ACHIEVING SUSTAINABLE GROWTH THROUGH ECONOMIC INCLUSION IN TURKEY

Turkey has faced a number of challenges in the recent past, but the government has acted swiftly and successfully to limit the impact on the economy. However, in order to generate sustainable growth in the country, structural reforms are required to enhance the competitiveness of the economy. This article looks at how Turkey can take advantage of its significant human capital potential in order to improve competitiveness and attract foreign direct investment (FDI), and details activities the European Bank of Reconstruction and Development (EBRD) is undertaking in the area of inclusion to help the country build a sustainable growth model.

Roger Kelly*

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* Roger Kelly is Lead Regional Economist at the European Bank for Reconstruction and Development (EBRD), Turkey Office.

The Turkish government has acted swiftly and successfully to limit the impact on the economy of the challenges faced in the recent past. However, in order to generate sustainable growth and improve competitiveness in the country, structural reforms are required. This article looks first at the nature of constraints on Turkey's competitiveness and related challenges the country has faced in attracting foreign direct investment (FDI). Attention is then turned to how the country can take advantage of its significant human capital potential in order to improve competitiveness, particularly within the context of the tight labor markets faced by its neighbors in South East Europe. Lastly, it details the activities the European Bank of Reconstruction and Development (EBRD) is undertaking in the area of inclusion in order to help Turkey build a sustainable growth model.

Recent Policy Developments in Turkey

Several policy choices have been made by the Turkish government to date which have helped the economy weather the potential economic storm resulting from the country's challenging domestic and external environments over the past 18 months. The government's policies have boosted credit via the Credit Guarantee Fund and it has introduced various fiscal stimuli. Measures of economic sentiment and leading indicators reveal that these policies should support growth in the upcoming months, provided that the global environment remains favorable towards emerging markets. A resurgence of growth, combined with a weaker Turkish lira and good value stock market, according to most metrics, has made the economy attractive to short-term investors. Recent highs hit by the Borsa Istanbul 100 Index are a testament to this.[1]

However, it is widely recognized that this is a short-term response. Consumption-driven growth is not sustainable. Rather than creating jobs, such growth tends to give rise to inflation and worsens the current account deficit. We are seeing evidence of this in the data. Domestic investment has stagnated as corporates are more concerned about addressing their extensive FX liabilities than investing in capital and machinery to build future growth. And FDI continues its secular decline, having fallen from 22 billion dollars in 2007 to 12 billion dollars in 2016.

Partial blame for the decline in investment can be attributed to ongoing domestic and geopolitical issues in the aftermath of the failed military coup and associated state of emergency. Additionally, the uncertainty surrounding the transition from a parliamentary system to an executive presidency has resulted in additional pressure being put on the already strained EU Accession process. The instability associated

[1] Borsa Istanbul is the second cheapest MSCI EM stock exchange on a 12-month forward price/earnings basis, after the Moscow Stock Exchange.

with these events may cause investors to question their acceptance of the domestic and geopolitical risk factors that have long been a characteristic of the Turkish economy. What appears to be an increasing concern for investors at the current juncture is the slow pace of the structural reforms, which are needed to improve the competitiveness of the economy. These reforms are needed to ensure economic sustainability in the country and to persuade investors that their investments will pay off in the long-run.

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Turkey's Competitiveness and Success in Attracting FDI

The traditional growth model of emerging markets is based on convergence: lower-income countries with export-driven economies take advantage of their low labor costs in order to undertake low-skilled tasks to generate high growth rates.[2] Over time, as wages increase, the relative competitiveness of lower-income countries is eroded. They need to introduce new processes and find new markets to maintain export growth. Ultimately, they need to move from resource-driven growth that is dependent on cheap labor to growth based on high productivity and innovation. Failure to do so can result in such countries becoming stuck in the so-called "middle income trap." FDI can play a critical role in improving a country's competitiveness and helping it avoid the middle-income trap by providing technology transfer and the possibility to access international markets.[3] The effect can be self-reinforcing as FDI is attracted to more competitive economies which offer potential for higher returns.

Over the past 15 years, Turkey has been successful in positioning itself as a low-cost manufacturing hub for Europe, which has been the basis of the country's impressive growth. However, the country has been less successful at taking the next step of integrating itself into global supply chains; almost half of Turkey's products are relatively generic final products with low import content. Low entry barriers to such markets gives rise to intense competition from other emerging market economies, resulting in a high price elasticity of demand. This is an issue for Turkey, a country

[2] "Transition Report 2016-17: Equal Opportunities in an Unequal World," European Bank for Reconstruction and Development, http://www.ebrd.com/transition-report

[3] Technology transfer refers to the transfer of technology developed in advanced economies for exploitation in less advanced economies.

that suffers from high domestic inflation rates and inflexible labor markets: real wages are prevented from falling in order to maintain competitiveness.

Furthermore, Turkey's weakness in the areas of innovation and research and development (R&D) prevent it from moving its production up the value chain, which would boost its competitiveness. The country ranks 103rd out of 138 countries in terms of the quality of its scientific research institutions, according to the Global Competitiveness Report.[4] There is also evidence of an ongoing "brain drain" from the country.

With regards to attracting FDI, Turkey's track record has not been spectacular. FDI flows were weak for the decade following the opening of Turkey's capital account in 1989, on average amounting to less than one percent of the Gross Domestic Product (GDP) per year. Structural reforms undertaken from 2001 onwards, notably in the banking sector, resulted in strong FDI inflows averaging around three percent of the GDP in the period leading up to the financial crisis. However, following the financial crisis, FDI flows declined again to its current level of around 1.4 percent of the GDP. This is low compared to the country's peers. In the face of economic volatility, investors have preferred to put their funds in portfolio investments, which have tended to be the main source of financing for the current account deficit.[5] Furthermore, much of the FDI the country has succeeded in attracting has been in the non-tradable sector (notably, financial intermediation) – giving neither access to international markets nor providing significant technology transfer. As noted by Yuko Kinoshita, an economist at the International Money Fund (IMF), FDI in the tradable sector is likely to increase exports over time (and potentially reduce imports through an import substitution effect), in the non-tradable sector however, FDI is likely to boost imports and fuel domestic demand booms, increasing internal and external imbalances, and fuel inflation.[6]

While there are a number of structural impediments limiting FDI flows to Turkey, not least of which is macroeconomic volatility, the focus of the remainder of this article will be on the impact of labor market inefficiencies on both FDI and investment more generally.

Labor Market Challenges

According to the Global Competitiveness Report, Turkey ranks 126th out of 138 countries in terms of labor market efficiency.[7] Turkey's labor market is characterized

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[4] "Global Competitiveness Report 2016-17," World Economic Forum, 28 September 2016, http://www3.weforum.org/docs/GCR2016-2017/05FullReport/TheGlobalCompetitivenessReport2016-2017_FINAL.pdf

[5] This is not optimal, as portfolio flows tend to be volatile and subject to reversals.

[6] Yuko Kinoshita, "Sectoral Composition of FDI and External Vulnerability in Eastern Europe," *International Monetary Fund Working Paper* WP/11/123, May 2011.

[7] "Global Competitiveness Report 2016-17," 28 September 2016.

by high severance costs, minimum wages, and employer labor taxes.[8] In this context, it is understandable that companies are reluctant to take on staff unless they are certain they will be needed in the long-term. The country has a low employment rate of 51 percent, which is much lower than the EU average of 67 percent. This is partly driven by low female participation rates of only 36 percent and a relatively low male participation rate of 78 percent, primarily due to the low retirement age.[9] The labor market is also distinguished by significant skills and educational mismatches (48 percent of the workforce is undereducated, eight percent is overeducated), manifesting themselves in a reported 1.2 million unfilled vacancies in the country. The unemployment rate remains high at approximately 11 percent, which increases to over 20 percent among youth. There are also large regional disparities regarding access to quality local education and training, and workforce diversity is low.

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As far as competitiveness is concerned, the inflexibility of the labor market has two effects: it hampers firms' ability to adjust to technological and market changes that require labor reallocation – pushing down on productivity – and disincentivizes formal employment. Although the numbers employed in the informal sector have fallen from 50 percent of the workforce 15 years ago, 34 percent continues to be employed without social security.[10] Informal firms have a cost advantage that infringes on the profitability of the formal sector. However, workers in the informal sector invest less in their skills, feeding low productivity once again.[11]

Improving Competitiveness through Economic Inclusion

Labor market tightness, as measured by the difficulties facing employers in filling positions, is at a critical level in South East Europe. A recent Manpower survey reported that Romania was ranked third globally in terms of difficulty in filling roles, with this being experienced by 72 percent of employers.[12] Bulgaria was sixth (62 percent). Similar to other countries in the region, Romania and Bulgaria have participation rates between 70-80 percent, the highest levels in many years, as the number

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[8] "Doing Business 2017 – Equal Opportunity for All," The World Bank, http://www.doingbusiness.org/reports/global-reports/doing-business-2017

[9] The participation rate measures the proportion of the population that is employed or actively looking for work.

[10] "Corruption Reports 2016: Hidden Economy in Turkey," *TESEV*, December 2016, http://tesev.org.tr/wp-content/uploads/2016/12/Corruption3_HiddenEconomy.pdf

[11] "IMF Turkey Country Report 13/364," The International Monetary Fund, December 2013, https://www.imf.org/external/pubs/ft/scr/2013/cr13364.pdf

[12] "2016-2017 Talent Shortage Survey," Manpower Group, http://manpowergroup.com/talent-shortage-2016

of young people entering the labor force is limited by low birth rates and emigration. The tightness of their labor markets has manifested itself in significant nominal wage growth. In 2016, for example, Romanian labor costs increased by 12 percent and by eight percent in Bulgaria. By contrast, in the EU the increase was only by 1.6 percent. This translates into real wage growth that is significantly in excess of productivity growth, meaning that these countries are rapidly losing their competitiveness. This will impact their ongoing ability to attract FDI: in order to remain competitive, real wage increases must be matched by a commensurate increase in productivity.

Compare this to Turkey, which also faces a tight labor market according to the above definition: 66 percent of employers confirm difficulty in filling roles according to the Manpower Survey, ranking the country fifth globally by this measure. However, unlike the countries of South East Europe – where the challenge is due to demographic issues – labor market tightness in Turkey is in the context of low participation rates. This is the case particularly among women, as discussed, and a high unemployment rate due to significant skills gaps. In Turkey, almost 10 percent of companies reported that a poorly educated workforce is the main constraint on growth. This presents Turkey with a large untapped resource compared to its neighbors in South East Europe, and with it, significant opportunities to improve its productivity and competitiveness – and potentially attract FDI which at the moment is going to South East Europe. With appropriate measures in place to equip women and young people and the increasing numbers of refugees with appropriate skills, there is clearly scope for Turkey to increase participation and thereby reduce labor market tightness, making the economy more competitive. The arrival of over three million refugees from Syria, who are gradually being granted work permits, should also help contain nominal wage pressures.

Of course, as discussed above, attracting FDI is not just a question of having a competitively priced workforce. South East European countries have a significant incumbent advantage when it comes to participating in Western European supply chains. But Turkey's proximity to the region already puts it at a significant advantage compared to many other emerging economies, and it has the possibility to capitalize on this to further leverage its position as a partner to the EU.

The EBRD and Inclusion in Turkey

The EBRD's mission is to develop open and sustainable market economies in countries committed to applying democratic principles. While this mission manifests itself through different activities according to the country in which it operates, the concept of sustainable growth is key. In Turkey, this mission is partly achieved by providing finance for projects, and partly by financing policy-related activities. The

ERBD has undertaken inclusion-related activities through both of these channels over the past few years.

An important example of the EBRD's project-related activities in this area is its Women in Business program. This is the first integrated and dedicated program in Turkey targeting small and medium-sized enterprises (SMEs) in which overall operational management responsibility is held by a woman. It is a 300 million euro program that aims to promote women's participation in business through various means, including dedicated credit lines through local banks; a risk loss cover mechanism protecting intermediary banks from losses on such loans; a technical cooperation program to build the capacity of participating banks to reach out to women-led SMEs; and a component to support women in accessing know-how and non-financial development services.

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On the policy side, the EBRD has sought to address issues related to the employment and participation of women and young people by enhancing the involvement of the private sector in updating and improving vocational skills standards and work-based learning policies. This has been done through direct engagement with local and national education authorities. The approach is grounded in the fact that the private sector experiences the greatest skills gap; companies need to work closely with governments to leverage resources and the education system to boost human capital in developing and emerging economies. In Turkey, the EBRD has used a three-pronged approach: First, to seek to improve national skills standards, in particular technical and vocational skills standards in the manufacturing sector as part of Turkey's National Qualifications Framework Reform; second, to provide more work based learning opportunities (apprenticeships) with private sector input; and third, to ensure the provision of private sector-provided career guidance, targeting the young, and particularly young women.

In concrete terms, to date the achievements of this policy-related activity have been to set up a public/private steering group to investigate work-based learning opportunities, in particular the development of national skills standards. This comprises of a number of ministries and agencies[13] working alongside private sector EBRD

[13] Ministry of Labor and Social Security, Ministry of National Education, National Employment Agency (ISKUR).

clients and prospective clients, and Turkish business society representatives.[14] This is supported by partnership with the European Training Foundation, the EU agency for vocational skills and human capital development.

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This model is being expanded to cover refugees and host communities by establishing vocational skills verification centers in key refugee areas, and integrating a focus on refugees into inclusion projects with local training and routes into formal jobs engagement. In addition, the EBRD recently joined forces with the Gaziantep Chamber of Commerce to support and encourage entrepreneurship in the city of Gaziantep and its surrounding region, in order to build the economic resilience of the region which has been deeply affected by the influx of refugees from neighboring Syria. The project will identify opportunities and barriers for the private sector in the region, including refugee-led enterprises. Using these data, new services will be implemented to help entrepreneurs and SMEs reach their full potential.

By working with both the private and public sectors, the EBRD seeks to ensure that young people, women, and refugees can be provided with the most appropriate skills to enable their participation in the workforce. This is both to increase participation rates and reduce skills gaps, ensure the labor market remains flexible, and ultimately help the Turkish economy become more competitive.

Concluding Remarks

The measures taken by the government to address the economic issues arising after the attempted military coup have had some success. However, structural reforms are needed to ensure the economy's ongoing competitiveness and generate sustainable growth. There is a need to rebalance the economy away from domestic sources of demand, and towards external ones. Consequently, there are significant gains to be made from developing activities in tradable sectors, in particular by attracting FDI and benefiting from the associated technology transfer.

Much can be gained by addressing labor market issues and thereby enabling Turkey to make much greater use of its human capital. Addressing the factors that make the

[14] TOBB, TUSIAD, TISK, TEPAV, TURKONFED, Ankara and Adana Chambers of Industry.

labor market inflexible – and thereby discourage employment in the formal sector and labor mobility – would give rise to an overall improvement in productivity, as labor moves to companies where it can best be utilized. Provision of vocational training and business support to those sectors of society that need it most such as women, youth, and refugees, can boost participation rates and address unemployment issues. In turn, this helps the economy become more competitive and productive, and thereby more attractive to FDI. Turkey is in a good position to capitalize on the difficulties currently being faced by its near neighbors in South East Europe as demographic issues give rise to tight labor markets, affecting their competitiveness.