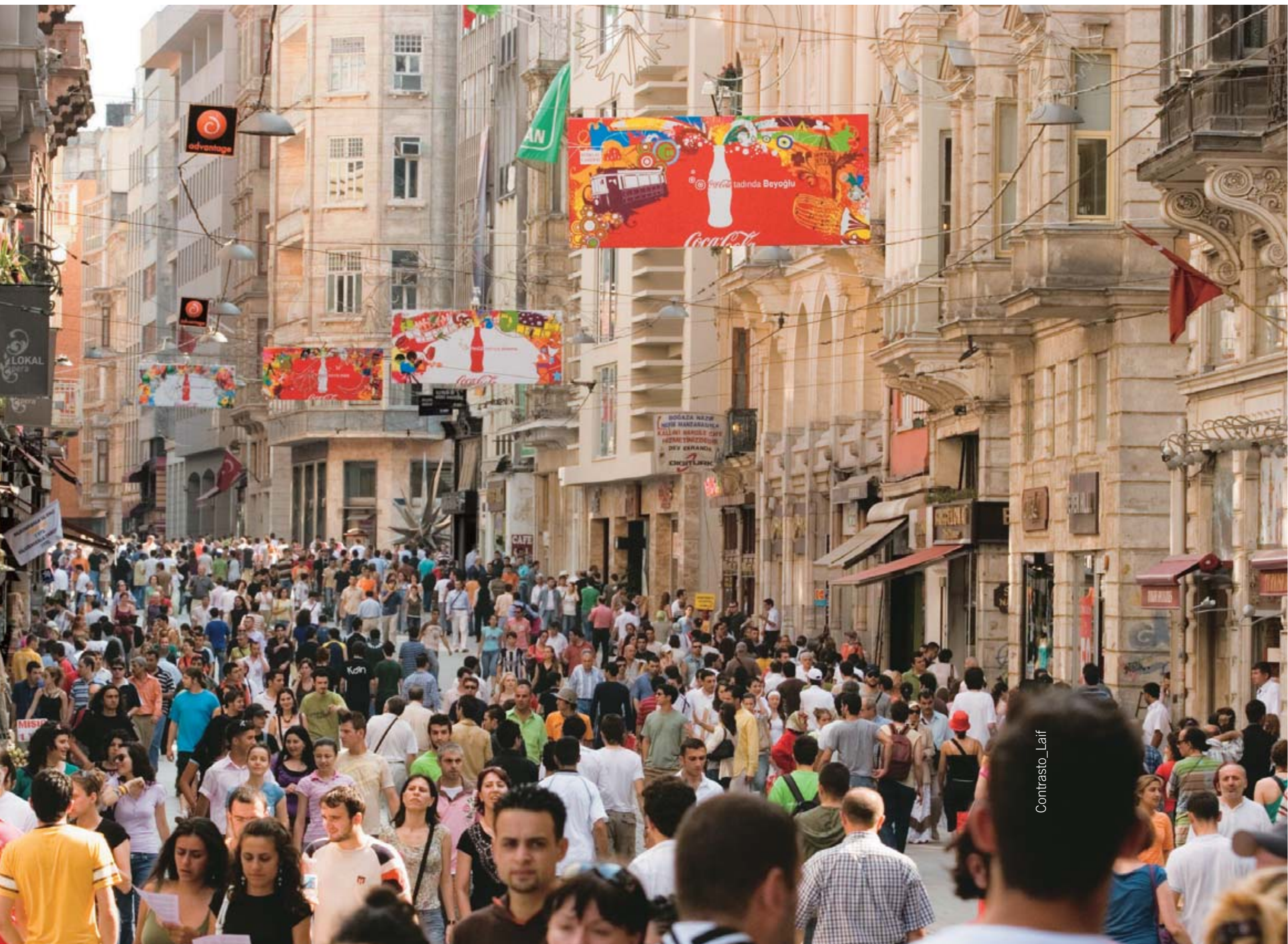
The interest of foreign entrepreneurs in the Turkish market is very high. In the last two years Turkey received twice the amount of FDI received in the whole of the previous decade. through a series of interviews to foreign entrepreneurs in the country, the main drivers of internationalization and the competitiveness of the country have been analyzed and compared...



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The impressive progress made by Turkey in the last 5 years in terms of economic stability and convergence towards European standards has dramatically increased the attractiveness of the country for foreign investors, especially for European investors (in parallel with the Turkish convergence process to the European Union). The booming FDI inflows are the most noticeable indicator in this sense. Resistance to foreign investment (with obstacles in terms of bureaucracy, customs and local competition) is a thing of the past: local authorities are now encouraging foreign investors to enter the Turkish market. The Turkish economy is much more open and more competitive than a few years ago. The economic crisis of 2001 must be considered the main turning point. The stabilisation process induced a strong and sound growth pattern (7%, on average, between 2002 and 2006), significant disinflation and inconceivable improvements in public finances. Political stability, the reform process in the banking and public sectors, robust economic growth, EU candidacy and IMF programs: all of these elements have put Turkey in the spotlight for foreign investment. Turkey has become the recipient of almost 30% of the total FDI inflows in Central Eastern Europe. Even if past experience of instability during the 1980s or 1990s is still a fresh memory, the image of the country among foreign investors is far better now than it was a few years ago.

The size and the potential of the local market – a population of 73 million whose

_Istanbul, with its population of 12 million and an important industrial base, is a potential target for companies developing networks in central and eastern Europe (below: the new headquarters of the Stock Exchange)


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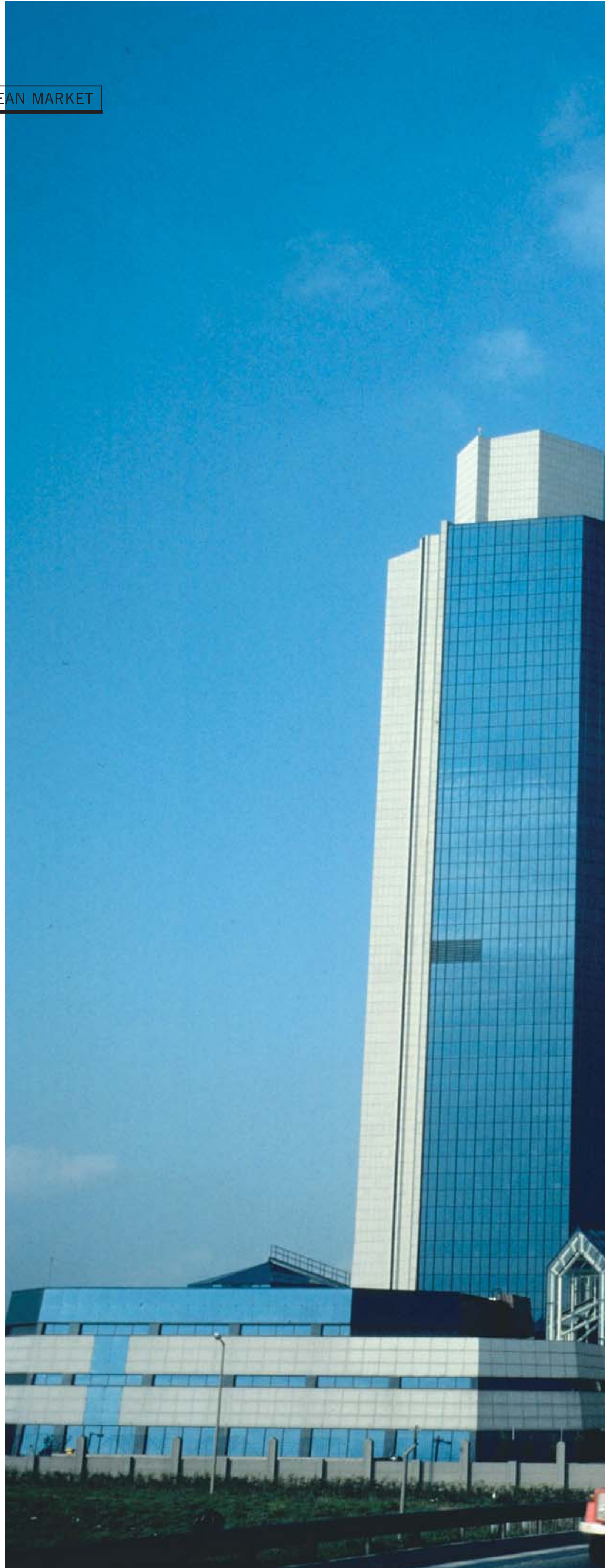
income levels are increasing fast – are among the main drivers for enticing foreign companies to the country. Turkey is the second biggest country in Europe in terms of population after Germany. Turkish GDP represents almost 30% of the total GDP of Central and Eastern Europe (considering the ten new members and the Western Balkans): hence it is a potential target for all the companies developing networks in Central and Eastern Europe. There are also specific demographic features worthy of note. First, Turkish citizens are very young on average, especially if compared with Europe (both Western and Eastern). The average age of the Turkish population is around 29 years, ten years less than the average European age. Second, Istanbul with its population of 12 million and an important industrial base nearby, is a very special and important gateway to enter the country. Finally, there is still a significant polarisation in the distribution of incomes, with a vast and rich upper class having tastes and habits comparable mainly with European standards. All these characteristics make Turkey a destination market with huge potential that has few peers among emerging markets and certainly cannot be compared with any other Central and Eastern European country.
But Turkey is not simply a large and fast growing outlet market: it is also a competitive production location as it has strong traditions in the manufacturing sector with important chains of suppliers and strong local brands. In particular, Turkish producers are major players in some specific sectors: textiles, non-metallic mineral products (cement, ceramic, glass, etc.), basic metals, white goods and automobiles. Pressures on costs in recent years are evident, and they are pushing towards a restructuring of labour-intensive sectors, in favour of higher value-added activities. The structure of exports is also evolving accordingly: historically the most



_Having overcome the instability of the 1980s and ’90s, Turkey has attracted the attention of foreign investors drawn by its economic and financial progress. Facing page: the Sabanci Center Towers in the Level business district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The services sector is very strong and competitive in Turkey, especially in the field of banking and finance, telecommunications and transport. These sectors have received the bulk of foreign direct investment flows

important export sectors in Turkey, textiles and clothing, lost its relevance dramatically in the 2000-2006 period due to difficulties encountered in competing with low-cost East Asian products.
As Turkey has been both an important destination market and an industrial base since the post-war period (in contrast to other Eastern European countries), local companies are quite developed and modern. For this reason many foreign investors enter Turkey by acquiring local firms and local brands (thus gaining access to clients, knowledge of the local market, etc.), especially in the manufacturing sector. This is not common for other "emerging" European countries, where foreign investors often prefer greenfield investments because existing plants are sometimes obsolete and local partners do not have strong brands and know-how. Entering Turkey with local partners, especially during the initial stages of internationalisation, is considered a *plus*.
The strong industrial base of the country makes it possible for the foreign company

to find high-level local suppliers. This has been very important for instance for Benetton (the Italian brand has more than 100 sale points in the country), which does not produce directly in Turkey but sells many goods "made in Turkey" taking advantage of its local supplier. This explains why foreign companies that produce or sell in Turkey (directly or through affiliates) do not represent a major driver for the internationalisation choice of other foreign companies, especially suppliers. This is mainly related to the fact that, contrary to the experience of other in-transition countries, foreign companies already find good services provided by local firms. This also has some implications for the patterns of internationalisation of foreign companies, which are less systemic if compared with other experience in Eastern Europe: "follow-the-client" strategies are less common than in other Central Eastern European markets. This has repercussions on the dimensions of the foreign firms involved in Turkey as well: the size of the local market represents a major barrier for SMEs and the strength of the local production system provides less scope for small "followers". On the other hand, all the medium-sized and large companies target the potential of the Turkish market. The Turkish production structure is characterised by having a network of small local enterprises and by the major role played by a few big family-owned conglomerates. They represent challenging competitors for foreign investors, and often many important partners. Koç Group is the largest of these groups, and it is active in the automotive sector (joint ventures with Fiat and Ford), white goods, retail, food, finance (in partnership with UniCredit). The Group comprises more than 120 companies, 21 of whom are listed on the Istanbul Stock Exchange, and has 93,000 employees. Five of the top-10 Turkish companies belong to Koç Group. The second group in terms of size is Sabanci, active in the field of services such as finance, tyres, food, retail, cement, chemicals, and the third is Dogufl, with interests in finance, construction, media and the automotive sector (in joint venture with Volkswagen). The services sector is very strong and

_The strong industrial base of the country has attracted foreign countries. This has been very important for Benetton, which sells many goods "made in Turkey", or Ford (above), which has a joint venture with the Koc group

competitive in Turkey too, especially in the field of banking and finance, telecommunications and transport. First, the services sector is mainly aimed at serving the vast, local market, and it can take advantage of the enormous possibilities in terms of economies of scale; second, many activities require a "white collar" labour force, and this can be considered one of the main sources of strength on the Turkish labour market in the main cities. Local conglomerates are very active in the above mentioned sectors, but many foreign companies are gradually entering the market, starting from recent years. Examining foreign investments in Turkey during 2005 and 2006, it is clear that investments in industrial sectors remained limited, while the bulk of investments were concentrated in services sectors (accounting for around 90% of total investments in both years). More specifically, two sectors, namely financial intermediation and transport, storage and communication, received most of the FDI (their share in total FDI being 40% and 36% in 2006 respectively). Inflows to the banking sector amounting to USD 12.8 billion were quite impressive in the two years (all but one of the major private banks have experienced some kind of foreign involvement in the last three years). The inflows to communication sectors, on the other hand, stemmed mainly from the sale of Turk Telekom to Oger Telecom and Telsim to Vodafone. The strength of the services sector represents not only a good source of foreign investments but also an important pillar of support for manufacturing activity in Turkey. Industrial companies can find the high level of service needed in terms of consultancy, legal services, marketing, banks and insurance. It must be stressed that this particular feature is not so common in all emerging markets. The competitiveness of the country on the cost side, which was not a topic of discussion some years ago, is now threatened by the strength of the currency, especially in the most

traditional price-sensitive sectors. Labour costs in Turkey are lower than in Europe, but some countries (in the Far East but also in Central and Eastern Europe) can be considered more attractive from this point of view. Lower labour costs can nowadays be found in Asia, North Africa, and even in some EU countries such as Bulgaria and Romania. This is why, according to the foreign investors we interviewed, the labour intensive sectors (textiles in particular) will be among those most affected in the future by the relocation of production towards other emerging countries. On the one side this is a painful process, especially for some small enterprises; on the other hand, it is pushing Turkish companies towards higher quality and higher value-added activities. The cost competitiveness of Turkey is very sensitive to exchange-rate developments. While the currency was linked to a basket exchange rate in 1990s and the currency was strong, the Turkish production system regularly experienced tensions and finally a crisis. Immediately after the 2001 devaluation Turkey became very competitive. The country is now considered less competitive because of the increases in salaries but especially because of the real appreciation of the local currency more recently. Some small and medium-sized enterprises working in more price-sensitive segments of the textile sector still regard the weaker currency as essential; but a weak – and unstable – currency is considered grim for many other producers, especially those involved in sectors characterised by high import intensity and where the stability of domestic demand plays a central role.
In some cases Turkey is considered by foreign investors to be a base for accessing other countries, especially in regions where the links with Europe are weaker. This role could become more significant in the future, but it is not fully exploited yet. First, Turkey is developing a very important network as an energy supplier, and serves as a bridge between producers (Russia and Middle East) and consumers (Europe). Apart from this, foreign companies are looking at Turkey as a possible base for future expansion, and two directions seem to be particularly appealing: one is the Caucasus (Georgia and Azerbaijan) and Central Asia and the other is the Middle East and North African Muslim countries. In both cases the geographical, historical, and even religious links are interrelated and play a role.
In the near future, the Turkish economy is going to remain outward oriented in terms of exports and imports and attract more FDI, in parts derived from privatisations. The long and bumpy journey towards the EU, even if not successfully completed (currently, 8 out of

_Turkey is developing a very important network as an energy supplier. Below: Aliyev, the President of Azerbaijan, with his Turkish counterpart Sezer and Turkish PM Erdogan at the inauguration of a pipeline in Ceyhan

35 accession chapters are "frozen" and the future of negotiations appears uncertain), will open up a huge market even more and attract foreign capital. The business community, both local and foreign entrepreneurs, see EU entry or at least the long EU convergence process as a huge opportunity to contribute to the stability of the country. Since in many CEE countries the opening of their economy has meant major opportunities for foreign investors even with a very weak local production system (that actually benefited later on from the rapid inflow from abroad of knowledge, skills and technology), many Turkish companies can leverage their strengths even in foreign markets, especially in some specific sector. And the EU convergence process will probably trigger more competition in the Turkish local market.

TURKEY'S NUMBERS AND THOSE OF ITS COMPETITORS

2006	Turkey	Poland	Hungary	Czech Rep.	CEE-84	Romania	Bulgaria	EU-15
Population (mn)	73.0	38.1	10.1	10.3	72.9	21.5	7.7	389.4
Average age, years*	29	37	39	39	38	38	41	39
Youth education attainment level5, % *	44	91	83	91	89	76	77	75
Science and technology graduates6 **	5.6	9.4	5.1	7.4	8.9	9.8	8.5	13.6
GDP per capita	4,244	7,121	8,925	10,981	8,227	4,327	3,172	27,660
Monthly labour costs,*	677	818	944	954	841	358	229	3,438
Labour productivity per person (EU25=100)	41	59	73	69	63	41	35	106
R&D expenditure, % of GDP *	0.66	0.57	0.94	1.42	0.83	0.39	0.5	1.91
Corporate tax (%)	20	19	16	24	20	16	10	29
EBRD Infrastructure reform index	n.a.	3.3	3.7	3.3	3.3	3.3	3.0	n.a.
FDI (in % of GDP, avg 2004-'06)	2.9	4.2	4.6	6.1	4.6	8.3	13.8	n.a.

Source: Eurostat, EBRD, New Europe Research Network; * Data as of 2005; ** Data as of 2004