Clothing export in trade between Turkey and EU:  

The importance of FDI
ABBREVIATIONS

- AFTA: Andean Free Trade Agreement
- ATC: Agreement on Textile and Clothing
- BD3: Benchmark definition, Third edition
- C/L: Capital-labour ratio
- CEEC: Central and Eastern European Countries
- CEPS: Centre for European Policy Studies
- CN: Combined Nomenclature
- CU: Customs Union
- EEC: European Economic Community
- EU: European Union
- FDI: Foreign Direct Investment
- FTA: Free Trade Agreement
- GAFTT: Global Alliance for Fair Textile Trade
- GATT: General Agreement on Tariffs and Trade
- GDP: Gross Domestic Product
- G-L: Grubel-Lloyd
- GTAP: Global Trade Analysis Project
- HIIT: Horizontal Intra-industry Trade
- H-O: Heckscher-Ohlin
- IIT: Intra-Industry Trade
- IMF: International Monetary Fund
- IPR: Inward Processing Regime
- ITGLWF: International Textile, Garment and Leather Workers’ Federation
- ITKIB: The General Secretariat of Istanbul Textile & Apparel Exporter’s Associations
- JV: Joint Venture
- KC: Knowledge Capital
- MFA: Multi-Fibre Arrangement
- MFN: Most Favoured Nation
- MFN: Most Favoured Nation
- MNE: Multinational Enterprise
- NAFTA: North America Free Trade Agreement
- NATO: North Atlantic Treaty Organisation
- OECD: Organisation for Economic Cooperation and Development
- OLI: Ownership, Location, Internalization
- OPR: Outward Processing Regime
- PRC: People’s Republic of China
- PTA: Preferential Trade Agreement
- R&D: Research and Development
- RCA: Revealed Comparative Advantage
- SITC: Standard International Trade Classification
- TCI: Trade Coverage Index
- TNC: Transnational Companies
- UNCTAD: United Nations Confederations of Trade and Development
- UV: Unit Value
- VIIT: Vertical Intra-industry trade
- WTO: World Trade Organisation
- YASED: Foreign Investor Association of Turkey
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I. INTRODUCTION

The fifty years after the ending of the Second World War have been a period of extremely rapid economic growth. World output has increased considerably fast and its main explanation is the increase in world trade. Actually, world trade has grown faster than world output due to international specialisation between countries. This phenomenon influenced all sectors of the economy but the trend has been more pronounced for manufacturing industry.

An important cause of the increase in trade has been the willingness of countries to lower their barriers to trade both at the multilateral level through GATT (General Agreement on Tariffs and Trade) and through the creation of regional trading arrangements such as the European Union (EU), North America Free Trade Agreement (NAFTA), Mercosur and Andean Free Trade Agreement (AFTA).

The arrangement between the different countries to form the EU has required a total integration on production structures within the Member States. The principal consequence of the creation of the single market in 1993 was the removal of trading barriers; once the barriers were eliminated, people, goods, services and capital could move freely around Europe as inside the home country. This way Europe was opened to the international markets.

Flows of Foreign Direct Investment (FDI) have expanded rapidly in recent years helped by the removal of many national barriers to capital movements and measures to enhance integration within the national market. This FDI has been the main channel for the multinational expansion of corporations.

Being a labour abundant developing country gives to Turkey a comparative advantage in the labour intensive manufacturing sector. As demand of textiles and clothing steadily grows in the world as countries become wealthier, countries that are specialized in this kind of manufacturing product, have bigger probabilities to observe an increase in their exports. The increase of Turkey’s exportations is helping to its industrialization process, economic growth and development.
Textile and clothing trade among World Trade Organisation (WTO) Members is governed by the ATC, which came into force with the WTO Agreement on 1 January 1995. This agreement means that alongside progressive application of General Agreement on Tariffs and Trade (GATT) rules, there will be progressive phasing out of quotas in the EU, US and Canada. After a 10 year period ending on 1 January 2005, the Agreement on Textile and Clothing (ATC) will expire and all quotas will be abolished.

The expiry of the WTO Agreement on Textile and Clothing has had significant impact on the textile industries of most Southeast Asian countries. This could result in an inflow of the FDI to other countries like China or India, where conditions of production are much cheaper.

The ATC agreement allows additional restrictions, to be imposed temporarily under strict conditions, if it is proved that industry is damaged because of the free trade. These “transitional safeguards” can be applied on imports from specific exporting countries, but the importing country has to show that its domestic industry is suffering serious damage or is threatened with serious damage. It also has to show that the damage is the result of two things: increased imports of the product in question from all sources, and a sharp and substantial increase from the specific exporting country.

In Turkish global economy, developments in foreign investments accelerated along with the changes in the economic and social structure. The deregulation of interest rates, establishment of organized financial markets for money, foreign exchange stocks and securities, liberalization of capital movements and reforms in the banking sector are just some of the major economic policy changes while one of the major policy decisions was the adoption of liberal and flexible foreign investment practices. As a result of the changes in the foreign investment legislation, the investment climate was made more efficient and suitable for potential investors, starting with the 1980s.

In recent years, Turkey has applied to join the EU, which is the second mayor importer for the Turkish clothing products, as it already did before in 1957 and 1987. Turkey proceeded with a closer integration with the European Union by signing The Ankara Agreement (12 of September, 1963) and also agreeing to a Customs Union (come in force on the 31st of December, 1995). Apart from that is an active participant of the
Organisation for Economic Cooperation and Development (OECD) and North Atlantic Treaty Organisation (NATO) between other unions.

1.1. PROBLEM STATEMENT

The stock of FDI in Turkey was only $300 million in 1971, and up until 1980 the average annual inflow of FDI was only $90 million. It was only with a shift in Turkey from a protectionist trade regime to export-oriented economic liberalisation in the mid-1980s that FDI increased significantly. Later on, the 2001 economic crisis had its effects on Turkish FDI, and the FDI flows decreased at that time. The relevant question is whether Turkish exports in clothing sector has been affected by FDI in the sector and whether an increase in the inward or outward FDI raises or lowers exports. Such investments can alter the range and technological characteristics of the goods and services produced within Turkey and thus affect the share of exports markets met by firms located within the exporting country.

The main point we would like to analyse is the following:

Is FDI the main explanatory factor of the increasing trade in the clothing sector between Turkey and EU?

HYPOTHESES:

- Considering that FDI made in the clothing sector in Turkey has contributed to the improvement of the production processes and has also increased trade with the EU, we would like to present the following hypothesis:

  The clothing exports from Turkey to the EU will have a positive increase due to the FDI made in this sector.

- China and India have the highest predicted growth in clothing sector, due to their low labour cost, access to a large domestic supplier base and improving product quality. Moreover, the expiration of the ATC seems to point that the
exportation from these countries to the EU will dramatically increase and consequently will make Turkey loose market share.

The expiration of the Agreement on Textile and Clothing the 1st of January 2005 will have negative effects on the exportations from Turkey to the EU.

- Trade relationship between Turkey and the EU in the clothing sector has taken place for centuries, besides the signing of a CU among is supposed to reinforce it.

The signing of the CU has had a positive impact in Turkey’s trade in clothing sector, increasing the confidence of the investing countries.

- Turkey is submerged in a process of reform to fulfil the Copenhagen criteria. These reforms are helping to the country to improve the actual situation, creating a better environment to attract FDI.

The changes that Turkey is pursuing in all the aspects mentioned will increase the country’s attractiveness for foreign investors.

1.2. METHODOLOGY

Among the different research methods that we can use, we will focus on a quantitative study based on a macroeconomic data. For this analysis we will use the theories described before, applying on them the data we can obtain from the different data bases.

We would also like to complete our thesis by analysing some case studies about European companies that have already made FDI in the clothing sector in Turkey.

All the data selected for this study will be analysed with the criteria of validity and reliability.
1.3. DELIMITATIONS

We will focus our analysis in the relationship between Turkey and EU, without ignoring the effects that third countries could have on it, taking into account that a large amount of trade relations occur among the two participants. We can confirm this with data collected in the 2003 that concluded that 58.1 percent of Turkey’s total export sales were conducted towards EU, and at the same time 52.4 percent of Turkey’s total imports came from the EU.

We will analyse the trade relations between Turkey and the EU-15. On 1st May 2004, ten countries joined the EU: Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovenia, and Slovakia, but as the period of data available is very short to make any conclusion we will ignore them.

The EU-15 will be considered a single market. The relationship will be analyzed between EU-15 as a conglomerate and Turkey. In spite of these, when analyzing actual data it is sometimes not possible to obtain data not including the ten new accessing Eastern European Countries, being in this case EU-25 the unit of analysis used.

We will delimitate our data to the time 1990-2004, period of time we consider extent enough to obtain reliable results. We consider that this lag of time is representative enough because it covers the entrance into force of the Customs Union (1995), the recognition of Turkey as a candidate state to join the EU (1999) and the time when the European Council decided that EU would open accession negotiations with Turkey if it fulfilled the Copenhagen political criteria in 2002.

Although our main unit of analysis is the clothing sector, it is sometimes difficult to move it apart from the textile. The output of textiles industry goes to three types of end-use, of which the clothing industry is by far the most important. The reason is that textiles and clothing industries form part of a larger production chain, and this makes difficult the delimitation in the analysis. Both industries are regulated by the same agreements in many cases, so the effects can also be interrelated. This is why sometimes it will be impossible to talk about clothing industry without mentioning the textiles.
The country of China, in terms of analysis, will be divided in People’s Republic of China (PRC) and Hong Kong Special Administrative Region. Hong Kong had been a British colony until 1st July 1997, date when United Kingdom transferred sovereignty to the PRC and the name “Hong Kong” was transformed to “Hong Kong Special Administrative Region”. At that time the PRC promised that under the “One Country, Two Systems” policy, the socialist economic system in mainland China would not be practised in Hong Kong, and Hong Kong’s previous capitalist system and life-style would remain unchanged for 50 years, until 2047.

1.4. PRELIMINARY STRUCTURE

Our thesis will be further divided into six main parts:

The first part will be aimed at presenting the theoretical concepts necessary to understand the existence of international trade and how nations can gain from trade, paying the main attention to the theory of intra-industry trade and FDI, and to the interdependence among both of them.

The second part will be aimed at analysing the global trends in the clothing sector, due to its weight in the Turkish economy. We will try to predict the future performance of this sector and the expected evolution it will have all over the world.

The third part of this thesis will be focused on the relationship between Turkey and EU. Between the different agreements they have signed since Ankara Agreement in 1963, we will give special attention to the customs union and the effects that it will have on trade in clothing industry.

The fourth part of the thesis will be aimed at examining the evolution of the clothing trade between Turkey and EU. In this phase, we will analyse the different factors that could affect the trade in clothing between these two markets, such as the macroeconomic factors, the enlargement of the EU and the customs union. We will also
pay attention to the rapid expansion of the new emerging economies (China and India) and the way they will affect trade between EU and Turkey once the ATC has expired.

The fifth part of the thesis will be focused on our main interest, the effect that FDI will have in the trade between Turkey and the EU, increasing it or acting as a substitute (vertical or horizontal FDI). The empirical analysis will be carried out through the comparison of Turkey’s performance with the new EU accessing countries.

The final part of the thesis will be aimed at drawing the final conclusions.
II: THEORIES OF INTERNATIONAL TRADE AND FDI

The objective of this second part is to provide the necessary theoretical information to understand the existence of international trade, starting from what the classical theories argue and evolving to the new trade and foreign direct investment theories. These theories will be related to the clothing trade among Turkey and EU, although they will be fully applied in the fifth and sixth chapter.

Why do Turkey and EU engage in trade? What benefits does trade bring to them? What products will Turkey export and what will it import? What determines the pattern of their trade? Which are the motivations for European countries to invest in Turkey? Has it increase the trade with the EU? Is there any discrimination in their trade-relationship for third countries? These kind of questions are some of which we are going to try to analyse in the empirical part, making use of the theories below.

We will identify some of the theories that economists have developed in an attempt to answer these questions and understand why trade takes place between countries all over the world, focusing our paper in the case of Turkey and the European Union.

First of all, the basic or more conventional Theories of International Trade will be explained, which set out the gains that countries can expect from specialising in those activities in which they are relatively efficient, considering the factor endowments of each participant. After that, we will explain the New Theories of Intra Industry Trade, which try to cover the deficiencies of the previous theories.

Once we have explained the theories related to the international trade, we will go through the FDI theories. In this case, we will analyse the motives that lie behind a European enterprise to realise this kind of investments in Turkey for which we will use the OLI paradigm. We will also go through the two main types of FDI, the horizontal and the vertical, for which we will make use of theories developed in this area.

After presenting the main theories for our thesis, we will explore the inter-relation between the International Trade and FDI, in an attempt to analyse the effect that the
amount of FDI made in Turkey could have in the rate of trade with EU, answering to the question of complementary or substitution relationship.

Finally, and considering the Customs Union (CU) free trade agreement that Turkey signed up with the EU, we will analyse the possible discrimination that can the rest of the countries suffer due to the advantage that Turkey could gain in this integration, by using the Economic Integration Theory.

2.1. INTERNATIONAL TRADE THEORIES

Lots of theories related to the international trade have been developed by many economists, such as Adam Smith (1776) or David Ricardo (1817) in an attempt to answer the question of why and how countries engage in trade. Starting with these two authors, economists have always viewed free international trade as a source of wealth and welfare gains.

2.1.1. NEOCLASSICAL THEORIES

The classical theory of trade left an unanswered question. It did not provide any explanation for why relative efficiencies and, hence, comparative costs should differ between countries. It was left to the Neo-Classical school to suggest an explanation.

*The Factor Proportions, Heckscher-Ohlin Theory of Trade*

Two economists, both of them Swedish, namely Eli Heckscher and Bertil Ohlin wrote the answer to the previous question simultaneously but independently in the early 20th century, named as the theory of the *factor proportion*, which is an expansion of Ricardo’s theory. They analysed the existence of differences due to the amounts of different factors (labour and capital) with which countries were endowed and differences in the factor proportions required for the production of different goods (it considers two goods). As a result, the relative prices of the different factors vary from one country to other and so does consequently the cost of production. So, in this case the important factors are the capital-labour ratios (C/L) in the two countries, thus their
size is not a determinant factor to explain trade. This way, what they wanted to explain was that countries will enjoy a comparative advantage in the production of the country’s most abundant factor of production. Thus, a country will export the commodity that uses its abundant factor most intensively and import the goods for which they have lack of factor of production.

In a first attempt to analyse the capital-labour ratio in Turkey we suppose that it is much lower than in the EU, giving to Turkey comparative advantage in the production of goods that require labour abundance. On the opposite side we can find the production that takes place in the EU, whose capital-labour ratio exceeds the one of Turkey, giving to EU the comparative advantage in the production of capital intensive goods. The conclusion taken from this analysis would be that Turkey will export labour intensive goods to the EU and at the same time will import capital intensive goods from the EU.

A limitation that the Heckscher-Ohlin Theory has is that it does not explain properly the trade between two developed countries where the factor endowments are similar. Even though, it is able to explain the trade between a developed and a developing country, such as the case of Turkey and the EU, in which the factor endowments are relatively different.

2.1.2. NEW TRADE THEORIES

In 1980 the New Trade Theories differentiated two different kinds of trade between countries, inter-industry trade and intra-industry trade. Inter-industry trade was already analysed in the Neoclassical Theories, where it was defined as the countries’ exchange of products belonging to different industries based on differences on comparative advantage. This kind of specialisation, giving rise to such trade, is called inter-industry specialisation.

However, much of the trade which takes place in the world is made by countries exchanging products which belong to the same industry. This suggests that countries involved in a more specific form of specialisation, specialise in particular products within a given industry and exchanging them for other products belonging to the same
industry. Such trade is known as *intra-industry trade (IIT)* and the kind of specialisation leading to such trade is intra-industry specialisation.

The reason why classical theories did not identify intra-industry trade was that they assumed that markets were perfectly competitive. What if they are not? Two aspects of perfect competition are important in this regard: the assumption that there are many sellers of a product each of whom is a price-taker and the assumption that the product of anyone seller is identical in the eyes of the consumer to that of another. The new theoretical developments emphasize the existence of imperfect competition and scale economies in industrial markets, and this can explain how in the last two decades, it has been seen that countries with similar factor endowments do more trade than countries with different factor endowments.

Among the determinants of Turkey’s intra-industry trade that Pinar Narin Emirhan defined, we want to mention specially two country specific variables; the economic cooperation and the FDI, due to the close relation they have with our analysis. As this author explains in her model, “When trade barriers are abolished among any two countries, both the volume of trade and the share of IIT in total trade is expected to increase. Therefore, IIT is expected to be high for Turkey’s trade with EU countries.” She also defines as an IIT determinant the level of FDI flows between Turkey and its trading partners, but the effect of FDI on IIT is uncertain due to the opposite views that writers have on this subject. “Some writers argue that increasing FDI both helps consumers to satisfy their differentiated demands and also helps scale economies to appear in production which in return increases IIT. On the contrary, some researchers suggested that FDI flows cause the differentiated demand of consumers to be satisfied by domestic production instead of imports, so it will have a negative impact on IIT”.

2.1.2.1. *Measurement of intra-industry trade*

A large share of world trade consists of intra-industry trade. This type of trade takes place when traders both import and export goods that have similar characteristics.
Grubel and Lloyd were among the first economists to measure the extent of intra-industry trade (Grubel and Lloyd, 1975). They measured intra-industry trade as the percentage of a country’s total trade (exports plus imports) which was matched or balanced, that is exports equal imports for an individual product group or industry $i$, the formula is:

$$B_i = \frac{(X_i + M_i) - |X_i - M_i|}{(X_i + M_i)} \times 100$$

Where $X_i$ and $M_i$ stand, respectively, for the exports and imports of the product group $i$. If all trade was balanced, $B_i$ would equal 100. If all trade was one-way, $B_i$ would equal 0. Thus, the closer $B_i$ is to 100, the greater the importance of intra-industry trade. For convenience, the simple G-L formula above may be rewritten as follows:

$$B_i = \left\{ 1 - \frac{|X_i - M_i|}{(X_i + M_i)} \right\}$$

In estimating the extent of intra-industry specialisation, according to Grimwade (2000), alternative formulas have been adopted by economists such as Bela Balassa (Balassa, 1974), Aquino (1978), Bergstrand (1983) and Glejser (Glejser, Goossens and Vanden Eede, 1979, 1982 and Glejser, 1983). But we won’t get into all these alternative formulas due to the minimum explanatory power.

2.1.2.2. *Distinguishing between Vertical and Horizontal Intra-Industry Trade*

Trade in the same industry between two countries can take the form of vertical IIT or horizontal IIT. One weakness that G-L index has is that it fails to distinguish them. Horizontal intra-industry trade is positively related to attribute diversity, when different varieties of a product are characterized by different attributes (a proxy for horizontal differentiation) and vertical intra-industry trade to skill intensity, when different varieties offer different levels of service (a proxy of vertical differentiation).
The importance of the distinction derives from the fact that different industry and country characteristics are likely to be associated with trade in the two types of products. Industry specific variables like product differentiation, scale economies and oligopolistic market structure are determinants of horizontal IIT, while country specific variables can determine both, horizontal and vertical IIT, through similarity in per capita income, developing grade, market size, transport costs, economic cooperation and FDI level.

Greenaway, Hine and Milner\(^1\) (1995) carried out an analysis to distinguish horizontal and vertical IIT. For this division quality differences between the exports and imports of an industry are used, which in trade are measured by export and import unit values (UV) per ton. The methodology is based on the assumption that the gap between the unit value of imports and the unit value of exports for each commodity reveals the qualitative differences of the products exported and imported between the two economies. The rationale for using UV as an indicator of quality is that, assuming perfect information, a variety sold at a higher price must be of higher quality than a variety sold more cheaply (Greenaway et al, 1995). Even with imperfect information, Stiglitz (1987) argued that prices of commodities are reflections of their qualities so, prices can be used as an indicator of quality.

- **Horizontally differentiated goods:**
  Dixit and Stiglitz (1977) and Lancaster (1979) offer alternative representations of horizontal differentiation – the first the “love variety approach”, the second the “favourite variety” approach. Both were incorporated in models of IIT in Krugman (1979) and Lancaster (1979).

According to Lancaster, each consumer has a preferred variety among all the varieties of a determined product; so, intra-industry trade in differentiated goods is beneficial because it brings a greater number of varieties to the consumer, increasing the likelihood of getting the product which is closer to their preferences, their favourite. The love variety approach explained by Dixit and Stiglitz assumes that the consumers prefer

\(^1\) “A large part of IIT is caused by vertical rather than horizontal product differentiation” (Greenaway, Hine and Milner, 1994-95).
to have access to many different varieties instead of having a preferred good; considering this, there will be as many producers as varieties are.

Both theories demonstrate that horizontal IIT can be expected to be associated with preference diversity and decreasing costs. So, the more similar the countries are in their factor endowments, the greater the share of horizontal IIT.

In addition, Helpman and Krugman (1985) contributed in explaining the co-existence of intra- and inter-industry trade, taking into account the relative factor endowment differences. This model predicts that the capital abundant country exports the capital intensive, horizontally differentiated good, and the labour abundant country exports the labour-intensive, homogeneous good as well as some quantity of the differentiated product. Relative factor endowments determine only inter-industry trade while IIT is determined through divergence in relative factor endowments. As factor endowments diverge, IIT in the differentiated good diminishes.

➢ Vertically differentiated goods:
Models of vertical IIT date from Falvey (1981). In this theory, vertical differentiation is explained as differences in quality between similar products.

In 1981, Falvey demonstrated that using a simple 2 x 2 x 2 structure, it was possible to explain the existence of vertical IIT. The pattern of vertical IIT follows the traditional endowment based model. To explain this fact, Falvey takes a case where two countries have differential endowments of capital and labour, and the higher variety of the differentiate good is produced using relatively capital-intensive techniques. As a result, the higher income or the capital-abundant country specializes in relatively high quality manufactures. The lower income or labour-abundant country will specialize in low quality manufactures.

Falvey’s theory was complemented by Falvey and Kierzkowski (1987) by considering the demand side in the explanation of VIIT. In this aspect it was considered that while consumers have identical preferences, the income is not equally distributed, being this factor the determinant of the demand. Consumers with lower incomes will demand low-quality varieties, and high-income consumers will demand high quality varieties. In this
model, the VIIT takes place because each variety of differentiated good is produced in only one country, but is consumed in all countries.

Following the work by Falvey (1981) and Falvey and Kierzkowski (1987) there is a potential for VIIT between EU and Turkey. We could expect Turkey to produce and export labour intensive lower quality varieties in exchange for capital intensive higher quality varieties from the EU. This hypothesis will be tested empirically in Part V following Greenaway et al. (1995).

2.2. FDI THEORIES

Today, most large companies and many medium-sized firms operate in more than one country. Such companies have come to be variously referred to as multinational enterprises (MNE) which invariably operate on a global basis, planning their activities on a regional or international scale. MNEs are recognised drivers of foreign trade as well as the responsible of the transnationalisation of many goods.

Overseas investment by companies to set up a new overseas subsidiary or acquire a controlling interest in another company is referred to as foreign direct investment (FDI). This is different from investment by individuals and financial institutions in the purchase of interest-bearing securities, which is called portfolio investment. FDI transfers a package of resources to the host country that portfolio investment does not, which include ownership of the foreign company, the exercise of control over the foreign company, the provision of some management expertise and the possible transfer of some technology.

2.2.1. THE BEGINNINGS OF FOREIGN INVESTMENT

In the period before the First World War capital flowed in the manner predicted by the neo-classical theories of the time, from the capital-abundant to the capital-scarce
countries of the world. But this kind of investment was portfolio investment, motivated purely and simply by the desire for financial gain.

In the period after the Second World War, however, an important shift took place towards direct investment undertaken by companies. The creation of new international economic institutions such as the International Monetary Fund (IMF) and the World Bank and the drafting of a new General Agreement on Tariffs and Trade (GATT) raised the confidence and encouraged the firms to expand operations overseas.

Some recent empirical evidence suggests that the volume of direct investment in the world economy has been growing faster than the volume of trade, especially among the developed countries, over the last two decades. But, there has also been a large increase in the flow of direct investment from developed to developing countries over the last five years.

2.2.2. **OLI PARADIGM**

Dunning (1977) presented a general framework, appropriately called the OLI framework or eclectic approach, explaining multinationalization and FDI in terms of advantages concerning ownership, location, and internalization. These advantages must be large enough to offset the initial disadvantages of operating abroad, such as language barriers, lack of familiarity with local markets and regulations, and the costs of coordinating activities taking place in different countries. The OLI framework focuses on:

1. Ownership advantages, meaning those advantages that are exclusive to the investing firm. Ownership advantages arise from the presence of firm-level assets as opposed to plant-level assets. Firm-specific assets include good reputation, marketing advantages, intellectual property, organizational skills, and entrepreneurial ability. To a large extent, ownership advantages are knowledge-based assets that can be transferred at a low cost within a firm.

Multinationals benefit from sharing a single set of headquarters facilities among many subsidiaries, which is considered an ownership advantage. Headquarters
services (e.g. central administration) can be provided at a common cost for the firm as a whole, thus achieving savings compared to the cost of providing the services to each individual plant. This cost advantage does not arise in a two-firm ownership structure entailing two-headquarters and potential duplication of costs.

2. Location advantages, favouring in-country production over exportation include proximity to the target market, availability of low input costs and low taxes benefiting FDI. The sources of location advantages differ depending on whether the multinational investment is horizontal or vertically-oriented. Horizontal foreign investment to produce abroad is encouraged when the host country market is large enough and transportation costs are high enough to discourage exportation. By contrast, vertical FDI spreading out the location of different stages of production is preferred if trade costs are low enough to permit the exploitation of cross-country factor-price differentials arising from differences in relative factor endowments.

3. Internalization refers to the decision to keep activities within the domain of the firm. Internalization advantages such as avoiding complex licensing contracts or keeping secrets and know-how from diffusing to rivals make it beneficial to produce within the boundary of the firm rather than dealing with foreign partners who might be more familiar with the local environment (Buckley and Casson, 1976). Internalization advantage is an important factor in explaining why companies choose FDI versus some type of alternative mode of entry, such as a joint venture (with less than 10 percent of foreign ownership or a contractual non-equity JV) or a licensing arrangement.

It is the simultaneous existence of these three sets of advantages – ownership-specific or O factors, location-specific or L factors and internalisation advantages or I factors – that explains FDI.

The OLI paradigm has the attraction to bring together the full range of factors that contribute to the decision of the firm to establish an overseas subsidiary. It also provides a convenient framework for explaining FDI flows between different countries. On the other hand, it further avers that the significance of each of these advantages and the configuration between them is likely to be context specific, and in particular, is likely to
vary across industries, regions or countries and among firms. Dunning has frequently asserted that no single theory can be expected to satisfactorily encompass all kinds of foreign-owned value-added activity simply because the motivations for, and expectations from, such production vary a great deal. The variables necessary to explain import-substituting FDI are likely to be different from those that explain resource-oriented FDI.

2.2.3. **FDI ENTRY MODES**

Multinationals engage in horizontal and vertical FDI trying to exploit a potential benefit that they can not manage in their home market. Horizontal FDI occurs when a company locates the manufacture of the same product or group of products at more than one plant located in different countries. Vertical FDI occurs when a company locates different stages in the production and marketing of a single product or group of related products in different countries.

The determinants of each type of FDI are likely to differ and, therefore, need to be considered separately:

2.2.3.1. **Horizontal FDI**


As Markusen (1984) said, previous attempts to explain the reason of international trade failed to explain the existence of multinational corporations. This does not carry out a very thorough explanation considering that imperfect competition and scale economies, characteristics of new trade theories are often dominated by multinational enterprises (MNE). That is why he analyzed the factors that motivated firms to multi-plant production. The explanation starts by considering firm-specific activities as sources of multi-plant economies opposed to plant-specific activities, giving rise to the existence of horizontally integrated MNEs. These activities include things like R&D, advertising,
marketing, distribution, and management services. They generate fixed costs that support varying levels of production, allowing additional plants without reducing the marginal product in existing plants. The result is that MNEs disperse geographically production activities but centralize the firm-specific activities.

The geographically dispersion mentioned above does not explain the mode of foreign production. Among other authors, Horstmann and Markusen (1987) compared licensing versus direct investment, concluding that in situations in which the firm acquires a reputation licensing contract does not guarantee the maintenance of it, though the firm may choose a strategy of direct investment rather than licensing.

Markusen (1995) focused on the knowledge-capital concept to define the situations where trade is substituted by FDI through the creation of MNE. Assets characterized as knowledge-capital (knowledge capital, know how, reputation, patents…) are more likely to give rise to FDI than physical capital assets due to their joint character and easiness to transfer. Thus, the model predicts that MNEs will be concentrated in industries that fulfil one of the following three conditions: “firm-level activities or intangible assets are important; plant scale economies are not particularly important; and tariffs and transport costs are high but barriers to direct investment are relatively low”.

Markusen (1995) also argues that horizontal FDI represents the largest share of world investment flows although much more work needs to be done on vertical investments due to its rapid growth as trade liberalization of many developing countries is taking place. Even though, recent studies have rejected horizontal models in favour of the Knowledge Capital (KC) model, which is a hybrid of horizontal and vertical FDI explanation.

2.2.3.2. Horizontal FDI vs. exporting

The choice between exporting and horizontal investing can be viewed as a trade-off between proximity and concentration advantages (Brainard 1993, Markusen and Venables 1998). The key decision is whether to locate production at home, shift all
activities to some target market, or produce in both locations. The export vs. foreign investment decision is taken on the basis of location advantages. Ownership and internalization advantages are not a sufficient condition for choosing horizontal FDI over exportation. First, ownership advantages such as common headquarters can be exploited by either foreign investing or exporting. Second, both exporting and FDI entail full internalization of decisions.

In the presence of trade costs, location advantages such as proximity to the target market to minimize trade costs call for servicing each market with separate facilities and favour FDI over exports. On the other hand, in the presence of economies of scale, there is a cost reduction benefit from concentrating production in a given location and other markets are served by exportation. The choice between FDI and exporting is determined by which factor dominates the trade off between proximity to market to minimize trade costs and production concentration to exploit scale economies.

2.2.3.3. **Vertical FDI**

Helpman, with his paper from 1984, was one of the economists that made early treatments in vertical foreign direct investment. He based his argumentation for the new theory, in the lack of treatment of the multinational corporation in the existing general theories of international trade. He found the necessity of a theory which described the conditions that makes the company fragment their activities to foreign locations (vertical FDI) considering that is profitable for them and the pattern of trade that emerges under these conditions. Some characteristics of this theory are the existence of differentiated products, economies of scale, monopolistic competition and firm-specific assets which can be used to service production plants in other countries.

In this paper, Helpman (1984) deals with single product firms. The fact is that firms want to maximize their profits and in an attempt to minimize the costs, they make location choices of product lines. Here, the emphasis is in the differences in relative factor endowments, following the factor-proportion explanation, locating skilled-labour-intensive activities in skilled-labour-abundant countries and so forth. In this theory, transportation costs, tariffs or any kind of tax are assumed away; thus, is clear that the
production facilities establishment is not made in order to avoid these costs. This theory associates multinational corporations with the ability of firms to exploit cross-country differences in factor prices by decentralizing their activities geographically to the cheapest locations.

In Helpman (1984) due to the fact that all firms were single product firms and there were no impediments to trade, no firm had more than one production facility, having no reason to engage in horizontal FDI. But this is inconsistent with the empirical findings that confirmed that trade takes place also in intermediate inputs and that multinational corporations have often production facilities in several countries.

Later, in Helpman (1985) he extended the theory taking into account the missing points in the previous works and evaluated their contribution to the explanation of trade patterns. This paper was made by incorporating the model of the horizontally and vertically integrated firm from Helpman (1983) into the theory of international trade and direct foreign investment in Helpman (1984). Thus, we get a theory of international trade where horizontally and vertically integrated firms which have production facilities in more than one country, trade in finished goods, intermediate inputs and invisibles. The extension gives a more realistic pattern of resource allocation.

2.2.3.4. Knowledge-capital model

There have been several attempts to integrate models of horizontal and vertical explanation in the same theory. The KC model, that first unified both models, was pioneered by Markusen et al. (1996) and Markusen (1997) and demonstrated in an empirical test in Carr, Markusen and Maskus (2001) and Markusen and Maskus (2001). This model integrates the horizontal and vertical models and allows for both multiplant scale economies and exploitation of factor-price differences. Since the KC model is a combination of the horizontal and vertical models, it comes as no surprise that skill differences can have positive and negative effects.

The principal assumptions of the KC model are: (1) knowledge based and knowledge generating activities can be geographically separated from production and supplied to
production facilities at low cost, (2) these knowledge-intensive activities are skilled-labour intensive relative to production, (3) the services of knowledge-based and knowledge-generating activities have a (partial) joint-input characteristic, in that they can be supplied to additional production facilities at low or zero cost. The first two characteristics explain the existence of vertical MNEs, while the third one replicates horizontal MNEs.

The final conclusion that is taken when considering the above assumptions is that vertical MNEs arise when factor price between the two countries in the model differ while they are similar in size, horizontal MNEs arise when countries are similar in factor endowments and size but transport costs are high, and national firms will dominate when home country is large and skilled labour intensive, countries are similar in relative endowments and size (no motive for vertical FDI) and there are low transport costs (no reason for horizontal FDI).

Economic reasoning suggests that vertical FDI is prevalent between the industrialized and developing countries, whereas horizontal FDI is prevalent among the industrialized countries.

2.3. RELATIONSHIP BETWEEN FDI AND TRADE

The relationship between trade and investment have attracted economic and policy attention for many years. Due to the increasing interest in this subject the WTO established a working group at the Singapore Ministerial Conference of late 1996.

The OECD has also written different working papers related to this subject. In 1999 an analysis of the complementarity and substitutability between trade and FDI was carried out, were the interaction among both factors was studied across countries and at different levels of aggregation (economy-wide, sectoral and at the level of the firm), being the results inconclusive due to the difficulties in establishing a causal relation between them. The results obtained from the analysis of different countries differed; however, all the relationships between trade and FDI had a common trend that was
affected by a turning point in the mid-1980s. Before the mid-1980s, there is evidence of many cases in which trade caused investment (the United Kingdom is the main exception, as outward FDI is found to have caused an increase in imports). In contrast, since the mid-1980s, two causal linkages seem to have dominated. First, outward FDI is caused by exports. This is verified for France, the United States, Japan, Sweden and Korea. Second, FDI causes trade for all countries with the exception of the United States and Korea.

The above mentioned trend makes difficult to establish a cause-effect relationship between trade and FDI, when saying that since the mid 1980s exports caused FDI while FDI caused trade. Nevertheless we will not get into a deeper analysis in the cause-effect relationship, due to the mixed opinions that different authors have in this subject. Our focusing will be in the effects that FDI can have in trade considering different perspectives.

From the perspective of the nature of the FDI, horizontal or vertical, two opposing views come up. On the one hand, it is considered that horizontal FDI displaces trade, due to the fact that instead of exporting the firm establishes a subsidiary in the foreign country, trading off lower trade costs against higher fixed costs (see, among others, Horstmann and Markusen, 1992). Nevertheless, Venables (2001) said that some qualification needed to be done to this affirmation, due to the fact that some positive aspects come up from the horizontal FDI, such as the trade in intermediate goods, the increase in total sales or the creation of a particular project that may be used to supply a larger regional market. According to Venables, these would compensate in part the loss, but his main conclusion from the analysis is that horizontal FDI replaces the exports.

On the other hand, it is considered that vertical FDI splits the production process into segments that are relatively intensive in different factors of production, involving specialisation. Each segment is located in the country that is abundant in the required factor (Helpman, 1984). Since each plant must export its output as an intermediate good to other plants, vertical FDI creates trade and it is eased by low trade costs. Furthermore, according to Venables (2001), vertical FDI may even create a larger trade flow than the value of the final good, due to the fact that the components cross borders repeatedly, included in the product being transported.
From the country perspective two points of view can be analyzed: investor country and host country. In the case of the investor country, FDI can be seen as substituting for trade as exports are replaced by local sales. On the other hand, FDI and trade can also be seen as complementary since investing abroad leads to greater competitiveness in foreign markets, and trade in intermediate goods (inputs).

The relationship between FDI and trade for the host countries can be seen to be symmetrical to the investing country. On the one hand replacement of imports for local production improves current account, domestic production and employment. While if inward FDI results in the importation of inputs, this might imply a weakening of the host country’s current account.

Markusen (1997) made a working paper analysing the relationship between trade and investment liberalization in a relatively skilled-labour-scarce economy. From the combination of three different firm types and four different scenarios he aims to understand the interrelation above mentioned.

He confirmed, among other, that FDI and exports would be seen as complements in the particular case were the foreign investors use these countries as export platform FDI.

2.4. ECONOMIC INTEGRATION THEORY

Since a regional economic integration agreement gives preferential treatment to the members of the agreement, but not equal treatment to non-members as would be in line with the Most Favoured Nation (MFN) clause of the GATT/WTO, any such agreement violates the non-discrimination principle of the GATT/WTO. However, regional economic integration agreements can be exempted from the non-discrimination principle, either because a move towards trade flows among a group of countries is seen as a step in the right direction of free trade, or because a preferential trade agreement provides an impulse to the growth and development process of less developed countries.
Regional economic integration, in which a group of countries eliminates barriers to international trade and competition, has become increasingly popular since the Second World War. For the integration of final good markets and factors of production, we can distinguish between the following types: preferential trade agreements (PTA), free trade area (FTA), CU, common market and economic union.

The two effects coming from an economic integration, (1) the increase of trade for the countries receiving a preferential treatment and (2) the reduction of trade for countries who do not, were described for the first time by Jacob Viner (1950), referring to it as trade-creation and trade-diversion, respectively. He analysed the way in which a customs union between two countries can affect trade flows and resource allocations.

2.4.1. TRADE-CREATION

Assume two countries A and B (both of them producers of the same good), where A is a more efficient producer than B, in which case the price of country A \( (P_A) \) is lower than the price of country B \( (P_B) \), because they have less consumption of factors. In this game, there is a third country C (the buyer), which imports a quantity of goods from the country A, and the price in country C is equal to \( P_A + t \). After the formation of the customs union, the tariff \( t \) between the countries A and C is eliminated, such that the price in country C falls to \( P_A \). As a result, the quantity demanded by country C increases and imports from country A rise, but at the same time the quantity domestically supplied falls, hence the term trade-creation. There is a trade creation because higher-cost production in country C has been replaced by lower-cost production in country A.

This way, not all the parts gain in this trade. Welfare for the producers in country C falls. As the demanded amount of goods for the other country has increased, the production in the country C decreases which is not good for the producers of the country. Welfare for the government of this country decreases too, as now is produce less inside the country and consequently the revenue obtained is less. But, welfare for the consumers of the country C increases, because now they can buy at a cheaper price, as well as the net welfare effect for this particular good, which is a gain for the country C.
2.4.2. TRADE-DIVERSION\textsuperscript{2}

Assume two countries, A and B (again both of them producers of the same good) where A is a less efficient producer than B, in which case $P_A$ is higher than $P_B$. In this game, there is also a third country C (the buyer), which imports a quantity of goods from the country B (the most efficient country with lower prices), and the price in country C is equal to $P_B + t$. After the formation of the customs union between the country A and the country C, the tariff $t$ between the country A and C is eliminated. Since imports from country B are still subject to the tariff $t$, and $P_A$ is lower than $P_B + t$, this implies that the price falls from $P_B + t$ to $P_A$. Consequently, quantity demanded by the country C to country A increases, quantity domestically supplied in country C falls, and there is trade-creation between the country A and C as imports rise. This results in a positive welfare effects.

This time, however, there is a second, negative, welfare effect operative, called trade-diversion. Since the customs union with the country C gives the country A preferential treatment, country C now starts to import goods from country A rather than from country B, that is trade is diverted from the more efficient producer to the less efficient producer.

Thus, welfare for the producers and the government in country C falls, as now is less produce inside the country and as a result the revenue obtained by the government is less. Even though, welfare for the consumers in country C increases due to the cheaper prices for the goods. Consequently, the net welfare effect for this particular good for country C could either be positive or negative.

The positive welfare effects arise from the efficiency gains from trade-creation. The negative welfare effects arise from the reallocation of resources from the more efficient to the less efficient producer as a result of trade-diversion. As mentioned above, Jacob Viner therefore argued that the net welfare effect of creating a customs union is positive if the trade-creation effects dominate the trade-diversion effects.

\textsuperscript{2} “The potential positive welfare benefit of the formation of a customs union, which after all eliminates artificial barriers to trade, was convincingly demonstrated by Murray Kemp and Henry Wan Jr. (1976)”.
III. GLOBAL TRENDS IN THE CLOTHING SECTOR

In this third part, the clothing sector will be our main interest. Nevertheless, sometimes it is difficult to take textile and clothing separately, as some agreements have been done for both of them considering as one. Furthermore, taking into account that textile industry supplies the clothing industry in many cases, it is obvious that they are interrelated. Due to the previous arguments, in the cases that we consider it necessary we will refer to both industries.

After explaining the general trends worldwide in this sector, we will apply Porter’s Diamond approach to the case of Turkey, to obtain an opinion about which is Turkey’s position in this sector of activity.

The arrangements that have been negotiated worldwide will be mentioned next, and the effects they have had in clothing trade. Lastly, the analysis of the clothing manufacturing industry in Turkey will be carried out, together with China and India, which are supposed to be a very important rivals in the sector.

3.1. GENERAL TRENDS

Clothing trade is a vital part of the world economy with many nations heavily dependent on the sector for foreign exchange earnings and employment generation, being central to the economies of many developing countries.

Advanced industrial countries in Western Europe and the US dominated the world economy and controlled most of the industrial production before World War II; times, where less developed countries tended to specialize in supplying raw materials.

It was in 1940 when clothing industrial production moved out from the developed countries to developing ones, due to their low labour cost and abundance of raw materials. This way, developing countries have had a positive average growth in the clothing sector while average growth in developed countries has been negative.
According to Peter Totterdill (International Journal, 1995), during the 1980s many companies, particularly in more developed countries, found that they could no longer compete in price sensitive markets against the imports of mass product garments. This situation gave rise to higher value fashion markets during the decade. From then on, price factors were no longer the principal determinants of competitiveness; style, quality and the ability to respond rapidly to changes in fashion were considered priorities for the success.

Following the new requirements of the clothing market, the European clothing industry has gone through significant restructuring and modernisation efforts during the last ten to fifteen years, increasing productivity throughout the production chain, and reorienting the production process towards innovative and high-quality products.

Turkey, besides being a developing country, also suffered the effects of the dynamic change as many other countries, being forced to shift its orientation from low value added textile products in fierce competition and threatened by Asian countries to clothing oriented exports. After 1985 the largest development in Turkey’s clothing sector took place in the product variety of the exports, increasing at the same time textile imports due to the tendency of sourcing from countries that offer cheaper raw materials.

Nowadays Turkey is trying to gain competitiveness pulling out of production low value added products and focusing on value added ones by utilizing highly skilled and productive labour force.

The actual situation in clothing exports worldwide (Table 3.1) shows the importance of the intra EU trade, accounting for 21.6 percent of total clothing exports in 2004. Nevertheless, only 7.4 percent of the trade is made outside the EU countries; we should then consider China as the country that counts with the higher percentage of clothing exports, being Turkey in third position after Hong Kong. China’s growth is not just because of its low cost labour force, but also because an important own textile industry and the possibility to take advantage and benefit from Hong Kong’s well established financial and marketing expertise. In this table can be observed the emerging superiority
for Asian countries, being India’s average annual growth 7 percent in the last four years, led by China, Turkey and the EU. According to the Centre for European Policy Studies (CEPS), the superiority of Asian countries is concentrated in low cost clothing production, being the candidate countries ranked second in terms of clothing quality followed by the EU new member countries, while the China/Asia group is in the third position.

Table 3.1 The world's leading clothing exporting countries, 2004

<table>
<thead>
<tr>
<th>Exporters</th>
<th>Value</th>
<th>Share in world exports</th>
<th>Annual percentage change</th>
</tr>
</thead>
<tbody>
<tr>
<td>European Union (25)</td>
<td>74.92</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>extra-EU (25) exports</td>
<td>19.13</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>China</td>
<td>61.86</td>
<td>4.0</td>
<td>8.9</td>
</tr>
<tr>
<td>Hong Kong, China</td>
<td>25.10</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Domestic exports</td>
<td>8.14</td>
<td>11.5</td>
<td>8.6</td>
</tr>
<tr>
<td>Re-exports</td>
<td>16.96</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Turkey</td>
<td>11.19</td>
<td>0.3</td>
<td>3.1</td>
</tr>
<tr>
<td>Mexico</td>
<td>7.20</td>
<td>0.0</td>
<td>0.5</td>
</tr>
<tr>
<td>India</td>
<td>6.62</td>
<td>1.7</td>
<td>2.3</td>
</tr>
<tr>
<td>United States</td>
<td>5.06</td>
<td>3.1</td>
<td>2.4</td>
</tr>
<tr>
<td>Romania</td>
<td>4.72</td>
<td>...</td>
<td>0.3</td>
</tr>
<tr>
<td>Indonesia</td>
<td>4.45</td>
<td>0.2</td>
<td>1.5</td>
</tr>
<tr>
<td>Bangladesh</td>
<td>4.44</td>
<td>0.0</td>
<td>0.6</td>
</tr>
<tr>
<td>Above 10</td>
<td>188.6</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>

Source: WTO (International Trade Statistics, 2005)

3.2. PORTER’S DIAMOND APPROACH

The term of “competitive advantage” has always been associated to labour costs and economies of scale. But Michael Porter worked on this concept and defended that competitive advantage couldn’t be standardized that way, arguing that cost differences were not the only reason that explained why some nation’s firms are better able to differentiate than others.

3 Based on Porter, Michael E. (1998) and Dicken, Peter (1998);
Each sector requires its own specific competitive advantage, and the main task is to understand why some nation’s firms reap them and not others. According to Porter (1998), the answer is based on four attributes of a nation, which he refers to as The National Diamond.

**Figure 3.1**  The Determinants of National Advantage

![Figure 3.1 The Determinants of National Advantage](image)

Source: Porter’s Diamond (1998)

The diamond is a mutually reinforcing system, due to the fact that the effect of one determinant has a result on the state of others. According to Porter and its Diamond, in a natural resource-dependent industry or industries which have not sophisticated technology or skill, advantage based on two determinants will be enough. This would be our case, considering that, as said before, clothing industry does not require high skill workers or sophisticated technology. But, in the other hand, knowledge intensive industries require advantage in the four attributes for reaping and sustaining their competitive success.

Next, we will explore the influence of the determinants individually:

**Factor Conditions**

Factors of production are the condition in which the standard trade theories, explained in Part II, are based; where a nation’s endowment of factors is the variable that gives
competitive advantage to one country rather than to other. But it is not the mere access to factors but the ability to use them productively that is the main characteristic for helping achieve competitive advantage. Although factor endowment clearly plays a role in the competitive advantage, other determinants in the diamond are necessary to explain it.

The first factor from which Turkey can obtain advantage is its abundance of raw material, such as cotton. Nevertheless the country has some other factors that act negatively to its competitive advantage such as wages. Turkey counted with cheap labour cost advantage in clothing until the mid 80s, time when increasing labour cost affected prices and consequently exports growth of clothing products.

The lack of skilled employees in administrative level creates disadvantages for advanced factors. The universities in Turkey still indicate a very low focus in the sector, forcing fashion companies send their designers abroad for further training.

The R&D investments in terms of process development, fiber and fabric development, and design development in Turkey are very low, being the main causes of losing competitiveness of Turkey.

In common with other industries, clothing industry suffers two energy related problems; high domestic prices compared with international tariffs and frequently power cuts. The domestic energy prices are three times that of the average of OECD countries while power cuts have forced big companies (which can afford it) to build their own power sources.

**Demand conditions**
A home country will have competitive advantage in determinate industry or industry segment when home demand gives local firms a clearer or earlier picture of buyers needs than foreign rivals have. Another way to have competitive advantage in this condition is buyers to pressure local firms to innovate faster and achieve more sophisticated comparative advantages compared to foreign rivals.
The characteristics of home demand conditions can not be applied to the case of Turkish clothing sector we are working on, because we will focus on Turkey from the perspective of clothing supplier country mostly to external customers. The same perspective is taken when analyzing clothing sector in India and China. Following our point of view, neither the competitive advantage of Turkey, India and China on clothing manufacturing sector can be explained by home demand conditions. The consideration made before has sense when taking into account that the three countries are net exporters of clothing and they mostly have customers from abroad, being their clothing production larger than internal requirements. Besides, the major determinant of the demand is personal income, restricting the size of domestic market in developing countries and forcing them to adopt export-oriented policies.

Even though we have already confirmed that home demand condition do not concern to our analysis, demand side on clothing sector can be studied from the foreign demand perspective even though its importance is lower. Demand of clothing has direct influence in the location of clothing manufacturing, being the EU and Turkey a good example; the geographical proximity to the EU as well as the lower labour cost and high quality in respect to Asian countries that Turkey has, makes its products attractive for foreign demand.

**Firm strategy, structure, and rivalry**

Goals strategies and ways of organizing firms in industries vary among nations, affected by national circumstances. Due to the different environment and the lack of a universally appropriate managerial system, nations will use management structures that best suit to their circumstances.

Turkey is mainly producing clothing for main world brands, producing for them nearly 90 percent of the exports. Our selected country is over concentrated in supplying the EU in clothing sector, making apparent the need to diversify the market, due to the fact that a slowdown in the market would have a huge effect in the whole Turkish economy. Competition to supply retailers is extremely fierce, but it was expected to bring innovation to the sector, although the real impact has been the price cuts that Asian countries have started, which harms Turkey.
The common characteristic that clothing manufacturers have to carry out is flexibility and adaptability. Whether a firm pursues a strategy of cost leadership or product differentiation must be able to respond quickly and flexibly to changing circumstances. This means that companies do not only choose the location of the production based on cost of labour. They want a production plant that is closer to their markets and want speed and flexibility from the manufacturers to respond to rapid changes in customer preferences. The flexibility and adaptability of Turkey’s manufacturers to changing fashion trends creates an advantage for Turkey. According to what was said in the International Istanbul Textile Congress (2004), unlike China, Turkey has a very strong fabric market and is able to produce new models within a very short time period.

The low technology sophistication and low barriers to entry that characterize the clothing sector, makes it very fragmented and dominated by small firms, taking the characteristics of a monopolistic competition. In Turkey there are about 40,000 medium-sized companies in operation. However, large firms are becoming increasingly important because they can afford to invest in new technology and build worldwide brand image. Out of the 500 largest companies in Turkey 100 of them operate in the textile and clothing industry.

Even though companies' size is becoming bigger, most of the textile and clothing companies in Turkey are family owned. The industry still can not attract well educated young people and authority is delegated to the owner. This restricts the firm for advancing themselves and investing in R&D.

The local rivalry acts as a pressure for domestic firms to improve and innovate in ways that upgrade the competitive advantage of nation’s firms. Clothing sector in Turkey is being affected by the increasing role that Asian countries like China and India are adopting, increasing rivalry in the sector and forcing Turkey to innovate.

**Related and supporting industries**

The competitive advantage that can be created from related and supporting industries can be of two types: (1) via to the access to most cost effective inputs and machinery and (2) through the advantages that home suppliers provide in terms of ongoing coordination.
The most important feature lies is the second advantage indicated above, which facilitates the exchange of R&D and joint problem solving among other benefits.

Turkey’s textile sector gives the clothing producers a major advantage over the competitors, due to the integration among textile and clothing that it counts with. Besides, even is not a must, geographical concentration also facilitates the benefits that can arise from related and supported industries. In the case of Turkey, even though the geographical clusters are not very well developed, some concentration in textile and clothing can be seen in the Marmara, Aegean, and South East Regions.

**The Role of the government**

Although the government is not one of the four determinants included in Porter’s diamond, many see it as an important element to explain the approach. Porter himself also considered to name it as the fifth determinant. The main role of the government, in the national competitive advantage, is to influence the four determinants, positively as well as negatively. The buyers’ needs are influenced by the regulations established by the government in areas like for example, the advertising media, supporting services and also the structure or the strategy of the company. The fact that the government is one of the major buyers of many products can help or hurt the nation’s industry.

Textile and clothing sector has special treatment in comparison with the rest of economic sectors. Governments in developed economies have been forced to intervene because of the increasingly severe competition from low-cost or more efficient producers. The purposes of the adopted policies were, on the one hand to restructure and rationalize the country’s textiles and clothing industries, and on the other hand to stimulate the industries through offshore assembly provisions and preferential trading agreements. Apart from these policies adopted independently for each government, international regulation has also been adopted to regulate international trade in clothing and textile sector.
3.3. MULTI-FIBRE ARRANGEMENT (MFA)

Actually, Textile and Clothing industry are subject of fierce political controversy between developed and developing countries and, increasingly, between the developed economies themselves. The reason is that newly industrializing and less industrialized countries have diminished the importance that older industrial economies had in the sector. This makes textile and clothing to be the only industries in the world economy to which special international trade restrictions apply through the Multi-Fibre Arrangement (MFA).

The world trading regime was initiated at mid-century with the creation of a General Agreement on Tariff and Trade (GATT) in 1947. The idea was that people from one country could have the right to sell its products to other countries that wanted to buy them. By the end of the twentieth century, it became the best example of cooperation between countries in the entire international system.

In the 1970s developing countries emerged as important exporters of textiles and especially of clothing and at the same time the industries in the developed economy were declining. This was a reason why in 1973 the MFA was negotiated. Its objective was to progressively liberalize world trade in textiles products.

MFA was initially negotiated for a period of four years where individual quotas were negotiated limiting the quantity of textiles and clothing products which could be exported from one country to another. The MFA has been renegotiated four times and its effects in the clothing sector have been immense. But it also had unwilling effects because developing countries made efforts to circumvent the restrictions.

3.4. AGREEMENT ON TEXTIL AND CLOTHING (ATC)

The GATT was created in 1947, with the main role of liberalizing trade and was established to support and handle the trade issues. It was a contract with thirty-five trade rules, which ensure the maintenance of the tariffs reduced, negotiated during
multilateral negotiations. One of the most important rules, about non-discrimination, is still the basic in the international trade system. The GATT was not supposed to work as an international organization although at the end it did.

The MFA and GATT have not the same principles, due to the fact that the latter one advocated tariff-based measures rather than quota restrictions. But the Agreement on Textile and Clothing (ATC) which was a transitory regime between the MFA integration of trading in textile and clothing in the multilateral trading system, settled some quota restrictions for a period of ten years, after which it has ceased to exist. This agreement, established quotas to a large number of products such as, silk, wool, fabric, cotton and made-up textile products and clothing, between others.

The ATC was expired in January 1 of this year, 2005. But during the transition period to a trade system without quota restriction, which was made by a continuous reduction of quotas, the ATC recognised the necessity of transitional safeguard mechanisms. These safeguards could be applied by any member to clothing products such as woman’s or girl’s blouses and shirts, man’s and boy’s swimwear or trousers, jerseys, pullovers or waistcoats.

Safeguard action could be taken in order to protect the production of the domestic industry, when a particular product was imported in big amounts

In Current Studies on FDI and Development carried out by UNCTAD, it is said that removal of quotas will consolidate the production into larger factories in a smaller number of locations, being China and India in a particularly strong position. But they also indicate some factors that act in favour of the plurality of clothing manufacturing countries, as the importance of the proximity to the market and the risk of becoming dependant of a single source country.

In the same study named before the focus of the analysis is whether the phasing out of quotas has implications on FDI. It is confirmed that “The removal of quotas generally means intensified competition for FDI in textiles and clothing”.
3.5. TURKEY, CHINA, INDIA AND THE CLOTHING SECTOR

3.5.1. TURKEY

Turkey, located at the junction between Europe and Asia, is not only an important regional player in the garment and textile industry, but it also has a significant role in the global garment and textile supply.

According to the International Textile, Garment and Leather Workers' Federation (ITGLWF) clothing and textile exports represents 40 percent of all Turkey's exports, working in this sector 35 percent of the country’s industrial workers. (Data: ITGLWF, 2003).

Despite an economic crisis in the late 1990s and in the period 2000-2001 that resulted in the closure of facilities, the sectors are once again going strong. The growing trade deficit and weaknesses in the banking sector in late 2000 and early 2001 was followed by a recession due to the floating of the lira, which effects will have a high degree of relevancy in the following analysis.

Important and known names in European garments, such as German fashion house Hugo Boss and sportswear giant Adidas, and Swedish retailer H&M are important customers of Turkey’s clothing manufacturers. Furthermore, some of Europe's top football teams, such as the Spanish team Real Madrid, AC Milan from Italy, and Bayern Munich from Germany, have their garments made in Turkey.

Being able to provide a full package of integrated services - from cotton to yarn, textiles, and clothing, dying and finishing, as well as the good geographical location respecting to its main market, Europe, Turkey has moved into a good position with in terms of clothing exports, behind China. Production capacity, plentiful raw materials (such as cotton) and cheap labour are all key factors in Turkey’s success in these sectors.

With no quota restrictions on Turkish clothing entering the EU, Europe is the major destination for Turkish clothing (73%), with the majority going to Germany. Other important markets are the United States (where Turkish goods are subject to quotas), the
UK, France, the Netherlands, Italy, Belgium-Luxemburg, the Middle East, and the Russian Federation (IGEME, 2002a).

Much of Turkey's export oriented garment production is produced in and around Istanbul (75%, according to the Istanbul Exporters Association). Other important locations are Bursa, Izmir, Denizili.

However, because costs are higher in the surrounding area of Istanbul the Turkish Clothing Manufacturers' Association is promoting investment in Anatolia, where costs are much lower and unemployment is higher. The manufacturers see this as a way to keep the global competitiveness of the industry (Knitting International, 2003).

Most production, the majority of which is carried out by women workers takes place in small or medium-sized enterprises; most are privately-owned. The more exported products in the sector are the knitted garments, followed by woven garments. In the garment industry, as well as in the rest, subcontracting is an important characteristic, and in reality much of production in Turkey takes place in unregistered workplaces (ex. small workshops and in homes). Subcontracting to other countries, particularly to Bulgaria, where Turkey is the main investor in the country's garment industry is also common. However, because most of the production is made in unregistered workplaces, it is difficult to find reliable detailed data.

Looking toward the future, comments from industry experts seem to suggest that Turkey is poised to consolidate its position as a producer and sourcing hub that serves the European market and beyond.

3.5.2. **CHINA**

As a result of the impressive economic growth that China is carrying out over the last 25 years, millions of people have been shifted out of poverty. Economic reforms implemented during these years have been essential in the good performance, leading to higher productivity growth than in the pre-reform period. Nevertheless, it is widely agreed that the industrial production, led by massive investment, has been the most important factor driving the GDP growth. China’s growth during this period deserves a
special attention. It has not only been because of its low cost labour force, but also a very important own textile industry and resource intensity, drawing heavily on physical capital, energy, and natural resources. This rapid increase is causing a big gap between the agricultural industry and the rest of the economy. Due to the widening rural-urban income, people are starting to doubt about the quality and sustainability of China’s growth.

The ATC agreement supposed a barrier for China’s growth in world trade operations, because it allowed all the developing countries to access the global market, preventing any country from monopolizing the market. This way, in 2003 there were a lot of countries which exported textile and clothing products, creating jobs and generating foreign earnings in some poorest countries, which were really helpful for their development.

However and according to the Global Alliance for Fair Textile Trade (GAFTT), since China joined the WTO at the end of 2001, it has made a lot of effort, some of them unfair (such as currency manipulation or excessive low prices), to monopolize the world trade in this sector. For example, when some clothing categories were removed from quota in 2002, China dropped its prices by an average of 53 percent in an attempt to dominate the world trade market, which was impossible for any of the competitors to allow. This membership could have been one of the reasons for China to grow its exports to the rest of the world and could also have implications in the slowing down of the exports growth of other competitors. China has been projected to benefit most from the complete phase-out of quotas in accordance to the UNCTAD.

Spinanger and Verma (2003) used the Global Trade Analysis Project (GTAP) model to estimate the impact of the end of the ATC as well as China’s full accession to the WTO on textile and apparel exports from individual countries. Their model estimates that China’s apparel exports will increase 168 percent as a result of the full trade liberalization (including all tariff cuts and services liberalization).

Actually, China’s average export prices for trousers, underwear, and woven and knit shirts are 58 percent below the average prices charged by other countries. Moreover, China already controls a combined 40 percent share of world exports for cotton and
man-made fiber trousers, men’s woven shirts, cotton and man-made fibre knit shirts, and underwear. According to GATT, if we exclude U.S. and E.U. exports in these categories, China’s world export market share rises to an astounding 57 percent. Finally, in these same categories, China already controls an 88 percent market share of the lucrative Japanese and Australian markets.

These unfair trade practices have severely disrupted world trade in textile and clothing. China’s market share in the clothing and textile products surged from less than 30 percent in 2000 to more than 40 percent in December 2004 after the removal of the quotas. Every player in the world trading community lost market share to China.

For the past four years, putting in evidence its strategy to dominate the market, China has dominated world sales of textile and apparel machinery, contrary to Turkey, were the low level of R&D investment makes it dependant on machinery equipment imports. Chinese government statistics reveal that China has invested $21.2 billion over the past three years in order to increase its textile and apparel production capacity.

China saw substantial growth in its market share in Europe as well, capturing anywhere from 30 to more than 50 percent market share in several key categories. The World Bank predicted that China will capture half the world’s apparel trade once quotas were removed.

The 1st of January of 2005, when the ATC expired after abolishing all quota restrictions in textile and clothing and China being already a member of the WTO since 2001, an avalanche of Chinese textile products flooded all over the world. But ATC countries reacted to this shift by enacting “safeguard” measures, they were allowed to do this if they believed imports pose a significant threat to domestic industries. One safeguard applied generally to the textiles industry until the end of 2008 permits any importing country to apply restrictions if sufficient evidence is produced that Chinese shipments are causing a market disruption.
Textile and clothing industry is the largest manufacturing sector in India. It has a big amount of workforce of 35 million people, low wages and abundant supply of cotton. Although, India’s market includes tailored and ready-made goods, its market is mostly based on traditional wear such as sari, dhoti or salwar.

Due to its abundance in cotton, the Indian’s textile industry is predominantly based in cotton, being made of cotton the 60 percent of all overall consumption in textiles and more than 75 percent in spinning mills. The Indian’s textile industry is dispersed and dominated by small, mostly tiny enterprises, under government policies that exercise a preference for small enterprises through fibre/yarn allocations and caps on investment in production facilities for several textile and clothing products. The latter action is taken in order to restrict the entry of large players in manufacturing woven garments and several items of knitwear such as socks, inner wear, woollen apparel, etc.

India’s major opportunities are in consolidate its competitive position in yarns and fabrics. With further deregulation, abundant opportunities exist for, modernisation of machinery and up gradation of apparel facilities in the near future, including avenues for relocation of EU plants.

There is an enormous potential for improving trade and investment flows between the EU and India. At the Summit on 7th September 2005, the EU and India adopted a Joint Action Plan to take positive steps to further increase bilateral trade and economic cooperation in order to secure market access for textiles.

Although the actual expiration of the quotas will expand opportunities for India, it will not be the only one. Many several competitors will also gain benefits from it. Therefore, future market shares will be characterised by an intense competition between important players, notably China, Turkey, Mauritius, Mexico, Mediterranean countries, Pakistan and Bangladesh. Some of these countries also enjoy some form of tariff preference over India under EU’s import regime.
Some of the most important names that have already made FDI in India includes: *Levis*, *Lee*, *Wrangler*, *Benetton*, *Pepe*, *Lacoste* and *Ralph Lauren*. A key trend has been the predominance of men’s wear in the foreign presence in India, mostly due to the higher penetration of branded apparel in the same, compared to women and children wear.

3.6. **EXPLANATORY TABLE**

Once we have explained separately the situation of each country in the clothing sector we present in the table below the main features by using the determinants of national competitive advantage that Porter defined in order to obtain a global view of the three countries.
Table 3.2  Application of the Porter’s Diamond

<table>
<thead>
<tr>
<th>P’s DIAMOND</th>
<th>Aspects:</th>
<th>Turkey</th>
<th>China</th>
<th>India</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. FACTOR CONDITIONS</td>
<td>*Raw material:</td>
<td>-Produced locally except the ones for acrylic fibres (Mostly cotton)</td>
<td>-Mostly Cotton</td>
<td>-Mostly Cotton, jute, silk and synthetic fibre</td>
</tr>
<tr>
<td></td>
<td>*Yarn quality:</td>
<td>-Good</td>
<td>-Good</td>
<td>-Good</td>
</tr>
<tr>
<td></td>
<td>*Labour cost:</td>
<td>-Low (increasing)</td>
<td>-Low</td>
<td>-Low</td>
</tr>
<tr>
<td></td>
<td>*Electricity cent/ kw h:</td>
<td>-7.5</td>
<td>-2.1</td>
<td>-2.8</td>
</tr>
<tr>
<td></td>
<td>*Location:</td>
<td>-Proximity to EU</td>
<td>-Far from EU</td>
<td>-Far from EU</td>
</tr>
<tr>
<td>2. DEMAND CONDITIONS</td>
<td>*Demand perspective:</td>
<td>-One of the most attractive country for developed countries</td>
<td>-Different conception of quality related to EU</td>
<td>-Based on traditional wear</td>
</tr>
<tr>
<td></td>
<td>*Production quality:</td>
<td>-Brand conscious</td>
<td>-Safeguard measures due to its high increase after the entrance in WTO and expiration of ATC</td>
<td>-Rise in exports and new capacity expansion</td>
</tr>
<tr>
<td></td>
<td>*Delivery time:</td>
<td>80 3-4 weeks</td>
<td>65-70 3-5 weeks</td>
<td>60-65 3-5 weeks</td>
</tr>
<tr>
<td>3. FIRM STRATEGY, STRUCTURE &amp; RIVALRY</td>
<td>*Strategy:</td>
<td>-Quality and fashion orientated, in order to get the ISO 14000 and Oeko-Tex 100 certificates demanded by EU (differentiation)</td>
<td>-Cost based: low cost- low price</td>
<td>-Increasingly fashion orientated</td>
</tr>
<tr>
<td></td>
<td>*Structure:</td>
<td>-Small-medium size companies</td>
<td>-Medium size companies</td>
<td>-Dispersed industry and tiny companies</td>
</tr>
<tr>
<td></td>
<td>*Rivalry:</td>
<td>-Fierce with supply retailers(innovation)</td>
<td>-High</td>
<td>-Good relations with neighbour</td>
</tr>
<tr>
<td></td>
<td>*Flexibility:</td>
<td>-Good flexibility to produce smaller branches</td>
<td>-Weak flexibility</td>
<td>-Weak flexibility</td>
</tr>
<tr>
<td>4. RELATED AND SUPPORTING INDUSTRIES</td>
<td>*Related industries and suppliers:</td>
<td>-Very strong cooperation with textile industry and infra-structure</td>
<td>-Strong cooperation with textiles industry and infra-structure</td>
<td>- Strong cooperation with textiles industry and infra-structure</td>
</tr>
<tr>
<td></td>
<td>*Government’s control:</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: adapted by the authors from different sources. (International Istanbul Textile Congress, World Bank data, CEFS and WTO)
IV. ECONOMIC COOPERATION: TURKEY AND EU

In this fourth part we will give an overview on how Turkey and EU’s relationship is evolving with regard to trade agreements. To begin with, we will explain the most significant features that gave rise to the Customs Union. Next, we will empirically analyze the effects of the signing of the Customs Union and the economic impacts that it can have. To conclude, a brief analysis of the actual situation of trade barriers in developing countries and developed ones will be carried out.

4.1. INTRODUCTION

For some European inhabitants, it is quite strange that a Muslim country like Turkey, which is mostly located in Asia, wants to join Europe, which is formed by countries that mostly follow the Christian religion. Anyway, it is in the mind of most Turkish, that the reborn for Turkey will come from the full membership in the EU.

Nevertheless, according to the EU Commissioner for Enlargement but actual Vice-president and Commissioner for DG Enterprise and Industry Günter Verheugen and Germany’s Foreign Minister, Joschka Fischer, it is reasonable to expect Turkey’s entrance into the EU no earlier than fifteen years from now.

4.2. RELATIONS BETWEEN TURKEY AND EU

Even though trade between Turkey and EU has taken place for centuries, the candidacy of Turkey for the access to the EU has been rejected in three occasions (1959, 1989 and the last one in 1997).

In July 1959, after the creation of the European Economic Community (EEC), the Turkish government applied, for the first time, its access to the union. Although the
application was rejected, the links between Turkey and the EU started in 1963 with the signing of The Ankara Agreement, which objective was to create a CU in three phases.

In the first phase, the preparatory phase (1963-1970), Turkey received financial help from the European Economic Community (EEC) in order to prepare its economy for the future access. The EEC loaned Turkey 175 million ECU, which was compensated by Turkey rising the share of the EEC countries in Turkey’s imports from 29 percent in 1963 to 42 percent in 1972.

The sign of an additional protocol in 1970, initiated the transitory phase, where all the necessary requirements to achieve the CU were established, in a period of 22 years. During this phase, the community countries should reduce the custom tariffs and the quantitative restrictions to the Turkish importations. At the same time, Turkey would have to eliminate the tariffs and restrictions to the imports coming from the EEC.

The military intervention in government in 1980 involved a temporary breakage in Turkish-EEC relations, however, three years later, with a civil government, they retake them. A turning point in Turkish economic policy came in January 1980. At the time, the government announced an economic reform program, after several unsuccessful attempts in 1978-1979 and several failed IMF programs. The economic reform programme consisted in replacing the actual inward oriented strategy by an export oriented one, which consisted, among other actions, in reducing direct government intervention in the productive sector, lowering of barriers to FDI, gradual import liberalization, financial sector and public enterprise reform and encouraging privatization of public enterprises.

In the middle of this positive evolution, the Ankara’s government applied once more for a new membership in 1987. This time the appliance was rejected again in 1989, European Commission’s opinion on Turkish membership was that democratization, Human rights, and the sustainable economic growth were not clear.
At the June 1993 European Council meeting in Copenhagen, membership criteria were laid down, specifying the rules that define whether a nation is eligible to join the European Union, referred as Copenhagen Criteria.

### Table 4.1  The Copenhagen political criteria:

*Copenhagen political criteria:

Membership criteria require that the candidate country must have achieved:

- Stability of institutions guaranteeing democracy, the rule of law, human rights and respect for and protection of minorities;
- The existence of a functioning market economy as well as the capacity to cope with competitive pressure and market forces within the Union;
- The ability to take on the obligations of membership including adherence to the aims of political, economic and monetary union;

Source: Portal side of the European Union - Europa (europe.eu.int.)

The third phase determined in the Ankara Agreement entered into force with the CU between Turkey and the EU in 1995. This made possible the free trade of goods between the two entities without any custom restrictions.

At the Luxembourg Summit, in 1997, EU leaders declined again to grant candidate status to Turkey. The long way made by Turkey since 1963 and the CU were not enough to get the acceptance from the EU. At this time, it was argued that Turkey did not fulfil the political and economic conditions necessary to allow accession negotiations (Copenhagen criteria). Governments in the EU had different opinions related to the accession; while French and Italian were supportive, the German and Greek were opposed to the Turkish candidacy arguing that cultural and social problems could arrive if Turkey accessed EU.

But the EU leaders rather surprisingly welcomed Turkey to be accepted as a candidate for full membership at the Helsinki Summit in December 1999. The decision stipulated that Turkey would start the membership negotiations with the EU once the former completed its domestic reforms to satisfy the political requirements of the Copenhagen
Criteria. Turkey was officially recognised as a candidate State destined to join the Union on the basis of the same criteria as applied to the other candidate States.

At this time Turkey designed a pre-accession strategy to stimulate and support its reform process. Turkey also drew up a National Plan for the Adoption of the Acquis Communitaire, which requires that all prospective members must enact legislation in order to bring their laws into line with the body of European law.

The European opposition to the Turkish entry was firstly due to the lack of alignment of human rights standards and practices on those in force in the EU and the allowance of death penalty. As Turkey made mayor improvements in these issues the opposition denied its entry arguing problematic democracy including cultural and minority rights, military control over civilian, and lack of transparency of the state institutions.

In December 2002 the Copenhagen European Council resolved that if the European Council in December 2004, on the basis of a report and a recommendation from the Commission, decided that Turkey fulfils the Copenhagen political criteria, the EU would open accession negotiations with Turkey without delay.

On the 17th December 2004 the European Council, taking into account the reforms made by Turkey and based on the EU Commission’s recommendation, concluded that it sufficiently fulfils the Copenhagen political criteria to open accession negotiations on 3 October 2005. Following the conclusion of the European Council, the Commission presented the principles and the procedures for the accession negotiations in June 2005.

Successfully EU-Turkey Intergovernmental Conference met on 3 October 2005 to start the accession negotiations.
4.3. CUSTOMS UNION

The Turkey-EU association relations that guided Turkey’s foreign economic and commercial relations were culminated with the establishment of the CU. The Union was the last step in Turkey’s liberalisation efforts to open to the world economy, a process that started in early 1980s.

Since the sign of the CU, which came into force on December 31\textsuperscript{st} 1995, Turkey has become a direct trade partner with no quota and no duty with the EU, except in trade in agricultural products, which have a specific regulation. It means that all kind of restrictions where liberalized while Turkey gradually adopted common external tariffs of the EU. In this way, Turkey applies the same quantitative restrictions to the same products from the same countries as the EU does. An important feature of the Turkey-EU CU is that Turkey is the only country that enters into such integration without being a full member of the Union.

The CU did not involve only the prohibition of the quotas with the EU; it also required a harmonisation on its commercial and competition policies, including intellectual property laws, with those of the Union, and extends most of the EU’s trade and competition rules to the Turkish economy. Nonetheless, there is a commitment on the part of both the EU and Turkey to expand and strengthen the CU, in order to cover new areas, such as services and public procurement. Nevertheless, the CU has being criticized in this sense, it is said that “if Turkey is not an EU member and cannot voice her demands during the bargaining process, the CU may be detrimental to her vital interests” underlying that “Under the CU framework, Turkey is in a position of implementer but not decision-maker”. Even though the criticisms, European Community’s share in Turkey’s foreign trade has continued to increase since the CU. Turkey is now the EU’s 7\textsuperscript{th} biggest trading partner; it is also now the 6\textsuperscript{th} biggest exporter to the EU. At the same time, the proportion of Turkey’s imports that came from the EU climbed to 47.3% in 2004. Referring to trade in clothing, in 2004, Turkey ranked in the second place following China in value of imports and also exports.
In the context of the CU, Turkey has already adopted a great part of the Community legislation, established necessary institutions, and is trying to implement them. Next we will show the points achieved in order to get a harmonisation between the Turkish legislation and institutional framework with those of the EU, taking into account that these achievements are applied to products other than agricultural:

- Elimination of all customs duties and equivalent charges from the EU, as well as all quantitative restrictions and all measures having equivalent effect;
  
  These measures were taken in order to liberalize the bilateral trade between Turkey and EU, eliminating all the barriers that existed and allowing free trade among the countries.

- Adoption of the Community’s common external tariff in trade with third countries;

  During the transition period between 1996 and 2001, customs tariffs higher than the Common External Tariff were applied to sensitive products from third countries such as automobiles, shoes, leather products and furniture. In 2001 the Common External Tariff became applicable to all industrial goods.

- Adoption of measures that are substantially similar to those of the common commercial policy of the EU, which include:
  
  o Common rules on imports and exports. Enlargement will extend a common set of rules to the new members, thereby raising the overall level of safety. Furthermore, the countries that take part in the customs union, apply a common external tariff to the imports from third countries instead of their national customs tariff, being the actual average tariff 4.6 percent. The average tariffs of 16 percent, which were applied to EU and EFTA (European Free Trade Area) countries, were removed to all industrial goods.

  o Management of quotas.

  Turkey has adopted the Community’s procedure for administering quantitative import and export quotas, adopting the European general administrative principles, specific rules for each administrative method and also rules concerning import and export licenses.
- Protection against dumped or subsidised imports
  It is the protection taken in order to safeguard from countries which are not members of the union. It is a procedure under which the Council, acting by simple majority of the Member States votes on a proposal by the Commission, imposes definitive measures. The Commission takes the proposal based on investigation procedures made when is considered that such imports could cause material injury to the Community producers of similar products.

- New common commercial policy instrument
  According to the European Constitution, it aims “to contribute, in the common interest, to the harmonious development of world trade, the progressive abolition of restrictions on international trade and the lowering of customs barriers”. Under it, the EU negotiates collectively in international trade matters.

- Officially supported exports credits
  The main purpose of the arrangement is to provide a framework for the orderly use of officially supported export credits. In practice, this means providing for a level playing field (whereby exporters compete on the basis of the price and quality of their products rather than the financial terms provided) and working to eliminate trade distortions related to officially supported export credits.

- Technical barriers to trade and standardisation of foreign trade
  The agreement adopts in conformity the process that certifies that a product conforms to the requirements set out by a given standard or regulation. But even if Turkish goods are produced under correct EU specifications, they can still face barriers upon export to the EU, if their certification is not recognised by the Community. The same is applied to EU exports into Turkey, as Turkish authorities may not recognise procedures in the EU and require duplicative testing and inspection.
Autonomous arrangements on textile imports and preferential trade regimes of the Community

Turkey shall align itself progressively with the preferential customs regime of the EU, which rests on the sets of autonomous regimes and preferential agreements, within five years starting from 1 January 1996. Article 16 of the Association Council Decision also sets the rules and modalities of the alignment and also provides that Turkey will take the necessary measures and negotiate agreements on a mutually advantageous basis with the countries concerned. Turkey gives priority to the adaptation of preferential agreements concluded between the EU and the third countries in which reciprocal trade provisions have been sought.

Inward and outward processing regimes

Inward Processing Regime (IPR) is a system allowing Turkish manufacturers/exporters to obtain raw materials and intermediate unfinished goods that are used in the production of the exported goods without paying customs duty and being subject to commercial policy measures. Having granting IPR authorization, the owner of the IPR authorization is obliged to import goods stated on authorization and export them after processing the imported goods. The scope is to maintain materials at the world market prices and enhance the competitiveness of Turkish exporters.

Outward Processing Regime (OPR) states that EU manufacturers can subcontract subsidiary and finishing processes to Turkish factories, as long as the major transformation of the garment takes place in EU. Major transformation, however, only needs to amount to 10 percent of cloth-processing. Thus, it is a custom procedure which allows the export of Community goods for processing abroad and the re-import of the processed products under total or partial duty relief.
4.4. ECONOMIC EFFECTS OF THE CUSTOMS UNION

Different authors have made researches with the objective to determine the effects that the CU will have in Turkey and in the EU. The conclusions have been diverse, concentrated mainly in terms of employment, welfare and output. Our objective in this section is to offer a general view of the opposite ways in which the economic integration achieved will affect the implicated countries and also thirds. The analysis of trade consequences will be carried through more accurately in the next section.

The CU can be seen as an agreement that lies in reciprocal economic interests. In first place it is the need that Turkey has to bring discipline to the economy, being the obligation of harmonization with the EU a good reason to achieve it. It is also expected that with CU, non-European foreign capital will also find Turkey’s human resources and dynamism attractive and will seed to take advantage of Turkey as a base for production. The EU will also obtain benefits from the CU when having no barriers to trade with a giant and unfilled market of 60 million people and judged by the USA to be one of the world’s ten most important developing markets. Besides the attraction of its domestic market, Turkey is also considered a trade and production base and a jumping board for the Middle East, Central Asia and the countries of the Black Sea and the Balkans.

That a CU may be viewed as a move towards free trade has been exhaustively evaluated in theoretical models. Murray Kemp and Henry Wan (1976) demonstrated that there exist transfers and domestic tax structures such that any arbitrary CU is potentially advantageous in welfare terms for all countries.

On the opposite side, Harrison, Rutherford and Tarr (1997) concluded that CU agreement would result in rather significant gains for the Turkish economy, to the order of 1 percent to 1.5 percent of Turkish GDP. According to them, Turkey’s biggest gains from the customs union arrangement will come from the improved access that Turkish exporters will have to third country markets; Turkey has to provide preferential access to all countries to which the EU grants such access and this is reciprocal. Another consequence of signing the union is the tariff reduction that third countries will have
due to the adoption of the “most favoured nation” (MFN) tariff of the EU. This reduces the trade diversion costs of the customs union, and results in additional gains from trade.

As can be seen in the previous studies, the signing of a CU can have diverse effects in the economy, being necessary an empirical analysis to test the reaction of Turkey’s economy to the CU with the EU.

Mercenier and Yeldan (1997) through the analysis of the specific case of Turkey’s CU with the EU, concluded that the impact of the CU on the Turkish economy will be negative. They argued that trade deterioration will take place because of the drop in the tariff rates that Turkey will suffer. Before the CU the existing EU tariffs on Turkish exports were already low, worsening the situation when they were abolished.

Bekmez (2002) suggests that customs union would lead to revenue losses for the government sector and in GDP, though it would benefit the private sector.

The previous explanation that we have carried out has had the objective of giving a global and theoretical view about the interactions that can occur due to the CU among countries. Although we have given a small presentation about the impact of the signing of the CU between Turkey and EU with the works made by Mercenier and Yelman (1997), and Bekmez (2002), we will not go deeper in this aspect.

The main interest that the CU has for our analysis is whether it has had positive or negative impact in the trade among Turkey and EU, fact that we will analyze in the next section. Even though we are aware that all the variations suffered in trade among them will not be directly related with the signing of the Union, it is not the main point of our analysis to go through an exhaustive explanation.

4.5. EVOLUTION OF THE EU-TURKEY BILATERAL TRADE

Our main interest in this section is to make an exhaustive analysis in the bilateral trade between Turkey and EU, going deeper in the years after the signing of the CU, in order
to detect any relationship between the possible increase or decrease of trade and the signing of the union.

The volume of bilateral trade between Turkey and EU has increased over the last decade (Look Annex 1, table 1). As we can observe in Figure 4.1, bilateral trade has grown dramatically since the 90s, with both exports and imports more than doubling over the last ten years. But, although this bilateral trade has have a positive evolution, the period of analysis shows a constant trade balance deficit, which is increasing in the last years.

**Figure 4.1** EU Turkish bilateral trade ($ million)

![](image)


The Customs Union expanded trade between Turkey and the EU in 1996 and this trend continued in 1997. Although the imports from the EU expanded significantly and Turkey’s trade deficit in this bilateral trend doubled from the year 1990 to 1996 ($5.7 billion to $11.6 billion), Turkish industries have managed to adjust themselves to the new competitive environment. According to the WTO’s review in Turkey’s trade policy of 1998, Turkey’s entry into CU with the EU without receiving economic and financial assistance indicates the capacity of the Turkish economy and its leading industries.

According to The Centre for European Policy, this is what one would expect given the fact that the main effect of the CU was to force Turkey to further liberalise its foreign trade.
In the first year of the CU, the exports from the EU to Turkey rose significantly while Turkey’s exports to the EU had a very low increase. The figure above indicates a slight increase of 4.2 percent in the Turkish exports to EU in 1996 as compared to the previous year, whereas EU’s exports had an increase of 37.2 percent in the same period. All this has resulted in an increase in trade deficit, which in a portion and according to the WTO, is attributable to the overheating of the Turkish economy in 1996 and to heavy investment in machinery. Nevertheless, EU exporters are benefiting from the CU while Turkey’s exports are not as good as expected.

Although in the first figure we have observed a positive trend in the bilateral trade, looking at the Figure 4.2, which represents the EU’s share in Turkey’s imports and exports with respect to the rest of the world, the interpretation can differ from the previous one.

Figure 4.2  EU’s share in Turkey’s imports and exports in respect with the world

Similarly as the case in the Turkey’s exports to the EU, the share of the EU in Turkey’s total exports was reduced from 51.2 percent to 49.7 percent in 1996 and even more in 1997 reaching 46.7 percent. In contrast, the share of the EU in Turkey’s imports increased from 47.2 in 1995 to 53 percent in 1996. Turkey’s main partners in the EU were and still are Germany, Italy, UK and France. At this point of analysis we can
clearly see what Harrison et al. (1997) concluded, the biggest gains that Turkey has had as a result of the CU is the access to third countries, decreasing in the following years after the agreement the share in the trade with the EU.

The most important aspect to underline when analysing this figure 4.2 is that the share of EU’s trade in Turkey’s exports and imports has maintained constant, among the range of 45-55 percent, during the whole period of analysis. Even though in value terms the evolution has been positive, when comparing the data to worldwide evolution we can conclude that the increase in trade mentioned in the first figure has been similar all over the world.

From the information above, we arrive to the conclusion that the CU did not have as much effect in the increase of trade between Turkey and EU, as some expected. The most remarkable increases were during the period 2003-2004, where the share of imports achieved 46.67 percent and the exports 54.57 percent.

According to the Turkish trade policy review, there is not just one reason for this lack of reaction to the CU, but a variety of them:

1) Taking into account that the EU had already abolished the nominal tariff rates on imports of industrial goods from Turkey in 1971, the CU did not lead to substantial reduction in trade barriers on the EU side. Furthermore, even if with the formation of the CU the quotas applied by EU to Turkey were abolished, the EU retained the right to impose anti-dumping measures, making use of this right in 2001 and 2002.

2) Turkey did not incorporated into its internal legal order the European Community instruments related to removal of technical barriers until 2003. This would allow the free circulation of the Turkish industrial products in the EU.

3) Due to the currency crisis faced by Turkey in 1994 and 2001, and the two disastrous earthquakes suffered in 1999, the import demand decreases during those years, reducing the GDP considerably.

4) Once Turkey had substantially reduced the trade barriers during 1996, the increase of imports was expected to happen if there was not a devaluation of the Turkish Lira. The fact is that it began to appreciate until the currency crisis of 2001.
4.6. IMPACT OF THE CU

Economic theory shows that a CU can act like a “double-edged sword”, which means that it can have a positive or a negative effect on trade. According to Jacob Viner (1950), the two opposite effects that can evolve from the economic integration are trade creation and trade diversion. On the positive side, the elimination of tariffs among Turkey and EU should lead to additional trade, which can be welfare increasing if it replaces EU’s high-cost domestic production with low-cost imports from Turkey. But if tariff barriers with respect to the rest of the world remain high, there is also a danger that the resulting additional trade between partners would replace lower-cost imports from places such as China or India, situation that is known as trade diversion. The overall effect that the CU can have in the economy will be conditioned by how strong these effects are.

As we have already mentioned, looking at the Figure 4.2, we can see that EU’s share of Turkish exports has remained more or less constant during all the years, which means that the increase in the bilateral trade has not been at the expense of trade with the rest of the world. Thus, our figure suggests that there has been considerable trade creation, but little trade diversion.

Once we have finished with all the analysis and taking into account all the results we have obtained, we can conclude that there has been a trade creation after the signing of the CU, but it is also true that the CU may not be the only reason of that trade creation. Although this increase has not been as big as the one expected and it has been mainly due to the increase in imports, it is true that the bilateral trade between Turkey and EU has increased.

4.7. ACTUAL SITUATION OF TRADE BARRIERS

The end of quota restrictions in December 2004 has not meant the end of protection. Instead, it has led to other forms of protection. Nowadays, the WTO encourages the transformation of quotas and other non-tariff barriers (import quotas, licenses, export taxes…) into tariffs.
The quotas are quantity restrictions that put a limit on imports from each exporter country. Contrary, tariffs per se do not prevent entry of products, because goods that are competitively priced always have a chance to jump over high tariff walls.

Tariffs on imports of textile and clothing in major developed countries are high relative to other industrial products. The reason is that industrialized countries import textile and clothing from developing countries, and the last ones have higher tariffs. To avoid this, developed countries employ preferential tariff rates and duty-free access to favour particular countries in trading.
PART V: NATURE OF THE BILATERAL TRADE

Turkey has had a noteworthy relation with the EU referring to the trade in clothing sector. Since 1993, Turkey’s clothing exports to and imports from the EU have accounted for more than 60 percent (A.1.1, A.1.2). This proves the close relationship that they have had during long time in clothing trade, not only in Turkey’s dependence on exporting to EU but also in importing from there. Anyway, the accuracy of the figures representing the situation described (A.1.1, A.1.2) is not enough to make a deep trade analysis among both countries, due to their lack of differentiation between intra-industry trade and inter-industry trade. The objective of the following section will be though to make the distinction among trade in products that belong to the same industry and the ones that do not.

First of all inter industry bilateral trade will be analysed, followed by the intra industry trade analysis. We will pay special attention to this last one identifying its nature, horizontal IIT or vertical IIT. Finally, a special mention will be done to the new emerging economies that are an obstacle in Turkey’s trade in the clothing sector.

5.1. EXPLANATION OF TRADE THROUGH THE H-O MODEL

In the Heckscher-Ohlin factor proportions model, the determinants of traded good industries are identified by their factor contents. As we have explained in the second chapter, the capital-labour ratio between Turkey and EU is the determinant of the trade between them based on the neoclassical theories. Countries that are rich in certain factors will export goods that make use of the abundant factors intensively.

In order to analyze the factor endowment structure of Turkey in relation to the EU, the trade sectors “Standard International Trade Classification (SITC)” values have been divided in five different groups or sub-sectors for the period between 1995 and 2004.

• Raw material-intensive goods [SITC 0, 2-26, 3-35, 4, 56]
• Labour-intensive goods [SITC 26, (6-62, 67, 68), (8-87, 88)]
• Capital-intensive goods [SITC 1, 35, 53, 55, 62, 67, 68, 78]
• Easily imitable-research oriented goods [SITC 51, 52, 54, 58, 59, 75, 76]
• Difficultly imitable research-oriented goods [SITC 57, 7-(75, 76, 78), 87, 88]5

The factor proportion model differentiates mainly labour and capital intensive sectors, but going through a deeper analysis, our classification will cover the five different groups identified before.

5.1.1. **TRADE COVERAGE INDEX**

Taking into account the classification above, we have obtained the Trade Coverage Index (TCI) for each of the five product categories to understand how strong the overall export-import ratio between Turkey and the EU has been evolving over the years.

\[
TCI_t^i = \frac{X_t^i}{M_t^i}
\]

where \( i \) stands for each of the 5 groups of analysis.

**Figure 5.1** Turkey’s TCI depending on the factor intensities that the products demand

Source: Authors’ own calculations with data based on COMEXT (Data table A.1.1)

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5 Note that SITC "3-35" means all of SITC 3 except for SITC 35, and SITC "6-62,67,68" means all of SITC 6 except for SITC 62,67, and 68, and so on.
The most important feature in Figure 5.1, as the H-O model predicts, is that Turkey’s TCI exceeds unity in the resource and labour intensive activities. This is explained by the resource and labour abundance that Turkey has relative to the EU’s capital abundance. The higher TCI takes place in trade with goods that require labour intensity as textile or in a higher grade, clothing manufacturing, which also requires lower technology. Whereas in goods that require resource intensity Turkey’s export exceeds in a lower degree of imports from the EU.

In three out of the five product categories TCI does not exceed the unity, namely capital intensive, easily imitable and difficultly imitable products. The evolution of TCI in capital intensive products has followed the same trend that labour and resource intensive products have had. Meanwhile, the evolution of TCI for easy imitable and difficultly imitable product categories has been constant.

Taking the results obtained from the analysis of TCI, we can argue that Turkey tends to have positive net exports in labour intensive, lower and middle technology product groups; whereas, it imports more from the EU-15 than it exports in capital intensive, higher-middle and high technology product categories.

5.1.2. REVEALED COMPARATIVE ADVANTAGE

To make a more complete analysis measuring competitiveness of Turkey and the EU depending on the most used factor of production, we will calculate the Revealed Comparative Advantage (RCA) for the five product categories differentiated before. The classical RCA, invented by Balassa (1965), reveals a country’s sectoral export-import relation divided by export-import relation of its total economy. In our analysis we will modify it with the objective to compare the share of different factor intensive goods in Turkey’s total exports to the share of those factor intensive goods in total world exports at a certain point in time. Since we are interested in analysing the comparative advantage that Turkey and the EU15 have in their bilateral trade, we take the exports made by Turkey to the EU instead of total exports worldwide. The modified RCA-Balassa for Turkey at time t is as follows:
where \( k \) stands for commodities in total, \( j \) stands for the EU15 and \( i \) for Turkey. The results obtained from the application of the formula to each product depending on the factor intensity that it demands are shown in the Figure below:

**Figure 5.2** Turkey’s RCA disaggregated by factor intensities that the products demand

RCA-Balassa has a minimum value of 0 and a maximum value of infinity. If RCA>1, Turkey has a comparative advantage as compared to the EU15 in the commodities that use that factor intensively. If RCA<1, Turkey has a comparative disadvantage.

The horizontal line at 1 indicates the border between comparative advantage and disadvantage. The five lines indicate different product categories depending on the type of factor intensity necessary to produce them according to the SITC classification.

The effects of the crisis suffered at the end of 2000 and beginning of 2001 can be seen in the Figure 5.2, as in the Figure 5.1, decreasing the RCA in resource and, in a higher degree, labour intensive product categories. In contrast the capital intensive products become more competitive, and as said when analyzing the TCI, increasing exportations.
in that category. But the main conclusion that can be taken from looking at the figure is that Turkey has maintained comparative advantage in labour and resource intensive goods in the entire sample, the product categories were it has highest TCI. This proves that Turkey’s trade is being in the right direction because it exports to the EU goods in which it has comparative advantage. Nevertheless, the comparative advantage in the resource intensive activities has decreased since 2001, giving rise to an increasing comparative advantage in labour intensive and easily imitable activities.

Even though since 2001 capital intensive activities have gained competitiveness, we would like to remark that trade flows between Turkey and EU still reflects differences in factors and technological know-how. Turkey exports goods requiring high labour intensity to the EU, while it imports goods produced with a high intensity of physical capital and high-skilled labour from the EU, similarly to what the last Central and Eastern European accessing countries do. As a consequence, production of goods that are dominated by low and middle technology such as clothing are exported from Turkey to the EU while goods that require capital intensity are imported from the EU to Turkey.

The strength that Turkey has in labour intensive activities can also be appreciated worldwide, being its two leading exporting goods worldwide labour intensive. “Articles of apparel and clothing accessories, knitted or crocheted” (CN62) accounted with 11.70 percent of Turkey’s total exports and “Articles of apparel and clothing accessories, not knitted or crocheted” (CN63), accounted with 8.50 percent in 2001. In contrast, the capital intensive activities are the leading imported items by Turkey worldwide. “Mineral fuels, oils and products of their distillation” accounted with 20.80 percent of Turkey’s total imports and 15.60 percent of imports were for “Reactors, boilers and machinery”. Nevertheless, we can not forget that it seems that Turkey’s capital intensity will go on increasing in the future.

Table A.1.3 in the annex corroborates our conclusion indicating that in 2004 Turkey was Europe’s second clothing supplier after China. Although in the table 45.9 per cent share of clothing imports to EU-25 comes from the same EU-25, we will not consider this trade due to the delimitation of EU as a single market. Taking into account that our main area of interest is the EU-15, to give a better explanation, we will look to the year 2003 in the Table A.1.4. We can observe that EU-15 is the main partner in the clothing
exports of Turkey, which underlines the importance of the trade between the two partners.

Despite of the importance of labour-intensive products’ exports, privatizations policy taken by Turkish government in the 1980 is still affecting the factor proportions between Turkey and the EU; privatized firms switch to a more capital-intensive technology, as capital, investment and the capital-to-labour ratio increases while employment decreases. According to a survey made by PNC bank (2005), less labour intensive production is opening a skill gap that will keep unemployment in Turkey high in the near term.

The explanation above gave us a global picture about which are the trade flows between the two countries of analysis. The conclusion taken from an H-O perspective would be that clothing, the result of a labour intensive activity, will be exported from Turkey to the EU while other goods that demand capital intensity will be imported from the EU, giving rise to inter-industry trade.

5.2. TURKEY’S INTRA-INDUSTRY TRADE IN CLOTHING

As said in chapter II, H-O model explains only inter-industry trade, assuming perfect competitive market. But going deeper in this analysis we should consider that products made in Turkey or made in the EU may not be identical in the eyes of the consumer, assuming that perfect competition is not possible. This assumption gives rise to intra-industry trade; trade in products from the same industry.

The analysis of IIT will be first conducted in a global basis, in a high aggregation level, comparing IIT levels in the clothing sector that Turkey has with its main trading partners. Secondly, a more disaggregated analysis will be carried out, for which we will operate with the Combined Nomenclature, based on COMEXT database, used by the EU trade statistics. We will use for our investigation a detailed 8-digit level commodity classification for the articles grouped in CN61, 62 and 63. To conclude the section, the nature of the IIT in clothing between Turkey and the EU will be analyzed based on the methodology presented by Greenaway et al. (1995).
5.2.1. TURKEY’S IIT IN CLOTHING SECTOR WITH ITS MAIN TRADING PARTNERS

The assumption of imperfect competition gives rise to the existence of intra-industry trade. This phenomenon is typically defined as two way trade in similar products. As explained in Part II, the unadjusted Grubel-Lloyd Index (1975) will be the method used to measure the share of IIT in the clothing industry.

The G-L index will be calculated for Turkey’s bilateral trade in the clothing sector with its main traders; EU15, USA, Russia and Switzerland. The time period of analysis will be short, 3 years, to obtain a static actual picture of IIT before going through a deeper analysis. The results of the application of the G-L index can be seen in the Table below:

**Table 5.1 IIT levels in the clothing sector for Turkey’s bilateral trade (percentage)**

<table>
<thead>
<tr>
<th></th>
<th>EU15</th>
<th>USA</th>
<th>RUSSIA</th>
<th>SWITZERLAND</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>4.75</td>
<td>0.70</td>
<td>1.13</td>
<td>1.65</td>
</tr>
<tr>
<td>2002</td>
<td>4.84</td>
<td>0.57</td>
<td>0.03</td>
<td>2.45</td>
</tr>
<tr>
<td>2003</td>
<td>5.06</td>
<td>0.70</td>
<td>1.36</td>
<td>5.02</td>
</tr>
</tbody>
</table>

Source: Authors’ own calculations based on ITKIB (Data table A1.4 and A1.5)

As we have already mentioned in the second chapter, the closer $B_i$ is to 100, the greater is the importance of intra industry trade. In the case of Turkey’s bilateral trade we can observe that the degree of IIT is nearer from 0 (one way trade) than from 100. As a first interpretation we would say that the percentage of IIT in clothing products that Turkey has with its main trading partners is low. Nevertheless, EU15 has the highest IIT compared to USA, Russia and Switzerland. The analysis over the years also shows a favourable evolution of IIT in the last years with all the partners, especially Switzerland, which has almost equalized to the EU in the last year of analysis. Even though the time period is not long enough to prove the trends in IIT, it has given us a brief description of the actual situation.

The results are consistent with our expectations. Considering that Turkey is a candidate member for accessing the EU, has a Custom Union agreement with the EU and its geographical proximity, has a bigger probability to have a larger IIT with this market.
5.2.2. IIT IN CLOTHING SECTOR BETWEEN TURKEY AND THE EU

After proving that the highest IIT of Turkey takes place with its trade with the EU, we will go deeper in the analysis, calculating the Grubel Lloyd index for the clothing sector products classified in the 8-digit Combined Nomenclature:

CN61 “Articles of apparel and clothing accessories, knitted or crocheted”.
CN62 “Articles of apparel and clothing accessories, not knitted or crocheted”.
CN63 “Other made-up textile articles; sets; worn clothing and worn textile articles; rags”.

**Figure 5.3** Breakdown of the IIT between Turkey and the EU in the clothing sector (percentage)

From the figure above we can not extract a defined trend in any of the three product groups, due to the fact that there are up and downs during the whole period of analysis. Nevertheless, there is a group that is clearly differentiated from the rest, which is the CN62, where the highest IIT level between Turkey and EU exists.

The effects of the signing of the CU are not clear either. Although at the beginning there is an upward trend in the percentage of IIT in all the product groups, it soon changed. In the next years CN61 and CN63 started to stagnate and CN62 was the only one increasing the IIT level, although it also started to drop in 1998. Actually it seems that a
general upward trend is present in all the groups, although again, the best performance is for CN 62.

5.3. NATURE OF THE IIT BETWEEN TURKEY AND THE EU

Based on the explanation provided in the second chapter, we will divide the IIT between Turkey and EU, into vertical and horizontal. In order to differentiate both types of IIT we will use the methodology presented by Greenaway et al. (1995). Vertical IIT is a term that is used to describe the IIT of commodities that are at different qualities, whereas horizontal IIT is used to define IIT of commodities that are at the same qualities. The quality analysis will be undertaken with the use of unit value (UV) indexes, where horizontal IIT takes place where the UV of exports relative to the UV of imports is within a range of +/- 15% (Greenaway et al. 1995), considering vertical IIT in the rest of the cases where relative UV are outside this range. The equation is presented next:

\[ 1 - \alpha \leq \frac{UV^x_{ij}}{UV^m_{ij}} \leq 1 + \alpha \]

Where \( UV^x_{ij} \) is country j’s unit value of exports in commodity i and \( UV^m_{ij} \) is country j’s unit value of imports in commodity i within a range of 15 per cent. When relative unit values lie outside the range, the sector faces vertical IIT. The equation for vertical IIT is though the following:

\[ (UV^x_{ij} / UV^m_{ij}) < 1 - \alpha \text{ or } (UV^x_{ij} / UV^m_{ij}) > 1 + \alpha \]

Where \( \alpha = 0.15 \).

5.3.1. AGGREGATED LEVEL

This condition will be first applied to trade in clothing, for the last years to have a view of the actual situation. In the table below we present the unit value of the clothing

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\[ ^6 \text{The transportation and freight costs are usually assumed to account 15 per cent of the value of the product, so } \alpha \text{ is taken as 0.15} \]
products exported from Turkey and imported to there for the selected years. These data is also based in the Tables A1.4 and A1.5:

Table 5.2  Unit value of Clothing trade of Turkey ($/tonne)

<table>
<thead>
<tr>
<th></th>
<th>2001</th>
<th>2001</th>
<th>2003</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>EXPORTS</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>VALUE ($)</td>
<td>5,333,810,730</td>
<td>6,411,123,216</td>
<td>8,155,486,061</td>
</tr>
<tr>
<td>QUANTITY (tonne)</td>
<td>196,940.26</td>
<td>215,050.38</td>
<td>236,710.63</td>
</tr>
<tr>
<td>UNIT VALUE ($/tonne)</td>
<td>27,083.39</td>
<td>29,812.19</td>
<td>34,453.40</td>
</tr>
<tr>
<td><strong>IMPORTS</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>VALUE ($)</td>
<td>129,897,212</td>
<td>159,092,760</td>
<td>211,703,562</td>
</tr>
<tr>
<td>QUANTITY (tonne)</td>
<td>1,933.50</td>
<td>2,206.19</td>
<td>2,236.97</td>
</tr>
<tr>
<td>UNIT VALUE ($/tonne)</td>
<td>67,182.60</td>
<td>72,111.90</td>
<td>94,638.53</td>
</tr>
</tbody>
</table>

Source: The General Secretariat of Istambul Textile and Apparel Exporters Associations)

Considering \( \alpha = 15 \) per cent we obtain that:

\[
0.85 \leq \left( \frac{\text{UV}_{i}^{x}}{\text{UV}_{i}^{m}} \right) \leq 1.15
\]

<table>
<thead>
<tr>
<th>Year</th>
<th>( \frac{\text{UV}<em>{i}^{x}}{\text{UV}</em>{i}^{m}} )</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>( \frac{27,083.39}{67,182.60} = 0.40 )</td>
</tr>
<tr>
<td>2002</td>
<td>( \frac{29,812.19}{72,111.90} = 0.41 )</td>
</tr>
<tr>
<td>2003</td>
<td>( \frac{34,453.40}{94,638.53} = 0.36 )</td>
</tr>
</tbody>
</table>

In all the three years of analysis it can be seen that the UV of exports relative to the UV of imports is outside the range of +/-15%. This fact gives us a first approximation to test that the IIT that takes place in the clothing sector is mainly of vertical type. Going back to the conclusion taken by the analysis of the factors proportion model, we can explain the existence of vertical IIT due to the differences in quality that can be generated because of the intensive use of labour, in the case of Turkey, or capital, in the case of the EU. Thus, we can conclude that the trade between Turkey and EU in the clothing sector is based in commodities differentiated by their qualities. The explanation is that rich countries like the EU continuously upgrade their qualities through investing in R&D while poorer countries like Turkey, try to produce similar products but with lower quality.

This case could be applied to the contribution of Falvey (1981) about models of vertical IIT, mentioned in part II. As these works presented, vertical differentiation is modelled
as differences in quality between similar products. Thus, taking into account the 2x2x2 structure of Falvey, EU would specialise in relatively high-quality manufactures, while Turkey in lower-quality manufactures.

We should also consider at these level of analysis, that relative positions concerning technology and quality are not permanent. Firms continuously try to improve in quality or in price to maintain competitive advantage, and Turkey’s trend to more labour and capital intensive sectors instead of resource intensive ones gives us a clue of the catching up in quality that the EU could suffer.

A deeper analysis taking into account the dynamic changes that can affect the quality catching-up process of Turkey relative to the EU will be carried out in the next section.

5.3.2. DISAGGREGATED LEVEL

We have concluded that in general perspective clothing trade between Turkey and the EU takes the form of vertical IIT, but at the same time, through the analysis made in an 8-digit CN classification (Figure 5.4) we have proved that the highest IIT takes place in trade among commodities corresponding to group 62 in the combined nomenclature. The next step in our analysis would consist then in analysing the three groups of interest separately to find the highest quality differences that occur due to the UV differences and give rise to vertical IIT.

With that purpose, we have calculated for all the 561 products classified in the CN 61, 62 and 63 the condition of vertical or horizontal IIT, through the application of the methodology presented by Greenaway (1995). We first calculated the UV of each of the products mentioned above and then classified them depending on if they were vertically or horizontally differentiated due to the quality differences on trade. Taking into account the number of products in each category (61, 62 and 63) that differentiated horizontally or vertically we obtained the percentage of horizontal and vertical IIT in each of the three categories. The conclusions taken out of the calculations can be seen in the Figure below:
The importance that vertical IIT has in the clothing sector can be seen in the Figure XX, were its share fluctuates in the range from 72 to 95 percent, confirming the previous global conclusion. We can not make any differentiation among the evolution that each commodity has had over the last ten years due to the similar trends the three of them have followed. Even though, we can see that products integrated in the CN 63 classification have suffered the highest variations.

As said before, quality differences give rise to vertical IIT. This is the conclusion we have just obtained through the analysis of bilateral trade among Turkey and EU in clothing. But which is the direction that Turkey’s clothing manufacturers are going to take in the following years? Are they going to continue producing lower quality products or are they going to catch up the quality of clothing products in the EU?

We will focus our analysis in the proposal made by Aiginger (1997) to distinguish between industries in which low unit values signal low costs and those in which high unit values signal high quality. Apart from the analysis through unit values he also included the “quantity” parameter in his analysis to avoid high unit values that represented low efficiency to be understood like high quality ones.
We will combine the figures above for each of the three categories of clothing sector products to interpret the characteristics of the sector in which they are competing.

**CN 61**
This product category has maintained lower UV than the EU almost in the whole period of analysis, even though it is next to equalize to the EU. In contrast, the quantity of the exported goods is superior to the EU, which means that Turkey is succeeding in a price competitive market with low cost goods. Finally, taking into account this success and going back to the UV figure, we can conclude that Turkey is catching up to EU in terms of quality.

**CN 62**
This product category has also had lower unit values than the EU, except for the year 2000, but similar to the previous one it is also catching up the EU’s quality, because as in the CN 61 is a sector of successful price competition in low cost goods.

**CN 63**
Although the previous two categories are just about to catch up the EU’s quality level, the CN 63 already has higher UV than the European goods, due to its progressive increase in value carried out in the last years. At the same time, Turkey’s exports are above the amount exported by EU, confirming the successful quality competition that is being carried out by Turkey in high quality products. Nevertheless and even if the quantity level is still above the EU’s one, in the last years it has had a downward trend.
If this trend goes on this way and at the end EU’s export exceed the Turkey’s one, the CN 63 will be facing a sector with deficit in price competitiveness.

5.4. TRADE BETWEEN CHINA, INDIA, TURKEY AND THE EU

Although our main characters are Turkey and EU, in this section we will analyse their bilateral trade in comparison with the new and powerful emerging countries, such as China and India, which are taking an increasing role in the exports of the clothing products. Furthermore, according to the WTO, China and India are expected to dominate the world trade in textile and clothing once the restrictions on imports or quotas have been removed, becoming important characters to analyse.

China, India and Turkey present similarities and differences which are reflected in the pattern of their international trade. China and India are demographic giants; China has 1,285,312,000 inhabitants and India, 1,087,124,000 (UNCTAD handbook of statistic, 2005). Although the population of Turkey is definitely smaller, 72,220,000 inhabitants, is still big for a European country, which in total has 383,593,000 inhabitants.

The economic opening of China (1990), as well as of Turkey (1980), has been associated with a strong rise of their foreign trade within their region; India, due to geography, is far from the regional integration processes taking place in Europe and in Asia. Nevertheless, the liberalization of industrial and trade policies in the early 1990s increased the competitiveness of much of India’s industry and service sectors, sparking robust growth in output and consumer demand.

Next, we will try to analyse the evolution of the clothing trade in order to present the actual and future strengths and weaknesses of the industry in Turkey.

5.4.1. TRADE BEFORE AND AFTER ELIMINATION OF QUOTAS

In 1994, MFA quotas governed most global trade in various goods of textile and garment categories. The quota restraints limited shipments from exporters, mostly
developing countries, to developed countries such as the EU. During this time, world clothing production and trade became fragmented, being the production supported in developed country markets and in countries having quotas to exports to these markets. But the goods were not necessarily produced where costs were lowest. In the markets of the developed countries, prices were higher and consumption lower than they would have been without the quotas. At this time, production and exports by low-cost producers of clothing, such as China and India, were limited by the quotas, which were being reduced step by step while their exports were increasing.

Turkish Textile and Apparel Industry has been forced to face with the unfair imports from Far East since 1996, although at the same time the EU Customs Union protected Turkey from the quotas applied to third countries. Additionally, as Turkey has been automatically applying the same foreign trade policy for the third countries as of EU, unlike the other candidates, the Turkish Textile and Apparel Industry has to face the negative impacts of the EU’s market access and wide open market policy. This has caused a flood of low-priced Asian imports into Turkish market and has benefit to all countries trading with Turkey.

After the expiration of the quotas in December 2005, clothing output is expected to accelerate among low-cost developing-country producers, including India and especially China, while production in EU, our partner country, will continue to decline. According to the Turkey’s minister for foreign trade, Kursat Tuzmen, “The abolishing of quotas by 2005 will change the trading environment in the textile and clothing sectors dramatically”.

5.4.2. CLOTHING TRADE BETWEEN EU AND THE SELECTED COUNTRIES

Actually, Turkey is focusing on producing high value-added products and becoming a leader in the field of fashion and design. In contrast, and as the WTO predicted, China has not yet shown a competitive strength in the design and fashion segment of the textile and clothing markets. Thus, and taking into account the importance of this sector in Turkey’s economy, this change in the strategy could give to Turkey a comparative advantage with respect to low cost competitors, such as China or India.
Nevertheless, due to the big increase of the Chinese and Indian products entering the EU in the last years, a reduction of the Turkey’s share in the European trade could have result as a consequence.

Nowadays, China is considered to be the most important competitor of textile and clothing producer countries in the world. Thus, taking into account the increasing importance of China and India in the clothing trade with EU, in the following pages we will analyse the role of the three players in their trade performance with EU. In the tables below, we will represent the trade-balance for the CN 61, CN 62 and CN 63.

**Figure 5.6** Trade balance in CN 61 of the selected countries to EU-15 (million €)

![Image of Figure 5.6](source)

Source: Own calculations based on COMEXT 8 digit database.

**Figure 5.7** Trade balance in CN 62 of the selected countries to EU-15 (million €)

![Image of Figure 5.7](source)

Source: Own calculations based on COMEXT 8 digit database.
**Figure 5.8** Trade balance in CN 63 of the selected countries to EU-15 (million €)

In all the figures, we can observe the upward trend of China and Turkey’s balance-trade, although the Asian country’s evolution is much faster, while India’s trend is not so clear.

Although, as we have analysed before, the CN 61 is not the subgroup in which Turkey-EU bilateral trade has the highest level of IIT, it is the only one, where Turkey’s trade-balance is superior to India and China’s one, putting in evidence the superiority of the Chinese market in the clothing sector.

In contrast, in the trade of the CN 62, the subgroup where Turkey and EU have the highest level of IIT, Turkey ranks in the second position. When comparing trade between Turkey and EU with the one between China and EU, we can observe that Turkey’s bilateral trade is far from China’s one. Furthermore, we can add that Turkey’s exports are bigger in the CN 61, while China’s exports are bigger in CN 62.

The CN 63 is the subgroup where we have identified the lowest level of trade between EU and the selected countries. In this figure, again we confirm the massive increase of the Asian giant.

Although Turkey is having an increase in the clothing trade, China’s access to the WTO in 2001 could have affected Turkey’s growth. Besides the increase that China is facing in the last ten years, we have to take into account the expansion of Turkey’s clothing
sector in the period 2002-2004, despite of the economic crisis underwent in 2001. This demonstrates the fast recovery and good performance of the industry in Turkey.

Nevertheless we can not forget that the abolition of quota restrictions will affect Turkey’s market. Its CU relationship with the EU will give less protection now that European companies can buy as much as they want from China, India and other low cost countries. According to Turkey’s minister for foreign trade, Kursat Tuzmen, the sector should allocate more funds through cooperation opportunities, and make more research and development activities and design, and increase the labour efficiency, in order to survive to the new coming situation.
6.1. DEFINITION OF FDI

According to the dictionary definition, “FDI stands for Foreign Direct Investment, a component of a country’s national financial accounts. Foreign direct investment is investment of foreign assets into domestic structures, equipment, and organizations. It does not include foreign investment into the stock markets. Foreign direct investment is thought to be more useful to a country than investments in the equity of its companies because equity investments are potentially “hot money” which can leave at the first sign of trouble, whereas FDI is durable and generally useful whether things go well or badly”.


The UNCTAD states that according to the IMF (BPM5), FDI refers to an investment made to acquire lasting interest in enterprises operating outside of the economy of the investor. Furthermore, in cases of FDI, the investor’s score is to achieve a powerful position in the management of the enterprise. The components that are classified as FDI are equity capital, the reinvestment of earnings and the provision of long-term and short-term intra-company loans (between parent and affiliate enterprises). But very often it is difficult for a country to comply with the recommended definitions and report on all three components of FDI because it relies exclusively on foreign exchange records of the central bank. Thus it is only able to account for capital which crosses its borders and not reinvested earnings.

According to the OECD (BD3), “Foreign direct investment reflects the objective of obtaining a lasting interest by a resident entity in one economy (“direct investor”) in an
entity resident in an economy other than that of the investor (“direct investment enterprise”). The lasting interest implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence on the management of the enterprise. Direct investment involves both the initial transaction between the two firms and the consequent capital transaction between them and among affiliated enterprises”.

A direct investment enterprise is defined by the BD3 as an incorporated or unincorporated enterprise in which a foreign investor owns 10 percent or more of the ordinary shares or voting power of an incorporated enterprise or the equivalent of an unincorporated enterprise. Nowadays, in accordance with the international standard, Turkey follows the mentioned criteria to define a direct investment enterprise, although prior to June 2003 all enterprises with some nonresident ownership, irrespective of the percentage of ownership by nonresidents, were defined as being direct investment enterprises in Turkey. Contrary to the international standard, enterprises in which the nonresident investor owns less than 10 percent but has an effective voice in management are included in the direct investment enterprise data of Turkey.

A firm can choose among different entry modes to access Turkish clothing market. Some of them involve shared control and risk, through contract manufacturing, licensing, franchising and non-equity joint ventures. There are also modes of entry which suppose higher level of control and risk, through sales representatives, sales and production subsidiary, regional headquarters, equity joint ventures and the establishment of a wholly owned subsidiary (MNE). This last one can take place through either an acquisition of an already existing enterprise on location, or by starting up a firm, also called Greenfield investment.

Turkey, as many other countries, has a variety of sources for FDI data, including those collected by the central bank that comply with the international standards and those collected by other institutions for monitoring and investment promotion purposes.

Differences in data about FDI level in Turkey can arise when using Turkish government’s official data and UNCTAD international data. Besides, the amount of FDI declared by the investor country differs in many cases with the one declared by the
recipient. One also has to bear in mind the very large role of the informal economy in the Turkish textiles and clothing industry, which makes the sector complicated in terms of data collection. Although it is known that the industry is based on small and medium sized enterprises the exact number is not known. This makes difficult to find data on production and precise data on employment in the sector.

In the analysis below we will mostly base our research in data from UNCTAD, however it is sometimes necessary to make use of alternative sources that do not comply with the international standard definition.

6.2. TURKEY’S FDI PERFORMANCE

6.2.1. OVER TIME

During the period corresponding to 1920-1970 government’s intervention in Turkey was very heavy, not giving much incentive to foreign companies to invest in there. The environment changed in 1980 when Turkey’s economic liberalization programme foresaw the need to attract FDI to sustain economic development and improve the balance of payments’ situation. Foreign investors were from then in on welcomed as a source of new technologies, know-how, better management and marketing techniques. The Foreign Investment Decree (8/168) was issued and a separate governmental institution, the Foreign Investment Directorate, was established in order to simplify administrative procedures and make them faster. The legislative changes contributed to the increase of FDI, but also the strategic location and the emerging potential of the domestic market encouraged the capital inflow.

Figure 6.1 shows the existing difference between the approved and realised annual FDI flows in Turkey. Approved investment indicates what investors said they were going to invest, while realized investment shows what they actually invested. As indicated in the figure, the FDI flows grew rapidly from the mid-1980s to the beginnings of 1990s, were it remained static until the signing of the customs union at the end of 1995. It was during the period that Turkey and the EU formed a CU were the approved and realized
investment started to differ. This happened due to the announcements of manufacturing investment in Turkey, were investors’ perceptions of the opportunities afforded by investing in Turkey did not meet the reality of the situation and most of the new investment was not realised. Though we can see that the good expectations that the signing of the CU entailed were not fully met, being the realized FDI four times less than the authorized one in 1996.

**Figure 6.1** Foreign Direct Investment in Turkey (Million $)

The average FDI inflow per year has been less than $1 billion until the year 2000. The year 2001 was an exception as Turkey’s FDI inflow reached $3.2 billion; in the British Embassy’s opinion, more than half of this was accounted for by Telecom Italia and HSBC acquisitions.

The slowdown of world economic growth in 2001 (1.3%, as compared with 4% in 2000) and a decrease in cross-border mergers and acquisitions were attributed as the main factors of the decline of FDI flows worldwide, whereas a limited impact of 11th September is suggested by the Transnational Corporations surveys in investment plans. However, in Turkey, this drop was largely caused by the shift of FDI flows to Hong Kong and the recent WTO acceding China.

The financial crises suffered by Turkey in November 2000 and February 2001 can also contribute to the explanation of the drop or FDI inflow. Due to a quarrel between the president and prime minister the Lira collapsed, numerous banks borrowed large amounts of foreign currency at low rates, converted it to Lira and placed the money into
high yielding Treasury bills. This forced the Lira to depreciate by almost 27 percent at the end of February 2001, retracting potential investors’ willingness to invest in a country with such a weak economical, financial and political framework.

The gradual increase of worldwide FDI in Turkey goes in the same direction as the number of foreign capital companies in Turkey. As Figure 6.2 indicates, in June 2003 the amount of foreign capital companies in Turkey was six times bigger than the amount in 1990, being the increase over time continuous.

Figure 6.2 Number of foreign capital companies in Turkey

6.2.2. COUNTRY GROUP AND SECTORAL BREAKDOWN

Due to the lack of data combining both sectoral and country group breakdown of FDI it results impossible to have accurate data regarding to the FDI made by the EU in the Turkish clothing sector. We are though forced to analyze them separately and obtaining conclusions through the combination of data.

The EU countries have been the main Foreign Direct Investors in Turkey (Figure 6.3) over time. Besides, Figure 6.4 shows that almost the whole amount of FDI in Turkey has been made in manufacturing and service sectors. Unfortunately it is not possible to deduce a trend neither in sectoral breakdown nor in country group breakdown of FDI.
The most obvious conclusion would be that due to the high percentage of FDI coming from the EU and the importance (even though in the second place) of the FDI in worldwide manufacturing sector, it is understandable that FDI made in Turkish clothing sector by companies from the EU is high.

We can also confirm that the evolution of the worldwide FDI inflows to Turkey, explained through Figure 6.1, can easily be applicable to the case of FDI coming from the EU to Turkey due to the high percentage of Turkey’s FDI coming from the EU.

**Figure 6.3** Breakdown of FDI flow to Turkey by country group (percentage)

[Graph showing breakdown of FDI flow to Turkey by country group (percentage)]

Source: Turkish Treasury – FDI statistic (Data table A2.2)

**Figure 6.4** Sectoral breakdown of FDI flows (percentage)

[Graph showing sectoral breakdown of FDI flows (percentage)]

Source: Turkish Treasury – FDI statistic (Data table A2.3)

Going through a deeper analysis of the FDI inflows in Turkey’s manufacturing sector, Table 6.1 shows disaggregated information related to textile and clothing sectors. The
Turkish Treasury divides manufacturing sector in 39 sub sectors from which we have calculated the average to compare them with data regarding to clothing. Ready Made Garments category has the highest mount of firms with foreign capital in manufacturing sector. This goes in accordance with previous affirmation when talking about firms’ evolution through a “full package” production due to the intensified competition for FDI in Textile and Clothing. Companies operating in Ready Made Garments count also with higher capital than the average, but the percentage corresponding to the foreign capital is a bit lower. Nevertheless 1.63 percent of the foreign capital in Turkey is invested in the mentioned category, exceeding the average in the manufacturing sector.

Table 6.1  Foreign capital firms in selected sectors in Turkey (June 2003, Million TL)

<table>
<thead>
<tr>
<th>Group</th>
<th>Nº of firms</th>
<th>Present foreign capital</th>
<th>% in total foreign capital</th>
<th>Total capital of the companies</th>
<th>% of foreign capital in total capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ready Made Garments</td>
<td>224</td>
<td>124,756,388</td>
<td>1.63%</td>
<td>249,092,277</td>
<td>50.08%</td>
</tr>
<tr>
<td>Wearing Apparel Excluding Knitted Products</td>
<td>7</td>
<td>1,198,709</td>
<td>0.02%</td>
<td>14,374,340</td>
<td>8.34%</td>
</tr>
<tr>
<td>Average of the manufacturing sub sectors</td>
<td>43</td>
<td>81,605,597</td>
<td>1.09%</td>
<td>142,019,443</td>
<td>57.95%</td>
</tr>
<tr>
<td>MANUFACTURING TOTAL (39 sub sectors)</td>
<td>1,667</td>
<td>3,182,618,272</td>
<td>41.52%</td>
<td>5,411,113,189</td>
<td>58.82%</td>
</tr>
<tr>
<td>TOTAL</td>
<td>6,511</td>
<td>7,665,750,139</td>
<td>100.00%</td>
<td>12,605,285,296</td>
<td>60.81%</td>
</tr>
</tbody>
</table>

Source: Turkish Treasury – FDI statistic

6.2.3.  **RELATIVE TO OTHER COUNTRIES**

In spite of the incorrect expectations that investors had, shown by the huge gap between the authorized and realized investment (Figure 6.1), FDI inflows to Turkey accounted for $885 million in 1995 and increased to $2,733 million in 2004 (Table A.2.4). However, this performance is not evaluated as a success when comparing it with the level of inflows relative to countries comparable in size and development. In 2004 Turkey attracted $2.7 billion of FDI, whereas Poland for example, attracted $6.16 billion (Table A.2.4).
In order to compare Turkey with other nations, we have selected those countries which fit in environment and economic development, that are, Hungary, Poland and the Czech Republic. According to OECD (2002), the Eastern European transition economies of Czech Republic, Hungary and Poland are three of the countries with the most rapid increase in intra-industry trade over the 1990s, due to the FDI inflows that they have received. Besides, the selected countries are considered as the main East European competitors for Turkey in attracting FDI and we consider them as good benchmarking due to their recent accession to the EU.

According to the UNCTAD report about TNC (2003), although the CU with the EU has reinforced openness to trade, Turkey’s integration in the world economy through FDI has been low comparing to other developing countries. Furthermore, Czech Republic, Hungary and Poland that had started the accession talks with EU in 1997 received FDI inflows valued in 6.3, 3.3 and 7.3 billion US$ in the year 1999. Contrary, in 1999 Turkey was accepted as a candidate to the access but it got an inflow of $783 million, almost ten times less compared to Poland.

Figure 6.5  FDI inflows in Turkey and 3 competitor locations (Million $)

As Figure 6.5 shows, despite some general growth trend, individual country trajectories exemplify a variety of paths, differing in the timing and in the size and frequency of the peaks in the series. Poland, Czech Republic and Hungary had the most noticeable increase in FDI inflows right after 1989, being the most privileged destinies of EU capital during the nineties. Contrary, Turkey did not followed this upward trend,
furthermore, it has always had the lowest FDI inflow compared to the three selected countries over the period of analysis.

The FDI inflows into CEEC started to change in the following years. Poland suffered a big decrease in 2000-01 as the cycle of mega-privatization deals slowed, contrary to the slightly upward trend followed by the rest.

In the following year, investment in the Czech Republic expanded significantly, while the rest of the countries in the analysis suffered a decrease, on account of a large single Greenfield investment ($1.35 billion) by a joint venture of Toyota Motor and PSA Peugeot Citroën.

The year 2002 was the exception in the Czech Republic, when FDI exceeded USD 8 billion. On the other hand in 2003 they reached only USD 2.1 billion, the balance was influenced by the purchase of Eurotel shares from the foreign investor and the sale of foreign shares in Český Telecom to the portfolio investors from the U.S.A. and the U.K.

The most important conclusion that can be taken out is that Turkey has not had the success that competing countries have had in attracting inward FDI. The reason of this underperformance is still unknown, but in the next pages we will try to find it out.

6.3. OLI PARADIGM

We will use the eclectic approach developed by Dunning (1977) and focus on the three kinds of advantages that a company can obtain from investing abroad to explain why FDI in CEEC countries is comparatively higher than in Turkey. Our main interest will be to disentangle the location motives of investing in CEECs rather than in Turkey, focusing our attention in location advantages as it will be explained below.

As explained in the second chapter, ownership advantages are exclusively related to specific advantages of the investing firm, though they will vary among firms, having each of the investing firms its own advantages concerning to ownership. Ownership advantage explains why the firms go abroad, but do not give a clue of why do they choose Turkey as host country or why CEEC’s are more attractive to invest in. The
internationalization of EU companies has been previously analysed, being the decrease in trade barriers due to the removal of quotas and the differences in factor endowments and consequent cost savings the main reasons for EU companies to make FDI in clothing manufacturing.

But, which factors do firms focus on when deciding the location of the investment? The answer should be found in the location advantages defined by Dunning:

* Cultural distance:
The closer geographically two countries are, the higher the possibility is for them to share a similar culture. Although Turkey is quite close to the EU, it is true that there is a cultural difference between the two countries, mainly related to differences in religion (99.8% of the Turkish population is Muslim, while EU is mostly Christian). Furthermore, other terms like social and political differences, different mentality, values, consumption patterns and ways of doing business also show the cultural distance between EU and Turkey.

In this aspect, the New Member States (NMS) or the CEECs (Central Eastern and European Countries) have an advantage, due to the fact that the culture of countries such as Poland, Hungary or Czech Republic is closer to the European one. Besides, for some firms, the presence of cultural distance only has a minor role on the firms’ investment decisions.

* Geographic position:
According to the Foreign Investor Association of Turkey (YASED), this country offers significant opportunities for foreign investors. Geographically is situated in a good position to function as gateway between Europe, Middle East and Central Asia and has the opportunity in establishing a very close economic, investment and trade cooperation between them. In fact, this proximity to EU could be a positive and determinant factor, when deciding where to invest.

Nevertheless, it is obvious that the CEECs, are closer to the EU than Turkey, and consequently they could receive more FDI inflows from the EU. But compared to the
new emerging countries, Turkey has further advantages in terms of freight cost and delivery time.

*Infrastructure:*  
Turkey has very good road connections to any destination within the region as presented by the Foreign Investor Association of Turkey (YASED). The highway network is excellent, so it is the preferred method of transportation for goods and passengers in Turkey. Domestic airlines offer regular connections to many cities, being the Istanbul Airport one of the largest and most modern airports in Europe.

In terms of telecommunication infrastructure, it is true that Turkey is still far from where most of the European Countries are, what could reduce the idea of investing in Turkey. Possible explanation for the infrastructure differences between Turkey and EU could be the country’s location and technological development. Anyway, Turkey has an efficient telecommunication system which has have a substantial growth during the last decade, such as the internet access.

*Market potential:*  
The Turkish T&C sector has a large and growing domestic market which has a positive effect on the investment decision. Although having faced economic problems of rather expected for such a fast-growing economy, Turkey’s growth has not changed from its upward direction. Turkey’s GDP has grown faster than the comparing countries, presenting the home market as a good one to invest in. In the last year, 2005, Turkey’s real GDP growth rate has been of 5.0% points while the EU-15 average has been of 1.4%. Hungary (3.7%), Poland (3.2%) and Czech Republic (4.8%) also have had a growth above the EU-15 average, but are below the one of Turkey, being Czech Republic’s growth the closest one.

Nowadays, international customers want more quality, diversity, variety and better supply management. Due to its young and increasing population Turkish internal market is gradually becoming more sophisticated, which will lead to increased product diversification in the textiles and clothing. Furthermore, EU market demand of Turkish textile and apparel is high because of the good price/quality ratio, quick response, diversification and integration to the EU.
* Labour cost:
Today, Turkish private sector enterprises compete in the world markets, not only as producers of goods at reasonable costs, but as the manufacturers of products with unique quality under Turkish trademark.

Turkey’s clothing industry has some strengths such as relatively low labour costs compared to EU countries, the timeless in delivery and the ability in production modes with high price/quality ratio and higher quality fashion goods. But Turkey also has threats coming from the new Asian competitors mentioned before, who are accessing the market with low prices through unfair competition. The Turkish firms need to change and strengthen their strategy to keep competitive in the near future.

* Educational level:
According to ITKIB, there are enough facilities, schools, universities, courses and trainings to educate people for the clothing sector. But the official data regarding to schooling rate in Turkey is not as optimistic as the previous affirmation; even though the 90.7 percent of the population has coursed primary studies, only 18.5 percent goes to university. The educational level differences between regions are considerable, being the regions in the west the most advanced in terms of education and the regions in the south less. It is also true that many companies are forced to look for qualified workers abroad. Even if there is young and motivated workforce who is increasing their skill level through vocational programs, Turkey still has lack of highly skilled workforce in SME.

* Business climate:
Turkish business structure has been transformed from family-business to corporate identity, which has facilitated the entrance of foreign investors in the country. The investment climate has also been improved through a series of latest modifications in the legislation. In 2001 a reform process to improve the administrative procedure was started together with the increase in the government spending, factors all that were crucial drivers of FDI.

Turkey has many bilateral and multilateral agreements, such as, the CU, NATO, OECD, GATT, WTO and IMF. The Custom Union Agreement of Turkey with the EU
represents a huge opportunity for foreign investors looking for a relatively low cost export base for the European market. This CU makes possible for companies located in Turkey to make a duty free trade with EU countries, which makes the location more attractive for the investment.

* Economic climate:
There has been a change from a closed economy to a competitive, market-oriented economy. Unstable but at the same time dynamic economy, the population is younger than that of other European countries (63 percent of the Turkey’s population is below 35, while the 68.4 percent of the EU’s population is between 15-64), implying an intense dynamism in the economy. Furthermore, the deregulations and privatization of major state-owned enterprises are promising a more dynamic market.

Anyway, inflation has been Turkey’s most important economic problem. With the committed measures taken by the former and current governments, inflation has entered into a decreasing trend, except for 2001. But, although the inflation rate has decrease in a huge percentage, from a value of 85.6 percent in 1997 to 8.1 percent in 2005, the annual inflation rate of the Eurozone is much lower being 2.1 percent. Finland and Sweden (both 0.8%) are two of the members with the lowest rate. Czech Republic (1.6%) and Poland (2.2%) also have a low inflation rate, but Hungary in contrast is one point above the average (3.5%) although is still below Turkish level.

To sum up, we would say that the location factors in which Turkey needs to make a special effort to improve are cultural differences, infrastructure, education and economic climate. In contrast, it has some strength like high GDP growth, cheaper labour force comparing to the EU and better geographical position than the New Industrializing Economies from where it could take advantage to attract FDI.

6.4. AUTHORS’ TURKEY’S ATTRACTIVENESS EVALUATION

Only a small number of case studies have documented the role of FDI in apparel and textiles. Furthermore, no systematic evidence is available to permit cross-country
comparisons of how the leading producers are allocating their investments by country and region, or how FDI by specific producers will be impacted by the quota phase-out. The authors specialised in this aspects have different opinions in answering to the above questions in general and also in the specific case of Turkey.

Henry Loewendahl and Ebru Ertugal-Loewendahl evaluate Turkey’s performance in attracting FDI both in time and with competitors. Their working paper finds that FDI is playing a good role in growing the Turkish economy, although Turkey is not performing as good as Central and East European Countries (CEEC) did in attracting FDI. They say that the main reason is the low level of privatisation-related to FDI.

As Dutz, Us and Yilmaz (2004) discuss, there are two reasons behind Turkey’s case in attracting FDI inflows. The first is the country’s fiscal problems and the macroeconomic uncertainty. The second is the infrastructure weakness. Both reasons diminish the attractiveness perceived by the investors, resulting in lower levels of FDI flows. Nevertheless, based on case studies, Dutz, Us and Yilmaz (2004) argue that the main obstacles to increase FDI in Turkey are governance and institutions-related problems related to rule of law and competition.

According to the UNCTAD (Transnational Companies, 2003) the Turkish failure in attracting FDI has economic and non-economic failures. In the economic causes they include the high transaction costs of entry and operation for foreign investors (due to the excessive bureaucracy and corruption), the high inflation (although has decrease it still remain in high levels), economic instability, inward orientation until 1980, lack of protection of intellectual property rights, such as patents (mainly because of remaining gaps in the existing legislation, weak implementation and enforcement of laws, and cumbersome procedures) lack of inflation accounting and internationally acceptable accounting standards, failure of privatization, insufficient legal structure and inadequate infrastructure (especially energy).

In the non-economic causes, they include the political instability, internal conflicts (specially the Kurdish problem), fear of foreign political domination within the civilian and the military bureaucracy, lack of FDI promotion (indicating an unwillingness or
reluctance to attract FDI flows), and the structure of Turkish business (family-owned and controlled and closed to foreign investors).

The European Commission also highlighted the poor performance of Turkey in attracting inward investment as a barrier to economic development and integration in its October 1999 progress report towards accession of Turkey.

Since 2001, recovering from the financial and economic crisis, Turkey has progressed in establishing principles of corporate governance (fairness, transparency, accountability, responsibility). Companies that focus on the importance of corporate governance principles are likely to attract capital and encourage foreign investors. But even Turkey’s geopolitical advantages and the potential for a booming economy, it has not yet become an appealing environment for foreign investment.

The International Monetary Fund (IMF) insisted on several major structural reforms for helping to the recovery of Turkey after 2001 crisis. The most important is that Turkey must attract more FDI, the lack of consistent economic growth increases investor’s fear and short-term portfolio investments are made instead of long-term investments. The government is now looking at ways to make the investment climate more attractive to foreign investors, because “there has been a firm realization in the government and among a lot of private groups that when the IMF loans run out, the only real option for sustaining economic growth in through inflows of FDI” (Chris Innes-Hopkins, head of the economic and commercial department at the British Embassy in Ankara)

6.5. NATURE OF THE EUROPEAN FDI IN TURKEY

First of all we would like to underline that a clear separation between horizontal and vertical FDI is not possible, because in case of horizontal FDI it is common for affiliates to draw some headquarter services from the parent company, even when the firm duplicates the same production activity in several countries.
According to Helpman and Krugman, 1985, vertical FDI is made due to cost gaps, fragmenting the production process and concentrating labour intensive stages of production in low wage countries. Furthermore, it is said that vertical FDI tends to create trade, which can be confirmed by the Annex 1 (where is observed that trade has increased with the EU in the last year). Besides, Markusen and Venables (1996) concluded that vertical multinationals dominate production when the countries differ significantly in relative factor endowments and trade costs are moderate to low. Thus, at first side and considering all the previous analysis regarding to the factor endowments, it seems that in the case of Turkey and EU, the vertical FDI is more prominent.

In order to give an empirical analysis about this case, a cost analysis between Turkey and a European Country has been made. The comparison will be made with Italy, considering that it is a well known country in the clothing and fashion garments, being a good representative of the EU-15.

<table>
<thead>
<tr>
<th>Costs</th>
<th>Turkey</th>
<th>Italy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Electricity cent/kW h</td>
<td>7.5</td>
<td>1.6</td>
</tr>
<tr>
<td>Water cent/m³</td>
<td>95</td>
<td>30-90</td>
</tr>
<tr>
<td>Natural Gas 1000 m³/Dollar</td>
<td>172.3</td>
<td>171.4</td>
</tr>
<tr>
<td>Labour cost dollars/tour</td>
<td>2.14</td>
<td>16.65</td>
</tr>
<tr>
<td>International telephone call dollar/minute</td>
<td>2.34</td>
<td>2.28</td>
</tr>
<tr>
<td>Transportation dollar/ton</td>
<td>1,600</td>
<td>1,100</td>
</tr>
<tr>
<td>Real Loan Interest %</td>
<td>21.0</td>
<td>6.3</td>
</tr>
<tr>
<td>Corporate Loan Tax %</td>
<td>25 + (23)</td>
<td>37</td>
</tr>
<tr>
<td>Cost USA = 100</td>
<td>51-53</td>
<td>127</td>
</tr>
</tbody>
</table>

Source: Report of Turkish Clothing Manufacturers’ Association (TCMA), Turkish Clothing Industry Horizon 2010 Road Map Global Targets and Policies

If we look to the table, we can observe that the cost structure of the two countries is quite different. Considering the production in the USA as 100 we can see that Turkey is in a cheaper position while Italy is above USA. But going inside the components of these production cost, we can see how there are some aspects in which Italy’s costs are lower comparing to the ones for Turkey.
The first differences could be found in the energetic resources. In this aspect we can distinguish that the costs are higher for Turkey than for Italy, although in the natural gas, the cost of both countries is almost equalized. The transport and telephone costs are also more expensive in Turkey, as well as the interests and taxes. But the highest gap between the two countries is in the labour force cost, being the cost of Turkey almost 8 times lower than the one that Italy has. Considering that the higher difference takes place in the cost of labour, we can suppose that it is the main factor responsible of the production cost gap among Turkey and Italy.

The application of the above cost analysis to what Helpman and Krugman (1985) said, let us conclude that production will be fragmented concentrating labour intensive activities in Turkey. Consequently creating trade among the countries that take part in the mentioned fragmentation.

6.6. EFFECTS OF THE FDI

As many developing countries have already made, taking into account that Turkey is a capital-scarce country, we consider that it can benefit substantially from inflows of foreign investment. These flows could help to expand productive capacity and stimulate job creation. Thus, we can observe that the FDI inflow is not the score, but the beginning to improve the actual situation.

The FDI could involve the transfer of fixed assets, technology, know-how and a bigger access to the international market, which usually have both direct and indirect impact on the economic growth of a country. Considering that it sometimes involves significant ownership control as well as the transfer of technology, the impact on economic growth takes place through increased productivity, human capital accumulation, research and development activity, and technological and productivity spillovers. These impacts could be greater if it stimulates domestic investment activity. (Dutz, Us and Yilmaz, 2004)
But, the FDI decision also has to be considered in the domestic market of the host country, where increases the competition faced through imports. Consequently, FDI decisions, especially in the manufacturing sector, are often made after seriously considering the international competitiveness of the affiliate firm. (Dutz, Us and Yilmaz, 2004)

The presence of multinationals may also affect local companies. As we have already mentioned, the local domestic market has to face with a more intensive competition, because once they received the FDI inflow they openness to the international trade is bigger. Other effect is that the local companies will be forced to adopt newer and more advanced technologies and to use the existing resources of the firm more efficiently in order to be able to compete.

6.7. INTERRELATION BETWEEN FDI AND IIT

The interrelation among the most important aspects in our analysis will be studied next. For that purpose we will make a regression analysis (1995-2004) for each of the three product categories corresponding to clothing in the Combined Nomenclature. Data available in Table A.1.6 and in Table A.2.4 will be used to obtain the results about the correlation coefficient that we expose below:

<table>
<thead>
<tr>
<th></th>
<th>R</th>
<th>R²</th>
</tr>
</thead>
<tbody>
<tr>
<td>CN 61</td>
<td>0,32</td>
<td>0,10</td>
</tr>
<tr>
<td>CN 62</td>
<td>0,37</td>
<td>0,13</td>
</tr>
<tr>
<td>CN 63</td>
<td>0,44</td>
<td>0,19</td>
</tr>
</tbody>
</table>

Source: Authors’ own calculations

The correlation coefficient is positive in all the observations, which proves that existence of IIT and FDI are positively related. Nevertheless, it is important to underline that it is not sure if the IIT gives rise to FDI or vice versa, being a complicated question in which many authors have gone through but any of them has obtained a clear result.
This is why we will not try to investigate the cause-effect relationship and we will only analyse the role that plays the FDI in the explanation of IIT.

The determination coefficient is very low in the three cases, indicating that the IIT in Turkey’s clothing sector with the EU is explained by the FDI in a very low level, while other variables can have around 80 to 90 percent of the explanation power.
VII. CONCLUSION

The present thesis was aimed at looking at the concept of FDI in the context of the importance in trade between Turkey and the EU. The two main objectives were, on the one hand, to examine the nature of the trade that takes place between the two countries of analysis in order to foresee its evolution and, on the other hand, to evaluate the reaction of such trade in the context of the FDI flows.

To answer these questions it is first necessary to prove the validity of the hypothesis we presented:

**Hypothesis 1:** The signing of the CU has had a positive impact in Turkey’s trade in clothing sector, increasing the confidence of the investing countries.

The evolution in clothing trade among the two countries of analysis shows how the impact of the CU has not been as big as it was expected, maintaining the share that EU has in trade with Turkey constant. Nevertheless, negotiations with the EU and the signing of the CU had an important role in creating a new image of Turkey in attracting new potential investors.

**Hypothesis 2:** The changes that Turkey is pursuing in all the aspects mentioned will increase the country’s attractiveness for foreign investors.

Turkey is managing successfully the structural reforms in order to fully access to the single market, although it has still a long way to achieve them all. One of the base economic reform was the liberalization of foreign trade and the organization of institutions for development of a foreign trade policy, where agreements with the EU were an important factor for its creation. Apart from this reforms that will increase Turkey’s attractiveness it is also important to underline that it has its own attracting characteristics like the geographical position, abundance of raw material and low cost workforce compared to the EU. Unfortunately, we conclude in our analysis that even though the attracting characteristics that Turkey has for foreign investors, the real situation shows how it is underperforming when exploiting them.
**Hypothesis 3:** The expiration of the Agreement on Textile and Clothing the 1st of January 2005 will have negative effects on the exportations from Turkey to the EU.

The most important competitor of textile and clothing producer countries in the world is China, which will increase its presence in the market after the expiration of the ATC. This fact is one of the main threats that Turkey has in the present; nevertheless, it is possible to apply safeguard measures when it is believed that imports pose a significant menace to domestic industries. The net effect will not be anyway favourable to Turkey, which will see its trade potential limited by new emerging and lower cost countries.

**Hypothesis 4:** The clothing exports from Turkey to the EU will have a positive increase due to the FDI made in this sector.

The FDI made in Turkey has helped the country in achieving better technology through the knowledge spillover, consequently improving the quality of the clothing products that it manufactures. Besides, we have proved that the determination coefficient is positive between FDI and IIT, even though it is not the main explanatory factor due to its low value. The conclusion we take from this fact is that the FDI has positive effects in the trade although its degree of influence is not very high. Nevertheless it is not proved the cause-effect relationship among FDI and trade, not being possible to confirm if FDI is the trade creation factor or vice versa.

Thus, the relevance that FDI has in the clothing trade between Turkey and the EU is proved to be positive, even though its explanatory power is not very high, being other factors also the generators of trade among the two countries of analysis.
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- State Institute of Statistics
  - http://www.die.gov.tr/

- The European Commission – Directorate General:
  - http://europa.eu.int

- The General Secretariat of Istanbul Textile & Apparel Exporter’s Associations:

- Turkish Treasury:

- Undersecretariat of the Prime Ministry for foreign trade

- United Nations Conference of Trade And Development:
  - www.unctad.org
- World Bank:
  - www.worldbank.org
- World of Garment, Textile and Fashion:
  - www.fibre2fashion.com
- World Trade Organization:
  - www.wto.org
- www.altavista.com
- www.google.com
- www.yahoo.com
APPENDIX I. TRADE DATA

Figure 1.1  EU’s share in Turkey’s total clothing imports (percentage)

Source: Undersecretariat of the prime ministry for foreign trade

Figure 1.2  EU’s share in Turkey’s total exports (percentage)

Source: Undersecretariat of the prime ministry for foreign trade

Table 1.1  Turkey’s TCI depending on the factor intensities that the products demand

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Ressource intensive activities</td>
<td>1.306</td>
<td>1.213</td>
<td>1.417</td>
<td>1.64</td>
<td>2.004</td>
<td>1.337</td>
<td>2.263</td>
<td>1.559</td>
<td>1.318</td>
<td>1.4</td>
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<tr>
<td>Labor intensive activities</td>
<td>2.396</td>
<td>1.896</td>
<td>1.812</td>
<td>2.073</td>
<td>2.435</td>
<td>2.151</td>
<td>2.871</td>
<td>2.702</td>
<td>2.81</td>
<td>2.513</td>
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<tr>
<td>Capital intensive activities</td>
<td>0.37</td>
<td>0.278</td>
<td>0.215</td>
<td>0.322</td>
<td>0.579</td>
<td>0.352</td>
<td>1.03</td>
<td>0.832</td>
<td>0.694</td>
<td>0.725</td>
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<td>Easily imitable</td>
<td>0.192</td>
<td>0.167</td>
<td>0.127</td>
<td>0.260</td>
<td>0.208</td>
<td>0.206</td>
<td>0.344</td>
<td>0.450</td>
<td>0.406</td>
<td>0.467</td>
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<tr>
<td>Difficulty imitable</td>
<td>0.187</td>
<td>0.171</td>
<td>0.153</td>
<td>0.199</td>
<td>0.248</td>
<td>0.212</td>
<td>0.302</td>
<td>0.274</td>
<td>0.277</td>
<td>0.256</td>
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</table>

Source: Authors’own calculations with data based on COMEXT
# Table 1.2 Turkey’s RCA depending on the factor intensities that the products demand

<table>
<thead>
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<th></th>
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<th></th>
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<th></th>
<th></th>
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<tr>
<td><strong>Ressource intensive activities</strong></td>
<td>0.995</td>
<td>1.137</td>
<td>1.47</td>
<td>1.402</td>
<td>1.319</td>
<td>1.281</td>
<td>1.122</td>
<td>0.906</td>
<td>0.885</td>
<td>1.038</td>
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<tr>
<td><strong>Labor intensive activities</strong></td>
<td>1.825</td>
<td>1.777</td>
<td>1.88</td>
<td>1.772</td>
<td>1.602</td>
<td>2.062</td>
<td>1.424</td>
<td>1.571</td>
<td>1.887</td>
<td>1.862</td>
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<tr>
<td><strong>Capital intensive activities</strong></td>
<td>0.282</td>
<td>0.26</td>
<td>0.223</td>
<td>0.275</td>
<td>0.381</td>
<td>0.337</td>
<td>0.511</td>
<td>0.484</td>
<td>0.466</td>
<td>0.538</td>
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<tr>
<td><strong>Easily imitable</strong></td>
<td>0.265</td>
<td>0.288</td>
<td>0.235</td>
<td>0.404</td>
<td>0.271</td>
<td>0.340</td>
<td>0.333</td>
<td>0.480</td>
<td>0.462</td>
<td>0.562</td>
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<tr>
<td><strong>Difficultly imitable</strong></td>
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<td>0.351</td>
<td>0.293</td>
<td>0.292</td>
<td>0.315</td>
<td>0.309</td>
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</table>

Source: Authors’ own calculations with data based on COMEXT
Table 1.3  Clothing imports of EU ( Million $ and %)

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<tr>
<th>Region</th>
<th>Value 2004</th>
<th>Share 2004</th>
<th>Annual percentage change 2003 2004</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Region</strong></td>
<td>Value</td>
<td>Share</td>
<td>2003</td>
</tr>
<tr>
<td><strong>World</strong></td>
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<td>100,0</td>
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<td>Europe</td>
<td>73904</td>
<td>60,7</td>
<td>20</td>
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<tr>
<td>Asia</td>
<td>37465</td>
<td>30,8</td>
<td>20</td>
</tr>
<tr>
<td>Africa</td>
<td>7683</td>
<td>6,3</td>
<td>13</td>
</tr>
<tr>
<td>Commonwealth of Independent States (CIS)</td>
<td>953</td>
<td>0,8</td>
<td>12</td>
</tr>
<tr>
<td>Middle East</td>
<td>614</td>
<td>0,5</td>
<td>11</td>
</tr>
<tr>
<td>North America</td>
<td>593</td>
<td>0,5</td>
<td>1</td>
</tr>
<tr>
<td>South and Central America</td>
<td>415</td>
<td>0,3</td>
<td>16</td>
</tr>
<tr>
<td><strong>Suppliers</strong></td>
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<td></td>
<td></td>
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<tr>
<td>European Union (25)</td>
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</tr>
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<td>China</td>
<td>16052</td>
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<tr>
<td>Turkey</td>
<td>9792</td>
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<td>Romania</td>
<td>4829</td>
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<tr>
<td>Bangladesh</td>
<td>4622</td>
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<td>Above 5</td>
<td>91087</td>
<td>74,9</td>
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<td>Pakistan</td>
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<td>Korea, Republic of</td>
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<td>Croatia</td>
<td>576</td>
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<td>Philippines</td>
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<td>Egypt</td>
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<td>United Status</td>
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<td>TFYR Macedonia</td>
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<td>12</td>
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<td>Serbia and Montenegro</td>
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<td>Japan</td>
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<td>21</td>
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<tr>
<td>Syrian Arab Republic</td>
<td>120</td>
<td>0,1</td>
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Source: WTO
Table 1.4  Clothing exports of Turkey

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<th>2001</th>
<th>2002</th>
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<tr>
<td></td>
<td>QUANT (kg)</td>
<td>VALUE ($)</td>
<td>QUANT (kg)</td>
</tr>
<tr>
<td>EU15</td>
<td>196,940,258</td>
<td>5,333,810,730</td>
<td>215,050,379</td>
</tr>
<tr>
<td>USA</td>
<td>48,601,583</td>
<td>1,210,990,560</td>
<td>63,237,625</td>
</tr>
<tr>
<td>RUSSIAN FED.</td>
<td>4,476,195</td>
<td>57,677,587</td>
<td>4,535,962</td>
</tr>
<tr>
<td>SWITZERLAND</td>
<td>2,130,988</td>
<td>69,564,261</td>
<td>2,217,870</td>
</tr>
</tbody>
</table>

Source: Author's own calculations based on ITKIB

Table 1.5  Clothing imports of Turkey

<table>
<thead>
<tr>
<th></th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>QUANT (kg)</td>
<td>VALUE ($)</td>
<td>QUANT (kg)</td>
</tr>
<tr>
<td>EU15</td>
<td>1,933,495</td>
<td>129,897,212</td>
<td>2,206,193</td>
</tr>
<tr>
<td>USA</td>
<td>122,229</td>
<td>4,268,480</td>
<td>92,367</td>
</tr>
<tr>
<td>RUSSIAN FEDERATION</td>
<td>18,842</td>
<td>326,902</td>
<td>629</td>
</tr>
<tr>
<td>SWITZERLAND</td>
<td>19,544</td>
<td>578,480</td>
<td>20,698</td>
</tr>
</tbody>
</table>

Source: Author's own calculations based on ITKIB

Table 1.6  Breakdown of the IIT between Turkey and the EU in the clothing sector (percentage)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>CN 61</td>
<td>1.60</td>
<td>3.16</td>
<td>4.12</td>
<td>4.05</td>
<td>3.55</td>
<td>5.42</td>
<td>4.54</td>
<td>3.60</td>
<td>3.46</td>
<td>3.95</td>
</tr>
<tr>
<td>CN 62</td>
<td>3.94</td>
<td>7.20</td>
<td>8.30</td>
<td>8.91</td>
<td>7.05</td>
<td>8.16</td>
<td>6.76</td>
<td>6.38</td>
<td>6.95</td>
<td>8.68</td>
</tr>
<tr>
<td>CN 63</td>
<td>3.20</td>
<td>4.53</td>
<td>3.88</td>
<td>3.49</td>
<td>3.23</td>
<td>3.72</td>
<td>3.61</td>
<td>3.06</td>
<td>2.94</td>
<td>3.60</td>
</tr>
</tbody>
</table>

Source: Authors’ own calculations with data based on COMEXT
### APPENDIX II. FDI DATA

#### Table A.2.1  Approved and realized FDI in turkey

<table>
<thead>
<tr>
<th>Year</th>
<th>Approved FDI (Million $)</th>
<th>Nº of foreign capital companies</th>
<th>Realization (Million $)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td>1,861</td>
<td>1,856</td>
<td>684</td>
</tr>
<tr>
<td>1991</td>
<td>1,967</td>
<td>2,123</td>
<td>907</td>
</tr>
<tr>
<td>1992</td>
<td>1,820</td>
<td>2,330</td>
<td>911</td>
</tr>
<tr>
<td>1993</td>
<td>2,063</td>
<td>2,554</td>
<td>746</td>
</tr>
<tr>
<td>1994</td>
<td>1,478</td>
<td>2,830</td>
<td>636</td>
</tr>
<tr>
<td>1995</td>
<td>2,938</td>
<td>3,161</td>
<td>934</td>
</tr>
<tr>
<td>1996</td>
<td>3,836</td>
<td>3,582</td>
<td>914</td>
</tr>
<tr>
<td>1997</td>
<td>1,678</td>
<td>4,068</td>
<td>852</td>
</tr>
<tr>
<td>1998</td>
<td>1,646</td>
<td>4,533</td>
<td>953</td>
</tr>
<tr>
<td>1999</td>
<td>1,700</td>
<td>4,950</td>
<td>813</td>
</tr>
<tr>
<td>2000</td>
<td>3,477</td>
<td>5,328</td>
<td>1,707</td>
</tr>
<tr>
<td>2001</td>
<td>2,725</td>
<td>5,841</td>
<td>3,288</td>
</tr>
<tr>
<td>2002</td>
<td>2,243</td>
<td>6,280</td>
<td>1,042</td>
</tr>
<tr>
<td>June, 2003</td>
<td>1,208</td>
<td>6,511</td>
<td>150</td>
</tr>
</tbody>
</table>

Source: Turkish Treasury - FDI statistic

#### Table A.2.2  Country group breakdown of FDI flows (Million $)

<table>
<thead>
<tr>
<th>Year</th>
<th>EU COUNTRIES</th>
<th>OTHER OECD COUNTRIES</th>
<th>OTHER</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995</td>
<td>704</td>
<td>218</td>
<td>12</td>
</tr>
<tr>
<td>1996</td>
<td>491</td>
<td>229</td>
<td>194</td>
</tr>
<tr>
<td>1997</td>
<td>522</td>
<td>290</td>
<td>40</td>
</tr>
<tr>
<td>1998</td>
<td>553</td>
<td>391</td>
<td>9</td>
</tr>
<tr>
<td>1999</td>
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<td>258</td>
<td>169</td>
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<tr>
<td>2000</td>
<td>1,172</td>
<td>210</td>
<td>325</td>
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<tr>
<td>2001</td>
<td>2,613</td>
<td>280</td>
<td>395</td>
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<tr>
<td>2002</td>
<td>455</td>
<td>60</td>
<td>75</td>
</tr>
<tr>
<td>2003</td>
<td>338</td>
<td>196</td>
<td>12</td>
</tr>
<tr>
<td>2004</td>
<td>860</td>
<td>207</td>
<td>42</td>
</tr>
</tbody>
</table>

Source: Turkish Treasury - FDI statistic

#### Table A.2.3  Sectoral breakdown of FDI flows (Million $)

<table>
<thead>
<tr>
<th>Year</th>
<th>MANUFACTUR</th>
<th>SERVICE</th>
<th>OTHER</th>
<th>TOTAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995</td>
<td>388</td>
<td>534</td>
<td>12</td>
<td>934</td>
</tr>
<tr>
<td>1996</td>
<td>424</td>
<td>467</td>
<td>23</td>
<td>914</td>
</tr>
<tr>
<td>1997</td>
<td>349</td>
<td>456</td>
<td>47</td>
<td>852</td>
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<tr>
<td>1998</td>
<td>553</td>
<td>362</td>
<td>38</td>
<td>953</td>
</tr>
<tr>
<td>1999</td>
<td>353</td>
<td>447</td>
<td>13</td>
<td>813</td>
</tr>
<tr>
<td>2000</td>
<td>932</td>
<td>763</td>
<td>12</td>
<td>1,707</td>
</tr>
<tr>
<td>2001</td>
<td>846</td>
<td>2,439</td>
<td>3</td>
<td>3,288</td>
</tr>
<tr>
<td>2002</td>
<td>78</td>
<td>510</td>
<td>2</td>
<td>590</td>
</tr>
<tr>
<td>2003</td>
<td>338</td>
<td>196</td>
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<tr>
<td>2004</td>
<td>272</td>
<td>766</td>
<td>71</td>
<td>1,109</td>
</tr>
</tbody>
</table>

Source: Turkish Treasury - FDI statistic
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>TURKEY</td>
<td>18</td>
<td>684</td>
<td>885</td>
<td>783</td>
<td>982</td>
<td>3.266</td>
<td>1.063</td>
<td>1.753</td>
<td>2.733</td>
</tr>
<tr>
<td>CZECH</td>
<td>xx</td>
<td>xx</td>
<td>2,562</td>
<td>6,324</td>
<td>4,986</td>
<td>5,641</td>
<td>8,483</td>
<td>2,101</td>
<td>4,463</td>
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<tr>
<td>REPUBLIC</td>
<td>1</td>
<td>623</td>
<td>5,104</td>
<td>3,312</td>
<td>2,764</td>
<td>3,936</td>
<td>2,994</td>
<td>2,162</td>
<td>4,167</td>
</tr>
<tr>
<td>HUNGARY</td>
<td>10</td>
<td>89</td>
<td>3,659</td>
<td>7,270</td>
<td>9,343</td>
<td>5,714</td>
<td>4,131</td>
<td>4,123</td>
<td>6,159</td>
</tr>
<tr>
<td>WORLD</td>
<td>55,108</td>
<td>207,878</td>
<td>341,086</td>
<td>1,092,052</td>
<td>1,396,539</td>
<td>825,925</td>
<td>716,128</td>
<td>632,599</td>
<td>648,146</td>
</tr>
<tr>
<td>%Tur/world</td>
<td>0.03%</td>
<td>0.33%</td>
<td>0.26%</td>
<td>0.07%</td>
<td>0.07%</td>
<td>0.40%</td>
<td>0.15%</td>
<td>0.28%</td>
<td>0.42%</td>
</tr>
<tr>
<td>%C.Rep/world</td>
<td>xx</td>
<td>xx</td>
<td>0.75%</td>
<td>0.58%</td>
<td>0.36%</td>
<td>0.68%</td>
<td>1.18%</td>
<td>0.33%</td>
<td>0.69%</td>
</tr>
<tr>
<td>%Hung/world</td>
<td>0.00%</td>
<td>0.30%</td>
<td>1.50%</td>
<td>0.30%</td>
<td>0.20%</td>
<td>0.48%</td>
<td>0.42%</td>
<td>0.34%</td>
<td>0.64%</td>
</tr>
<tr>
<td>%Pol/world</td>
<td>0.02%</td>
<td>0.04%</td>
<td>1.07%</td>
<td>0.67%</td>
<td>0.67%</td>
<td>0.69%</td>
<td>0.58%</td>
<td>0.65%</td>
<td>0.95%</td>
</tr>
</tbody>
</table>

Source: UNCTAD Handbook of Statistic, 2005
APPENDIX III. CASE STUDY: MODES OF ENTRY IN TURKEY

Talking about the modes of entry, we have come across with some enterprises that have already made foreign investment in the clothing sector of Turkey. We talk about the foreign investment, due to the fact that not all of them are FDI. These enterprises are the German fashion company Hugo Boss and the Italian companies Benetton and Calzedonia. Next we will explain which kind of investment has each of them realized in Turkey:

Hugo Boss
Hugo Boss is one of the biggest fashion companies in the world with a turnover of 1.2 billion € and 4,800 employees worldwide. Furthermore, it operates in 108 countries and has more than 5,000 sales points all over the world.

Hugo Boss Textile Industries, Ltd., established in Izmir (Turkey) in August 1999, is the biggest production facility of this company with 2,000 men suits and 4,400 men shirt production per day and 1,500 employees.

Taking into account that this is a location of a new plant of production in a new country, from the first side it seems to be a case of horizontal FDI. Nevertheless, we have known that all this company established in the Aegean Free Zone exports all its production; thus, this proves that the objective of the company is to fragment labour intensive production process in Turkey giving rise to vertical FDI.

But this is not the only investment made by this fashion giant. In 2003, it announced to produce women’s apparel and sportswear at its plant in Turkey, even though, the board member did not reveal if the new investment will lead to new production lines being set up or if they simply replace existing lines.

United Colors of Benetton
On the 21st of April 2005 in Istambul, the Benetton Group and Boyner Group signed an agreement for a joint venture for the management and development of the Benetton brands commercial activities in Turkey and in the region.

Benetton Group, which was first presented in Turkey in 1985 through a license agreement with the Boyner Group, has invested about 14 million euro for 50% of the Bofis Company, a wholly owned subsidiary of Boyner, which manages all commercial activities of the United Colors of Benetton, Sisley, Playlife and Killer Loop brands in the Turkish area.

The agreement signed in Turkey, at a time of a favourable economic climate and negotiations to join the European Union, represents an investment that is part of Benetton Group’s growth strategy and which, at the same time, consents the evaluation of eventual manufacturing opportunities in the area.

Calcedonia
Calcedonia was founded in 1987 with the intention of building a company to sell panties and women, men and boys’ clothes through franchising. In less than 18 years it expanded all over the world with 985 shops: Italy, Spain, Austria, Cyprus, Croatia, Russia, Greece, Lebanon, Mexico, Poland, Portugal, Slovene, Turkey, Serbia and Hungary.

Its success could be due to various factors. The products offered distinguished for their variety, the good attention to actual trends and the inimitable quality/price relation are the main characteristics that guarantee to the enterprise the capacity to satisfy also the demand of their most exigent customers.

The philosophy of Calzedonia is based in the wish of creating a new way of selling, fresh and immediate, with a young and dynamic style, but highly qualified.
APPENDIX IV. CASE STUDY: BASQUE FDI IN TURKEY

The Society for the Industrial Promotion and Restructuring (SPRI) is the agency for business development that the Basque Government built in 1981 to give support and service to the Basque industry (in Spain). SPRI is the leader of a group of societies that help to a business project since the beginning until it is implanted. SPRI actually is based on four strategic performances: Innovation, Internationalization, Industrial Development and Information Society.

Our main interesting topic here is the internationalization of fourteen Basque SMEs (Small and Medium Enterprises) to Turkey which is going to be driven by SPRI during the following six months. The projects that are going to take place in this case are not related with the clothing sector, due to the fact that the main industry in the Basque Country is the manufacturing machine tool; nevertheless, we have considered interesting to analyse an internationalization process carried out by companies from our region (Basque Country) to Turkey, which is the country of our analysis.

INTERNATIONALIZATION PROCESS

The SPRI is going to drive until September, the internationalization of fourteen Basque SMEs in Turkey. The majority of these initiatives will correspond to the commercial area, in order to increase the exports to the Turkish market which according to the agency is facing a strong expansion, and less to the productive investments.

The projects carried out by SPRI come from the sectors of manufacturing machine tool, automotion components, components for electrical appliances, agricultural machinery, small electrical appliances, industrial software for tool-machinery and material goods for building.

This new projects of internationalization have surged due to a recent visit of the SPRI’s agent to Turkey, who has been in touch with 27 enterprises during one week. All of them will last for six months and could be working since next September.
Actually Turkey is generating a lot of interest in the Basque industry. Until now, there are seven Basque enterprises in Turkey, such as Imeguisa, Fagor Industrial, Ormazabal and Copreci, and another seven of commercial offices and technical assistance. In respect to the exports to Turkey from the Basque Country, a total amount of 120 enterprises of the Basque Autonomy sell their products in this market, mainly electronic and automotion components, equip goods and tools.

Among the principal Basque exporters to Turkey we can find to enterprises like Brigestone, Batz, Al-Ko, Araluze, Quinton Hazell, CAF, Corpeci, Orkli, Efa Master, Goratu, Agria Hispania, Soraluce, Belgicast, Tauxme, ECN, Hijos de Juan de Garay, Electrotécnica Arteche, Alcanza, Flexix, Cikautxo, Gequisa, Sun Chemical, Rochman o Alcoa. More than 45 per cent of these exporter enterprises do not reach to fifty employees and consequently they are SMEs, a segment to which SPRI supports specially in this market, due to the fact that it considers that they can have a great future in that country.

In fact, Turkey is the commercial partner number twelve of the Basque Country, with exports of 500 million Euros between 2001 and 2004, exceeding the sells realized by other countries such as Poland, China, Morocco, Czech Republic, India and Russia.

Turkey is an attractive market for the Basque Enterprises due to its size as well as the population and the PIB, its high industrialization and its good commercial relations with the nearer countries, among which there are the Eastern Countries of Europe, the Middle East and Turkistan, Uzbekistan and Kazajstan.