UniCredit Group

APRIL 2007

Competitiveness Report Turkey

ANALYSIS BY THE UNICREDIT GROUP NEW EUROPE RESEARCH NETWORK

For authors see last page

The report is based on data and information available from local and international sources, and on a number of interviews with foreign entrepreneurs operating in Turkey.

Imprint

Published by UniCredit Group/Bank Austria Creditanstalt Aktiengesellschaft
http://www.unicreditgroup.eu
http://www.ba-ca.com

Edited by CEE Research Department
E-mail: cee.economic.research@ba-ca.com
Bernhard Sinhuber, Tel. +43 (0)50505-41964

Produced by BA-CA Public Relations Department (pub@ba-ca.com),
Tel. +43 (0)50505-56141

Printed by Bösmüller

Layout: Horvath Grafik-Design

Disclaimer

Turkey

UniCredit Group

The challenges of the biggest converging market

- The impressive progress made by Turkey in the last 5 years in terms of economic stability has dramatically increased the attractiveness of the country for foreign investors. Strong growth and a significant disinflation process have characterized the country after 2001. In the last two years (2005–'06) Turkey has attracted twice the amount of foreign direct investment received in the whole of the previous decade. The local market is growing fast: GDP per capita (now greater than EUR 4,200) is 80 % higher than five years ago.
- The size and the potential of the local market (Turkey is the second biggest country in Europe in terms of population after Germany) are among the main drivers for enticing foreign companies to the country.
- But Turkey is not simply a large and fast growing outlet market: it is also a competitive production location as it has strong traditions in the manufacturing sector with important chains of suppliers and strong local brands. Pressures on costs (of labour, land, inputs) in recent years are evident, and they are pushing towards higher value-added activities and a restructuring of labour-intensive sectors.
- The EU convergence process, independently from the final outcome, will be a big opportunity to contribute to the stability of the country and improve the business environment.

MOODY'S LT FC RATING	S&P'S LT FC RATING	FITCH'S LT FC RATING
Ba3/Stable	BB–/Stable	BB–/Positive

Macroeconomic scenario

	2005	2006	2007f	2008f	2009f
Nominal GDP (EUR bn)	290.6	309.7	335.8	368.8	405.2
GDP per capita (EUR)	4,032	4,244	4,546	4,932	5,357
Real GDP, yoy (%)	7.4	5.2	5.4	6.4	6.2
Inflation (CPI) yoy, avg (%)	8.2	9.6	8.1	5.9	4.9
Unemployment rate (%)	10.3	9.9	9.3	9.0	8.5
Exchange rate/€, eop	1.595	1.860	1.970	1.978	2.009
Interbank O/N, simple, eop	13.50	17.50	16.50	14.00	12.50
Current Account/GDP (%)	–6.3	–8.0	–7.2	–7.9	–7.8
FDI/GDP (%)	2.7	5.1	3.4	3.1	2.7
Budget balance/GDP (%)*	–2.0	–0.7	–2.6	–2.0	–1.5
Public debt/GDP (%)	71.6	65.0	63.0	61.0	59.0

*) Until 2005, the budget and primary balance figures are based on the consolidated budget, whereas after 2006 these data are based on the central administration budget.
Source: The Central Bank, Turkish Statistical Institution, Yapi Kredi Strategic Planing and Research, UniCredit Group New Europe Research Network

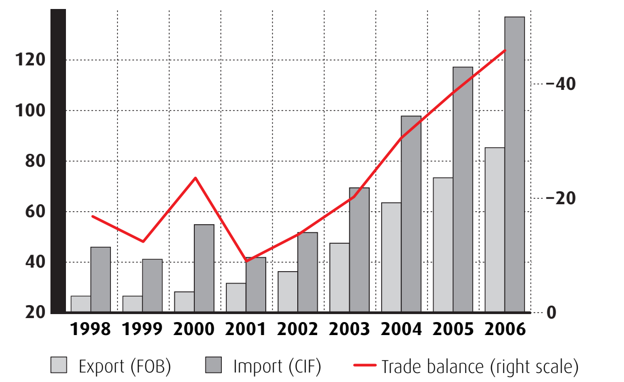
- The Turkish economy has developed very favourably in the last five years, with solid growth and declining inflation. Growth has been higher than 7 %, on average, in the last five years; inflation declined under the 10 % threshold (it was around 70 % five years ago). Public deficit, the Achilles' heels of the Turkish economy in the past, was almost balanced in 2006.
- Despite some slowdown in growth during the second half of 2006, following the financial turmoil which weakened the currency and brought higher interest rates, the growth picture remains very benign for the coming years, and the Turkish economy will continue to attract significant foreign investment. Declining oil and commodity prices can contribute to the disinflation process in the coming months, as well as helping the current account deficit (at 8 % in 2006) to decline.
- The political scene is crowded. The upcoming presidential elections in May and general elections in November are already at the centre of attention. EU accession negotiations, after playing a very positive role in recent years, are now partially frozen, and the long journey towards the EU seems increasingly difficult. Still, the EU convergence process, independently from the final outcome, will continue to represent a big opportunity to contribute to the stability of the country.

Turkey

Trade Flows and Foreign Direct Investments in the country

Turkish Trade Flows

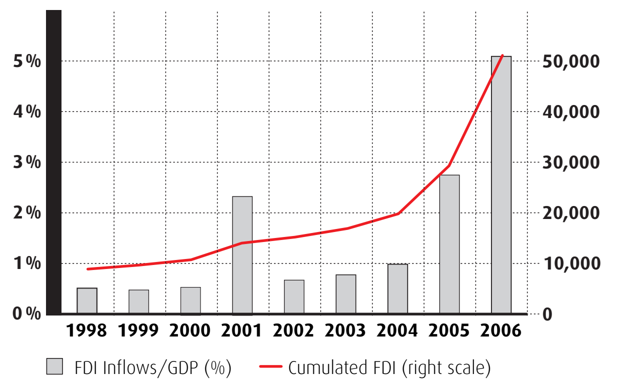
USD mn



Source: Central Bank of Turkey, Turkish Statistical Office, New Europe Network Research

Foreign Direct Investment

% of GDP and USD mn



Source: Central Bank of Turkey, Turkish Statistical Office, New Europe Network Research

Turkey's foreign trade volume has reached unprecedented levels in the last few years. Trade volumes, which averaged only USD 68 billion in the second half of the 1990s, reached USD 222 billion in 2006. The reasons behind the boost in exports from USD 25 billion on average in the same period to USD 85 billion were the robust and sustained demand from Turkey's major trading partners, namely Europe, as well as increased labour productivity and reduced labour costs in the aftermath of the 2001 economic crisis. Imports, on the other hand, jumped from an average of USD 43 billion in the late 1990s to USD 137 billion at the end of 2006. Imports were driven by robust GDP growth as well as the increased international commodity prices, especially in 2006.

Turkey's major trading partner is the EU. The EU-25 constitutes 52 % of Turkey's total exports and 39 % of total imports as of the end of 2006. More specifically, in terms of exports, Germany with a share of 11 % is followed by the United Kingdom and Italy (each accounting for 8 %). For imports the major trading partners in 2006 were the Russian Federation (13 %, mainly oil-related products) followed by Germany (11 %) and China (7 %). Italy and France rank fourth and fifth respectively. Turkey registers deficits in bilateral trade with her major trading partners: imports from the Russian Federation were five times as high as exports to that country in 2006, leading to a bilateral deficit of USD 14.3 billion. More striking is the fact that imports from China outweigh exports heading in the other direction fourteen times, accounting for a deficit of USD 8.9 billion. The trade deficit with Italy is comparably lower, namely USD 1.8 billion, indicating a relatively more balanced trade volume.

Over time, Turkey's exports have continued to shift from agricultural goods to manufacturing industry products that now account for 94 % of total exports. Considering that in the second half of the 1980s the share of manufacturing goods and agricultural goods in total exports were approximately 75 % and 20 % respectively, the tremendous change in the structure of Turkey's exports and the increasing competitiveness in manufacturing industry products is more comprehensible.

Further details reveal that the structure of exports has been changing within the manufacturing industry in recent years as well. Historically the most important export sectors in Turkey, textiles and clothing, lost share dramatically due to difficulties encountered in competing with low-cost East Asian products. From 2002 to 2006, the share of textiles and clothing within total exports dropped from 36 % and 23 %. By contrast, the automotive and basic metal industries became the new driving sectors, with the share of the automotive industry increasing rapidly from 6 % in 2000 to 15 % in 2006 and the share of basic metals increasing from 8 % to 11 %. Apart from these two sectors, Turkey's other major exporting sectors (such as machinery and equipment, chemicals and plastics, and communication equipment) rely on substantial use of imported intermediate inputs, which raises concerns about the low value added in production, increasing imports and the trade deficit.

In fact, Turkey's imports consist mainly of intermediate goods (72 % of total imports in 2006). Imports of investment goods and consumption goods, on the other hand, constitute 16 % and 12 % of total imports respectively. The four items which together make up 66 % of total imports are oil-related products, chemicals, basic metal goods, machinery and automobiles. The rise in international oil prices led to USD 26.6 billion worth of oil-related product imports in 2006, corresponding to 19 % of the total import bill. The expected decline in commodity prices in 2007 is anticipated to alleviate the burden of metal goods and oil imports to some extent. Nevertheless, given the high import content of production in Turkey, import growth is not expected to slow down considerably in the coming years as long as economic growth is sustained.

In terms of foreign direct investment, Turkey is a remarkably different case with respect to the other CEE countries: the latter opened their economies to foreign investment only in the 1990s, during the transition, while major FDI flows in Turkey have been present since the post-war period. The similarity to CEE countries is related more to the acceleration of FDI flows in recent years, together with the convergence process towards the European Union and a deep process of reform. FDI inflows, which hardly averaged USD 0.8 billion in the 1990 – 2000 period, reached USD 9.8 billion in 2005 and peaked in 2006 at USD 20 billion, corresponding to 5.1 % of projected GDP. Political stability, the reform process in the banking and public sectors, robust economic growth, EU candidacy and IMF programs as anchors: all of these elements have put Turkey in the spotlight for foreign investment. Direct investments in emerging Europe in 2006 are estimated to be close to USD 70 billion and, hence, Turkey has become the recipient of almost 30 % of the total FDI inflows.

The surge in FDI inflows also coincided with the acceleration in the privatisation programme of the government: realised privatisations reached record levels in 2005 and 2006. Privatisation projects worth USD 8.2 billion were carried out in 2005, which is almost 50 % of all the privatisations conducted since 1986. In 2006, realised privatisations amounted to USD 8.1 billion and, consequently, total privatisations since 1986 amount to USD 25.8 billion. In the last two years, the telecom operator Turk Telecom, oil refinery Tupras, steelmaker Erdemir and Mersin Port were among the major assets privatised.

Until recently, the privatisation agenda for 2007 included important assets such as TEDAS (electricity distribution company), electricity production plants, TEKEL (tobacco unit), Milli Piyango (national lottery), Halkbank and some major ports. However, a series of postponements in these planned auctions have created concern on the part of investors. The sale of three electricity grids has been deferred, the privatisation of the tobacco firm TEKEL has also been delayed, and lastly, the government decided to change the planned block sale of Halkbank into a 25 % IPO. Hence, it seems that the 2007 privatisation programme has lost some momentum ahead of the general elections in 2007.

Examining foreign investments in Turkey during 2005 and 2006, it is clear that investments in industrial sectors remained limited, while the bulk of investments were concentrated in services sectors, oriented towards the domestic market. Investments in services sectors accounted for around 90 % of total investments in both years. More specifically, two sectors, namely financial intermediation and transport, storage and communication, received most of the FDI (their share in total FDI being 40 % and 36 % in 2006 respectively). Inflows to the banking sector amounting to USD 12.8 billion were quite impressive in the two years. The inflows to communication sectors, on the other hand, stemmed mainly from the sale of Turk Telekom to Oger Telecom and Telsim to Vodafone. In 2007, FDI inflows are expected to continue, but they may fall just short of the peak levels in 2006. Our expectation is that FDI/GDP will total 3.4 % in 2007.

Looking at the countries of origin of FDI in the 2002 – 2006 period, Europe emerges as the main region where 82 % of total FDI inflows originates. The Netherlands tops the list accounting for 22 % of total FDI in this period, Belgium comes second (16 %), followed by Greece and France (10 %). Italy's share in FDI inflows in this period is not negligible either, at 4 %. Together, the share of the Arabian Gulf countries has increased in the last three years, amounting to 12 % on average between 2002 and 2006.

Drivers of competitiveness (2006)

	Turkey	Poland	Hungary	Czech Rep.	CEE-8[1]	Romania	Bulgaria	EU-15
Population (mn)	73.0	38.1	10.1	10.3	72.9	21.5	7.7	389.4
Average age, years[2]	29	37	39	39	38	38	41	39
Youth education attainment level[3], %[2]	44	91	83	91	89	76	77	75
Science and technology graduates[4]	5.6	9.4	5.1	7.4	8.9	9.8	8.5	13.6
GDP per capita €	4,244	7,077	8,925	11,010	8,221	4,510	3,172	27,660
Monthly labour costs, €[2]	677	818	944	954	841	358	229	3,438
Labour productivity per person (EU25=100)	41	59	73	69	63	41	35	106
R&D expenditure, % of GDP[2]	0.66	0.57	0.94	1.42	0.83	0.39	0.5	1.91
Corporate tax (%)	20	19	16	24	20	16	10	29
FDI (in % of GDP, avg 2004–'06)	2.9	4.2	4.6	6.1	4.9	8.3	13.8	n.a.

1) CEE-8 are the CEE countries that entered EU in 2004. 2) Data as of 2005; 3) Percentage of the population aged 20 to 24 having completed at least upper secondary education; 4)Tertiary graduates in science and technology per 1.000 of population aged 20–29 years. Data as of 2004
Source: Eurostat, EBRD, UniCredit Group New Europe Research Network

Foreign Investment in Turkey – Main Lessons

The impressive progress made by Turkey in the last 5 years in terms of economic stability and convergence towards European standards has dramatically increased the attractiveness of the country for foreign investors, especially for European investors (in parallel with the Turkish convergence process to the European Union). The booming FDI inflows are the most noticeable indicator in this sense: in the last two years (2005–06) Turkey attracted twice the amount of FDI received in the whole of the previous decade. Resistance to foreign investment (with obstacles in terms of bureaucracy, customs and local competition) is a thing of the past: local authorities are now encouraging foreign investors to enter the Turkish market. And the Turkish economy is much more open and more competitive than a few years ago. The economic crisis of 2001 must be considered the main turning point, as revealed by a few macroeconomic indicators: in 2001 real GDP declined by 7.5 %, inflation reached its peak at around 70 %, the budget deficit was higher than 16 %, and public debt totalled 108 % of GDP. It is striking how much the Turkish economy has changed since then and how foreign entrepreneurs perceive it. The stabilisation process induced a strong and sound growth pattern (7 %, on average, between 2002 and 2006), significant disinflation (with a decisive re-orientation of inflation expectations that finally brought increases in prices down below 10 %) and inconceivable improvements in public finances. The EU anchor offered strong support, culminating with the start of accession negotiations with the EU in October 2005[6]. All of these factors were key aspects in the perception of the entrepreneurs we interviewed: even if past experience of instability during the 1980s or 1990s is still a fresh memory, the image of the country among foreign investors is far better now than it was a few years ago.

The main driver of foreign investments in Turkey is still related to the **vast potential of the local market: a population of 73 million whose income levels are increasing fast.** Turkey is the second biggest country in Europe in terms of population after Germany (excluding Russia). GDP per capita (now greater than EUR 4,200) is 80 % higher than five years ago. Turkish GDP represents almost 30 % of the total GDP of Central and Eastern Europe (considering the ten new EU members and the Western Balkans[7]): hence it is a potential target for all the companies developing networks in Central and Eastern Europe. There are also specific demographic features worthy of note. First, Turkish citizens are very young on average, especially if compared with Europe (both Western and Eastern). The average age of the Turkish population is around 29 years, ten years less than the average European age. Second, Istanbul with its population of 12 million and an important industrial base nearby is a very special and important gateway to enter the country. Finally, there is still a significant polarisation in the distribution of incomes, with a vast and rich upper class having tastes and habits comparable mainly with European standards. All these characteristics make Turkey a destination market with huge potential that has few peers among emerging markets and certainly cannot be compared with any other Central and Eastern European country.

But Turkey is not simply a large market: it is also **an important productive base with strong traditions in the manufacturing sector.**

In particular, Turkish producers are major players in some specific sectors: **textiles, non-metallic mineral products (cement, ceramic, glass, etc.), basic metals, white goods and automobiles.** Turkish exports in textiles, for example, account for almost 4 % of the entire world textile trade (and 7 % of EU-15 imports), despite the difficulties due to increasing competition from emerging markets. The sector is characterised by having many small enterprises and a very interesting chain of suppliers. Turkey is also a world leader in non-metallic mineral products (with an export share of 2.5 % in the world) as a significant producer of cement, glass, and other goods and materials. The production of white goods, in which local manufacturers are particularly strong, is also attracting foreign investors. Looking at the automotive sector, Fiat, Ford, Toyota and Renault are all in Turkey, manufacturing light vehicles in particular and mostly through joint ventures with local groups. The presence of many local and foreign car producers attracts numerous international suppliers and producers in related sectors. *Pirelli*, the fifth largest tyre producer in the world and a long-standing international company, is one of them. The Italian company[8] was founded in 1872 and expanded abroad (to Spain) in 1902; it has been producing in Turkey since the 1960s: its first Turkish plant was established in 1962. Now the Izmit plant is Pirelli's biggest around the world (Pirelli also manufactures in Italy, Germany, Great Britain, China, Romania, Brazil, Argentina, and Venezuela). Pirelli produces a large amount of tyres in Turkey because of the presence of many vehicle manufacturers, the proximity to European demand (80 % of the tyre production is exported), and also because of local demand: Turkey actually represents the main European market for truck tyres due to the strength of the local manufacturing system associated with an underdeveloped railroad system.

Many foreign companies targeted the Turkish local market because of its potential in terms of consumers, but later understood the advantages that could be exploited producing locally. *Zegna*, a famous Italian brand for wearing apparel, has been targeting the Turkish market since 1989 to exploit the commercial opportunities in the country. This strategy was coherent with the traditions of the company, which at that time also entered the Chinese market, almost twenty years ago, as a destination market rather than a mere production base. Zegna wanted to open a shop in Istanbul, and the company started to produce locally as well: the Turkish plant of the company in the special zone of Tuzla is now the main global plant for Zegna shirts, despite the company also having plants in Mexico, China, Italy, Spain and Switzerland. Around 99 % of the Zegna shirt production in Turkey is exported and sold abroad. The company has a shop in Istanbul and it is also working as wholesale trader, taking advantage of some local producers (especially for belts, jackets and coats). The main driver of Zegna's presence in Turkey is related to the strong role of the textile and apparel sector in the country, in all the production segments, from fabrics to garments. This is not common for other low-cost locations that mainly cover only a few phases of the production process.

The presence of *Ferroli* in Turkey, a company specialised in air conditioning systems, boilers and radiators, dates back to 1989 as a distributor. The company imported and sold goods to the local market that were mainly produced in Italy. More recently, the company decided to start producing locally. The local market is booming (natural gas distribution started recently), logistically it is a good location, as raw materials are available, and there are still cost advantages. Around 75 % of the production is going to be exported.

As Turkey has been both an important destination market and an industrial base since the post war period (in contrast to other CEE countries), **local companies are quite developed and modern.** For this reason **many foreign investors enter Turkey by acquiring local firms and local brands (thus gaining access to clients, knowledge of the local market, etc.),** especially in the manufacturing sector. This is not common for other CEE markets, where foreign investors often prefer green-field investments because existing plants are sometimes obsolete and local partners do not have strong brands and know-how. Entering Turkey with local partners, especially during the initial stages of internationalisation, is considered a plus. Some of the manufacturing companies interviewed adopted this strategy, acquiring local companies and maintaining the brands. The Italian *Barilla*, one of most famous pasta makers worldwide, entered Turkey by acquiring Filiz Gida, and maintained the Turkish brand without imposing the Italian brand that is rather popular at international level (see box 1). Along the same lines, *Menarini*, an Italian pharmaceutical company, bought Ulagay, a Turkish company, which is still distributing medicines with its local and well established brand. Menarini is commercially present in many European countries with production sites in Turkey, Italy, Germany and Spain. Ulugay was acquired in 2001 with the aim of further developing business activities in Turkey; export activities from Turkey are minimal, while production mainly serves the local market. Turkey in this case has been seen as a natural expansion of the European market but with the advantage of buoyant expansion on the local market. The pharmaceutical sector is expanding fast thanks to rapid improvements in the health care system.

The strong industrial base of the country makes it possible for the foreign company to find high-level local suppliers. This has been very important for *Benetton*, which does not produce directly in Turkey but sells many goods "made in Turkey" taking advantage of the quality of its local supplier. This explains why foreign companies that produce or sell in Turkey (directly or through affiliates) do not represent a major driver for the internationalisation choice of other foreign companies, especially suppliers. This is mainly related to the fact that contrary to the experience of other CEE countries foreign companies already find good services provided by local firms. This also has some implications for the patterns of internationalisation of foreign companies, which are less systemic if compared with other experience in CEE: **"follow-the-client" strategies are less common than in other Central Eastern European markets.** This has implications for the dimensions of the foreign firms involved in Turkey as well: the size of the local market represents a major barrier for SMEs and the strength of the local production system provides less scope for small "followers". On the other hand, all the medium-sized and large companies target the potential of the Turkish market. *Metro*, for instance, the big German retailer, has been in Turkey since 1990. It is present in more than 31 countries and around 45 % of its turnover comes

6) Political stability at domestic level has also helped. Since 2002 the AKP (Justice and Development Party) government has been able to rely on a strong majority and pass many reforms. In March 2003 Recep Tayyip Erdogan (AKP) became Prime Minister. AKP received around one third of the total votes of the Turkish electorate and actually controls around two thirds of all the seats (due to the 10% threshold that excludes small parties). This is the fifth year of the current parliament, for the first time in recent Turkish political history, a clear sign of the political stability achieved. The next parliamentary elections in November 2007 will probably deliver a strong majority in the Parliament again.

7) The ten new EU members considered are Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia; the Western Balkan countries are the countries of ex-Yugoslavia (Bosnia-Herzegovina, Croatia, Montenegro, Serbia) and Albania. The weight of Turkish GDP in the above mentioned CEE area (including Turkey) is 29 %, or as large as 40 % of GDP of these 15 countries if we exclude Turkey.

8) The role of Italy, as Turkey's second trading partner, is quite important. Italian foreign policy (through its warm support for the Turkish candidacy to the EU) and Italian entrepreneurs have demonstrated strong interest in the country. While the main trading partner for Turkey is Germany, Italy that focuses more on South Eastern Europe and the Mediterranean considers Turkey as one of its priorities for developing business links. For instance, the increasing role of Turkey as an energy hub is particularly relevant for Italy, as ENI, the biggest Italian company and active in the oil refinery business, is involved in different projects around the country. Industrial links are very strong, with all the major Italian companies already present in Turkey, such as ENI (oil), Pirelli (tyres), Fiat (automotive), UniCredit and Generali (banking and finance), Finmeccanica (Machinery, Defence) and Indesit (white goods).

from abroad. The company mainly sells Turkish goods in its supermarkets and "cash and carry" stores, and it also exports many Turkish goods to Germany (since the 1970s before establishing its presence in the local market). Retail trade through large chains and shopping malls is not as new a concept in Turkey as in other emerging markets: Migros and some municipality retail chains started to position themselves in the local market in the 1960s. Some foreign chains are active in Turkey (apart from Metro also Tesco, Carrefour and Lidl), but the local competition is very strong.

The Turkish production structure is characterised by having a network of small local enterprises and by **the major role played by a few big family-owned conglomerates.** They represent challenging competitors for foreign investors, and often many important partners. Koç Group is the largest of these groups, and it is active in the automotive sector (joint ventures with Fiat and Ford), white goods, retail, food, finance with companies such as Yapi Kredi Bank (finance, in partnership with UniCredit Group), Arcelik (white goods), Migros (retail), Tofaş and Ford Otomotiv (automotive) and Tupraş (energy). The Group comprises more than 120 companies, 21 of whom are listed on the Istanbul Stock Exchange, and has 93,000 employees. It is the only Turkish company in the top 500 companies at global level (Fortune 500). Five of the top-10 Turkish companies belong to Koç Group. The second group in terms of size is Sabanci, active in the field of services such as finance, tyres, food, retail, cement, chemicals, with companies such as Brisa (tires), Cimsa (cement), Akcansa (cement) and Akbank (finance). The third group in terms of size is Doguş, with interests in finance, construction, media and the automotive sector through companies such as Garanti Bank (finance) and Doguş Otomotiv (automotive, joint venture with Volkswagen). It is still difficult to understand whether in the future those conglomerates will concentrate their attention more on some specific sector, or whether they will maintain a major involvement in very different activities as they currently do.

The services sector is very strong and competitive in Turkey too, especially in the field of banking and finance, telecommunications and transport. First, the services sector is mainly aimed at serving the vast, local market, and it can take advantage of the enormous possibilities in terms of economies of scale; second, many activities require a skilled labour force (mainly "white collar"), and this can be considered one of the main sources of strength on the Turkish labour market in the main cities. Local conglomerates are very active in the above mentioned sectors, but many foreign companies are gradually entering the market, starting from 2004–05. The main FDI inflows in Turkey over recent years have been related to telecommunications (Turkcell, Telsim, and Avea) and finance (all but one of the major private banks have experienced some kind of foreign involvement in the last three years). *TIM*, the mobile arm of Telecom Italia and the main mobile operator in Italy, acquired *Avea* in 2000. Avea is the third mobile operator in Turkey, with around 8 mn subscribers. Turkey

Producing pasta with a Turkish brand

(Box 1)

Barilla is one of the most famous Italian pasta brands, selling pasta worldwide. The company also has other business units producing snacks and biscuits. Barilla produces in Italy but also in Greece and Mexico.

Barilla entered the Turkish market in 1993 (another case of a long-standing presence, especially if compared with the relatively recent appearance of foreign investors in other emerging markets), in partnership with Filiz Gida, a company previously owned by Doguş Group, one of the main local conglomerates. From 2003 Filiz became wholly owned by Barilla and is now the second biggest pasta maker in Turkey.

There are two main drivers behind the internationalisation of Barilla: the availability of a large market in terms of population and opportunities, and the existence of a local company with good standards and strong traditions (hence also a well-known brand). The chain of suppliers in Turkey is equally very strong: suppliers of wheat and packaging for Barilla and agents are Turkish for instance. Services such as insurance, marketing and auditing are mainly multinational corporations already working in Italy with Barilla. Competitors are mainly local producers.

Far less pasta is consumed in Turkey than in Italy, as the yearly consumption is around 6 kilos per person in Turkey (where pasta is a side dish and a substantial amount is still home made) and more than 25 kilos in Italy (where pasta is a main course). Some products are considered specifically attractive for Turkish costumers, like softer pasta and smaller cuts.

The Turkish company is strongly independent from the Italian Barilla: the links with the parent company are strong, but no Italians are employed in Turkey; R&D activities are located both in Italy and in Turkey. The company exports the pasta produced in Turkey to North Africa, the Middle East, the United Arab Emirates (UAE) and Somalia, even if we consider that 90 % of sales are directed towards the Turkish market.

was considered a very interesting target for the expansion of the business: a huge potential market in terms of population, with a relatively low penetration of mobile phones (the penetration of mobile phones relative to the population is around 60 % in Turkey against 100 % in Europe, and 120 % in Italy), made Turkey one of the preferred choices of the company. Turkey was considered "a growth story" at that time (the beginning of the decade), when financial markets were concentrating their attention on the expansion of telecommunication companies. Italian Telecom was expanding in Europe (Spain, Greece, France and Germany), Latin America (Bolivia, Peru and Venezuela) and even North Africa. Although the experience of the company in Turkey is considered very positive, TIM is now leaving Turkey as the result of a more general strategy to reduce its foreign commitments and concentrate more on the Italian business, thereby cutting its debt exposure. The Italian telecommunications company still maintains an indirect stake in the fixed lines operator Turk Telecom.

The strength of the **services sector** represents not only a good source of foreign investments but also an important **pillar of support for manufacturing activity in Turkey.** Industrial companies can easily find the high level of service needed in terms of consultancy, legal services, marketing, banks and insurance. It must be stressed that this particular advantage is not so common in other emerging markets.

The competitiveness of the country on the cost side, which was not a topic of discussion some years ago, is now threatened by the strength of the currency, especially in the most traditional price-sensitive sectors. Labour costs in Turkey are lower than in Europe, but some countries (in the Far East but also in Central and Eastern Europe) can be considered more attractive from this point of view. Lower labour costs can nowadays be found in Asia, North Africa, and even in some EU countries such as Bulgaria and Romania[9]. This is why, according to the foreign investors we interviewed, the labour intensive sectors (textiles in particular) will be among those most affected in the future by the relocation of production towards other emerging countries. On the one side this is a painful process, especially for some small enterprises; on the other hand, it is pushing Turkish companies towards higher quality and higher value-added activities. The cost competitiveness of Turkey is very sensitive to exchange-rate developments. While the currency was linked to the dollar and the currency was strong, the Turkish production system regularly experienced tensions and finally a crisis. Immediately after the 2001 devaluation (the domestic currency depreciated by more than 130 %) Turkey became very competitive in costs. In the most recent years the currency has been strong, driven by FDI and renewed confidence in the Turkish economy, appreciating by more than 28 % in 2004 – 2005 in real terms versus the euro. Today, even after the financial turmoil that weakened the currency in spring 2006, the country is considered less competitive in costs (because of increases in salaries but especially because of the level of the exchange rate), and not very convenient to outsource to from European labour-intensive production sites. The Turkish production system is gradually adapting to this new environment, but small and medium-sized enterprises working in more price-sensitive segments of the textile sector still regard the weaker currency as essential. On the other hand, a weak – and unstable – currency is considered grim for many other producers, especially those involved in sectors characterised by high import intensity and where the stability of domestic demand plays a central role. These main trends are well illustrated by the strategies of some companies active in textiles and wearing apparel, such as Zegna (producing and selling in Turkey), Linea Sprint (producing textile swimsuits in Turkey and exporting abroad), and Benetton (for whom Turkey is an outlet market and a supplier of goods): Linea Sprint is the most affected by the strength of the currency, while Benetton and Zegna are enjoying the booming local market (see box 2).

The quality of the labour force is considered by foreign entrepreneurs to be one of the main strengths of the Turkish economy, especially concerning "white collars". The upper-middle class is very well educated, universities are very selective, and the services sector, which employs many highly skilled workers, is strong, especially in the main cities. On the other hand, salaries for these categories are very often aligned with Western standards and there are no strong advantages in this respect for foreign companies in Turkey.

In some cases Turkey is considered by foreign investors to be a **base for accessing other countries**, especially in regions where the links with Europe are weaker. This role could become more significant in the future, but it is not fully exploited yet. First, Turkey is developing a very important network as an energy supplier, and serves as a bridge between producers (Russia and Middle East) and consumers (Europe). Apart from this, foreign companies are looking at Turkey as a possible base for future expansion, and two directions seem to be particularly appealing: **one is the Caucasus (Georgia and Azerbaijan[10]) and Central Asia and the other is the Middle East and North African Muslim countries.** In both cases the geographical, historical, and even religious links are interre-

9) Bulgaria and Romania joined the EU in 2007. Their monthly labour costs, according to Eurostat, were around EUR 229 and EUR 358 respectively in 2005. Turkish labour costs were between EUR 650 and 700, while China has monthly salaries of between EUR 170 and 200.

10) Both countries are involved in the transit of the Baku-Tibilisi-Ceyhan (BTC) pipeline that serves Turkey and Europe. Azerbaijan has a Turkic and majority-Muslim population.

lated and play a role. The example of the *Benetton Group* is indicative in this respect. Benetton entered the Turkish market in 1986, in partnership with a local company; at that time it was the first foreign retail brand in Turkey (it entered before McDonald's). In 1998 Benetton started to explore possible expansion in former Soviet countries and entered Kazakhstan, Uzbekistan, Turkmenistan and lately Georgia, Kyrgyzstan and Tajikistan. Benetton represented the first foreign investment in some of these countries. The "first comer" advantage is seen as very significant, especially in terms of finding locations and reaching agreements with local partners. Benetton now has more than 100 stores all over Turkey, where it controls its activities in the Caucasus and Central Asia. The company sees the former Soviet countries as being crucial for future expansion. *Barilla* produces pasta in Turkey and also serves North Africa, the UAE and Somalia from Turkey. *Ferroli* supplies other CEE markets from Turkey such as Ukraine, Bosnia, Romania and the Czech Republic, while Turkey is considered to be a very good place even for future expansion. *Menarini*, the Italian pharmaceutical company who bought the Turkish firm Ulugay, exports Turkish products to many Mediterranean countries (while ex-Soviet countries are managed from Germany).

In the near future, the Turkish economy is going to remain outward oriented in terms of exports and imports and attract more FDI, derived from privatisations and greenfield/brownfield investments: 2005 has already been a turning point in this respect. **The long and bumpy journey towards the EU, even if not successfully completed[11], will**

11) Currently, 8 out of 35 accession chapters are frozen and the future of negotiations appears uncertain.

Italian companies in the Textile sector: a challenging future (Box 2)

The textile and wearing apparel sector in Turkey is one of the most important for the country: it represents around one quarter of total exports (down from 39 % in 1998), and plays a major role in the European markets (it represents 7.4 % of total European imports of textiles and wearing apparel). The textile sector is also very important for Italy (constituting around 12 % of Italian exports and 8.5 % of European import demand). In both countries the sector is undergoing a significant process of restructuring following the increasing competition coming from low-cost countries, especially from Asia. Many Italian companies have adopted the strategy of outsourcing their production abroad, mainly to Eastern Europe, where they found lower costs and a very favourable business environment.

Our interviews have highlighted different patterns of future developments for the sector. Turkey cannot be considered competitive in this sector as it was in the past, when the country could take advantage of strong traditions and lower costs (of labour, inputs, land) at the same time. Cost competitiveness has been eroded in recent years by the strength of the currency and by the emergence of other low-cost competitors, especially in Asia and in North Africa. Asia has a leading role in terms of costs, while North Africa also exploits its proximity to European markets.

We interviewed three Italian companies active in the sector; two of them produce in Turkey, while the other is in Turkey mainly to sell its goods: we met the top management of *Ermenegildo Zegna*, which produces shirts and targets wealthy clients with very high quality standards and a well known brand; *Linea Sprint*, a producer of high quality swimsuits, whose brand was popular in the past but is not so strong on an international level; and *Benetton*, which has more than 100 stores in the country and can be considered a sort of pioneer having been present in Turkey since 1986. Benetton makes use of Turkey's strong industrial background in the textile sector to produce goods in outsourcing and sell them through its stores.

The companies that produce directly in the country (including Zegna and Linea Sprint) are more sensitive to costs and on the level of exchange rate. For Benetton that mainly targets the local market, the level of exchange rate is not so important (even if many suppliers are Turkish), while improvements in the purchasing power of Turkish consumers are essential. Hence the appreciation of currency and the increase in salaries are mainly hurting those who produce in the local market and sell abroad. Companies that can impose their brand (Zegna for instance, which targets the market of relatively wealthy consumers) are not so affected: high quality goods associated with a strong brand are less sensitive to costs. On the other hand, the Turkish plant of Linea Sprint is suffering from competition from the other plants belonging to the same company that are located in areas more competitive in costs, like North Africa for instance. Linea Sprint is thus gradually reducing its production capacity in Turkey, even if the plant is going to be maintained, especially for the sake of diversification. The strong appreciation of the currency in the period 2004–06 is also causing a gradual loss in competitiveness for many local companies, which are experiencing a painful restructuring process.

For these reasons the EU convergence process is seen in a different light by local and foreign producers. It can have positive effects on the stability of the country, but can also contribute to the increase in land and labour costs (via higher wages and a stronger currency).

open up a huge market even more and attract foreign capital. However, the EU convergence process, if associated with a strong currency (driven by FDI flows) and rising salaries, could create some competitive tensions for some Turkish SMEs involved in the labour-intensive sectors. For these companies a gradual shift towards higher production ranges (in terms of quality and technology) must be expected if they want to survive the entrance of many emerging competitors in the international arena.

The business community, both local and foreign entrepreneurs, see EU entry or at least the long **EU convergence process as a huge opportunity to contribute to the stability of the country and improve the business environment.** Moreover, a huge outlet market will be available for the Turkish production system. Since in many CEE countries the opening of their economy has meant major opportunities for foreign investors even with a very weak local production system (that actually benefited later on from the rapid inflow from abroad of knowledge, skills and technology), many Turkish companies can leverage their strengths even in foreign markets, especially in some specific sector. And the EU convergence process will trigger more competition in the Turkish local market.

Special thanks is due to all the interviewed companies and institutions, which shared with us their experience and knowledge of the country:

Company name	Sector/Activity
AVEA	Telecommunications
Benetton	Wearing apparel
Ferroli	Air conditioning, radiators, boilers
Filiz Gida (Barilla)	Food
Metro	Retail trade
Pirelli	Tyres
Riva Linea Sprint	Wearing apparel
Ulugay (Gruppo Menarini)	Pharmaceutical
Ermenegildo Zegna	Textile and Wearing apparel

A special thanks to Roberto Lorenzon, head of New Europe Desk in Yapi Kredi, and Gamze Çakarcan of the New Europe Desk in Yapi Kredi for their support in organising and managing the interviews.

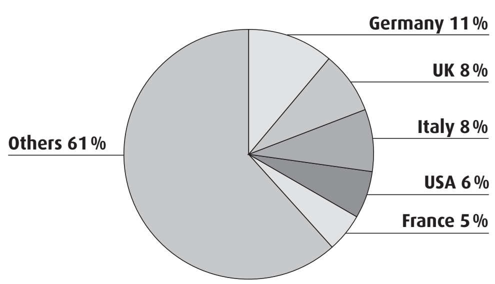
Annex

Main trading partners and investors

Exports (2006)	USD mn	Imports (2006)	USD mn	Trade Balance (2006)	USD mn	FDI stock (2002–2006)	USD mn
Germany	9,673	Russia	17,494	Germany	–4,881	Netherlands	6,251
United Kingdom	6,812	Germany	14,554	Russia	–14,267	Belgium	4,628
Italy	6,749	China	9,553	Italy	–1,820	Arabian Gulf Countries	3,514
USA	4,996	Italy	8,569	United Kingdom	1,730	Greece	2,860
France	4,602	France	6,601	France	–1,999	France	2,726
Total	**85,142**	**Total**	**137,032**	**Total**	**–51,891**	**Total**	**28,650**

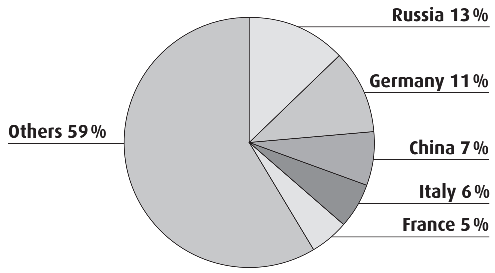
Source: Turkish Statistical Institution, Central Bank of Turkey, UniCredit Group New Europe Network Research

Turkish exports to



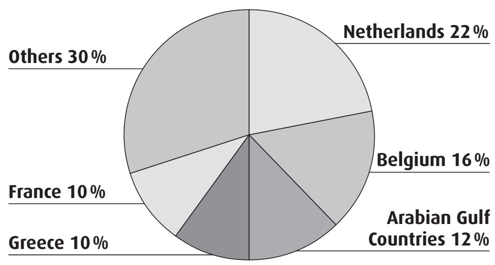
Source: Turkish Statistical Institution, Central Bank of Turkey, UniCredit Group New Europe Network Research

Turkish imports from



Source: Turkish Statistical Institution, Central Bank of Turkey, UniCredit Group New Europe Network Research

FDI in Turkey from



Source: Turkish Statistical Institution, Central Bank of Turkey, UniCredit Group New Europe Network Research

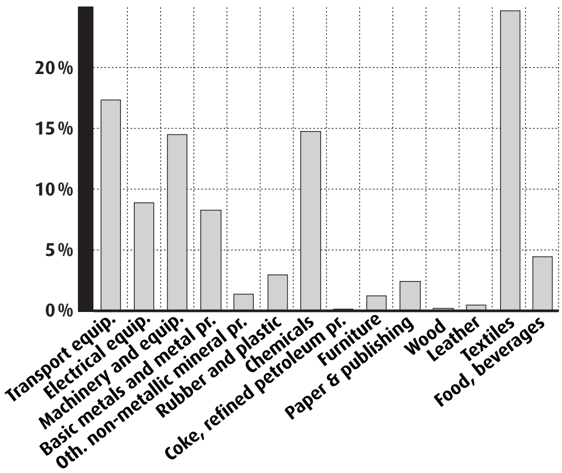
Trade flows and FDI by sector (2006, % on total)

	Exports	Imports	FDI* stocks
Food beverages	5.6	2.3	2.3
Textiles	24.3	4.8	0.8
Leather	0.5	1.0	0.0
Wood	0.4	0.6	0.0
Paper and publishing	0.9	2.5	0.3
Refined petroleum products	4.3	6.8	0.1
Chemicals	4.4	17.9	2.9
Rubber and plastic	3.8	2.4	0.3
Oth. Non-metallic mineral pr.	3.5	1.3	0.6
Metal products	15.8	17.8	0.8
Machinery and equipment	7.5	13.1	0.4
Electrical equipment	7.8	14.3	0.3
Transport equipment	18.3	13.6	1.5
Furniture, manufacturing n.e.c.	2.9	1.7	0.0
Total manufacturing	**100**	**100**	**10.3**
Electricity, gas, water supply	–	–	1.2
Construction	–	–	2.3
Wholesale, retail trade	–	–	6.5
Transportation & Communications	–	–	35.7
Finance, Insurance, Real Estate & Business Services	–	–	39.8
Others (Agriculture, Mining, Social & Business Services)	–	–	4.3

Source: Central Bank of Turkey, UniCredit Group New Europe Network Research
*) 2002–2006

Trade flows and FDI with Germany

Turkish-German trade flows (% of total)



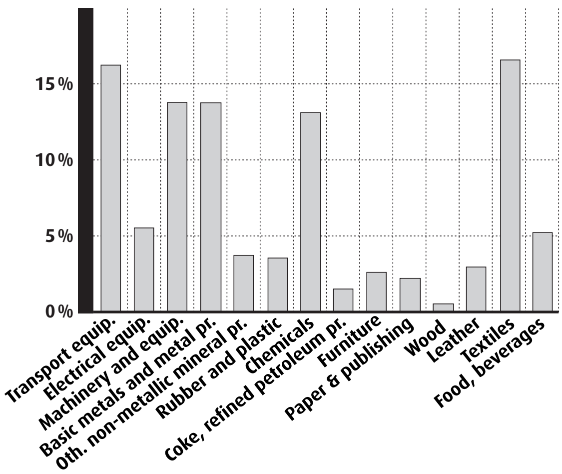
German FDI in Turkey

- German FDI in Turkey amounts to 3.7 % of total cumulated FDI received in the 2002–2006 period.
- Germany is the ninth largest investor in the country, active mainly in sectors such as transport, energy and communication.

Key German investments in Turkey:
- Siemens
- Mercedes Benz
- Man
- Bosch
- Steag
- Praktiker
- Bayer

Trade flows and FDI with Italy

Turkish-Italian trade flows (% of total)



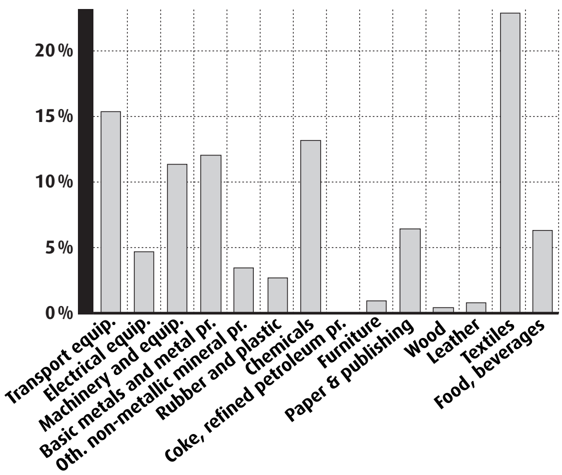
Italian FDI in Turkey

- Italian FDI in Turkey amounts to 4 % of total cumulated FDI received in the 2002–2006 period.
- Italy is the sixth largest investor in the country, focusing mainly on the banking sector and SMEs

Key Italian investments in Turkey:
- UniCredit (Yapi Kredi)
- Fiat (Tofas)
- Pirelli
- Barilla (Ulugay)
- Magneti Marelli
- Finmeccanica
- ENI
- Indesit

Trade flows and FDI with Austria

Turkish-Austrian trade flows (% of total)



Austrian FDI in Turkey

- Austrian FDI in Turkey amounts to 3.9 % of total cumulated FDI received in the 2002–2006 period.
- Austria is the seventh largest investor in the country, focusing mainly on the banking sector, but is also active in the areas of paper and construction

Key Austrian investments in Turkey:
- OMV
- Red Bull GmbH
- Austria Tabak
- Austria Haustechnik AG
- Hobas Engineering GmbH
- Capsnap Europe Packaging GmbH
- Austria Card GmbH

Source: Global Insight, YASED, UniCredit Group New Europe Research Network

UniCredit Group CEE banking network

The Baltics

HVB Bank Tallinn
Liivalaia Street 13/15, EST-10118 Tallinn
Phone: +372 668 8300
www.hvb.ee

HVB Bank Vilnius
Vilniaus Gatve 35/3, LT-01119 Vilnius
Phone: +370 5 2745 300
www.hvb.lt

UniCredit Bank (Latvia)
Elizabetes Iela 63, LV-1050 Riga
Phone: +371 708 5500
www.unicreditbank.lv

Bosnia and Herzegovina

UniCredit Zagrebacka banka
Kardinala Stepinca b.b.,
BH-88000 Mostar
Phone: +387 36 312112
E-Mail: unizaba@unizaba.ba
www.zaba.ba

HVB Central Profit Banka
Zelenih Beretki 24, BH-71000 Sarajevo
Phone: +387 33 533 688
E-Mail: info@hvb-cpb.ba
www.hvb-cpb.ba

Nova Banjalucka Banka
Marije Bursac 7, BH-78000 Banja Luka
Phone: +387 51 243344
E-Mail: info@novablbanka.com
www.novablbanka.com

Bulgaria

Bulbank
Sveta Nedelya Sq. 7, BG-1000 Sofia
Phone: +359 2 923 2111
www.bulbank.bg

HVB Bank Biochim
Ivan Vazov Street 1, BG-1026 Sofia
Phone: +359 2 926 9210
E-Mail: info@biochim.com
www.biochim.com

Hebros Bank
Tzar Boris III Obedinitel
Blvd. 37, BG-4018 Plovdiv
Phone: +359 32 90 57 73

Croatia

Zagrebacka banka
Paromlinska 2, HR-10000 Zagreb
Phone: +385 1 6305 250
www.zaba.hr

Czech Republic

Živnostenská Banka
Na Prikope 858/20, CZ-113 80 Prague 1,
Phone: +420 2 2412 1111
E-Mail: info@zivnobanka.cz
www1.zivnobanka.cz

HVB Bank Czech Republic
Nám. Republiky 3a, CZ-110 00 Prague 1,
Phone: +420 221 112 111
www.hvb.cz

Hungary

UniCredit Bank Hungary
Szabadság place 5–6,
H-1054 Budapest,
Phone: +36 1 269 0812
Fax: +36 1 353 4959
www.unicreditbank.hu

Macedonia

BA-CA Representative Office
Dimitrie Cupovski 4–2/6,
MK-1000 Skopje
Phone: +389 2 3215 130

Poland

Bank Pekao
ul. Grzybowska 53/57,
PL-00-950 Warsaw
Phone: +48 42 6838 232
www.pekao.com.pl

Bank BPH
Al. Pokoju 1, PL-31-548 Cracow,
Phone: +48 12 618 68 88
E-Mail: bank@bph.pl
www.bph.pl

Romania

UniCredit Romania
Ghetarilor Street 23–25,
RO-014106 Bucharest 1,
Phone: +40 21 200 2000
E-Mail: office@unicredit.ro
www.unicredit.ro

HVB Tiriac Bank
Charles de Gaulle Sq. 15,
RO-011857 Bucharest 1,
Phone: +40 21 203 2222
E-Mail: contact@ro.hvb-cee.com
www.hvb.ro

Russia

International Moscow Bank
Prechistenskaya emb. 9,
RF-19034 Moscow
Phone: +7 095 258 7200
E-Mail: imbank@imbank.ru
www.imb.ru

Yapi Kredi Moscow
Goncharnaya emb. 2,
RF-115172 Moscow
Phone: +7 495 234 9889
E-Mail: yap@online.ru
www.ykb.ru

Serbia

UniCredit Bank Serbia
Rajiceva 27–29, 11000 Belgrade
Phone: +381 11 3204 500
E-Mail: office@unicreditbank.co.yu
www.unicreditbank.co.yu

Slovakia

UniCredit Bank Slovakia
Šancova 1/A, SK-813 33 Bratislava,
Phone: +421 44 547 6870
E-Mail: kontakt@unicreditbank.sk
www.unicreditbank.sk

Slovenia

Bank Austria Creditanstalt Ljubljana
Šmartinska 140, SI-1000 Ljubljana,
Phone: +386 1 5876 600
E-Mail: info@si.bacai.com
www.ba-ca.si

Turkey

Yapi Kredi
Yapi Kredi Plaza D Blok, Levent,
TR-34354 Istanbul,
Phone: +90 212 339 70 00
www.yapikredi.com.tr

Ukraine

HVB Bank Ukraine
Yaroslaviv Val 14A, UA-01034 Kyiv
Phone: +380 44 230 3300
E-Mail: hvb-kiev@ua.hvb-cee.com
www.hvb.com.ua

UniCredit Bank Ukraine
14, D. Galitskogo St., UA-43016 Lutsk,
Phone: +380 332 776210
www.unicredit.com.ua

This is a product of the New Europe Research Network. The New Europe Research Network involves all the research offices of the Group dealing with the CEE region, with the aim of providing a shared view in terms of economic developments at the single country and at the regional level

Debora Revoltella
UniCredit Group, CEE Chief Economist
Network Coordinator
Neweuroperesearch@unicreditgroup.eu

UniCredit Group, CEE Economic Research
Carmelina Carluzzo – Matteo Ferrazzi – Sandor Gardo – Hans Holzhacker – Fabio Mucci – Lisa Perrin – Bernhard Sinhuber – Gerd Stiglitz

Bulbank Planning and Control Division, Economic Research Section
Kristofor Pavlov, Chief Economist
Elena Georgieva

Zagrebacka Banka – Macroeconomic Research
Zarko Miljenovic, Chief Economist
Nenad Golac

Zivnostenska Banka – Financial Markets Division
Patrik Rozumbersky, Chief Economist

HVB Bank Czech Republic – Economic Research
Pavel Sobisek, Chief Economist
Vaclac Verner

Pekao SA – Macroeconomic Research Office
Andrzej Bratkowski, Chief Economist

UniCredit Romania – Economic Research
Rozalia Pal, Senior Economist

UniCredit Bank Slovakia – Macroeconomics & Market Analyses
Viliam Patoprsty, Chief Analyst
Lubomir Korsnak

Yapi Kredi Bankası
Cevdet Akcay, Chief Economist
Ahmet Cimenoglu, Head, Strategic Planning and Research
Suzi Apalaci – Yelda Yucel – Veyis Fertekligil

International Moscow Bank Treasury
Alexander Morozov, General Manager
Sergei Kondrashov – Valery Inyushin – Sergei Alenkin

UniCredit Bank Hungary
Márta Szegő Biróné, Chief Economist
Tibor Nagy

The authors of this issue

Matteo Ferrazzi – Yelda Yucel

Your Leading Banking Partner in Central and Eastern Europe

Bank Austria Creditanstalt
Bank BPH
BANK PEKAO SA
Bulbank UniCredit Group
HEBROS BANK
HVB Bank
HVB Bank Biochim
HVB Central Profit Banka
HVB Ţiriac Bank
HypoVereinsbank
INTERNATIONAL MOSCOW BANK
Nova Banjalučka Banka
UniCredit Bank
UniCredit Romania
UniCredit Zagrebačka banka
YapıKredi
Zagrebačka banka UniCredit Group
Živnostenská Banka UniCredit Group

UniCredit Group