Opportunities beyond the Bosphorus

Exploring growth, FDI and trade flows in view of Turkey's EU-accession

ABN AMRO

Economics Department

Charles Kalshoven
Serdar Küçükakin

Emerging Market Analysis & Multilateral Organisations

Frank Vinke

This study was commissioned by the Dutch ministry of Economic Affairs

May 2004

Table of contents

Summary		2
Introduction		4
Chapter 1	Challenges... for Turkey today	6
Chapter 2	Opportunities... for growth	13
Chapter 3	Opportunities for FDI and trade	23
Literature references and data sources		36

Summary

In December 2004, during the Dutch Presidency, the EU will decide whether to open accession negotiations with Turkey. The Dutch Ministry of Economic Affairs has commissioned this report to describe the possible economic implications of Turkish accession to the European Union with a focus on growth, foreign direct investments (FDI) and trade flows. This report will evaluate the economic dynamics that Turkey could experience in the period ahead, given an accession scenario. It focuses on potential developments in economic growth, trade and investment. The study takes a comparative approach, drawing lessons from the experiences of Central Europe and earlier EU entrants. This analysis was written from the perspective of a Turkey that is progressively adopting policies to align itself with the EU, in tandem with further improving macroeconomic stability. We assume that ten years from now, the country will become member of the European Union.

Structural and macroeconomic achievements and challenges

Turkey's economy has been moving towards increased stability and predictability. Although this can be only indirectly linked to its EU accession ambitions, it offers a favourable basis for accession negotiations. However, stability remains tentative. Vulnerabilities and obstacles to growth are still present and additional and enduring reform efforts are required to sustain the current positive trend. From a structural viewpoint the Turkish economy is in a relatively solid position for European Union rapprochement. No major overhaul is needed, as was the case in Central and Eastern Europe. In most areas, a gradual but steady improvement of the functioning of its institutions will be adequate to prepare the country for membership. During the severe budget constraints imposed in recent years, government investment in infrastructure and education has been very low. The government must take a more active investor role to facilitate the anticipated broad -based economic development. In order to make this possible, an overhaul of the tax system and pension reform are also required. The banking sector is a separate issue. It will be confronted with major changes as it adapts to the new, low-interest environment. Balance sheets remain weak and it will still take some years for the sector to function effectively. However, the entry of foreign players could jump-start the required developments.

All these factors are to be addressed in the period ahead as Turkey proceeds towards EU membership. The overarching macroeconomic problems can be reasonably overcome, or at least reduced to more acceptable levels, within a few years – provided the government maintains its current efforts. The structural obstacles are likely to take longer before satisfactory outcomes are achieved. The apparent break in the macroeconomic trend suggests that Turkey's future economic growth performance will move closer to its potential growth rate. This trend will be further boosted by the fact that conditions for Foreign Direct Investment are increasingly in place. If the economy is managed well and privatisation is encouraged, substantial FDI could start to flow.

Opportunities for economic growth

How much of the potential will actually materialise, depends on market imperfections (reform success) and aggregate demand. Experience with previous accession candidates shows rapid catch-up is possible. Turkey already has a high historical trend growth and an improved stable environment could add to this. We project average economic growth up to 2014 at 4.9% per year. During the subsequent decade, economic growth is projected at between 5% and 6.2%, depending on the external environment. In the latter case the size of the economy will have tripled by 2024.

Opportunities for FDI

FDI will increase substantially. Historically, accessions have almost always been accompanied by robust increases in foreign direct investments, especially in the past twenty years. The Central European example shows that the flow can start well ahead of accession. We project an annual FDI-flow of EUR 4.4 billion in the pre-accession phase. In the post-accession decade, the total average FDI flows are projected to be around EUR 11 to 14 billion per year. Until 2014, the flows from the Netherlands will be around EUR 0.3 billion per year and will add up to EUR 3 billion. If the Netherlands maintains its current share of around 7.5%, the Dutch FDI flows in the post accession decade will total EUR 9 to 11 billion.

Opportunities for trade

In each of the previous accessions the openness to trade increased considerably. Trade volumes at least doubled and in some cases tripled within a decade. Generally, there is a shift towards intra-EU trade. For Turkey, trade is set to rise fast. Although it already has a customs union with the EU since 1996, in practice there is still room for improvement. Also, an increase in FDI flows from their low levels will spur trade. Total Turkish trade – imports and exports - is projected to grow by 150% until accession compared to its 2003 trade level, reaching an annual level of EUR 239 billion in 2013. An increasing share of total trade will be with the EU, with annual Turkish imports from the EU increasing to EUR 86 billion in 2013. After accession, trade will continue to grow and intensify its focus on the EU. Annual imports from the EU may amount to EUR 167 - 190 billion in 2024, depending on the external environment.

Opportunities for the Netherlands

In almost every example of previous accessions, the Netherlands increased its share of total EU exports to new members. If we in spite of this observation take the conservative assumption that its market share will remain stable, Dutch exports to Turkey would grow to a level of EUR 5.2 billion in 2013, compared to EUR 1.9 billion in 2003. Ten years after projected accession, export levels would amount to EUR 10 to 11 billion according to the different scenarios. However, if we take past experience as a guide, Dutch exports to Turkey may surprise on the upside….

Introduction

For a long period now, Turkey has been looking more to the West than to the East. In 1928, five years after the establishment of the Republic of Turkey, its founder, Mustafa Kemal Atatürk, replaced the Arabic script for the Latin. In 1948, Turkey became the first Islamic country with a parliamentary democracy. In 1963, 40 years after its founding, the Republic expressed its interest in becoming part of the recently established European Economic Community. Now, as another 41 years have lapsed, there is considerable likelihood that the European Union leaders, at the Summit this December, will decide to start the accession negotiations. The long-held ambition of further integration with the EU is within reach. Furthering economic integration will be a key component of the whole project.

In several respects, the Turkish economy already bears similarities to that of the EU. It has a relatively well functioning market economy, with several competitive advantages in international trade, and its economic laws and institutions are comparable to those of the EU. But it requires no expert to spot the differences: the Turkish track record of macroeconomic stability has been notoriously poor. And the level of economic development is far below the EU; in 2002 the Turkish per capita income (corrected for price differences) was only 26.8% of the level in the Netherlands.

At the EU's Copenhagen summit in December 2002, Turkey was offered a tangible perspective: if it demonstrated full commitment to the political principles of the EU, it would receive an invitation to start EU membership negotiations by the end of 2004. On a parallel track, since 2001, Turkey has been engineering and executing a thorough economic reform programme with the help of the IMF. The program was designed in particular to break with several adverse practices of the past. The political and economic changes recorded over the past two or three years have been striking and surprising to observers from all corners.

This study itself can be seen as a testimony to the shifting paradigm. Just a few years ago, most Europeans would not have expected Turkey to join the EU within the next generation. Now the start of the Turkish EU accession process in 2005 has become a realistic proposition.

Comparative and dynamic research approach

This report will evaluate the economics dynamics that Turkey could experience in the period ahead, given an accession scenario. The study will focus in particular on developments in trade and investment. It will not address the subject of migration. Also excluded are the costs to the EU in the form of transfers. There are other studies that focus on this issue.

Experience from Central Europe and earlier EU candidates shows that EU accession processes are associated with profound economic transformation. Countries tend to modernise and their economies tend to become more open to the outside world. This report will analyse the lessons from past EU accession processes and will assess theirrelevance to the case of Turkey. Thus the study will take a comparative approach, which is suitable in exploring the matter in question. It can incorporate the dynamic changes that will take place, including ‘virtuous circles’ and critical mass effects (e.g. once investors come, they come in packs). And it can capture relevant developments, even when they may not be directly linked to EU accession.

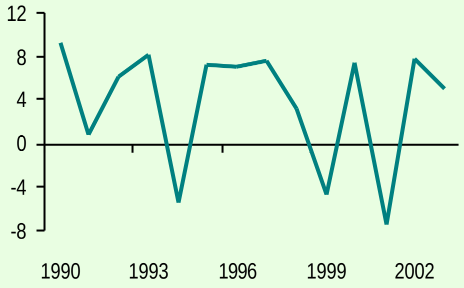
A number of studies have already been carried out on the impact that the EU-accession process would have on the Turkish economy and its links to the outside world. Noteworthy in this respect is the study carried out by the Dutch Bureau for Policy Analysis (CPB) that was published in April 2004. This report by ABN AMRO can be seen as complementary to other studies.

This analysis was written from the perspective of a Turkey that is progressively adopting policies to align itself with the EU, in tandem with further improving macroeconomic stability; we will assume –without making any actual forecast- that ten years from now, the country will become member of the European Union. Clearly, other scenarios are possible. A confidence crisis could develop, possibly followed by a cooling or freezing of the accession plans. We will not elaborate on such scenarios and assume reform continuity and absence of new economic crises. This does not mean that such achievements come naturally. Turkey has a massive reform agenda ahead of it and its success in pursuing this course will be the determining factor in whether or not its economic promises are fulfilled.

Chapter 1

Challenges... for Turkey today

GDP-growth
% y-o-y



Source: EIU

Copenhagen economic critaria

At its summit in Copenhagen in 1993, the EU formulated criteria with which future members must comply in order to join the Union. In the economic domain, the two main criteria are:

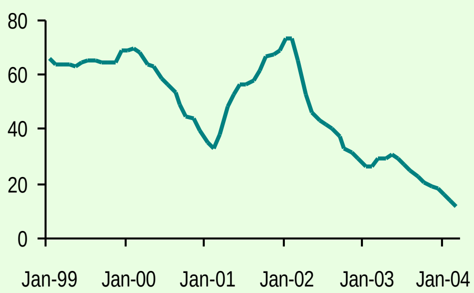
- *The existence of a functioning market economy*
  This covers such issues as macro-economic stability, the role of government in the private sector and the quality of the banking system

- *The capacity to cope with competitive pressure and market forces within the Union*
  This covers the quality and flexibility of human capital, education, infrastructure and other factors determining competitiveness.

For the latest assessment of Turkey see box on the next page.

Note that the Copenhagen economic criteria must be met at the time of accession, not at the start of negotiations.

Turkish consumer price inflation
% y-o-y



Source: EIU

This chapter examines the current situation and trends in the Turkish economy. Macroeconomic factors will first be assessed, followed by a description of the structural aspects of the economy. It will become clear that economic conditions have improved considerably in the past years and that the economy is marked by notably weak but also by notably strong characteristics. At the end of the chapter we look ahead to the forces that may be unleashed by a favourable EU decision in December.

Macro economic overview

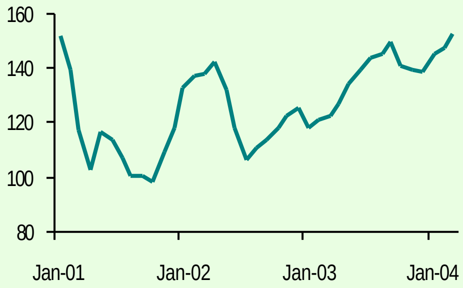
In the 1990s, Turkey's economic performance was very volatile. No less than three economic crises have been recorded over the past 10 years. Turkey used to be a medium indebted country but became a highly indebted country after the 2001 crisis required large government-funded injections in the banking sector. Both external debt and sovereign debt are high, and are a considerable burden to the economy and can be considered as a mortgage on future economic developments. Inflation has been very high for many years, but is now declining. In early 2002, an IMF-sponsored reform program was launched. Considerable commitment to this program by the previous and current government has resulted in a much-improved macroeconomic environment. Some vulnerabilities still remain, however, notably in the form of heavy debt servicing obligations and a fragile banking sector. The Turkish liberal capital account facilitates real and financial cross-border transactions, but is also associated with volatile currency movements. Turkey is the third largest receiver of remittances in the world according to the IMF. These amounted on average to USD 3.6 billion per annum from 1998 to 2003, or 1.9% of GDP. EU transfers to Turkey currently amount to approximately EUR 0.5 billion per year. Net IMF funding is drying up and Turkey is scheduled to become a net repayer to the IMF in the years to come.

Recent macroeconomic achievements

Government finance, which has been the major stumbling block in Turkey in recent years, is showing improved health. Notorious budgetary loopholes, through secondary institutions like (state) banks and off-budgetary institutions, have been closed under the IMF-supported reform program. The overall fiscal balance is adequately strong to put government finance on a sustainable path –provided the current policies remain in place. As a result, and coupled with economic recovery and declining inflation and interest rates, the net sovereign debt to GNP ratio has come down at a marked pace, from 91% at its peak in 2001 to 71% at the end of 2003. The level of debt is still a concern. At this level Turkey will remain vulnerable to shocks. Public debt will continue to put a drain on the resources of the government for some time to come.

A second major positive development is the reduction in inflation levels. Year-on-year producer price inflation fell below 10% in February 2004. This is the lowest level seen in over 30 years. Year on year consumer price inflation

Real effective exchange rate
1995=100



Source: Central Bank of Turkey

EC Conclusion in its 2003 Regular Report on the Copenhagen economic criteria

Turkey has significantly improved the functioning of its market economy. ...

Economic stability and predictability have increased with a continued decline in inflationary pressures, although these are still high, and the modernization of Turkey's market regulations and institutions. The positive effects of adopted and gradually implemented structural reforms have helped to withstand the effects of the Iraq crisis without a major economic setback. The independent regulatory and supervisory agencies played a crucial role in this respect. Financial sector surveillance has been strengthened and the base for modern foreign direct investment legislation has been laid. Transparency and efficiency of public finance management has been improved. ...

Source: EC Regular Report on Turkey 2003, p. 56 (recommendations omitted)

The impression arising from the European Commission assessment is that the current position of the Turkish economy is not unfavourable and that remaining obstacles can be reasonably overcome in the years, ahead provided reforms continue.

was 10.2% in April 2004 and set to move to single digit level in May 2004. The reason behind the disinflation trend again lies with measures adopted under the IMF-agreed reform program, notably the fiscal stringency along with measures taken in 2002 to enhance the independence of the central bank, focus its policies on achieving price stability and prohibit money printing for the government. The improved confidence that inflation will soon be brought under control has prompted the Turkish authorities to decide that six digits will be scrapped from the Turkish lira as of 1 January 2005. By that time, one Euro will purchase less than two liras. For the record, this does not constitute a re- or devaluation but rather a change in denomination.

In line with declining inflation, domestic interest rates are coming down. The yield on one-year treasury bills stood at just over 20% during April 2004. Real interest rates are still high, but no longer stand at the abnormal levels (10-30%) seen in 2001-2003. The dynamics in inflation and sovereign debt have been supported by the strengthening trend of the lira. The real effective value of the currency (adjusted for inflation and trade-weighted) is now comparable to the level at the onset of the currency collapse in February 2001. This is reason for some concern, but recent developments in exports and in the current account suggest that Turkish competitiveness has not suffered.

Remaining macroeconomic challenges

Several macroeconomic aspects continue to be weak and are hindering the country's economic progress:

- Sovereign debt is still high and characterised by a short maturity profile and high real interest cost. Private sector borrowing is being crowded out by the government's financing requirement. The drain on government finance leaves little room for much-needed state investment in priority areas such as infrastructure and education.
- High external indebtedness introduces vulnerability and unpredictability in the economic climate. Turkey's debt/export ratio is around two, which is at the threshold of remaining acceptable. External debt poses a considerable burden as long as the debt ratio does not come down markedly. The best way out of this situation is the continuation of the current export growth.
- Inflation is declining, but remains high, which distorts economic performance and limits planning horizons.
- The exchange rate is showing signs of overvaluation as of April 2004. Policy continuity is the main factor that will prevent the return of excessive volatility
- The IMF stand-by program will end in early 2005. The programme has been effective in reminding the government of the need for fiscal austerity. Continued IMF involvement after 2004 would offer safeguards to fiscal policy continuity and would help to prevent the return of market uncertainties. The challenge for the authorities is to find a formula of renewed cooperation, reflecting the reduced financial reliance on the Fund while recognising the assistance it may offer.

Structural overview

Turkey has a relatively well functioning, diverse market economy, with a large share of industry and services. The country also has a dynamic private sector. The relatively high proportion of newly established companies (entries amount to about 10% of the existing volume of companies each year) is evidence of low market entry barriers and a dynamic entrepreneurial sector. Attracting funding is a major problem for many companies, however.

The economy is known for its flexibility. It is relatively easy to lay off redundant workers in the private sector and wages and prices adjust swiftly, allowing businesses to quickly adapt to changing circumstances. In many respects, the Turkish economy is vibrant and adaptable, especially in comparison to certain countries in the EU.

But Turkey also has a number of notorious structural obstacles. The banking sector is weak and does not adequately play its intermediation role in the economy and the government still plays a significant role (which it is seeking to reduce). The taxation structure frustrates the business sector and lack of direct tax revenue prevents the government from assuming an accommodative role in the economy. The informal sector is significant.

In the 2003 Corruption Perceptions Index drawn up by Transparency International Turkey scored poorly at 3.1 out of 10. This is worse than the 2004 accession candidates (Poland received the lowest score at 3.6) but comparable to Romania and Bulgaria. Although it is difficult to make a precise estimation, the broad impression is that corruption is indeed a problem, although not much worse than in Central Europe. As Turkey approaches EU membership, the level of corruption can be expected to decline, which is positive for economic growth. For instance, if corruption would reach a level comparable to Portugal, it is estimated aggregate trade could more than double[1].

The State of the Economy
Selected aspects

Strengths

- Macro-economic reform momentum
- Favourable economic cycle
- Dynamic private sector
- Improving legal framework for businesses
- Turkish people abroad provide transfers
- Sizeable domestic market
- EU accession negotiations outlook already supports business confidence

Weaknesses

- High foreign and sovereign debt
- High inflation
- Small inflow of foreign direct investment
- Embedded economic volatility
- Taxation structure frustrates business
- Large government presence in various sectors
- Large regional income disparities

Reaching its Economic Potential
Policy issues for the Turkish government

Policy Opportunities

- Privatisation will bring in foreign investors
- Continued macro-reform will boost confidence, lift country credit ratings, ease financing constraints
- Start of accession negotiations can be marketed to attract and facilitate FDI flow
- Renewed co-operation with IMF after 2004

Policy challenges and risks

- Maintain economic stability through consistent policies
- Reduce sovereign debt while controlling overall foreign debt level
- Bring inflation under control
- Guide adjustments in banking sector
- Reform tax and pension systems
- Reduce government presence in various sectors
- Address regional income disparities
- Combat corruption

Structural issues

Structural progress has been impressive than the recent macroeconomic achievements. Progress has mainly been booked in the legal and institutional spheres and has been slower in specific areas such as banking and energy, and in taxation and pension reform.

Privatisation starting to make progress
State enterprises are still key players in some sectors, such as banking, energy and basic industries. They account for about 5% of GDP and about 19% of the value added in the manufacturing sector. State banks generate around 1% of GDP, but make up nearly one third of the value added in the banking sector. The management of those entities is improving but they often continue to be overstaffed and inefficient. Since the start of privatisation in 1985, total privatisation receipts amounted to only USD 4.7 billion. The new government has breathed new life into the privatisation process and

[1] CPB Netherlands Bureau for Economic Policy Analysis (2004), *Assessing the economic implications of Turkish accession to the EU*

has put key state enterprises, such as Turk Telecom, the Istanbul Stock Exchange, Petkim, Turkish Airlines and the National Lottery on its 'for sale' list. Actual progress has already been made. The oil refiner Tupras is being sold to a Turkish-Russian joint venture, and is awaiting the step of final payment of approximately EUR 1.1 billion. There is serious foreign interest in TEKEL, the tobacco and beverage monopoly, which may be sold later this year for an estimated EUR 1.2 billion to 1.6 billion. Market players and official observers such as the IMF anticipate that this time round, the process will remain on track. This remains to be seen, however, and experience in Turkey and elsewhere dictates it is best to be cautious. If indeed privatisation proceeds as planned, it will have notable secondary effects. These include reducing the sovereign debt stock, triggering additional economic activities, enhancing the presence of foreign investors, helping finance the current account deficit and supporting market confidence.

Progress is being made on legal framework for accommodating FDI inflows
A framework law on foreign direct investment was adopted on 17 June 2003, which simplifies bureaucratic requirements and reduces the number of procedures involved in the registration of a new company. Furthermore, a bill was submitted to parliament in April 2004, which will grant large foreign investment projects a 10-year exemption for income tax. The Execution and Bankruptcy Act was amended in 2003 to facilitate the closure of non-viable companies. Thus, the laws for accommodating FDI are broadly in place. However, obstacles remain with respect to putting the legal changes into practice. The time lag between the adoption of legislation and its actual implementation continues, at times, to be long. Staffing and training of legal personnel is being addressed but evidently will take time to show its impact. Further improving these aspects will require a sustained effort in the years to come.

Banking sector weak and ineffective
Major improvements to the banking sector have been made since the 2001 financial crisis. The system has received a large capital injection, its short position in hard currency has been neutralised and a total of 20 problematic banks have been closed or merged with other banks. Still, not all is well in the sector. Two-thirds of banks' assets consist of Turkish government exposure (representing 37% of GDP in late 2003), whereas any share in government assets exceeding 30% is usually considered on the high side. For decades, Turkish banks have lived off the interest differential between client deposits and credits issued to the government. Financial sector intermediation in the private sector remains below standard, at 13% of GDP in late 2003. Offshore banking activity must also be taken into account, which is concentrated on wholesale lending in Turkey and which could be of similar magnitude as domestic lending to the private sector.

As the economic environment normalises (single-digit inflation, a reduction in the government funding requirement and lower real interest rates), the banking sector will shift to private sector lending. At the same time, banks will move from a focus on hard currency business towards more TRL-denominated activities. These changes will take substantial time to materialise however and could involve substantial creative destruction. An additional obstacle is that taxation on bank intermediation remains high and distortionary, and therefore needs to be addressed in order to facilitate financial deepening. In general intermediation costs remain high, in part because of limited efficiency. In addition, the capital adequacy of several banks remains questionable, despite the official picture. Plans to privatise two main state-run banks (Halk and Vakif) have been announced but the process remains at an early stage.

Tax structure outdated

The lack of direct tax revenue is a barrier to further economic development. With direct taxes only representing 30% of total revenues (compared to 70% in the EU), Turkey is relying heavily on indirect taxes (VAT, tariffs), which overtax some while undertaxing others. Taxes are high for such things as car purchases, fuel and telephone charges, which particularly impacts enterprises and investors. In order to unleash Turkey's economic potential, the taxation structure requires a major overhaul. Reforms in this area have yet to get off the ground.

Turkish bond spread*

Over US treasury bonds, in basis points

* This represents the difference between interest on Turkish bonds denominated in USD and on US treasury bonds. Spreads are often used as a measure of country risk. A spread in excess of 1000 bp (=10%-points) signals an imminent threat of government payment difficulties.

Source: Datastream / JP Morgan

Pension system unreformed and draining government finance

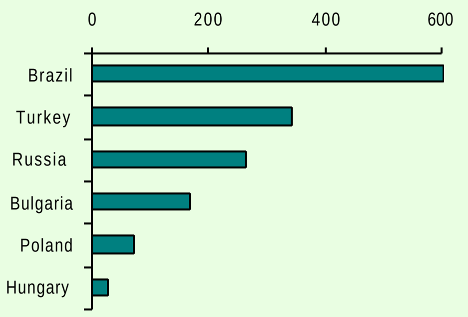
The pension system is running a deficit of 4.5% of GDP. Pensions are quite generous, with pension spending at 9% of GDP against 5% in premium collections. Pension reform should reduce the state role and will help raise the economy's savings rate. This area, too, so far remains unreformed.

Large informal sector

Much of the country's economic activity takes place in the informal sector, which is estimated to be large in Turkey, representing 20-50% of the registered economy. This sometimes creates a non-level playing field, where certain companies find themselves competing against others that are not paying taxes and that do not comply with official regulations.

Bond spreads

Selected countries, values 26 April 2004



Source: Datastream / JP Morgan

Large regional economic disparities

There are large regional disparities in economic development. One particular case concerns the poorer (south) eastern parts of the country that are mainly populated by Kurds, which represent 20% of the total population. The difficult political situation in these regions has restricted economic progress. Should there be a sustained improvement, previous barriers to regional development will be removed with potentially significant positive economic implications.

Starting EU accession negotiations

The decision to start negotiations is expected to have a considerable short-term economic impact. The decision is sometimes referred to as a 'letter of guarantee' from the European Union. Business attitudes will swing towards the positive in what may be qualified as a credibility shock. Turkey will be seen as a different country and the business focus will shift from risks to opportunities.

Immediately thereafter, interest risk premiums are set to contract, the currency will strengthen, and the stock exchange will correct upwards. These effects could already become apparent in the run-up to the decision - depending on its pre-cooked nature. In fact, there are already some signs of anticipation; favourable market developments in early 2004 can be partly attributed to EU-related factors such as supporting statements from the German Chancellor and the Turkish support for resolution of the Cyprus issue. The process of improving creditworthiness appears to be already underway, given that Standard & Poor's and Fitch have upgraded the country since mid-2003. Still, as of April 2004, all main credit rating agencies rank Turkey at single-B level, which signifies a high degree of country risk. The formal start of EU accession negotiations, and possibly their anticipation, is likely to prompt the agencies to upgrade their Turkish credit rating to a more acceptable double-B. Every EU candidate country has seen its credit standing improve, which offers powerful economic advantages. Investor confidence is boosted and funding becomes more readily available, which positively affects the economic climate and facilitates higher levels of economic growth.

The shock-wise nature of the new EU perspective may actually confront the Turkish authorities with new economic challenges, e.g. in the form of large and potentially destabilising capital inflows and a marked deterioration in the current account balance. The economic impact of the Turkey decision in December may offer an interesting contrast to the impact of the recent 1 May enlargement, which is widely seen as a non-major economic happening. The alternative scenario must also be noted, in which the decision is unfavourable. This too, could have a major impact. The short-term reaction of the markets will likely be very negative. The Turkish commitment to maintaining its momentum on reforms could be negatively affected. In the longer run, the economic and political consequences of a break in the EU accession process are difficult to foresee. In a broader context, Turkey's pro-western course has been the cornerstone of foreign policy since Atatürk – and thus pre-dates the entire European integration process. This Western orientation is also anchored in tight links to NATO and the US and finds broad popular support among the population.

Conclusion

Turkey's economy has been moving towards increased stability and predictability. Although this can be only indirectly linked to its EU accession ambitions, it offers a favourable basis for accession negotiations. However, stability remains tentative. Vulnerabilities and obstacles to growth are still present and additional and enduring reform efforts are required to sustain the current positive trend.

From a structural viewpoint the Turkish economy is in a relatively solid position for European Union rapprochement. No major systemic overhaul is as was the case in Central and Eastern Europe. In most areas, a gradual but steady improvement of the functioning of its institutions will be adequate to prepare the country for membership. During the severe budget constraints imposed in recent years, government investment in infrastructure and education has been very low. The government must take a more active role to facilitate the anticipated broad -based economic development. In order to make this possible, an overhaul of the tax system and pension reform are also required. The banking sector is a separate issue. It will be confronted with major changes as it adapts to the new, low-interest environment. Balance sheets remain weak and the sector will not function effectively for some time. However, the entry of foreign players could jump-start the required developments.

All these factors are to be addressed in the period ahead as Turkey proceeds towards EU membership. The overarching macroeconomic problems can be reasonably overcome, or at least reduced to more acceptable levels within a few years – provided the government maintains its current efforts. The structural obstacles are likely to take longer before satisfactory outcomes are achieved.

The apparent break in the macroeconomic trend suggests that Turkey's future economic growth performance will move closer to its potential growth rate (this will be discussed in the next chapter). This trend will be further boosted by the fact that conditions for Foreign Direct Investment are increasingly in place. If the economy is managed well and privatisation is encouraged, substantial FDI could start to flow soon.

The decision to start negotiations is expected to have a considerable short-term economic impact. A credibility shock will occur and business focus will shift from risk to opportunities.

Chapter 2

Opportunities… for growth

GDP per capita

% of EU-15 average in year of accession

	Current EUR	EUR, PPS
Ireland ('73)	59.0	62.6
Greece ('81)	51.6	78.2
Portugal ('86)	31.1	55.5
Spain ('86)	55.2	71.8
AC10* ('04)	24.0	49.0
PM		
Turkey ('04)	12.9	24.9
AC10* ('94)	15.2	39.8

*10 countries that acceded in May 2004

Source: European Commission

Per capita GDP growth before and after EU accession

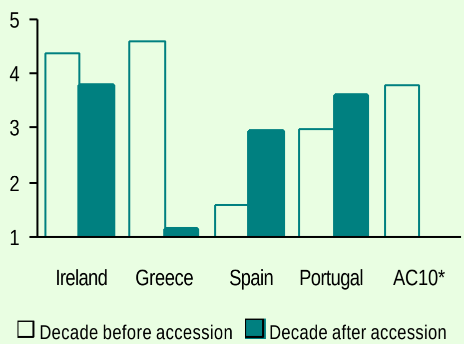
(EU growth between brackets)

	< decade	decade >
Ireland ('73)	3.7 (3.9)	2.4 (1.6)
Greece ('81)	3.6 (2.5)	0.7 (2.3)
Spain ('86)	0.8 (2.0)	2.7 (1.9)
Portugal ('86)	2.0 (2.0)	3.6 (1.9)
AC10 ('04)	4.3 (1.6)	n.a.

Source: European Commission, calculations ABN AMRO

Average GDP growth

% y-o-y

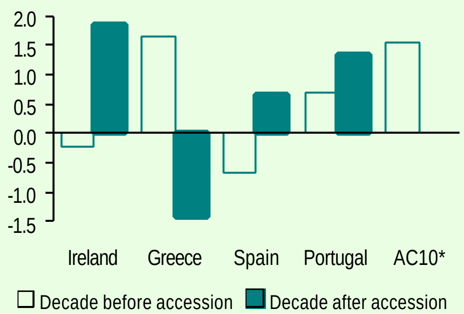


* Only decade before accession

Source: European Commission, calculations ABN AMRO

Average GDP growth differential with EU15

% y-o-y



* Only decade before accession

Source: European Commission, calculations ABN AMRO

This chapter will arrive at a long-term projection for GDP growth in Turkey. Earlier accession experiences will be assessed, to learn more about the possible economic dynamics up to and after EU-accession. They can also be used as a reference for future Turkish performance. Past experience of Turkey itself provides another approach. The historical trend growth was realised in the presence of obstacles. Taking part of these away in the future will add to economic growth. As Turkey is no island, the external environment also plays an important role in how the economy fares. Therefore, we introduce two external scenarios. Ultimately, economic trend growth cannot be higher than potential. This 'maximum speed' of the economy will be calculated by demographic trends and assumed labour participation and productivity potential.

Earlier accession experiences

In order to learn from the experience of earlier EU accessions, one must bear in mind that every country is unique. Comparisons can therefore only go so far. Environmental factors vary, such as the economic climate at the time of accession and international rules and regulations. The initial economic position of countries varies, as well as domestic policies. Few will dispute that EU accession affects economic performance, but the effect is difficult to isolate. Taking this in account however, previous experiences can still offer valuable insights.

For one thing, it is helpful to analyse countries that more or less compare to Turkey regarding the relatively low standard of living compared to the EU average. Several times in the past, the EU has been enlarged to include poorer countries. This was the case for Ireland in 1973, Greece in 1981 and Portugal and Spain in 1986. And the 10 countries that joined the EU in May 2004 (referred to as Accession-10 or AC10) also lag behind in terms of income. In order to create a fair comparison, a second factor must be taken into account. Economic growth among new member states will partly depend on the international economic cycle. To more accurately assess performance, one can use a benchmark. This will make it is easier to evaluate whether, for instance, economic growth of 3.5% is a major achievement or quite the opposite. In this report, the group of countries that currently make up the EU15 will be used to gauge the relative performance of new member states before and after accession.

As a percentage of per capita GDP at the time of accession, so far Portugal (in 1986) and the 10 new members (May 2004) are the poorest. Turkey still lags behind in per capita income (see table at left). Assuming that Turkey accedes ten years from now, a further convergence of income levels is possible before it joins the EU. However, Turkey may already be further than these figures suggest. The conversion of the national accounts to the European ESA 95 method – planned to be introduced by 2005 – might increase the GDP figure considerably. Another factor causing

GDP growth in the decade before and after EU accession
(EU growth between brackets)

	< decade	Decade >
Ireland ('73)	4.4 (4.6)	3.8 (1.9)
Greece ('81)	4.6 (3.0)	1.2 (2.6)
Spain ('86)	1.6 (2.3)	2.9 (2.3)
Portugal ('86)	3.0 (2.3)	3.6 (2.3)
AC10 ('04)	3.8 (2.2)	n.a.

Source: European Commission, calculations ABN AMRO

Labour productivity growth before and after accession
(GDP per worker, EU growth between brackets)

	< decade	decade >
Ireland ('73)	4.4 (4.4)	3.2 (1.9)
Greece ('81)	3.9 (2.6)	0.9 (1.8)
Spain ('86)	3.2 (2.1)	1.4 (1.8)
Portugal ('86)	3.3 (2.1)	2.9 (1.8)
AC10 ('04)*	3.3 (1.2)*	n.a.

** Data starting in 1995*

Source: European Commission, calculations ABN AMRO

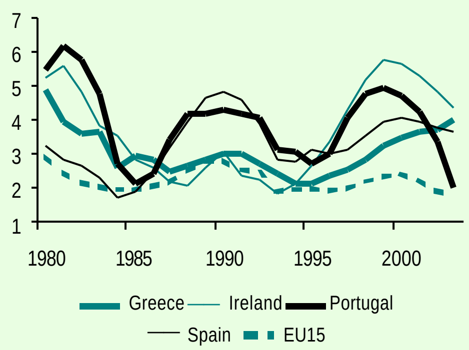
Employment growth before and after accession
(number of workers, EU growth between brackets)

	< decade	decade >
Ireland ('73)	-0.1 (0.3)	0.5 (0.0)
Greece ('81)	0.7 (0.4)	0.3 (0.8)
Spain ('86)	-1.5 (0.1)	1.6 (0.5)
Portugal ('86)	-0.3 (0.1)	0.7 (0.5)
AC10 ('04)*	-0.2 (1.0)*	n.a.

** Data starting in 1995*

Source: European Commission, calculations ABN AMRO

Growth net capital stock
% y-o-y



Source: European Commission, calculations ABN AMRO

underestimation of Turkish GDP is the relatively large size of the informal economy.

GDP growth before accession
Experience reveals that an economic growth spurt can start well before EU accession, but this is not always the case. Greece and the 'AC-10' clearly outperformed the EU15 in the decade before joining the EU, both by a GDP growth differential of 1.6%. Measured in GDP per capita, the Greek caught up 1% and the new members as much as 2%. Portugal's GDP outperformance of 0.7% vanishes when population growth is taken into account. During the pre-accession decade, income levels in Spain and Ireland actually failed to keep pace with the benchmark EU15.

Zooming in on the 10 accession countries (AC10), we learn that they posted a remarkable per capita GDP growth of 4.3% over the last decade, against 1.6% in the EU15. As a group, this performance stands out, but the performance of certain individual countries is even more remarkable. Average GDP growth among the Baltic states was 6% per year. The fact that they were 'catching up' is an important explanation for this, as this trio was the poorest of the AC10 in 1994. As a percentage of the EU average, income per capita (EUR, PPS) stood at 26 to 30%. The initial starting position actually seems to be an important determinant of future growth, as the graph on the next page shows. From this perspective, economic growth in the pre-accession phase looks promising in Turkey, whose per capita income stands at 25% of the EU average in 2004.

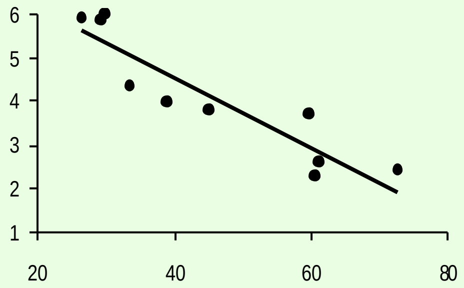
In all cases[2], labour productivity (GDP per worker) growth was higher than in the EU15. Employment growth, however, was negative across the board (except for Greece), in contrast to the EU15. The necessary economic adjustment process can explain this labour market divergence in the pre-accession phase. In order to be able to cope with competition from the EU, production must become more efficient. Productivity can be enhanced by laying off redundant workers.

GDP growth after accession
With the exception of Greece, the accession of less wealthy countries has proved successful in terms of post-accession GDP growth, especially in the first five years. On average, Ireland grew 2.0% faster than the EU15 in that period. For Spain and Portugal the differentials are 1.3% and 2.3% respectively. In the five years thereafter, only Ireland could keep up a similar pace, while Spain and Portugal fell back to growth levels close to the EU average. Still, with the exception of Greece, all new member states outperformed the benchmark regarding per capita GDP growth in the decade after accession (see table). In Spain employment growth stood out, in Portugal labour productivity and in Ireland both. The outperformance continued after the first ten years. Irish GDP has recorded an average real growth differential of 2.9%-point per year over the last 30 years. Portugal and Spain were also growing in high gear compared to the EU15. In the 17 years

[2] Employment and labour productivity figures for the 10 new member countries start in 1995.

GDP per capita and economic growth in AC10

% y-o-y



- The horizontal axis depicts the GDP per capita in 1994 as a percentage of the EU15 average (current EUR, PPS)
- The vertical axis represents the average economic growth in the period 1994-2004

R= -0.91, R-squared = 0.84.

Source: European Commission, calculations ABN AMRO

GDP per capita and economic growth in AC10

	Per capita GDP relative to EU15 in 1994 (EUR, PPS)	Average economic growth 1994-2004
Estonia	29.9	6.0
Latvia	26.5	5.9
Lithuania	29.4	5.9
Poland	33.4	4.3
Slovakia	38.9	4.0
Hungary	45.0	3.8
Slovenia	59.9	3.7
Czech Rep.	60.7	2.3
Malta	61.0	2.6
Cyprus	72.7	2.4

Source: European Commission, calculations ABN AMRO

EU cash flows as % GDP, 1990-2000

	Agricultural-subsidies	Structural funds and other	Total
Ireland	2.09	3.19	5.28
Greece	2.79	2.24	5.03
Portugal	0.66	2.98	3.64
Spain	0.88	1.01	1.89
AC10, estimate 2004-2006	0.81	0.98	1.79*

* 1.6-2.0, depending on success in utilisation of project funds.

Source: WIIW, Eurostat, calculations ABN AMRO

since accession, Spain and Portugal beat their benchmark by 0.9% and 1.0% per year, respectively.

However, alongside these success stories, there is underperformer Greece that acceded in 1981. In the 10 years following accession, economic growth in Greece failed to keep pace with the other 14 countries. The outperformance of the pre-accession decade was negated by an economic growth differential of -1.7% in the ten-year period after accession. Part of this 'Greek tragedy' was reversed afterwards, but not all of it. On average, in the 22 years of membership, the differential has remained negative (-0.3%), stemming from both lagging employment and productivity growth. Double-digit budget deficits, inflation at around 20% and corruption certainly have not helped support growth[3].

Capital stock growth

Both in the decade before and the decade after accession, the net capital stock of these four new members has grown faster than in the EU15, by between 1.0% in case of Spain and 1.9% in case of Greece (see graph previous page). A reason for this high growth may be the initially high capital productivity, which renders investment in capital attractive. Over time, the boom in net capital stock has pushed capital productivity down, closer to the EU average. Of course, these investments have been supportive to growth. Another way of looking at the role of investment is to gauge the contribution of gross fixed capital formation to GDP growth. Noteworthy is that in the twenty years around accession, the contribution of gross fixed capital formation was highest in the countries with the best economic performance: Ireland and Portugal.

Domestic and external demand

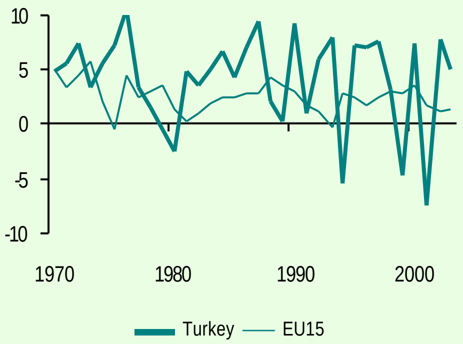
Now let us take a look at the role of domestic demand and the external sector. In all new member states, the contribution of the external sector to GDP growth was negative - both in the decade before and after accession. It means that the volume of imports grew faster than the volume of exports. This is a typical thing for fast growing economies, because domestic demand rises faster than external demand. All countries - bar Greece - have a higher growth contribution of domestic demand than the EU15 the twenty years around joining the union. One of the underlying reasons is that investment and consumption gain less restricted access to (foreign) capital. The availability of foreign capital translates into additional imports.

EU-funds

For relatively poor countries, joining the European Union has the benefit of financial aid. EU commitments range from structural and cohesion funds to the field of agriculture and have added up to substantial amounts in the past. During the 90s, Ireland and Greece received transfers worth 5% of GDP (see table). Those days are over now, however. The 10 accession countries can realistically expect anything between 1.6 and 2% of GDP in the next few years (formally EU-structural fund transfers are limited to 4% of GDP). Translated

[3] Note that new members must meet the Kopenhagen criteria, among which is the rule of law.

GDP growth
% y-o-y



Source: European Commission, calculations ABN AMRO

Turkish historical economic growth and components
(EU15 figures between brackets)

	GDP growth	Growth number of workers	Labour productivity
1970-1980	4.1 (3.0)	1.8 (0.4)	2.2 (2.6)
1980-1990	5.2 (2.4)	1.5 (0.7)	3.6 (1.7)
1990-2000	3.6 (2.1)	1.1 (0.5)	2.5 (1.7)
1970-2003	4.0 (2.4)	1.3 (0.5)	2.6 (1.9)

Source: European Commission, calculations ABN AMRO

Economic growth projections by others

	Period	Average growth
Short term		
IMF	2004	5.0%
OECD	2004-2005	5.1%
Consensus forecasts	2004-2005	4.8%
Development plan government	2004-2006	5.1%
EIU	2004-2005	2.8%
Oxford Economic Forecasting	2004-2005	4.8%
Medium/long term		
EIU	2006-2008	4.5%
Oxford Economic Forecasting	2006-2013	4.8%
McKinsey	2005-2015	8.5%

to the Turkish situation in 2003 this would imply an inflow of transfers of EUR 3.4 –4.3 billion per year (prices 2003).

Final remarks

In short, we have experienced pre-accession phases in the past that were characterised by a catch up in labour productivity, combined with a decline in employment, albeit modest in most cases. The post-accession phase shows that countries have outgrown the EU considerably on a sustained basis, with the exception of Greece. Ireland has been the most notable example, outgrowing the EU by 2.9% annually over the past 30 years. To put it shortly, the economic growth difference can stem from employment growth (Spain), labour productivity (Portugal) or both (Ireland).

Historical GDP growth in Turkey

Now let us take a closer look at Turkey's past. As described earlier, the macro economic environment has not always supported a sustained trend of stable high growth. Still, in the long term, economic growth has been considerably higher compared to the EU15.

Since 1970, the growth differential with the EU has amounted to 1.7% per year. Turkey's economy boomed, especially during the 1980s, outpacing the EU by 2.8% on average. With only one party in government, Prime Minister Özal was able to push through reforms and open up the economy. This clearly resulted in economic benefits. During the crisis-prone 1990s the growth difference amounted to a 'mere' 1.5%. Historically, 4% to 5% economic growth is actually quite normal for Turkey in the absence of crises.

Turkish growth forecasts by other institutions

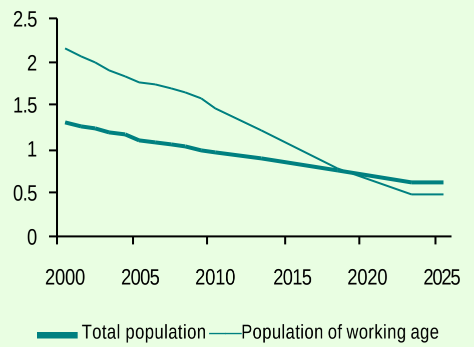
Various organisations provide projections for economic growth, using different time horizons. There seems to be a consensus that the economy will grow by about 5% in this year and next (growth rates are in real terms). The government's economic plan – as established in the standby agreement with the IMF – assumes a 5.1% growth rate from this year until 2006. The only deviation in the short term is the Economist Intelligence Unit (EIU) that predicts an average growth of only 2.8% in the period 2004-2005 and 4.5% in the three years thereafter. Oxford Economic Forecasting and McKinsey provide longer-term projections. For the period up to 2013, OEF estimates an average growth rate of just under 5%. For the decade starting in 2005, McKinsey[4] estimates a more bullish growth of 8.5% per annum, assuming economic reforms are implemented, including a reduction of the informal economy, liberalisation of utilities within a robust regulatory and judicial framework and macroeconomic stability.

Potential economic growth in Turkey

In order to estimate GDP growth in the long run, one must assess both the supply and demand side of the economy. The supply side determines the

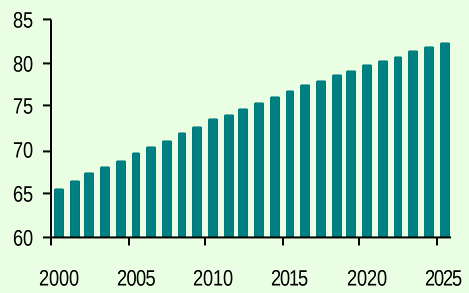
[4] McKinsey (2003), *Turkey, Making the productivity and growth breakthrough*

Population growth Turkey
% y-o-y



Source: US Census International Database

Population projection Turkey
Millions of persons



Source: US Census International Database

potential growth of the economy – or 'speed limit'. Supply can only grow as fast as the growth of the available inputs and their potential productivity. Actual economic growth may lag potential because of market imperfections or when aggregate demand is not sufficient. This section now first focuses on potential output.

The ingredients of potential output

In the long run, the potential economic output is determined by the amount of inputs available and their potential productivity. One can simply calculate a GDP level by multiplying the number of workers by their average labour productivity. Potential output growth may stem from the growth of either factor. The number of workers may increase for demographic reasons or because of a hike in labour market participation. Labour productivity can increase due to technology advancements, more capital per worker or education. Let us examine the various aspects in Turkey.

Working age population. Unlike many European countries, Turkey's population is still growing (see graphs). The working age population is projected to grow by an average 1.0% in the period from 2005-2025[5]. The pace will be fastest in the coming years, with a growth of 1.7% between 2004-2010, and 1.2% in the five years thereafter. In 2014, the potential labour force will be 15.7% higher than in 2004. If we assume a constant employment rate, this means an additional 3.4 million workers – or around twice the workforce of Ireland.

Labour market participation. Currently, of the working age population (age 15-65 years) only 46.8% are actually employed, which compares to 67.2% in the EU15. In the early 1970s, the employment rate was well above 70% but it has gradually declined since. If this trend can be stopped, it alone would boost economic growth, all else remaining equal. A reversal of the trend would cause an even further increase. To illustrate the potential, imagine that Turkey's employment rate would, at some stage, equal the current EU employment rate. That would imply 44% extra employees – or 9.4 million workers – more than the number of workers in Greece and Portugal combined in 2003.

Informal economy. One of the reasons for the declining employment rate is the growth of the informal economy, which started to flourish along with urbanisation. With not enough work around, a large number of job seekers in the cities resorted to informal jobs. Because of the anaemic labour market, married women stayed at home. When this population segment still lived in the countryside, all their labour went towards the production of agricultural goods. Hence, urbanisation is an important explanation behind the declining labour participation. If the degree of informality can be reduced, this will add to both the official employment figure and GDP. McKinsey estimates the informal output at 20% of GDP. Formalisation will also allow for a larger direct tax base. This will not only help fill the government coffers, but it also allows for tax smoothing, meaning that the disturbing effects of taxes are diminished, which spurs economic growth.

[5] US Census Bureau, International Database

Labour productivity. In 2003, labour productivity measured in terms of GDP per worker, was only 34.8% of the EU average in current EUR, PPS. Labour productivity grew by 2.6% on average in Turkey from 1970 to 2003, against only 1.9% in the EU15. During the 1980s, labour productivity grew by up to 3.6% a year, more than double the EU rate of 1.7%. As stated earlier, EU accession can boost productivity growth. Turkey has already been able to outgrow EU labour productivity rates by significant percentages. It therefore seems reasonable to assume that Turkey can equal Portugal, which registered annual productivity growth of 3.4% in the two decades around accession (compared to 2.0% in the EU15). It should be relatively easy to outpace the EU in this respect. The four poor countries acceded during a different economic climate, but in the decade before and after accession all posted capital stock growth levels exceeding that of the EU (the average differential being 1.7%). Turkey could exceed this figure, as the level of capital is low. Its net capital stock per worker is roughly one-sixth of the EU average, which corresponds to about half the Portuguese level. In terms of capital per worker, Turkey's initial position actually compares well with that of Portugal 10 years before accession. Within twenty years, Portugal doubled that figure. As capital flows more freely nowadays, Turkey is in a good position to match Portugal's capital stock growth curve. Starting from a low level, growth should be easy to achieve and can greatly add to labour productivity. Note that net capital stock figures do not take into account the transfer of knowledge that is associated with incoming foreign direct investments. Viewed in this light, labour productivity growth similar to Portugal of around 3.5% seems to be well attainable and a figure between 4% and 5% within reach.

Potential growth estimate

If all the various elements are added up, the potential number of workers over the next 20 years is 79% higher than in 2004 (24% attributed to demographics and 44% to participation). Over the same time span the level of labour productivity can increase by 100 to 165% – assuming an average labour productivity growth of between 3.5% and 5%. The implication is that the size of the economy would increase by at least a factor 3.6 and could even rise five-fold. On a year-on-year basis, this means an estimated growth potential of 6.5% to 8%[6].

Demand side scenarios

An economic growth projection cannot ignore the demand side. Supply side factors may determine the 'speed limit', but without enough fuel (demand) the actual speed will be a lot slower. Reforms of market imperfections can act as a lubricant. We will briefly introduce two different (demand side) scenarios in our effort to forecast long-term economic growth. Both scenarios assume reform continuity in Turkey. The scenarios differ in levels of external demand – read EU economic growth – and structural EU policies:

---

[6] *The figure could be higher as there is no natural law preventing Turkey from having an employment rate that exceeds the EU average. However, we do not see this happening anytime soon.*

1. EU trend. In this scenario the EU is growing at a pace of 2% per year[7] and there is no major overhaul of economic policies in the EU.
2. Lisbon. This is a scenario whereby the short term is characterised by economic malaise (1% growth for five years), after which the economic reforms kick in that EU leaders committed themselves to at the Lisbon summit in 2000. This facilitates a higher growth path of the EU (3%).

In the EU trend scenario, EU markets grow at trend (conservatively estimated). In the alternative Lisbon scenario, the EU picks up speed, but likely with a slowdown in the first few years – the very slowdown that will trigger the reforms that lay the foundation for high future EU growth. Turkish exports will be able to grow faster, as export markets rapidly expand. From this perspective, the first scenario is preferable for the first five years, followed by the second. In an environment of slow EU growth, accelerating Turkish export growth is still possible by taking a bigger slice of the cake, which should be possible given EU membership. In addition, imports from Turkey depend on the external environment. After all, in order to export, a country needs to import such items as raw materials or capital goods. Turkish domestic demand remains the same under both scenarios. It will outpace European domestic demand, as seen in the earlier accession cases, because easier access to capital allows for consumption and investment growth.

Growth projection in the pre-accession phase

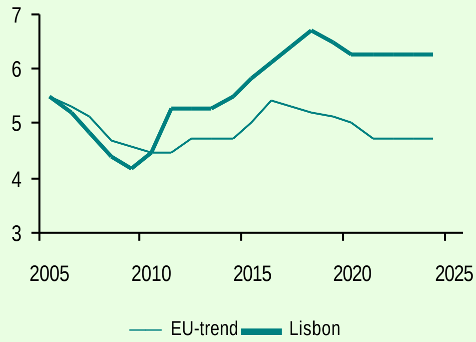
To arrive at possible outcomes for actual growth, both the supply and demand side come in play. As is evidenced by earlier accessions of relatively poor countries, a process of restructuring marks the pre-accession phase. Labour productivity typically accelerates as redundant staff is eliminated. Regardless of external demand, this is likely to occur in Turkey as well. Note that the working age population is set to grow fast in the coming years. Combined with declining employment, this implies a surge in unemployment. This phase will be critical and the government will be tested in its ability to persevere and stick to the reform process when things temporarily get ugly. Of course, the 'carrot' of EU membership is helpful here. An effect that will partly compensate for the lay-offs is the formalisation of the informal economy, which will add to the pool of (registered) jobs. Still, it will be a challenge to increase labour productivity without a loss of employment.

Assuming that the European Commission gives the green light to accession negotiations in December, an 'announcement effect' is to be expected. A resulting 'credibility shock' may mean inward foreign direct investment increases and financing conditions ease. In addition, Turkey is now in a favourable stage of the economic cycle. An extra impulse to economic growth in the next two to three years is to be expected.

Both scenarios start off with 5.5% economic growth in 2005, composed of 5% labour productivity and 0.5% employment growth. Based on the

[7] *Since 1970, average economic growth among the EU15 has amounted to 2.4%.*

Projected long term economic growth in Turkey
% y-o-y



Source: ABN AMRO

Macroeconomic stability and growth

Average Turkish economic growth since 1970 amounts to 4.0%. Note that the underlying growth pattern is very volatile, with year on year growth ranging from –7.5% to 10.5%: an economic roller coaster. Stabilisation of the growth path would boost average growth. One can see this from a micro economic viewpoint: the boom bust cycle involves capital destruction and upsets rational planning of economic individuals. For example, high inflation causes economic agents to focus on superior cash management, rather than being engaged in making real productivity gains. There is also empirical evidence from cross section country data. A recent working paper from the World Bank* shows a significant negative relationship between macroeconomic volatility and long-term economic growth. Depending on the method, one standard deviation of volatility is negatively correlated with a long-term per capita GDP growth rate of between 0.5% and 2.2% - too significant to ignore.

*Hnatkovska and Loayza (2003), '*Volatility and Growth', World bank macroeconomic and growth working papers*, nr. 3184

assumption that Turkey implements the necessary reforms over the coming decade, labour productivity growth will increase by 5% per year, regardless of the economic situation in the EU. However, the two scenarios diverge when it comes to employment. In the Lisbon scenario, the EU economy first stagnates until 2010, and weak demand for Turkish exports leads to job losses. To a lesser degree, jobs are also lost in the EU-trend scenario due to restructuring. Until 2010 projected growth is highest in the EU-trend scenario.

Over the next few years, the population can reap the rewards of reforms and restructuring efforts. Increased efficiency enables Turkey to gain market share in exports markets, adding to employment. Informal jobs are swapped for real jobs. This works against the restructuring effect on labour demand. On balance, employment growth is slightly positive in both scenarios. In the EU trend scenario labour productivity growth now starts to slow down to around 4¼%. As a result, GDP growth in the years prior to accession stands at 4¾% in the EU trend scenario and 5¼% in the Lisbon scenario. Although the growth patterns are very different, average growth up to accession amounts to 4.9% in both scenarios.

Growth projection in the post-accession phase

Assuming continued reforms, the absorption capacity for foreign capital is enhanced and the labour market can employ a greater share of idle workers. In both scenarios for the external environment, labour productivity growth will gradually decline, but remain high when compared to the EU. The Lisbon scenario will be most positive for Turkey. A combination of demographic and participation effects will add to the number of workers each year (0.5% in 2014 rising to 2.5 % from 2018), while their productivity will grow 3¾% annually (starting at 5% in 2014). On average, economic growth reaches 6.2% in the post-accession decade in the Lisbon scenario. In the EU trend scenario, Turkish productivity growth will slowly move down to 3¼%, while the employment will only grow 1.5%, which is just enough to employ newcomers in the labour market and slightly increase participation. At the end of the post-accession decade, the economy will grow at a rate of 4¾%. On average, growth amounts 5.0% (see graph for growth pattern). As was the case in most of the earlier accessions discussed, Turkey too will beat the benchmark EU15 in both scenarios.

Removing past barriers: the lubricant approach

As pointed out earlier, potential growth can be seen as a 'speed limit' for the economy. If demand is the fuel of the economy, then market imperfections can be seen as 'sand in the engine' and reforms as a 'lubricant'. Less sand and more lubricant can bring the economy closer to potential. So in order to arrive at an economic growth projection, the influence of the changing circumstances on the growth rate must be assessed. As seen in chapter 1, Turkey's obstacles have hindered it from realising its potential. These include macroeconomic instability and the underdeveloped banking sector. If Turkey is able to face these challenges and improve the situation, it should be able to realise additional growth.

Macroeconomic stability will improve the investment climate and smoothing of the growth path will add to long-term economic growth (see box). Another bonus can be expected from the potential of privatisation, liberalisation and an improved legal framework. From this perspective, an additional growth of some 1% or 2% on top of the historical rate of 4.0% seems feasible.

Concluding remarks

In this chapter, different routes were taken to arrive at a long-term projection of economic growth in Turkey, based on the assumption of a continuing reform process that leads to EU membership in 2014.

The ‘maximum speed’ of the economy (potential growth) over the next two decades was calculated on the basis of demographic trends and assumed participation and productivity potential. We arrived at a potential growth projection of 6.5% to 8% for the next two decades. This figure is higher compared to earlier EU entrants for two reasons. First of all, Turkey has the lowest starting position - high growth rates are easier to achieve from a low base. Secondly, population growth is higher than in the earlier cases. A high ‘speed limit’ in principle means a country can grow faster without ‘accidents’ (overheating of the economy).

To arrive at a growth projection, a comparison was made with earlier accessions of relatively poor countries. The most successful in outpacing growth among the EU15 before accession were the countries acceding in 2004 (AC10) with a per capita growth differential of 2.7%. Interestingly, the AC10 countries that most closely compare to Turkey in terms of per capita income posted the highest economic growth (6%) in the pre-accession decade. Three out of the four countries examined that acceded earlier performed better in the first decade of EU membership than in the last decade prior to joining the Union. Part of this can be explained by the surge in global capital mobility that started in the mid eighties after the accession of Portugal and Spain. For the AC10, these higher capital flows were already part of their pre-accession environment and explain part of their success. Also Turkey can profit from the current liberal markets, which is why its growth performance may compare closely to the AC10’s in the pre-accession phase and to Spain’s and Portugal’s after accession.

Since 1970, economic growth in Turkey has averaged 4.0% while hindrances were present. Gradually removing these obstacles towards EU accession will ultimately add to economic growth. In the short run however, the necessary reforms are expected to be a drag on growth. Working against this effect in the early years of the pre-accession phase is an anticipated initial one-off growth impulse associated with the start of accession negotiations in 2005.

When the various elements are combined and two scenarios for the external environment are introduced, a growth pattern emerges. Economic growth is projected to average around 4.9% in the pre-accession decade and accelerate to 5.0-6.2% in the post-accession decade, depending on the external environment. This is a good performance – in twenty years time, the economy could triple.

Chapter 3

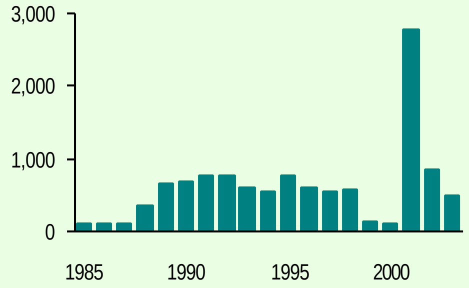
Opportunities for trade and FDI

In this chapter we consider the developments which can be expected with regard to the inflow of foreign capital to Turkey and the country's foreign trade. We will rely on the experiences gained with previous enlargements over the last two decades and with the experiences of the latest EU newcomers. With respect to trade we will consider in detail the question whether a shift can be expected from extra- to intra-EU trade. After all, what matters to the EU is not only the size of the Turkish cake as a whole, but also the size of the slice it will be able to capture. At the same time we will identify for foreign direct investment as well as trade some promising sectors. Before conducting this analysis, we will describe the current state of affairs with regard to Turkey's foreign investment and trade.

After this analysis, we will consider the development of the economic relationship between the Netherlands and Turkey over the last decades. In this context we will also make an extrapolation of projected future developments.

Net annual FDI Inflows in Turkey

USD mn



Source: EIU

FDI Permits by sector

USD mn

Year	Manu-facturing	Agri-culture	Mining	Service
1995	1.996	31	60	849
1996	641	64	8	3.122
1997	871	12	26	767
1998	1.017	6	13	609
1999	1.123	16	8	553
2000	1.105	59	5	2.3078
2001	1.244	134	29	1.317
2002	892	32	17	1.3001

Source: Treasury Turkey

FDI by sector

Share in total permits, 1995-2002,

Sector	Share %
Manu-facturing	42.2
Agri-culture	6.2
Mining	2.9
Services	48.7

Source: Treasury Turkey

Turkey's current foreign direct Investment relations

Foreign Direct Investment has been remarkably low in Turkey. In the 10 years to 2003, the average annual inflow amounted to USD 750 million or 0.4% of GDP. The UNCTAD's investment report compares countries' share in global FDI with their share in global GDP. For Turkey this ratio is 0.1, giving the country a ranking of 123rd in terms of success in attracting FDI, on a par with Haiti and Bangladesh.

According to the Turkish employer organisation Tusiad, foreign direct investment amounted to USD 15.6 billion at the end of 2002, representing 8.5% of GDP. Of the total inflows, 67% originate from the European Union.

This year, the amount of inward investment is set to exceed the past average. Two deals alone, the sale to foreigners of stakes in Garanti Bank and oil refiner Tupras, are expected to yield USD 1.35 billion in FDI. In terms of portfolio investments, several large foreign banks, including Deutsche Bank, have started to actively participate in the scenario of improving stability and launched negotiations by taking large positions in lira-denominated government securities.

In past years, around 55% of Foreign Direct Investment went to manufacturing (automotive, food and drink and chemicals). Investments in services accounted for about 40% (banking and trade).

Turkish investments abroad

Turkey is a major foreign investor in countries like Romania, Bulgaria, Kazakhstan, Uzbekistan, Georgia and Azerbaijan. Although no reliable data are available, the experience is that certain larger corporations, but primarily medium-sized Turkish companies are active in a wider region. These medium-sized Turkish companies tend to be geared towards

Five enlargements
The European Union and its predecessors

1957: EU6 = Germany, France, Italy and the Benelux
1973: EU9 = + United Kingdom, Denmark and Ireland
1981: EU10 = + Greece
1986: EU12 = + Spain, Portugal
1995: EU15 = + Sweden, Finland and Austria
2004: EU25 = + Poland, Hungary, Czech Republic, Lithuania, Latvia, Slovakia, Estonia, Slovenia, Cyprus, Malta

Average net inflow of foreign investments
% GDP

	1980-1985	1986-1991
Spain	1.4	2.5
Portugal	1.5	2.6

Source: Europesan Commission

Average net inflow of foreign investments
% total investment

	1980-1985	1986-1991
Spain	6.3	10.3
Portugal	5.5	10.2

Source: European Commission

Stock of foreign investment
% GDP

	1985	2002
Spain	5.4	33.1
Portugal	6.1	35.8

Source: European Commission

servicing the domestic markets in areas such as retail and real estate. One of the reasons why the investments of these Turkish companies are not reflected in the merchandise export figures could be the fact that a majority of trade with these countries comes under the so-called "luggage trade". However, note that the size of the luggage trade is quite substantial (USD 3.9 bn in 2003) and it is part of the official balance of payment figures. Still, given Turkish businesses' presence in, and familiarity with, a wide international region, Turkey could become a springboard for connecting those economies to the more developed economies in the West.

Foreign investment: lessons from previous enlargements

Over the last 25 years, the EU has undergone three enlargements, by a total of six countries. The six acceding countries can broadly be divided into two categories: the three South European countries on the one hand, and the two Nordic countries and Austria on the other. As was shown in the previous chapter, at the time of their accession the three South European countries were considerable poorer and had relatively closed economies compared to the EU as a whole. The two Nordic countries and Austria, by contrast, enjoyed levels of prosperity around the EU average and had relatively open economies, especially in terms of trade.

South European countries
In the five years before EU accession, the average net inflow of foreign investments to Spain and Portugal[8] amounted to 1.5% of GDP per year[9]. The corresponding figures for Finland and Austria were 0.6% and for Sweden 1.6%.

From the EU membership date, a trend change occurred in Spain and Portugal. During the five years following accession, the net inflow of foreign investments increased by the equivalent of nearly 1 percentage point of GDP per year in both countries. This higher level accelerated after the first five years of accession. The impact of foreign investment in both countries can be illustrated by the rising share of foreign investments in total investments. Not least owing to the large inflow of foreign investments, Spain and Portugal were transformed after accession from relatively closed economies with marginal levels of foreign investment to competitive western market economies. Thus in Spain the automotive industry is now the main exporter, accounting for a quarter of exports in value terms. Key Portuguese exports include machines and transport equipment and components, which are produced in branches of large multinationals.

The problem for Greece was that when it joined the EU, Europe was in recession. Many European countries were concentrating on restoring their own economies to health. Foreign activities had a relatively low priority for European businesses at this time. However, Greece was not able to profit from EU membership either when the European economies gathered momentum again in the mid 1980s. The volume of foreign investments has fallen since 1981, both as a percentage of GDP and of total investment. A

[8] Figures for net foreign investment in Greece during the 1970s are unfortunately not available.
[9] Figures for the net inflow of foreign capital are unfortunately not available for the period 1976-1981.

Average net inflow of foreign investments
% GDP

	1993-2002
Poland	3.2
Hungary	4.9
Czech Republic	6.4
Slovakia	4.5
Slovenia	n.a.
Turkey	0.6

Source: European Commission

Average net inflow of foreign investments
% total investment

	1993-2002
Poland	15.5
Hungary	22.5
Czech Republic	22.5
Slovakia	16.1
Slovenia	n.a.
Turkey	3.0

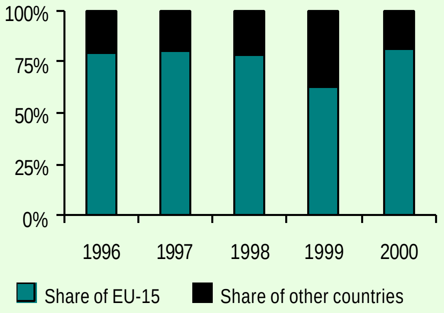
Source: European Commission

Stock of foreign investment
% GDP

	1995	2002
Poland	5.8	25.1
Hungary	29.8	44.3
Czech Republic	14.1	50.8
Slovakia	6.7	41.3
Slovenia	n.a.	n.a.
Turkey	8.8	9.8

Source: European Commission

Foreign investment in Central and East European countries



Source: Eurostat

possible reason for the absence of a large inflow of foreign capital may have been the policies pursued during this period. Because of the spending programmes by successive socialist governments during the 1980s, Greece's sovereign debt rocketed from 27.1% of GDP in 1981 to 112.3% of GDP in 1996. This surge in sovereign debt, coupled with high inflation rates approaching 20%, did not inspire confidence among potential foreign investors.

Nordic countries and Austria

Austria and the two Nordic countries were also able to attract considerably more foreign investment after they joined the EU. The two Nordic countries were relatively more successful than Austria, however. In fact, in 2002 more than half of all investments in Sweden were made by foreigners. The reason for the success of the two Nordic countries and Sweden in particular in attracting foreign investment may be due to the considerable contraction of the public sectors in those countries. Many enterprises were privatised, which offered scope for foreign direct investment.

Central European countries

While foreign investments increased in the South European countries especially after accession, in the case of the new Central European members this process started well before accession. In the period 1993-2002 the net inflow of foreign capital to the Central European countries surged both in terms of GDP and total investment (see table).

The special situation of the Central European countries offers an explanation for this large inflow of foreign investments. Until the late 1980s these countries and the EU stood with their backs to each other. After the fall of the Berlin Wall, these countries rediscovered their historical links with the West. They replaced their planned economies with market economies. The subsequent transition process sparked a wave of liberalisation and deregulation. EU investors gratefully took advantage of the many privatisation projects and the new opportunities they presented. The inflow of foreign capital was also buoyed by the prospect of EU membership. The Europe accords signed in the early and mid 1990s between the various Central European countries and the EU provided the official framework for bilateral cooperation between the candidate member states and the EU, and can be regarded as the 'road map' to EU accession.

The approach to the current round of EU enlargement has been more professional than in the case of the South European countries. At the time of the accession of Greece, Spain and Portugal, there were no formal accession criteria. Now candidate members have to meet the strict Copenhagen criteria. The advantage of this approach is that it obliges countries to meet the political criteria even before the accession negotiations start. The economic criteria aimed at fully preparing the country for membership can be fulfilled after the start of the negotiations. This approach requires far more preparation and effort from the acceding countries, but it also offer a guarantee that both the newcomers and the existing members can enjoy the fruits of an enlarged EU from the accession date.

Projected GDP and inflow of foreign investment to Turkey, 2005-2013

Average GDP growth of 4.9%

	GDP (EUR bn)	FDI
2004	228.7	
2005	240	3.6
2006	252	3.7
2007	264.1	4
2008	277	4.2
2009	290.1	4.3
2010	305	4.6
2011	320	4.8
2012	335.5	5
2013	352	5.3

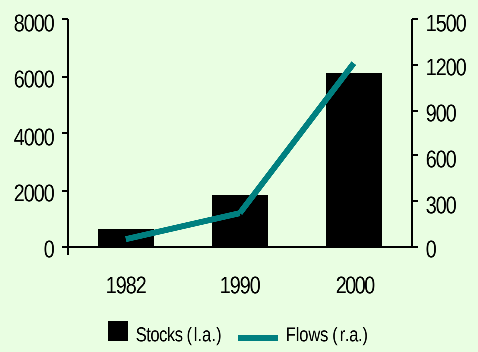
	Total	39.5
	Average per year	4.4

In the pre accession period the average growth rate for the EU and Turkey in the both scenarios equals respectively 2% and 4,9%. For this reason in this chapter we have opted not to deal with the both scenarios separately.

Source: ABN AMRO calculations

World FDI flows and stocks

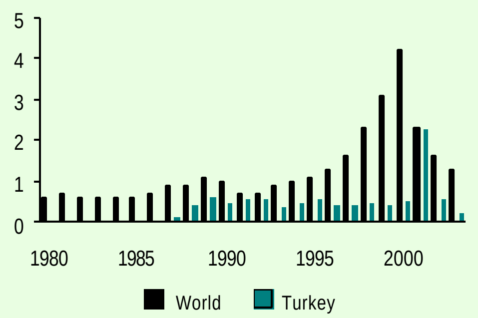
Dollar bn



Source: EIU

FDI flows

% GDP



Source: EIU

Concluding remarks

EU membership sparked a considerable inflow of foreign investments to the South European countries, although Greece was less successful in this respect than Spain and Portugal. The international capital flows took off above all from the liberalisation of markets in the mid 1980s. In the case of the Central European countries the large inflow of foreign capital started after the collapse of communism, well before these countries' actual accession to the EU.

Foreign investments: opportunities for the EU and Turkey

Compared to Spain, Portugal and the Central European countries, the net inflow of foreign investments to Turkey has remained rather modest until now. This could change in the near future, however. As outlined in chapter 1, the conditions for investing in Turkey have improved considerably. The start of accession negotiations in 2005 would generate a strong investment impulse, because, as in the case of the Central European countries, the start of the process would mark a trend change in perceptions concerning Turkey. That is why investment flows may well pick up immediately after the start of the negotiations. As far as the volume of the expected net inflow of foreign investments to Turkey from 2005, the experiences with Southern and Central Europe outlined above offer a number of clues.

Pre accession period

The average net inflow of foreign investment for the four largest Central European countries amounted to 4.8% of GDP per year in the period 1993-2002. A similar inflow for Turkey on average would amount to EUR 13 billion per year in the period to EU accession.

However, the inflow of foreign investments to the Central European countries was so large not least because of their special situation. In planned economies, virtually all enterprises were state-owned. Hence there was a lot to privatise. Foreign investors gratefully took advantage of the opportunities. For instance, by the end of 2002 most banks in Poland, Hungary, Slovakia and the Czech Republic were in foreign hands. Turkey already has a functioning market economy. Although the state still owns some enterprises there will be less to sell off. Because of this difference, Turkey may not equal the Central European countries' success in attracting foreign investors in the run-up to EU membership.

Turkey's current economic structure is much more comparable to that of the three South European countries at the time of their accession. These countries also underwent a process of transformation from the basis of an already functioning market economy. A similar process may well unfold in Turkey in the period leading up to EU accession.

On the basis of an average inflow of foreign capital of 1.5% of GDP to Spain and Portugal in the five years before their accession, Turkey should be able to attract foreign investments of more than EUR 4 billion per year in the period 2005-2014 (see table). However, during the South European countries' pre-accession phase the capital markets were fragmented, so that capital flows were relatively small. The international capital market is now much more liberalised, so that capital flows are much larger (see chart). Furthermore, the privatisation process in Turkey in the run-up to EU membership will attract many foreign investors. On the other hand the average EU-growth in the pre-accession period of Spain and Portugal was higher than what we assume for the pre accession period of Turkey. On average however we think that Turkey can outperform Spain and Portugal in terms of attracting foreign investment in the run-up to EU membership.

Post accession period

Again in line with the experiences of Spain and Portugal, the average annual capital inflow to Turkey should increase further after EU accession. We do not expect Turkey to follow the path of Greece. The average inflow of capital to Greece amounted to less than USD 1 billion per year in the period 1981-2002. As mentioned, Greece joined the EU at the wrong time. Another factor was that its maco-economic policies did not inspire confidence among foreign investors in particular. As explained in chapter 1, the Turkish economy still has some weaknesses, but there are also ever more guarantees of success. For one thing, under the Copenhagen economic criteria, a country must stick strictly to the course set towards membership. For another, under the stand-by agreement with the IMF Turkey is already pursuing a fiscal policy aimed at reducing budget deficits. Because of this preparatory work Turkey will be well equipped to join the EU in 2014.

Projected GDP and annual inflow of foreign investment to Turkey, 2014-2024

Average	GDP growth 5.0%		GDP growth 6.2%	
	GDP	**FDI**	**GDP**	**FDI**
2014	369.5	8.5	374	10.5
2015	388	9	397	11.1
2016	407.4	9.4	421.5	11.7
2017	428	9.8	447.6	12.5
2018	449.1	10.3	475.4	13.3
2019	471.8	11	504.8	14.1
2020	495.2	11.3	536.1	15
2021	520	12	569.4	16
2022	546	12.5	604.7	17
2023	57 3.2	13.2	642.2	18
2024	602	13.7	682	19.1
		--------		----------
	Total	120.7	Total	158.3
	Average	11	Average	14.4

Source: ABN AMRO calculations

In the previous chapter we developed two scenarios for average Turkish economic growth from 2014-2024, both linked to developments in the EU. In the first scenario Turkey will expand by an average of 5.0% per year until 2024, in the second by 6.2%. The success of Turkey in attracting FDI is, beside the internal economic outlook, also dependent on the economic developments in the EU. In the EU-trend scenario we forecast for the EU an average yearly growth rate of 2% in the period 2014-2024. This projected growth is less then the 2.3% growth rate the EU realised in the 10 years after the accession of Spain and Portugal. The net average inflow of capital to both Spain and Portugal amounted to 2.6% of GDP per year in the period 1986-1996.

Because of the assumed lower growth in the EU, companies will simply have less money to invest and Turkey will because of this not match the success of Spain and Portugal in attracting foreign investors. If Turkey attracts 2.3% of GDP (2.6 -/- 0.3) per year in foreign investments and has an average annual growth rate of 5% between 2014 and 2024, it would receive an average of 11 billion EUR per year in foreign direct investment.

In the Lisbon scenario the EU-economy has, like set forth in the previous chapter, a higher growth potential. Because of this Turkey realises a higher annual growth rate of 6,2% between 2014 and 2024. Given these assumed higher growth rates for the EU as well as Turkey, in this scenario Turkey can as percentage of it’s GDP attract more foreign capital then Spain and

Portugal did after their accession to the EU. We assume that Turkey on average could attract more then 14 billion EUR of foreign capital per year. This relates yearly to 2,8% of the GDP of Turkey.

Sector opportunities for foreign direct investment
Given Turkey's size and EU membership outlook, there are investment opportunities in a number of sectors including agriculture, automotive (components), building (including materials), energy; environment (water & wastewater treatment), food and drink (processing & packaging), healthcare, information technology and oil & gas. In view of the country's electricity shortages, there is also scope for power sector investment.

In the banking sector, the Italian bank Intesa's purchase of a 40% stake in Garanti Bank (plus an option to acquire another 10.01%) is in the final stages. The banking sector appears set to receive increased foreign attention once membership talks are underway. Currently, foreign banks' market share in terms of assets is less than 5%.

Turkey is located close to main oil and gas fields in the Middle East and Central Asia. Oil and gas are often shipped to the Black Sea coast and then routed through the Bosphorus to their final destinations. There is a great deal of pressure from environmental and commercial parties to provide alternative, pipeline routes. There is also geopolitical pressure to route liquid energy from Central Asia and the Middle East though routes passing through Turkey. The Baku-Tblisi-Ceyhan pipeline, which connects the Caspian to the Mediterranean Sea, is one example. More examples could follow, involving investments in the pipelines and in supporting infrastructure. It remains to be seen whether such investments will have a one-off character or whether additional value-added activities will be created.

Concluding remarks:
The start of the accession negotiations with Turkey in 2005 will generate a strong investment impulse. After all, as in the case of the Central European countries, the start of these negotiations will mark a trend change in perceptions. However, Turkey will not be able to attract as much foreign investment as the Central European countries, because after the collapse of communism they put more or less everything up for sale. Turkey's current economic structure is more comparable to that of Spain and Portugal at the time of their accession. These countries also underwent a process of transformation on the basis of an already functioning market economy. If Turkey is able to repeat the achievement of Spain and Portugal in the run-up to EU membership; it should be able to attract an average of EUR 4.4 billion per year in foreign investments. After accession, the flow of foreign investments to Turkey may well rise to EUR 11-14 billion per year.

Investment opportunities for foreigners exist in many sectors ranging from agriculture to the banking sector.

Merchandise exports
% GDP

	1994	2003
Turkey	14.1	19.4
Poland	15.8	27.8
Spain	12.9	16.0
Portugal	18.0	19.9
AC-8	23.9	41.9

Source: EIU, IMF

Turkish trade by country goups
USD mn, 2003

	Exports	Imports
EU	24397	31525
EFTA	529	3357
USA	3740	3423
Africa	2120	3246
Middle East	4954	4051
CIS	2957	7727
Others	8370	15480
Total	47068	68808

Source: Ministry of Trade Turkey

Main EU trade partners
Share in total EU-Turkey trade, %, 2003

	Exports	Imports
Germany	33.8	29.8
Italy	14.3	17.3
France	12.8	13.2
United Kingdom	16.6	11.0
Netherlands	6.9	5.2
Other EU	15.7	23.5

Source: Ministry of Trade Turkey

Description of current trade relations

For a country of its size, Turkey has a moderate degree of openness in terms of trade, comparable to the levels of Spain and Portugal. And Turkey is more open now than Poland was ten years before its accession to the EU. But it also is considerably less open than Poland is today, which testifies to the different speeds of economic transformation in the past ten years between the EU accession candidate Poland and the prospective EU accession candidate Turkey. On average, the eight new EU-members are about twice as open as Turkey. This can largely be attributed to the small size of the countries concerned.

Trading Partners
In terms of geographical distribution, Turkish trade is relatively diversified. Almost half of trade is with the EU, with a substantial share (31% of exports, 38% of imports) conducted with developing countries, mainly in Europe, the Middle East and Asia. Trade links with the Caucasus and with Central Asia are modest compared to those with Russia, for example. Trade with the new accession countries is underdeveloped and accounts for only 1.7% of exports and 1.8% of Imports. It may be expected that, in time, trade with these countries will intensify.

If and when Turkey joins the EU, the Union will border on a number of countries that previously had no direct border with the EU (Georgia, Armenia, Syria, Iraq, and Iran). This offers opportunities for the countries concerned, and obviously for Turkey as well. Before the Gulf war, Turkey was Iraq's main trading partner. As its own economy becomes stronger, Turkish entrepreneurs will likely look to fresh opportunities, which could create some new economic dynamics in the region. The Turkish Eximbank, the state bank for trade promotion, is currently concentrating its activities on facilitating trade in the wider region. It is clear that unsaturated economic links in this region offer considerable potential. It is difficult, however, to make any accurate estimation of the extent to which Turkey can become a stepping stone for the region. A large foreign investor, Unilever, indicates that if Turkey starts EU membership negotiations, it will consider expanding its production facilities there in order also to source its activities in neighbouring countries.

No major shift has occurred in the Turkish trading pattern over the past five years. Within the EU, Germany lost ground at the expense of Mediterranean countries such as France, Spain and Greece. To an extent this reflects growth differentials within the EU. Looking ahead, on the Turkish import side, the EU is likely to strengthen its position. On the export side, several existing or new export markets offer development potential: NAFTA countries, the Russian Federation, the Ukraine, Eastern and Central European countries, Central Asian and Transcaucasian Republics, Japan and East Asian countries (particularly China).

Trade sectors
Not so long ago Turkey's export sector was dominated by agricultural products (processed and non-processed) and by textiles and clothing in

Turkish Exports, selected commodities
USD mn

	1998	2003*	%
Agriculture	2693	2364	-12
Food and beverages	2057	2291	11
Textiles	5920	8773	48
Clothes	4589	6081	33
Metal products	587	1358	131
Machines & equipment	1149	3176	176
Motor vehicles	985	5303	438
Furniture	379	1263	233

* Jan-Nov 2003 data extrapolated to 12 months
Source: SIS

particular. In recent years, however, several new industrial export sectors have emerged. Exports of such products as cars, machinery and

equipment, as well as furniture, have at least doubled over the last few years. Allegedly, one in every two television sets sold in the EU, including the new plasma screens, was assembled or produced in Turkey. Many western car manufacturers (Ford, Fiat, Renault, Hyundai and Toyota) are currently assembling cars in Turkey for the European market. In some cases Turkey is the exclusive producer of certain models, such as the Renault Megane II. Because of this specialisation, Turkish car imports (of other Renault models, for example) are also high. This situation signals an already high degree of trade integration with the EU in this particular sector.

In some cases the boost in exports was triggered by the exchange rate collapse of February 2001. The economic crisis that followed meant that a lot of production capacity became idle and was then used to service foreign markets. Although the currency has since recovered to historical highs and the domestic economy is once again showing healthy activity, export dynamics in these categories show no signs of abating. Turkey's continued price competitiveness is derived from low wage levels, but is also connected to the relatively low costs of logistics as Turkish ports and other logistic facilities allow for efficient transportation. The Customs Union between the EU and Turkey that has been in place since 1996 also serves to facilitate trade flows.

Trade: lessons from previous enlargements

South European countries
In the run-up to EU membership, the trade volumes of the three South European countries doubled and trade flows shifted towards the EU. But the real trend change came when these countries joined the EU. Not only did foreign trade rise sharply, there was also a further significant shift towards intra-EU trade. Trade volumes with other EU countries expanded fourfold in Spain and fivefold in Portugal. Greece's share of trade with EU partners also increased in the first instance, but it has been falling since 1996; however, this is due in part to the fact that Greece is concentrating increasingly on candidate member states such as Bulgaria.

Foreign trade
% GDP

	1980	1985	1990	2002
Greece	51.4	46.4	46.0	48.6
Spain	32.0	41.4	39	59.6
Portugal	60.2	68.6	72.4	68.2

Source: European Commission, IMF

EU trade
% total trade

	1980	1985	1990	2002
Greece	42.4	52.3	56.8	46.7
Spain	41.2	45.8	66.1	68.1
Portugal	54.1	57.1	75.3	78.0

Source: European Commission, IMF

The main reason for this shift in trade flows is the trade integration which EU membership entails. With the adoption of joint standards, for instance, intra-EU trade receives an additional impulse. Another reason is the positive knock-on effects which foreign investments generate. Foreign investments in the new member states not only boost output and sales, they also lead to higher import demand for capital goods and intermediary products. These goods are imported from the richer EU partners and only to a limited extent from the United States for instance, because intra-EU trade does not attract import tariffs. What is more, a considerable proportion of the financial assistance which Spain, Portugal and Greece have received since their accession within the framework structural and cohesion funds flows back to the richer EU partners through the purchase of goods in these countries.

Foreign trade
% GDP

	1993	2002
Poland	45.8	63.4
Hungary	61	133
Czech Republic	108.8	125.2
Slovakia	117.8	150.8
Slovenia	119.4	114.4
Turkey	33	60.4

Source: Europan Commission, IMF

EU trade
% total trade

	1993	2002
Poland	66.7	64.8
Hungary	56	65.2
Czech Republic	52	64.7
Slovakia	28.7	55.9
Slovenia	88.3	63.8
Turkey	48.1	47.9

Source: Europan Commission, IMF

Dutch exports
EUR bn

	2002	2003
Poland	2.8	2.7
Hungary	1.3	1.6
Czech Republic	1.5	1.6
Slovakia	0.4	n.a.
Slovenia	0.3	n.a.
Turkey	1.6	1.9

Source: Statistics Netherlands

Dutch share of EU exports to:
%

	Year before accession	2002
• Greece	6.8	10.4
• Spain	5.5	7.3
• Portugal	6.6	5.9
• Sweden	6.5	10.2
• Finland	13.1	19.3
• Austria	4.4	6.6

Source: IMF

Incidentally, the falling EU share in total Greek imports has not occurred at the expense of Dutch businesses. These have been able to steadily increase their share in both total and EU imports to Greece since it joined the EU. Dutch businesses have also done well in Spain since that country's accession. Imports from the Netherlands have increased significantly both as a share of total imports and of imports from EU countries.

Central European countries

The benefits which the richer EU countries gain, in the form of additional exports, from investments in countries with incomes well below the EU average is not restricted to the period after those countries' joined the EU. The large EU investments in the Central European countries in the run-up to their EU membership have been accompanied by strong export growth to these countries. Since 1993 EU exports to the accession countries has increased fourfold. Dutch investments in the region have also borne fruit. Since 1996 an average of more than 20% of all EU investments in Central and Eastern Europe have originated in the Netherlands. This makes it one of the EU's largest investors in the region. The demand for Dutch goods from the Central European economies has increased by 10% per year in recent years, and the region is now a major export destination for Dutch goods. Since 1998, Poland in particular has turned into a major buyer of Dutch goods. Dutch exports to Poland were valued at EUR 2.7 billion in 2003, which made Poland the Netherlands' 12th largest export market.

It is in particular those countries with incomes far below the EU average which concentrate on EU trade in the run-up to EU membership. The same trend did not occur in the case of the two Nordic countries and Austria. At the time of their accession these countries already had 'mature' economies, with close trade relations across the world. And in the case of Sweden and Austria, their trade flows with EU countries were already substantial before they joined. Even so, Dutch businesses were still able to benefit from the EU membership of these three countries. In all three the Dutch share of imports has increased since their accession. The fact that the Netherlands has been able to increase its export share in the EU total after almost every enlargement is due in part to the Netherlands's export specialisation, in which intermediary goods play an important role. The higher output among the newcomers also generates higher demand for intermediary goods.

Concluding remarks

Generally speaking, all accession countries undergo a far-reaching process of trade opening in the run-up to EU membership. The trade volumes of the South European countries doubled on average in the ten years before accession. These counties also shifted towards trade with their future EU partners.

The trade volumes of the Central European countries have actually trebled in the run-up to EU membership. The EU's share in their total trade has the last years more or less stabilised, at around two-thirds on average.

increase their share in both total and EU imports to Greece since it joined the EU. Dutch businesses have also done well in Spain since that country's

accession. Imports from the Netherlands have increased significantly both as a share of total imports and of imports from EU countries.

Trade: opportunities for the EU and Turkey

Over the last decade Turkey's foreign trade has increased, but less so than experienced by the South and Central European countries in the run-up to their EU memberships. Nor was there a shift towards EU trade in Turkey's case. This share hovered around 50% throughout the 1990s.

Pre accession period

This picture may change from 2005, owing to a combination of the start of accession negotiations and a large inflow of foreign investments. Turkey will probably not be able to equal the achievement of the Central European countries. As mentioned, after the fall of the Berlin Wall they had a lot of catching up to do, as it were, which sparked large trade flows. What is more, the Central European countries have borders with the EU. Turkey is further away. A longer geographical distance generally has a negative correlation with trade flows.

Volume of Turkish foreign trade, 2005-2013

Total trade

On the basis of a total trade volume of EUR 95.7 billion in 2003, a 150% increase in trade until 2014 means a volume of EUR 239 billion, which is equivalent to a 67,8 share of GDP (239 / 352).

EU share

239 * 60% = EUR 143.4 billion.

EU exports to Turkey

143.4 * 60% = EUR 86 billion worth of exports from the EU to Turkey in 2013.

Dutch exports to Turkey

86 * 6% = 5.2 EUR in 2013

The Dutch share in EU exports to Turkey averaged around 6% over the last decade. We take the assumption that this market share will remain stable

However, the increase in Turkey's trade volume in the period 2005-2013 may exceed the doubling which the South European countries recorded in the run-up to their EU memberships. Firstly, as in the case of foreign investments, markets are much more deregulated than in the early 1980s, which has a positive impact on trade flows. Secondly, Turkey has up to now experienced, like described, low levels of FDI-inflow. In other words, FDI-inflows were not as supportive of Turkish trade. The projected influx of foreign investment in the run up to the EU-membership therefore will have a positive impact on the Turkish foreign trade. Thirdly, Turkey may be able to benefit from its low wages compared to the EU countries. Last but not least, already since 1996 Turkey has a customs union with the EU. EU-exports benefited in the first years of the agreement with average increase of 43%. However in practice there is still room for improvement in harmonisation and streamlining custom formalities. In the run up to the accession improvement is to be expected. Against this background, Turkey's trade volume in the run-up to EU membership may increase by the average of the Southern and Central European countries, which would be equivalent to a 150% increase. This may seam a huge increase. But actually it only equals to an average yearly increase of 9%. This is less than the average export growth of 13,1% and 9,1% of import growth in the past 23 years.

In addition to a steep expansion in trade volume, there will also be a shift in the trade flows towards the EU during this period. Experience shows that both the South and the Central European countries concentrated on trade with the EU in the run-up to EU membership. Broadly speaking, at the time of accession intra-EU trade accounted for around 60% of total trade in all these countries.

The EU share in Turkey's total trade volume stood at around 48% in 2003. During the period leading to Turkey's EU membership in 2014, the EU share could thus increase by more than 10 percentage points. On the basis of the

Volume of Turkish foreign trade, 2014-2024

1. **EU trend scenario, average annual growth of 5.0% in Turkey**

Total trade
In the scenario in which Turkey expands by an average of 5.0% per year between EU accession and 2024, GDP volume will reach EUR 602 billion in 2024 and total trade volume EUR 408.2 billion (602 * 69%).

EU share
The share of intra-EU trade will increase to 68.4% to 2024, equivalent to a trade volume of EUR 279.2 billion (408.2 * 68.4%).

EU exports to Turkey
279.2 * 60% = EUR 167.5 billion worth of EU exports to Turkey in 2024.

Dutch exports to Turkey
6% * 167.5 = 10 EUR billion in 2024

2. **Lisbon scenario, average annual growth of 6.2% in Turkey**

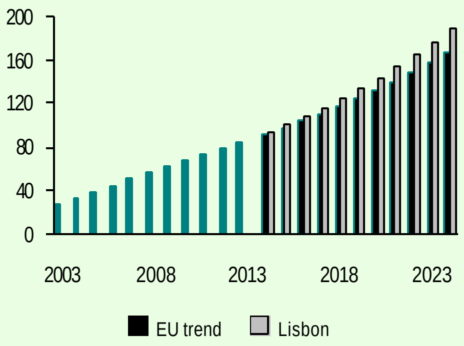
Total trade
In this scenario GDP volume will increase to EUR 682 billion by 2004, and foreign trade volume to EUR 462.4 billion (682 * 67,8).

EU share
In this scenario the share of intra-EU trade will increase to EUR 316.3 billion (462.4 * 68.4%).

EU exports Turkey
316.3 * 60% = EUR 190 billion worth of EU exports to Turkey in 2024.

Dutch exports to Turkey
6% * 190 = 11.4 EUR billion in 2024

Projected EU exports to Turkey*
EUR bn



* Exports average growth path
Source: ABN AMRO calculations

total trade volume of EUR 239 billion calculated above, trade between the EU and Turkey could thus amount to EUR 143 billion in 2013.

Over the last decade the EU exported far more to Turkey than it imported. The share of EU exports in Turkey's total trade volume averaged around 60%. Turkey imports more from the EU than it exports because of its surging demand for capital goods as well as rising consumer demand. We assume that this balance in trade will remain in the period to 2024. This means that the value of EU exports to Turkey may increase to EUR 86 billion until 2014.

Post accession period
In the case of the three South European countries, the volume of trade as a percentage of GDP at the time of their EU accession was rather low compared to the figures being projected for Turkey at the time of its accession. This share rose appreciably after the South European countries joined. As outlined above, for Turkey we project an increase of this trade openness to 67,8% in the run-up to EU membership, which is higher than the current level for the three South European countries. For the period 2014-2024 a stabilisation around 68% therefore seems likely. But because of the projected growth of the Turkish economy, trade in absolute terms may well rise sharply (see box).

When Turkey joins the EU, the lifting of remaining trade barriers will probably spark a further shift in Turkey's trade towards intra-EU trade. In the case of Greece, Spain and Portugal, intra-EU trade as a percentage of total trade increased by 6.0, 10.9 and 8.3 percentage points in the ten years following accession. An increase in intra-EU trade by the average of these three counties implies an increase in the share of intra-EU trade for Turkey by 8.4 percentage points to 68.4%.

Sector opportunities for trade
The textiles/clothing sector is often seen as a sector that stands to greatly benefit from accession (due to the lifting of EU barriers). In reality, however, this remains to be seen. From 2005, the multi-fibre agreement of 1986 will end and a global, free market for textiles and clothing is set to emerge. It is not clear to what degree this ambition will be achieved in practice. To the extent that the market is liberalised, however, Turkey will be faced with increased competition – particularly from Asian countries that have a considerable cost advantage – and potential benefits will evaporate. The outlook for the sector in Turkey is thus marked by both challenges and opportunities.

In the agricultural sector, certain barriers are set to remain in place in the years ahead, possibly until EU accession. In recent years, exports of agricultural produce have declined. Given its climate, Turkey is well suited to expand exports to the EU for a range of products. The bulk of Turkish agricultural produce consists of products that are not included in the EU's Common Agricultural Policy. This means the base agricultural potential is not limited from the start, as was the case for several Central European countries.

In the services sector, Turkish road cargo transport companies have an established position in the European market. One area with significant potential is tourism. According to the Central Bank, Tourism receipts accounted for 6% of GDP in 2003. Turkey's coastal climate is highly favourable. Like France, Spain and Portugal, Turkey could become a destination for pensioners. The undeveloped parts of the coastline are bound to draw a great deal of interest from developers.

Concluding Remarks

Turkey's foreign trade is likely to receive a strong impulse from 2005 from a combination of the start of accession negotiations and a large inflow of foreign investments. In line with the projected pattern for foreign investments, trade volumes will probably not expand as much as those of the Central European countries, because these had a lot of catching up to do, as it were, after the fall of the Berlin Wall. However, Turkey may achieve a higher increase in trade volumes than the South European countries. Markets are now much more deregulated, which has a positive impact on trade flows. The trade expansion achieved by Turkey in the run-up to EU membership may thus come out between the respective performances of the South and Central European countries, which would be equivalent to an 150% increase in 2013 compared to 2003.

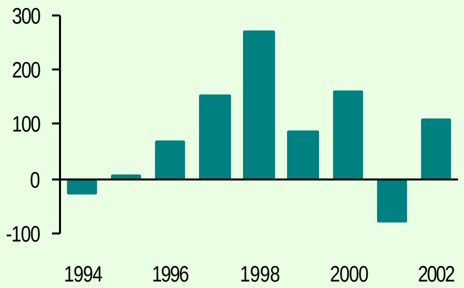
Given previous experiences in pre-accession periods, Turkey will also concentrate more on trade with the EU. EU exports may well amount to EUR 86 billion in 2013. After Turkey joins the EU, total trade will probably increase further. A further shift towards intra-EU trade will also occur. In 2024 EU exports to Turkey are projected to climb to EUR 167.5 billion in the EU trend scenario or to EUR 190 billion in the Lisbon scenario.

The opportunities in various export sectors will go hand in hand with additional import requirements of capital and intermediary goods from abroad. As the economy expands and sectors develop, import requirements in specific fields will also increase.

Existing and projected economic relations between the Netherlands and Turkey

Dutch investment flows to Turkey

USD mn



Source: EIU, Dutch Ministry of Economic Affairs

The Netherlands and Turkey already have close and long-standing economic relations. Unilever was one of the first foreign investors in Turkey, for instance. It is true that, in line with the patterns outlined above, Dutch investments have remained modest. As the figure shows, Dutch investments over the last decade have reflected economic developments in Turkey. The economic crises of 1994 and 2001 were accompanied by disinvestments by Dutch businesses in Turkey.

Over the last decade, Dutch investments accounted for around 7.5% of the EUR 10 billion worth in foreign investments in Turkey. If this Dutch share remains the same over the coming decade, then the cumulative volume of Dutch investments to 2014 could grow with EUR 3 billion (7.5% * 39.5 billion). After Turkey's accession to the EU an additional growth of up to EUR

Projected Dutch investment in Turkey, 2005-2013
EUR Billion

	FDI
2005	0.27
2006	0.28
2007	0.30
2008	0.31
2009	0.33
2010	0.34
2011	0.36
2012	0.38
2013	0.40

Total	3.0
Average per year	0.33

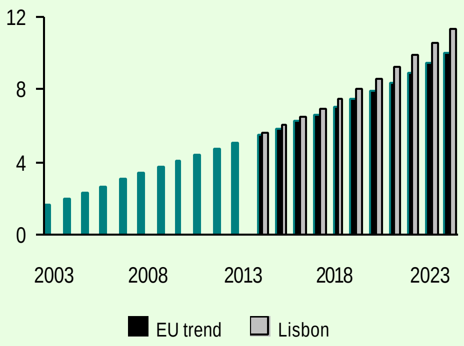
Source: ABN AMRO calculations

Projected Dutch investment in Turkey, 2014-2024
EUR Billion

	EU-trend	Lisbon
2014	0.64	0.78
2015	0.67	0.83
2016	0.70	0.89
2017	0.74	0.94
2018	0.77	1
2019	0.81	1.1
2020	0.85	1.13
2021	0.90	1.2
2022	0.94	1.27
2023	0.99	1.35
2024	1.04	1.43
	-----	-----
Total	9.1	11.9
Average per year	0.82	1.1

Source: ABN AMRO calculations

Projected Dutch exports to Turkey*
EUR bn



* Exports average growth path
Source: ABN AMRO calculations

9.1 billion in the EU trend scenario or EUR 11.9 billion in the Lisbon scenario could take place.

The flow of Dutch exports to Turkey was also disrupted on several occasions during the last decade by the economic crises. Yet despite these disruptions, Dutch exports to Turkey increased by more than 9% per year on average over the last decade. Over this period Turkey thus developed into an important market for the Netherlands. Turkey is the Netherlands' third-largest export destination among the emerging economies, after Poland and Russia.

The Dutch share in EU exports to Turkey averaged around 6% over the last decade. On the basis of total EU exports of EUR 86 billion in 2013, this means that Dutch exports may increase to EUR 5.2 billion (86 * 6%). This equals to an average yearly increase of 12.1%. After Turkey's accession to the EU, Dutch exports may increase further to EUR 10.1 billion (167.5 * 6%, average yearly increase 6.3%) in the EU trend scenario or EUR 11.4 billion (190 * 6%, average yearly increase 7.5%) in the Lisbon scenario.

However, it is quite possible that the Netherlands will perform much better. Experience shows that after virtually every EU enlargement the Netherlands was able to expand its share in the EU export total to new member states. Given the prominence of Dutch investors, the Netherlands should be able to increase its share in EU exports. In terms of its export mix the Netherlands is well placed in Turkey, since intermediary goods were the most important exports to Turkey in 2002.

Concluding remarks
On the basis of the Dutch share of 7.5% in foreign investments in Turkey to date, Dutch investments may increase to EUR 3 billion in the pre-accession phase. In the decade after Turkey's accession to the EU, Dutch investments may amount to EUR 9.1 billion in the EU trend scenario and EUR 11.9 billion in the Lisbon scenario.

Given the Dutch share of around 6% in total EU exports to Turkey over the last decade, Dutch exports may increase to EUR 5.2 billion in 2013. In the period from Turkey's accession to 2024, Dutch exports may well increase to EUR 10.1 billion (EU trend) or EUR 11.4 billion (Lisbon). It is quite likely, however, that after Turkey's accession to the EU the Netherlands will be able to expand its share in total EU exports to Turkey.

References

Literature

- CPB Netherlands Bureau for Economic Policy Analysis (2004), *Assessing the economic implications of Turkish accession to the EU*
- Dutch Ministry of Economic Affairs (2001, 2002, 2003), *Opkomende Markten: Ontwikkelingen en perspectieven*
- European Commission (2003), *Regular Report on Turkey*
- Foreign Investors Association (2004), *The New Turkish Investment Environment*
- Hnatkovska and Loayza (2003), 'Volatility and Growth', *World Bank macro economic and growth working papers*, nr. 3184
- Mc Kinsey Company (2003), *Turkey, Making the productivity and growth breakthrough*
- Organisation for Economic Co-operation and Development (December 2002): *Economic Survey of Turkey*
- Republic of Turkey Prime Ministry Undersecretariat of Treasury (2003), *Foreign Investment in Turkey 2002*
- Republic of Turkey Prime Ministry State Planning Organisation, *Eighth five-year development plan*
- The Royal Netherlands Embassy in Ankara, Economic and Commercial Department (2004), *An Overview of Developments Between January 2002-December 2003 and Outlook on 2004*.
- Turkish Industrialist's and Businessmen's Association and Foreign Investors Association (2004), *FDI Attractiveness of Turkey: A Comparative Analysis*
- Turkish Industrialist's and Businessmen's Association (March 2004), *Investment Environment and Foreign Direct Investments in Turkey*
- Wiener Instituut für Internationale Wirtschaftsvergeleiche (2003), *From Accession to Cohesion: Ireland, Greece, Portugal and Spain, and Lessons for the next Accession*

Data sources

- Central Bank of the Republic of Turkey (www.tcmb.gov.tr)
- Consensus forecast, *Emerging markets consensus forecast*
- Economist Intelligence Unit (www.eiu.com)
- European Commission: Annual macro economic database (AMECO), (www.europa.eu.int/comm/economy_finance/indicators)
- *Eurostat*, (www.europa.eu.int/comm/eurostat)
- International Monetary Fund, *Direction of Trade Statistics*
- Oxford Economic Forecasting: The OEF forecasting model
- Republic of Turkey Ministry of Trade (www.sanayi.gov.tr)
- Statistics Netherlands (www.cbs.nl)
- Republic of Turkey Prime Ministry Undersecretariat of Treasury (www.treasury.gov.tr)
- Thomson Financial Datastream
- US Census Bureau, International Database (www.census.gov)