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How Global Value Chains can reshape Turkey's Economy

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Turkey has always been a country of strategic significance. Its geographic position as a bridge between East and West, its long and unique history of relations with the European Union (EU), and the particular route that Turkey chose towards modernization after its foundation in 1923, have attracted attention of both historians and political scientists (Laura Tuck, Vice President Europe and Central Asia Region).

This work thesis focuses on Turkey's experience in the transition from lower to higher middle income, a transition that has accelerated in the past decade and has gained Turkey many admirers. Indeed, according to the OECD, by 2060 Turkey will be the 12th largest economy in the world, with a GDP of around 4 trillion USD or just around 20 percent less than the forecast GDP of Germany (The World Bank, 2014).

Furthermore, the Custom Union with the EU has opened Turkey up to higher quality imports as well as to European FDI. This has been an important driver of quality improvements. The consequence has been the upgrading of Turkey's export quality and the rising prominence of Turkish producers in Global Value Chains (GVCs).

Turkey's interest in its experience outside the country is strong, but on the other hand, opinions on evaluating Turkey's recent economic and social history remains divided both within the country and among outside experts. There is no accepted narrative on what has worked and what might need to change, which leaves the country vulnerable to costly policy mistakes.

This work will focus on two main themes that describe the increasing attention on Turkey. The first concerns the economic integration that has been the driver for economic progress, where both structural and policy choices have ensured that this progress has been socially inclusive, and hence the policy course chosen has been politically sustainable. The second theme instead, will focus on the fact that, in spite of the remarkable achievements so far, Turkey has yet to establish the institutional prerequisites of high-income economy. In fact, the risk of the "middle income trap" looms for countries that let off the reform efforts. Improvements in the rule of law, in public accountability and transparency, and in the climate for entrepreneurship and innovation will thus be needed for Turkey to complete the transition to a high-income economy.

Following, in the first chapter, it will be discussed the economic and political environment which characterize a growing country such as Turkey. The "Hedef 2023" and the priorities highlighted in the 10th Development Plan, will be the main topics that are going to give birth to a clearer idea on what made this economy growing on one hand, and what are the challenges Turkey has to face on the other.

The second chapter will take into account the topic of Global Value Chains, focusing on the means altering trade relations between economies, where individual countries, instead of producing an item domestically and exporting it abroad, now make products in parts across a wide array of economies that contribute to a product's creation by adding value throughout the production process. This brought competitive pressure on governments to adopt reforms that would help their producers to find niches in which they will try to make the most of their capabilities. The drivers and impacts will be analyzed in order to understand the consequences of participating in the GVCs and these will lead to the third chapter, where specifically will be underlined the role of Turkey in the GVCs.

In fact, in this chapter, it will be discussed the position of Turkey that, in order to realize its ambitious export targets, will need to upgrade along the value chain. Already its role is well placed because Turkey has strong presence in economic activities with longer than average value chains, its trade costs are low and its logistics infrastructure is performing well.

Finally, the last chapter will highlight the main achievements but also the remaining challenges Turkey has to deal with. This is done to answer the leading question: can Global Value Chains bring Turkey to be more competitive in a world where markets are increasingly becoming more internationalized?

Turkey's integration into the European and global economy has brought the country to the threshold to high income. The most significant achievements can be held under several macro areas: trade, finance, enterprise, infrastructure, urbanization, labor markets, welfare and finally public finance.

Turkey's openness has risen from 11 percent in 1970 to 58 percent in 2012. Over the past decade, exports of goods and services in US$ terms grew by 15 percent annually. Medium-technology exports have increased as Turkey has become more integrated in European production chains. Diversification of exports has allowed Turkey to mitigate the slump in EU demand.

Turkey's banking system is resilient and was the only one in the OECD that withstood the headwinds of the global economic and financial crisis without an injection of public

funds. It boasts strong capital buffers and the sector's loan to deposit ratio, while increasing, is only around 110 percent.
Productivity growth has been strong, driven by a re-allocation of the labor force out of agriculture and into services and manufacturing. Patterns of productivity growth are supporting regional convergence within Turkey, although productivity levels in the Western part of the country remain the highest.
Turkey has improved the quality of its infrastructure in transport, telecoms and energy and ranks in the top 30 worldwide for its logistics performance.
This country is one of the world's fastest urbanizers and has created a system of cities that is economically efficient, whilst widening access to municipal services to the whole population.
Employment growth, since the 1980s, has roughly kept pace with increases in the labor force. Most of the new jobs created have been of higher productivity, boosting overall growth and social progress. The pace of job creation has accelerated after 2008, when Turkey created more than 4 million new jobs, many of which at higher skill levels.
Health and education outcomes have imported significantly addressing equity as well as access, benefiting also the less well off.
Finally, comprehensive structural reforms in the public sector have supported a sharp and continuing decline in Turkey's public debt to GDP ratio and created fiscal space for improved public services (The World Bank, 2014).

Turkey had many noteworthy achievements that contain lessons for other emerging markets, but since 2012, growth has moderated and the economic activity is expected to remain subdued in the first half of 2015, limiting the full year growth rate to 3.0 percent.
To realize its underlying growth potential, Turkey needs to accelerate structural reforms and improve trust in its institutions. Turkey's main assets include a young, dynamic population, a large domestic market, and a strategic location, combined with strong infrastructure and improved public services. However, domestic and foreign investors remain deterred by unpredictability and a lack of trust in key institutions. An increase in business investment and innovation as well as in education and skills is needed to boosts productivity growth and create enough high-productivity jobs to accommodate Turkey's rapidly growing labor force (The World Bank Group, 2015).
This means that Turkey is still facing challenges that are slowing down its hike toward the high-income status. The particular challenge for this purpose is that Turkish firms

are not helping Turkey to increase its productivity. Two possible reasons will be given below.

For example, in a recent survey of management quality, Turkey ranked between China and Argentina and well below advanced economies. The primary obstacles that the firms in Turkey face were lack of employee involvement, illiteracy and unawareness between the employees, inappropriate firm structure, and lack of the resources. The reasons stand behind the fact that Turkey needs to focus more than ever on increasing the level of education and the participation in the labor market of the youngers. Higher is their level of skills and higher will be the productivity and performance of the firms.

Furthermore, many SMEs also need to modernize their governance and introduce professional management to improve their ability to absorb and adapt new technologies. As seen in chapter 1, SMEs represent more than 99 % of all enterprises and absorb the main part of the labor force employed in the business sector but, at the same time, they lag behind European competitors in the field of internationalization. It is well known that Turkey has an urgent need to increase its exports, so it is essential for it to provide companies, especially the smallest ones, with the necessary tools to start operating or to expand into foreign markets. Internationalization, in general, and FDI in particular are associated with more innovation, better management, and higher productivity.

Furthermore, the burdensome bureaucracy and concerns about rule of law in the country still hold investors back, according to surveys regularly conducted with foreign firms. The 10th National Development Plan 2014–18 focuses on increasing the productivity and competitiveness of the Turkish economy through improving the overall environment for doing business and the relevant regulatory framework (The World Bank Group, 2015). A series of legal initiatives, including the introduction of a new commercial code, a new patent law, and new income tax legislation, confirm the Government's commitment to improve the business climate. This is particularly critical for SMEs, which account for 80 percent of jobs in Turkey.

The 2013 enterprise survey suggests that high taxes, informality, political instability, and access to finance are the top four obstacles to business in Turkey. The survey suggests that regulatory barriers are highest for SMEs, higher even than for micro-firms. Indeed, in the Doing Business report of 2015, Turkey ranks 55 out of 189 countries, a position that moved from 54 in 2014.

Improving the business environment is the key, especially for SMEs. However, in order to reach the goal of being among the top 50 countries by 2018, as expressed in the 10th Development Plan, the country would need to accelerate the implementation of reforms.

The rise in Turkey's global footprint has been impressive, but it still has a long way to go to reach the levels of exports performance of Eastern Europe or East Asia. Turkey's openness is not much higher that that of much larger economies such as Brazil and India. Foreign Direct Investment (FDI) inflows have risen in nominal terms, but as a share of global flows to emerging markets, Turkey's position today is hardly better that a decade ago (The World Bank, 2014).

Foreign Direct Investment (FDI) has been a driver of growing intra-industry trade as have been the reduction in trade costs that resulted from the harmonization with the EU standards, the elimination of tariff and most non-tariff barriers to trade, and the improvement in Turkey's logistics performance.

While FDI has increased since 2003, Turkey continues to lag behind large emerging market peers in attracting foreign investors.

FDI peaked at US$19.1 billion in 2007, but fell sharply during the subsequent global financial crisis, and has since failed to recover both in absolute terms as a share of total FDI inflows to peer developing countries.

According to surveys regularly conducted by the International Investors Association (YASED), the main barriers to FDI in Turkey are microeconomic. In the most recent survey, lack of legal assurance, economic instability and tax and incentive policies are the top three factors.

But they are not the only one, in fact, FDI inflows, among other things, are driven by human capital and institutions. First, low skills and inadequate level of training impact adversely on the rate of return of FDI, and thus deter capital inflows. Countries with appreciable levels of human capital attract more FDI inflows. Second, because FDI is now a very large share of capital formation in growing countries, the FDI-promoting effect of good institutions might be an important channel of their overall effect on growth and development.

FDI is considered one of the most stable components of capital flows to countries in transition and can also be a vehicle for technological progress through the use and dissemination of improved production techniques.

Turkey prescribed a list of economic reforms to advance its economy beyond middle-income status. This means tackling the two main bottlenecks to growth: quality of human capital and incomplete reform of governance and institutions in order to increase its share of FDI.

The quality of human capital in terms of education and training remains a major constraint on growth and innovation in Turkey.

The sophistication of productivity has been linked with human capital meaning that high educational quality is a fundamental plank of a competitive economy.

Turkey has regressed eight places in the latest Human Capital Index of the World Economic Forum (WEF), now ranking 68 out of 124 and is the second worst in Europe, after Moldova, and Central Asia.

In Turkey, education system has been insufficient in fully satisfying the needs of the labor market. Ongoing rapid change in the business world requires individuals to attain both vocational qualifications and basic skills. These skills allow individuals to remain longer at work, to increase their productivity in work-life and adapt to changing business and living conditions more quickly. Improving human capital and increasing the effectiveness of labor market will be important policy areas in the implementation of growth strategy in the forthcoming period.

The advantage of having a young population has to be turned into a driver of economic progress. This means boosting participation in the labor force and ensuring that the skills of new entrants as well as existing workers are continuously upgraded and kept relevant to the demands of a changing labor market.

Focusing on the second bottlenecks, the pace of institutional reforms has slowed since 2007, with only marginal improvements in overall governance, and some concerns over reversals in selected areas such as voice and accountability or independent regulators in finance and infrastructure.

Turkey has yet to establish the institutional foundations for the transition to high income. Improvements across the board are needed, including in the business climate, the rule of law, regulatory policies, the guarantee of civil and political rights, public sector accountability, and decentralized decision-making.

Turkey’s achievements may be at risk without further steps to strengthen public and private sector governance and deepen institutional reforms. Turkey’s reform drive has slowed over the past five years, leaving the country vulnerable to reversals in investor sentiment (The World Bank, 2014).

Turkey needs stronger rules, reliable arms’ length regulation and improved mechanism for government accountability to its citizens. This will help to maintain Turkey’s attraction for private investors to develop its cities and infrastructure in ways compatible with long-term financial, environmental and social sustainability.

Climbing toward a High Income Country

Turkey's reemergence as a global economic player begins with the economic opening in the early 1980s. Since then, Turkey's economy has been transformed in many ways. Whatever Turkey has done so far has worked, in general, however, each source of growth has its boundaries and Turkey reached them.

Now, in order not to remain stuck in the "middle income trap", this country needs to make a jump over the threshold to become a high-income country.

There are three main challenges to face in order to move forward to high income (The World Bank, 2014): first, Turkey will need to find a way to sustain productivity growth once the positive contribution of the shift of labor out of agriculture slows down. This involves boosting innovation, attracting more FDI and deepen financial markets; second, Turkey's demographic transition will deliver greater prosperity only if it continues to create jobs at a pace sufficient to accommodate the rising inflows of women and youth into the labor market. Policies to do so encompass making labor markets more flexible, investing in upgrading the skills of the workforce and measures to support women and men as they seek to combine work and family life; finally, Turkey needs to deepen institutional reforms to firmly establish the rule of law and arms' length regulation of the market. The reform momentum slowed in the wake of the global economic and financial crisis. Sustained progress towards high income will require closing the gap in the quality of economic institutions.

The transition to high income is difficult; during the 2000s, Brazil, Malaysia, Mexico, Poland, Russian Federation and Turkey all converged rapidly towards this threshold. But after 2008, the process of convergence slowed and, among these peers only Poland and Russian Federation made it across to high income.

Eventually, Turkey as well will cross the threshold to high income, but the rate of progress may be not fast enough to significantly close the gap to the advanced countries.

Today, more than ever, the growth of a country is strongly linked to the ability of business internationalization. In light of this evidence, what now can directly support the internationalization lies in a growing feature of the current wave of economic globalization: Global Value Chains.

The emergence of global value chains (GVCs) is the defining feature of twenty-first-century trade and has fundamentally altered trade relations between economies. Instead of individual countries producing an item domestically and exporting it abroad, products are now in parts across a wide array of economies that contribute to a product’s creation by adding value throughout the production process.

This has two implications for trade policy. First, nontariff trade barriers have become more important than ever to ensure efficient value chains. Rather than bargaining primarily for market access for their exports in goods and services, economies must ensure the smooth flow of investment, technology, and inputs across and behind borders. Any barrier to trade becomes a self-imposed “tax” on an economy’s exports since it increases the costs of doing trade with a given economy (Nadeau, 2014).

Second, the emphasis on adding value means that economies no longer need to focus on large-scale manufacturing or “national champion” industries but can deepen economic participation by emphasizing the addition of value across the production chain.

Global value chains (GVCs) have become a dominant feature of the world economy, involving countries at all levels of development, from the poorest to the most advanced. This brought competitive pressure on governments to adopt reforms that would help their producers to find niches in which they will try to make the most of their capabilities.

For the reasons mentioned above, Global Value Chains could be the key for Turkey to move foreword.

Turkey’s presence in GVCs is rather robust, yet this presence is concentrated in the lower segments of production chain. One of the main reasons lying behind this problem is that SMEs in Turkey could not effectively participate and upgrade in the production chains due to their structural constraints. Therefore, Turkey should aim at implementing concrete actions in terms of improving SMEs’ R&D capacity and human capital structure while focusing on capital and technology intensive sectors and supporting clustering activities for them. These policy actions would help SMEs to transform their production schemes and take part in the higher value added segments of the production chain by improving quality and technological sophistication of products. Increasing productivity and technological upgrading in its export performance would allow Turkey to become more competitive in its exports markets.

Without any doubt, for firms to upgrade in the Global Value Chains, technology dissemination and skills upgrading is important. In order to improve R&D capacity and human capital structure of the SME's supporting their clustering activities, certain actions are worked out as well (Republic of Turkey, 2014).

This will give Turkey not only incentives to quality and productivity but also access to a global demand characterized by high potential to growth.

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