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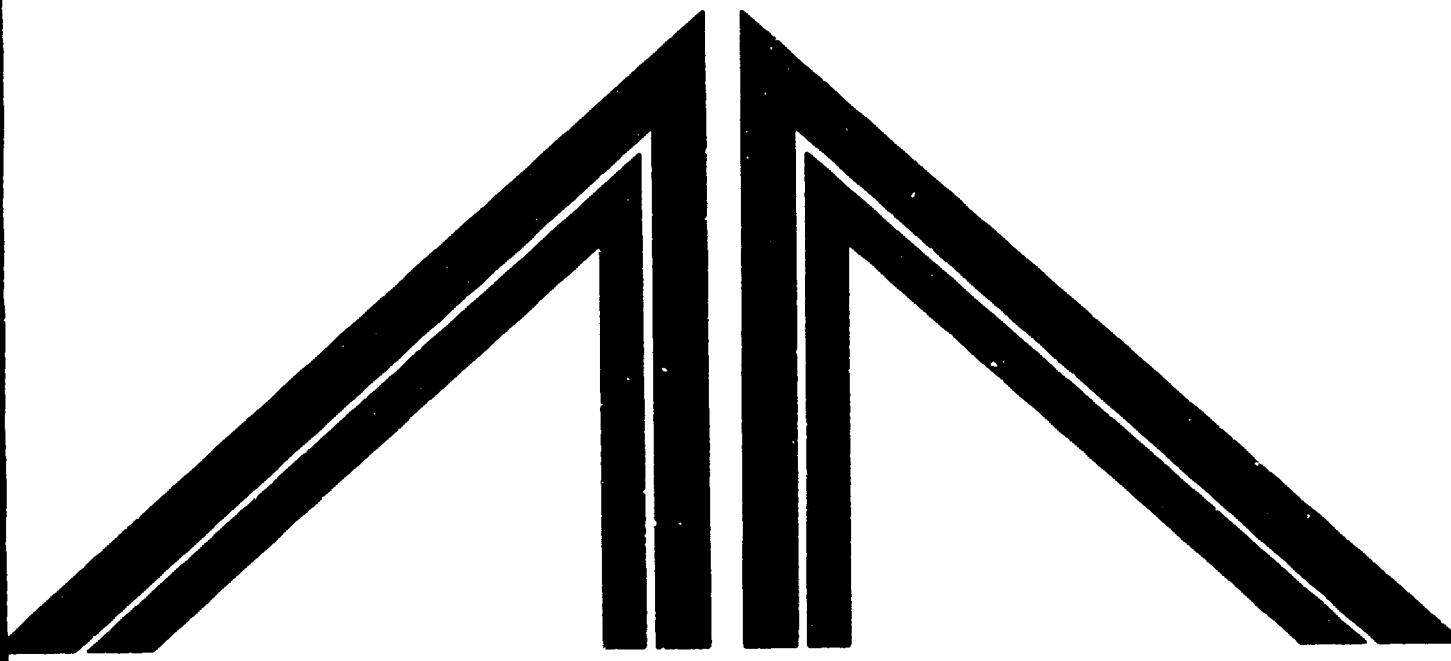
Policies for Competition and Competitiveness



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General Studies Series

Policies for Competition and Competitiveness

THE CASE OF INDUSTRY IN TURKEY

Refik Erzan, editor

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LIST OF ACRONYMS AND INITIALS

BSECZ	Black Sea Economic Cooperation Zone
CAP	Common Agricultural Policy
CET	Common external tariff
DEIK	Council of Foreign Economic Relations
EC	European Community
EU	European Union
ECO	Economic Cooperation Organization
EFTA	European Free Trade Association
GAP	Southeast Anatolian Project
GATT	General Agreement on Tariffs and Trade
GDP	Gross domestic product
GNP	Gross national product
IKV	Economic Development Foundation
ILO	International Labour Office
IMF	International Monetary Fund
ISIC	International Standard Industrial Classification
ISO	Istanbul Chamber of Industry
ITO	Istanbul Chamber of Commerce
KOSGEB	Administration for Development and Support of Small and Medium Size Industry
MFA	Multi-Fibre Arrangement
MFN	Most Favoured Nation
MTN	Multilateral trade negotiations
MTO	Multilateral Trade Organization
NIC	Newly industrialized country
NIE	Newly industrialized economy
NTB	Non-tariff barrier
OECD	Organization for Economic Cooperation and Development
PSBR	Public sector borrowing requirement
SEE	State economic enterprise
SIS	State Institute of Statistics
SITC	Standard International Trade Classification
SMSE	Small or medium scale enterprise
SOE	State-owned enterprise
SPO	State Planning Organization
TIKO	Turkish Cooperation and Development Agency

TKB	Turkish Development Bank
TL	Turkish Lira
TUGIAD	Young Turkish Businessmen's Association
TUSES	Turkish Social, Economic and Political Research Foundation
TOBB	Turkish Union of Chambers and Exchanges
TUSIAD	Turkish Industrialists' and Businessmen's Association
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
UNIDO	United Nations Industrial Development Organization
UTFT	Undersecretariat for the Treasury and Foreign Trade
$	United States dollars

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CHAPTER I

INTRODUCTION

Refik Erzan

In Turkey — like in many other countries today — the issues of competition and international competitiveness are widely discussed. This was not the case about ten years ago, when imports were strictly regulated and manufactured exports essentially consisted of textiles. In the meantime, however, views have changed: There is increasing awareness of the fact that gains from trade are comparable in magnitude to gains from improved sectoral allocation of resources along the lines of comparative advantage. And it is being realized that an outward-oriented strategy can work well, not only due to its potential to improve allocative efficiency, but also due to greater productive efficiency at the firm level which is likely to be induced by international competition. Enhanced productive efficiency can be expected from the effect that competitive pressure is likely to have on internal efficiency of organizations, on a selection process favouring efficient organizations and on technological innovation (Vickers, 1995).

Only few commentators question the merits of an open economy and a competitive environment. However, (i) the desirable level of trade liberalization as well as the degree of engagement in regional economic arrangements, (ii) the extent of the "market discipline" effect of imports on competition, (iii) the need for competition policies other than a liberal trade regime and, more generally, (iv) the role of an industrial policy or strategy are issues that are being debated worldwide. The present volume analyzes these and some other questions in the Turkish context.

1. Some Elements of the Policy Debate

After two decades of import substitution, the 1980 liberalization marked a turning point in Turkish economic policy. A generally liberal trade and financial system has been implemented and there seems to be widespread agreement about its usefulness. There appears to be also consensus about the need for a policy towards inflation. Opinion polls prior to the general elections of 1991 indicated that inflation was considered especially harmful. And on the assumption that the budget deficit was the predominant cause of inflation, shortcomings of the taxation system as well as the losses made by state economic enterprises (SEEs) were viewed as particularly problematic.

After the 1991 elections, privatization could have been pursued with more determination than was actually the case. Although investment and exports were faltering, the schemes for investment and export subsidies of the 1980s remained in their largely indiscriminate form,

making funds generally cheaper for investors and exporters. At one point during 1992 it had become impossible to pay subsidies for which entitlement certificates had been issued previously.

In an intense debate on industrial policy the Turkish Industrialists' and Businessmen's Association (TUSIAD), whose members come mainly from large enterprises, supported sectoral policies that would "build up" comparative advantage in promising industries (TUSIAD, 1991-93, Vols. I and II). Suggestions were for the formulation of an active (selective) industrial policy through a dialogue between the government and the private sector (TUSIAD, 1992). In the discussion the Turkish Union of Chambers and Exchanges (TOBB), which represents a broad range of industrialists and merchants, took a more liberal stand emphasizing the importance of macro-economic stability. According to this position incentive schemes were to be phased out, the taxation system reformed, and government support to be shifted to improve education and health services. Eventually, the debate lost some of its intensity. In the summer of 1993, TOBB and TUSIAD joined forces as the macro-economic situation continued to deteriorate and the target date for the customs union with the EU was approaching

Another interesting development has to do with the country's relations to the European Union (EU). Turkey's Association Agreement with the then European Community (EC) dates back to 1963. With the Additional Protocol, endorsed by the Turkish Parliament in December 1972, the two sides pledged to enter into a customs union within 23 years. Over the years, both Turkey and the EU have been cutting tariffs according to agreed schedules. Since a pledge of free movement of labour was withdrawn by the EU in 1986 and also Turkey's 1987 application for full membership frozen, few believed that the customs union would take effect in 1995/96. Furthermore, the general assumption was that the customs union would play a big role in the negotiations for full membership.

As regards trade policy in general, Turkey has had numerous surcharges and duties in addition to tariffs proper. Under various governments, the State Planning Organization (SPO) and the Undersecretariat for the Treasury and Foreign Trade (UTFT) have attempted to introduce a unified tariff schedule, which could serve as a benchmark in Turkey's tariff equalization with the EU (the common external tariff, CET)). Finally and to almost everyone's surprise, the government enacted an almost unified tariff in January 1993. The unification resulted in one tariff rate for the EU and EFTA, another one for all other trading partners, and a surcharge (the Mass Housing Fund, or the Fund) applying to both, but presumably to be phased out by 1998.

To the business establishment tariff unification was a strong indication that eventually the customs union with the EU might become reality. In response to this development the private sector entrusted to the Economic Development Foundation (IKV) the task of working out options for negotiations with the EU about the customs union. In the meantime the government requested the SPO to analyze those sectors that would be most affected by the customs union, both in a positive and in a negative way.

Issues such as those of the recent policy debate in Turkey provide the starting point for the analyses presented here. As a matter of course, these analyses have to expand their scope far beyond the themes of public discussion. And they are hoped to go into some depth of investigation too.

2. Plan of the Book

The study opens with a review by D. Rodrik (Chapter II) of the elements of successful industrialization. The chapter provides the conceptual framework in which to analyze the broad issues of competition, competitiveness and industrial policy. Based on economic theory as well as on evidence from East Asian countries it aims at informing the policy debate and correcting frequent misperceptions of the role of economic policy. In this attempt the discussion proceeds from first principles, analyzing the economic case for pro-industry policy and the shape that such policy should take. In particular, the chapter considers specific types of market failure and externalities in order to assess the justifiability of government intervention.

In Chapter III (by E. Katircioglu, N. Engin and C. Akcay) the impact of Turkey's trade liberalization on the country's manufacturing industry is assessed with econometric methods. The major findings of the work are that import competition has depressed price-cost margins in some industries, but the disciplinary effect of imports appears not to have materialized with the same vigour across all industries due to differences in import penetration.

Chapter IV (by C. Denizer) provides an econometric analysis of the effects of liberalization on competition in the Turkish banking market. One of the main results is that, although reform reduced concentration, uncompetitive pricing of banks is still wide-spread and a major cause of high profitability in the sector.

Investment and export subsidies are scrutinized in Chapter V (by R. Erzan). In this context the Turkish record on subsidies is reviewed and an attempt is made to answer the question whether the current system is viable and/or desirable. On the basis of this evaluation a number of specific policies are recommended.

Chapter VI (by I. Atyias) deals with restructuring and exit policies in the context of the Turkish economy. Based on a review of Turkey's experience in the 1980s and general considerations recommendations are made for a coherent approach to industrial restructuring. An important element of these recommendations is to take restructuring decisions independently of socio-political objectives. Furthermore, it is recommended that the government refrain from getting directly involved in the restructuring of individual firms.

Chapter VII (by M. Dutz) analyzes competition law and its relevance for the country's economy. In this connection the desirability of introducing a competition law in Turkey is analyzed and the question answered in the affirmative. The arguments for this proposal are taken from general analysis and a review of legal frameworks for competition in other countries.

Chapter VIII (by P. Messerlin) renders an account of antidumping and antisubsidy policies and their economic impact. It is critical of the present legal framework because of its inherent danger to lead to protectionist results. Recommendations are made for improvement through more transparency, the reduction of procedural biases and the introduction of a 'national interest' provision into antidumping procedures.

Chapter IX (by H. Forstner) provides an overview of theoretical and empirical results on competition and competitiveness in a global perspective. Specific issues are the relationship between competition and competitiveness, the theoretical framework and empirical results regarding the prominent sources of competitiveness and some policy implications deriving from these results.

Chapter X (by P. Low) assesses the international setting in which country-specific policies are placed. First, it analyzes the question of how important different trading arrangements have been in defining Turkish trade policy. Second, it tries to assess the consequences of changes in the international situation for Turkey's future policy options.

Chapter XI (by R. Safadi) identifies the role of 'new' trade theories and new trading opportunities from the point of view of Turkey. A brief discussion of recent developments in international trade theory is presented with a view to potential implications for the policy options of Turkey. In addition, an empirical analysis of newly arising export market opportunities in the countries of the former USSR is reported.

Chapter XII (by R. Erzan) summarizes the discussion of previous chapters and highlights major policy points.

Annex I (by C. Pazarbasioglu) gives an overview of economic developments in the country over the recent past. Here the historical background from the 1950s onwards is covered in all the major aspects of economic performance. The past decade is given special consideration in regard of developments in both the public sector and the external sector. Annex II (by R. Erzan) attempts to draw some lessons from the experience of Turkey for the case of Egypt.

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CHAPTER II

TRADE LIBERALIZATION, COMPETITIVENESS AND INDUSTRIAL POLICY: MAJOR CONCEPTUAL ISSUES

Dani Rodrik[1]

1. Introduction

During the 1960s and 1970s the protection of domestic industries as a means to encourage import substitution was the primary motivating principle of Turkish economic policy. In the 1980s the emphasis shifted to export promotion, and the import regime was liberalized significantly. As a consequence of the transition to an export-oriented economy, two myths about the Turkish economy were shattered: First, that Turkey was doomed to remain a largely agricultural country if more reliance was placed on comparative advantage and on foreign trade and second, that the manufacturing sector would be slow to take advantage of export opportunities. In effect, Turkey replicated the experience of many other middle-income developing countries that have made a decisive shift to outward orientation: A determined, sustained policy effort to increase the relative prices faced by exportables is typically rewarded by an export boom.

The industrialization strategy implicit in the protectionist policies of the past may have been a dead end, but at least it had the virtue of being a **strategy**. According to the infant-industry argument, local industries needed time to catch up with their competitors in advanced countries, and therefore had to be nurtured and protected in the meantime. Protection favoured industrialization and was hence perceived as a desirable medium-term policy. With the demise of import-substitution policies, Turkish economic policy has become open to the charge of having also given up on an industrialization strategy. Nothing has yet replaced the import-substitution consensus of the previous decades, and there is widespread concern that a steadfast emphasis on exports is no substitute for a well-articulated strategy for best positioning Turkish industries in the global market of the 21st century.

The absence of a clear beacon to guide Turkish economic policy has aggravated certain problems endemic to policy making. In particular, the lack of well-articulated priorities has meant that the authorities have sought to fulfil too many, and at times contradictory, objectives. Agriculture is promoted alongside industry, import-competing firms alongside export-oriented ones, and subsidies exist for such a myriad of activities that it is a veritable nightmare to figure out the net effect of all the interventions (Chapter V). It is clear that the bulk of these well-intentioned policies serve no other purpose than to offset the consequences

of other (equally well-intentioned) policies -- with a net increase taking place only in the amount of bureaucracy and red tape created in the system. When there is no over-arching strategy which frames day-to-day policy making, the result is necessarily haphazard.

This chapter discusses conceptual issues related to the question of what such a strategy should look like. It is aimed at using economic theory, as well as evidence from several countries, to inform the policy debate and to illuminate frequent misperceptions of the role of government policy. The discussion will proceed from first principles, analyzing the economic case for a pro-industry policy and the shape that such a policy should take.

I will argue that outward orientation is not incompatible with a strategy of industrialization. But an appropriate industrial policy is not necessarily one that selectively attempts to pick "winners" and protects them. First and foremost, it is one that establishes a stable and predictable policy environment which ensures that entrepreneurial activity receives its full reward. It is one that focuses on building the physical and human infrastructure which constitutes the corner-stone of industry. It is also one that presents greater rewards to those who bring new products to market and crack new markets abroad than to those who spend time trying to alter this or that government regulation to their benefit.[2] And when specific sectors are selected for promotion, an appropriate industrial strategy is one that acts truly selectively: that is, it identifies a necessarily narrow group of industries and sets out transparent policies to promote them as well as clearcut guidelines against which their success can be evaluated.

When these conditions are not met, selective intervention and protectionist policies are likely to remain ineffective at best; with them, such policies can do limited damage at worst.

2. Why Encourage Industrialization?

This might appear at first sight to be a naive question, as it is common to view industrialization as equivalent to economic development. As a historical matter, the association is certainly deserved. It is difficult to name developed countries that seriously qualify as non-industrial. It is a short jump to the proposition that presently underdeveloped countries must go through a similar process of industrialization to become rich. Indeed, if there has been a single over-arching goal for economic policy in developing countries, it has been that of industrialization. It is only with the generalized debt crisis of the 1980s that attention has shifted to short-run stabilization concerns.

Yet the question of this section's title is not "why industrialization?", but "why **encourage** industrialization?" There is an important difference between the two that is too often missed. There is a presumption that growing economies would industrialize over time even when policy is broadly neutral between industry and other sectors. In relatively closed economies

this is likely to happen because industrial goods tend to have higher income elasticities of demand than agricultural goods, minerals, and many services. In open economies the same can be expected as a consequence of a generalized process of learning and technology transfer, which progressively diminishes the comparative disadvantage of poor countries in standardized manufactures. On both accounts, we are likely to observe a certain amount of import substitution in industry, quite independently from any role played by policy. The question is, however, whether a useful purpose is served by quickening the pace of industrialization through policy. In other words, the issue is not whether industrialization is good **per se**; but whether government intervention is desirable to alter the speed and character of the industrialization likely to result naturally

The confusion between the two questions finds reflection in one of the frequent lessons drawn from the experience of Japan, the Republic of Korea, and the other successful East Asian countries. Demand-side decompositions in these countries often find that import substitution has typically played a more important role than exports in fostering economic growth in the early stages (Bruton, 1989 and the references therein). Many have drawn from this the "lesson" that a period of import-substitution policy is required before opening up to trade. In fact, no such conclusion is warranted from the evidence. As pointed out above, a certain amount of import substitution is likely to take place naturally, even in the absence of import-substitution **policies**. The East Asian evidence, at least the one referred to here, does not provide any guidance on whether active policy in favour of import substitution (to the extent that there was any) added to or detracted from the success of the strategy.

A similar fallacy underlies the argument that a pro-industrial policy is needed to protect an economy from the consequences of an inexorable deterioration in the external terms of trade of primary commodities. This argument, called the Prebisch-Singer thesis, was the basis of the import-substitution consensus of the 1950s and 1960s. Leaving aside the empirical validity of the assertion with respect to trends in the terms of trade, this once again confuses what is likely to happen even in the absence of policy with what must be ensured by policy. A trend deterioration in the prices of primary commodities will naturally reorient an economy's resources towards industry (and services). Industrialization will be the automatic consequence of the shift in relative prices. That governments must speed up the process through industrial policies is by no means a logical corollary. The argument can be (partially) rescued only by assuming that (a) the government has better information than domestic producers with respect to future prices in world markets and (b) it has no suitable way of disseminating this information. Both assumptions are unrealistic.

Therefore, the question of whether policy ought to be pro-industry is not answered by considering whether we like industrialization. The answer lies instead in specific market failures and externalities which, in the absence of corrective policies, may leave the industrial sector in command of a socially suboptimal share of the economy's resources.

The list of potentially relevant market failures is a long one. First, labour markets can be subject to important distortions in urban areas, to the detriment of manufacturing activities. For example, many industrial skills are acquired through on the job learning at the factory floor. Due to labour turnover, enterprises cannot fully appropriate the benefits of imparting such skills on their workforce, and therefore underinvest in upgrading the skills of their employees. Labour training externalities of this sort, important enough in developed countries, must be even more important in a developing country like Turkey where the divide between skilled and unskilled labour is much larger. A second labour-market distortion is created by urban wage premia due to either legal (e.g., a minimum wage) or institutional (e.g., trade unions) reasons. Such wage differentials keep urban (and therefore industrial) employment too low from an economic perspective.

Distortions also exist in the product markets. Entrepreneurs who try new techniques or explore new markets — whether successful or not — provide valuable information to other entrepreneurs in the economy. When they are successful, their strategies can be widely emulated. These informational and technological externalities cannot be readily internalized, and hence are underproduced. Product markets are also subject to scale economies. Whenever scale effects are important, the best that can be hoped from decentralized markets is that firms produce at the point where price equals average cost; but this still leaves a gap between price and marginal cost and therefore too low a level of production. An economy's basic infrastructure (such as education, energy, and transport networks) may be subject to important scale economies as infrastructure requires substantial investment in fixed costs[3]; it may pay to subsidize industry — to which infrastructure is an input — to get the needed cost savings from scale effects.

Finally, capital markets are thin and subject to many inadequacies. In the absence of an adequate prudential and regulatory environment, the financial sector is likely to do a poor job of financial intermediation, especially where long-term investment in industrial activities is concerned. Entrepreneurs therefore become dependent on internal and family-generated funds. Once again, manufacturing investment and capacity are likely to remain too small without corrective policies.

But even these arguments have some problems. First, it is difficult to observe many of these distortions directly, and even more difficult to gauge their quantitative importance. This leaves the needed interventions open to question and subject to abuse. Second, many of the distortions apply to non-industrial sectors as well, so that the net balance in favour of industrial intervention may not be that clear. Capital market distortions, for example, certainly affect smallholders in agriculture more than they affect larger industrial establishments; pro-industry policies may very well make one worse off on this account. Finally, one should not lose sight of the powerful Baldwin (1969) critique: Even if the existence of these distortions is taken at face value, the proposed remedy (trade protection)

is rarely the most appropriate one: occasionally it will prove worse than the disease itself. The next section turns to the role of trade policy proper.

3. Why Trade Policy?

This sections's title may sound naive too. But there are deep and difficult questions raised by the use of trade policy for industrialization purposes. Briefly put, trade policy is unlikely to be a first-best instrument for correcting any of the distortions discussed above, and hence its use should be subject to careful scrutiny.

One of the crowning achievements of the microeconomic theory of policy is the principle of targeting: To maximize real income, policy instruments must be targeted as closely as possible to the source of the market failure (Bhagwati, 1971, Corden, 1974 and Dixit, 1985). A clear implication is that only when the distortion originates in international trade is the use of corrective trade policy first-best. What distinguishes the arguments offered in the previous section about why industry may need policy encouragement is the property that essentially none of them has trade at its origin. Thus, wage differentials and labour training externalities are best treated with employment subsidies. Production externalities and production distortions due to scale economies are best corrected with production subsidies (or taxes if the externality is negative). Capital market imperfections call for interest rate subsidies.

In all these cases, trade policy, and import protection in particular, gets to the problem in a very indirect way, and is therefore of limited effectiveness. To take one example only, the effect of import protection on the amount of labour training undertaken in an import-competing sector can be considered. The impact effect of protection is to increase the profitability of the industry in question. In the medium run, one would expect the industry's output to increase, possibly by attracting new entrants into the industry. Provided the industry is on its labour demand schedule, the increase in output may go along with an increase in employment. But the labour training externality has not disappeared and leaves entrepreneurs with incorrect incentives. Under the best of circumstances the level of training will be broadly related to the volume of employment, so that an increase in the positive externality as an incidental by-product of protection is obtained. But the cause and the desired effect are in this case connected through a large number of unreliable links. Trade policy is nowhere near as powerful as would be a subsidy directly targeted at training programs run by industrial establishments — the latter being of doubtful effectiveness itself.

The only instance where trade policy may have a first-best role to play is on the export side.[4] Where manufactures are concerned, Turkish entrants to world markets are frequently hampered by their lack of a previous track record in terms of reputation for quality, reliability of supply, and knowledge of markets. Successful entrants may thereby provide an important positive externality to subsequent exporters in the same industry. For example, present-day

exporters in Korea and Taiwan benefit from the national reputation built up by the earlier exporters in the early 1960s, when these two countries were hardly known for high-quality products. The presence of such an externality in exporting creates a case for an export subsidy (Mayer, 1984; but also Grossman and Horn, 1987). Other arguments in favour of export-based externalities are discussed in de Melo and Robinson (1990). That a better case can be made for export subsidization than import protection on industrialization grounds is ironic: Turkish government policy — much like policy elsewhere in the developing world — has preferred import protection; when export subsidies were employed (as during the early 1980s), they have rarely offset the anti-export bias of prevailing trade regimes.

What, then, is the case for import protection on industrialization grounds? First, one has to recognize that many of the first- or second-best policies needed to offset the market failures noted above are not available in the real world. No government's administrative capability is adequate to the task set for it by the targeting principle: The flexible execution of finely tuned tax/subsidy schemes is simply not within reach. Aside from administration, there is another issue that detracts from the attractiveness of the subsidy solution: The closer the subsidy is to the source of the distortion, the more likely it is that it will be captured by the agents which have created the distortion in the first place (Rodrik, 1987). The occasional folly of the targeting principle can be observed in considering the case of union-created wage differentials. Theory tells us here that the first-best remedy is a wage subsidy to the high-wage sectors; common sense tells us that a smart union will simply raise its wage demands and capture the subsidy for its own members. While this is perhaps an extreme example, it nonetheless drives home the point that the targeting principle can go very wrong indeed if applied blindly. Often, common sense will require a policy which is distant from the source of the distortion so that it can blunt undesirable reactions from agents who gain from the distortion. When the first-best policies are either unavailable or damaging on other dimensions, a pro-industry trade regime has a second-best role to play.

The second main role for trade policy in industrialization is to generate government revenue. Only an ideologue would deny the important role that government has to play during industrialization. Government spending on health, education, and infrastructure is a primary input to the industrialization process and the productivity of private initiative. This spending has to be financed. Once again, while trade taxes would not be on any theorist's list of optimal tax instruments (save for a country with market power in international trade), practical and administrative considerations dictate that trade taxes will be an important source of revenue for a developing country. The poorer the economy, the higher the reliance on trade taxes. For countries with large primary export sectors such exports will provide a natural tax handle. For others imports will be the natural source. For a middle-income country like Turkey, the rationale for the taxation of trade on revenue grounds is somewhat weaker, save during periods when there is a great premium on government revenue.

The case for import protection on industrialization grounds, then, rests on a number of ill-fitting second-best rationales. On balance, there is a weight of arguments in favour of import protection; but the list of arguments is more impressive by its length than by the strength of any of its elements. And the arguments are strongest not for a country like Turkey, but for the poorest countries with the least access to direct tax/subsidy instruments.

4. How Much Protection?

How much protection should manufacturing industry receive in light of the above considerations? This section concentrates on average protection, deferring a discussion of inter-industry variation to the section on "targeting, selectivity and dispersion".

In principle, the size of protection has to be calibrated by examining each of the alleged market failures and gauging their magnitude. On the one hand, the larger the distortion, the larger is the needed intervention; on the other hand, the larger the by-product cost of protection (in its second-best role), the smaller is the requisite trade intervention relative to the optimal subsidy. As a practical matter, however, it is difficult to apply these principles in any serious way. The distortions in question, as discussed earlier, are nebulous and difficult to measure. What motivates the policymaker is the conviction that "there is something there after all" rather than knowledge of specific, well-defined distortions. So there is no choice but to apply what appear to be reasonable rules of thumb.

A "reasonable" level of protection is bound from above by four considerations. First, as already stressed, trade protection will rarely ever be a first-best instrument because it creates by-product distortions which could have been avoided had a more directly targeted policy been available. These by-product distortions can take many forms. For example, there is always a consumer cost that arises from forcing domestic consumers to pay prices higher than the world prices. Additional by-product distortions arise from mismatch between target and instrument. With a labour-market distortion, for example, trade protection has the costly side effect of over-encouraging the use of capital and other resources even though, by hypothesis, only labour is underemployed. The practical implication of these by-product distortions is to limit the size of the desirable intervention. More precisely, it is a general result in the theory of economic policy that the second-best level of a policy always falls short of the optimal level of the first-best instrument. Suppose, for example, that a production externality would call for a 40 percent production subsidy at the optimum. If the subsidy is not available and an import tariff has to be used instead, the optimal level of the tariff will have to lie **below** 40 percent; how much below depends on the price-sensitivity of consumption and therefore the size of the by-product consumer cost.

Second, because the distortions in question cannot be identified precisely, policy will have to cast a wide net. That in turn means that a lot of sectors will be protected that do not

require protection. As a result, activities will be encouraged which do not generate positive externalities, do not operate with scale economies, and also do not provide labour-training externalities. For obvious reasons, resources will be misallocated. Once again, rational policymaking would take that into account by scaling down the overall level of protection.

Third, one has to face up to the unpleasant fact of smuggling. Whenever domestic prices diverge greatly from world prices, incentives are created for smuggling. As a consequence, the real protection provided to industry by the trade regime can lie substantially below the notional level written down in the customs regulations. As a general rule, it makes no sense to push protection beyond the level where smuggling takes over. Where that point is, varies from country to country. In a country with long and porous borders like, for example, Bolivia, it could be as low as 20 percent. By contrast, in a country protected by the sea and a strong bureaucracy, like Japan, smuggling can be kept at bay even when price differentials reach several hundred percent. Turkey lies somewhere in between the above polar cases, but surely closer to Bolivia than to Japan in this respect.

Fourth, revenue reasons come into play. When tariffs are low, a small increase in their level is likely to raise total customs revenue; when they are very high, a further increase will likely reduce total revenue. Since trade taxes may have an important role in creating fiscal resources, it makes sense to avoid tariffs high enough to put the economy on the wrong side of the Laffer curve.

These are reasons why import protection should not be "too high". There are also two arguments for why it should not be "too low". The first and obvious one comes from the revenue motive, which is the mirror image of the last argument above. The second argument is somewhat more subtle. It is difficult to show that small to moderate tariffs (say of the order of 10-20 percent) can do serious damage to the functioning of an economy. Using the well known Harberger formula, the welfare effect

w = ½ x (share of imports in GNP) x (percent reduction in imports) x (tariff rate)

of a tariff can be approximated. For an economy with an import share of 25 percent and a proportionate reduction in imports of 20 percent as a consequence of a 20 percent tariff, the cost of protection amounts to one-half of a percentage point of GNP

(0.5 x 0.25 x 0.20 x 0.20)

— hardly something to get excited about. Therefore, there is no strong efficiency argument in favour of very small or zero tariffs. However, the efficiency costs of protection increase more than proportionately as tariffs are raised.

Where do these arguments leave the policymaker? It is trite to say that import protection should be neither too low nor too high. But the above considerations suggest that a range of 10 to 50 percent for the average protection rate is not unreasonable. The range can be further narrowed by considering specific circumstances of different countries. Poorer countries (especially those in Africa) should probably go to the high end of this range, while middle income countries (like Turkey) should strive for average rates of 10 to 30 percent. Countries open to smuggling should have lower rates irrespective of their income levels.

5. Price versus Non-Price Measures

So far trade policy has been discussed broadly, without distinguishing between different trade policy instruments. One distinction, however, is of particular importance: price versus non-price measures. Both types of measures affect the relative price of importables to exportables, but in different ways. Price measures such as import tariffs, export taxes, and export subsidies act directly on the price of traded goods. Quantitative restrictions (QRs) and licenses, on the other hand, have an indirect effect on the domestic price by creating scarcity. In a static, perfectly competitive world, there is little to choose between tariffs and QRs in terms of their resource allocation effects. Both provide industry protection by driving a wedge between domestic and world prices. In practice, however, the two operate quite differently. For all purposes but possibly that of providing temporary emergency protection in a crisis, price measures are preferable to QRs.

The first reason for the superiority of price measures is again related to revenue motives. Import tariffs generate revenue for the public treasury; quotas generate rents for well-connected or adventurous entrepreneurs. Of course, quotas could be auctioned in principle, turning rents into public revenue. But they rarely are.

Second, in practice QRs are likely to generate an unpredictable and arbitrary rate of protection over time. With a given level of tariffs, import-competing firms receive a constant, transparent rate of protection (say 20 percent), which does not change as long as the same tariff rate remains in force. QRs can in principle be calibrated to provide exactly the same rate of protection as the tariff initially, but keeping the rate of protection constant over time requires frequent readjustments in the level of the QR as demand and supply conditions change. Since government officials cannot be expected to undertake the fine-tuning needed, the likely result in practice is a variable rate of protection that will appear as arbitrary and unpredictable. This is a disadvantage from the viewpoint of policy, as the actual consequences of policy may, over time, diverge significantly from the intended effects. It is

also a disadvantage from the import-competing entrepreneurs' perspective, as the incentives they receive become capricious and unreliable for long-range planning and investment decisions. Both on transparency and incentive grounds, then, tariffs are preferable to QRs.

Third, protection through QRs allows domestic oligopolists to exercise market power, whereas tariffs do not. When there is a QR in place, a domestic firm faces a downward-sloping demand curve, over which it can maximize profits by setting marginal revenue equal to marginal cost. This will lead to the familiar monopolistic distortion in that too little will be produced. With a tariff, by contrast, the demand curve faced by a domestic firm is rendered flat as the firm can charge only a fixed price equal to the (fixed) world price plus the tariff. Therefore tariffs force domestic monopolists and oligopolists to behave in a perfectly competitive manner, eliminating monopoly distortions.

Finally, as Krueger (1974) discussed and illustrated, QRs are notoriously prone to rent-seeking: Activities in pursuit of lucrative import licenses use up resources. The costs of such rent-seeking can easily amount to several times the efficiency cost of the trade restriction itself. While frequently quoted numbers of 10 to 15 percent of GNP need not be taken seriously, it should be clear to any observer of the Turkish economy that the amount of rent-seeking is not trivial. From the perspective of industrialization, these activities perhaps have an additional cost: They divert entrepreneurial energies away from what should be their main preoccupation — namely, searching for new markets, learning manufacturing skills, and producing low-cost, high-quality items — to short-term profit-seeking through bribery and political clientelism. In principle tariffs could give rise to a similar sort of activity, called revenue-seeking (Bhagwati and Srinivasan, 1980). The difference is that the revenues raised by tariffs go into the general government budget, and their anonymity shields them to a much greater extent from such activities.

6. The Role of Targeting, Selectivity, and Dispersion

How differentiated should the actual structure of protection be? Should governments select specific sectors and provide them with higher protection than the rest? How much dispersion in protection should be allowed?

There is a strong theoretical case for selectivity in providing protection. In the first instance, the market failures and distortions discussed above are unlikely to have spread uniformly across all industries. In principle, policy needs to be targeted on those sectors with genuine distortions; and, leaving second-best interactions aside, those sectors that have larger distortions should receive higher protection. If the distortions and their magnitude could be identified precisely, the requisite interventions would likely yield a highly differentiated structure of protection.

The second economic argument for differentiation is related to the consumer costs of protection, due to the fact that import tariffs are equivalent to a combination of production subsidies (to the import-competing sector) with consumption taxes. The consumption tax element in tariffs adds a second layer of taxation on top of the prevailing sales tax (or VAT) system. As is well known, the theory of optimal commodity taxation calls for a differentiated tax structure, with (broadly speaking) higher taxes on commodities with lower (compensated) demand elasticities. Therefore, any tariff structure which is sensitive to efficiency considerations would allow for differentiation on these grounds too.

The problem in practice is that neither of these theoretical considerations is likely to be a strong guide for designing the appropriate tariff structure. As mentioned before, it is an almost hopeless task to identify the specific distortions afflicting particular sectors and sub-sectors, let alone to gauge their magnitude. Policy is guided rather by some vague feeling that these distortions do exist, even though one cannot put one's finger on them. Similarly, the need for information on demand elasticities to design the structure of optimal commodity taxes is daunting, and related data of a sufficient degree of confidence unavailable. Public finance theorists would hold that it is pointless to have more than two or three different rates (Stern, 1990).

Administrative and political economy considerations strengthen the case for a simplified structure with few rates. From an administrative point of view, it is certainly easier to run a tariff schedule which has only one or two rates. A relatively uniform tariff system also makes it easier for governments to resist pressure from industry groups for differential treatment. Such special pleading, when undertaken by all, results in higher and more haphazard levels of protection than would have been desirable. One of the chief discoveries of Balassa and associates (1971) in their study of protection in six developing countries was the high variance of effective rates of protection (ERP), with little evidence that the resulting structure was the outcome of deliberate policy design. The same no doubt applies to Turkey as well. In the absence of discipline imposed by a uniform system (or one with only two or three rates), selective interventions can multiply and cumulate over time, with the net effect bearing no relationship to the desired outcomes of any of the participants in the process.

None of this is to say that specific industries should not be selected for special promotion or protection when there is evidence of particularly egregious market failure connected with such industries. The point is simply that such evidence must exist before targeting is exercised. Advocates of targeting too often forget that selecting specific industries for protection amounts to taxing the remaining industries. Since the economy as a whole has limited resources, the benefitted industries can expand only at the cost of others contracting. It makes sense to pick and choose only when there are good economic grounds based on the existence of market distortions - for discriminating among industries.

Sometimes the above argument is turned on its head to suggest that targeting of specific industries is preferable **precisely** because across-the-board protection in the end favours none. The question that should be asked once again is what the reason is for favouring a particular import-competing industry over another. In the absence of a good answer to this question, we are left with a much weaker argument in favour of targeting, which runs as follows. Supposing that market distortions have discontinuities or are of the "threshold" type — that is, assuming that a certain critical mass is needed (in terms of output levels, for example) before benefits can be realized — the spreading of protection across a wide range of industries may well leave all or most of them under the threshold, with few gains. It would be preferable to target industries, even though **ex ante** none presents a more deserving case than any other. Whether this is an argument that has practical relevance is unclear, however.

Taking the above viewpoint, the usual preference for an escalated structure of protection, with capital goods (and intermediates) receiving less protection than consumer goods can hardly be defended, since it is difficult to make a general case for the latter type of goods being subject to a greater share of market imperfections than the former. Consequently, the argument more often is that consumer goods represent the easier stage of import substitution, and should therefore be the natural priority. Once again, this argument confuses what is likely to happen in the absence of (discriminatory) protection with what policy ought to be encouraging. If producing shoes, bicycles and soft drinks is "easier" than producing ball bearings or precision machinery, entrepreneurs will naturally flock towards them in any case. Therefore, the first stages of industrialization will be biased towards these consumer goods, even in the absence of discriminatory policies. Hence, tariff escalation has little economic rationale.

To sum up the previous discussion: Although recommendations have to be tailored to specific country experience, practical and economic reasons suggest that a decent trade regime have no more than two or three tariff rates.

7. Protection over Time: Stability, Discretion and Time-Bound Incentives

One aspect of incentives to which economic theory has remained blind until very recently is their stability and predictability over time. In the static textbook model, a government chooses a particular tariff rate, and the private sector responds accordingly. Implicit in the model is that the tariff and its level are set permanently, and viewed as such by agents in the economy. In reality, of course, the trade regime and the incentives emanating therefrom can change frequently. These changes can come about as the government uses its discretion to alter specific policies — i.e. change tariff rates, impose or eliminate import deposits or put on temporary surcharges — as circumstances require. They can also come about in the way of **unchanged** policies — such as a given quota — interacting with a variable economic

environment. In either case, individuals will consider the likelihood of these changes when they decide how to respond to **current** incentives.

All this would not be a major issue if decisions taken by entrepreneurs, workers, and farmers could be easily reversed. But the resource reallocation that trade policy seeks to foster typically involves costs which cannot be recouped when the initial decisions are reversed - i.e., they involve sunk costs. The entrepreneur who invests time and capital in building, say, a motorcycle factory cannot recover the full value of this investment, if he eventually has to convert it into a bicycle workshop due to a change in the incentive structure. Workers who invest in learning new skills take a capital loss in their human capital when a change in trade policy renders the activity concerned less profitable. The farmer who decides to plant a cash crop rather than a staple cannot instantaneously switch back when the policy environment ceases to be hospitable to the former. Decision makers are obviously aware of these uncertainties, and take them into account.

A direct implication is that when the policy environment is unpredictable, individuals respond to incentives slowly if at all. They prefer to invest their wealth in liquid assets at home or abroad rather than committing it to physical capital at home. For this reason, instability in policy cannot only render policy ineffective in the sense of blocking the supply response in favoured sectors, but it can also depress the overall level of physical investment which would have taken place at home (Rodrik, 1991). This places a large premium on a transparent, predictable system of trade incentives, with ad hoc interventions and alterations kept to a minimum. Since unpredictability can be quite harmful, a trade regime with high but stable rates of protection can be preferable to one which fluctuates more or less randomly between low and medium rates.

These considerations pertain to the **predictability** of incentives rather than their **stability**, and the two are not quite the same thing. The question remains whether it makes sense to provide select industries with temporary, time-bound protection on a pre-announced schedule. There are two arguments in favour of doing so, one general and the other more specific. The general argument is that most if not all of the arguments that favour protection for industry are likely to become less powerful as an economy develops and income grows. While an average protection rate of 50 percent may not be unreasonable for a country with a per capita GNP of $350, it is probably too high for one with an income level of $2,000. Therefore, some gradual reduction in protection over time seems sensible.

The specific argument is related to learning-by-doing (LBD) and the infant-industry rationale for protection. Suppose that entrepreneurs and workers build up experience and knowledge as they produce more widgets. The true marginal cost of producing widgets today will then be lower than the current marginal production costs by the discounted sum of future cost savings arising from the experience being accumulated today. But if firms cannot borrow against these future cost savings, they may not be able to produce at a large enough level to

generate the socially optimal amount of learning. If neither borrowing subsidies nor production subsidies are available, tariff protection may provide the right incentives. But presumably such learning effects are not permanent since all real infants (as opposed to impostors) grow to adulthood eventually. Once firms reach the world technological frontier and the LBD effects are exhausted (or at least reduced), they become less deserving of protection.

Unfortunately, governments are ill-equipped to look into firms and evaluate how steep learning curves are. They can only observe how well the firms they protect appear to be doing. Firms, in turn, have the incentive to prolong the protection they get by either appearing or remaining adolescent. In practice, temporary protection has all too often become permanent under these pressures.

8. What Do We Learn from the East Asian Experience?

The East Asian success stories — i.e., the stupendous growth rates achieved by Japan, the Republic of Korea, Taiwan Province of China, Singapore, and Hong Kong — raises the challenge of how this experience can be emulated in other settings. Economists who prescribe openness and price liberalization to developing countries typically present a picture of the East Asian experience that differs rather sharply from that presented by East Asian specialists themselves. A widespread caricature is that these countries achieved their miracles by minimizing price distortions, giving markets free rein, and emphasizing exports. In the case of the Republic of Korea and Taiwan Province of China, in particular, emphasis is placed on reforms during the 1960s that greatly reduced the restrictiveness of the trade regime, eliminated financial repression, and established a free-trade regime for exporters. Analysts who have studied these countries in depth describe a much more nuanced situation, and stress that government intervention has been pervasive (except for the territory of Hong Kong). The latter credit East Asian governments for making the miracles happen, not by getting out of the way of private entrepreneurs, but by actively nurturing and protecting infant industries.

With regard to liberalizing trade restrictions, for example, it is clear that East Asian countries did not go nearly as far as some Latin American countries have done recently, and that whatever was done took place a lot more gradually. Here is how Hong (1991, p.245) describes the progress of liberalization in Japan, the Republic of Korea, and Taiwan Province of China:

> "It was not until the 1960s that Japan eliminated the bulk of its formal quantitative restrictions: the nominal import liberalization ratio (by items) expanded from less than 70 percent in 1960 to about 93 percent in 1964, and to 97 percent by 1976

> Similarly, Taiwan did not eliminate the bulk of its formal quantitative restrictions until the early 1970s. the nominal import-liberalization ratio increased from 61.5 percent in 1970 to 96.5 percent in 1973. Korea is scheduled to eliminate the bulk of its quantitative restrictions during the period 1984-88".

According to a Korean Development Institute (KDI) study (cited in Hong, 1991), the average effective rate of protection in the Republic of Korea (for domestic sales only) actually rose from 30 percent in 1963 to 38 percent in 1978, after a dip to 24 percent in 1970.[5] The contrast with the rapid and overwhelming liberalization that has taken place in Chile in the second half of the 1970s, and in Bolivia, Mexico, and Argentina in the 1980s is staggering. With regard to industrial policy, the following evaluation of Tanzi and Shome (1992, p.57) of the tax incentives of Taiwan Province of China is noteworthy:

> "Taiwanese policymakers believed that they could pursue an investment strategy that would second-guess the market and pick winners. As a consequence, Taiwan kept its tax rates much higher than Hong Kong but pushed the investors in the desired direction through the widespread use of tax incentives. These incentives were fine-tuned to a degree rarely seen in other countries".

The same objectives were pursued in the Republic of Korea via selective and discretionary credit subsidies (Lee, 1992).

Two influential books have led the way in the re-interpretation of the East Asian experience: Amsden (1989) on the Republic of Korea and Wade (1990) on Taiwan Province of China. While many of Amsden's and Wade's arguments have been made before, the new elements in these books are a wholesale re-conceptualization of the East Asian experience as well as extensive documentation of the government's role in allocating resources and guiding industrialization in both instances.

Amsden (1989) describes in detail the use by the government of the Republic of Korea of trade protection, selective credit subsidies, export targets (for individual firms!), public ownership of the banking sector, export subsidies, and price controls -- all deployed single-mindedly in the service of acquisition of technological capabilities and of building industries that would eventually compete in world markets. She argues that government policy was successful not because it got prices right, but indeed because it got them purposefully wrong. However, a key element of the strategy, Amsden explains, was that in exchange for subsidies

and trade protection the government also set stringent performance standards Firms were penalized when they performed poorly and became subject to "rationalization" (i e. government-mandated mergers and capacity reduction) in the wake of over-extension They were rewarded when they fulfilled government objectives by way of awarding subsidized credit for fulfilling export targets Such discipline kept the system free of the rent-seeking that has contaminated incentive schemes in other settings "In other countries -- like Turkey and India, for example -- subsidies have been dispensed primarily as giveaways In Korea the 'wrong' prices have been right because government discipline over business has enabled subsidies and protection to be less than elsewhere and more effective" (Amsden, 1989, p vi)

Wade (1990) does not deny that there were elements of the free-market recipe -- typical for Hong Kong also in the strategy of Taiwan Province of China, but qualifies his statement significantly He calls Taiwan Province of China a governed market economy which is characterized by (i) high levels of investment, (ii) more investment in certain key industries than would have resulted in the absence of government intervention; and (iii) exposure of many industries to international competition He documents the pervasiveness of incentives and controls on private firms through import restrictions, entry requirements, domestic content requirements, fiscal investment incentives, and concessional credit He argues that Taiwan Province of China has consistently acted in **anticipation** of comparative advantage in such sectors as cotton textiles, plastics, basic metals, shipbuilding, automobiles, and industrial electronics "Taiwan manages its trade differently from many other developing countries, but not less" (p 113) Like Amsden, he stresses the "hard" nature of the East Asian state, but also argues that the emphasis on exports helped reveal policy mistakes and made reversal possible when some ventures got too costly

It is worth repeating here the most striking aspect of the revisionist accounts of the East Asian experience The policy instruments used to such benefit in that context were no different from those that have apparently failed so miserably in Turkey, as well as in Latin America and Africa The policies in question are import quotas and licenses, credit subsidies, tax exemptions, public ownership, and others For example, export subsidies that have worked so well in the Republic of Korea in the 1960s have been somewhat effective, but also a source of rent-seeking in Turkey

The reason for different experience seems to lie in differences regarding the way in which the government interacts with the private sector Using the terminology of Jones and Sakong (1980), the Republic of Korea and the other East Asian states have had a "hard" state - i e, one which can exercise effective leadership over the private sector and use carrot-and-stick strategies to get business and other actors to do what it would like them to do By implication, strong policies are those that eventually are implemented as originally formulated Weak policies implemented by a "soft" state by contrast, can be reshaped by resistance from actors whose behaviour they try to influence Table 2 1, taken from Jones and Sakong (1980), is based on a survey of entrepreneurs and illustrates the difference between Park's hard

state in the Republic of Korea and its soft predecessor under Rhee. The figures in the table represent striking evidence of the difference between a government that actually carried out its policies and one whose policies either were not implemented or executed only after being refashioned. In most areas of policy, Turkish governments have looked more like the Rhee regime than the Park regime in this respect.

The practical consequence of the distinction between hard and soft states is that discretionary policymaking gives very different results under the two types of regime. Weak policies are liable to be captured by special interests and distorted beyond their original purpose, with their main contribution becoming the creation of rents rather than the provision of appropriate incentives. As soon as their inadequacies become apparent, they are "mended" by adding on another layer of equally weak policies.

It should be noticed that what is at issue here is not the good intentions of governments, but the extent to which they can effectively impose on the private sector the desired consequences of discretionary policies. Neither is this a question of authoritarianism: many dictatorial regimes, notably in sub-Saharan Africa, are particularly soft in this respect. Therefore, trade regimes in two countries may look exactly alike in terms of laws and regulations in force, and yet serve benign ends in one country and malign ones in the other. This qualitative dimension of trade regimes is frequently overlooked, for example, when instances of Korean or Japanese interventionism are used as a justification for import-substitution policies in developing countries. The prevalence of a weak policy regime is a powerful argument for eschewing selective protection of industries and downplaying the discretionary element in trade policy.

A set of conclusions regarding the East Asian experience to which most knowledgeable observers would agree could be stated as follows: (i) there has been a considerable amount of government intervention and an active trade and industrial policy; (ii) but intervention has taken place above all in the context of stable macroeconomic policies in the form of small budget deficits and realistic exchange-rate management; (iii) equally important, the governments' emphasis on and unmitigated commitment to exports helped minimize the resource costs and incentive problems that would otherwise have arisen from heavy intervention; (iv) also, intervention has taken place in an institutional setting characterized by a "hard" state and strong government discipline over the private sector; (v) furthermore, such a setting is lacking in most other developing countries. What one then does with these conclusions depends on one's predilections. Some would argue that it is possible to engineer local versions of the institutions that have made Korea's or Taiwan's policies so successful (e.g., Wade, 1990, chap. 11). Others would conclude that softer governments should economize on their scarcest resource, administrative competence, and restrict their involvement in the micro-management of the economy (Krueger, 1990). Still others would call for an entirely hands-off approach (Lal, 1990).

9. What Do We Learn from Recent Models with Imperfect Competition?

One of the common arguments against East Asian type industrial policies is that governments could not possibly make informed decisions about which industries could eventually become successful and hence deserve support. Wade (1990) argues that this objection misses the point: "The governments of Taiwan, Korea, and Japan have not so much **picked** winners as **made** them" (p. 334, emphasis in the original). In other words, Wade implies that under the right set of government policies, industries can be nurtured into competitiveness even if these industries are ex ante undistinguished with respect to potential comparative advantage. Now, while this statement may be true as a matter of objective description, its normative implications are not as salutary as Wade assumes. Indeed, in an economy approximating perfectly-competitive conditions, the policy just described would have to reduce the economy's real income. Making "successful" exporters out of industries that do not possess an underlying comparative advantage is a resource-subtracting policy.

However, one may assume for a moment that much of manufacturing operates under increasing returns to scale, at least up to a point. Another realistic assumption is that industrial production typically exhibits demand or technological spillovers: that is, the expansion of a firm leads to an increase in demand faced by other, neighbouring firms or a reduction in their costs.[7] Under these circumstances, the pattern of comparative advantage can be largely arbitrary. A policy that subsidized a sub-group of firms or industries exhibiting such demand complementarities or technological spillovers would permanently alter the economy's "comparative advantage" **and** raise its real income (Murphy et al., 1989; Krugman, 1991 and 1992). Moreover, the informational requirements of a policy of this sort need not be heavy: an input-output table and some knowledge of the industrial structure of more advanced countries are basically all that the policy makers would need.

There are strong echoes of Rosenstein-Rodan (1943), Nurkse (1953) and Hirschman (1958) in this. Indeed, one consequence of the emergence of this new literature has been the partial rehabilitation, at least at the level of theory, of concepts such as "big push," "balanced growth" and "linkages".

This is just one example of how conventional wisdom can be upset by explicitly considering increasing returns to scale. However, the new literature is far from having yielded robust conclusions. More often than not it has led to a bewildering array of special cases and an embarrassingly rich set of possible outcomes from policy intervention. In the new models of trade and growth, trade policy has at least **three** distinct effects (Grossman and Helpman, 1991, chap. 9, and Rivera-Batiz and Romer, 1991).

The comparative-advantage or allocation effect: Static comparative advantage determines the instantaneous resource-pulls in an economy opening up to trade. If the effect of these is to direct resources towards the "growth sectors" of the economy, the effect of trade is to speed up economic growth; otherwise, opening up to trade leads to reduced growth. For example, a country that is poorly endowed with human capital would experience a reduction in the relative wages of skilled labour, and therefore a decrease in the cost of doing R&D. The consequence would be an increase in that country's growth rate. The opposite is true for an economy that is well endowed with skilled labour (Grossman and Helpman, 1991, chap.6). More broadly, trade is likely to enhance growth to the extent that innovative activity is more closely linked to the exporting sector than the import-competing sector.

The market size or integration effect: International trade expands the size of the market which the R&D sector services; but it also increases the competition faced by the home R&D sector. The first of these effects generally increases growth, as long as there are some increasing returns built into the R&D sector. For example, when intermediate goods are traded and used in the R&D sector, the enlarged market size allows a wider range of inputs, lower costs, and therefore a boost in R&D activity and growth. Alternatively, when there is learning-by-doing, the larger market size speeds up the rate of learning (Davis, 1991). The second effect is generally detrimental to growth because the smaller market share implied by each of the innovating domestic firms reduces the incentive to innovate. Feenstra (1990) provides a model of two countries with unequal size in which intermediate goods are of the non-traded type. The latter property implies that the smaller country has a cost disadvantage in producing these goods, and its firms lose market share when trade is opened up. Consequently, trade unambiguously reduces the smaller country's growth rate.

The redundancy effect: In the absence of trade, some innovative activity is necessarily duplicated in different countries. That is, resources are devoted to developing identical products. With trade, such duplication can be avoided.

In view of this embarrassment of riches, it is possible to come up with models of trade and growth to satisfy any type of priors or to rationalize any kind of conventional wisdom. Some analysts have noted that returns to scale and imperfect competition are rampant in developing countries, which makes the new ideas particularly relevant to this setting (Krugman, 1989, Helleiner, 1992). Others have dismissed them as largely irrelevant to developing-country circumstances and concerns (Srinivasan, 1989 and Corden, 1990). All would agree that the new literature provides, at best, limited support for the subsidization of a narrow range of industries with demonstrable and significant spillovers. In particular, there is very little in it that would justify average protection levels in excess of, say, 15 percent.

10. Avoiding Some Common Policy Pitfalls and Misconceptions

By way of recapitulation, several sources of misconception regarding the role of government policy in industrialization shall briefly be discussed here.

First, under pressure from various constituencies, policy makers are always tempted to try to subsidize and protect **all** activities — the textile weaver as well as the garment producer, the import-competing producer of steel as well as the exporter. To some extent, current Turkish industrial policy is built on the fallacy that this is indeed possible. But the first thing that economics teaches is that any policy that alters relative prices in favour of one sector must have negative effects on some other sector that now faces an adverse terms-of-trade shift. In the case of vertically-dependent industries this is immediate and transparent: Protecting the textiles producer, for example, hurts the clothing exporter who now faces higher input costs. In other cases the effects are more round-about and work through general-equilibrium interactions. But the essential point remains: Every act of encouragement specific to one sector or industry has to have adverse effects on some other sectors or industries. Any industrial policy worth its name has to confront this basic law of economics and make explicit choices regarding which sectors are more deserving than others.

In the absence of such choices, trade and industrial policies degenerate over time into a morass of regulations that are self-defeating and of uncertain consequences. Each supplicant, often complaining of the adverse effects deriving from someone else's favourite intervention, is granted his own protective policy. In time, these interventions multiply and generate effects on resources that are divorced from any meaningful rationale the intervention may have had originally. With the snowballing of regulations, the distinct effects of the policy are the creation of bureaucracy, red-tape, and rent-seeking. Hence, the practice of discretionary and selective industrial policy requires making clear strategic choices.

Second, as mentioned above, such choices cannot be made on the basis of a judgement as to which industries look like being winners. The tempting strategy is to project where Turkey's future comparative advantage is supposed to lie, and to put public resources into such industries. The trouble with this strategy is that it gives too little credit to the private sector, which should be ready to take advantage of this potential **even** in the absence of government support. If government officials believe they know something about the future that the private sector does not, then the appropriate policy is to simply disseminate this information. The real rationale for public intervention, instead, is the removal of specific market distortions and imperfections. There is no reason to believe that such distortions are predominantly located in the growth industries of the future.

Third, it is a mistake to think that the most effective form of industrial policy is that which takes place through direct, targeted intervention in specific sectors. Possibly the two most potent forms of industrial policy are (i) the building of physical infrastructure (transportation

networks, telecommunications, and power plants) and of human skills (technical and secondary education), and (ii) stable macroeconomic policies which produce balanced budgets over the economic cycle and single-digit inflation rates. These policies do not discriminate among industries, and their payoff in terms of the quantity and quality of private investment is vastly superior to that of sector-specific policies.[7]

Finally, the industrial strategy inherent in outward orientation should not be mistaken for one that calls for rolling back and weakening the state. The principles discussed in this paper do not aim at reducing the role of the government; rather, they aim at improving its capacity to achieve its objectives by providing clarity and greater focus to these objectives, by encouraging more selectivity in action, and by directing intervention to areas where they are the most effective.

Table 2.1: Survey Evidence on "Soft" and "Hard" States

Question: Once the current (Park) government has made a decision affecting business, how effective is it in insuring compliance? What about the Rhee government?

Responses:

	(percent)	
	Park	Rhee
Always implemented; impossible to avoid complying	78.2	3.2
Almost always implemented; sometimes possible to avoid complying	16.6	17.2
Implemented with modification	1.7	50.5
Seldom thoroughly implemented	3.5	29.5

Source: Jones and Sakong (1980), Table 22.

Notes

1. This chapter draws extensively on two other papers by the author: Rodrik (1992) and (1993). I am grateful to Refik Erzan, Helmut Forstner and Ziya Onis for helpful comments, and to the sponsors of the project for financial support.

2. These arguments parallel those recently made by Capoglu (1992).

3. Considerations such as these lay at the root of the Rosenstein-Rodan "big-push" theory of industrialization, recently revived by Murphy et al. (1989).

4. Strictly speaking, trade policy has a first-best role to play also in economies that have market power in international trade; this is the familiar optimum tariff argument. Since it has little to do with industrialization, save in the instance where export staples can be taxed to generate funds that can be channelled towards industry, the optimum tariff argument is left aside here.

5. This reflects an increase in protection of the agricultural sector, however. For manufacturing proper, the effective rate has declined from 26 percent in 1963 to 13 percent in 1978.

6. See Stewart and Ghani (1992) for a survey of evidence on this and other types of spillovers. It should be noted that a demand spillover, taken on its own (i.e., in the absence of increasing returns), would not constitute grounds for policy intervention whereas a technological spillover normally would.

7. See Kaufmann (1991) for an in-depth analysis of how sensitive project returns are to the quality of the macroeconomic policy environment.

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CHAPTER III

THE IMPACT OF TRADE LIBERALIZATION ON THE TURKISH MANUFACTURING INDUSTRY: AN EMPIRICAL ASSESSMENT

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1. Introduction

Can we rely on trade liberalization to discipline domestic markets through increased competition? The present chapter addresses this question by analyzing the impact of trade liberalization in the 1980s on pricing behaviour in the Turkish manufacturing industry.

Weaknesses of the Heckscher-Ohlin-Samuelson (H-O-S) theory in explaining trade flows between countries have been the subject of a growing literature on international trade (see, e.g., Helpman and Krugman, 1985 and 1989). Assuming perfectly competitive markets, the H-O-S theory attempts to explain international trade by differences in factor endowments. The underlying law of comparative advantage requires no specification of behaviour with regard to firms, all of which are price-takers. Likewise all markets and industries are taken to be competitive, economies of scale and product differentiation are assumed away, and firm size is taken to be irrelevant. Under these circumstances, it is shown that trade liberalization increases the welfare of a country, and that there is little room, if any, for either strategic trade policy or industrial policy.

In conventional trade theory, welfare gains from trade liberalization come from the induced more efficient allocation of resources across industries and sectors -- known as "allocative efficiency." However, once the existence of imperfect competition is acknowledged, there is an additional source of welfare gains. Such gains also stem from increased efficiency in production processes within firms (productive efficiency) arising from greater competition from abroad.

The H-O-S theory faced a significant challenge in the 1970s when imperfect competition was explicitly introduced into models of international specialization. During the same decade, empirical studies on market structure supported the view that the assumption of perfectly competitive markets was shaky, at best. The existence of industries and markets where firms would be numerous and incapable of affecting their environment seems to be the exception rather than the rule. Be it in the domestic or the international markets, firms' efforts are often focused on manipulating their environment and influencing prices. In other words, markets in the real world "normally" operate imperfectly and theoretical models would have to take this fact into account.

Acknowledging the significance of imperfect competition, however, does not necessarily imply a more interventionist policy stance. On the contrary, to the extent that trade liberalization and a consequent increase in import penetration reduce distortions caused by domestic market power, the arguments for freer trade become stronger.

2. The Background to the Import Regime of Turkey

Prior to the 1980 stabilization program, Turkey pursued an inward-looking strategy for about two-and-a-half decades. Until 1981, imports into Turkey were controlled by annual import programs and a varying mix of trade-restricting measures such as tariffs, tariff-like taxes and surcharges, import bans, quotas, advanced-deposit requirements and foreign-exchange controls. This system of import programs was established in 1958 and placed importable goods on one of three lists: The Liberalized List I (LL I), the Liberalized List II (LL II), and the Quota List (QL). Importation of goods that were on none of these lists was prohibited. Tariff rates were generally lowest on raw materials and intermediate goods that were not produced domestically and highest on finished goods that were produced domestically. In addition, domestic production was protected by an extensive system of quotas.

Periodic balance-of-payments crises and the stop-go pattern typical for the import-substitution strategy intensified towards the end of the 1970s, until in January 1980 the opening of the economy was initiated. A series of far-reaching reforms in foreign trade and exchange rate policy, and in the financial markets were introduced.[2] The most crucial trade policy reforms were the elimination of quantitative restrictions, a gradual shifting of goods from the more restrictive LL II to LL I, the simplification of import procedures, and reductions of the stamp duty (from 25 to 1 percent) as well as of pre-deposit rates. In 1981 quantitative restrictions were partly phased out and about one-third of the items in QL were transferred to LL I, while the rest was included in LL II. In the same year, about 200 tariff positions under LL II were transferred to LL I.

The major step in the reform of the import regime after 1981 was announced at the turn of 1983/1984. The new Import Program reduced both tariff and non-tariff barriers liberalizing roughly 60 percent of 1983 imports. The import regime specified a short list of commodities which could not be imported,[3] another list of goods subject to a license,[4] and still another list, the "Fund List", which covered mainly luxury goods that could be freely imported subject to a special levy. All this amounted to a substantial reduction of the role of quantitative restrictions in the Turkish import regime.

The Prohibited List initially consisted mostly of consumer goods. In 1985 this list was abolished and the goods on the list either became freely importable or were transferred to the License List which did not impose any quantity or value restrictions. The number of goods on this list was 369 initially, but was reduced in 1987 and again in 1988. The list was abolished altogether at the beginning of 1990 so that all goods could be imported. However, in 1990 the importation of 17 items was made conditional upon obtaining permission from

the Undersecretariat of the Treasury and Foreign Trade. This reversal points to an interesting characteristic of import liberalization in Turkey. Although the general tendency has been towards a reduction of the level of protection, "trade liberalization continues to carry attributes not befitting the principles of liberalization in general, such as frequent changes in import duties and rent-seeking tinkering with subsidies" (Aricanli and Rodrik, 1990, pp. 1349-50). A typical example of this can be seen in an event which took place in February 1992, when duties on a short list of commodities, most remarkably on cotton yarn and cotton textiles, were raised by between 50 and 1400 percent.

In summary, starting from 1983 Turkey has gradually and steadily dismantled its extensive system of non-tariff barriers (NTBs). As Harrison et al. (1992) point out, by the early 1990s Turkey can be thought of as a country without NTBs. However, while the NTBs were being dismantled, tariff-like barriers were increasing. For instance, while consumer imports were almost completely liberalized in 1984, their level of tariff protection was increased from 18 percent on average prior to December 1983 to 26.2 percent after January 1984 (Baysan and Blitzer, 1990). Tariff rates were revised again in 1985 and 1986 yielding the highest rates on capital goods (20.8 percent), lower ones on non-durable consumer goods (8.2 percent), and the lowest ones on intermediate goods (7.0 percent). The tendency of tariff barriers to increase continued until 1988.[6] Since then Turkey has been reducing its tariff barriers as well. Yet, until the end of 1992 there were at least six types of duties and surcharges, together with an extensive system of exemptions from import taxation.[7]

In January 1993 Turkey's tariff harmonization efforts with the EU yielded some important results for the overall import regime. The process was initiated in 1973, but Turkey began to postpone its obligations in 1977 and the process was stalled until 1988. Recently, Turkey has converted all its customs duties and surcharges into a single import tax plus a single surcharge, the Mass Housing Fund. According to the schedule with the EU, the tariffs will be set to zero by 1995, and the Common External Tariff will be adopted against third parties. The future of the Housing Fund remains unclear.

3. Theory and Previous Empirical Studies

Recent studies have shown that trade liberalization increases competition in markets which are basically imperfect. What is meant by imperfection is that "any single firm's actions affect the market price and competitors understand this interaction" (Waverman, 1991, p. 59). As Rodrik (1988) and Levinsohn (1991) pointed out, domestic industries, especially in developing countries -- after having reaped oligopoly profits in protected markets -- are forced to behave more competitively when faced with international competition. This is the essence of what Levinsohn calls the "imports-as-market-discipline hypothesis".[8] Firms' response to a change in trade policy and changes in price-cost margins (PCM) following import liberalization constitute the gist of the argument.[9] In a perfectly competitive market, the industry PCM is always zero (regardless of the presence of imports) due to free entry and exit. However, when the market is imperfect, firms are able to raise prices above marginal

costs and import penetration plays a crucial role in determining the market power domestic firms enjoy. That the constraining effect of import competition on market conduct and performance of producers will be stronger with a higher degree of imperfection in domestic markets is an underlying premise of the imports-as-market-discipline hypothesis. Import liberalization in this context puts pressure on domestic monopolistic firms to behave more competitively, thus reducing monopolistic distortions and improving allocative and production efficiency.

Two major studies concerning the effect of import penetration on the PCMs in Turkey are Foroutan (1991) and Levinsohn (1991). Foroutan's model does not include an indicator of industry concentration due to unavailability of data. The distinction between the private sector and the public sector and the impact of increased import penetration on the PCMs in both sectors for different levels of capital intensity are the main points of focus in Foroutan's study. The main finding pertaining to the PCMs is that the effect of import penetration is significant mainly in the private sector, and to some extent in those public enterprises with higher than average capital intensity. One of her conclusions, namely that the Turkish private manufacturing industry most probably did not enjoy a significant market power prior to the 1980 reforms is in clear contradiction with some other studies (Tekeli et al., 1983, Bagriacik, 1981, and Katircioglu, 1989).

Levinsohn utilizes firm-level data for 11 industries in the greater Istanbul area and demonstrates that imperfectly competitive industries have been affected by the import regime shift of 1984 exactly in the manner predicted by the imports-as-market-discipline hypothesis. Reduction in the PCMs of those industries where protection decreased coupled with the same pattern in the other direction as well. His model is based on an estimated production function with a time-indexed (pre-liberalization and post-liberalization) price-cost margin as its parameter. Tests of hypotheses concerning competitive pricing and price-cost margin behaviour are all conducted on the basis of that single parameter. Three-digit concentration ratios and changes in import protection are used as auxiliary tools in the interpretation of the findings. Levinsohn's study is directly aimed at testing the markets-as-discipline hypothesis, and as such, emphasizes the distinction between perfectly competitive and imperfectly competitive behaviour at the industry level.

4. The Model

The model developed in this chapter is similar to that of Levinsohn's, in that it deals mainly with the impact of increased import penetration on industries with higher than average concentration ratios.

Table 3.1 is designed to give a broad idea about the average magnitudes of some relevant indicators of the Turkish manufacturing industry in 1982 and 1989. The table is merely a snapshot, and as such, does not indicate any direction of causality. Nevertheless, the following claim can be made. While the nominal protection rate (NPR) was lower, and the

import penetration rate higher in 1989 than in 1982, the PCM was not lower in 1989 as would be expected, but higher. There are many factors affecting the PCM, import penetration being only one of them. Either import penetration affected the PCM positively or, although the effect was negative as expected, the positive influence of other factors overwhelmed this negative effect. The relationship between import penetration and the PCM thus must be examined with some rigour as is done in this study.

In the regression equations employed here use was made of some variables that are commonly found in the industrial organization literature. In addition, an interactive variable (CRIMP) was introduced in order to test the hypothesis that the effect of import competition increases with growing market power in domestic markets.[11] The specification used here is:[12]

$$PCM = \beta_0 + \beta_1 IMP + \beta_2 CRIMP + \beta_3 EXP + \beta_4 CAP + \beta_5 HET + \beta_6 GR + u \quad (1)$$

with

PCM price-cost margin: (value added minus wages) / output
IMP import penetration ratio: imports / total domestic supply
CRIMP interactive variable formed by CR4 x IMP (see below)
EXP exports / output
CAP capital / labour, a proxy for capital intensity[13]
HET intra-industry trade index, defined as

$$\frac{X + M - |X - M|}{X + M}$$

where X stands for exports and M for imports,

GR annual growth rate of output
CR4 four-firm concentration ratio (the share of the four largest firms in industry output)
u error term.

In addition to the above specification the so-called conventional trade equation:

$$PCM \quad \beta_0 + \beta_1 CR4 + \beta_2 IMP + \beta_3 EXP + \beta_4 CAP + \beta_5 HET + \beta_6 GR + u \quad (2)$$

was used here. Furthermore, data for 1982, 1985-1989, 1982-1985, and 1985-1989 were pooled and estimations repeated.

Import penetration: With regard to the impact of import penetration on the PCM, it is expected that a high rate of imports will tend to depress the PCM. This effect may be attributed to at least two factors. Firstly, a high rate of imports may reveal a comparative disadvantage and thus be associated with lower profits. Secondly and more importantly, firms in the domestic market may find it difficult to increase prices above marginal cost when faced

with substantial import competition (see Jacquemin et al., 1980). Here, the implicit assumption is that at least some firms in the domestic market practice oligopolistic pricing; otherwise, there would be nothing to discipline. If, however, domestic markets were highly competitive to begin with, profits would already be in the close vicinity of their competitive levels and increased import competition would merely drive marginal firms out of business leaving the profit rates intact (Turner, 1980, p.160).

In order to be able to capture the effect of import penetration on profitability at different concentration levels, import penetration was entered into the regression equations interactively together with the concentration ratio. The sign and significance of the estimate for β_2 in equation (1) is crucial for whether the imports-as-market-discipline hypothesis is valid or not.[14]

Exports: Theoretically, the link between export performance and profitability is more complex than that between imports and profitability. In the absence of any barriers to trade, the firms would behave as price-takers in the world market. The elasticity of demand in world markets is likely to be higher than what they would face in an imperfectly competitive market of an autarkic economy, so that their PCMs are bound to be reduced. The basic tenet then is that the volume of exports would be invariant with respect to market structure. In other words, the same volume of exports would be observed irrespective of whether the market is competitive or monopolistic. If barriers to trade do exist, then the volume of exports will depend on the prevailing market structure. With a competitive domestic market, the level of exports would be identical to that in the barrier-free setting. If, however, this market is not competitive and firms are able to price-discriminate between domestic and foreign markets, the overall PCM can be higher with increased exports. Thus the volume of exports is positively correlated with the PCM in a non-competitive environment with barriers to trade.[15]

Capital intensity: Capital requirements may act as a crucial factor in explaining PCMs. If entry into a certain industry necessitates high levels of capital investment, then the firms in that industry are relatively more secure against potential competition. Thus, firms can enjoy the privilege of charging prices that exceed the would-be competitive levels. In countries where capital is relatively scarce and financial markets are underdeveloped, capital intensity will serve as an even more important barrier to entry, thus putting further upward pressure on the PCMs.[16]

Intra-industry trade: The intra-industry trade variable is included as a measure of product heterogeneity. It also reflects the degree of non-substitutability of domestic goods for foreign products (Lyons, 1981), and as such is expected to be positively correlated with the PCM.[17]

Growth: Growth in demand is expected to exert a positive influence on profits since growth as such is likely to cause an increase in prices while reducing per unit costs through increased capacity utilization.

5. Results

The first set of equations estimated are given in Table 3.2.[18] Version (a) corresponds to the regression equation with the interactive variable and version (b) to the aforementioned "conventional" equation. The results of version (a) for the three estimation periods is most striking, and for the purpose of this study, most relevant. The interactive influence of concentration and import penetration is negative and statistically significant for both 1985 and 1989, lending support to the imports-as-market-discipline hypothesis. However, the coefficients of import penetration are insignificant yet positive for both periods, a fact which calls for some explanation. The results for 1982 are also interesting in this regard; the effect of import penetration is insignificant yet positive both for "all industries" and "concentrated industries".

The positive influence of import penetration can be explained in a number of ways (Urata, 1984). First, the import competition proxy (IMP) picks up not only the effects of imports that are directly competitive with domestically produced goods, but also the effects of imports used as inputs in domestic production. Taking this into consideration, it may be asserted that imports can affect profitability in both directions. If the former type of imports are predominant, then the negative effect on domestic average PCM is expected to overwhelm the positive one. The ultimate effect will depend on the relative strength of the two effects.

In Turkey, the share of imports for production purposes has historically been higher than the share of imports for consumption purposes.[19] The implication is that the proxy IMP is more likely to reflect the positive effect of the latter type of imports rather than the negative effect of the former type.[20]

The effect of exports on the PCM was found to be significant only for 1982. The positive coefficient could be interpreted as an indication of a non-competitive market structure and the ability of domestic firms to price-discriminate between domestic and foreign markets. However, it has to be pointed out that the above interpretation needs to be viewed with caution. Overinvoicing and the resulting unreliability of the data may well have contributed to the positive effect of exports on the PCM.[21]

The effect of growth on the PCM was found to be positive and statistically significant for 1985 and 1989, as expected. This relation did not hold, however, for 1982.

Contrary to expectations, the sign of the CAP coefficient was negative in almost all regressions.[22] A potential interpretation of this result goes as follows: New firms using capital-intensive technologies that were made cheaper by trade liberalization entered the markets, increased thereby overall capital intensity of manufacturing and simultaneously reduced the PCM through increased competition.[23]

Intra-industry trade, as expected, had a negative effect on profitability for all estimation periods. The effect was significant at the five percent level of significance for 1985, but insignificant for 1982 and 1989.

Estimation of the "conventional trade equation" for the three estimation periods produced the results of Table 3.2. In version (a) the import penetration coefficient and the interactive variable displayed the same sign pattern with respect to time; positive in 1982, but negative in 1985 and 1989. It is likely that the favourable effects of import penetration on the PCM were felt following the 1984 policy changes. The estimates of the coefficient for the concentration-ratio suggest a strong positive influence on profitability in the last two estimation periods.

To gain more insight on the effects of CRIMP and IMP on the PCM, a pooling technique was utilized together with simple differencing where each variable was expressed as the difference between its values in two successive estimation periods. As none of the regressors was assumed to be time-invariant, a fixed-effects model was chosen for pooling, with the implication that the disturbance term in the regression could systematically be higher for some time periods.[24] The pooled-data results are given in Table 3.3.

Pooled data in all pooling combinations indicate a negative correlation between the interactive variable (CRIMP) and the PCM. The effect, however, is statistically significant only for the 1985–1989 pooling, when the impact of change in the import regime in 1984 started to be felt. Hence, once the average effect of import penetration on profitability is accounted for by means of the IMP variable, the effect on concentrated industries is observed to be negative as the "imports-as-market-discipline" hypothesis suggests. Hence, our findings indicate a favourable effect of increased import penetration on the price-cost margins in the less competitive sectors of the Turkish manufacturing industry.

Results for the conventional trade equation based on pooled data are also given in Table 3.3. The import penetration coefficient indicated a negative effect on profitability only when the pooling covered the two final periods, whereas the concentration variable was positively correlated with the PCM in all pooling combinations.

Finally, the same specification was estimated via differencing. Differencing for 1982–1985 yielded highly insignificant results for almost all variables. The 1985–1989 differencing, however, provided the following results (with t-values in parentheses):

$$PCM = \underset{(0.354)}{0.055} + \underset{(1.68)}{0.108}\,IMP - \underset{(-1.75)}{1.55}\,CRIMP - \underset{(-0.07)}{0.002}\,EXP - \underset{(-1.596)}{0.051}\,HET$$

$$- \underset{(-1.23)}{0.075}\,CAP + \underset{(0.91)}{0.07}\,GR$$

$$R^2 = .09$$

With the exception of the intra-industry trade index, all signs were identical to those obtained for the estimation periods 1985 and 1989 separately. More importantly, the coefficient of the interactive variable was negative and significant at the ten percent level of significance. The differencing results indicate that the specification version (a) is time-invariant with respect to the last two estimation periods. This implies a continuity in the structure of Turkish manufacturing following the policy changes of 1984.

6. Conclusions

The main objective of this chapter was to examine the effect of import competition on the performance of the Turkish manufacturing industries in the 1980s. The imports-as-market-discipline hypothesis predicts that import competition will exert a downward pressure on the prices charged by domestic producers. Our findings from both single period and pooled data regressions indicate that import competition has depressed price-cost margins in "concentrated" industries after the implementation of a more liberal import regime in 1984. However, due to differences in the degree of import penetration in different industries, the disciplinary effect of imports may not have been realized across industries at the same rate. Table 3.4 provides some insight into this issue at the industry level. The table shows sectoral PCMs and import shares averaged over the three years 1982, 1985 and 1989.

For those industries in the sample that have been labeled "competitive,"[25] the average PCM was about 25 percent during the studied period. Yet in some concentrated industries where the degree of import penetration was weak the average PCM was greater than 30 percent. Hence, import penetration in these industries was so weak that they experienced a negligible effect on their PCMs following import liberalization. On the other hand, when there was strong competition from imports, the PCM in some concentrated industries was only one percent higher than the competitive industries' PCM.

The main policy implication of the results obtained in this paper is that import liberalization has to be pursued rigorously in all industries. Our results show that Turkey had "too little" liberalization, not too much. Of course, the greatest potential efficiency gains are in industries with high concentration levels and weak import penetration. While we defend general import liberalization, domestic competition policies which, by definition, target concentrated industries, will be important complements in this respect.

Table 3.1

Average Protection, Exposure to Trade and Profitability in the Turkish Manufacturing Industry
(percent)

Nominal Rate of Protection	1983	65.22
	1989	41.16
Import Penetration	1982	11.69
	1989	15.69
Price-cost Margin	1982	24.95
	1989	29.80

Source: Nominal rates of protection were taken from Olgun and Togan (1991). Other ratios are the authors' own calculations.

Table 3.2

Estimation Results[a]

Version (a)[b]

	IMP	CRIMP	EXP	CAP	HET	GR	b_0	$\bar{R}^2$
1982	0.004	0.069	0.072	-0.09	0.04	-0.27	-0.85	0.21
	(0.12)	(1.31)	(2.48)	(-1.69)	(1.19)	(-1.92)	(-5.14)	
1985	0.04	-0.163	-0.02	-0.16	0.06	0.35	-1.40	0.27
	(0.96)	(-2.94)	(-0.79)	(-2.89)	(2.01)	(1.69)	(-8.03)	
1989	0.068	-0.186	0.029	0.002	0.06	0.24	-1.43	0.10
	(1.52)	(-2.85)	(0.74)	(0.04)	(1.21)	(1.23)	(-5.31)	

Version (b)[b]

	IMP	CR4	EXP	CAP	HET	GR	b_0	$\bar{R}^2$
1982	0.035	-0.01	0.07	-0.08	0.05	-0.22	-0.89	0.19
	(1.34)	(-0.09)	(2.39)	(-1.42)	(1.5)	(-1.57)	(-5.12)	
1985	0.06	-0.24	-0.02	-0.16	0.07	0.35	-1.24	0.25
	(-2.34)	(2.65)	(-0.75)	(-2.89)	(2.24)	(1.64)	(-6.75)	
1989	-0.04	0.27	0.04	-0.002	0.08	0.20	-1.18	0.10
	(-1.25)	(2.91)	(0.91)	(-0.03)	(1.78)	(1.04)	(-4.41)	

Notes:

a) The t-values are given in parentheses. The b_0-values are estimates of the constant term. The regression F-values are 3.52, 4.63, and 2.06 for version (a) and 3.13, 4.28, and 2.11, respectively, for version (b).

b) Version (a) corresponds to equation (1), the regression equation with the interactive variable and version (b) to equation (2), the "conventional" equation.

Table 3.3

Estimation Results - Pooled Data

Version (a)

	IMP	CRIMP	EXP	CAP	HET	GR	$\bar{R}^2$
1982-1985	0.03	-0.02	0.03	-0.09	0.04	-0.07	0.11
	(1.3)	(-0.47)	(1.45)	(-2.38)	(1.58)	(-0.60)	
1985-1989	0.07	-0.13	0.01	-0.05	0.03	0.27	0.12
	(2.41)	(-3.01)	(0.66)	(-1.37)	(1.19)	(2.05)	
1982-1985-1989	0.04	-0.04	0.03	-0.06	0.04	0.02	0.09
	(1.96)	(-1.32)	(1.97)	(-1.90)	(1.88)	(0.23)	

Version (b)

	IMP	CRI	EXP	CAP	HET	GR	$\bar{R}^2$
1982-1985	0.02	0.12	0.03	-0.08	0.04	-0.07	0.13
	(1.05)	(1.61)	(1.59)	(-2.07)	(1.78)	(-0.57)	
1985-1989	-0.007	0.21	0.018	-0.05	0.04	0.26	0.14
	(-0.35)	(3.35)	(0.82)	(-1.25)	(1.51)	(1.97)	
1982-1985-1989	0.01	0.15	0.04	-0.05	0.04	0.02	0.12
	(0.84)	(2.62)	(2.14)	(-1.61)	(2.19)	(0.21)	

Note: For an explanation of versions (a) and (b) see Table 3.2.

Table 3.4
Profitability in Highly Concentrated Industries[a]

	Degree of Import Competition	PCMs[b] (%)	Import Shares[b] (%)
(i) High			
3841	Ship building and repairing	29.6	57.4
3821	Engine and turbines	28.7	51.6
3832	Radio, TV and communication equipment	31.7	40.5
3901	Jewellery and related articles	28.6	40.4
3829	Machinery and equipment (not elsewhere classified)	27.0	34.7
3513	Synthetic resins and gibres	26.1	24.6
3842	Railroad equipment	11.6	24.2
3529	Chemical product (n.e.c.)	32.4	20.8
3720	Non-ferrous metal	20.7	19.4
3231	Tanneries and leather	24.7	15.9
3521	Paints, varnishes and lacquers	25.4	15.1
	Average	26.0	31.3
(ii) Low			
3233	Leather and leather substitutes	27.7	10.2
3833	Electrical appliances	27.6	9.9
3319	Textiles (n.e.c.)	25.6	9.4
3112	Dairy products	22.5	6.3
3822	Agricultural machinery	16.7	5.9
3530	Petroleum refineries	37.7	4.1
3551	Tyre and tube	33.3	3.9
3312	Knitting mills	17.9	3.8
3620	Glass products	38.5	3.3
3523	Soap and detergents	30.3	3.2
3212	Made-up textile goods	19.7	3.0
3610	Pottery China and earthenware	39.6	2.6
3114	Canning, preserving of fish	25.1	1.9
3131	Distilling, rectifying and	78.8	0.4
3132	Wine industries	39.0	0.3
3117	Bakery products	19.4	0.01
	Average	31.2	4.3
Average of competitive industries in the sample		25.1	13.9

Notes

a) CR4 greater than 0.50 in 1982 and 1989

b) Averages over the three years 1982, 1985 and 1989

Notes

1. The authors are grateful to Izak Atiyas, Refik Erzan and Suleyman Ozmucur for their helpful comments on an earlier draft, and to the sponsors of the project for financial support.

2. Thus, caution has to be exercised in interpreting the econometric results in the study, since they may be influenced by reforms in different areas of the economy.

3. This list initially included some 219 tariff positions which were gradually eliminated later on. By 1985, the only commodities still on this list were arms, ammunition and drugs.

4. The License List (more appropriately, the Prior Approval List) was the most important form of non-tariff protection for Turkish manufacturing after liberalization.

5. Calculations done by Olgun and Togan (1991) show that the average nominal protection rate in the economy rose from 65.2 percent in 1983 to 70.2 percent in 1984, but went down to 55.4 percent in 1988, and to 41.2 in 1989. The average effective rate of protection rose from 58.82 percent in 1983 to 78.78 percent in 1984, and to 79.25 percent in 1988, but went down to 53.8 percent in 1989 (Olgun and Togan, 1991, pp. 164–169).

6. During the 1984--1988 period tariff collections as a percentage of dutiable imports rose steadily from 24.8 percent to 37.2 percent, but dropped to 33.8 percent in 1989 (Harrison et al., 1992, Appendix B.7).

7. The taxes and surcharges payable on imports were customs duty, municipality tax, stamp duty, Support and Price Stabilization Fund (SPSF), transportation infrastructure duty (the wharf tax), and the Mass Housing Fund.

8. The so-called "Structure-Conduct-Performance" (SCP) paradigm basically addresses this issue. For results, see Caves (1985).

9. Changes in the PCM measure firms' competitive behavior, whereas the PCM itself is mainly used as a yardstick of gross profitability in an industry. According to the SCP paradigm, a high PCM is an indication of market power. Studies have shown that high PCMs are consistent with either market power or consumers' desires for product differentiation (Waverman, 1991).

10. The averages relate not to the whole of Turkish manufacturing industry, but are limited to 59 (57 in 1982) ISIC-four-digit industries that make up our sample.

11. The theoretical relevance of this modification is based on a non-cooperative oligopoly model (Jacquemin et al., 1980, and Lyons, 1981).

12. Since the data described sectors in which both privately owned and state-owned firms contributed to overall production, an additional variable reflecting the impact of state-ownership on profitability was inserted into the above specification. Defined as the share of state-owned firms' production in the total production of the sector, the variable provided no meaningful contribution to the overall results, and was therefore abandoned.

13. Since no data on capital stock were available, we used the horsepower/labour ratio as a proxy.

14. Prior to 1984, the Turkish manufacturing industry was protected behind high tariff and non-tariff barriers. This had resulted in a concentrated and oligopolistic market structure where firms exercised significant market power. More than 60 percent of the manufacturing sector in Turkey was highly oligopolistic in 1976 (İlkin et al., 1981, Bagriacik, 1981 and Katircioglu, 1989). Hence the Turkish experience of import liberalization is a good testing ground for the imports-as-market-discipline hypothesis as there was ample room for "discipline" by means of increased import penetration.

15. If price discrimination is not permitted by antidumping actions, the domestic producer will have to choose between not exporting and exporting the competitive amount. His ultimate decision will be based on a comparison of the two surpluses he can earn in each case. For a more detailed discussion of the exports-PCM relationship, see Utton and Morgan (1983), pp. 58-59.

16. There were only two suitable sets of data available in Turkish censuses to develop proxies for capital intensity: the data on horse power (HP), and on electricity use (E). The proxies developed were the horse power/output ratio, and the electricity use / output ratio. Since both of these proxies led to similar and unsatisfactory results, following Turner, 1980, another ratio, HP / labour was employed here.

17. When an industry's product is perfectly homogeneous and there is no intra-industry trade and no "seasonal trade", the value of either exports or imports should be zero and the index value will also equal zero. If, however, exports are exactly balanced by imports, then the cross-trading of differentiated goods will be at a maximum and the value of the index will be unity.

18. The Breusch-Pagan test was used to test for heteroskedasticity. The chi-square test statistic strongly indicated homoskedasticity for the first two estimation periods. Significance levels were 30.6% and 44.5%, respectively. For 1989, the test statistic had a significance level of 4.03%.

19. According to the State Institute of Statistics statistics, the shares of investment goods, raw materials and consumer goods in 1982 were 26.9%, 71.6% and 2.1%, respectively. The respective shares changed to 22.9%, 69.1%, and 8.0% in 1985, and to 24.3%, 66.8% and 8.7% in 1989.

20. Other research also found a positive relationship between imports and PCMs for the pre-liberalization period in Turkey (see Aksoy, 1983 and Katircioglu, 1990).

21. On the overinvoicing issue in exports in the 1980s see Arslan and Wijnbergen (1990), p. 4.

22 Ozmucur (1990) also found a negative yet insignificant relationship for the 1983–1988 period.

23. To see whether the negative impact of CAP could somehow be linked to state-ownership, a second interactive variable was used to investigate the effect of capital intensity on profitability in sectors where state-ownership was predominant. The negative sign prevailed for the interactive variable as well, and in the absence of any significant contribution to the overall results, the variable was left out of the final specification.

24. Each variable was expressed in terms of deviations from its mean across sectors.

25. Competitive industries have been defined here as those with CR4 smaller than 50 percent.

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CHAPTER IV

LIBERALIZATION AND COMPETITION IN THE TURKISH BANKING MARKET

Cevdet Denizer[1]

1. Introduction

Until 1980 the Turkish financial system developed under an umbrella of monetary and regulatory policies aimed at supporting the state-orchestrated development strategy the country followed during most of its modern history. Already in the 1960s the financial system dominated by commercial banks became an instrument of planned industrialization. Entry to this system was restricted and it operated in a framework of controlled interest rates, directed-credit programs, high reserve requirements, and other restrictions on financial intermediation. While these financial and regulatory policies no doubt contributed to Turkey's industrialization, they had their costs in terms of the banking system's competitiveness and efficiency.[2] Interest-rate controls led to non-price competition in the form of branch-network building by banks already in the system. In this situation restrictive entry policies, coupled with the exit of a significant number of banks between 1960 and 1980, led to a concentrated market. This market was dominated by public banks and by private banks that were owned by industrial groups and for which excessively large branch networks and high overhead costs were typical. In retrospect, the combination of these factors seems to have created an uncompetitive market structure and in turn an inefficient banking system.

In contrast to the earlier period, the years after 1980 have seen a major trend towards liberalization of financial markets in Turkey. Starting in June 1980 the government implemented — as part of a far-reaching stabilization and structural adjustment programme — financial liberalization and deregulation measures. These measures aimed at developing an efficient (and competitive) financial system which was expected to support the functioning of a more liberal economy. To that end reforms eliminated interest-rate controls, eased the entry of new financial institutions of both the bank and the non-bank type, and accepted new types of instruments. There were also policy measures introduced to develop equity and bond markets. Although there were occasional setbacks and policy reversals in the form of interest-rate controls and a banking crisis in 1982, reforms have led to major changes in the sector. Reduction of regulatory barriers has attracted a significant number of banks, both of Turkish and foreign ownership, into the system. Reforms were also successful in halting the decline in financial intermediation observed prior to 1980 and contributed to financial deepening and a revitalization of the stock market. At the same time, product variety increased and the quality of financial services improved. Moreover, the Turkish banking system became more integrated with the external financial world and improved its financial technology and human capital.

The objective of this chapter is to assess the structure and the state of competition of Turkey's banking market. Some of the questions raised in this connection are: What kind of market

structure exists in the banking sector after the reforms? Has the entry of new banks been sufficient to transform the market into a competitive one or have distortions resulting from earlier financial and regulatory policies built endogenous constraints into the system which thwart competition regardless of new entry? Now that regulatory entry barriers are gone, are there mobility barriers in the system? The present study attempts to provide answers to some of these questions by applying methods of industrial organization analysis to the Turkish banking market. The focus is on the commercial retail banking market, since it is primarily through this channel that resources are mobilized and allocated. However, it should be noted at the outset that, although recent theoretical developments have improved our understanding of financial intermediation, there is still no fully developed model of banking competition and that therefore any quantitative results must be interpreted with caution.[3]

The chapter is organized as follows: Section two briefly examines the evolution of banking in Turkey and identifies the set of factors which shaped its structure from the days of the establishment of the Republic to the late 1970s. The third section reviews the reforms of 1980 and analyzes developments in the market structure of the banking sector. Some international comparisons are also made. Sections four and five present the methods used and the hypotheses tested in the study as well as their underlying rationale, model specifications and data. Section six discusses the empirical results, and the final section assesses the impact of reforms in light of the results obtained here and discusses policy options to enhance competition in the system.

2. Development Policies and the Financial System in Retrospect

When modern Turkey was established in 1923, the formal financial system was comprised of 35 banks (22 of which were of Turkish ownership and 13 of foreign) with a total of 439 branches.[4] Most of the foreign banks dealt with foreign trade and foreign companies operating in Turkey whereas their involvement with Turkish firms was limited. On the other hand, Turkish-owned banks were mostly small local banks and were too weak to support the newly emerging industry and commerce. During the first Economic Congress held in Izmir in 1923 it was emphasized that the country suffered from scarcity of capital and that without establishing a national banking system the country would not industrialize (Akguc, 1987). It was also argued that the banks should take the initiative in financing large industrial enterprises and that the state should provide capital for new banks, since the private sector was too weak to do that.

The conference had a significant impact on economic issues in general, and on banking and credit in particular, influencing government policies in the following years. Between 1923 and 1932 the government's regulatory approach to banking and finance was quite liberal aiming at a national banking system. While the government provided initial capital for four banks, which still exist today and lead development efforts, it also allowed and actively encouraged the formation of private banks. As a result, about 29 private banks — most of them single-branch and local — were established. As there were practically no restrictions

for entry, the number of banks had reached 60 by the year 1932 with 45 of them being national and 15 foreign. Nevertheless, the most important event of this period was the founding of the Central Bank in 1930.

Such liberal economic policies did not last long, however. Partly in response to the worldwide depression and partly due to the view that the private sector was too weak to be the engine of growth, the government adopted a new strategy in the early 1930s. This new strategy, generally labelled "etatist", emphasized state-led development and assigned a secondary role to the private sector. In order to accelerate industrialization, the government established state enterprises which still exist today. The important aspect for banking was the creation of new public banks, in order to provide support for the new state enterprises. Although there was no significant change in the government's regulatory policy, between the early 1930s and the mid-1940s no new banks entered the system. On the contrary, many small local banks exited during an economic slowdown which resulted from the global economic crisis and World War II. These developments reduced the number of banks in the system and increased the dominance of public banks in the sector. As a result, the number of banks had fallen to 40 by 1945 and the number of branches declined from 483 to 411.

The years following World War II brought attempts to reduce the role of the state in the economy. On the banking side, the period between 1944 and 1960 was characterized by the entry of 27 private banks and three public banks, including Akbank, Yapi ve Kredi Bankasi, Garanti Bankasi, and Sinai Kalkinma Bankasi. By 1958 there were 62 banks in the system, a number which was not surpassed until 1989. The number of bank branches increased dramatically and reached 1759 by the year 1959 with the process of nation-wide branching being well underway. However, most of the newly established banks did not stay in the system for long and ten small Turkish-owned banks as well as four foreign banks were liquidated between 1945 and 1959. With a net entry of 16 banks between 1944 and 1960 and a small number of mergers among the existing banks the total number of banks in the system was 59 by the end of 1960. The slowdown in economic activity towards the end of the 1950s and the 1958 recession as well as the government's stabilization program led to further bank failures. Between 1960 and 1964, 15 more of the small banks ended their operations. Some were liquidated and some were merged with others bringing the number of banks to 49 and the number of branches to 1909 by the end of 1964.

The launching of a planned-development strategy in 1963 and to a lesser degree the failure of a large number of banks during the early 1960s caused significant changes in banking and finance policy. In order to attain plan targets, the public sector assumed a larger role in the allocation and mobilization of resources through directed-credit programs, subsidized lending to priority sectors and other constraints on financial intermediation which had the effect of turning the financial system into an instrument of industrialization policy. Although the efficiency of this arrangement in terms of directing credit according to plan targets was questioned (Akyuz, 1984), it remained until as late as 1980. At the same time, there were no changes in interest-rate policy. Like before, interest rates were set by the government. Since the 1940s, deposit interest had been controlled by the government and

changed only five or six times between 1940 and 1978.[6] Hence in retrospect it could be said that restrictive financial policies were principally aimed at directing credit rather than at explicit financial repression.[7] Nevertheless, the cumulative impact of these policies was to increase the role of the state in financial markets. According to Hanson and Neal (1986) only about one-quarter of total credit was free from government control as late as 1983.

The adoption of a planned-development strategy also brought significant changes for the regulatory policies which were a major determinant of market structure prior to the 1980 reforms. Development plans in effect shaped regulatory policies of successive governments. Over time, these policies became more conservative by way of restricting entry which in turn made it easier for the state to control financial resources. One element in the three plans that Turkey implemented over the studied period was that the smaller banks in the sector should be merged to reduce overheads so that stronger institutions could be built (Akguc, 1987). Along this line of reasoning it was argued that the need for new commercial banks should be clearly demonstrated, if they were to be established at all. At the same time, the plans proposed the establishment of development and specialized service banks, mostly to support industry.[8] Between 1962 and 1975 the government permitted the establishment of four new development and specialized banks which were not authorized to collect deposits. During the same period only three new commercial banks were established, a fact which demonstrates the existence of strong regulatory entry barriers. This together with liquidations and mergers resulted in a reduction of the number of banks from 59 at the end of 1959 to 43 by the year 1980.

From the mid-1970s on private banks owned by industrial groups began to emerge. This development is referred to by Akguc (1987) as the beginning of "holding banking". The reasons for this are straightforward. Until about 1974 Turkey followed a strongly growth-oriented strategy led by both public and private sector investments which were mostly directed to import-competing sectors, infrastructure and heavy industries. Public sector investments were financed by monetizing budget deficits, issuing low yield bonds which were mostly purchased by public pension funds and bank deposits. At the same time the private sector, encouraged by the government through high protection rates and a complicated incentive scheme for investments, was also expanding through a holding-company structure and, therefore in need of financing. While the government did have access to capital for its large investments, the private sector did not. In the absence of capital markets, firms had to rely on bank loans to finance their investments (Fry, 1988). Since public banks primarily financed public investment, the private sector had all the incentives to establish or acquire banks to finance private investment. Consequently, major groups began to acquire banks that had been established earlier, so that by the early 1970s almost all major private banks belonged to holding groups (Akguc, 1987).

The 1960s and 1970s also saw a rapid expansion of the number of branches of banks already in the system. Under interest rate controls the only way to compete for deposits was non-price competition in the form of establishing a branch network throughout the country. Rising inflation provided another strong incentive for banks to expand their branch networks. With

negative real interest rates the opening of new branches to collect deposits and investing them into real assets became highly profitable. As a consequence, the number of branches of both public and private banks increased. However, it must be noted that as long as deposit rates were controlled by the government and inflation was rising, this made sense and was consistent with profit maximization.[3] Due to these factors the number of branches had risen to 5769 by 1980 (from 1720 in 1960), although over the same period the number of banks dropped significantly. What is important to note here, is that excessive investment in bank branches took place contributing to the banks being larger than they would have been with undistorted capital costs. Due to insignificant entry the concentration in the sector also increased remarkably.

The combination of restrictive financial and regulatory policies led to a high degree of concentration in an overbranched, largely inefficient banking system. By 1980 the top five banks controlled about 70 percent of deposits and 64 percent of assets and owned 60 percent of all branches. They also controlled more than 70 percent of the number of deposit accounts (Table 4.1). Overhead costs in the sector amounted to around seven percent of total assets, which was almost three times as high as the OECD average. Hence, Turkey's development strategy and its related financial and regulatory policies — despite their contributing to the industrialization of the country — have introduced distortions in the banking system that are difficult to eliminate. Fry (1979), for example, noted that even if all interest rate restrictions were abolished, a minimum deposit rate would be needed to move Turkey's cartelized and oligopolistic banking system some way towards the desired competitive market structure.

3. Financial Reforms and Liberalization

In June 1980 the government launched financial reforms simultaneously with structural adjustment and broad liberalization policies that put an end to the import substitution era. The goal was to develop a competitive and efficient financial system that would support a more liberal economy. This was to be achieved through deregulation and promotion of entry into the system. Reforms eliminated interest-rate restrictions on deposits and loans, eased entry into the market and permitted new types of financial instruments and institutions. The initial phase of deregulation saw sharp increases in interest rates and attempts by the larger banks to hold them low through the so-called gentlemen's agreement which in essence was open collusion. However, this proved unsustainable. Faced with higher rates offered by the unregulated brokerage houses, larger banks increased their rates. This resulted in fierce competition and extremely high real interest rates. In conjunction with financial distress in other sectors this led to the collapse of six banks during 1983 and 1984. These developments in turn led to a partial reversal of reforms. The Central Bank began again to regulate deposit rates, though at much higher levels relative to the pre-1980 situation. However, as much as this was to restore financial stability it was also a measure to deal with collusive practices of banks.

The Central Bank continued to regulate deposit rates until 1988, adjusting them occasionally to maintain positive real rates of return. Towards the end of 1988 deposit rates were again liberalized and this policy has been maintained since that time, although there were a number of temporary interventions. The resulting higher levels of interest rates led to substantial growth of the financial system and contributed to financial deepening. By the end of 1990 the stock of financial assets had reached 47.7 percent of GDP – compared to around 28 percent in 1980 – while the M2/GDP ratio had risen to 25.6 percent from about 21 percent in 1980 (Table 4.2). In line with financial liberalization policies, most directed-credit programs and preferential rates were eliminated with the effect of contributing to a more efficient allocation of resources. Although reserve requirements were lowered, liquidity ratios were increased which in turn put a wedge between deposit and loan rates.

The reforms were successful in achieving a key objective, namely that of attracting entrants into the banking system. As a result of the easing of entry restrictions, the number of banks increased from 43 to 66 between 1980 and 1990. Out of the 43 banks that existed in 1980, eight were either liquidated or merged with other institutions (Table 4.3). Hence, there were 31 new entries into the system, of which 19 were foreign and 11 national. However, almost all of the new entrants specialized in trade finance and wholesale corporate banking. None of the new banks, foreign or Turkish, established offices beyond the three largest cities, and by and large they eschewed the retail banking market despite the fact that there were no restrictions on the scope of their operations. At the end of 1990 the new banks accounted for less than half a percent of savings and commercial deposits. Hence, the new financial institutions filled certain profitable niches which in itself was a positive development. Their impact on the level of retail banking, however, was quite limited. Nevertheless, as pointed out by Akkurt et al. (1992), the entry of new banks, particularly foreign ones, has been instrumental in improving skills and financial technology of the sector.

As expected, the reforms reduced concentration in the sector. Table 4.3 presents concentration ratios in terms of deposits, savings deposits, loans, assets, and the number of savings accounts. The decline was most pronounced in the three-firm and five-firm concentration ratios. This result has been mainly due to the top five banks – except for one losing market shares, especially in total deposits. With the exception of the Ziraat Bank, banks that had ranked among the top five in terms of deposits in 1980 all saw their market shares decline in varying magnitudes. The decline in the share of the second-largest bank in total deposits was particularly significant with a drop from 20 percent in 1980 to around 12 percent at the end of 1991. While the largest banks lost market shares, second-tier banks generally increased theirs. It appears that they benefitted from the deregulation of interest rates and probably came closer to their optimal scale.

While the decline in some measures of concentration was large, some others showed only a small decrease, considering the number of entries. For example, the three-firm concentration ratio in terms of total deposits declined from 53 percent in 1980 to 40 percent in 1990, while the five-firm concentration ratio fell from 69 percent to 55 percent. However, when eight-firm and ten-firm concentration ratios are analyzed, the decline appears to be much less

pronounced. The top ten banks accounted for 88 percent of total deposits in 1980 and 82 percent in 1990 representing a decline of only six percentage points. Likewise, ten-firm asset and loan concentration ratios registered a comparatively small reduction. This indicates that while the reforms brought about some changes in the market shares of banks — possibly reflecting some inter-bank rivalry — these changes have been mostly among the top ten or the top 15 banks which had been in the system before the 1980 reforms. This suggests that a critical number of branches is needed to be an effective competitor in the retail banking market.

Savings deposits are particularly important for an analysis of competition in retail banking since they represent a major output of retail banks and certainly are the basic financial asset which people hold.[7] At the end of 1991 36.7 million out of the 45.6 million bank accounts in Turkey were savings accounts comprising more than one-half of the volume of total deposits in the system. During the first half of the 1980s, there was a marked increase in the concentration ratios for savings deposits as shown in Table 4.1. By 1986 the three-firm concentration ratio had reached 63 percent and the ten-firm concentration ratio 92 percent. However, the process was reversed in 1987 and at the end of 1991 the three-firm and ten-firm concentration ratios stood at 42 percent and 83 percent, respectively. As before, the decline in the magnitude of the latter ratio for savings deposits was less than that in the former concentration ratio.

Another statistic of interest in this connection is the number of savings accounts. Between 1980 and 1991 the number of savings accounts increased from 26 million to 36.7 million. Looked at in more detail, this increase appears to have been particularly marked in the case of large banks. Table 4.1 shows an increase of the three-firm concentration ratio (in terms of the number of accounts) from 55 percent in 1980 to 62 percent in 1991, whereas the ten-firm concentration ratio increased from 89 percent to 94 percent. While in volume terms the percentage of savings deposits placed with the leading banks declined, the concomitant increase in the number of deposit accounts with the large banks probably implies that these large banks attracted mostly small deposits leaving larger funds for other banks or other profitable investment. Thus, the power of the top ten banks appears not be have decreased with respect to the basic item of retail banking, i.e. small savings accounts.

Profitability of the banking sector improved after the reforms despite declining concentration ratios and new entry. As shown in Table 4.3, and pointed out by Atiyas and Ersel (1993), profits in the banking sector increased substantially (particularly after the mid-1980s) and by 1990 attained levels more than three times as high as the OECD average. At the same time, the declining trend in operating costs was reversed. This would imply that deregulation has not improved productive efficiency as had been expected. The ability of banks to increase and maintain high profit rates under these circumstances would rather suggest that the source of profits was market power or some other market imperfection rather than productive efficiency. In addition, as pointed out by Rhoades (1993), it would also mean that additional resources are not entering the market, implying the existence of non-regulatory entry barriers.

4. Methodology

The previous review of developments in the banking system suggests that market structure continues to have a significant impact on the conduct and performance of banks, and implicitly on competition. However, these observations by themselves are not sufficient to establish a causal link between the parameters involved. In order to provide empirical evidence, the study presents and tests a number of hypotheses derived from the theory of industrial organization. The analysis is divided in two parts. The first part attempts to determine whether there is a relationship between market structure and the performance of banks. In this attempt the structure-conduct-performance (SCP) paradigm is used as the framework of the analysis. The study examines the two main hypotheses, namely the "traditional" and the "efficient-structure" hypothesis concerning the explanation of the market structure-performance relationship. The second part focuses more directly on competition in the retail banking market. In particular, it analyzes the impact of new bank entry and sunk investments that resulted from pre-1980 interest-rate and regulatory policies on competition.

Market structure: The traditional SCP hypothesis emphasizes market structure in the analysis of pricing and output decisions of market participants. In this context, market structure refers to the number and the size distribution of firms where a market is treated as the unit of analysis. If the market is concentrated, e.g., in terms of assets, sales, deposits or some other measure of economic activity, then non-competitive, collusive behavior is likely to be observed with industry profitability depending upon the degree and stability of collusion among firms. Therefore, the higher the share of the market controlled by a small number of large firms, the greater is the possibility that market participants will agree to collude, either tacitly or overtly, and raise prices above costs, thus earning supranormal profits. Hence, the existence of a positive relationship between some measure of concentration (proxying market structure) and profits (proxying performance) would imply that the market is not competitive and participants enjoy profits primarily due to their market power.

The second (more recent) hypothesis is known as the efficient-structure hypothesis. It maintains that firm-specific efficiency, arising from superior management, use of new technology, etc., enables some firms to increase their market share at the expense of other relatively inefficient firms, with the consequence of increased market concentration. Here an implicit assumption is that differences in efficiency levels among firms lead to unequal market shares and high levels of concentration. The leading firms will earn above-average profits even if they charge prices at the level of secondary firms. Therefore we observe a positive relationship between market concentration and profits which is, however, not due to collusion and does not necessarily imply a causal link between structure and performance. The efficient-structure hypothesis implies that causation will be from firm efficiency to market share and denies a causal relationship between market concentration and profitability. The positive relationship between concentration and profits found in some industry studies is in light of this hypothesis spurious and simply reflects the correlation between market share and concentration

It is important to note that both hypotheses point to a positive relationship between market structure and profits, but differ as to the causal factors that generate it. While it is possible that both hypotheses are valid simultaneously, it is nevertheless important to distinguish between them as they have different public policy implications. If supranormal profits are the result of concentration, then a regulatory policy to reduce concentration and consolidation in the sector may be justified. On the other hand, if performance is due to efficiency, then such a regulatory policy may be welfare reducing. Weiss (1974) suggested that by estimating a profit function that takes into account both market share and a concentration measure, it may be possible to ascertain whether profitability is due to efficiency or to market structure. This reveals the validity of the two hypotheses in explaining the structure-performance relationship. Tests of this nature have been undertaken by Smirlock (1985), Evanoff and Fortier (1988), and Molyneaux (1992), and constitute the approach adopted in this study.[11]

Entry and competition: A number of earlier studies, in particular, Heggestad and Rhoades (1976), Rhoades (1980), Rhoades and Rutz (1981), and Bodenhorn (1990) investigated competition in banking markets in the United States by analyzing the degree of stability in inter-firm relationships. Their approach proxies inter-firm rivalry or competition by mobility and turnover and analyzes the impact of a number of important variables that are expected to influence competition, such as entry and size of pre-existing firms. In this context, mobility indicates changes in the rank position of leading firms. Turnover, on the other hand captures the movement into the leading group of banks formerly outside that group and is taken to reflect aggressive behaviour. It is also thought that the above measures indicate a certain market structure. In other words, changes in the rank and possibly output shares of firms in the market do not necessarily result in a certain kind of conduct (competitive or uncompetitive), but rather reflect conduct that arises from a given market structure. In uncompetitive markets successful cooperation (collusion) among firms will not lead to changes in firm rankings or in market shares. However, in competitive markets the opposite is expected. This study in its methodology follows the aforementioned earlier studies, but modifies them slightly. The objective is to assess the impact of entry, of the size of the leading banks, and of market structure on competition in the banking market.

5. Model Specifications and Data

The market structure model: Earlier studies of the relationship between market structure and profitability used linear regression techniques, regressing some measure of profits on a market concentration variable and other control variables. Following Weiss (1974) and Smirlock (1985), Evanoff and Fortier (1988) and Molyneaux (1992), a cross-sectional profit equation including both firm-specific market share (proxying for firm efficiency) and concentration variables is specified here

$$ROA_{it} = b_0 + b_1 CR_t + b_2 MS_{it} + b_3 CA_{it} + b_4 TA_{it} + b_5 LA_{it} + b_6 DT_{it} + b_7 OEA_{it} + b_8 MDGR_t + b_{11} D1 + b_{12} D2$$

with

ROA	bank i's profits measured as the return on assets
CR	market structure variable, five- (ten-) firm deposit (asset) concentration ratio
MS	market share measure, bank i's deposits as a percentage of total market deposits
CA	bank i's capital-to-assets ratio
TA	bank i's total assets
LA	bank i's loans-to-assets ratio
DT	bank i's demand deposits-to-total deposits ratio
OEA	bank i's operating expenses-to-total assets ratio
MDGR	market deposit growth rate
D1	1 for private, 0 for public banks

Values of $b_1 > 0$ and $b_2 < 0$ support the traditional SCP hypothesis. On the other hand, if $b_1 < 0$ and $b_2 > 0$, the efficient-structure hypothesis is supported. It is, of course, possible that both b_1 and b_2 are positive and significant, indicating that both factors are effective simultaneously. The effects of market concentration and market share on profits will be given by partial derivatives $\partial ROA/\partial CR = b_1$ and $\partial ROA/\partial MS = b_2$, respectively.

The performance measure serves as the dependent variable and is defined here as bank profits measured as the return on assets (ROA), i.e., net income divided by total assets. Other possible performance measures are return on equity (ROE) and bank stock prices. ROE is not considered to be the best measure because banks can divide capital between debt and equity, making the comparison of equity values across banks difficult. The banks in Turkey are held by various industrial groups, individuals, and the government, and their stocks are

not traded. Hence, we are unable to observe and use bank stock prices. ROA is the most widely used bank performance measure and, as suggested by Evanoff and Fortier (1988), it is comparable across banks because bank assets are a common denomination. For all these reasons ROA has been chosen as the dependent variable here.[11]

The independent variables include both firm and market specific variables. Following previous studies, market structure is proxied with the share of the five leading banks in total deposits. Hence, the concentration ratio is defined as the sum of shares of the five leading banks in total deposits, CR5.[12] It must be noted, though, that what constitutes an appropriate measure of market structure is not easy to answer in particular, since theory provides little guidance. As noted by Evanoff and Fortier (1988), theory does not indicate the number or size distribution of firms necessary to exercise market power. Nevertheless, the questions about which number of firms is large enough to prevent collusion, and which volume of output sufficient to make price setting impossible, are empirical in nature. Theory only suggests that there is a relationship between the level of output controlled by a small number of large firms and performance, and probably because of this an overwhelming number of researchers have used the CR measures despite their limitations.[13]

The market share variable (MS) is assumed to be a proxy for firm-specific effects, and is defined as bank deposits divided by total market deposits. There are also a number of control variables similar to those that can be found in earlier SCP studies. They are included in order to take into account factors like risk, costs and demand that influence profitability. Given the fact that ROA is not risk-adjusted, a capital-asset ratio (CA) is included to account for the unequal risk levels between banks, with low ratios indicating relatively risky positions. Banks with low CA ratios may be more aggressive and take on risks expecting high returns. On the other hand, highly capitalized banks might play it safe and hold less risky assets (loans) and remain profitable. Therefore, the expected sign of CA is indeterminate.

Another control variable from the liability side of the balance sheet is the amount of demand deposits relative to total deposits (DT). This ratio gives a bank's relative cost of funds and should be positively related to profitability given the fact that demand deposits are a relatively cheap source of funds. If this ratio is high, then banks do not need to make use of purchased funds, which are expensive. From the asset side of the balance sheet comes the ratio of total loans to total assets (LA). This ratio is of particular interest because loans usually represent the major category of income-earning assets, generating more income than the main alternative assets, government securities, in addition to providing some idea about a bank's risks. A high ratio may reflect aggressive loan marketing which could increase profits. On the other hand, large loan portfolios may be costly to manage and could result in substantial loan losses, which decrease profits. Therefore, the coefficient on this portfolio variable could be positive or negative.

In order to control for bank size, total assets (TA) of each bank are included in the sample. In this way, the possibility of scale economies that could arise from size, and the possibility that larger banks have a greater potential for loan and product diversification is taken into

account. As pointed out by Smirlock (1983) and Evanoff and Fortier (1988), diversification reduces risks and therefore the required rate of return. Hence, the sign on this coefficient is indeterminate. Operating expenses (OEA) — which are included in the analysis as a proportion of total assets — should exert a negative impact on bank profits. Market demand is accounted for by including the market deposit growth rate (MDGR). Markets with high growth rates are likely to increase the bank's deposit base, but the contribution of deposits to profits will depend upon a number of factors. First, it will depend on a bank's ability to convert deposit liabilities into income-earning assets, which are related to macroeconomic factors such as GNP growth and the level of interest rates. In addition, high growth rates attract additional competitors who reduce profits for all market participants. Therefore, the sign of MDGR is also indeterminate. In order to account for different types of ownership, a dummy variable is included. D1 is set to one for private banks and to zero for public banks.

The competition model: Following Rhoades (1980) and Bodenhorn (1990) the following model is estimated:

$$R_i = b_0 + b_1 ENT_i + b_2 AVG_i + b_3 MDGR_i + b_4 CR5_i$$

with

R	rivalry
R_1	mobility among top ten banks
R_2	mobility among all banks
ENT	number of entries
CR	five-firm deposit concentration ratio
AVG	average fixed asset size of top ten banks
MDGR	market deposit growth rate

The dependent variable in the analysis has two forms and takes into account both the price and non-price dimensions of competition. However, it is slightly different from that in earlier studies which proxy competition by mobility and turnover among the top three and top five firms. The first mobility measure used in this study focuses on the top ten banks in terms of deposits because of their similarity to each other. They operate large branch networks nationwide and hence may be expected to display similar operational characteristics. The reason for focusing on the leading firms is one of method. As pointed out by Heggestad and Rhoades (1976), size differences among the leading firms is often significant but differences among firms, both in relative and absolute terms are observed to decline rapidly once one

moves down in size from the industry leaders. Hence, a rank change among industry leaders is probably due to some significant event which influences structural inter-firm relationships while rank changes among the smaller firms are more likely to be due to other factors not related to structural characteristics of the market. Another important reason is that leading firms in a given industry are well established names and have a capacity to enforce desired strategies which in turn may create a pattern of conduct for the entire market. For these reasons the first mobility measure is defined as the sum of rank changes among the top ten banks for each quarter during the 1986-1992 period.

While the first measure is intended to capture structural changes in inter-firm rivalry, its focus on the leaders may not capture the aggressive behaviour of fringe firms. Earlier studies attempted to overcome this problem by the turnover measure which accounts for changes in the identity of leading firms. In other words, turnover measures the number of times firms below the top five or top ten move into the ranks of the top five or top ten. However, in the Turkish context the turnover measure appears not to be appropriate. The size differences between leading and fringe firms are too large in Turkey for fringe firms to make it into the leading group. The second mobility measure, by contrast, takes into account the rank changes for all banks in the market. It is defined as the sum of rank changes for all banks in each quarter during the 1989-92 period.

Among the independent variables in this study the entry variable is of particular interest, since the financial reforms aimed at increasing competition by promoting entry. The entry measure is proxied by the number of gross bank entry into the system during the 1986-92 period. However, considering the fact that most entries into the system took place during the first part of the 1980s, and that a four-year period may be a relatively short time for new entrants to have an impact on market rivalry, this variable is lagged up to five years. The sign of the variable is expected to be positive, since it increases the number of banks in the market which should alter the competitive stance of existing banks toward their rivals. As pointed out by Rhoades (1980), entry reduces concentration and tends to increase uncertainty among the firms in the market as regards their perception of the actions of rivals and of new entrants. Hence, entry is expected to weaken the established relationships among old firms and contribute to competition.

The competitive structure of the market is captured by a concentration variable. As noted earlier, high concentration is expected to influence the conduct of market participants by making cooperation among them easier, which in turn would keep firm rankings stable. As pointed out by Heggestad and Rhoades (1976), such stability may also be due to vigorous but stalemate competition where all competitors strain and succeed equally. However, such an outcome would be improbable in the sense that not all competitors would perform equally well at all times. Hence, the greater the stability deriving from high concentration, the higher the chances that overt or tacit cooperation exists. Consequently, the corresponding variable is expected to exert a negative influence on inter-firm rivalry.

Two other independent variables are included to take into account other factors that are expected to influence competition. The five largest banks' average of fixed assets is introduced on the grounds that large firms are perceived as intimidating by other rivals or potential entrants. The variable proxies investments made in fixed assets and should be a good measure in determining the impact of sunk investments on competition. In addition, size may have an important reputation component. In either case, the variable should negatively affect mobility. Finally, a market growth variable is included for two reasons. First, growing markets make entry more attractive and easier. Second, rapid growth should increase uncertainty in inter-firm relationships and make tacit or overt cooperation more difficult with the consequence of increased mobility. The growth variable is defined as the quarterly growth rate of deposits over 1986 to 1992.

Data: The source of the data used in this study is the Central Bank's General Directorate of Banking. They cover the period between 1986 (I) and 1992 (I), and include all deposit money banks. The sample contains 1302 observations, covering ratios and a number of level variables compiled from the income statements and balance sheets of the banks. For the analysis cross-section and time-series data have been pooled.

6. Results

The market structure model: Regression results are reported in Tables 4.4, 4.5, and 4.6. All of the equations were estimated using OLS.[4] Based on the results of the White (1980) test, homoskedasticity can be assumed. In general, the explanatory power of the regressions can be considered good, if the cross-sectional nature of the sample is taken into account. The first equation reported in Table 4.4 tests the traditional SCP hypothesis by estimating equation (2) without the market share (MS) variable, but with the market structure measure CR5. The coefficient on the market-structure variable is of particular interest. As Table 4.4 shows, the results support the hypothesis that market structure is related to the rate of profits. The coefficient on the market-structure variable is positive and statistically significant at the one percent level. This supports the conclusion that market structure is an important factor in explaining profitability in the Turkish banking market.

In the next step, the same equation was estimated with both market-share and market-structure variables. By doing so, the validity of the two competing hypotheses in explaining bank profitability is tested. According to the efficient-structure hypothesis there should be a direct relationship between market share and profits. Therefore, if b > 0 and b > 0, it is possible to infer that bank profitability is directly linked to market share. Banks controlling large portions of deposits are more efficient than others and earn rents due to their efficiency. Such a finding will also imply that market concentration does not enable banks to earn supranormal (monopoly) profits. On the other hand, if b > 0 and b = 0, it can be assumed (Smirlock, 1985), that market share does not impact firm rents and that rents reflected in higher profitability are monopoly rents that result from market concentration.

However, the results might yield other possible combinations of b_1 and b_2, due to the possibility that both forces described previously operate simultaneously. The purpose of this exercise is to determine the impact of MS on CR5 and profits. In Evanoff and Fortier (1988) and Smirlock (1985) the inclusion of market share in the model in addition to the market-structure variable changes the overall relationship: Market share enters with a strong positive influence and market concentration becomes insignificant. Corresponding results are shown in Table 4.5. They do not support the efficient-structure hypothesis in that the coefficient of the market share is not even marginally significant. On the other hand, the market-structure variable carries a positive sign and is significant at the one percent level.

Another test was for the possible effect of market share on bank profitability by including the market-share variable in the estimation and excluding the market-structure variable. Both hypotheses interpret the market-share variable differently. Researchers who support the efficient-structure hypothesis would argue that a high market share is an indication of superior efficiency. On the other hand, the traditional structure-performance school would regard market share as proxying market power, due to product differentiation or some other factor, which would give the leading banks the ability to collude, and thereby earn higher-than-average profits. Table 4.6 shows the results. The coefficient on the market-share variable is positive but not significant. Such a finding does not support the argument that market share is a source of power by itself, nor does it support the hypothesis that firm-specific effects resulting in high market shares exist. This result can be interpreted as additional evidence of the validity of the SCP hypothesis for the Turkish banking market, since the market-structure variable is significant on its own, as well as together with the market-share variable. On the other hand, the market-share variable is neither significant on its own nor in conjunction with the market-structure variable.

The robustness of the results supporting the SCP hypothesis is further tested by dropping the top five firms from the data set and estimating the same equations with the same concentration ratio. This is done in order to determine whether some influential observations are driving the results, and to assess the influence of market structure on the behaviour of smaller (fringe) firms (Demsetz, 1973). If, on the one hand, both large and small firms enjoy profits, then collusion is present and the SCP is supported. If, on the other hand, leading firms achieve rents, the efficient-structure hypothesis cannot be rejected because small firms do not benefit from concentration.

There is another aspect of the possible correlation between market concentration and fringe firms' profits. A positive and significant relationship may indicate the existence of "collusive price leadership" (Markham, 1951). Hay and Morris (1979) note that in markets with a relatively small number of firms and slightly differentiated products with similar costs behaviour of the leading or price-setting firms could mirror the conditions facing each firm, and is likely to be accepted by other firms. As pointed out by Smirlock and Brown (1986), the collusion lies in accepting the price leader's actions in order for all firms to earn monopoly rents. Given that the banking market is usually made up of a relatively small number of firms producing only slightly differentiated products, it may be characterized by collusive price

leadership (Smirlock and Brown, 1986). As a consequence, secondary bank profits should be correlated with market concentration. If there is no collusion, the coefficient of CR5 should not be greater than zero. If smaller banks are profitable because of their efficiency, then the MS variable must be positive and significant. Finally, to determine the relative importance of MS and CR5 for smaller banks, both variables are utilized in the same equation simultaneously. As before, values for $CR5>0$ and $MS<0$ would indicate the presence of collusive price leadership and support the SCP hypothesis. If, on the other hand, $CR5<0$ and $MS>0$, then the efficient-structure hypothesis cannot be rejected.

The results are presented in Tables 4.7, and 4.8. As before, the market-structure variable on its own is highly significant and its coefficient is substantially larger than before. This implies that smaller banks also benefit from concentration. In fact, these findings suggest that they benefit even more than the largest banks. Next we estimate the same equation with the market share included. As Table 4.8 shows, the coefficient of MS is not significant while that of CR5 is significant at the one percent level. However, the coefficient of MS is larger than in the estimation reported in Table 4.5. The results demonstrate the robustness of our findings with respect to the validity of the SCP hypothesis, and suggest collusive price leadership in the Turkish banking market.

Results for control variables will be summarized briefly. The coefficient of the capital-asset ratio is highly significant, entering with a positive sign. This is probably because of well capitalized banks behaving much more cautious, earning relatively low returns, but still remaining profitable. Results with the total-asset (size) variable are inconsistent. In all equations except one, this variable has a positive sign, but is always insignificant. Nevertheless, such results are also found in other studies[3]. The loan-asset ratio is highly significant in all equations and enters with a negative sign. This indicates that banks with large loan portfolios relative to assets absorb high administrative costs and incur substantial loan losses. Relatively cheaper sources of funds contribute to profits. The corresponding demand deposits-total deposits ratio (DT) is statistically significant at the five percent level. The operating expenses-total asset ratio is significant in all equations and has the expected sign. The market deposit-growth rate (MDGR) turns out to be insignificant with a positive sign suggesting that MDGR does not impact profits significantly. The coefficient for the ownership variable is significant suggesting that privately owned banks are more profitable than public banks.

The competition model. The tobit regression results of this model are presented in Table 4.9. Two equations were estimated. The first one uses mobility among the top ten banks while the second one uses mobility among all banks in the market as the dependent variable. In both equations, most variables have the expected sign and are significant at the one percent level, except the entry variable. The entry variable, in its lagged and unlagged form, enters with a negative sign in the first equation, and is not significant. This is inconsistent with our theoretical expectations, although similar results were obtained by Rhoades (1980). When mobility among all firms is used, the sign of the entry variable changes, but it still remains insignificant. These results would imply that the entry of some 30 banks during the last

decade or so did not have a significant pro-competitive effect on rivalry and has not been sufficient to alter the inter-firm relationships among banks in the market.

The above observation is made due to a number of reasons. First, it may be that more time is needed before new entrants can have an impact on market relationships, so that the five-year lag allowed for in the model might not be enough to capture the expected adjustments in inter-firm relationships. Second, the entry of new banks has been on a small scale, thus reducing the likelihood that they will change the nature of established relationships. In other words, a minimum entry size may be needed in order to compete — as a new entrant — with established banks effectively. Third, new entrants chose to focus on trade finance and other specialized services, although they were authorized to collect deposits. This in effect left the pre-existing large banks unchallenged in the retail market. Fourth, the decline in concentration ratios has been primarily due to the top five banks losing deposits to the ones below the top five where the magnitude of these losses was not sufficient to alter the ranking. Given these considerations, it is not surprising that entry did not positively influence competition in the equations estimated here. However, the results do not mean that entry does not matter. Rather, they highlight the importance of conditions under which entry would be more effective in promoting competition. These conditions seem to have to do with type and size of the entrants (Hannah and Kay, 1977, Kheamani and Shapiro, 1988).

The results for the concentration variable are consistent with expectations — market concentration is a determinant of competition in the retail banking market and is correlated with a low level of inter-firm rivalry. Such a finding is in line with Heggestad and Rhoades's proposition that mobility is an element of industry structure and reflects conduct predicted to arise from certain market structures. This result also corroborates the earlier result that found a positive relationship between concentration and profits. The average-fixed-asset size of the top five banks also has a strong negative impact on competition. This result suggests that branch network and equipment owned by the top five banks negatively affect competition in the market, and probably deter newcomers from entering into the retail banking market.[17] It may also be an indication of reputation effects which are thought to be significant in banking. As expected, market growth is strongly related to competition which is in line with most other competition studies.

7. Conclusions and Policy Implications

The results of this study have a number of important policy implications. The first one is that, although reforms reduced concentration so that the cooperative attitudeand the tradition of understanding among banks is now much weaker, the present findings suggest otherwise. Leading banks are still able to coordinate their pricing decisions overtly. This is also obvious to the casual observer. As recently as March 1993, the general manager of a large public bank commented to the press that deposit rates were lowered in agreement with the leading large banks. Another noteworthy example is that in October 1992 public banks were directed to raise their deposit rates in response to large banks setting rates below those of the smaller

banks and the inflation rate. This reflects recognition by the authorities of collusive pricing and attempts to deal with it.[17] These developments clearly suggest that the high profitability in the sector was primarily due to uncompetitive pricing of banks and not to their efficiency. Hence, the deregulation and liberalization process that started in 1980 should be continued and broadened.

A second policy implication, related to the first one is that the size and type of the entrants is as important as the entry itself, and that future policies should take this factor into account. The findings of this study indicate that entry at a small scale has not been sufficient to alter inter-firm relationships in the market. While it may be argued that reforming the financial system should be regarded as a process and that entry will increase competition in due course, it is not clear that entry at a small scale will deliver that result at all. Atiyas and Ersel (1993) report that small banks were not planning to increase their customer base and that they would continue to work with large firms. This implies that new banks, at least for now, are not planning to challenge institutions in the retail banking business and in line with this strategy do not establish offices beyond the three large cities. This means that they will not be a factor of competition in the retail banking market, and hence cannot be expected to influence market structure.

The unwillingness of new financial institutions to enter into the retail banking market also demonstrates the importance of distortions caused by previous interest rate and regulatory policies which led to excessive branch networks and emphasis on size by the banks. It has already been noted earlier that between 1960 and 1980 -- when the price of capital was distorted and inflation on the rise -- it was very profitable to collect deposits by opening new branches. However, with deregulation of interest rates in 1980, this situation changed as capital became expensive and eliminated rents that had been earned by collecting deposits. In the two competition equations estimated here, the size of large banks exerted a significantly negative impact on competition which may indicate that the size of banks has now become a mobility barrier in the system.[18] Such a proposition seems to be in line with Caves and Porter's (1977) contribution, which generalized Bain's (1954) original theory of entry barriers to include mobility barriers, i.e., competition not only depends on new entry but "structural restraints on firms' abilities to change their market shares" or mobility within an industry as well. Hence, both the entry and mobility barriers need to be taken into account in promoting competition in the system.

Given these considerations, a pro-competitive policy would need to foster rivalry among the leading banks which continue to dominate the system. This in turn requires the entry or creation of new banks with a reasonable number of branches. In other words, what is needed is entry at a certain size. In the short run, this could be achieved by breaking up and privatizing public banks, with some exceptions though. Breaking up public banks is not likely to lead to welfare losses because there seem to be no scale economies in banking in general, and in particular in the banking sector in Turkey, as was recently demonstrated by Cilli (1993). Hence, the breaking up of public banks which currently represent 30 percent of sectoral assets (excluding the Agricultural Bank and three development banks) can easily

result in the creation of some 15 to 20 new banks with 40 to 50 branches. This would reduce concentration and facilitate mobility in the retail banking market.

Such a strategy is also likely to improve efficiency in the sector. Recent studies by Bauer et al. (1993), Berger (1993), Berger et al. (1993), and Berger and Humprey (1991, 1992a and b) indicate that there are significant amounts of X-inefficiencies in banking. In other words, differences in managerial ability to minimize costs and maximize profits seem to be larger than the cost effects of the choice of scale and scope of the output level. If so, the breaking up of public banks prior to privatization is likely to improve their governance structure and productive efficiency. Another lesson to be learned here is that banks with relatively large branch networks should not be permitted to merge. Rhoades (1993) for example, finds that banks in the United States involved in horizontal mergers during the 1981-86 period did not experience efficiency gains. The recent mergers between Denizbank and Emlak Bankasi on the one hand and Ogretmenler Bankasi and Halkbank on the other hand are not likely to contribute to sectoral efficiency gains. Instead they are bound to increase concentration and should therefore be avoided in the future.

Promoting the entry of non-banks and local banks would also be desirable as there is a need to increase the number of institutions competing for deposits. In most OECD countries, savings and loan associations, building societies and co-operative banks are numerous and actively compete with each other. In Germany for example, there are some 280 commercial banks, 558 savings banks, and about 2800 co-operative banks. In Spain, the number of commercial banks is 160 while the number of savings and co-operative banks is around 175.[19] In Turkey, depositors do not face such a variety of institutions and the market is far from being "overbanked". First steps to redress this situation could be the creation of institutions for housing finance, and the development of a mortgage market. In general, the entry of new institutions should not be restricted.

Finally, it should be noted that the experience of both developed and developing countries suggests the promotion and competition through policies of the type proposed above. This involves striking a balance between a number of potentially conflicting objectives and managing the risk that financial deregulation brings.[20] In almost all countries the policy objective has been to maintain financial market stability and investor protection together with achieving productive and allocative efficiency through deregulation. However, as pointed out by Mayer and Vives (1993), competition in banking has its particular features, in that there are risks and distortions that make the welfare effects of increased competition uncertain. As many economists — most recently Stiglitz (1993) — pointed out, financial markets are incomplete and market failures are a reality so that a case can be made for government intervention.

The above arguments imply that — owing to conflicting objectives — banking will need to be regulated and be different from other industries, which in turn will limit the intensity of competition. However, in the case of Turkey, this does not mean that the present low degree of competition in banking should be accepted. Even if the best of conditions were created

for a competitive system, owing to conflicting objectives and regulations imposed on the financial sector, profitability would still be higher than in other industries. For example, Neven (1993) and Vives (1991) do not consider the banking sector in Europe as highly competitive, although sectoral profitability is far below that of the Turkish sector. Hence, there is ample room for competition in the market. A corollary to these arguments is that the quality of the regulatory framework and the supervisory capacity of the authorities are crucial factors in striking a balance between a high degree of competition, system stability and efficiency.

Table 4.1: Number and Concentration of Commercial Banks in Turkey

	Year				
	1980	1983	1986	1989	1991
Number of Commercial Banks (excluding Development and Investment Banks)	36	39	49	53	55
• State owned	8	9	8	8	8
• Private	24	19	24	24	26
• Foreign	4	11	17	21	21
Number of Branches (total)	5894	6221	6337	6579	6460
Concentration Measures (percent)					
CR3D deposits	53	57	53	45	40
CR5D deposits	69	71	68	61	55
CR8D deposits	82	83	80	77	74
CR10 deposits	88	88	86	85	82
CR3L	56	53	55	49	44
CR5L	70	65	69	60	56
CR8L	82	78	81	74	70
CR10L	87	83	85	80	78
CR3A	50	51	48	45	40
CR5A	64	63	62	58	54
CR8A	76	76	76	73	69
CR10A	83	81	81	79	77
CR3SD	55	61	63	50	42
CR5SD	72	74	76	66	58
CR8SD	83	84	86	81	75
CR10SD	90	90	92	89	83
CR3NSD	55	60	68	65	62
CR5NSD	70	72	79	75	74
CR8NSD	84	85	92	87	87
CR10NSD	89	90	98	93	94

Sources: The Banks' Association of Turkey, the Central Bank of Turkey and calculations by the author

Notes: CR3D deposit concentration (3, 5, 8, 10 banks)
CR3A asset concentration (3, 5, 8, 10 banks)
CR3SD savings deposit (level) concentration
CR3NSD savings deposit (number) concentration

Table 4.2: Indicators of Financial Deepening (End-of-Year Figures)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
Stock of Financial Assets (SFA) (TL Billion)	1,224	2,148	3,335	4,339	7,304	12,059	18,356	30,519	49,086	86,631	133,379
GDP (TL Billion)	4,328	6,414	8,507	11,532	18,212	27,552	39,288	58,299	100,826	167,770	279,920
M1 (TL Billion)	738	1,019	1,407	2,084	2,448	3,420	5,357	8,682	11,311	19,560	31,399
M2 (TL Billion)	924	1,710	2,679	3,477	5,493	8,540	12,276	17,702	27,195	47,142	71,571
SFA GDP (%)	28.3	33.5	38.8	37.6	40.1	43.8	46.7	52.4	48.7	51.6	47.7
M1 GDP (%)	17.1	15.9	16.4	18.1	13.4	12.4	13.6	14.9	11.2	11.7	11.2
M2 GDP (%)	21.4	26.7	31.1	30.2	30.2	31.0	31.3	30.4	27.0	28.1	25.6

Sources: The Central Bank of Turkey and the Undersecretariat for the Treasury and Foreign Trade.

Notes: Stocks of financial assets include currency in circulation, deposits (sight, time and FX deposits excluding interbank deposits), special house finance participation accounts, corporate bonds, shares, financial bills, mutual funds participation certificates, bank bills and bank guaranteed bills, government bonds, treasury bills and income sharing certificates.

M1 = currency in circulation + sight deposits

M2 = M1 + time deposits

Table 4.3: Bank Profitability

Country	Year	GEM	OC	NEM	PBT	Number of Commercial Banks
				(as percentage of total assets)		
Turkey	1983	5.0	3.6	1.3	1.0	39
	1984	5.7	3.3	2.4	1.9	41
	1985	3.8	2.9	0.9	0.6	44
	1986	5.4	2.8	2.6	1.9	49
	1987	7.3	2.8	4.5	3.0	50
	1988	8.5	3.3	5.2	3.5	52
	1989	7.4	3.8	3.6	2.4	53
	1990	12.3	5.1	7.2	3.6	56
Spain	1990	5.13	3.01	2.12	1.53	160
Austria	1990	2.56	1.66	0.90	0.40	1165
Italy	1990	4.16	2.74	1.42	0.88	188
Netherland	1990	1.19	0.44	0.74	0.22	173
Belgium	1990	1.75	1.21	0.54	0.33	91
Denmark	1990	2.99	2.05	0.94	-0.27	119
Germany	1990	3.19	2.03	1.16	0.63	281

Sources: OECD (1992a), Iskenderoglu, Ozturk and Temel (1991); the Banks' Association of Turkey and author's calculations based on data compiled at the Central Bank, Banking Department.

Notes: GEM: Gross economic margin = Interest received - Interest paid + Other income (net)
OC: Operating costs
NEM: Net economic margin = GEM - OC
PBT: Profits before taxes = NEM - other expenses (net)
Total assets: Arithmetic averages of end-of-year values.

Table 4.4: Regression Results of the Market Structure Mod. . The Traditional Version

Dependent Variable = Return on Assets

Independent variable	Coefficient	t-Statistic
C	-0.10407	-2.15
CA	0.13340	6.87
TA	5.498E-10	1.27
LA	-0.02217	-6.00
DT	0.006066	2.30
OEA	-0.174486	-3.20
MDGR	0.00013	0.05
CR5	0.172756	2.98
DI	0.91478	2.57

R^2	0.54
F-Statistic	21.84

Notes C = constant term
CA = capital / assets
TA = total assets
LA = loans / assets
DT = demand deposits / total deposits
OEA = operating expenses
MDGR= market deposits' growth rate
CR5 = five firm deposit concentration ratio
DI = dummy for private banks

Table 4.5: Regression Results with the Market Share Variable (MSHARE)

Dependent Variable = Return on Assets

Independent variable	Coefficient	t-Statistic
C	-0.097	-1.97
MSHARE	0.0137	0.548
CA	0.135833	5.47
TA	6.294E-10	0.656
LA	-0.02261	5.97
DT	0.00653	2.34
OEA	-0.172673	-3.15
MDGR	0.000196	0.076
CR5	0.160317	2.576
DI	0.90890	2.47

R^2	0.53
F Statistic	19.40

Note: See the notes to Table 4.4.

Table 4.6: Regression Results Excluding the Market-Structure Measure

Dependent Variable = Return on Assets

Independent variable	Coefficient	t-Statistic
C	-0.00454	1.26
MSHARE	0.037221	1.56
CA	0.123172	6.17
TA	-6.318E-10	0.54
LA	-0.02046	5.44
DT	0.007065	2.52
OEA	-0.177827	-3.19
MDGR	0.001463	0.59
DI	0.89376	2.29
R^2	0.51	
F-Statistic	29.98	

Note: See the notes to Table 4.4

Table 4.7: Regression Results Excluding the Top Five Firms

Dependent Variable = Return on Assets

Independent variable	Coefficient	t-Statistic
C	-0.14677	-2.06
CA	0.125419	5.47
TA	6.1214E10	1.13
LA	-0.02071	-4.60
DT	0.008158	2.86
OEA	-0.213746	-3.80
MDGR	0.000863	0.30
CR5	0.239629	3.44
DI	0. 99378	2.44

R^2	0.561
F-Statistic	21.44

Note: See the notes to Table 4.4.

Table 4.8: Regression Results Excluding the Top Five Firms, with the Market Share Variable

Dependent Variable = Return on Assets

Independent variable	Coefficient	t-Statistic
C	-0.12324	-1.54
MSHARE	0.096954	1.54
CA	0.148375	5.44
TA	6.412E10	0.85
LA	-0.62495	-4.95
DI	0.010267	3.26
OEA	-0.191380	-3.29
MIXR	0.001398	0.50
CR5	0.198141	2.66
DI	0.87596	2.34
R^2	0.56	
F-Statistic	22.04	

Note: See the notes to Table 4.4.

Table 4.9: Tobit Regression Results for the Competition Model

Dependent Variable = Mobility Among the Top-10 Banks

Independent variable	Coefficient	t-Statistic
C	8.1069	2.2610
ENT (-5)	-.1274	-1.8081
CR5	-13.4431	-2.4905
AVG	-.2088E-06	-4.2828
MDGR	.0349	4.1027

Dependent Variable = Mobility Among All Banks

Independent variable	Coefficient	t-Statistic
C	2.5356	2.98
ENT (-5)	1.6780	1.23
CR5	-6.8759	-3.76
AVG	-1.6884	-2.95
MDGR	.1349	3.11

Notes: C = constant term
ENT = number of entries
CR5 = five-firm deposit concentration ratio
AVG = average fixed asset size
MDGR = market deposit growth rate.

Notes

1. I am grateful to the Central Bank of Turkey, particularly to Hasan Ersel and Almila Tutuncuoglu for providing data. My thanks are also due to Atif Cezayirli, Tarhan Feyzioglu, Deniz Gökce and Mark Wohar for helpful comments, and to Didem Altop and Refik Erzan for their help in editing the paper.

2. Vives (1991) and Mayer and Vives (1993) pointed out, that until the advent of global financial deregulation in the 1970s most countries — both developed and developing — followed restrictive financial and regulatory policies (see also OECD, 1992). However, it should also be noted that financial restriction did not turn into financial repression in the industrialized countries as it did in the industrializing ones.

3. For a recent discussion of the theory of the banking firm, including competition in general as well as the benefits of increased competition in banking, see Mayer and Vives (1993).

4. For a more detailed account of the evolution of banking in Turkey, see Akguc (1987).

5. See the tables presented at the end of Fry (1979)

6. However, rising inflation and the government's unwillingness to liberalize interest rates turned the system into a repressed one after the mid-1970s. See Hanson and Neal (1986) and Fry (1988).

7. See the discussion of banking and finance policy in Akguc (1987), pp. 48-58.

8. As long as the marginal cost of deposits, i.e., the interest on deposits plus the cost of buildings and equipment, was less than the inflation rate, banks would expand their network to collect deposits. Hence, as the spread between deposit rates and the inflation rate widened, profit maximization required more investment into bank branches.

9. Although there is disagreement over what banks produce, it seems reasonable and technically acceptable to view major deposit and loan categories as bank outputs (see Berger and Humprey, 1992b).

10. There is considerable disagreement in the literature as to which of the two hypotheses best explain the correlation between market concentration and profits. For a review of the literature see Evanoff and Fortier (1988), and Berger (1993). Most recent studies like Berger and Hannan (1989), Neuberger and Zimmerman (1991), Saunders and

Udell (1991), Hannan (1991) and Neumark and Sharpe (1992) use deposit rates or loan rates instead of profits as the dependent variable. This provides a much more direct test of the SCP hypothesis in a manner that excludes as an alternative explanation the form of efficient-structure hypothesis that is used to explain the positive relationship between profits and concentration. The weight of the evidence these studies provide supports the SPC hypothesis.

11. Business Week (April 9, 1984, p. 83, and April 8, 1985, p. 106) also suggests that ROA is the single best performance measure for banks, as cited in Rhoades (1987).

12. This study differs from others in that the five-bank concentration ratio is for the entire retail banking market in Turkey while other analyses use concentration ratios for local banking markets. Theoretical models establishing a relationship between market concentration and profits do not specify local market concentration or national market concentration as the appropriate variable (Hannan, 1991). Furthermore, the concentration variable used in this study is based on quarterly data and hence does not create any problems for estimation. Finally, there is no doubt that in the Turkish context structure influences performance as evidenced by gentlemen's agreements.

13. Alternatively, some researchers have used the Herfindahl-Hirschmann index (HHI) with no change in the empirical results. HHI is often criticized on the grounds that it is mainly concerned with the dispersion of sellers, whereas the theory is more concerned with concentration, so that a concentration measure should be used. For all the above reasons, the various CR measures in terms of deposits are used as a proxy for market structure. See Rhoades (1993) for a recent discussion of the issue.

14. Since the data were pooled, equations were estimated using both fixed effects (least squares dummy variables) and random effects (variance components) techniques with no difference in the results. The detailed results are available form the author upon request.

15. Shepherd (1972) finds a negative relationship between size and profitability in his study of the relationship between market share and rate of return and attributes this to X-inefficiency. Newman, et al. (1979) report similar results in their analysis of the relationship between market concentration and profitability. Like Shepherd (1972), these authors attribute their finding to X-inefficiency. More recently, Evanoff and Fortier (1988) find a negative relationship between size and profitability in their re-evaluation of the structure-performance relationship.

16. Bodenhorn (1990) presents similar results.

17. It is probable that the authorities viewed cuts in deposit rates as "excessive". Otherwise they would not have intervened, as they tolerated collusion among banks in the past.

18. Switching costs may also be a barrier to mobility. The number of savings accounts controlled by the large banks after the reforms actually increased, which seems to indicate that proximity to bank offices was an important factor in consumers' choice. See Dermine (1993), Giovannini and Mayer (1991) and Klemperer (1987).

19. For more details about the structure of the banking market in OECD countries, see Canals (1993) and OECD (1993).

20. For a review of the experience of developing countries with financial liberalization and deregulation, see Caprio et al. (1993); for that of developed countries, see Mayer and Vives (1993), Giovannini (1993), OECD (1992) and Khoury (1990).

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CHAPTER V

INVESTMENT AND EXPORT SUBSIDIES IN TURKEY

Refik Erzan[1]

1. Introduction

In economic reality subsidies are an important element of the framework for competition. They are highly topical, for example, in connection with "strategic trade policy" or as an instrument of "unfair trade practices" (Tyson, 1992). Accordingly, a strong case is often made for subsidies in the name of "national interest".

Almost all chapters of this study can be viewed as dealing with some aspects of subsidies, be they theoretical, legal or otherwise. The task of the present chapter, however, is a more focussed one. It is to briefly review the Turkish record on investment and export subsidies (often called "incentives") and to ask whether the current system is viable and desirable. This analysis is followed by a set of policy recommendations.

2. Investment Incentives[2]

During the 1960s and 1970s Turkey followed an import substitution strategy, where the main instrument of industrial policy was protection. Quotas and licenses applied to both final products and inputs. While these instruments enabled the government to direct investment, the strategy did not follow a predetermined pattern. As an additional measure the State Planning Organization (SPO) started issuing "certificates of encouragement" for investments in 1968. Eligible investments received subsidized credits and enjoyed certain exemptions from customs duties as well as tax breaks. With a regulated domestic credit market and severe international exchange and payments restrictions, the real interest rates could be kept low so that funds for subsidized credits were manageable.

In the 1970s import substitution began to be extended to investment goods and intermediate inputs where again the foreign trade regime was the main instrument. However, the emphasis on "heavy industry" investment was actually achieved directly through state economic enterprises (SEEs).

Between 1968 and the end of 1980 about 4,800 investment encouragement certificates were issued. The corresponding number for the period from 1981 to 1991 was nearly 27,000 (Guvemli, 1992). As a general rule all investments (with minor exceptions) must receive encouragement certificates to qualify for the various incentives. Since 1992 these certificates have been issued by the Undersecretariat for the Treasury and Foreign Trade (UTFT) with only few limitations imposed on the eligibility of investments for an encouragement certificate

The eligibility criteria of an investment for the various subsidies and their rates are of three different kinds: **location**, **sector/activity** and **scale**. In addition to minimum scale requirements in each sector, the size of the investment matters. Besides new investment, also the expansion of existing capacity, completion, renewal, restoration, modernization, integration or transportation of facilities, and investments for quality improvement are eligible for incentives. Applications can also cover leasing and projects to "eliminate bottlenecks".

Table 5.1 lists 16 instruments used for promoting investment since 1978 and indicates the time period during which they were effective. The major ones — most of them currently still being in use — are briefly described in the Box below.

Main Investment Incentives

Exemption from customs duties: Importation of investment goods receives a complete or partial exemption from customs duties and other surcharges. The rate of this exemption is determined by location, sector/activity and scale. Similar treatment can be granted to intermediate inputs for a limited duration.

Tax credit: This is a tax break concerning mainly the corporate tax. A certain percentage of the initial investment (up to 100 per cent) is deductible from the tax base, depending on location, sector/activity and scale.

Subsidized credits: Credits with below-market interest rates (often considerably below the rate of inflation) are extended either directly from the treasury or from public development banks. The rates applied, the maximum amounts (in relation to the size of the investment or turnover), the maturity and the grace periods are differentiated according to location, sector/activity and scale.

Exemption from taxes and duties on credits: Medium-term and long-term credits are exempted from taxes and duties, subject to a pledge for a certain export volume, defined as a percentage of production. This percentage varies between 5 and 20, where the lower requirement is for priority development regions.

(continued)

Main Investment Incentives (continued)

Value added tax (VAT) refund: The VAT component of the domestically produced capital goods and equipment purchased in an investment is returned to the investor. This is the counterpart of the customs duty exemption for imported investment goods.

Investment Subsidy: This subsidy, paid from the so-called "Fund to Support Resource Utilization", was recently phased out. The corresponding cash grants were in proportion to "own capital actually spent". The rate depended on location and sector/activity.

Reduction in labour fees and taxes, and the energy price: Depending on the sector and the location of the investment as well as its scale, there are reductions in the social security premiums and other labour fees payable by the employer, as well as in the payroll tax. There is also a write-off for a certain percentage of electricity used during the first three years of operation.

Land allocation: Allocation of public land for projects in priority development regions, sectors and scales.

Trends in Investment Incentives With the steep rise in the 1980s of the number of investment encouragement certificates granted, monitoring the realization of investments became very difficult. The SPO has delegated some of its functions and monitoring duties to the district governors and public banks. Consequently, the statistical information on investments receiving state aid deteriorated sharply. The present analysis of trends is based on investment encouragement certificates granted. Statistics on actual investments receiving state aid, particularly their distribution by sector, region, scale and type of investment are not available.

The sectoral distribution of investments that received encouragement certificates between 1976 and 1991 is given in Tables 5.2, 5.3 and 5.4. The number of certificates for each sector, their percentage distribution, and the distribution of total fixed investment qualifying for incentives are tabulated. In value terms manufactures declined from above 80 percent of the total to around 50 percent during the decade. Services, on the other hand, increased their share from a few percentage points to 40 percent or more. The most striking feature, however, appears to be the volatility from year to year of the figures shown in the table.

Among the subsectors of manufacturing (Tables 5.5 and 5.6), the only clear trend was in the share of textiles and clothing, with an increase from 5 to about 45 percent. In general, new investment accounted for three-fourths of the total volume, while capacity expansion attained a share of around ten percent in most years (Table 5.7). Another major item was modernization.

In the present context an important question is whether the incentive schemes of the 1980s were effective in directing investments. In a comparison of location, sector/activity and scale, the incentive schemes showed a consistent and pronounced impact on direction only with respect to location. Both tax and financial incentives appeared to move industry from developed regions into less developed areas or to organized industrial zones. Concerning sectoral impacts it was difficult to generalize over the whole of the 1980s, as there was a large number of very specific activities that were promoted. One possible generalization is that most of the specific incentives related to foreign-exchange earning activities.

It would be quite difficult to determine whether the incentive schemes of the 1980s achieved their locational goals or attained other specific targets. As mentioned earlier, the available statistics on investments are based on encouragement certificates rather than realized projects. The overall realization rate of investments that received such certificates is estimated at between 15 to 20 per cent for the 1980s. This value appears to be quite low in view of the fact that about 27,000 encouragement certificates were processed and granted during the 1981—1991 period. It casts doubt on the potential of the incentive scheme to give investments a systematic direction.

In the present exercise an effort was made to determine whether there was any relation between encouragement certificates and sectoral developments. To this end, the average annual growth rate in investments qualifying for encouragement certificates was correlated with growth and export performance across manufacturing subsectors (Table 5.8). Based on these correlations — which cannot indicate the direction of causality — it might be stated that the government largely followed investment demand in issuing encouragement certificates. Another finding is that subsectors with low export performance seem to have received some priority.

An overall evaluation of investment promotion policy during the 1980s would therefore suggest that, by design and by default, there was little direction. However, the promotion of specific activities, most of them related to the earning of foreign exchange, may have achieved intended results. An indication of this can be seen in the tripling of hotel/motel beds over the examined decade and a corresponding increase in revenues from $ 0.5 to $ 3.5 billion. The question about the cost to the country of this incentive scheme can only be answered by way of a rough estimate. Investment subsidies (including tax breaks) appear to have cost Turkey about 2.0 to 2.4 percent of GNP per year during the 1980s.

The 1992 investment incentive program was somewhat more selective in terms of economic activity, as it excluded a list of subsectors from the scheme altogether. Investment in education, health, environment and technology was put in the highest premium class as well as "large scale" investments and the completion of unfinished projects. Nevertheless, the programme still included promotion of some very specific activities, like special provisions for construction activities and investment in transition economies through expanded Eximbank credits.

The 1993 scheme appeared to be highly selective by switching from a "negative" list of sectors that ought not to be encouraged to a "positive" sector list. In addition, a "narrower" list was published indicating "especially important sectors" to which more generous treatment would be offered. In any event, all of the sectors mentioned in the scheme were defined extremely broadly. There were also special provisions for uncompleted investments, especially in tourism and shipbuilding and particular emphasis was laid on small and medium scale enterprises (SMSEs).

3. Export Incentives[3]

Until 1980 the exchange rate of the Turkish Lira was fixed and the currency overvalued with the exception of brief periods following devaluations. This in combination with high protection of imports yielded an "effective exchange rate for exports" considerably lower than the "effective exchange rate for imports". To compensate for this discrimination, the government provided substantial financial incentives to exports starting from the early 1960s. The certification procedure for export subsidies was similar to that for investment incentives. With the shift to export orientation in 1980 a market-based exchange rate policy was adopted. However, financial incentives to export were not removed. On the contrary, subsidy rates were increased. Presumably, the purpose was to make exporting highly profitable with the aim of breaking the inertia of import substitution. The policy succeeded in a way, but started also an avalanche of rent-seeking activities. In 1986 Turkey signed the GATT subsidies code and pledged to phase out outright export subsidies by 1989. At about the same time the foreign exchange retention schemes lost their value, as the black market for foreign currencies disappeared. In the meantime, as the export boom faded away in the mid-1980s, the government introduced new export incentives.

Table 5.9 lists the instruments used in promoting exports. The major ones among them are described in the Box below.

Main Export Incentives

Export tax rebate: This was intended to refund taxes on the inputs of the exported good. Yet in reality, it was an outright subsidy. Its rate varied, depending on the sector of export, its destination, and, at times, the size of total shipments of the exporter during the calendar year. It was phased out in 1989/90.

Duty free import privileges: Exporters are allowed to import raw inputs and packaging materials up to a value of 80 percent of the value of exports pledged. This remains a major financial incentive.

Exemption from corporate income tax: This provision, which was similar to the tax rebate in investments, was phased out. Up to 20 percent of the export value could be deducted from the corporate tax base.

Temporary import permits: Exporters can bring in imported inputs on a temporary basis, free of all duties, on condition of re-export.

Transportation premium: Exports to distant countries receive a subsidy on transportation. This subsidy was recently increased to promote sales to Far East Asia and the Americas.

Energy subsidy: Producers are getting a subsidy on the electricity consumed for making goods that are exported. This recently installed subsidy is meant to put Turkish energy prices at par with the OECD average.

Eximbank credits: Subsidized export credits at interest rates considerably below the inflation rate.

Exemption from financial transaction tax and stamp duty: Financial transactions related to exports are exempt from all taxes and duties.

In the mid 1980s, the export tax rebate alone amounted to about 13 percent of total exports. Since most agricultural commodities were excluded from the scheme, the rate on eligible exports was actually above 20 percent.

A reliable figure on total export subsidies is difficult to compute. Estimates range between 15 and 40 percent for the 1980s (see Togan, Olgun and Akder, 1987, and Togan, 1993). Alternatively, export subsidies are estimated to have cost Turkey between 2.5 and 4.0 percent of GNP per year during the 1980s (Togan, 1993).

The impact of these subsidies on the apparent export boom of the early 1980s is clear, but their net contribution is controversial (see Milanovic, 1986, Baysan and Blitzer, 1990, Aricanli and Rodrik, 1990a and 1990b, and TUSES, 1992). In all likelihood, the intensification of promotion efforts in the mid-1980s did not produce the intended results. In 1989 and 1990, as a result of major capital inflows, the Turkish Lira appreciated considerably and the profit margins of exporters fell significantly. The export volume did not decline, however, with subsidies possibly being instrumental in avoiding a fall in exports during this period.

The 1992 export incentive scheme introduced an energy subsidy and increased the premium on transport costs to distant destinations. In addition, most tradable services became eligible for export promotion measures. Eximbank credits were expanded and transition economies received generous quotas in these subsidized credits. In terms of the specificity of export subsidies, there was targeting by market, rather than by product. All exports which were not contained in a short list of exceptions were eligible for incentives where the states emerging from the former USSR with a Turkic-speaking population were the prime target. The 1993 scheme closely resembled that of previous years with increased emphasis on Eximbank credits. In August 1993, the energy subsidy for export production was increased from 25 to 50 percent.

4. A General Evaluation

In view of the history of both the investment and the export incentive schemes the question arises of whether they followed a coherent strategy. The schemes as such date back to the 1960s and their complexity has increased manyfold since then. Until about 1980 the import regime and foreign exchange allocation were the main instruments for promoting industry, while outright export subsidies under the guise of "tax rebates" and foreign exchange retention schemes were used to make exports profitable.

When quotas were dismantled, licensing abolished, and foreign exchange restrictions removed, the most potent instruments of industrial policy were no longer available. Furthermore, since the quota and licensing schemes had put the burden of subsidizing industry directly on consumers, their elimination necessitated more generous duty and tax exemptions as well as cash payments from the treasury to maintain the same level of support. Given fiscal constraints, a selective approach would have been advisable. Nevertheless, investment certificates were issued to many kinds of investment. The main effect of this was to reduce the effective tax rate of the larger companies (which could exploit all the investment and export incentives) to about 10 to 15 percent — an effect which was not necessarily bad for the economy.

By and large there seems to have been no need for complex incentive schemes which promoted rent-seeking and in addition had a strong bias in favour of large corporations. Large enterprises

are much less affected by adverse macro-economic conditions and their market power in some sectors allows them to pass on cost increases to customers

Customs duties pose another problem. Although the average rate for duties and surcharges is somewhere between 30 and 40 per cent, the actual rate -- due to exemptions -- amounts to about ten percent. This creates a major distortion in the system with the consequence of the few who pay full duties carrying the whole burden.

It appears that in order to make tax incentives potent instruments, the taxation system might have to be reformed by cutting base rates and probably abolishing most of the current tax benefits. This would both increase government revenues, and establish the transparency needed for pursuing a coherent strategy. In this connection investment and export encouragement schemes might be abandoned altogether.

There are four areas which seem to deserve special attention in the present context: (i) the promotion of small and medium size enterprises and new entrants, (ii) priority development regions, (iii) restructuring, and (iv) export marketing, especially in new markets. While some specific measures are required in each one of these areas, institutional reform and general measures which work through the markets should be the main instruments. More specifically, an efficient administrative system might be established to follow-up and coordinate government support as well as to provide feedback. At the same time market mechanisms should be used to their full extent within any public scheme. The following paragraphs dwell on the first two of the subject areas outlined previously, while the other two are dealt with in Chapters VI and XI, respectively.

Promotion of small and medium size enterprises and new entrants. In the 1980s small and medium size enterprises (SMSEs) accounted for 53 percent of employment in Turkey's manufacturing sector and produced 25 percent of its value added.[4] In most EC countries corresponding figures are even higher (see, e.g., Akan, 1988, and IKV, 1987). According to a recent survey only 19 percent of these enterprises, however, used bank credit and seven percent of them made use of any incentive scheme with the majority benefitting from export incentives.[5] The public sector bank, Halkbank, which is the main source of credit for SMSEs, has a share of seven percent in total commercial credits in Turkey.

New investment, modernization and expansion of SMSEs often fall below the threshold to qualify for investment encouragement -- except in priority development regions. Similarly, the minimum annual shipments to receive export incentives and Eximbank credits surpass most SMSEs' export capacity or past record on which such support is based.

The discrimination against SMSEs was largely by design. Relatively high administrative costs in dealing with a large instead of a small number of firms are a legitimate concern. Arguments about low productivity and backward technology may also have contributed to this discrimination. By contrast, it is a widely held view today that a sizeable portion of technological innovations in industrial countries originate from SMSEs. Furthermore, in many activities (particularly in electronics) technological change has considerably reduced minimum-scale requirements. Finally, new entrants are the main stimuli for competition, where entry at a small scale is feasible in many activities and sectors.

Given the prominent role of SMSEs in employment creation in a country with high unemployment, discrimination against these enterprises is surprising. The main reason for it seems to lie in their relative weakness in lobbying. This weakness relates not only to defending special interests, but also to shaping the priorities in general policies. More generally, SMSEs lean towards an industrial strategy geared to improving the functioning of the markets. Macro-economic stability, low inflation and low interest rates are crucial for their prosperity. Furthermore, SMSEs would benefit from general state aid to education, health and the infrastructure more than proportionately compared to large firms as their capacity to carry overheads is considerably smaller.

As a consequence of the above, some specific measures would be warranted to promote SMSEs. These would have to do with improving their access to factor and product markets, both domestic and international. It has to be noted here that in Turkey SMSEs are not altogether deprived from support. The local chambers of commerce and industry and various public bodies and semi-official associations (founded by the SMSEs with public support) provide advice in finance, marketing, education and technical know-how as well as collateral and financial support. However, the survey mentioned previously has found that about 90 percent of SMSEs were unaware of the existence of such centers and activities. The newly founded Administration for Development and Support of Small and Medium Size Industry (KOSGEB) aims at coordinating pertinent efforts of the government and the functions of various SMSE associations. One of its first priorities could be to reach out to the SMSEs to inform them of existing services available to them.

Unlike large businesses, SMSEs do not have corporate links with banks. SMSEs have major problems in providing collateral to the banks for commercial credit. In any case, commercial banks do not extend medium-term or long-term credit, and short-term credit available to SMSEs is very expensive. The 1992 SMSE survey of the SIS found that for 75 percent of these firms high costs (interest rates and fees) were the prime reason for not using credits. The main source of subsidized credits for SMSEs, Halkbank, is by far not sufficient to put SMSEs at par with large enterprises.

To be eligible for the Eximbank's subsidized export credits, a track record of $ 1 million in shipments during the previous year is usually required. Few SMSEs fulfil this eligibility requirement. The avenue currently open to them to benefit from such credits is to make their sales through a "foreign trade joint stock" company which fulfils the requirement. This option was designed to encourage small producers to join forces, and to cut administrative costs of the Eximbank in screening loan applications. The Eximbank can ease the track record requirement subject to certain conditions. To reduce screening costs, it can rely on commercial banks that are willing to co-finance a certain minimum percentage of a transaction. Alternatively, Eximbank can rely on certified public accounting firms in small loan applications, and charge higher export credit guarantee premiums.

Helping the SMSEs with their collateral problem would improve their access to bank credits and lower interest charges. A loan guarantee scheme for SMSEs' short-term credit needs could be instituted along the lines of similar schemes in the United States, the United Kingdom and continental Europe (see, e.g., IKV, 1987). All commercial banks, public and private, should be able to participate in the programme. In extending the guarantees, the government could rely on certified public accounting firms. These firms would be required to hold consultations with public and semi-public bodies in the area to tap local knowledge about the particular industry and the loan applicant.

For medium-term and long-term capital needs of SMSEs, the government could consider promoting an investment fund scheme. Individual and institutional investors can be given tax incentives to participate in such funds which have in their portfolio a certain percentage devoted to the SMSEs. Investment funds, life insurance companies and pension funds (including the public social security system) are prime resources to be tapped.

A promising finding of the quoted survey on the SMSEs was that 89 percent of the surveyed firms were considering to float their stock in the stock exchange. The fact that very few of them are actually listed, points to a lack of know-how and high costs involved. The unlisted securities market in the United Kingdom seems to be a good solution to this problem, keeping quotation costs minimal and minimum share flotation requirements lower than at the stock exchange.

Finally, to provide risk capital for new entrants as well as for the expansion of existing small businesses, a venture-capital scheme would be essential. Currently, there are preparations under way to start such an operation under the auspices of a state bank. Given public funding difficulties, it is uncertain whether the plan could have a substantial impact.

To provide SMSEs with know-how, universities and technical schools can be tapped. As research is suffering from a lack of resources, a legal framework might be established and

working capital provided to set up "consultancy agencies". After provision of start-up support, these entities could be run on a private-enterprise basis.

Occasionally there seem to be problems with SMEs' not following basic rules of competition. This relates to tax evasion, labour being employed without social security coverage and environmental and safety standards being ignored. Specific measures would have to be designed with the double purpose of giving the SMSE's a boost while bringing them under the umbrella of the general standards. As many SMSEs would partly lose their cost advantage in this process, cash incentives and tax benefits might be provided over an interim period. Such incentives could be tied to voluntary inspection schemes. Here improved accounting practices could be rewarded by tax credits while investment that is intended to upgrade working conditions and environmental standards may be supported by subsidies.

Priority development regions Income per capita in first-degree priority regions is only one-third of the Turkish average and unemployment is at twice the national rate. The social, political, and security consequences of this skewed distribution are of great concern to government authorities. All five-year development plans, yearly programmes and incentive schemes contained generous provisions to promote all economic activity in those regions, however, with little impact. The number of investment encouragement certificates granted to priority development regions increased drastically over recent years (Table 5.10). In 1990 these regions accounted for 43 percent of total investment qualifying for subsidies. Besides their predominant share in agricultural projects, in manufacturing this share was 41 percent of the country total. Had all projects been realized, 39 percent of the employment due to subsidized new investment would have been generated in priority development regions (Table 5.11). However, the SPO acknowledges that the realization rate of investments in these regions is low (SPO, 1992). This may in part be explained by the fact that, no matter how generous tax and other incentives are, they cannot compensate for adverse economic conditions. In the aforementioned regions local markets appear to be too thin, skilled labour scarce and the infrastructure not sufficiently developed. Social unrest could be an additional factor reducing investment.

Turkey seems to have followed the example of the EU in its approach to regional development. The closest parallel is with Southern Italy, which has been receiving enormous sums in subsidies and tax benefits since the 1950s. Currently, Italy receives about 40 percent of all grants from the EU Regional Fund and has similar shares in the other funds to promote agriculture, industry and living standards (European Community, 1985 and King, 1975). While the South accounts for 35 percent of Italy's population, and 40 percent of its land area, its share in GDP is only 24 percent. Furthermore, the unemployment rate in the South is 21 percent, about three times as high as in the North (Economist Intelligence Unit, 1992). The instruments used in promoting economic activity in Southern Italy are very similar to those of Turkey. After forty years of

continuous support the infrastructure is in relatively good shape, whereas other results are often less encouraging (see, e.g., Economist Intelligence Unit, 1992 and Esin, 1988).

An alternative to investment promotion schemes seems to be a project-based approach with a central authority for the region. There are two versions of this model. The prototype of a central authority with wide-ranging powers is the Danodar Valley Corporation in India (see, e.g., United Nations, 1955). The other version is that of the "river basin" projects in the United States, with the classic example of the Tennessee Valley Authority (TVA) of the 1930s (see, e.g., Finer, 1944). In promoting industrialization TVA assumed -- besides providing flood control, irrigation and hydro-electric power — only the roles of research and planning in support of private enterprise. During the 1930s, the rate of growth in investment and employment in the TVA area was 10 to 15 percent higher than the United States average. Likewise the increase in per capita income was nearly 50 percent higher in Alabama, Mississippi and Tennessee. Even after making allowance for the depression in the industrial centres of the United States, the results achieved by the TVA were encouraging.

Another suggestion would be that of more and better co-ordinated "GAPs". Southeast Anatolia is the economically most deprived region of Turkey. At the same time, it is home to a bright spot in regional development efforts of Turkey — the Southeast Anatolian Project (GAP). When eventually completed in 2005, GAP is expected to account for 19 percent of Turkey's land under irrigation (compared to four percent before the project) and 2[illegible] percent of hydroelectric power (GAP, 1992). Conceptually, the GAP Regional Development Administration is close to the TVA (Acma, 1991). However, in addition to research and planning, it assumes the coordination function for all public development efforts in the region (SPO, 1989b).

Judged by the past record of investment promotion, the GAP was not so successful in its coordination function. During the 1980s, the region accounted for ten percent of all investment encouragement certificates, and in the early 1990s this share doubled (Table 5.12). Realization rates, however, were rather poor (SPO, 1992). Nevertheless, there is the consolation that most components of the project are still under construction, and that the GAP authority has only recently been fully empowered.

GAP has adopted a novel concept in comparison to past regional development efforts in Turkey. A major element in this is the focus on three "magnet" cities (Gazi Antep, Sanli Urfa and Divarbakir) which are relatively well developed large population centres and lie on an "axis" which is to connect them (SPO, 1989b).

To replicate the GAP experiment which revolves around the huge water and energy potentials of the Tigris and Euphrates rivers in other regions and on a smaller scale is a tempting idea. In any case, from the institutional point of view the performance of the GAP administration in

fulfilling its coordination functions and in balancing public and private initiatives will have to be closely scrutinized.

Table 5.1: Investment Incentives

	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
Customs Duty Exemptions	.	.	.	.	.	.	.	.	.	.	.	.	.	.	.	.
Investment Tax Credit	.	.	.	.	.	.	.	.	.	.	.	.	.	.	.	.
Subsidized Credits	.	.	.	.	.	.	.	.	.	.	.	.	.	.	.	.
Exemptions from Financial Transaction Tax and Stamp Duty	.	.	.	.	.	.	.	.	.	.	.	.	.	.	.	.
Investment Financing Fund	.	.	.	.	.	.	.	.	.	.	.	.	.	.	.	.
Building and Construction Tax Exemption	.	.	.	.	.	.	.	.	.	.	.	.	.	.	.	.
Value Added Tax Postponement	.	.	.	.	.	.	.	.	.	.	.	.	.	.	.	.
VAT Refund	.	.	.	.	.	.	.	.	.	.	.	.	.	.	.	.
Reduction in Labour Fees and Energy Prices	.	.	.	.	.	.	.	.	.	.	.	.	.	.	.	.
Land Allocation	.	.	.	.	.	.	.	.	.	.	.	.	.	.	.	.
Additional Employment Incentive	.	.	.	.	.	.	.	.	.	.	.	.	.	.	.	.
Exemptions from Financial Tax and Stamp Duty in Investments in Priority Development Regions and in Housing Construction	.	.	.	.	.	.	.	.	.	.	.	.	.	.	.	.
Tax Reduction in Wages of Workers in Specific Important Sectors and in Priority Development Regions	.	.	.	.	.	.	.	.	.	.	.	.	.	.	.	.
Foreign Exchange Allocation	.	.	.	.	.	.	.	.	.	.	.	.	.	.	.	.
Investment Subsidy	.	.	.	.	.	.	.	.	.	.	.	.	.	.	.	.
Financial Leasing	.	.	.	.	.	.	.	.	.	.	.	.	.	.	.	.

Sources: The State Planning Organization, the Undersecretariat for the Treasury and Foreign Trade and the Official Gazette of Turkey.

Table 5.2: Number of Investment Encouragement Certificates, by Sector

	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
Agriculture	26	24	38	46	101	485	200	167	107	94	81	203	118	444	1415	142
Mining	50	73	27	17	17	54	48	32	53	89	145	160	161	139	65	70
Manufacturing	605	825	584	339	399	1033	428	385	543	956	1320	1533	1536	1575	1231	1014
Energy	2	12	1	1	1	5	8	8	13	21	12	13	13	11	3	20
Services	258	157	88	21	55	1662	748	401	407	661	901	901	914	1087	427	529
Transportation	n.a.	n.a.	37	n.a.	n.a.	1612	641	257	261	411	466	285	192	185	48	149
Tourism	n.a.	n.a.	8	n.a.	n.a.	16	17	57	51	91	193	294	468	593	138	141
Trade	n.a.	n.a.	2	n.a.	n.a.	7	30	34	31	60	62	89	71	119	69	57
Education	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	32	53
Health	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	46	66
Others	n.a.	n.a.	41	n.a.	n.a.	27	60	53	54	99	180	233	183	190	94	63
Total	941	1091	738	424	573	3239	1432	993	1123	1821	2459	2810	2742	3256	3141	1775

Sources: The State Planning Organization and the Under Secretariat for the Treasury and Foreign Trade.
Note: n.a. = not available.

Table 5.3: Distribution of Investment Encouragement Certificates, by Sector
(percent)

	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
Agriculture	2.76	2.20	5.15	10.95	17.63	14.97	13.97	16.82	9.53	5.16	3.29	7.22	4.30	13.64	45.05	8.00
Mining	5.31	6.69	3.66	4.01	2.97	1.67	3.35	3.22	4.72	4.89	5.90	5.69	5.87	4.27	2.07	3.94
Manufacturing	64.29	75.62	79.13	79.95	69.63	31.89	29.89	38.77	48.35	52.50	53.68	54.56	56.02	48.37	39.19	57.13
Energy	0.21	1.10	0.14	0.24	0.17	0.15	0.56	0.81	1.16	1.15	0.49	0.46	3	n.a.	n.a.	n.a.
Services	27.42	14.39	11.92	4.95	9.60	51.31	52.23	40.38	36.24	36.30	36.64	32.06	33.33	33.38	13.59	29.80
Transportation	n.a.	n.a.	5.01	n.a.	n.a.	49.77	44.76	25.88	23.24	22.57	18.95	10.14	7.00	5.68	1.53	8.39
Tourism	n.a.	n.a.	1.08	n.a.	n.a.	0.49	1.19	5.74	5.43	5.00	7.85	10.46	17.07	18.21	4.39	7.94
Trade	n.a.	n.a.	0.27	n.a.	n.a.	0.22	2.09	3.42	2.76	3.29	2.52	3.17	2.59	3.65	2.20	3.21
Education	n.a.	n.a.	0.00	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	1.02	2.99
Health	n.a.	n.a.	0.00	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	1.46	3.72
Others	n.a.	n.a.	5.56	n.a.	n.a.	0.83	4.19	5.34	4.81	5.44	7.32	8.29	6.67	5.84	2.99	3.55
Total	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00

Sources: The State Planning Organization and the Under Secretariat for the Treasury and Foreign Trade.
Note: n.a. = not available.

Table 5.4: Distribution of Total Investment Subject to Encouragement Certificates, by Sector
(percent)

	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
Agriculture	1.11	0.38	1.48	3.17	13.31	4.42	4.85	3.96	2.09	11.36	0.73	2.35	1.08	2.62	10.50	1.50
Mining	2.97	0.88	7.00	1.84	1.79	2.85	2.81	5.58	20.32	38.71	5.95	7.56	1.99	2.73	2.68	3.58
Manufacturing	80.21	68.73	85.76	90.15	78.06	48.13	42.09	49.23	52.83	26.01	38.73	3.76	49.25	48.31	68.94	62.56
Energy	0.63	27.77	0.92	0.00	0.25	0.06	0.20	0.49	2.39	8.53	4.04	94.06	9.26	1.88	2.04	4.31
Services	15.08	2.24	4.84	4.84	6.60	43.58	50.05	40.73	22.37	42.80	50.56	43.15	37.98	44.45	15.84	28.04
Transportation	n.a.	n.a.	0.03	4.84	4.89	42.13	42.99	29.28	11.18	26.18	30.20	18.96	17.17	14.31	2.68	9.01
Tourism	n.a.	n.a.	0.18	0.00	1.25	0.34	1.73	4.62	8.08	20.63	6.00	12.15	16.79	18.51	7.44	3.96
Trade	n.a.	n.a.	0.10	0.00	0.16	0.08	1.34	1.73	0.88	34.68	1.22	3.72	0.69	3.20	0.79	2.17
Education	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	1.43	1.23
Health	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	1.72	3.09
Others	n.a.	n.a.	1.99	0.00	0.00	1.03	3.99	5.11	2.22	8.07	13.14	8.32	3.76	8.42	1.78	8.58
Total	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00

Sources: The State Planning Organization and the Undersecretariat for the Treasury and Foreign Trade
Note: n.a. = not available

Table 5.5: Number of Investment Encouragement Certificates in Manufacturing Subsectors

	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
Food and Beverages	74	n.a	n.a	233	89	56	99	202	190	216	192	276	353	174
Textile and Clothing	50	n.a	n.a	68	84	83	147	301	351	369	344	501	325	253
Forestry Products	52	n.a	n.a	20	9	10	7	17	27	62	66	73	57	41
Paper	11	n.a	n.a	5	8	3	3	10	10	45	26	14	13	13
Leather and Leather Products	11	n.a	n.a	16	8	10	16	30	35	59	61	32	24	29
Rubber	3	n.a	n.a	1	2	2	9	15	25	39	60	76	61	48
Chemicals	40	n.a	n.a	47	22	33	47	48	53	58	45	57	41	55
Glassware	9	n.a	n.a	5	4	4	3	9	12	19	25	19	8	10
Iron and Steel	30	n.a	n.a	4	8	19	18	30	35	25	25	29	20	21
Non-Ferrous Metals	9	n.a	n.a	5	2	3	8	9	9	14	16	14	6	16
Transport Vehicles	98	n.a	n.a	452	99	46	43	19	66	59	94	131	68	74
Metal Goods	32	n.a	n.a	31	17	21	23	48	64	69	79	54	62	61
Measuring Devices	0	n.a	n.a	3	10	13	11	8	14	17	22	24	8	7
Machinery	39	n.a	n.a	22	17	13	11	31	35	35	39	61	22	38
Electrical Machinery	31	n.a	n.a	11	9	8	10	16	12	21	32	29	16	24
Electronics	0	n.a	n.a	5	4	8	8	11	25	16	13	15	15	16
Cement	27	n.a	n.a	14	5	11	9	32	106	130	105	30	27	40
Clay and Cement Products	54	n.a	n.a	47	16	19	26	65	188	251	222	65	48	37
Ceramics	8	n.a	n.a	3	3	2	5	3	8	6	12	8	12	11
Others	6	n.a	n.a	41	12	21	40	52	50	53	58	67	41	36
Total	584	339	399	1033	428	385	543	956	1315	1563	1536	1575	1227	1004

Sources: The State Planning Organization and the Undersecretariat for the Treasury and Foreign Trade
Note: n.a = not available

Table 5.6: Distribution of Total Investment Subject to Investment Encouragement Certificates among Manufacturing Subsectors (percent)

	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
Food and Beverages	3.91	4.21	8.64	13.11	8.99	10.52	13.57	14.33	13.56	6.87	5.03	10.86	11.17	11.47
Textile and Clothing	5.36	4.96	13.48	13.35	19.20	22.11	40.24	31.86	21.53	31.16	45.48	46.29	45.61	32.47
Forestry Products	7.99	4.25	2.89	2.04	1.43	0.50	0.25	0.57	1.17	1.95	1.47	1.11	2.37	1.64
Paper	2.93	3.76	2.51	1.51	4.07	4.16	0.30	4.49	1.07	1.46	3.78	0.70	1.27	0.61
Leather and Leather Products	1.01	0.63	0.39	0.39	0.45	0.64	1.15	1.06	1.04	1.89	1.06	1.56	1.20	1.03
Rubber	0.12	1.35	0.07	0.22	0.22	0.24	0.41	0.11	0.83	3.94	2.06	1.57	1.98	1.62
Chemicals	13.13	14.85	9.32	4.19	13.33	19.66	9.74	14.13	9.06	4.08	5.86	3.59	4.77	16.32
Glassware	1.64	6.47	0.00	0.38	0.82	1.79	0.29	1.91	0.51	2.97	1.89	0.64	0.53	1.01
Iron and Steel	6.98	17.13	16.79	0.36	2.67	9.50	3.12	5.26	10.25	2.86	1.94	3.44	5.31	2.55
Non-Ferrous Metals	1.29	0.00	1.03	0.62	0.16	0.20	0.26	0.48	0.23	0.82	0.39	0.48	0.22	2.02
Transport Vehicles	10.54	8.72	18.56	52.22	24.69	11.34	11.34	2.19	2.43	3.71	5.73	17.57	6.87	7.54
Metal Goods	6.29	5.71	4.68	1.52	1.82	4.23	1.64	5.06	2.13	5.45	3.38	1.62	4.06	4.55
Measuring Devices	0.00	0.25	0.00	0.16	0.52	0.84	0.68	0.59	0.44	1.02	2.87	0.77	0.29	0.43
Machinery	15.06	7.98	8.81	1.50	3.13	1.40	0.75	1.76	0.54	1.77	0.66	1.26	0.51	1.24
Electrical Machinery	7.02	3.87	3.61	1.98	2.39	2.11	3.39	1.12	0.59	0.84	1.62	1.05	2.15	1.72
Electronics	0.00	0.59	0.00	0.56	2.53	1.14	1.00	1.67	2.47	1.12	0.41	0.46	3.25	1.24
Cement	10.39	4.82	1.29	2.38	1.14	2.29	1.44	3.48	5.19	14.50	6.95	1.64	3.07	7.02
Clay and Cement Products	3.05	1.61	2.56	1.31	1.86	2.91	4.33	6.04	4.59	9.68	5.73	1.75	1.49	1.52
Ceramics	3.00	4.23	1.28	0.40	0.33	0.18	1.71	0.57	1.75	1.64	1.61	1.94	2.35	2.61
Others	0.19	4.56	4.10	1.80	10.23	4.24	4.40	3.31	19.63	2.26	2.08	1.70	2.14	1.40
Total	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00

Sources: The State Planning Organization and the Undersecretariat for the Treasury and Foreign Trade.

Table 5.7: Distribution of Total Investment Subject to Encouragement Certificates, by Type of Investment (percent)

	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
New Investment	88.47	79.74	65.91	64.95	81.10	72.50	61.92	74.45	78.71	76.58	68.99
Expansion	6.56	6.62	17.00	16.86	8.23	15.32	9.57	11.95	7.91	11.50	18.75
Completion	0.64	0.77	1.43	4.04	0.80	1.88	0.66	1.49	1.10	1.38	3.71
Renewals	0.75	6.88	2.64	5.52	1.28	0.99	3.19	0.69	1.16	0.82	1.51
Quality Improvements	2.56	2.59	1.40	2.08	1.23	1.64	0.39	0.31	0.13	0.20	0.06
Elimination of Bottlenecks	0.39	1.85	3.56	3.35	0.86	2.06	1.57	2.05	0.96	1.56	0.60
Modernization	0.48	0.82	6.34	2.43	4.16	4.46	21.70	7.40	7.94	5.28	5.20
Integration of Facilities	0.15	0.74	1.72	0.77	2.34	1.16	0.86	1.56	1.97	1.64	0.32
Move of Site	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	0.00	0.00	0.07	0.50	0.00
Leasing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	0.14	0.10	0.03	0.50	0.17
Restoration	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	0.00	0.00	0.01	0.03	0.01
Transfer	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	0.00	0.01	0.00	0.00	0.67
Total	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00

Sources: The State Planning Organization and the Undersecretariat for the Treasury and Foreign Trade.
Note: n.a. not available.

Table 5.8: Rank Correlation of the Average Annual Growth Rate in Investment Subject to Encouragement Certificates, and the Growth Performance of Manufacturing Subsectors, 1979-1989

Employment Growth	0.158*
Investment Growth	0.441**
Value Added Growth	-0.106
Export Growth	-0.161*

Sources: The State Planning Organization and the State Institute of Statistics.

Notes: The correlations cover eighteen manufacturing subsectors defined by the State Planning Organization.

* Significant at the 5 percent level.

** Significant at the 2 percent level.

Table 5.9: Export Incentives

	1985	1986	1987	1988	1989	1990	1991	1992	1993
Export Tax Rebate	.	.	.	.	.	.	.	.	.
Duty Free Import Privileges	.	.	.	.	.	.	.	.	.
Retained Foreign Exchange Earnings	.	.	.	.	.	.	.	.	.
Custom Duty, Financial Transaction Tax and Stamp Duty Exemption in Sales Goods and Services Classified as Exports	.	.	.	.	.	.	.	.	.
Exemptions from Financial Transaction Tax and Stamp Duty	.	.	.	.	.	.	.	.	.
Exemption From Corporate Income Tax	.	.	.	.	.	.	.	.	.
Temporary Import Permits	.	.	.	.	.	.	.	.	.
Transportation Premium	.	.	.	.	.	.	.	.	.
Energy Subsidy	.	.	.	.	.	.	.	.	.
Eximbank Credits	.	.	.	.	.	.	.	.	.

Sources: The Undersecretariat for the Treasury and Foreign Trade and the Official Gazette of Turkey.

Table 5.10: Share of Priority Development Regions in Total Encouraged Investment
(percent)

	1982	1983	1984	1985	1986	1987	1988	1989	1990
Agriculture	12.10	12.96	17.42	10.81	19.57	20.78	38.13	79.32	98.10
Mining	7.36	68.66	7.52	32.20	7.68	3.58	17.88	17.56	20.89
Manufacturing	3.89	5.53	9.23	5.36	17.82	10.84	19.21	21.54	41.37
Energy	0.00	0.00	1.68	18.41	0.97	3.50	3.80	0.00	66.45
Services	4.88	15.93	4.27	6.24	11.77	2.73	2.14	3.37	14.31
Transportation	4.14	21.55	5.76	7.23	19.25	4.39	2.31	3.80	5.35
Tourism	0.00	3.09	0.79	0.31	1.85	1.67	1.11	2.63	10.19
Trade	29.36	2.17	17.94	10.40	2.52	1.62	8.18	6.35	53.31
Education	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	7.24
Health	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	17.66
Others	6.74	0.00	4.00	3.70	0.07	0.98	4.59	3.11	30.13
Total	4.87	13.56	7.76	12.28	13.51	6.33	11.39	14.47	43.00

Source: The State Planning Organization
Note: n.a. not available

Table 5.11: Employment Share of Priority Development Regions in Total Encouraged Investment
(percent)

	1982	1983	1984	1985	1986	1987	1988	1989	1990
Agriculture	14.46	17.54	14.91	11.99	19.32	27.39	35.20	77.10	98.04
Mining	10.21	54.77	12.44	48.10	14.42	12.81	25.92	23.21	24.90
Manufacturing	4.86	5.90	12.26	11.96	17.99	15.15	8.60	16.59	34.35
Energy	0.00	0.00	10.87	16.41	7.83	0.49	0.19	0.00	68.25
Services	15.95	7.33	7.14	12.46	11.45	9.86	3.84	10.73	22.24
Transportation	6.92	11.17	10.29	16.63	25.28	15.44	4.62	19.66	10.07
Tourism	0.00	4.99	2.04	0.77	- 2.88	2.72	2.41	4.22	14.56
Trade	71.19	2.49	17.65	7.62	4.76	25.01	5.80	28.99	82.46
Education	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	7.43
Health	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	19.93
Others	8.30	0.00	3.51	5.53	0.15	4.00	5.43	15.57	24.26
Total	9.69	10.57	11.30	14.68	14.85	13.09	7.58	17.05	39.35

Source: The State Planning Organization
Note: n.a. not available

Table 5.12: Share of the East and Southeast Regions in Investment Encouragement Certificates (percent)

	Share in Number of Certificates		Share in Total Investment with Certificates	
	East	Southeast	East	Southeast
1978	5.28	4.88	4.93	8.61
1979	3.30	2.59	1.83	1.19
1980	4.01	3.14	2.26	1.94
1981	3.16	5.45	3.48	4.23
1982	3.27	5.92	2.32	5.46
1983	3.01	5.04	1.59	10.21
1984	5.78	4.34	3.76	5.43
1985	4.61	4.94	1.36	7.20
1986	5.16	5.33	3.04	6.61
1987	3.63	4.20	1.43	5.40
1988	3.87	5.03	2.66	11.68
1989	5.63	12.26	3.87	8.17
1990	22.22	36.23	10.84	22.57
1991	10.76	14.65	4.38	13.03

Sources: The State Planning Organization and the Undersecretariat for the Treasury and Foreign Trade

Notes

1. The author is grateful to Gokhan Capoglu, Nezih Guner and Dani Rodrik for their valuable comments on an earlier draft.

2. In understanding the investment incentive schemes published in the Official Gazette of Turkey, the author benefitted from Bali (1977), Mazlum et al. (1989), and various publications of ISO, ITO, SPO and UTFT.

3. Export incentive schemes are published in the Official Gazette of Turkey. In understanding the schemes, the author benefitted from Bali (1977), Ersun (1990), Esin (1991), and various publications of ITO, ISO, SPO and UTFT.

4. Small enterprises are defined as those employing 20 persons or less, medium enterprises cover the 20—100 range. Employment and value added shares pertain to 1985 (SIS).

5. The survey is based on a sample of 1,000 firms among members of ITO (Uludag and Serin, 1991).

6. An exception to this was a World Bank financed project to extend export credits to SMSEs. The project had been initiated in 1988 and its volume was about $ 200 million. The Eximbank authorized also some state owned banks to extend credits from this fund.

7. See Uludag and Serin (1991) for a complete list of public and semi-public bodies which extend technical help, advice and financial support to SMSEs.

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CHAPTER VI

RESTRUCTURING AND EXIT POLICIES IN TURKEY

Izak Atiyas[1]

1. Introduction

Restructuring and rehabilitation of distressed firms has been on Turkey's agenda throughout the last decade. First, the implementation of a stabilization program in the early 1980s radically changed the economic environment surrounding the corporate sector. Especially those companies that were nurtured through subsidized credit policies, or sheltered from foreign exchange risk through government guarantees found themselves faced with both significant increases in domestic interest rates and steep devaluations. Already characterized by over-leveraged capital structures, they experienced an erosion of their financial viability. Second, some firms encountered difficulties restructuring their production in line with the requirements of a more outward-oriented economy that emphasized import competition and export promotion. The viability of another class of firms, in particular those established in priority regions, was put at risk from the beginning through a haphazard system of subsidies and incentives that was rich in fiscal and financial support, but poor with respect to performance criteria, screening, and monitoring. The changing economic environment, and the reduction or elimination of subsidies simply brought to light inherent weaknesses.

The purpose of this chapter is to appraise the economic environment surrounding corporate restructuring efforts in Turkey, and in particular, to review recently implemented government policies towards distressed companies. The next section outlines the analytical framework for the ensuing discussion. The third section reviews market imperfections that hinder the flow of finance to restructuring activities. The fourth section presents an overview of experience with restructuring policies towards distressed companies in Turkey, while the fifth section makes recommendations for restructuring policies in Turkey. The final section provides concluding comments.

2. The Problem of Industrial Restructuring

A company may need restructuring for several reasons. It may have lost profitability as a result of a steady erosion of competitiveness due to an inability or unwillingness to respond to gradual changes in the economic environment. It may experience a severe shock that changes relative prices, such as devaluation, trade reform, financial liberalization or elimination of subsidies. Or it may be the case that the initial investment was badly designed and the company was not viable in the first place. In all these cases, there are basically three restructuring options. The company may be closed down, it may be reorganized and

rehabilitated, or no drastic action may be taken. Efficient restructuring requires that one of these options be implemented depending on what is socially optimal.

Reorganization often has two interrelated components. On the one hand, the assets of the company are restructured which may include a scaling down of capacity, adoption of new technology, reduction in the labour force, reorientation of marketing functions, change of product mix, change in management, etc. In addition, restructuring often entails reorganizing of the liabilities of the company, including debt write-offs or rescheduling as well as conversion of debt into equity.

Corporate restructuring decisions face important barriers. Lack of discipline protects enterprises from competitive pressure and encourages firms to delay restructuring. Barriers to mobility of capital and labour increase the costs of a necessary redeployment of resources. Resource related barriers (especially lack of skills, information and finance) prohibit firms from undertaking efficient restructuring even when enterprises feel the competitive pressure to restructure and are not constrained otherwise in redeploying productive factors.

To overcome barriers like the ones mentioned above, a comprehensive and mutually consistent set of government policies is required that creates an environment conducive to efficient restructuring. Such an environment would - by facilitating and expediting efficient restructuring in a decentralized manner — help to minimize the risk of ex-post government intervention in the restructuring process. It would also prevent politization and make sure that restructuring decisions are economically efficient.

Regarding discipline, the objective of such measures would be to increase domestic and international competitive pressure on enterprises, eliminate unconditional subsidies (that generate soft budget constraints), and establish a regulatory and supervisory framework for the financial sector. For public enterprises, enhancing discipline usually requires privatization. If privatization is not feasible in the short to medium term, mechanisms are needed that increase the autonomy and accountability of managers. As far as mobility is concerned, government policies would aim at eliminating regulatory barriers to the redeployment of labour and capital. The costs of adjustment for labour, and social resistance to restructuring may be decreased through adequate unemployment compensation as well as job training and placement mechanisms. In addition, capital mobility requires bankruptcy procedures that allow for fast liquidation or rehabilitation.

With respect to the resources needed for restructuring, among the most critical constraints are turnaround skills and finance. These two constraints are closely related, since raising funds for restructuring often requires expertise in promoting agreements between creditors and debtors. What is usually involved here is reorganization of the debtor's liabilities, as well as measures to restructure the debtor's assets and increase their profitability.

The present chapter pays particular attention to barriers constraining the availability of finance, as these have played a major role in the rescue and rehabilitation programmes

implemented by the Turkish government over the past decade. By contrast, elements of a more comprehensive approach to restructuring will be discussed in some detail in the section that will outline recommendations.

3. Agency Problems in the Finance of Industrial Restructuring

Financing the restructuring activities of a distressed firm is particularly risky. This is because financial distress aggravates adverse incentive effects or agency problems that are associated with external, especially debt financing. The literature has identified two main sets of agency problems. The first arises from conflicts of interest between owners and managers. While the main objective of owners is to maximize the equity value of the firm, management is typically interested in pursuing objectives such as maximizing perquisites, on the job consumption or the duration of employment. The second set of agency problems, more relevant to Turkey, is associated with diverging interests of creditors and owners. In particular, the owners' objective of equity maximization diverges from the creditors' objective of maximizing the value of their claims. Because of limited liability, once debt financing is obtained, owners have incentives to attempt transferring wealth from creditors by increasing the riskiness of activities of the firm.

Both sets of agency problems are aggravated when the firm experiences financial distress and its survival is endangered. Managers or owners may attempt to prolong the survival of the firm by taking undue risks. If the firm survives, owners and managers reap the benefits. If, on the other hand, the firm goes bankrupt, the losses of owners and managers are bounded from below due to limited liability. If the survival of the firm is very unlikely, owners and managers strip the assets of the firm so that for the case of bankruptcy the value of the remaining assets for creditors is very low. Hence, before they provide finance, creditors need to make sure that the resources will be used efficiently, rather than for furthering the benefits of owners or managers. Efficient use of resources requires that they be spent for restructuring with the goal of maximizing the total value of the firm.

In addition to the above agency problems, restructuring also suffers from a problem of imperfect information. This problem has to do with the fact that the true value of a firm in need of restructuring is often unknown, and so are options for its rehabilitation. In addition, information may be asymmetric, in that owners and managers may know more about the true state of the firm than other stakeholders, and may have incentives to overstate the chances for rehabilitation. These problems are less severe in countries with sound accounting and auditing practices, but likely to pose significant barriers to efficient restructuring in countries such as Turkey.

Under what conditions, then, would creditors be willing to finance restructuring activities? First they need to be able to monitor the activities of the firm concerned. And maybe more important, they often need to acquire control rights over the firm to be in a position to dictate restructuring measures. This will, of course, in many cases run counter to the interests of

managers and owners. Nevertheless, creditors will want to have a say in the management of the firm, at least until profitability is restored and the adverse incentive effects of financial distress are reduced or eliminated. Furthermore, gathering of reliable information about the firm -- a costly activity in itself -- would also be necessary to attract creditors.

Usually restoration of profitability is predicated on the adoption of a set of restructuring measures. These measures have to address both real and financial problems that impair profitability. On the real side, they include changes in the product mix of the firm, adoption of more appropriate technology, a redefinition of marketing focus (and often export orientation), rationalization of capacity, or even exit from some lines of business. On the financial side, they often include agreements between creditors and the firm to redistribute the financial claims on the enterprise. Such agreements may include debt forgiveness or rescheduling, as well as conversion of debt into equity. Besides reducing the debt burden on the firms, debt-equity conversions also grant creditors some control rights and hence make them more willing to provide additional finance. In principle, creditors would be willing to write off some of their claims, only if such write-offs, by reducing the adverse effects of excessive debt, increased the value of their remaining claims.

An important determinant of the efficiency of restructuring policies is the way in which they -- given the institutional structure of the economy -- affect agency problems. There is substantial variation among countries in their policies towards corporate restructuring. Countries also differ in the way they attempt to resolve the agency problems mentioned above. More generally, the nature and scope of government intervention in industrial restructuring exhibit substantial diversity across countries.

In stock-market based economies such as the United States and the United Kingdom, bankruptcy reorganization procedures provide one of the main mechanisms. In the US, for example, Chapter 11 of the Bankruptcy Code provides a legal framework within which debtors and creditors try to reach an agreement on a reorganization plan. The reorganization plan often entails restructuring the liabilities of the debtor, and is accompanied by a "disclosure statement" that describes actions to be taken by the debtor to restore profitability. At the same time, along with elements of the bankruptcy reorganization code, it also serves to alleviate agency problems, by imposing restrictions on the activities of the debtor. While the parties negotiate for an agreement, debtors are protected from creditors' legal actions to seize the assets of the firm. Present owners retain control rights over the firm, unless the bankruptcy judge decides to appoint a trustee to take over management. The Insolvency Act of the UK provides a similar mechanism called "administration", where, however, management of the company is automatically transferred to a trustee appointed by the creditors. In both cases, if an agreement is not reached between creditors and debtor, the reorganization procedure ends, and liquidation procedures may start. Hence, reorganization procedures allow the parties to seek ways to rehabilitate the firm and avoid its liquidation. Even though the US and UK approaches differ substantially, they do share a common feature in that rehabilitation of companies requires a minimum degree of agreement on the part of

creditors. However, in the US the retention of control rights by the debtors allows them to exercise substantial bargaining power during reorganization.

Stock-market based economies also rely on informal, or "out-of-court" reorganizations for corporate restructuring. Informal reorganizations entail agreements between creditors and debtors, without entering a formal bankruptcy procedure. Since bankruptcy procedures are costly, informal reorganizations provide substantial savings over formal reorganizations. According to recent empirical studies, firms that undergo informal reorganizations are often in a better financial state than those that enter formal bankruptcy reorganization procedures (Franks and Torous, 1991).

In Japan, where the banking system, rather than the stock market plays a major role in corporate finance, restructuring often takes place under the leadership of a "main bank" (Aoki, 1990 and Hoshi, Kashyap and Scharfstein, 1990). Bankruptcies, especially in the case of large firms, are rare. When a firm experiences financial difficulties, its main bank intervenes and appoints its representatives to join the management. The financing of corporate restructuring is provided by a consortium of creditors, led by the main bank. This practice both endows the bank with a monitoring capability, and grants it control rights. In the late 1970s and the 1980s, the government of Japan played an important role in industrial restructuring. Through special laws on distressed industries the government allowed and encouraged such industries to design and implement coordinated capacity reduction schemes in order to eliminate excess capacity.

Whereas in the United States, the United Kingdom and Japan the government has traditionally played an indirect role in corporate and industrial restructuring, the government of the Republic of Korea intervened directly in the restructuring of individual subsectors and even companies. Such restructuring typically involved capacity reduction and the acquisition of financially weak firms by stronger companies (Leipziger, 1988). Restructuring was promoted by fiscal and financial incentives and accompanied by financial restructuring measures. The government also forced the banking system to finance restructuring activities. In effect, the Korean government has attempted to resolve agency problems by directly dictating restructuring to both creditors and debtors.

4. The Turkish Experience in the 1980s

It seems that the overriding concern of the Turkish approach to restructuring has been prevention of job losses. It also seems that most of the policies targeted companies whose creditors were state-owned banks. This suggests that helping to resolve the debt problems of state-owned banks was an additional objective of restructuring policies.[1] The main element of actual or proposed government policies has been the provision of finance to keep distressed companies in business, or to rehabilitate them. Policies in this area can be summarized under three headings: the Company Rescue Law, random bailouts, and policies towards distressed firms in Priority Development Regions (PDRs).

The Company Rescue Law The first systematic effort to develop a government policy towards distressed companies in Turkey was the enaction of Law No 3322 in 1987 This law attempted to provide a legal framework for rescuing companies in financial distress by promoting negotiations and an agreement between debtor and creditor banks whereby banks would convert their debt claims into equity in the debtor company.[4] In this process first creditor banks were to draft a proposal for the financial restructuring of the debtor The proposal would include the conversion of their debt claims into equity, and the participation of third persons in the equity capital of the debtor The equity position of banks was to be limited by the value of their debt claims, unless banks also advanced cash against additional equity The third persons were required to participate with cash Creditors that did not participate in the debt-to-equity conversion had to accept a deferment of their claims for five years with no interest Social security and tax liabilities were also postponed for five years, at a "deferment" (tecil) interest rate This interest rate could be as high as one-half of the deferment interest rate determined by the Ministry of Finance All transactions in the rescue operation would be exempt from taxes and duties The new financial structure had to be such that the banks and the third persons acquired at least 51 percent of the restructured firm

The proposal, which reflected an agreement between the banks, the said third persons and the company, had to be approved by the company's general assembly The proposal had then to be presented to a government committee that consisted of the minister in charge of Treasury and the finance minister They, in turn, were to analyze the proposal and present a report, with a recommendation for the prime minister who had the authority for final approval

There were additional fiscal incentives The shares acquired by banks had to be sold to the public within seven years, starting in 1992 Capital gains made on such sales were to be exempted from income or corporation taxes

The law can be interpreted as having been designed to provide a legal fra work to encourage informal or out-of-court reorganizations The positive feature of the law was that, at least potentially, rescue of a company was left to voluntary negotiations between the creditors and the debtor In other words, a company was to be rescued only if the main creditor was willing to do so However, when the draft law was presented to the parliament, it drew severe criticism from the banking sector This criticism revolved around three issues First, the banking sector had not been consulted Second, banks complained that it was not clear whether the law intended to save the company or its owners Finally, the law was criticized for treating banks that acted "prudently" by securing themselves with collateral equally with those that did not act in a similarly cautious manner

Technically, the law had several important shortcomings and lacked a number of procedural and substantial details that would have been necessary to protect the interests of different parties It granted the largest creditor a dominant position in negotiations, leaving banks with smaller claims both out of the decision-making process, and with no options other than either accepting the agreement or suffering substantial losses in the value of their claims It did not

provide a priority ordering among different classes of creditors; in particular, it did not recognize the seniority of secured debt. The implications of conversion of debt claims into equity for assets provided as collateral against debt claims were also not clear. Moreover, it lacked an adequate check against fraudulent conveyances. In other words, no mechanism was foreseen that would allow creditors to legally assess the validity of recent transactions of the debtor that may have changed the asset and liability structure of the firm.

Finally, a legal framework that promotes voluntary financial restructuring and debt-equity conversion is not likely to be effective unless the alternative of formal bankruptcy or liquidation is a serious threat. Since owners of distressed firms are typically not willing to lose control rights, the mere existence of an opportunity for financial restructuring would not prompt firms to negotiate with creditors unless the alternative of being taken to court for bankruptcy imposes credible costs.

Formal bankruptcy reorganizations in Turkey are mainly governed by Section 12 of the bankruptcy law (Icra Iflas Kanunu), which stipulates a concordat process for firms experiencing financial difficulties. However, in practice the law has not effectively promoted corporate restructuring due to serious shortcomings (Oztek, 1993). First, the law does not sufficiently differentiate between an economic enterprise, and its owners and managers. In particular, firms whose owners or managers are deemed dishonest are not eligible for a concordat. Second, the concordat period cannot exceed four months which has proven to be too short especially for large enterprises. Third, creditors' means for controlling and monitoring the debtor are very limited so that the debtor retains significant effective control of the enterprise. Fourth, the law does not assign priority status to debts incurred during the concordat process which discourages the flow of finance for rehabilitation. As a result of these problems, the concordat procedure provides breathing space to debtors at best, or is used by them to gain concessions from creditors, at worst. Overall, it does not provide enough pressure to restructure the company and eliminate the root causes of financial difficulties. The law is also very outdated, and has not benefitted from substantial reforms in international bankruptcy laws over the last decade.

All in all, the Company Rescue Law did not become a popular means of company rehabilitation. In fact, only one prominent rescue operation took place in the context of the law (see Box: the Man-Manas Story). Banks were turned off by the requirement to float acquired shares in the market and were also hesitant to enter the business of company management, even on a temporary basis. One banker was quoted in a daily newspaper as having said: "We are not industrialists. If we put our money in the business of managing industry, our fate will be unhappy" (Gunes, March 18, 1988). On the other side, debtors were reluctant to lose control over their firms.

The Man-Manas Story

The most prominent application of the Company Rescue Law was the case of Man and Manas, companies that belonged to Ercan Holding. Man, producer of truck engines and trucks, started producing truck engines in 1984. With a capacity of 3,500 units, production dropped from 2,500 units in 1984 to 1,000 units in 1985 and further to 250 in 1987 at which point the company defaulted on its liabilities to banks. Following the breakdown of negotiations with banks, the company petitioned for bankruptcy. The government intervened and the minister of state in charge of economic affairs, convened a meeting with Is Bank, five state-owned creditor banks (together representing 60 percent of total debt) and the representatives of Ercan Holding. A new agreement was put together under the Company Rescue Law reducing participation of the holding company in Man and Manas to 20% each, and transferring majority ownership to a consortium of banks led by the state-owned Vakiflar Bank. The Ercan family did not participate in the recapitalization of the companies. Private banks (especially Pamukbank and Yapi Kredi) that did not participate in the agreement were given until noon of the day following the agreement to rethink their position, with the threat that their claims would be postponed for five years without interest if they decided not to participate. A professional team was appointed to the management of the companies. The new Board of Directors was dominated by representatives of banks. Eventually, the previous general manager of the two companies was re-appointed.

The rescue operation drew severe criticism from private banks that had not participated in the deal. Some of them complained that since the Ercan family did not participate in the recapitalization, the operation was designed to rescue the family rather than the companies involved. In addition, seniority of debt claims was violated, because debts incurred after the reorganization were to be repaid at a high interest rate, while old debts were simply postponed at zero interest.

What was the impact of this rescue operation? In late 1990, management announced that production would be resumed in early 1991, to honour contracts from the military and the government. There were also rumors that the Ankara municipality may be pressured by the government to buy trucks and buses from Manas, rather than import them from abroad. Overall, there was no indication that the rescue operation resulted in making Man or Manas internationally competitive.

Random bailouts

In addition to and independently of the Company Rescue Law, there were a series of other rescue operations in the 1980s, most of them involving direct government intervention. A synopsis of the more prominent cases is presented in Table 6.1.

The case of Metas was a saga that took almost two years to unfold. The company, a member of the Ege Yatirim group, stopped production due to financial difficulties in early 1990. In the following two years several attempts at reaching an agreement between creditor banks and

the company to convert debt claims into equity failed. Likewise, efforts to obtain concessions from workers, in the form of reducing wage claims or relinquishing severance claims in exchange for shares remained unsuccessful. The company was finally rescued in 1992 after a two year delay. In another case (that of Izdas) the main creditor (Is Bank) simply took over two debtor companies (IDC and Asmas).

In many cases rescue operations -- under pressure from the government -- were led either by state-owned banks or by Is Bank. Sometimes state-owned companies were used as instruments of bailouts where the decision to extend credit to troubled companies was often taken by the Higher Planning Board (Yuksek Planlama Kurulu, YPK) and financing was secured by the Public Participation Administration (KOI). For example, a food processing company in Erzincan was bought by a state-owned meat and fish producer. In the case of Beslen Makarna, another food processing company, the YPK simply ordered the Soil Products Office (Toprak Mahsulleri Ofisi, TMO) to acquire the company.

The main feature of these operations is that the identification of companies to be rescued did not rely on any objective criteria. There were no detailed public pronouncements on how rescue decisions were taken, or why a particular financing package was preferred to another. In that sense, random rescue operations were even worse than the Company Rescue Law. Ultimately, random rescues have been seen as reflections of political calculations rather than a systematic effort to promote efficient restructuring.

Distressed firms in priority development regions (PDRs). For (public and private) firms in the PDRs policy makers tried to develop a more concerted strategy. The problems of these enterprises were assessed in a report by the State Planning Organization (SPO, 1990). In this report the criteria for identifying "problem enterprises" were the following: plants that operated with excess capacity; projects that had been eliminated from investment programmes; plants that were used for purposes other than those initially identified, and plants that had been or were to be privatized, i.e., had already been sold or transferred to the Public Participation Administration.

These enterprises were promoted as part of a regional development effort that provided substantial fiscal incentives (especially customs duty exemptions and investment tax allowance on taxable income), and subsidized credit mechanisms (from the Resource Utilization Support Fund). Incentives were granted without sufficient project screening, monitoring and enforcement of performance criteria. As a result, many of the promoted enterprises are not viable at competitive product and factor prices.

According to the aforementioned report many private companies had locational problems. They were either far away from suppliers of inputs, or their operations were predicated on the completion of public investments which had been discontinued. Some projects were initiated in the 1970s and financed by foreign-exchange denominated credit without exchange rate guarantees, so that they became financially unviable as a result of devaluations. Others did

not have access to working capital or were not viable at prevailing interest rates. In some sectors (e.g. flour and meat processing) incentives resulted in the establishment of too many firms and excess capacity. Similarly, projects in the public sector were initiated with inappropriate locational and technological choices. Many of the firms did not have access to inputs, product quality was low and sales units were incapable of responding to changes in patterns of demand. In many cases, projects were not completed; while buildings were constructed, purchases of machinery and equipment were not made.

In the public sector, a total of 104 enterprises were identified as problem plants. Ten of these enterprises were transferred to the Public Participation Administration and sold to private owners. As of 1991, ten more had been put in the pipeline for privatization. Privatizations were realized through payment plans with maturities ranging from three to ten years. However, some of the problem plants benefitted from subsidies without producing. The rest of the 84 state-owned enterprises consisted of those producing with excess capacity (64), those whose investment programmes were interrupted without completion (13) and those that were used for "other purposes".

In the private sector 129 problem enterprises were identified. Of these, 57 companies were producing with excess capacity, 13 had not completed investment, while for 30 companies investment programmes had been completed without the companies operating.

One approach towards firms of the type described previously was advanced by the Turkish Development Bank (TKB) (TKB, 1991). The proposed solution envisaged the establishment of a Priority Development Region Fund. This fund was to be used to complete unfinished investment projects, to initiate production in non-operational plants with completed investment projects, to meet working-capital demands of plants working with excess capacity, and to finance technical assistance, training and consulting services. The fund was to be managed by the TKB, which was to earn a two percent commission on credits advanced from the Fund.

The TKB also proposed that defaults on the principal and interest on credits advanced from the Fund be treated as losses on the Fund's account, thereby absolving the TKB from any credit risk. This proposed allocation of credit risk to the Fund rather than to the TKB - which is supposed to manage the Fund - is seriously flawed. Currently a minimum of ten percent of the Public Participation Fund is required to finance investments and working capital in the priority development regions. These resources are intermediated by the TKB which also bears the credit risk. In recent years applications from problem enterprises in the PRD to obtain loans from the Public Participation Fund were rejected because the enterprises were deemed as too risky or unviable at the prevailing interest rate applied to these funds (30 - 35%). Hence, proposing to shift the credit risk to the Fund was a conscious effort to protect the TKB from being exposed to companies that the TKB itself has identified as not being creditworthy.

A large number of private enterprises in the PDRs are "workers' companies" established during the 1970s with equity capital from Turkish workers abroad. The DESIYAB (now the TKB) also designed a model for the rehabilitation of these companies (DESIYAB, 1986). The model is noteworthy in that it includes both financial and real restructuring measures to rehabilitate the companies. However, it also has several important shortcomings. First, the restructuring options that it presents are biased in favour of rehabilitation and against closure and exit. According to the decision tree implicit in the model, identification of the enterprises' problems is followed by the design and implementation of rehabilitation measures. This is clearly inefficient, since the identified problems could be such that rehabilitation may no longer be a viable solution, and closure or partial exit may be required. Second, even though the model implicitly acknowledges the importance of agency problems and conflict of interests — and therefore proposes mechanisms whereby the DESIYAB would be able to monitor the implementation of the proposed rehabilitation programme — it is nevertheless inflexible in that it aims at preserving the main ownership structure of the enterprises even in cases where creditor banks participate in the enterprise's capital (DESIYAB, 1986, para 2.2.4.1). A priori, there is no need to restrict the options available for the restructuring of capital. Similarly, regarding the management of a company, the model mentions measures "to support higher management" and rules out, for example, a complete change in management.

5. Recommendations for an Approach to Industrial Restructuring

Priority development regions. The main difficulties of many of the "problem" enterprises in PDRs are structural, and many of these enterprises are not viable at competitive product and factor prices; hence, their survival is likely to require a continuous flow of subsidies. The first step in any attempt to restructure companies in the PDRs is to de-couple the restructuring problem from the regional development or employment problem. The value of an additional job in the region and the subsidy that it deserves should be established independently of the cost of restructuring. Then, the costs and benefits of different forms of restructuring need to be assessed, given the volume of subsidies.

As a matter of course all options of restructuring — as, e.g., non-interference, reorganization, relocation or exit — should explicitly be considered before any action is taken. Enterprises that are assessed as being unviable even when developmental subsidies are taken into account need to be closed down and their assets sold. Such enterprises are unlikely to have any positive developmental impact in the PDRs. Any attempt to rehabilitate them would only raise false hopes and cause eventual disappointment. In effect, such efforts will hinder, rather than promote efficient restructuring.

Naturally the question arises about who should act as the restructuring agent. Here it can be stated that the identity of this agent is less important than the principles that should be followed. First, the restructuring agent should have a stake in the restructuring process. In other words, the agent should share in the risk of restructuring and bear the credit risk of its

financing. Second, the agent should take the subsidy parameters as given and best not take part in the formulation of subsidies. Third, restructuring should rely on a serious feasibility study that identifies the costs and benefits of alternative restructuring options.

Restructuring options for non-priority regions. With respect to the economy as a whole, the policy objective should be to create an environment which encourages and enables restructuring activities to be undertaken in a decentralized manner and which minimizes direct government intervention. Random rescue operations should be eliminated, since they simply generate unwarranted unequal competition and are seriously vulnerable to politization. Outright subsidies for rehabilitation should also be ruled out, and restricted to explicit developmental goals. The question of whether a distressed company deserves any additional support should be left to creditors. Instead, an approach that focuses government intervention directly on market imperfections is needed. There are two critical areas that deserve the government's attention.

The first relates to financial resources. The government's attempts to encourage the banking system to play a major role in restructuring -- as was the case with the Company Rescue Law -- has so far failed, in part because commercial banks lack the expertise and willingness to participate in or take over enterprise management. Banks are also constrained by recent banking regulations that limit equity participation. This reluctance to assume control rights of enterprises makes banks also unwilling to finance risky restructuring activities.

One solution would be to promote market agents that specialize in company workouts. Such agents have two sets of skills. First, they have sectoral expertise, i.e., they either contain or have access to expertise regarding appropriate technology, product mix, marketing skills, and export opportunities. Second, they have financial engineering capabilities, enabling them to negotiate agreements between creditors and debtor companies in need of restructuring. Moreover, they perceive the restructuring activity as a source of profits. They either provide their services for a fee that is tied to the success of restructuring or temporarily assume the ownership of enterprises with a view to sell them, in a reorganized form, at a profit. In both cases they have a stake in the company to be restructured. Such agents may be hired by the main creditors who delegate to them the monitoring and control functions that are necessary to deal with the agency problems discussed above.

Agents that specialize in corporate workouts often engage in informal reorganizations without getting involved in a legal bankruptcy procedure. Outcomes of informal reorganizations, however, depend critically on the nature of bankruptcy procedures. Bankruptcy reorganization procedures complement informal reorganizations. Reforming the legislative framework for the concordat process would substantially improve the policy environment for restructuring.

Most random bailouts in Turkey have been and are being carried out without any serious feasibility studies. Resources spent for these operations would be used much more efficiently if they also financed such studies. Information about the viability of firms in need of

restructuring is essential for efficient decisions as well as for raising the necessary finance (especially from private financial institutions)

Reforming the bankruptcy system in Turkey would also help increase the flow of financial resources for restructuring. This is especially true for the concordat process. The current code attempts to accomplish in a few pages what in most modern legislation is a major branch of law in itself and an important component of exit policies. The law needs to be re-written. The reform of the bankruptcy law should devote critical attention to the issue of how to distribute control rights over the debtor firm's assets between the debtor, the creditors and the court. Delegating substantial control rights to creditors and providing some priority status to debts incurred during the concordat process should be given serious consideration.

The second critical area relates to labour mobility. Concerns with unemployment or its political consequences have often delayed or otherwise hindered efficient restructuring. In general, labour mobility may be enhanced through unemployment compensation schemes as well as job placement and retraining services. Once these measures have been taken and the cost of unemployment to workers has been adequately addressed, the restructuring options can and should be decoupled from the unemployment question.

Restructuring of state economic enterprises (SEEs). This is likely to present special problems. In some cases, closure of SEEs is bound to have serious regional implications, as would be the case, for example, with coal mines in the Zonguldak area where displaced workers would not find job alternatives in the same region. In such cases, unemployment compensation schemes may be supplemented by regionally targeted public programs that increase the productivity of private investments in a region (van Wijnbergen, 1992).

In order to generate benefits that can be sustained over time, restructuring of public enterprises often requires fundamental changes in the way they are being managed. In Turkey, as in many other developing countries, public enterprises face two types of managerial problems. First, enterprise management is often subject to political influence where in particular employment and investment decisions are critically influenced by political considerations. Second, the management of public enterprises is rarely held accountable for the competitive performance of enterprises. These problems are both major causes for the poor performance of public enterprises and major barriers to restructuring. The most efficient way to solve them seems to be privatization. However, if that strategy is not applied, mechanisms establishing accountability and autonomy are required. Such mechanisms should both link managerial reward to performance, and enable the monitoring of performance against clearly formulated criteria.

6. Concluding Remarks

The Turkish government's approach to restructuring and rehabilitation of companies has serious shortcomings. A major one is that it does not clearly distinguish between economic efficiency and socio-political objectives. As a result, restructuring decisions, including the choice of companies and restructuring options, often appear arbitrary and lacking objective criteria. Moreover, rehabilitation is usually carried out with a weak information base where in particular feasibility studies are rare if not absent. More often than not companies are rescued without a clear assessment of whether they can become viable or how costly their survival would be.

A more efficient approach to restructuring requires that technical decisions be taken independently of socio-political objectives: the latter should be subsumed in clearly designed subsidies, unemployment compensation, training and job placement schemes which should be taken as given when restructuring options are chosen. Production of relevant information should become an essential component of industrial restructuring.

The government should refrain from getting directly involved in the restructuring of individual enterprises and should limit its role to that of formulating general policies. These policies would best aim at creating an environment conducive to restructuring and target identified market imperfections. To give an example of the latter, the government may play a significant role in promoting the development of skills and private agents — such as turnaround entities — that are critical for restructuring. In addition, to enhance labour mobility and to decrease the costs of adjustment to labour, the government should develop unemployment compensation schemes as well as retraining and job placement programmes.

Table 6.1: Company Rescue Operations

Name of Company	Nature of Rescue Operation	Date
Tobank	Ziraat Bank, Halk Bank and Emlak Bank became partners, providing TL 12 billion of financial support	April 21, 1987
Turk Otomotiv Endustrisi	Applied to the Capital Markets Board, requesting support to repay TL 20 billion debt	May 9, 1987
Gulum Sut	49% of shares offered to Ziraat Bank in exchange for payment of TL 26 billion of debt	January 8, 1987
Man-Manas (Ercan Holding)	In exchange for TL 122 billion of debt, banks took over 80% of shares, leaving 20% to Ercan Holding	October 2, 1989
Narin Holding	68% of shares taken over by creditor banks in exchange for debt relief of TL 40 billion	June 13, 1988
AK Gubre	Rescued by state-owned petroleum company	December 9, 1988
Izdas	Is Bank acquired minority shares in two subsidiaries, Izmir Demir Celik (20%) and Agir Makine Sanayi (49%) in exchange for Izdas' debt	November 18, 1988
Erzincan Gida Maddeleri	99.8% of shares bought by the state-owned meat and fish company in exchange for the company's debt	March 3, 1990
Metas	Five banks became partners. The claims of 27 other banks frozen for 8 years	March 14, 1990
Beslen Makarna	41% of shares bought by the Soil Products Office	April 8, 1991
Vestel	State-owned banks provided US$70 million credit	January 7, 1991
Pinar Et	TL 30 billion of credit advanced by the Public Participation Administration	June 1, 1991
Paktas	Bought by the state	June 9, 1991

Source: Major Istanbul daily newspapers

Notes

1. The author is grateful to Cevdet Denizer, Hasan Ersel, Tulin Ersel, Refik Erzan and Ozer Ertuna for helpful comments on an earlier draft.

2. This section summarizes the arguments contained in Atiyas, Dutz and Frischtak with Hadjimichael (1992).

3. The term "state-owned banks" should be defined broadly to include Is Bank — even though strictly speaking Is Bank is a private firm — since its credit policies have been influenced by political considerations.

4. The law was prepared in cooperation between the Ministry of Finance and "a large Bank" (Milliyet, Feb. 26, 1987).

5. For example, a firm that owed TL one billion and did not want to repay could approach a "friendly bank" and get a loan of TL three billion, granting this new bank the status of the "largest creditor". An agreement with this bank, then, could be used to jeopardize the claims of other creditors. The law did not provide for any remedies against such actions.

6. The Turkish code contains some additional sections that were designed to promote the rehabilitation of distressed firms, but have not proven effective. For a detailed discussion, see Oztek (1993).

7. The degree to which the concordat can be used by debtors to threaten creditors through delaying or suspending their debt collection attempts has been limited by recent amendments. These amendments have also accelerated debt collection procedures, in particular by making it more difficult and more costly for debtors to raise unsubstantiated objections to debt claims. However, there is still ample scope for objections, especially under bankruptcy, the resolution of which take a long time mainly because of delays in the judicial system. Since interest rates applied to unsecured loans are below the rate of inflation, debtors may reduce the real value of unsecured creditors' claims, and increase the possibility that liquidation proceeds will surpass the value of liabilities, simply by delaying the process. In addition, creditors have complained that in practice debtors often influence the choice of the commissioner and therefore may tilt the concordat procedure to their advantage.

8. Several East European countries are currently trying to design legal frameworks that attempt to promote out-of-court negotiations between creditors and debtors to restructure distressed enterprises. One of the objectives of these attempts is to delegate the main task of restructuring to commercial banks, and consequently to decentralize the process. For details, see Atiyas (1993).

9. For example, a cheese and butter factory was not operational because it did not have access to milk.

10. See Atiyas, Dutz and Frischtak with Hadjimichael (1992) for a detailed discussion of such "turnaround entities".

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CHAPTER VII

COMPETITION LAW AND ITS RELEVANCE FOR TURKEY

Mark Dutz[1]

1. Introduction

The process of deregulation and the increasingly free-market orientation of the Turkish economy over the past twelve years is having an important impact on competition and competitiveness. As remaining government controls and regulations are being reduced, an important policy question is about whether new measures should be introduced in order to improve the performance of markets.

This chapter provides an analysis of the likely consequences of introducing a competition law in Turkey. In principle, the design of competition laws and any changes to such laws should reflect the country's economic goals, prevailing market forces and also the basic features of the national legal system and judiciary. Competition laws, if appropriately designed, play an important role in creating or maintaining well-functioning, competitive markets.

One of the main tenets of the present chapter is that an appropriately designed competition law should be established also for the Turkish economy. Such a law can be a critical component in promoting a more open, competitive and predictable environment for the benefit of businesses and individual consumers. Quite importantly, the law would provide businesses with an economic code of conduct, i.e., a description of what is acceptable business behaviour. In this sense, competition legislation plays an educational role, signalling to business that competitive, efficiency-enhancing conduct is desirable and that, conversely, cartel formation and price fixing are unacceptable. At the core of any such regime should be guidelines making businessmen fully aware of what actions are detrimental to the public interest.

While a well-designed competition law and its active enforcement can help promote competition, experience from many countries shows that such regulation should be used in a very careful and limited manner, to ensure that these policies do not stifle competition. It may be best, at the outset, to restrict the scope of activities of competition authorities in Turkey by having high thresholds for specific rules below which enterprises would be exempted. Such thresholds could be lowered over time, once both public understanding of the rules and the administrative capacity to enforce them have increased.

In the following section, a brief survey is provided of the principles and procedures underlying competition law in most countries. Such an overview is useful to put the current Turkish draft law in an international context. Next, the main features of market concentration

as well as private and public ownership in major Turkish industries are examined. Finally, the chapter provides a few recommendations for competition legislation in Turkey.

2. Competition Law: A General Regulatory Framework

Competition law is a legal code which governs the economic relations between economic actors by defining the "rules of the game" in the business arena in relation to conditions of competition in the marketplace. Unless specific exemptions are provided, the law generally applies to all sectors of economic activity within given geographic boundaries. In other words, it is a general law of general application (with the potential for limited exemptions). The legislation generally defines the types of conduct and transactions that are deemed undesirable — i.e., do not promote the goals of the law — describes the relevant penalties, and provides an institutional structure to enforce its prohibitions.[2]

Objectives of competition law In OECD countries there is a broad consensus that competition law is intended to promote, maintain or protect "effective competition" or "the competitive process", by eliminating or preventing both restraints on trade and abuses of economic power. However, in addition to this broadly accepted objective, there are often a variety of other economic, social or political goals that competition law is intended to achieve. They include the protection of individual enterprises from unfair hinderance, the protection of small business, the promotion of pluralism, the maintenance of fairness and honesty in the marketplace, and inflation control.[3]

The extent to which competition law is intended to promote supplementary objectives varies across countries. One of the supplementary objectives of the European Union (EU) competition law, for example, is to promote economic integration; in this context, the EU law is intended to help ensure that regulatory barriers eliminated in the creation of the common market are not reintroduced through anticompetitive practices of private or public enterprises.

There are some differences among industrialized countries as regards broad objectives. Thus, the general goal of the United States antitrust law and the Canadian competition law is to prevent the unilateral or collective abuse of "market power" (the ability to raise price by restricting output) with the underlying objective of promoting economic efficiency and consumer welfare. Consequently, the emphasis is placed predominantly on protecting and promoting the competitive process. By contrast, the general goal of German, British, French and EU laws is to prevent — in a broader sense — the abuse of "dominance". While limiting the exercise of market power, the European laws also defend a legal right to commercial opportunity by preventing a "dominant" enterprise from restricting business options of smaller rivals or trading partners. That is, maintaining "freedom of economic action" is central to the European approach towards competition legislation.

While the specific goals of these and other countries' competition laws differ to some extent, there is an increasing convergence of views that competitive behaviour, even if fairly

aggressive, should not be restrained, as long as no overt predatory intentions or monopolizing objectives are likely to succeed. Competition often leads established enterprises to introduce new products and processes, and requires weaker rivals to restructure operations or exit. This Schumpeterian process of "creative destruction" is as essential to economic progress as the entry of new actors in the market. Certainly, neither entry, expansion nor exit should be impeded by competition law. Enterprises that have achieved a leading position in a market through effort and skill should not be penalized, since it is precisely the hope for high profits that motivates businessmen to investigate market conditions, plan their response, and risk their capital. It is critical, however, to distinguish between enterprises that attain a dominant position through offering consumers high quality goods at low prices, from those that attain such a position through anticompetitive exclusion of other suppliers.

Generally, there appears to be a tension between multiplicity of objectives and independence of administration of a competition law. To the extent that the law attempts to promote objectives supplementary to economic efficiency, the risks of inconsistent application increase. It is therefore desirable to restrict the objectives of competition law, or at least make them as explicit as possible, both in their definition and ranking. It would also be desirable to announce how conflicts between the promotion of competition-policy objectives and other public-policy objectives will be resolved, as well as to ensure consistency in government decision-making and thereby reduce business uncertainty. To avoid ambiguity, it would be desirable to announce whether or not competition policy is viewed as the fourth cornerstone of government economic policies, along with monetary, fiscal and trade policies, and to what extent the formation of other government policies will take competition policy concerns into account[4].

Institutional development of competition laws Over the past few years, many countries strengthened or substantially modified their existing competition laws (such as Canada, Belgium, Denmark, Greece, Ireland, and the EU). In addition, a considerable number of countries introduced competition legislation for the first time (such as Italy, Venezuela and various countries of Eastern Europe as well as States of the former USSR). Still other countries, such as Argentina, Austria, Colombia, Finland, Norway, and Sweden are in the process of amending their existing laws. All these developments are motivated by international and country-specific factors, including the global impact of deregulation and an increasingly free-market orientation in many countries, changing domestic and international business practices, and evolving approaches to what constitutes an appropriate public policy stance to the promotion of competition.

Canadian and United States competition laws have evolved over more than a hundred years through jurisprudence, precedents and explicit policy changes. The background to the enactment of a new competition law in Canada in 1986 is instructive because it highlights the extent of preliminary work that is often done before successful adoption of such a law. It should be mentioned here that Canada's original legislation (1889) was not enforced for more than ten years because of its ambiguous wording, the lack of any specialized enforcement agency, and the inadmissibility of private actions. In the subsequent eight or nine decades

the law underwent various changes, but remained entirely ineffective in one important area, namely merger control. A major impetus for change came in 1966, when the government directed a state-funded think-tank (the Economic Council of Canada) to study and recommend changes to the law. Over the next 20 years two different proposals were withdrawn because of intense opposition from business. The final version was only adopted after extensive consultation with business groups as well as consumers, labour and academics) and taking into account substantial input from these groups into the drafting of the legislation. There appears to be a consensus among officials within the Canadian Bureau of Competition Policy that many objections to earlier attempts to introduce new legislation were well placed and helped improve the final draft.

All the changes in competition legislation in Western Europe over the past few years have at least in part been motivated by the acceleration of the European integration process which created momentum for countries to enact policies consistent with those prevailing at the EU level. With very few qualifications, the main inspiration of all current EU members has been the EU competition rules, notably Articles 85 and 86 of the Treaty of Rome (1957). Most EU countries have enacted legislation that closely follows the wording of Articles 85 and 86, so that domestic enterprises would face similar, harmonized rules in the home market in addition to those that they already faced in transnational markets under EU jurisdiction. This is particularly important in the context of fostering economic integration and facilitating business transactions. It should be mentioned, however, that there has been and is no legal obligation for any of these countries to adopt new national legislation that is similar to EU law.

In general, enactment of legislation by countries that were amending existing laws followed several years of discussion. In the case of Denmark, for example, the new Competition Act that was finally passed by Parliament in 1989 (replacing the Monopolies Act 1955 and the Prices and Profits Act 1974) was the result of a process dating back at least to 1984. In December 1984, the Minister of Industry appointed an expert committee to analyze the existing control of monopolies and make proposals for modernization. This report, released in 1986, contained both a review of competition laws of Scandinavian countries, the United Kingdom, Germany, the United States and the EU and an analysis of changes in trade conditions and market structure in Denmark since 1955, in addition to a proposal for a new law with carefully argued reasons (OECD, 1988, pp.81 - 2). The report was submitted to a large number of organizations for discussion and comment, and further studied by a Committee of Ministers and a parallel Committee of Heads of Departments before being introduced to Parliament.

As another example, the enactment of the Irish Competition Act in 1991 (replacing the Restrictive Practices Act 1972, certain provisions of the Mergers, Takeovers and Monopolies Act 1978, and the 1987 RPA amendments) followed analyses, discussions and debate dating back at least to 1988. In January 1988, the Minister of Industry and Commerce asked the Irish competition authorities to undertake a detailed "Study of Competition Law", more specifically, the merits and disadvantages of changing the regulation of competition, with

particular reference to the required administrative and legal changes to base the new Irish law on existing EU law, to the experience of other EU countries, and to the implications of having different exemptions at national and EU levels (OECD, 1991, p. 145). The report, completed in 1989, was submitted to the Minister together with the proposed new act. A major motivation of this legislation was to prepare Irish companies for the increased competition which was expected to follow the completion of the European Internal Market.

The case of Italy is perhaps the most relevant one for Turkey, since until October 1990, Italy and Turkey were the only two of the 24 OECD countries that lacked any specific legal provisions for the protection and promotion of competition. Though many bills were debated by the Italian Parliament between 1950 and 1990, none was adopted because of lack of consensus in political, business and labour circles. In the 1950s and 1960s, educated industrialists apparently considered competition law to be "something between a 'naive' useless idea of the Americans and an instrument to deprive the market system of its freedom in favour of 'colonizing' American enterprises". Trade unions and left-wing parties, on the other hand, preferred nationalization to policies that would reduce public control and risk substantial unemployment. In the 1970s it was felt that competition law would prevent Italian industry from becoming bigger and stronger. It was only in the 1980s that a new climate began to develop, both at the domestic and the international level. Gradually, opposition from big industries decreased with growing evidence of the importance of a competitive market structure for the diffusion of new techniques and a larger proportion of the population accepted the idea that greater competition could make the economy healthier and thereby also increase employment (Ughi, 1991, p. 38).

In 1986, the Minister for Industry, Trade and Crafts set up a special commission (committee of experts) to study competition in the Italian economic system. The commission's responsibilities included a detailed study of the Italian industrial structure and conduct, an analysis of prevailing entry barriers, an assessment of the impact of lack of competition on consumers and on the efficiency of the economy, and proposals for legislative and administrative changes to improve competition (OECD, 1988, p. 141). Likewise, the Senate's Industry Commission made a detailed survey of competition, including a long series of interviews with experts from the fields of economics, manufacturing and competition policy. Following the publication of reports in 1988, the presentation of two draft competition laws to Parliament, and an extensive debate, the new Italian competition law was finally enacted.

As a final example, the development of the Russian Antimonopoly Law, enacted in 1991, occurred over a much shorter time frame with initial work dating back to 1989. One interesting wrinkle in the development of this law is that Gossnab (the State Committee of Deliveries and Supplies) — one of the main regulating bodies of the former regime — first wanted to establish such a law, in order to both maintain control over powerful enterprises and carve out a new mandate for itself that would support its power. Two independent parallel groups of economists and lawyers worked on the first drafts, with a second draft written by more senior lawyers. The subsequent decree on competition policy benefitted from substantial input through a series of working group meetings coordinated by the OECD, and

including competition policy specialists from various European countries, the United States and Canada. The process of revision has continued after enactment of the law, with frequent consultations with Western competition policy experts and the recent publication of detailed guidelines that interpret and provide the context to the original legislation.

The treatment of market conduct Most forms of commercial behaviour that attempt to impede the competitive functioning of markets, either through unilateral or concerted action, can be classified either as horizontal or vertical restraints. While "horizontal restraints" are based on arrangements between competing suppliers in the same market, "vertical restraints" arise from arrangements between a supplier and business customers in different upstream and downstream markets. All industrialized and industrializing countries that have competition laws have prohibitions against different types of horizontal and vertical restraints.

An important distinction for the authorities in deciding whether a particular conduct is illegal is whether a "per-se" approach or a "rule-of-reason" form of analysis should be used. For the per-se approach it is sufficient to show that the alleged conduct has in fact occurred. No analysis of the actual effects on competition of the conduct is required. On the other hand, under the rule-of-reason approach, the particular conduct must be examined in detail, and will be held illegal only if economic analysis of its effects shows that it is sufficiently detrimental to the goals of the competition law. In general, competition laws apply the per-se standard to types of conduct for which the harm to competition is obvious and relatively undisputed, since the approach is inexpensive in terms of enforcement resources and provides a clear, transparent message that specific types of conduct are unacceptable regardless of the context. For these types of conduct, penalties tend to be more severe in order to act as a strong deterrent. In the United States, for example, the Department of Justice generally brings criminal cases against conduct that is illegal per-se (e.g., under Section 1 of the Sherman Act), with the possibility of substantial fines and imprisonment publicized widely for more effective deterrence. In contrast, offenses that are illegal under the rule-of-reason approach almost always are conducted under civil procedures, with less severe penalties.

Horizontal restraints to competition in a particular market, by allowing higher and less efficient pricing (approaching that of a monopolist) and by excluding potential competitors, raise competition law concerns based on both market power and dominance standards. Just as independence among competing suppliers in a given market is at the core of competition, prohibitions against cartel behaviour are central to appropriate competition law. Price fixing, that is, a cooperative cartel agreement on pricing between enterprises in the same market, is usually perceived to be the most damaging form of horizontal restraint. It is not surprising, then, that horizontal price fixing, along with agreements to bid collusively or to limit production and allocate customers are generally illegal per-se in industrialized countries.

Vertical restraints to competition typically restrict the geographic area, the types of customers, the services provided, or the prices at which a distributor must sell the products of a supplier. In many countries, the competition law treatment of such conduct is less strict than with horizontal restraints, since these practices often tend to be efficiency-enhancing and

procompetitive in their ultimate effect. Because the impact on competition of most vertical restraints is less clear (absent a case-by-case analysis), most industrialized countries adopt a rule-of-reason approach to such conduct in their laws.

The treatment of market structure In recent years, the regulation of structural changes in the relationships among enterprises — including mergers, asset transfers, technology licensing and joint ventures – has become a very important means of pursuing the goals of competition law. For emerging market-economy countries with sizeable state ownership of productive assets structural competition rules are playing a significant role in guiding the privatization process and ensuring that the resulting environment does not become excessively concentrated. More generally, regulation of market structure is widely recognized as an important complement to the regulation of market conduct in that it preserves the independence of enterprises in specific markets and makes monopoly-like behaviour more difficult. In addition, even if merger control does not finally result in a pattern of asset transfers different from that of an unregulated environment, the economic analysis that generally follows premerger notification can be critical in uncovering other forms of anticompetitive behaviour in related markets.

In many countries, including France, Germany, the United States, Canada and the EU at large, competition laws control mergers by blocking certain transactions which would create or increase interdependence between enterprises in a market through a formal process known as "premerger notification".[11] An economic analysis of the effect of the structural transaction **before** the actual transfer of assets is deemed critical, since it may be much more costly to break up anticompetitive structures once internal changes in the enterprises' configuration have been introduced. In the event that the proposed transaction is deemed undesirable, it appears to be advisable to keep enterprises at some distance from each other until the economic analysis is completed, since this also prevents an exchange of commercially sensitive information between the parties. Important considerations in the formulation of such rules include a delineation of the types of enterprises that must notify the competition agency of their merger proposals, the information that must be included in such notification, the time the agency is allowed for an analysis of the proposal, and the criteria to be used in the evaluation of the proposal.

Although countries differ in the standards they require for prenotification, most of them base their selection on the presumption that large transactions by large enterprises are of greater concern than smaller ones. While Japan, for example, requires notice of all corporate asset transfers, the United States require prenotification only of enterprises that meet specific criteria with respect to the "size of the parties" (under the 1976 Hart-Scott-Rodino Act, one of the enterprises must have annual sales or assets of at least $100 million while the other of at least $10 million) as well as the "size of the transaction" (the value of assets of the acquired enterprise must be at least $15 million and at least 15 percent of the assets of this enterprise must be acquired). The EU on the other hand applies a standard based on a size of the parties threshold, that is derived from world, EU-wide and country-wide sales. It is to be noted that the critical shortcomings of standards based on local or national market shares

are that they are neither simple (an enterprise may not know the total sales in the specified market) nor easily enforced (in particular, the definition of what constitutes a "market" is not at all transparent, and the different parties will have opposing incentives for choosing a particular definition).

The type of information that must be included by enterprises in premerger notification depends on the country's constitutional law and the consequent scope of investigative powers of the competition agency. In the United States, for example, the information requirements are very extensive (including sales by product lines, owners of large blocks of shares, and all internal documents analyzing the rationale and impact of the transaction). EU requirements are even more extensive. Importantly, in both cases, the beginning of the premerger waiting period is conditioned on the provision of particular information, which creates an incentive to avoid delay on the part of enterprises. While in countries with lower levels of constitutional protection of private and commercial confidentiality the competition agency usually enjoys a greater power of investigation, it still remains critical to structure the incentives facing all parties in order to avoid unnecessary delay.

A clear understanding by all parties of the time period and the criteria relevant for the competition agency's economic analysis is important too for reasons of transparency, expectations and avoidance of delay. While the time period will shorten with the agency's growing experience with analyses, a relatively strict, time-bound process is important from the beginning. The EU, for example, allows one month after prenotification to decide whether an investigation should be initiated and four months after prenotification to decide whether the merger should be blocked. The United States provide one month before the merger can proceed with another 20 days if additional information is required. In practice, these time frames do not matter much because enterprises usually cooperate with the competition agencies to close their transactions successfully. An important feature of the EU (and a few other countries') rules is that the merger is deemed approved, once the time period allowed for study has elapsed and no formal decision to the contrary has been made.

Finally, the statutes of most countries describe the criteria that a competition agency should use to judge the balancing of competitive loss from merger with any public benefit. In the United States, for example, a horizontal-merger investigation follows a series of discrete steps, including the delineation of the relevant product and geographic market, the identification of enterprises participating in the relevant market, a calculation and interpretation of market shares and concentration, an assessment of the ease of entry, a consideration of other factors (that may influence the ease and stability of collusion in the market) and an assessment of any efficiencies arising from the merger.[11] European merger control, on the other hand, is more concerned with the absolute size of enterprises, and mergers have been blocked where at least one party was a large enterprise (even though the enterprise may not have had significant market power).

Enforcement practice The administrative means by which competition law is enforced vary considerably throughout industrialized and industrializing countries. An understanding of such

differences in enforcement practices, and of how a particular country's competition law can be tailored to its own economic circumstances and national goals is important for identifying the appropriate type of legislation for a given country. Whether enforcement is subject to administrative or judicial review, whether it is public or private, and whether penalties include compensatory or punitive damages are critical questions.[12]

While the EU, Germany, the United States and Japan are prime examples of judicial enforcement of competition law, the United Kingdom uses administrative enforcement for merger control and so does Mexico in an even more general fashion.[13] The main difference is that under pure administrative enforcement, there is no judicial review at all. Enforcement decisions are taken by a separate quasi-judicial body which is subordinate to elected officials. All judicial forms of enforcement include some judicial review. Although the flexibility of administrative agencies may be limited by legal constraints on their conduct, administrative enforcement without judicial review generally has very wide discretion, and often can be too responsive to changing political and economic circumstances.

The degree of centralization of enforcement also varies across countries. In the United States, for example, there are in addition to two federal competition agencies also state antitrust laws as well as provisions for private actions. Regarding the latter individual private parties can have the competition law enforced directly through the courts. Enforcement of competition law in the United Kingdom, by contrast, is reserved to the central government agency. There are several potential advantages to private lawsuits, but there are of course also costs. In cases where success of a suit is relatively certain, private lawsuits promote voluntary compliance. In addition, the development of efficient legal standards can be influenced by private incentives to sue. When private litigants must bear associated costs, they will likely choose to litigate precisely in those instances where they are most directly affected by a specific standard and expect to influence its evolution.

The structure of penalties can affect the degree of voluntary compliance with competition laws. Some countries allow the injured party to recover punitive damages in addition to compensatory damages that result from illegal behaviour. For example, Germany allows the recovery of three times the illegal profits obtained from objectionable conduct, while the Philippines allows private complainant parties to recover treble damages plus litigation costs from guilty parties. Though such penalties can act as powerful deterrents to objectionable behaviour — particularly when enforcement efforts by a central agency are uncertain — they should only be employed for unambiguous per-se prohibitions so as not to encourage excessive litigation.

Competition law in a broader context. Competition law is clearly not the only mechanism to promote competition in a given country. Open international trade and investment regimes, in addition to other government policies that encourage efficiency and competition, also have a critical role to play. However, even in a country with negligible tariff and quota barriers to imports and with a transparent and open regime towards foreign investment, competition law and broader competition policy are pivotal. International trade cartels may preclude the

benefits of competition at the domestic level. In spite of free international trade, many important markets will remain local in character. The reasons for this are high ratios of transportation costs to unit values, the perishable nature of some goods, and the inherently nontraded nature of most services, including wholesale and retail distribution services, personal services and small-scale construction. Open economies will always remain vulnerable to anticompetitive conduct.

3. Market Concentration and Ownership Patterns in the Turkish Industry[14]

Concentration in domestic production. Turkey's domestic industrial structure is fairly concentrated by international standards. There are only three industrial products, automotive tyre cord, acrylic fibre, and plate glass, for which a single enterprise accounts for 100 percent of domestic production. However, a list of three-firm concentration ratios for almost 50 different industrial products in 1989—1990 reveals a high degree of concentration in domestic production: the average three-firm concentration ratio across all selected products is over 86 percent with 18 products having three or fewer enterprises accounting for 100 percent of domestic production (Table 7.1).

In addition to having fairly high levels of concentration in the domestic production of individual industrial products, ownership of productive assets across product groups is concentrated through the predominance of a few large industrial holding companies and associated banks. The 15 largest private corporations in Turkey controlled over 500 separate industrial enterprises in 1988 and accounted for sales of over $25 billion. Of these 15 holding companies the largest three had sales of $14 billion and directly employed well over 90,000 people. As an example, the largest group, Koc Holding, alone had sales of $ 6.5 billion in 1988, employed some 37,000 people, and its 106 firms and 15 participations were active in automobile production, white goods, brown goods, consumer electronics, and virtually every other sector of the economy from matches to automotive tyres to textiles.

Many of these large private holding companies also control the country's largest financial institutions. For example, Sabanci Holding, Turkey's second largest private corporation, also controls the country's second largest private bank as well as six other banks and four insurance firms. The four largest private sector banking groups, three of which also rank among Turkey's largest industrial holding companies, controlled over 73 percent of private sector bank assets in 1988 and approximately 40 percent of assets held by the banking sector as a whole.

It must be stressed, however, that relatively little meaning in terms of the level of actual or potential competition in the domestic economy should be attributed to domestic producer concentration ratios (market shares defined narrowly in terms of domestic private sector production, or even total domestic production). The structure of economic markets does not predetermine economic behaviour, and it is natural to have concentrated markets in industries with scale economies when the size of the domestic economy is relatively small. Policy-

makers should not be concerned with high concentration per-se, but rather with the effects on the economy that may flow from highly concentrated markets. Effects detrimental to economic efficiency are much less likely in a more open economy. Policy-makers should therefore strive to make markets more contestable, by lowering or removing barriers to the entry of domestic and foreign competitors.

Evolution of domestic concentration Levels of domestic industrial concentration in Turkish manufacturing industries at a somewhat more aggregate level (the four-digit level applied by the Turkish State Institute of Statistics, comprising 82 industries) have been falling over time.[15] If the data analysis is restricted to the period 1975--85 and to private sector enterprises, four-firm concentration ratios are seen to have decreased for 51 industries (which accounted for over 70 percent of value added in 1985), increased for only 13 industries, and changed by less than 3 percentage points for the remaining seven industries.[16]

Accompanying the decrease in concentration levels there has been a substantial amount of entry of new enterprises in the manufacturing sector over the past ten years. In 1981 1,275 new enterprises entered the market. In the boom year of 1987, when the economy grew at over seven percent, 3,999 new enterprises were registered as new entrants in manufacturing. The number of new entrants in 1989 fell only slightly to 3,871 in spite of a large reduction in public investments and a sharp downturn in the economy in 1989 (GNP growth of less than two percent). The increase in outward orientation of the economy during the 1980s and the larger share of manufacturing sector investments undertaken by the private sector (85 percent of total manufacturing investments in 1989 compared to 42 percent in 1981) appear to have rendered this sector less susceptible to changes in government spending and to short-term downturns in the economy. A number of entrants into areas where production was relatively concentrated had a substantial effect on levels of competition and will continue to do so. To give an example, over a very short time span a new entrant became a sizeable competitor in white goods production, and new entrants are investing substantial amounts to create more competition in automobile production. Even though many of these entrants are affiliated with existing large holding companies, their entry into specific product lines will likely have strong beneficial effects on the level of competition in those markets.

In the banking sector the 1988 concentration levels have changed little to date (see Chapter IV). While a number of new banks have started operations since then, these operations are small and do not have much effect on overall concentration. Furthermore, the new banks also are affiliated with established holding companies. These entrants appear to come in to take advantage of new opportunities such as those presented by the growing stock market and offshore banking activities.

Relative importance of the public sector Currently, there are 42 state-owned enterprises (SOEs). Of these eight are public economic institutions operating in electricity production and distribution, transportation and communications, and in agriculture. Of the rest 12 are banks and the others are non-financial state economic enterprises (SEEs), with 14 involved in manufacturing (ranging from pulp and paper to cement, ferrous and non-ferrous metals,

shipbuilding and food processing). There are a number of public sector monopolies, notably in petrochemicals, aluminum ingots, sulphur production, the postal and telecommunications sector, and electric utilities.

The total number of SOEs accounted for roughly seven percent of total non-agricultural employment in 1990 (633,700 out of 9.3 million employees). Given the importance of SOEs in the domestic economy, it will be important to apply the competition law evenly to all SOEs engaged in commercial activities. Especially when SOEs are in competition with private enterprises, it will be essential that SOEs not be accorded special treatment regarding the pricing of inputs and outputs, nor regarding access to finance.

4. Recommendations for a Turkish Competition Law

The present status of competition-related laws Turkey does not have and has never had a competition law. However, Article 167 of the 1982 Constitution can be considered as the foundation for such legislation by stipulating that "The state shall take measures to promote the sound, orderly functioning of the money, credit, capital, goods and services markets; and shall prevent the formation, in practice or by agreement, of monopolies and cartels in the market."

Competition-related official pronouncements can be found in the 1986 Framework Decree on Foreign Investments, which contains a clause stating that the Foreign Investment Department of the State Planning Organization may not approve foreign investments which would lead to a monopoly or cartel in the domestic market. It is noteworthy, however, that there is no provision in the law requiring divestiture, should such a situation arise after the foreign investment has been made, for instance, as a result of exit of a competitor.

There have been only a few attempts to enact a competition law in Turkey.[1] The first attempt, following the setting up of a commission in 1978 by the Ministry of Industry and Commerce, failed due to prevailing political instability. Following the 1980 military coup, a shift toward more liberal economic policies, and the adoption of a new Constitution in 1982, a few more attempts to create the required momentum took place. In July 1992 a new draft proposal for a competition law was prepared by the Competition Law Review Committee, a group of academicians commissioned by the Ministry of Industry and Commerce.[2] The present section provides some discussion of key provisions of the latest available draft, revised in March 1993 and officially translated into English (henceforth "Draft").[3] The Draft contains five parts. Part One on the purpose, scope and definitions of the Act. Part Two, on prohibited practices, powers of the competition authorities, and penalties. Part Three on examination and investigative procedures. Part Four on civil consequences of violation of rules ("The effects of restraint of competition in private law"), and Part Five on institutional structure and procedures.

Rationale for a competition law in Turkey A careful assessment of arguments both for and against instituting a competition law in Turkey is a prerequisite to the formulation of such a law in the Turkish context. A rather compelling argument **against** such a law is that it would provide another instrument that could be manipulated and used to serve the interests of a narrow group of constituents rather than the public interest at large. According to this view, instituting a competition law may be worse than not doing anything at all. Not only would policy-making be distorted away from its intended objective as a result of interest group pressure, but resources would be diverted from more productive uses, both by officials enforcing the law who could be doing something else and by specific interest groups who would spend scarce resources in their lobbying efforts.

A second set of arguments against a new competition law, perhaps based on ignorance of what the objectives of a competition law are or based on a general preference for the **status quo**, can be summarized by the dictum "if it ain't broke, don't fix it." Proponents of this view may perhaps argue that Italy seems to have done fine for many years without any competition law.

There is also the widely held view that Turkey can ill afford any legislation that may hamper enterprises that are investing at a global level. This argument is based on the notion that Turkey needs large, financially strong enterprises, if it wants to compete in international markets and on the belief that a competition law would constrain such activities. Large size, however, is not antithetical to competition. Finally, there is opposition to a competition law from businesses that fear losing lucrative monopoly rents.

The most persuasive argument in favour of a new competition law for Turkey is that such a law, by creating and maintaining a more competitive and predictable environment, is in the interest of most enterprises and all consumers, both industrial users of the outputs of other, upstream enterprises as well as final consumers. Through the exercise of monopoly power, a small number of enterprises can control scarce resources, block entry, restrict purchases or sales in the domestic market, and thereby raise domestic prices. In turn, high monopoly prices lead to the inefficient use of those products: enterprises and individuals are harmed by having fewer goods available and paying higher prices, and investment decisions for the future may be distorted. While specific enterprises may be dominant in certain markets today, they may be victims in other markets or be on the losing side tomorrow. Private enterprises may be disadvantaged through unequal and preferential treatment received by SOEs. Without clear rules regarding what type of market behaviour is unacceptable, both today's and tomorrow's victims would have no recourse. It is important to stress, though, that the rules are intended to strengthen market forces rather than to interfere or regulate too much. Just like the referee's role in a soccer game, competition rules work best when they provide a predictable framework with minimal intervention. An appropriate competition law, if properly enforced, does help to create a level-playing field and more certainty for the benefit of most enterprises. In the ensuing economic environment, rewards from entrepreneurial effort and skill would be more predictable.

The increased globalization of goods and services markets provides another compelling argument in favour of the adoption of a competition law for Turkey. With Turkish enterprises increasingly operating in European markets, a national law in harmony with EU competition laws will help Turkish enterprises adapt to internationally accepted norms of business conduct. The substantive rules on competition of the current Draft regarding horizontal and vertical agreements, abuse of dominant position, and concentrations closely follow the EU model. It should be stressed that Turkey's desire to join the EU does not necessitate the enactment of a competition law. And even if Turkey joins the EU, its commercial legislation does not need to be harmonized with European laws. However, whether or not Turkey joins, Turkish enterprises would benefit abroad and become stronger international competitors if they were forced by their domestic environment to be stronger competitors at home. By following closely the spirit of the EU law, a Turkish law would help businesses to become familiar with a system at home that is already in operation abroad. An EU-harmonized rather than distinct Turkish law would also encourage European firms to trade with and invest in Turkey, since they would face familiar rules. Likewise, Turkish competition authorities could use EU enforcement practice and court decisions as guidance. However, the main argument for instituting a competition law in Turkey should not rest on EU membership. It is based on the economic benefits to society at large from greater competition and a more predictable environment in the home market.

An understanding of the objectives of a competition law should remove any concern that large enterprises would be persecuted based on their size or dominance in a market. There is nothing inherently wrong about a monopoly position obtained and maintained solely through offering consumers higher quality products at lower prices compared to other suppliers. The development of Canada's new competition law is instructive in this regard. Many people also argue that, being a small open economy, Canada needed enterprises with a large absolute size to compete with large foreign manufacturers. Thus the merger law should not prevent enterprises from expanding to compete internationally. In fact, this thinking is reflected throughout the Canadian law, which is intended to maintain and promote competition in order to "expand opportunities for Canadian participation in world markets, while at the same time recognizing the role of foreign competition in Canada."

Finally, if and when momentum for privatization of SOEs picks up, it will be desirable to have a competition law in place to ensure that transfer of ownership of state-owned assets does not result in the transfer of public monopolies to private ones. The merger control elements of competition law address these concerns.

Competition law as an instrument of overall government policy. The best type of competition policy is the facilitation of international and domestic entry, so that imports, production from other regions and new local entrants can compete against incumbent local producers. Entry of additional suppliers in a local market spurs a more competitive response by monopoly enterprises, since what matters for the ability to raise prices is not concentration of production but concentration of sales in the domestic market.

Perhaps the most important role for Turkish competition authorities would be to help create conditions for markets to be more contestable, by reducing artificial barriers that prevent newly created enterprises from entering markets where prices and profits are relatively high and that prevent existing enterprises from switching to or also entering such markets. Where entry barriers are the result of actions by private enterprises or SOEs, and are less visible, the competition authorities should have access to necessary resources from the state budget to undertake background analyses, document their findings, and seek to lower or remove such barriers. Where barriers to entry are the result of decisions or actions by other government bodies that discourage competition, the competition authorities should have the authority to intervene.

This role of "competition advocacy", of promoting competition in government policy-making at the local and national levels and more broadly throughout the economy, should be articulated explicitly in Turkey's competition law. At a minimum, a broad advisory and consultative role for the competition authorities should be established formally in the law. Article 47 of the Draft empowers the competition authorities "to declare their opinion, on their own initiative or upon the application of the Ministry, on the necessary modifications to be made in competition law legislation." It should be amended, to provide a legally established right to comment under competition aspects of all draft laws, giving the competition authorities the mandate to prepare submissions and make presentations whenever decisions of other government bodies appear to be limiting competition on domestic markets. In this way, competition principles can be incorporated more broadly and systematically in government policy-making.

Clear prohibitions against cartel agreements In addition to reducing entry barriers and being a loud voice for competition throughout the country, the Turkish competition authorities should encourage sellers in the same domestic market to make independent offers for the business of buyers. Article 4 of the Draft deals with agreements, decisions and concerted practices in restraint of competition. It is very similar to Article 85(1) of the Treaty of Rome. It forbids all agreements that cause or have as their object or effect the prevention, distortion or restriction of competition. Penalties in the form of fines are provided for in Article 16.

Rivalry is central to competition. To help deliver this message clearly to the business community, Turkish prohibitions on restrictive agreements between enterprises should differentiate clearly between horizontal and vertical agreements. Horizontal agreements to fix prices on a collective basis, to divide patterns of distribution along rigid and exclusionary patterns, or to agree on allocation of markets should be unambiguously (**per-se**) illegal, and should face tough penalties. On the other hand, vertical agreements which often have pro-competition rather than anticompetitive effects should be dealt with separately and more leniently, with less harsh penalties. Although separate treatment of horizontal and vertical agreements is preferable in the interest of clarity, the Draft's joint treatment is in line with EU law (and the recent laws of Italy, Ireland and Belgium, that justified their decision by a motivation to harmonize national law with the EU law). If a decision is not made to modify the current Draft, it will be highly desirable, in line with the approach of other countries that

have a single rule, to introduce appropriate secondary regulation or guidelines clarifying the different actions to be expected in horizontal and vertical cases. A differentiation of penalties should also be provided, with heavier fines for horizontal agreements. The approach of several countries which provide for criminal sanctions against individuals who engage in horizontal agreements, in order to send a strong signal that cartel behaviour is unacceptable, would not be feasible in Turkey unless decisionmaking is shifted from an administrative to a judicial body.

Abuse of a dominant position Article 6 of the Draft follows the wording of Article 86 of the Treaty of Rome, and prohibits the abuse of dominant positions. Such a provision appears desirable to counteract at least the most blatant forms of abuse, given the high levels of concentration of sales in various subsectors of the Turkish economy. Although the Draft defines the concept of "dominant position" in Article 3, it does not define the more relevant concept of "abuse of dominant position". It would be important to include sufficiently clear definitions and subsequent guidelines to reduce business uncertainty regarding the interpretation of this law.

Whether or not an enterprise is designed as being dominant or as having monopoly power should depend on a rule of reason approach, that is, a careful analysis of factors such as the availability of alternative products available to consumers and the likelihood of entry from foreign suppliers or new domestic ones. No enterprise should be labelled as "dominant" based exclusively on its share of production in the domestic market, since the ability to raise prices depends not on production but on broader conditions of supply and demand in the country. The authorities will need to distinguish between cases where raising prices stimulates new entry (and eventually drives prices back down), and those where barriers to entry allow high prices over the long run; in the latter case, policy action should focus first on attempting to reduce such barriers.

Review of concentrations Another important function of the competition authorities is to prevent the creation of new sources of monopoly power through mergers or other concentrations. EU merger control has served as a model for the Draft's provision contained in Article 7. Under the Draft, mergers or acquisitions that "would strengthen the dominant position of one or more undertakings" or "create a monopoly situation" are prohibited. A revised Draft should clarify that the same standard of market power is to be applied in both these instances, as well as what constitutes a merger. Until the competition authorities publish rules defining which enterprises are to be exempted, all mergers and takeovers appear to require prior notification. Development of more detailed merger guidelines therefore appears urgent. In the current Turkish environment, the prenotification threshold may be based on the size of the parties (value of annual sales or assets), with the chosen number updated annually with inflation. It may be desirable to start with a very high threshold when the capacity of the competition authorities is still small, and lower such a threshold only later once administrative capacity has increased. It also may be desirable initially to restrict review to horizontal mergers within the same market.

Merger control rules should also specify the information to be included in notifications, the time allowed for the agency for analysis of the proposal, and the criteria that the agency should use to evaluate the cost-benefit tradeoff of proposed transactions. Article 10 of the Draft authorizes mergers to be deemed approved if no decision has been taken by the competition authorities after 30 days following notification. Such incentives are desirable. If a more detailed investigation is deemed necessary, opportunity should be provided for the parties to the transaction to negotiate with the authorities to exclude from the transaction particular products or activities which cause competitive concerns. In addition, it may also be desirable to link the timing of the investigation with the provision of information when requested. This would create an incentive for investigated enterprises to comply with information requests in a speedy fashion, where the investigation "clock" would be stopped when information is demanded, and set in motion as soon as the information is supplied.

An independent administrative structure In its role as a competition advocate, the Turkish competition authorities should ensure that all other state administrative authorities do not unduly restrict competition. In addition, in their control of horizontal cartel agreements, the competition authorities should treat SOEs and private enterprises equally. To perform such functions in an objective and transparent manner, the competition authorities should have a clearly defined investigative mandate, and remain autonomous and independent from other state bodies. An undesirable conflict of interest would arise if the competition regulating body were merged with one of the regulated bodies. Therefore, it is desirable that the competition authorities be completely independent from all Government Ministries.

The organizational proposals contained in Part Five of the Draft are inadequate in these regards. As proposed, the Competition Authority would consist of the fifteen-member Competition Board, a Directorate and service departments, and would be under the control of the Ministry of Trade and Industry (henceforth, the "Ministry"). The Council of Ministers is empowered to appoint all members of the Board, and also specifically appoints the Director of the Board. Members of the Board are appointed for a period of six years, but reappointment is possible. Reappointment creates very undesirable incentives, since members of the Board seeking another term would take into account the preferences of the Ministry even if they diverged from the pursuance of competition principles. At the end of every second year, five Board members are to be renewed, creating a potentially serious problem of lack of continuity. The qualifications to become a member of the Board include a university degree in law, economics, business administration or finance, and at least ten years work experience, but not graduate or doctoral education for any member. Decisions on the level of required annual financing and the authority to disburse funds both must come from the Ministry; under the current Draft, all requisition orders must be signed by the Minister or by one of his representatives. Criminal and disciplinary investigations of members of the Board are to be carried out by the Ministry, another very undesirable requirement, since it is another mechanism that permits the Ministry to influence outcomes. A very careful study still seems warranted to determine what type of appointment process is most appropriate for Turkey, to increase the likelihood that members are chosen for their skills and objectivity rather than on account of their political connections.

While the Board has the decision-making mandate, the Directorate has the mandate to run the Competition Authority, implement or enforce Board decisions, and decide on general competition policy issues. Under the Draft, the Directorate would be composed of the Director and Vice-Director of the Board (the Vice-Director is appointed by members of the Board), as well as one or two Associate Directors. There is no mention of who will appoint the Associate Directors nor what their qualifications should be.

In the context of Turkey, the organizational structure is perhaps the most important aspect that would contribute to the effectiveness or failure of the law, since it will affect how the law would be implemented. The current proposed structure, with the Competition Authority "independent in carrying out its tasks" yet "related to the Ministry of Trade and Industry" (Article 40) can be improved upon. Under the Draft, the income of the Authority consists largely of "an appropriation reserved in the budget of the Ministry", in addition to collected fees and fines (Article 59). Greater budget independence, very high qualification standards for personnel, and single terms for perhaps a smaller number of Board members all seem essential.

Ideally, it is desirable both for the adjudication function to be separate from the investigative function and for the adjudication decisions to be subject to review, to create checks and balances consistent with the general setup of democratic systems. Under the Draft, investigative and adjudication functions are both under the purview of the Competition Authority. To ensure justice, there is an appeal process to the judiciary, the Council of State (Article 35). This model is close in spirit to the new Italian law, where both investigation and adjudication functions are within the same completely independent agency, and an appeal system to the regional administrative courts is provided for.

Professional administrative staff The draft law proposes that all ongoing duties be performed by full-time staff of the Competition Authority, with the provision of hiring consultants when necessary. There is an explicit process for "assistant competition experts" to become "competition experts". While the monthly salary of the Director and other Board members is to be determined by the Ministry (and requires Cabinet acceptance), the salary of the Competition Authority staff and consultants is to be determined by the Board (and requires Ministry acceptance).

It is desirable for the law to authorize the competition agency to hire high-quality full-time economists, accountants, business analysts, lawyers and other technical experts as part of its staff for investigations. It would be critical for this staff to be paid at comparable private sector wage levels, rather than the much lower public service rates. It is also desirable that the agency have the authority to contract with outside parties for required economic and technical studies. In addition, the agency will need computers and online access to an updated and carefully collected annual industrial database.

A limited mandate Competition law and its enforcement should be crafted to keep possibilities of abuse of its intended objectives to a minimum. A variety of approaches to insulate the enforcement process exist, and include restricting the purview of the law to a few critical areas to allow institution-building to occur over time. However, rather than introducing a law that would subsequently need to be amended it may be preferable to introduce a comprehensive law with all the instruments needed in the long run, but rather restrict the scope of activity of the competition authorities by having initial clauses or thresholds to ensure that specific rules are used only sparingly at first and limited to instances of gross misconduct. As an example of gradual institution-building, it may be desirable to restrict the scope of activity of the competition authorities in the control of "dominant enterprises" by having a "safe harbour" clause, so that enterprises with less than a specified percentage of market share would explicitly lie outside the purview of those rules. In the control of mergers it may be desirable to start with a very high prenotification threshold, so that only mergers beyond a large size would be reviewed. Both of these thresholds would only be lowered over time, once administrative capacity has increased. It may also be desirable to keep the merger prenotification threshold at a relatively high level to allow sufficient restructuring of industry in response to the customs union with the EU.

Critical to ensuring that the competition authorities maintain a limited mandate is a clear statement of the objective of competition law within the Turkish context. If, as in the Draft, the agreed-upon objective is to protect competition, it may be desirable to be more precise and specify "to maintain and promote competition **in order to** promote economic efficiency and to increase consumer well-being". The explicit emphasis on economic efficiency would signal that distributional or political considerations would be met by other policy instruments, and not by competition law. In this context, it would also be desirable for the law to apply to all enterprises, both public and private, except for those natural monopolies that may be most efficiently regulated through non-market mechanisms. While the definition of "undertaking" in Article 3 of the Draft appears to cover commercial activities of the government, it may be worthwhile to include explicitly SEEs and other commercial activities of the government to make the law as clear as possible. Regarding the purview of the law, Article 6 of the Draft should be amended since "within the whole territory of the state or in a substantial part of it" may exclude the applicability of the law to local or regional markets.

In the context of limiting the mandate of the competition authorities, it would be important to explore the feasibility, and the benefits and costs associated with relying on private enforcement of relevant sections of the competition law.

5. Conclusions

It would be desirable for Turkey to have a legal framework to strengthen market forces, to create both more business certainty and a standard of business morality that is compatible with international practices. The logic underlying such a competition law should be geared to changing perceptions regarding what types of conduct conform to internationally acceptable

norms of doing business, and what types of conduct are unacceptable because they create major damage to the public at large. Cartel formation and price fixing, for example, should be regarded as theft, as morally unacceptable practices.

The challenge for Turkey is to build a set of competition rules and an accompanying enforcement institution to accomplish this task. Establishing a new code of business morality takes time, and there are major risks that the process itself would be diverted away from its intended objective. It is therefore very important to allow for a transitional period, so that conduct that was morally accepted and legal does not become immoral and illegal overnight. In addition to allow for gradual institution-building in an environment where conflicting pressures are likely to be brought to bear on the competition authorities, it may be desirable to begin in a minimalist fashion, with interventions limited to instances of gross misconduct.

This chapter has reviewed some important experiences in the development of competition law in other countries, and has discussed select aspects of the principles and procedures underlying competition law. It has then attempted to relate some of these insights to the prevailing context in Turkey.

Based on this overview and an assessment of the existing Draft, it appears that supporting the adoption of the current Draft, even with major amendments, would be inadvisable. There is a very real risk that starting down the wrong path may be counterproductive, and may allow possibly misinformed opponents to postpone reintroduction of the debate for many years. It is therefore strongly recommended that the current effort to introduce a competition law in Turkey be replaced with a completely new effort that attempts to take into account the views of all major players in the Turkish economy, including business, as well as relying heavily on lessons from other countries as to what is likely to work within the broader Turkish environment.

Experience from other countries that have successfully introduced their own competition laws suggests that the process often begins with one or more studies on prevailing market structure conditions, and the merits and disadvantages of different forms of competition legislation. A lot more attention needs to be focused especially on the organizational aspects of the law, to ensure limited but effective enforcement in line with more clearly stated objectives. Business input at an early stage appears to be indispensable. To build a consensus in support of such a law, the preparatory phase should serve an important educational function stressing the benefits of competition and a more predictable business environment for the country as a whole.

Table 7.1: Three-Firm Concentration Ratios for Selected Goods, 1989–1990 (percent)

Selected Products	CR-1	CR-3
Televisions	35	74
Audio electronics	62	88
Vacuum cleaners	55	90
Sewing machines	50	100
Washing machines	80	100
Refrigerators	53	100
Electric irons	50	80
Household cooking ranges w/ ovens	63	100
Household heating radiators	47	90
Electrical porcelain goods	86	100
Audio tapes	75	100
Copper pipes & rods	50	80
Cardboard	50	100
Corrugated cardboard packaging	18	42
Sanitary paper products	59	98
Sanitary ceramicware	51	94
Beer	65	100
Toothpaste	72	99
Polyester fibre	73	100
Polyester yarn	36	86
Acrylic fibre	88	100
Machine-woven carpets	10	26
Pencils	95	100
Ballpoint pens	60	85
Steel cord & wire	70	90
LPG	50	75
Matches	60	100
Cosmetic goods (tons of production)	57	78
Aluminum plates	60	100
Aluminum rolls & sheets	30	70
Plate glass	100	100
Margarine	52	81
Light bulbs	40	90
Electrolytic copper	30	70
Ceramics	39	70
Newspapers	27	68
Paints	29	60
Detergents	35	80
Pesticides	18	43
Trucks	46	80
Pick-up trucks	52	97
Buses	95	100
Minibuses	96	100
Passenger cars	55	100
Agricultural tractors	43	94
Automotive batteries	70	86
Automotive tire cord	100	100

Source: Annex 1 of "Are there any private sector monopolies?" in Karasapan (1992)
Note: CR-1 refers to the share of total domestic sales accounted for by the largest producer, while CR-3 refers to the share of domestic sales accounted for by the three largest producers

Notes

1. I am grateful for ...pful comments from Ates Akinci, Refik Erzan, R.S. Khemani, Eric Lacey, Dominik Lasok, Paul Malric-Smith and Kurt Stockmann.

2. For an overview of the fundamental concepts of competition policy and specific legislation and enforcement practices in the United States, Germany, Japan, the United Kingdom, France, Canada, Sweden, Australia, the Republic of Korea, Spain and the EU, see Boner and Krueger (1991). For specific emphasis on small and industrializing countries, see Boner (1992) on which this section draws heavily. The reader is referred to both papers for more detailed information on the topics covered here.

3. For an overview of the various objectives ascribed to competition policy across selected OECD countries, see Khemani (1992).

4. For a more detailed elaboration of this argument, see Khemani (1992).

5. Canada's first competition law was passed in 1889 (Act for the Prevention and Suppression of Combinations Formed in Restraint of Trade), and precedes the first United States antitrust law by one year (Sherman Act, 1890).

6. EU competition law is applicable even in the national market of a member country if the anticompetitive practice "may affect trade between Member States." (Arts. 85—6 of the Treaty of Rome; in applying this law, member countries have consistently interpreted "may affect" based on the French translation "est susceptible d'affecter" as meaning "directly, indirectly, actually or potentially affecting"). Therefore, anticompetitive agreements between two or more enterprises based in the same country may or may not fall under the scope of application of EU law. However, as markets become more integrated, any such agreements are increasingly likely to affect inter-state trade and thereby fall under the purview of EU law.

7. For a succinct description of the United States experience, its relevance for emerging free-market economies, and the importance of tough and clear rules against cartel behaviour, see Willig (1992).

8. Horizontal price fixing and collusive bidding is illegal per se, for example, under most industrialized country competition laws; such behaviour is met with criminal penalties in all such cases (Boner and Krueger, 1991, pp. 51—3).

9. See, in particular, the section on "The Legal Treatment of Vertical Restraints" in Boner and Krueger (1991), pp. 56—63.

10. Some other countries rely on post-merger notification, and at least one relies on voluntary registration of transactions that may violate the competition law (with very high penalties if a transaction in violation of the law occurs). For a detailed description of merger control regulations and enforcement practice in industrialized countries, see Boner and Krueger (1991), pp. 68—83. A more detailed examination

of the United States antitrust approach to horizontal mergers is provided by Willig (1991) on the basis of industrial organization theory. Finally, for an analysis of the merger provisions of four new Central and Eastern European competition laws, and comparisons and contrasts with the corresponding provisions of the United States and EU laws, see Pittman (1992).

11. See, in particular, United States Department of Justice and Federal Trade Commission (1992).

12. This sub-section summarizes the main arguments contained in Section 7: "The Legal and Administrative Structure of Competition Law Enforcement" in Boner (1992).

13. In the United Kingdom, the minister responsible for trade and industry has sole authority to enforce merger control laws through references to the Merger and Monopolies Commission, while Mexico uses pure administrative enforcement of competition laws by the President. In Hong Kong, Singapore and Taiwan Province of China on the other hand competition law is not enforced through either standard judicial or administrative means. Rather private enforcement of certain commercial tort laws (similar to certain competition law prohibitions) is allowed.

14. A large part of the material in this section is drawn from Karasapan (1992).

15. See Katircioglu (1989) and Chapter III of this volume.

16. Eleven out of 82 industries had to be deleted due to incomplete information. No information is given regarding the likely direction of bias arising from the deletion of more than 10 percent of the studied industrial subsectors (Katircioglu, 1989, p. 32).

17. This paragraph relies heavily on information contained in the introductory section of Akinci (1992).

18. It should be mentioned that representation of business circles in the Competition Law Review Committee was kept at a minimum. Experience from other countries suggests that substantial input from business is critical in the design of a law that is intended to strengthen market forces and create a more predictable environment.

19. Government of Turkey, Ministry of Trade and Industry, **Draft Act on the Protection of Competition**, Ankara, March 1993. Written comments by Kurt Stockmann were helpful in strengthening this section.

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CHAPTER VIII

ANTIDUMPING AND ANTISUBSIDY POLICIES IN TURKEY

Patrick Messerlin[1]

1. Introduction

In June 1989 Turkey has adopted the law "on the prevention of unfair competition in importation" containing both antidumping and antisubsidy provisions. This adoption is part of a general move among major newly industrialized or industrializing countries: the Republic of Korea (1986), Mexico (1986) and Brazil (1988) have also introduced such laws. Until January 1993 Turkey had initiated 57 antidumping actions. It is important to note that Turkey is not the only country in the region to implement such rules: Since the 1970s the EU has been a heavy user of antidumping regulations and since 1980 has initiated roughly 450 antidumping actions out of which 16 have involved Turkish exports.

The Turkish law raises four questions. First, is there an economic rationale for antidumping and antisubsidy laws which could justify their adoption, and do the adopted laws serve this rationale? Second, if there is no or little economic rationale behind the existing antidumping laws (including the Turkish law), what is the purpose of these regulations, and what are their major effects on their own economies? Third, what are the major features of the antidumping cases initiated by Turkey since 1989? Lastly, what can be done for improving matters — with the perspective of keeping international and domestic competition as the engine of Turkish growth?

2. The Economic Rationale for Antidumping and Antisubsidy Laws: The Search for a Rare Bird

This section shows that the economic rationale for antidumping and antisubsidy laws is limited to narrowly defined situations. The most important point is thus: how frequent are these situations in the real world? The section underlines the widespread belief among economists that these situations are very rare.[2]

The economic rationale for antidumping laws GATT law and general practice provides two definitions of dumping. The first definition focuses on a price comparison whereas the second definition involves a cost-price comparison.

Under the first definition, dumping occurs when goods are sold by foreign firms in export markets at a price lower than the price they charge in the domestic market. Such a situation can occur in three cases. First, there is "price discrimination" within the context of

international trade. Economic analysis shows that when the demand faced by the exporter in his home market differs from that in the export market in terms of price elasticities (and if domestic and export prices are not connected by arbitrage) profit-maximizing firms should charge a higher price in the market with the lower demand elasticity. If this market happens to be the domestic market of the exporter, profit-maximizing firms are said to "dump." There are a host of reasons for which a firm can enjoy more market power in its domestic market than in foreign markets. The firm is usually best known and can invest more in after-sale maintenance in its home country, it can design a product better fit for its domestic clients, etc. In all these cases, there is nothing wrong, and consequently, there is no need for antidumping laws. However, there is a case for public action when the relative monopoly power of the firm in its domestic market is "man-made": The firm can be protected from foreign competitors by high tariffs or low import quotas, or it can abuse a dominant position without being threatened by antitrust actions. In these cases, dumping is the sign of non-competitive markets in the exporter's domestic economy. However, the cure of this kind of dumping is not antidumping laws by the importing economy (which can only lead to higher prices in the importing economy) but more competition in the exporting country — promoted either by free-trade policy or active competition policy.

The two other cases involving dumping based on price comparisons cover situations where market power is created by strategic or predatory pricing. Strategic dumping occurs, when there is an overall strategy of the exporting nation covering both the pricing of exports as well as restraints protecting the exporters' home market (Willig, 1992). What counts in this case is learning-by-doing, static or dynamic economies of scale (in particular, with respect to the size of the exporters' home market) and the commitment of the exporting country to protect the exporters' home market. Predatory pricing occurs when a foreign firm charges a low price for its products in the importing market in order to drive out of business domestic firms of the importing country and enjoy a monopoly situation in the importing market. If both cases provide a rationale for antidumping laws, they impose strict conditions on their possible use. Furthermore, the question should be raised about using specific antidumping laws instead of general competition laws. If exporters' domestic markets are small compared to the scale economies involved, strategic dumping is hardly conceivable. If initially foreign firms have small market shares in the import market, the same can be said about predatory dumping. And if the "predator" is not able to eliminate future potential competitors by preempting and deterring their entry in order to keep its monopoly power intact, predatory dumping does not make sense.

The second definition of dumping is based on price-cost comparisons. Dumping is said to occur when a foreign firm charges an export price lower than its production cost. Such a definition enlarges the scope of dumping to two new situations: cyclical dumping when export prices are lower than production costs because of a sudden downturn in demand, state-trading dumping when exporters are from centrally planned economies where production costs are neither well assessed nor taken into consideration.[1] Economists believe that in both cases gains for the importing country from such dumping are larger than its costs, except if

adjustment costs in the importing country are very high. But, economic analysis shows that such a situation can be handled by more appropriate instruments than trade barriers.

There is abundant evidence that price discrimination is frequent within domestic economies. That prices differ between locations by more than the differences which could be attributed to transport or transaction costs is often observed at both the national and the international level. The same can be said about cyclical pricing. By contrast, there are very few cases of predatory pricing (less than a handful of cases in the United States during the last century) and economists strongly believe that the same can be said about strategic dumping. As a result, evidence suggests that the economic rationale for antidumping laws is extremely limited.

Economic rationale for antisubsidy laws The economic rationale for antisubsidy laws is thin as well. Foreign subsidies represent transfers from foreign governments to the buyers in the importing country. These transfers are positive if the resources of the importing country are perfectly mobile. If foreign subsidies impose a costly relocation of resources in the importing country from one activity to another, the transfers granted by foreign subsidies are net of adjustment costs occurring in the importing country. Economic theory shows that to address adjustment problems by taking antisubsidy measures at the level of products (that is, trade measures such as duties imposed on imported goods) is far from the optimal solution (Snape, 1988 and Chapter II of the present study).

Subsidies can be conceived as public support to foreign firms' strategies aimed at preempting competitors to enjoy monopoly power — a case similar to strategic or predatory dumping. This type of subsidies leads to the same conclusions: there is a need to sustain competition, but duties which "countervail" foreign subsidies (that is, raise the prices of the foreign goods by the amount of the subsidies) are not the optimal instrument for sustaining competition.

The Economic rationale and GATT-consistent antidumping and antisubsidy laws Do the antidumping and antisubsidy laws currently enforced by the major industrial and industrializing countries obey the rationale evoked above? As most of these antidumping laws follow GATT rules, the answer is provided by looking at the economic soundness of GATT Article VI.

GATT Article VI, and the corresponding "code of interpretation" adopted during the Tokyo Round focus on dumping as practices of price discrimination, cyclical or state-trading dumping. As a result, GATT-consistent antidumping laws correspond to the non-economic cases for antidumping, and they cannot cope with the thin cases where there can be an economic rationale for intervention. For instance, in the case of predatory pricing, GATT rules would not condemn a predator which would lower its price simultaneously in its domestic and export markets in order to eliminate the domestic producers of the importing country.

Concerning subsidies, the GATT texts introduce two levels of rules. On the one hand, GATT Article XVI and the corresponding "code of interpretation" adopted during the Tokyo Round aim at defining situations where subsidies are prohibited — an approach likely to be economically sound in most cases. On the other hand, the same GATT texts allow an importing country to take measures aimed at countervailing foreign subsidies at the product level —thus favoring an inefficient management of adjustment problems as mentioned before.

3. GATT-Consistent Antidumping Laws: From Protection to Protectionism

The fact that GATT-consistent antidumping and antisubsidy laws are not based on sound economic motives raises the question about what the real purpose of these regulations might be. A possible answer can be given with a view to the Turkish antidumping law which entered into force in October 1989.[4] The EU antidumping rules, which will be presented here, are relevant for the Turkish case for four reasons: (i) They have substantially inspired the Turkish antidumping and antisubsidy laws; (ii) being older than the Turkish rules, the EU rules are likely to offer a good illustration of what will happen in Turkey; (iii) the EU is the main trading partner of Turkey; and (iv) there are close links between a substantial number of EU and Turkish antidumping cases.[5]

The rationale behind GATT-consistent antidumping laws stems from the condition imposed by GATT Article VI:1 for taking antidumping measures:

> "The contracting parties recognize that dumping [...] is to be condemned if it causes or threatens material injury to an established industry in the territory of a contracting party [...]."

The exclusive purpose of GATT-consistent antidumping laws is thus the protection of the import-competing domestic producers.

Does this focus on domestic producers favour a drift from protection to protectionism (that is, a systematic attitude of protection)? Two opposite forces are at work. On the one hand, Article VI does not impose on a contracting party any obligation to take antidumping measures. Rather, it suggests that a country should rely on its conviction that free trade is better than protection from its own point-of-view. On the other hand, Article VI favours a drift to protectionism because it does not mention the wider interests of the domestic industrial users or consumers of the imported good allegedly dumped. By not providing the legal background for incorporating a sound balance between the interests of producers and consumers when deciding whether to protect an industry, GATT rules make the implementation of economically-sound internal disciplines more difficult. The enforcement of the EU antidumping regulations during the last two decades has shown that the second force is much more powerful than the first force. There is no reason to believe that the enforcement of the Turkish rules will lead to a different outcome, and indeed experience from 1990-92 supports this belief.

GATT rules impose on antidumping legal procedures a common format which is based on four elements or steps: (i) the initiation of an investigation based on an industry complaint; (ii) the determination of dumping by foreign exporters; (iii) the determination of the injury suffered by domestic firms; and (iv) the proof of a "causal link" between dumping and injury. In Turkey (as in most other countries) this format has been developed in a quasi-judicial procedure in the aforementioned steps.

Initiation of a case In a typical GATT procedure, an antidumping action is initiated by the public authorities upon a complaint lodged by domestic firms. Indeed, domestic firms are de facto the real initiators of antidumping cases because all complaints tend to be accepted by the authorities as soon as they meet the following two lax conditions: (i) the complaining firms should represent a "major proportion" of the industry, and (ii) their complaint should provide "enough" evidence about the existence of dumping and injury.[6]

The Turkish law differs from this typical GATT procedure in three main respects. First, Article 4 of the Turkish antidumping law does not require that complainants constitute a "major proportion" of the industry. This specificity of the Turkish law opens the legal possibility that a very small firm could lodge a complaint — definitively a liability for the generally open-trade stance of Turkey. However, it should also be noted that the GATT's "major proportion" provision (defined in terms of total domestic production of a product) is not a panacea because it is often on a collision course with competition rules for the following reasons. Focusing on domestic production is in sharp contrast to looking at market share based on consumption — which is the concept normally used in competition actions. Furthermore, the "major proportion" condition is closely related to the competitive structure of the market examined. It means that one firm will be able to lodge a complaint, if it represents a sufficiently large market share of the domestic production. In other words, the "major proportion" provision reflects a "weighted majority" rule which de facto gives the rights of lodging a complaint to a subset of the industry — the few firms with the largest market shares. In sum, this provision protects monopolistic or oligopolistic structures against trade pressure.[7] Indeed, the EU antidumping cases involving Turkish firms illustrate the ambiguity of the "major proportion" provision very well. Two out of the nine EU antidumping cases (for which information is available) initiated against Turkey were initiated by sole EU producers (ferro-chromium and glass). Five other cases were initiated by barely half a dozen large EU firms which together enjoyed a dominant position in EU markets. All EU antidumping cases in textiles involving Turkish firms were lodged by a core of three firms: two EU firms (Hoechst and Montefibre) and, interestingly, a "foreign" firm (Du Pont).

The second specificity of the Turkish law is that its Article 3 adds a third reason - the "impairment of the market" - to the two motives mentioned by the GATT rules for initiating antidumping actions (in addition to material injury and threat of material injury). Lastly, Article 4 introduces an ex officio clause allowing Turkish authorities to lodge a complaint in the absence of complaints lodged by domestic firms. In the following articles of the Turkish law, the ex officio procedure is frequently mentioned, so that ex officio complaints appear as a serious alternative to private complaints.

The Turkish law and subsequent regulations do not elaborate on the concept of "impairment of the market", and the enforcement of the Turkish antidumping law is too recent to provide a record on the role of small firms in lodging complaints and on the frequency of "ex officio" cases. However, all the specificities of Turkey's law are a source of concern: They have the potential to nurture a more dramatic drift to protectionist policies than the law of the United States or the EU.

This concern is reinforced when one observes that even the GATT concepts adopted by the Turkish antidumping law may lead to unusual enforcement, as best illustrated by the provision according to which antidumping actions require that the foreign product and the competing domestic good should be closely similar, i.e., "like—products". Whereas some Turkish antidumping cases deal with goods defined at the eight-digit level of the Harmonized System (thus at a level disaggregated enough to suggest some similarity between the goods involved), there are a substantial number of cases which cover products defined at the six-digit or even four-digit level of the trade classification —particularly, the textile cases. To extend the definition of the like-product to a group of goods defined at the four-digit level of the trade classification clearly represents a massive increase of the trade barriers. In addition to its international dimension, the issue of the like-product is important because it is a major source of conflict between antidumping and domestic competition regulations. The EU history of antidumping shows that the Antidumping Office has always adopted a much broader definition of the like-product than the Competition Directorate General when the two authorities have examined the same cases. This difference means that antidumping measures have a scope systematically wider than competition measures.[8]

Determination of dumping In the second step of a typical GATT case, the public authorities determine whether there is dumping, and if their finding is in the affirmative, they have to calculate the margin of dumping.[9] Price comparisons or price-cost comparisons as a means to determine the dumping margin are notoriously difficult. The rules of comparison play a crucial role, and biased rules of comparison can easily show dumping where in fact there is no dumping. These biases emerge during the enforcement process: to solve a new case requires an "extended" version of existing rules of comparison, and this extension generally implies the introduction of rules of comparison less favorable to firms which were allegedly dumping than the previously existing rules.[10]

It is difficult to evaluate the existing biases in the Turkish rules of comparison because the Turkish antidumping enforcement is still in its very first years. However, there are signs that biases are already present. There is a large and increasing number of Turkish antidumping cases in which the investigating authorities have used constructed values which are prone to such biases. In a few cases, foreign prices have been estimated on the basis of the Turkish costs of production with a "reasonable" rate of profit — an approach similar to EU basic prices in steel. And there is a positive correlation between the use of constructed estimates and the frequency of restrictive outcomes.

In order to present a more complete picture, it is useful to give some examples of the EU biases which are likely to be repeated by the Turkish authorities (as indeed suggested in the glass cases reported in this paper). The most extreme bias — well known to all Turkish firms having been caught in EU antidumping actions — is that of transactions where export sales at prices **above** the domestic price of the exporter are excluded (through biased averaging methods) in determining the existence and extent of dumping — making almost certain the finding of dumping (Hindley and Messerlin, 1993).[11] Another bias is the treatment of vertical relationships between foreign firms, as best illustrated by the 1986 EU antidumping cases in polyester fibers where transactions between Turkish production and sales firms were not considered by the EC Commission as "transactions between unrelated parties" — leading the Commission to the conclusion that "it is only the sales prices of the sales companies to their customers that can be relied on to reflect the true normal value of the product" (EC Official Journal, L103:12, 15-4-87).

All these biases on price estimates are compounded by the fact that the antidumping authorities do not feel obliged to assess price differences in terms of sound economics. For instance, the fact that the allegedly dumping firms often hold small market shares of the importing country market has not stopped the EU Commission to take actions. The initial market shares held by all the allegedly dumping firms in cases involving Turkish firms range from 0.0 to 9.6 percent of EU consumption — with an average of 3.2 percent.[12] Such figures preclude the possibility that predatory pricing by the allegedly dumping firms is a likely and frequent behaviour.[13] Rather they suggest that antidumping complaints are predatory behaviour of the EU complainants which have 50 to 90 percent of the EU markets and use antidumping rules for eliminating fringe competitors.

Lastly, allegedly dumping firms from non-market economies face special rules justified on the basis that domestic prices in these economies are not market determined. As a result, the investigating authorities do not consider the price in the exporting non-market country, but the price charged for a like-product in a "surrogate" country which might be directly observable or at the costs (in a surrogate country) which have to be "constructed" by the investigation authorities.[14] As many Turkish antidumping cases involve non-market economies, this bias has been extremely important. Italian domestic prices were used for estimating Romanian prices of polyester fibers, Spanish prices were used for estimating costs of production of electrodes in Hungary, Romania and China, etc. Other worrisome methods also deserve close attention. In the glass cases against Romania, the Turkish authorities have used Greek prices as reference prices — despite the fact that these prices were regulated, charged by a Greek monopoly, and protected by EU antidumping measures.

Determination of injury The determination of injury to the domestic industry is based on a series of criteria, the most frequent of which are increases of import market shares held by foreign firms, decreases of the consumption market shares held by EU firms, and the allegation that foreign firms "undercut" EU prices on EU markets. None of these criteria makes much economic sense, and their application demonstrates amazing examples of captured rules. The scarce information on Turkish cases suggests that the material injury

clause is predominantly related to import surges. More can be said if the EU enforcement practices are taken as proxies of present and future Turkish enforcement practices.

Increases of import shares are often meaningless, as best illustrated by the 1985 EU antidumping case against Turkish exporters of glass to Greece. In this case, the market share of the allegedly dumping firms increased from 2.8 to 55 percent. However, the Commission mentioned **en passant** that the sole Greek producer was selling at prices fixed by the Greek government. This observation should have led to the conclusion that the Greek pricing policy based on domestic monopoly and public intervention was the major culprit of the increase in the import market share. But, the EU Commission decided to impose antidumping measures in order to "eliminate the difference between import prices and prices fixed by the Greek government" (EC Official Journal, L51:26, 28-2-1986).

Decreases of the consumption market shares held by EU firms can easily be captured by import lobbies. For instance, in the 1987 polyester fibers case, the stability of the production of EU firms coupled with the increase of the EU demand was considered as injurious on the ground that the growth of imports "did deprive the Community industry of the benefits of increased consumption" (EC Official Journal, L151:25, 17-6-1988).

Lastly, price undercuttings (that is, when the prices charged by foreign exporters in the importing market are lower than the prices charged by import-competing firms in the importing market) have never been used as an argument against antidumping measures, though it would seem reasonable not to take measures when price undercuttings are larger than dumping margins — a situation possible in five out of seven EU antidumping cases involving Turkish exporters.

The determination of injury may also be based on the GATT Article VI concept of "threat of injury" — that is, the possibility to take into account the harm in the future related to currently harmless dumping. This concept is of crucial importance for the rapidly industrializing countries because it is often interpreted by the investigating authorities of the importing country as the combination of two criteria: current dumping, and a planned increase of the production capacities of the exporting country. By definition, rapidly industrializing countries meet these two criteria. Their firms have to meet competition — a situation which make them likely to follow price discrimination strategies, hence to dump — because they have to be known and to build a reputation, and by definition they are building new capacities of production. Industrializing countries are thus particularly vulnerable to the "threat of injury" argument. Indeed, that has been (and still is) the case of Turkey's being harassed by EU antidumping, as best illustrated by the 1985 EU case against Turkish exports of acrylic fibers (EC Official Journal, L272:22, 24-9-1986). An increase of the EU consumption market share held by the allegedly dumping firms from 3.0 (1981) to 5.4 percent (1985), combined with margins of dumping of 5.5 percent were considered by the EU Commission as sufficient evidence of a "threat of injury," once combined with increasing capacities of production. On the other hand, a brief overview of the Turkish antidumping cases initiated since 1989 shows that industrializing countries are the main target of Turkish antidumping actions.

Antidumping measures Antidumping measures can take two main forms: duties (ad valorem or specific) or undertakings — that is, the commitments by the foreign firm to raise prices to a minimum level or decrease exports to a maximum level. In other words, undertakings consist in voluntary export restraints or voluntary price increases. Concerning measures to be taken, the Turkish law contains one potentially more liberal clause and three more protectionist provisions than the other comparable laws.

Article 7 introduces the "lesser-than-margin of dumping" rule by which the antidumping (antisubsidy) measure can be lower than the estimated margin of dumping (subsidy) based on what is necessary for eliminating the injury. It should be stressed that this potentially liberal provision has limited impact. More biased rules for estimating the margins of dumping and injury can preemptively ruin the potentially positive effect of this provision.

Among the more protectionist provisions, Article 11 officially recognizes that undertakings consist in voluntary export quantity restraints or in voluntary price increases. Article 12 introduces an "inverted national interest" clause. Normally, a national interest provision allows the authorities not to take measures in the "interests of the nation" — even when dumping and injury have been established. By contrast, the Turkish law defines the national interest as a situation where immediate intervention under the form of (provisional) measures is required. Lastly, Article 13 of the Turkish law does not seem to exclude the possibility to concurrently enforce antidumping and antisubsidy duties, and it adds that when it is not the case, the duty with the higher rate shall prevail.

A quasi-judicial process under severe constraints The examination of the Turkish law would be incomplete without a description of the institutions in charge of this quasi-judicial process and constraints imposed on the process.

Turkish antidumping cases are carried out exclusively by administrative bodies: a Board in charge of the investigations which also suggests the measures; the General Directorate of Importation which is the secretary of the Board, and the Ministry to which the General Directorate of Importation is attached. Does this organizational setup aggravate or limit the economic impact of the Turkish antidumping law — i.e., what is the protectionist content of this law? Again, it is too early to have a complete and balanced view. However, two remarks are useful at this stage.

First, this organizational setup does not guarantee transparency and suggests that an appeal in case of litigations would be difficult to win. Indeed, Akinci (1992) has underlined the fact that the organization of the Turkish antidumping procedure could create tensions within the legal Turkish system. On the one hand, the bodies involved make the whole antidumping process falling under the ambit of the Turkish administrative law. On the other hand, the antidumping procedure has to respect time limits (in order to allow its quasi-judicial aspects to be developed) which have to be more generous than the time limits which should be respected under the general Turkish administrative law. Under this law, any dispute should

be solved within 60 days after the complaint. As a result, future cases may lead to internal legal inconsistencies.

Moreover, the Turkish procedures are very close to the EU way of handling antidumping cases, and the EU's record of the past decade does not give an optimistic message. The enforcement of the Turkish antidumping law will be subject to the constraints on Turkish trade policy arising from its relations with the EU. First, as a candidate for EU membership, Turkey had strong incentives to adopt a law closely similar to the EU rules and it has strong incentives to enforce it in a parallel manner. As the EU Commission has suggested a distant and vague date for the negotiations for accession, Turkish antidumping cases can cause complex situations. They can aggravate trade conflicts with the EU. For instance, they can be an instrument of retaliation against EU antidumping actions initiated against Turkish firms. Or they can be an instrument used by Turkish **and** EU firms in order to protect Turkish markets against non-EU exporters. They can duplicate EU antidumping cases against exporting firms from non-EU countries. Second, the strong anti-competitive content of antidumping actions is likely to lead EU firms established in Turkey to initiate Turkish antidumping actions against **other** EU firms exporting to Turkey — making even more complex and chaotic the economic and political forces driving the enforcement of the Turkish antidumping law.

4. The Turkish Antidumping Cases: A Preliminary Assessment

After a brief overview of the Turkish antidumping cases initiated from December 1989 to January 1993, this section raises the question of the "efficacy" of these trade actions.

An overview of the Turkish antidumping cases From December 1989 to January 1993, 57 cases have been initiated by the Turkish authorities. This record is impressive, especially as the outcome of 49 cases is already known — meaning an average time span of investigation of roughly 10 months by case. Table 8.1 presents a breakdown of these cases by year, group of countries, and industries.

The time pattern of the cases shows an upsurge in the first two years, and a lower rate of initiation in 1992. This apparent trend may be related to the initially high level of expectations raised by the adoption of the antidumping law and/or to increasing bottlenecks in processing cases. As all the 14 cases of 1989 were lodged in December 1989, the year 1990 has witnessed a more regular inflow of cases. The first final outcomes were published in October 1990. They show some decline in official antidumping measures: the "restrictiveness" (the number of cases terminated by restrictive outcomes as a percentage of the number of cases initiated) has declined from two-thirds for the cases initiated in 1989 to 50-45 percent for the cases initiated in 1990 and 1991. This decline suggests two alternative interpretations. It can be related to the desire to maintain an open-trade policy or it can merely reflect the time limits in processing cases. More observations are needed for getting a clearer view of what has really happened.

The country breakdown shows some similarity with the EU antidumping record. A high percentage of cases deal with "non-market economies" and Asian newly industrialized countries - with a strong focus on China and Taiwan Province of China. On the other hand, Japan was never caught in Turkish antidumping cases while it is a prime target of the EU procedures. Also, less-developed countries such as Egypt, India, Indonesia and Pakistan are caught in several Turkish cases, whereas they are largely unaffected by EU antidumping cases (though less so in the most recent years 1990-1993). The restrictiveness widely varies between countries — implying a possible rise of international trade tensions between Turkey and the countries exporting products targeted by the most successful Turkish complainants.

The breakdown by industry is the most important information to look at because protection is driven by domestic industries (not by the desire to target foreign countries). The 57 cases cover a wide range of industries — perhaps reflecting the fragility of the recent free trade orientation of the Turkish economy. The most active industries have been textiles (ISIC 3211), synthetic chemicals (ISIC 3513 related to synthetic textiles), glass products (ISIC 3620), metal products (ISIC 3819) and scientific equipment (ISIC 3851). The restrictiveness ratios by industry shows that some complaining industries — such as glass or machinery — are clearly more "successful" than others.

The impact of antidumping actions This brief description shows that the Turkish antidumping rules have already become a regular instrument of "contingent protection". What have been the major effects of this instrument on the Turkish economy?

To answer this question requires some knowledge of the degree of additional protection provided by antidumping actions. Table 8.1 gives some information by providing provisional and final duties when they are known and given under an ad valorem form. Average final antidumping duties are very high — almost 40 percent — with peaks up to 100 percent for some trading partners (non-market economies) and industries (glass and machinery). One can also observe an escalation of duties by type of trading partners: EU countries face lower duties than other OECD countries which in turn face lower duties than Asian NICs and LDCs. Lastly, the main observation by industry is that antidumping duties are extremely discriminatory by sector.

All these observations fit well the usual pattern of antidumping measures enforced by the OECD countries. For instance, roughly 70 percent of the antidumping actions initiated by the EU Commission have been terminated by restrictive measures, and the average ad valorem tariff equivalent of these measures is roughly 23 percent. Turkish exporters caught in EU antidumping actions face an average antidumping ad valorem tariff equivalent of roughly 18 percent (including undertakings).

Such high trade barriers should be expected to have a substantial impact on the Turkish economy. Table 8.2 presents the preliminary information available for assessing this impact. It suggests two results.

First, imports from the allegedly dumping countries drop drastically after the introduction of the antidumping measures. Two years after the initiation of the cases, they add up to only one-fifth of the values of the initiation year (assuming that cases lodged in December 1989 are considered as cases lodged in 1990). However, changes in value can reflect changes in quantity and/or in price. These two changes should be examined separately. This is possible only for five cases lodged in 1989 for which the required information is available. Table 8.3 shows that the decline in quantity (roughly 50 percent) is indeed accompanied by increases in prices (roughly 13 percent, including the dumpers which have lowered their before—duty prices probably in order to absorb the 15 to 20 percent antidumping duties to align with the competitors' prices). The developments observed in the Turkish cases seem more marked than those observed in the EU cases where three years after the initiation, imported quantities have decreased by 35 percent, and two years later, by 50 percent.

Second, antidumping actions are discriminatory by nature: they deal only with a portion of the imports of the product under question. The extent of trade diversion depends on the existence and efficiency of alternative sources of supply. However, Turkish cases are too few and recent to provide some stable results on these aspects. Based on the very limited evidence available, Table 8.2 suggests that the main beneficiaries could be producers located in Turkey since the exports of the "non-dumping" foreign producers have declined. However, this evidence should not be used as a justification of the use of antidumping. Case studies in other antidumping enforcement reveal a huge gap between the adjustment targeted and the adjustment achieved. One of the best examples is the United States antidumping case on TV sets which has been imposed in 1982. Nine years later, the United States industry is completely dominated by foreign firms (most of them having been involved in the antidumping case). Another example is given by the EU antidumping case in photocopiers initiated in 1985. Seven years later, the foreign firms involved in the case held a larger share of the EU markets, and the two remaining EC firms were rapidly becoming mere distributors of the copiers produced by these foreign firms -- despite "anticircumvention" cases aimed at making investments by these foreign firms in the EU more costly. The United States and EU steel sectors, and the EU chemical sector offer increasingly numerous similar examples.

How costly are such "inefficient" antidumping measures for the importing economy? Among the many elements to be taken into account, two aspects deserve particular attention. First, price increases following antidumping barriers are high, a crucial observation when one takes into account the economic analysis which shows that the welfare cost of trade barriers is a function of the square of price increases. The second aspect is particularly crucial for countries - such as Turkey - characterized by small domestic markets. There are strong links between anti-competitive behavior and antidumping actions. For instance, half of the cases for infringement to EU competition rules (Article 85.1 of the Treaty of Rome) have been accompanied by EU antidumping actions. This correlation supports the anti-competitive content of antidumping actions which has been observed above - from the initiation step (the "major proportion" clause) to the final step of measures (the role of undertakings or specific duties). Protectionist measures introducing a non-competitive environment generate even higher costs because they allow the cartel to impose full monopoly prices instead of

monopolistic prices "limited" by the potential shift of consumers from domestic products to foreign ones.

Lastly, it is essential to mention that Turkey offers a good example of the "fatal attraction" syndrome. Many Turkish cases (almost one third) concern the same goods and countries as the EU cases. This is shown in Table 8.3 which presents the Turkish antidumping cases that are common (in terms of products and countries) with EU antidumping cases. Already one fourth of EU anti-dumping cases against Turkey (four out of 16) are "mimicked" - both in terms of products and countries - by the Turkish anti-dumping cases. It might be argued that such mimicking merely reflects the fact that "dumpers" dump all over the world. However, the glass case examined above suggests an alternative hypothesis: that "antidumpers" "antidump" all over the world. Such a mimicking adds to the fragmentation of the world markets and to the costs of protection.

5. Conclusion: What Can be Done?

The Turkish antidumping and antisubsidy law is based on the same wrong economic premises as other GATT-consistent antidumping and antisubsidy laws. It is biased in favour of protectionist outcomes which may endanger the liberalization policy Turkey has been following since the early 1980s. There are three possible improvements.

First, more transparency and information could be provided in the cases published in the Official Gazette. For instance, it would be useful to mention the names of the complainants and of the foreign firms involved, whether they are Turkish firms or foreign firms established in Turkey, the market shares of all the firms involved in Turkish imports and the level of domestic consumption before the initiation of the cases, etc. All this information would help to have some evidence on the impact of the antidumping cases on the degree of competition in the Turkish markets. Clearly, this type of information would reveal the restraints imposed on foreign and domestic competition, and the impact of vested interests on public authorities. Such transparency would be a clear statement of commitment to an open trade regime.

A second improvement would be to reduce all the procedural biases (who can complain, how to estimate prices and costs, how to compare them, etc.) which have been described in this paper. However, this approach is likely to be a Sisyphean work. As soon as some biases are eliminated, complaining firms will be clever and powerful enough to introduce other biases again if no clear political stance for an open trade regime is maintained.

A third improvement would represent a huge step. It would consist of introducing a "national interest" provision into antidumping procedures. According to this provision, each case would be analyzed not only in terms of producers' interests but also in terms of users' or consumers' interests. Both interests would then be compared. Logically, the final decision would be taken in accordance with the net impact of an antidumping measure. If it hurts consumers more than the existing "dumping" hurts producers, no action should be taken. Or,

at least, the authorities would know the "price" of the measure taken — a piece of information which per se is likely to be enough to reduce the risks of excessively protectionist measures.

In the present context nothing has been said about international disciplines. The Uruguay Round negotiations clearly suggested that it is too early to expect better disciplines in antidumping from an international agreement. As a result, there is no other way than a unilateral improvement of antidumping rules. This would represent a bold move for Turkey in the direction of a more open trade regime, and a move which would sustain its tradition of unilateral trade liberalization.

Table 8.1: The Turkish Antidumping Cases, 1989—1992

		Number of cases	Provisional duties		Definitive ad valorem duties			Other definitive measures		No measures	Restrictiveness[a] (%)
			Number	Average duties (%)	Number	Average margins (%)	Average duties (%)	Specific duties	Mixed measures	Number	
All cases		57	17	39.9	23	52.8	38.7	3	1	26	47.4
	Breakdown by year of initiation										
Cases initiated in 1989		14	9	32.8	9	55.9	32.8			5	64.3
Cases initiated in 1990		27	6	57.0	11	53.0	48.5	1	1	15	48.1
Cases initiated in 1991		11	2	29.5	3	44.0	23.7	2		6	45.5
Cases initiated in 1992		5	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
	Breakdown by trading partner										
EU countries		3	1	9.0	1	15.7	9.0			1	66.7
Other OECD countries		5	3	23.3	3	52.1	12.5			2	60.0
Asian NICs		12	2	17.5	4	24.8	15.5		1	6	41.7
Developing countries		9	3	20.0	2	24.4	20.0	1		7	33.3
Non-market economies		28	8	60.6	13	82.3	55.0	1		10	50.0
	Breakdown by industry										
3211	Spinning & weaving	12	3	20.0	2	17.3	20.0			11	8.3
3411	Pulp & paper	2	2	12.5	2	28.1	12.5				100.0
3511	Basic chemicals	1	n.a.	n.a.	n.a.	n.a.	n.a.	1	n.a.	n.a.	n.a.
3513	Synthetic chemicals	6	5	15.8	5	37.0	15.8			1	66.7
3610	Pottery & china	1				100.0		1			100.0
3620	Glass	6			2	79.9	100.0	1		1	75.0
3691	Clay products	1	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
3710	Iron & steel	1				32.8			1		100.0
3819	Metal products	7	3	66.7	5	85.3	44.0			2	71.4
3823	Metal-working machines	6	3	83.3	3	97.5	83.3			1	60.0
3839	Electric machines	2			1	23.3	12.0			1	50.0
3843	Motor vehicles	5	1	45.0	2	100.0	10.0			3	40.0
3851	Scientific equipment	6								6	0.0
3909	Other manufacturing	1		0.0	1	20.7	15.0				100.0

Source: The Official Gazette of Turkey.

Notes: a) Restrictiveness is defined as the percentage of cases terminated by official measures in all initiated cases

b) n.a. - not available

Table 8.2: The Impact of Antidumping Measures: A First Assessment of the Turkish Cases, 1989—1992 (index values, 1990 = 100)

	1989	1990	1991	1992
Averages of 15 cases[a]				
Evolution of import values				
Year 1989	124.6	100.0	36.8	11.2
Year 1990	29.2	100.0	32.1	21.5
Both years	70.1	100.0	34.1	18.7
Evolution of import values in relative terms[b]				
Year 1989	210.2	100.0	55.3	26.6
Year 1990	59.6	100.0	40.1	25.9
Both years	117.5	100.0	46.6	26.1
Averages of 5 cases[a, c]				
Evolution of import values				
"Dumping" countries	129.0	100.0	36.0	23.0
Evolution of import quantities				
"Dumping" countries	95.0	100.0	45.0	n.a.
"Non-dumping" countries	64.0	100.0	56.0	n.a.
All countries	66.0	100.0	57.0	n.a.
Evolution of import unit values				
"Dumping" countries	106.0	100.0	94.0	n.a.
"Non-dumping" countries	123.0	100.0	114.0	n.a.
All countries	118.0	100.0	113.0	n.a.

Sources: State Institute of Statistics and calculations by the author.

Notes: a) Unweighted averages of indexes.

b) Evolution of "dumped" imports with respect to non-dumped imports.

c) Synthetic staple fibers against Romania, Korea, Taiwan and Italy.

d) n.a. = not available.

Table 8.3: Turkish Antidumping Cases with EC Counterparts

Turkish anti-dumping cases								EU anti-dumping cases involving Turkey		
								EU measures against Turkey		
Year	Products involved	Countries involved in both EU and Turkish cases								
		Countries	in Turkish cases		in EU cases		Other countries involved			
			Types[a]	Level[b]	Type[a]	Level[b]		Year	Type[a]	Level[b]
1990	glass, cast	Romania	duty	100.0	undert.			1985	undert.	
1990	glass, drawn	Romania	duty	100.0	undert.				undert.	
1990	glass, float	Romania	none		undert.				undert.	
1989	polyester fibers	Taiwan	duty	20.0	duty	9.1	Rep.of Korea	1987	duty	9.4
1989	polyester fibers	Romania	duty	20.0	duty	23.4	Italy		duty	
1989	polyester fibers	Romania	duty	15.0					duty	
1991	polyester staple						Italy			
1990	cotton yarn	Egypt	none		none			1990	duty[c]	9.9
1990	cotton yarn	India	none		none		Pakistan			
1991	steel, bars						Brazil	1990		

Source: Hindley and Messerlin (1993)

Notes: a) Undert.: undertaking. Mixed: mixed outcome (duty and undertaking or no measure).
b) Ad valorem amount for duty (no official estimates are available for other measures).
c) Provisional duty

Notes

1. I would like to thank very much Refik Erzan for his patient help, and his assistants for gathering data and information. My thanks go to Nazim Engin, Mark Dutz and Patrick Low for their very helpful comments on an earlier draft, and to the sponsors of the project for financial support.

2. The economic literature which is abundant in these topics has been surveyed in particular by Deardorff (1989) and Willig (1992).

3. Moreover, this definition of dumping requires a definition of the production costs to be considered. Economic analysis requires to use marginal costs — not average or total costs as used in "real" antidumping cases.

4. This section focuses on the antidumping law because so far Turkey has not initiated any antisubsidy case. Antisubsidy actions are very similar to antidumping actions, except that they directly involve the state authorities of the exporting firms in the procedures — leading to more cumbersome and much more politically difficult discussions. As a result, antisubsidy actions tend to be much less frequent than antidumping actions (except in the United States). Between 1980 and 1992 there have been only a dozen EU antisubsidy cases, compared to roughly 450 EU antidumping cases, and these antisubsidy cases have always been coupled with antidumping cases. So why has Turkey been the major target of these few EU antisubsidy actions? It seems that the goal was to send a political signal on the subsidy issue to Turkey (Chapter V), since they did not lead to effective measures. So far the EU has always applied antidumping measures on Turkish exports, following the GATT rules which exclude the imposition of both antidumping and antisubsidy measures on the same product).

5. Most of the observations reported in this section concern also other users of antidumping laws — Australia, the United States and Canada. So far, Japan and the EFTA countries remain exceptions: They have no such laws or do not implement them. The number of developing countries adopting such laws is steadily increasing: a handful in 1990 (including Turkey), a dozen in 1992—93 (among them Argentina, Costa Rica, Hungary, Morocco, and Tunisia).

6. This power devolution to domestic firms may be limited (as in the EU case, by the possibility of the EU Commission not to initiate a case) but not necessarily so (as in the United States case). However, it is interesting to note that the "major proportion" provision is almost always met: the termination without measures of the 1990 EU antidumping case against Turkish exporters of cotton towels is one of the very rare cases closed because the complainants did not represent a major proportion of the industry.

7. The conflict between antidumping enforcement and competition rules is even more striking given that the EU competition rules have provisions and procedures for exempting a concentrated industry in difficulty from competition rules — for creating the so-called "crisis-cartels." That these rules have rarely been enforced during the 1980s mirrors the fact that the EU antidumping enforcement provides an easy substitute. There are a number of other competition aspects in preparing and lodging an antidumping complaint which give rise to other potential conflicts between antidumping and competition enforcement. As shown by Bourgeois (1989), in such cases firms exchange information relating to their sales prices, market shares, costs of production and profitability. Arguing that firms may exchange only the information needed for antidumping purposes is not realistic.

8. This bias is exacerbated by the mechanism of the "residual duty" which consists of imposing the antidumping measures to all the firms of the country concerned which export the good under investigation, and not merely to the specific firms investigated.

9. Antidumping actions may consist of a preliminary and a definitive investigation.

10. This dynamic aspect in the antidumping and antisubsidy laws and practices is crucial. There is a constant inflow of more protectionist practices which are first introduced in individual cases, and then extended to other cases before finally being introduced in regulations. Norall (1989) has best described the drift of the EU rules from the first vintage (1969) to the fourth vintage (1989). In particular, he has shown how "asymmetric" treatment of the costs of domestic and foreign operations of the allegedly dumping foreign firms (for instance, sales staff salaries and expenses are dealt with similarly in the domestic and export price estimates by the antidumping office, but that is not the case for advertising, overhead and profit estimates) have been "legalized" by the 1988 EU Regulations.

11. A fascinating consequence of these biased methods is that the more similar domestic and export pricing policies of the foreign exporters are, the more certain is the finding of dumping. For instance, an exporter concludes two pairs of similar domestic and foreign transactions at two different periods: On the first day, the domestic and foreign prices are Ecu 100, and on the second day, they are Ecu 200. This exporter will be credited of a normal value (domestic price) of Ecu 150, to be compared to two export prices (Ecu 100 and Ecu 200). This exporter does not discriminate at all between domestic and export markets at the time of the transactions. However, the antidumping authorities will consider the first transaction as dumping (the export price is lower than the "normal value") and will dismiss the second transaction (because the export price is higher than the domestic price). An antidumping margin — and potentially a duty - of 50 percent is the outcome of such a procedure.

12. These figures are based on the six cases for which information is available

13. Recent OECD studies show that predatory pricing is not likely at all in more than 95 percent of United States and EU antidumping cases.

14. This procedure has led to obvious biases when the United States and Swedish prices were used for estimating "domestic" prices in Central European countries or in China.

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CHAPTER IX

CONDITIONS OF COMPETITION AND DETERMINANTS OF COMPETITIVENESS: THEORY VERSUS EMPIRICAL EVIDENCE

Helmut Forstner[1]

1. Introduction

The present study is about policies that affect both competition and competitiveness. Maybe more than for the discussions contained in previous chapters for the analysis to follow a clear distinction between these two basic concepts is vital. For this reason it appears worthwhile to summarize the major 6 points about competition and competitiveness at the outset of the present chapter.

Regarding competitiveness — more precisely **international** competitiveness — no concise definition of the notion seems to exist. In somewhat loose terms international competitiveness can be circumscribed as the general ability of a country to sell its products on international markets. Alternatively and still more elusively international competitiveness can be viewed as that potential of a country which determines its performance in international trade at large.

In contradistinction from competitiveness as the source of strengths or weaknesses in international trade, the term competition refers to conditions under which production and trade take place. More specifically, these conditions — and hence the form of competition — are usually characterized by the concept of market structure. Therefore, depending on the specifics of the latter, a particular type of competition is characteristic of a given market. And it is under the rules of a given "competitive game" that a country enjoys the fruits of its competitiveness or has to pay a price for its lack of competitiveness.

In summary, competition and competitiveness are basic elements of any framework designed to analyze production and international trade. The conceptual and functional difference between the two notions on the one hand is contrasted by a strong relationship between them on the other. As will be elaborated on and also empirically demonstrated later in this chapter, the form of competition largely determines international competitiveness of a country in a given industry.

Both the sharp conceptual distinction between competitiveness and competition on the one side and their strong substantive relationship on the other have to be reflected in any analysis of the type of policies studied presently. In this connection two general points deserve to be mentioned. First, competition policies and policies for enhanced competitiveness share

common objectives due to the fact that they are both efficiency-oriented. To the extent that enhancement of productive efficiency of domestic industries is the goal, both types of policies are expected to contribute to its achievement. Second, policy measures from the one area usually have an impact on the other area. This is true in particular for measures that are aimed at strengthening competition in domestic markets and normally — through enhancing productive efficiency — also increase international competitiveness. By contrast, measures that are directed at strengthening the country's competitive position in international markets — like ,for example, government policies in support of technological innovation or certain trade policies — may have repercussions on domestic market structure and the form competition takes in the home market.

With regard to policies for competition or competitiveness the present chapter will pursue two major objectives. First, it will shift the focus of attention on international competitiveness and deal with competition only insofar as it bears on competitive abilities. Second, the approach taken in the present analysis tends to emphasize that aspect which is the most neglected in this area, namely empiricism. While there is abundance of intuition and speculation about competition, competitiveness, their determinants and implications and while there is also a fair and growing amount of theoretical models dealing with these subjects, empirical evidence is scant. By contrast, the present contribution attempts to outline the major theoretical arguments concerning international competitiveness and provide a selection of empirical material on the theme.

The chapter is organized in four sections. The first section complements earlier chapters in outlining some features of the conceptual background for analyses of policies for competition and competitiveness. The next section presents selected empirical material on conditions of competition and sources of competitiveness in the "conventional" view of a generalized factor abundance model. The following section does the same for alternative forms of competition and the corresponding "new" sources of competitiveness. The final section states a few implications of empirical results for the above policies.

2. Policies for Competition and Competitiveness: A Few Remarks on Fundamentals

The discussion about policies for competition and competitiveness can be viewed as taking place between two poles. One of them is theoretical. It has to do with modelling the various forms of competition and deducing welfare implications of these forms as well as of policy measures. The other pole is empirical. It concerns the actually observed patterns of international specialization and trade which emerge from a number of primitive factors — like technology, factor endowments and demand patterns — but are also influenced by strategic behaviour of firms and **not least** by government policies. If the aim is to arrive at a better understanding of the impact of policies for competition and competitiveness, both theoretical and empirical analyses have to be intensified. And what is maybe more important: an attempt has to be made to bring together as closely as possible the results obtained under these two different perspectives.

The ideal of perfect competition A brief discussion of relevant theoretical concepts is best opened with a few remarks on the perfectly competitive model. In any analysis of policies for competition, the theoretical reference — explicitly or implicitly -- is to what economists have termed "perfect" competition. Without such reference most of the arguments "for competition" would lose their firm theoretical basis in the sense that only little could be said about the implications for the whole economy of the prevalence of a given form of competition.

The major elements in a definition of the purely technical concept of a perfectly competitive market are the following: Each one out of a large number of firms produces one homogeneous good, where the output of each individual firm is only a small share of the total output of any one good. In making their input and output choices firms are assumed to operate with the sole objective of **maximizing profits**. In this maximization process each firm treats all prices as fixed parameters and an individual firm's activities, either as a supplier of goods or as a demander of factor inputs, have no effect on market prices.

As is well known, an assessment of the characteristics of perfectly competitive markets in general equilibrium reveals a number of optimality properties. In this connection the major point is that such markets allow the price mechanism to lead to **overall** efficiency in the allocation of scarce resources. Especially in the present context of policy analysis the emphasis is on "overall", including the maximization both of consumers' utilities and producers' profits. An economy in a perfectly competitive equilibrium would thus guarantee an allocation of resources in such a way that both consumers and producers would be satisfied. And furthermore no one in the economy could improve his or her situation without worsening that of someone else. The major givens that determine the details of such optimum allocation are consumer preferences, production technologies and the initial distribution of resources within the economy.

From the viewpoint of the policy maker this means that measures that would help to bring about a perfectly competitive equilibrium would have to be considered the best that one could hope for as a policy tool. However, it is important at the same time to issue a warning. Only the idealized state of such an equilibrium possesses all the attractive features of overall efficiency and a lot can happen on the way towards this destination.

Nevertheless, the plea for competition policies normally uses arguments that refer to the ideal of perfect competition — even if that ideal is not explicitly mentioned. This can best be seen from a description of the general goal of competition policy in the words of one author: " competition policy seeks to ensure the efficient allocation of resources by means of open and competitive markets" (OECD (1984)). If in this statement "efficient" is given the meaning that economists attach to the notion — i.e., a state that cannot be improved upon — and if likewise for "competitive" "perfectly competitive" is substituted, the relationship becomes obvious. Against this background the analysis of competition policy must be seen as explicitly **normative** in that it is concerned with welfare effects of situations in which markets depart from the ideal of the perfectly competitive model.

However, the goals of competition policy are not always stated as clearly as theory may suggest. Thus in the literature on the subject one can find much looser descriptions, like for example that of a "policy designed to create and maintain competition" (Swann, 1983, p. 1). Likewise in the case of developing countries competition policy is widely understood in a negative sense as the dismantling of domestic regulatory regimes with the objective of strengthening the efficacy of competition in promoting cost discipline and increasing productivity. Nevertheless, even behind fairly loose descriptions of the goals of competition policy the ideal of a perfectly competitive economy remains visible.

A central dilemma associated with the perfect-competition background of the theory of competition policy has to do with the inevitable second-best nature of all such policy measures. In almost all cases they operate in a reality of which it is known that more than one market departs from perfect competition presumably in a variety of ways. If the realistic objective of the policymaker is to approach the ideal of perfect competition without being able to attain it, a second-best situation arises. And for this case the economic theory of distortions and welfare is rather short of results that would encourage an activist policy.

More specifically, if domestic markets -- for goods or for factors — are not perfectly competitive, this is usually due to a so-called endogenous distortion which is in turn based on some form of market imperfection. In the case that policy measures — e.g., those relating to competition — succeed in reducing the "degree" of such a distortion, this reduction will not necessarily be welfare increasing, if there is at least one other distortion in the system (Bhagwati, 1971). Since real-life economies are usually plagued by more than one distortion, this result considerably weakens the theoretical case for intervention in favour of "more" competition — at least to the extent that this case is built upon the ideal of overall allocative efficiency.

Competition policy as an instrument to enhance productive efficiency Since theory does not provide a clear endorsement for policies that attempt to approach the ideal of perfect competition as closely as possible, the question has to be asked about what remains as the major rationale underlying competition policy. Here the argument builds on conjectures which increasingly find theoretical as well as empirical support, mainly from the field of industrial organization. Thus, many researchers are convinced that the positive effects of the competitive process are mainly on productive efficiency and not so much on allocative efficiency. In this connection recent work in industrial organization has issued warnings that the real dangers of imperfect competition, i.e. the exercising by firms of market power, lie not so much in excess profits but in abnormally high costs. As a result, in the discussion about the merits of competition the focus has shifted from allocative efficiency to productive efficiency.

If productive efficiency is the major rationale behind measures intended to increase competition, the linkage between competition policies on the one hand and international competitiveness on the other clearly emerges. The argument here is generally for an

enhancement of international (cost) competitiveness through the positive impact of competition on the efficient use of resources in production.

In order to examine the relationship between the nature of competition and the level of production costs a number of informal factors have to be invoked. Foremost among them is the suspicion that imperfect competition can lead to the formation of cosy cartel arrangements. Such arrangements would allow their members to enjoy a quiet life without much pressure to increase cost efficiency, promote innovations or adapt to changes in markets. Another form in which imperfect competition may impact on costs is through added costs that a firm would incur in order to keep its incumbency position.

While there is much to say for a positive impact of increased competition on productive efficiency, there are limits to generalizing the argument. Recent experience of countries like Japan or the Asian NIEs would suggest that a high degree of competition is not a necessary condition for achieving international competitiveness. These countries seem to provide examples of the fact that market concentration does not necessarily impact economic performance in an adverse manner. And similar examples can be provided for particular industries in other countries, where international competitiveness was achieved, if not on the basis, so at least in the presence of domestic market concentration.

3. Conventional Sources of Competitiveness

The previous section has underlined the central role of the notion of perfect competition in the normative analysis of competition and trade policies. Although a "new" approach to the field has come to challenge the traditional framework, it is quite clear that up to now the major results of policy analysis have been derived by use of the perfectly competitive model.[3] Notwithstanding the fact that this model can hardly be said to describe realistically the working of modern economies, its analytical power appears to suffice to make it the preferred tool for economists to examine the implications of various policy options. Furthermore, the optimality properties of a perfectly competitive economy render it the ideal point of reference for the normative appraisal of policy options.

A similar situation holds for the positive analysis of international competitiveness – though perhaps with stronger rivalry for the perfectly competitive model from the side of "new" trade theories. Here too the traditional framework still serves the purpose of highlighting features of the international patterns of production and trade that are vital to any attempt at identifying in a comprehensive manner the sources of international competitiveness. In particular, the nature and the determinants of comparative advantage – a concept which has retained its significance despite the emergence of theories that build on other explanations of international trade – are best described and analyzed in a perfectly competitive framework. Like in the case of policy analysis, also in that of the investigation of patterns of specialization and trade the gap between demanding model assumptions and economic reality does not seem to invalidate the traditional approach as will be explained in more detail later on.

The theoretical framework Before spelling out the major results on international trade that can be obtained on the basis of the conventional framework, a few general remarks shall be made on the way theories of international competitiveness and trade are designed. They may prove useful later on when the investigations are about particular sources of competitiveness. First, the various theories of international trade suggest three major groups of factors as the basis of an explanation of the structure of production and trade worldwide. These groups are resource factors, technological factors and demand factors. Second, there is no one model of international specialization and trade that can deal with all three groups of factors simultaneously. Instead, each particular model can be characterized by its highlighting one particular explanatory factor and playing down or even deliberately excluding the others.

Regarding the particular case of the perfectly competitive model it must be seen as the effort to analyze in the most rigorous way conceivable the role of productive resources and their unequal distribution among countries. The rigour of this analysis is achieved in a radical way, namely at the cost of neutralizing the effects of both technology and demand on the international pattern of specialization.

Until recently the critics of the traditional approach to explaining international competitiveness and trade took exception chiefly at three of the basic assumptions underlying the corresponding model. These were the assumption of constant-returns-to-scale technologies, of perfectly competitive markets for both products and factors and of minimum dimensionality meaning that only two countries, two factors and two goods were allowed in the trading world whose workings the model is expected to explain. The severe constraint on dimensionality is no longer valid, since recent developments in trade theory showed a way to generalize the original case to that of arbitrary numbers of countries, factors and goods. However, constant returns to scale and perfectly competitive markets still are essential to the model's predictions about the international patterns of production and trade. And these two pivotal assumptions are not independent. In other words, the constant-returns technology is an important pre-condition for perfect competition to prevail. Thus it is at the cost of neglecting the important role of economies of scale that analytic results can be obtained on the significance of productive resources for international competitiveness.

The central message of the perfectly competitive model about international specialization and trade is intuitively clear. In a world where relative endowments with resources (or factors of production) differ among countries and where these factors are also not completely mobile across national borders, factor abundance must be at least one of several sources of international competitiveness. And in the perfectly competitive model from which technology and demand factors have deliberately been excluded it is the only one. In particular, in such a framework trade in goods can be seen as a way to exchange indirectly factor services and in this process take advantage of factor abundance or compensate for factor scarcity.

The theory's main proposition is about the direction of trade. In the low-dimensional world of two countries, two factors and two goods each country will export that good that makes intensive use of its abundant factor. Thus for the model of minimum dimensions the direction

of trade can be predicted unequivocally based on knowledge of factor endowments of the two countries and of factor requirements of the production of the two goods.

The generalization of the factor-abundance proposition to the case of higher dimensions has produced results which uphold the basic idea, albeit at some cost in predictive power. As opposed to the original, "strong" version of the factor abundance proposition, the new, "weak" version asserts that factor abundance determines patterns of international competitiveness only in an on-average sense. Thus countries **tend** to export those goods whose production makes relatively intensive use of abundant factors. The formal expression of this new factor-abundance proposition is by a correlation-like positive association between net exports, factor intensities and factor abundance.[4]

In summary, the contribution of the perfectly competitive model to explaining international competitiveness is in the form of a clear statement about the impact of resource abundance on comparative advantage and, hence, on international trade. On account of this statement the intuition that factor endowments must be of — admittedly varying — significance to the shape that trade patterns take receives rigorous support. And similar to the case of traditional analyses of trade policy it does not matter so much that the central results are derived from assumptions that neglect features of real economies in order to be able to focus sharply on one particular issue — in the present case the role of factor endowments.

In the predictions on international competitiveness derived from the traditional model the concept of factor intensity plays a pivotal part. By contrast, the same concept is also crucial to a definition of what may be called an industry, in the sense that usually factor intensities are assumed to be quite similar or even identical for firms belonging to the same industry, but significantly different between firms belonging to different industries. In other words, homogeneity in terms of factor intensities is one of the defining characteristics of an "industry". These two things together imply that the factor abundance theory of international competitiveness would be ideally suited to explain differences **between** industries in terms of production and trade performance in a perfectly competitive world. The latter feature being a methodological idealization, this theory can still be expected to contribute to an explanation of inter-industry patterns of production and trade in the real world economy. For this reason it appears to be useful to take a look first at the basic empirical features in such patterns as they evolved over the past two decades. The evidence gained from such a survey is expected to provide a first broad impression of the conditions of worldwide competition in the manufacturing industries.

An empirical overview of the patterns of specialization The share of the developed market economies (DMEs) in world manufacturing output[5] has been overwhelming over the past decades, although there was a substantial decline between 1970 and now.[6] Despite the significant contraction of specific industries in specific countries, the inter-industrial structure of total manufacturing output has remained relatively stable. The co-existence of these two empirical facts throws some light on the form of competition in industrial production that members of this country group face. It confirms the view that among the DMEs competition

from the industries in other DME countries is the prime source of pressure on the manufacturing industries. The pre-dominance of within-group competition among the DME countries is a notable and somewhat surprising feature in the overall empirical picture of **inter-industrial** competitive rivalry. The surprise element in this evidence has to do with the theoretical background of inter-industrial specialization outlined previously. Predictions based on the factor-abundance model would be for most inter-industrial competition to originate between countries that differ substantially in terms of factor endowments. Hence, comparatively strong competitive pressure on senescent industries in the DMEs would be expected to come from the developing countries and thus result in structural change on the scale of the DME group as a whole. This prediction is not clearly supported by empirical evidence.

In addition to the above hint at stronger-than-expected intra-group competition among DMEs the weak signs for a change in the inter-industrial structure of manufacturing production of this country group as a whole point to the increased significance of intra-industrial structural change accompanying the overall relative decline of DME manufacturing production. In contrast to the former feature the latter one is as expected on the basis of theoretical propositions.

Quite contrary to the picture obtained for the DMEs that of broad developments in the developing countries over the past two decades is characterized by sizeable changes in the inter-industry structure associated with a substantial rise in these countries' share in world manufacturing output. Here the single-most significant inter-industry shift is a large drop in the share of textiles in manufacturing output of the country group as a whole. Again this is a surprising result in view of predictions of the traditional theory of international competitiveness about gains for the developing countries to be most likely in labour-intensive industries — of which the textile industry is one. On the other hand such gains for the developing countries in aggregate could be observed for labour-intensive portions of the range of manufacturing activities like wearing apparel and footwear. But most impressive was their collective progress in resource-intensive industries such as petroleum refining, industrial chemicals and iron and steel — none of which is labour-intensive.

Surprising as some of this evidence may be from the viewpoint of the traditional theory of international competitiveness it appears to be highly relevant to Turkey's "structural" experience over the studied time period. First, almost all industrial branches that showed a remarkable performance in an inter-industry context for all developing countries figure prominently in the country's structure of manufacturing output. This applies in particular to the industries of petroleum refining, textiles, iron and steel and industrial chemicals. Thus, Turkey's manufacturing could not have been left unaffected by significant structural trends in industry over the past two decades. Second, structural gains and losses for the country in these major industries were partly in accordance with broad trends and partly countered them.

To start with the country's largest industry (in terms of the value of output), petroleum refining, Turkey could not benefit from the relative expansion of this industrial branch in the developing countries at large. Its contribution to the country's manufacturing output fell from 16.3 per cent in the mid-1970s to 14.2 per cent in the second half of the 1980s. Likewise, the relative size of the iron and steel branch declined from 7.7 percent to 6.7 percent over the same time period. By contrast, in the other two industries mentioned above Turkey followed the developments that were characteristic of the developing countries in their aggregate. Thus, the textile industry contracted in relative terms over the studied time period (from 13.8 to 11.8 percent), while industrial chemicals expanded their percentage contribution to manufacturing output from 4.2 to 5.9 percent.

The evidence on broad trends in inter-industrial competitiveness obtained on the basis of production figures is usefully complemented by similar information on international trade in manufactures, in particular, exports of such goods. Here the dominance of the DME countries is even more pronounced than in the case of production, yet their share in world exports has likewise been declining over the past twenty years. Especially with regard to competition it is interesting to note that the bulk of the DMEs' manufactured trade is with other members of the same group. In light of the factor-abundance explanation of international competitiveness this fact presents somewhat of a theoretical curiosity which holds the implication that conventional forms of comparative-advantage trade are less significant for DMEs than is trade that is conducted for other reasons.

A broadly painted empirical picture of two different types of international trade that spring from different sources of competitiveness and also represent different modes of competition in international markets arises from analyzing trade flows for various categories of goods. The first of these categories is termed Heckscher-Ohlin (H-O) goods and represents that group of industries for which the perfectly competitive model is likely to predict the pattern of international trade best.[7] The developments in world trade in H-O goods over the past two decades show -- among other things -- how developing countries have become increasingly competitive in those industries which derive comparative advantage from the abundance of certain factors of production. While the DME countries have long enjoyed a favourable and relatively stable balance of trade in H-O goods, this situation was reversed in the 1980s, when the group became a net importer of such goods. By contrast, the developing countries were traditionally net importers of H-O goods and the size of their negative trade balance grew steadily during the 1970s. By the middle of the 1980s, however, the developing countries in the aggregate became net **exporters** of H-O goods, mainly due to fast increasing exports of this type by the NIEs. Thus in summary it can be said that developing countries as a whole have improved significantly their trading position in those goods where competition on the basis of cost advantages that are rooted in factor abundance is decisive.

The second category of goods labelled product-cycle goods chiefly for historical reasons reflects an area of competition where technological capability and innovative activity figure prominently. Here the DME countries naturally excel in both production and exports, however, with a time pattern of net exports that indicates a gradual change in position. While

net exports of product-cycle goods had risen almost sixfold over the 1970s, a decline set in around 1980, mainly due to circumstances in the trade of the United States and the United Kingdom. As expected, the trade balance of the developing countries in product-cycle goods has remained negative over the whole of the past two decades. Nevertheless, the beginning of the 1980s marked a watershed also for the trade of these countries in that net imports have declined from that year onwards. Again the countries to be held accountable for this development are the NIEs which succeeded in reducing their trade deficit in product-cycle goods substantially. On the whole this evidence points to the by now well-known fact that technological competition by no means remains restricted to the DME countries, but is increasingly being spread to the developing countries too.

The role of factor abundance Empirical facts like those presented previously suggest a view which at present seems to be the most reasonable concerning sources of international competitiveness. They clearly show that the trading world — and by implication the global distribution of international competitiveness — cannot solely be explained by the working of comparative-advantage forces that are grounded in factor abundance. The perfectly competitive model cannot comprehensively account for the real-life patterns of production and trade and most probably was never meant to do so. However, there are also strong signs that factor abundance does matter as a source of comparative advantage and, hence, international competitiveness. And this appears to be quite plausible as it would indeed be a very strange trading world, if only factor endowments did matter, but an equally strange one if they did not matter at all.

If factor endowments do matter — at least to some extent — as determinants of international competitiveness, it is important to assess their distribution
on a global scale in order to understand part of the motives behind international trade flows. Furthermore, such an assessment should contribute to an understanding of conditions of competition insofar as these conditions are subject to the impact of "natural", resource-determined forces as much as to that of policy forces.

What the factor-abundance approach to international competitiveness pictures as the major source of trade are **differences** among countries. Until recently this remark would have sounded trivial, since it could be tacitly assumed that such differences called forth the equilibrating forces of international trade. This is no longer so by necessity due to the fact that similarity between countries has been shown to provide equally and increasingly strong motives for trade. Nevertheless, inasmuch as the role of factor abundance is to be explored, inequalities in the global distribution are the major point of interest.

In the present assessment four broadly defined factors of production are taken into account, namely, physical capital, highly-skilled labour, semi-skilled labour and, finally, unskilled labour. For reasons of data availability investigations are confined to a sample of forty-seven significant exporters of manufactured goods.[8] In a comparison among broad country groups, the DME countries' abundance in physical capital emerges as the salient feature. In the benchmark year 1985 these countries commanded a share of over 85 percent of the stock of

physical capital of the surveyed countries. A similarly striking feature is provided by the overwhelming abundance in unskilled labour shown by the developing countries in their aggregate. The group's share in the sample total of unskilled workers was over 97 percent in 1985.

Considering the overall structure of factor abundance, the various groups of developing countries differ substantially among themselves. Thus the NIEs can be characterized as having a fairly balanced resource structure with clear advantages in semi-skilled and also highly-skilled labour. A similar pattern is observed for the group of second-generation NIEs which, however, are better endowed with unskilled labour and semi-skilled labour in comparison with first-generation NIEs. For the remaining developing countries a striking characteristic is their extremely high portion of the world's unskilled labour force on the one side and a likewise extreme scarcity of physical capital. While the nature of the world distribution of endowments of productive resources among these broad groups of countries is neither new nor surprising, the extent of differences in factor abundance is not altogether trivial. And given such striking imbalances in the global resource patterns, an immediate conclusion is that on both the ways in which competition in international markets is carried on and the outcome of this competitive process factor abundance is likely to have a significant impact. This must be the case in spite of mounting empirical evidence for the increasing importance of driving forces behind international trade other than comparative advantage.

As a complement to the profiles of factor abundance of broadly defined country groups those of individual countries are of interest too. They reveal a few instances of extremely high concentration of factor supplies the most conspicuous example of which is that of India. This country accounted for 65 percent of the unskilled labour force of the whole country sample in 1985. Another case of high factor concentration is that of the United States which commanded about one-third of the stock of physical capital of the sample aggregate in the same year, while the corresponding share of Japan was still over 17 percent.

An assessment of the position of Turkey on this world map of factor endowments reveals the country's relative abundance/scarcity in the four surveyed types of productive factors If 1985 is again taken as the benchmark year Turkey is seen as having the relatively strongest resource base in semi-skilled labour and also unskilled labour. Its position is weaker in highly-skilled labour and weakest in physical capital. This pattern of relative factor abundance has largely been the same already in 1970 with the only exception that in the earlier year unskilled labour had been the relatively most abundant resource whereas semi-skilled labour had taken second place.[11]

Given the broad diversity of factor endowments across countries and the ensuing great likelihood that factor abundance does matter as a determinant of international competitiveness the empirical question arises about which factor matters for which industry and to what extent this is the case. In order to answer this question at least partially, industries need to be characterized in terms of the factor requirements of their production or in more technical terms by means of their factor intensities. Conventional theory asserts that differences among

industries in the intensities of use of the various factors lead to specialization in response to factor abundance or scarcity. Hence assessing the variation across industries in factor intensities allows conclusions to be drawn in regard of likely patterns of international specialization and trade.

Maybe the most astonishing empirical result in this connection is one on the variability of factor intensities across countries. As desirable as it would be to label industries as "capital-intensive", "skill-intensive" or "labour-intensive" in an unequivocal manner, this seems to be impossible at least with the current understanding of an industry as one of 28 manufacturing branches. More precisely there is no pair of countries within the sample of major exporters of manufactures for which the rankings of these branches in terms of any of the three types of factor-intensity mentioned previously would be identical. The immediate conclusion to be drawn from this result is that on a surprisingly broad range of techniques in use in the various countries.

In spite of such complexity of industries in regard of their technical characteristics, it makes sense to establish a broad classification along the lines of these three types of factor intensity. It is on the basis of such a classification that countries' patterns of industrial output and trade can be appraised. The empirical evidence in this regard is that the structure of manufacturing output largely concords with the "weak" version of the factor-abundance proposition stated previously. And this concordance, somewhat surprisingly, appears to be stronger in the case of the DMEs than in that of the developing countries.

Against this general background the specific example of the structure of Turkey's manufacturing output as well as exports can be evaluated. The result of this evaluation is interesting, in particular regarding the distinction that it shows between the structure of production and that of exports. To start with the former, the proportions both of capital-intensive industry and of skill-intensive industry in total output are relatively high and approach levels that can be considered standard on average over the chosen country sample. By contrast, the analogous proportion of labour-intensive industry is considerably lower lying at about one-half of the percentage that characterizes the major exporters of manufactures on average

When the transition is made from the structure of output to that of exports, the relationship is found to be reversed. In exports the product composition is heavily biased towards labour-intensive goods, whereas both capital-intensive and skill-intensive goods receive much smaller weights in the overall structure. In general and despite the recent drastic shift towards outward orientation, Turkey's share in world exports of labour-intensive goods still is way below that of most of the successful developing country exporters of those goods.

Both of the observations reported above can be substantiated by the examples of individual industries in order to examine to which extent productive structure and international competitiveness have evolved along the lines of traditional theory and where they have deviated from its predictions. In the case of output the large shares of petroleum refineries

and also of iron and steel account to a large extent for the impressive overall weight of capital-intensive industries. Relatively high shares of industrial chemicals and of both electrical and non-electrical machinery on the other hand explain the comparatively large weight of skill-intensive industries in the production structure. The lower-than-expected contribution of labour-intensive industries to manufacturing output builds mainly on the textile industry which, in terms of value added, was the second largest of the country's branches and, in terms of employment, the largest in the late 1980s.

In the case of exports of manufactures the commodity composition has changed tremendously over the 1980s. By the end of the decade clothing had emerged as the singly most prominent export industry accounting for almost one-third of manufacturing exports. In 1990 textiles contributed another 13 percent to these exports. The performance of these two categories together — both classic examples of labour-intensive activities — illustrates vividly the general feature of a dominance of labour-intensive industries in the foreign sector. The comparatively much weaker position of capital-intensive exports builds mainly on iron and steel which increased its percentage contribution to the total of manufactured exports from less than 2 percent in 1980 to over 14 percent in 1990. The relative importance of these three industries in foreign trade is even more clearly reflected in measures of their revealed comparative advantages (RCA). According to one of these measures[10] international competitiveness of Turkey was greatest in the clothing industry as witnessed by an RCA index of 10.1 in 1990. Still highly competitive — but clearly behind clothing — was the textiles industry exhibiting an RCA value of 4.0 in the same year. Close behind on the third place iron and steel was found with an RCA value of 3.7. For all other industries – with the exception of the rather small animal-and-vegetable oils category – revealed comparative advantage was considerably lower than for the three leading industries by the end of the 1980s indicating a relatively high concentration of international competitiveness in a handful of mostly labour-intensive industries.

In order to appraise developments in a particular country's structure of manufacturing production and exports, a broader picture needs to be painted encompassing, if possible, a large number of countries and all manufacturing industries. Such general background is usually drawn up on the basis of an econometric analysis of patterns of trade in relation to either factor abundance or factor intensities or both[11]. The major results of an exercise of this type can be used to put in perspective the special case of Turkey's production and trade structure and to also reach a few conclusions concerning policies for competition and international competitiveness.

Physical capital does matter. The first of these empirical results is both straightforward and somewhat surprising in light of the most recent developments in theorizing about the major sources of international competitiveness in the manufacturing sector. It says simply that for competitive advantage in manufacturing at large the crucially important factor – among a brief list of basic productive resources – is physical capital. In other words, in the 1980s competitive strength in the manufacturing sector at large still lay with those countries that in comparison with their competitors – were abundantly endowed with physical capital. That

this statement appears to hold for physical capital rather than for human capital or skills comes as a surprise in light of some of the "new" thinking about the major sources of international competitiveness in manufacturing.

This general result about the basis of international competitiveness in the manufacturing industries suggests the following conclusion about the case of Turkey. From the empirical evidence on the structure of manufacturing output on the one hand and on abundance of resources on the other it appears that Turkey's pattern of industrial specialization shows a larger weight in capital-intensive activities than seems to be warranted by the country's resource structure. Thus, despite the proven significance of physical capital for industrial competitiveness at large, this bias in specialization cannot be seen as wholly positive.

The significance of labour skills A second fairly general empirical result on the sources of comparative advantage can be stated at the level of individual industries. While physical capital appears to be of overriding importance for creating comparative advantage in manufacturing as a whole, there is little doubt about the fact that the actual pattern of industry-specific specialization is heavily influenced by other factors. If all manufacturing industries are viewed together, then it appears that so-called semi-skilled labour — that is workers that are neither unskilled nor possess skills and knowledge of the highest degrees — is the major determinant of comparative advantage at the industry level.

More specifically it can be asserted that factor abundance does play a role also in the formation of the inter-industry pattern of international competitiveness within the manufacturing sector. And according to the underlying theoretical model this role is likely to increase with the broadening of possibilities for competition. In addition, it seems to be clear that only one of the basic factors of production, viz. semi-skilled labour, deserves to be seen as the "carrier" of the impact of factor abundance on competitiveness.

The fact that this particular resource accounts for most of the factor-abundance influence on trading patterns is not altogether counter-intuitive, for at least two reasons. First, of the factors considered in the present context, semi-skilled labour to a large extent fulfils the assumption of immobility between countries, a condition which is crucial to any factor-abundance reasoning. The movement of highly skilled labour between countries, as well as the influx of unskilled labour in great numbers into North America, West Europe and also Japan, make the immobility assumption questionable for these two factors. Second, and maybe more importantly, semi-skilled labour by all means represents a vital input in most industries due to the fact that it is composed of the broad category of workers whose skills are particularly closely related to the production process. It is not hard to believe that a large reservoir of workers with production-oriented skills provides a solid basis for comparative advantage in specific industrial activities.

In summary, the two distinct effects of factor abundance on patterns of international specialization outlined previously call for special consideration in the context of the design of at least some of the policy measures discussed presently. This consideration usually has

to be given not only to one particular type of policy but to several of them and in particular to the consistency of policies directed at the enhancement of competition or competitiveness. Furthermore, claims may be raised in this connection for policy measures that transcend the narrow sphere of competition policies, but are related to them, as for example broadly defined industrial policies that aim at the strengthening of a country's base of productive resources as a means to increase international competitiveness.

4. Alternative Forms of Competition and Sources of Competitiveness

The previous section reported a number of empirical results in support of the view that some of the factors that would completely determine international competitiveness in a world in which perfect competition rules also have a bearing on specialization and trade in the imperfectly competitive real world. It was also shown in which way such factors impact the pattern of international competitiveness. While the significance of conventional determinants of competitive strength comes as a surprise, there is little doubt that increasingly an alternative set of determining factors shapes the global patterns of specialization and trade in the manufacturing sector. And the influence on competitiveness of these factors is closely linked to forms of competition other than the one postulated in the perfectly competitive framework.

The conceivable alternatives to a world of perfect competition are many and accordingly a multitude of theoretical accounts can be thought of that would describe different forms of imperfect competition. Nevertheless, there are a number of traits that seem to be common to several versions of an imperfectly competitive world. One of these traits is the existence of economies of scale in production. On the one hand scale economies usually change the nature of competition in that they call forth larger firms that are not merely price-takers. On the other hand, in an imperfectly competitive environment the potential to exploit scale economies becomes a crucial determinant of international competitiveness.

Another feature that is characteristic of the imperfectly competitive real world of international specialization and trade is the diversity of consumer preferences which leads to various forms of product differentiation. Such differentiation constitutes a particular form of imperfect competition which is a "natural" response of producers to diverse preferences. Like in the case of scale economies also in that of product differentiation not only the nature of competition and thus market structure are influenced, but also an industry's competitiveness. It depends to a large extent on firms' abilities to engage in product differentiation.

In the "classic" case of a non-traditional form of competition economies of scale and product differentiation work together to produce a pattern of specialization that deviates substantially from what can be explained by conventional trade theories. Empirically such specialization manifests itself in the form of intra-industry trade by which is meant the concurrent export and import by a country of a narrowly defined category of products. Such trade cannot usually be explained on the basis of comparative-advantage arguments but demands to invoke

a model of some form of imperfect competition. For this reason empirical measures of intra-industry trade can in an indirect way be interpreted as indicators for the extent of international specialization and trade that take place under conditions of imperfect competition.

The growing importance of intra-industry trade: Over the past two decades intra-industry trade in manufactured products has been growing substantially throughout the world. In the mid-1980s the developed market economy countries on average conducted over 40 percent of their trade in manufactured goods in the form of intra-industry trade whereas this share had been around 35 percent at the beginning of the 1970s. Over the same time period the major developing-country exporters of manufactures had even doubled their share of intra-industry trade which reached over 15 percent by 1985. Among the developing countries the NIEs have the highest share of two-way trade whereas this type of trade is far less important for the second-generation of NIEs and for other developing countries.

Another interesting feature of international trade of the "new" type lies in the differences in performance among industries. Such differences in the respective shares of intra-industry trade point to differences in the way competition is taking place and also differences as to which are the sources of international competitiveness. If for each industry the share of intra-industry trade is calculated on average across most of the major exporting countries, electrical machinery, plastic materials and office machines emerge as those industries for which this share is highest. Other industries with shares of intra-industry trade far above the average include pharmaceutical products, various categories of both electrical and non-electrical machinery, aircraft and organic chemicals.

For all these industries it can safely be assumed that imperfect competition plays a significant role. For most of them changes in the shares of intra-industry trade moreover suggest that this role may be of growing significance. In general, out of the 90 industries[12] that can be said to constitute the manufacturing sector, 67 recorded an increase in intra-industry-trade shares between 1970 and 1985. And on average over all industries increases in two-way trade were of substantially greater magnitude than decreases. Thus intra-industry trade and the various forms of imperfect competition that it represents not only account for a significant portion in world trade but this portion is on the increase throughout the majority of manufacturing industries.

As far as the case of Turkey is concerned intra-industrial specialization across the whole of manufacturing trade is substantial and has been growing over the past two decades. On average over all manufactured products the country's share of intra-industry trade was around 35 percent in the 1980s, the result of an increase by over nine percentage points from 1970 onwards. With about one-third of trade in manufactured goods in the form of intra-industry trade Turkey is representative of the average of NIEs. The same order of magnitude of intra-industry trade is found for individual developed market economies like Greece and New Zealand, but also for second-generation NIEs like the Philippines or Thailand. Thus, Turkey can be said to exhibit substantive involvement in the "new" forms of international specialization throughout the whole of the manufacturing sector.

Upon closer inspection of Turkish trade data it turns out that - like for most other countries - shares of intra-industry trade vary widely among industries. If only those industries are taken into account that contributed more than 3 percent to Turkey's exports of manufactures in the late 1980s, the shares of intra-industry trade are seen to vary from a minimum of 0.3 percent for clothing to a maximum of 82.5 percent for iron and steel. Low to intermediate levels of two-way trade were recorded for textiles (29.0 percent), food products (30.9 percent), non-electrical machinery (43.1 percent) and electrical machinery (44.5 percent).

Economies of scale, barriers to entry and industrial concentration The "classic" reason for some form of imperfect competition to prevail is the presence of economies of scale. Although there are plenty of technical and also economic arguments to suggest the pervasiveness of scale economies, precious little is available in terms of actual empirical evidence on the subject. In the following paragraphs a number of findings will be reported that would seem to slightly narrow this gap between theory and empiricism and also provide evidence on the differences between industries with regard to this all-important characteristic.

A first piece of empirical evidence on the role that increasing returns to scale play in the various industries comes from analyses of intra-industrial forms of international specialization. From such analyses it becomes quite clear that size-related characteristics are behind much of the "new" kind of specialization. This is the case at the country level where it has been demonstrated that countries' market size largely determines their extent of engaging in intra-industrial forms of specialization and trade. Such findings suggest a strong role for economies of scale in determining a country's competitive strength in an imperfectly competitive environment. In addition, direct measures of scale economies at the industry level also show a positive association with the extent of intra-industrial trade. Both results confirm the theoretical proposition that the presence of scale economies throughout the manufacturing industries is a major source for the "new" forms of international specialization whose significance is rising quickly.

If an attempt is made to measure empirically the extent of economies of scale at the level of individual industries evidence can be obtained on the degree to which industries differ in respect of this characteristic. On the basis of such measurement[3] industries like food processing, petroleum and coal products, glass, pulp and paper and non-industrial chemicals are proven to operate with high economies of scale both in the developed and the developing countries. On the other hand scale economies are comparatively least significant in textiles, rubber products and wearing apparel.

In many cases the extent of scale economies for a given industry differs between the developed and the developing countries. Electrical machinery, for example, shows substantive economies of scale in the DMEs though not usually in the developing countries. On the other hand, for the cases of the non-metallic minerals and the basic metals industries the relationship is seen to be reversed. Likewise the footwear and plastics industries reported relatively modest scale economies in the DMEs whereas the corresponding values were high for the developing countries.

In general, empirical measures of scale economies tend to be greater in developing countries than in the DMEs. This contrast reflects the greater disparities between small and large establishments in the former countries. Scale economies are believed to be the major reason for the marked difference between large and small establishments in the two country groups. Another explanation relates to competition in that larger establishments in developing countries tend to have more highly protected markets. In comparison with their smaller competitors they are able to generate relatively higher monopoly profits. Large firms operating in the DMEs, by contrast, may not receive the same relatively generous levels of protection

Scale economies are often regarded as a natural barrier to entry. In an attempt to measure empirically the effectiveness of entry barriers in the various industries, usually the increase in the number of firms/establishments is compared with the growth of output. In a comparison of the results of such an exercise between developing countries and DMEs marked differences emerge between the two country groups. Thus in the developing countries those industries with the highest entry barriers are relatively intensive users of physical capital or depend to a considerable extent on scale economies. These industries include food processing, beverages and tobacco, petroleum and coal products and basic metals. A different picture emerges for the DMEs where industries like furniture, pulp and paper, non-industrial chemicals and glass show indications of substantial barriers to entry. Again these barriers must be attributed to heavy initial capital requirements or economies of scale.

Barriers to entry affect the degree of industrial concentration. The latter can be measured empirically[14] allowing for comparisons between industries and also between country groups. Regarding the latter it can be said that industries tend to be less concentrated in the DMEs than they are in developing countries. This feature may in part be explained by systematic differences in market size between the two groups of countries. Industrial concentration may be less pronounced in large countries than in small ones owing to the interaction between economies of scale and the size of the domestic market.

As regards differences among industries in the degree of industrial concentration patterns are surprisingly consistent among countries and country groups. Thus the most highly concentrated industries both in the developing countries and the DMEs are beverages and tobacco, footwear, industrial chemicals, petroleum and coal, rubber and glass. By contrast, among the least concentrated industries are food products, wearing apparel, wood, printing and publishing, metal products and non-electrical machinery.

In addition to an empirical assessment of industrial concentration **per se** the relationship between this characteristic and the extent of scale economies is of prime interest. Here it is somewhat surprising to find only a weak positive correlation between the two measures. This is particularly so in the case of the DMEs whereas the relationship is somewhat stronger for developing countries. Nevertheless, the empirical indication is that economies of scale are only one of several possible reasons for barriers to entry and that their significance in this respect is greater in the case of the developing countries than in that of the DMEs

Salient features in intra-industrial specialization Given that intra-industrial specialization and trade are characteristic of imperfectly competitive markets, the relationship between the extent of such specialization and the prevalence of some of the industry or market characteristics described previously can be assessed. Such assessment can be of considerable value with a view to policies for competition and competitiveness that have to take into account the increasing importance of "new" intra-industrial forms of international specialization.

A first result in this context concerns the role of industrial concentration for the extent of intra-industry trade. Here it can be stated as a general finding that the less concentrated an industry is, the higher its share of intra-industry trade must be expected to rise. This result appears somewhat surprising at first glance for the reason that economies of scale are usually supposed to lie at the core of intra-industrial specialization. And to the extent that scale economies create entry barriers, the relationship between industrial concentration and intra-industry specialization would rather be expected to be positive than negative. The observed negative association, however, can be explained on the basis of the model of monopolistic competition. This model specifies a market structure of numerous suppliers and hence a low degree of industrial concentration. By means of (horizontal) product differentiation each one of these suppliers secures the possibility for exploiting scale economies. According to empirical evidence a good deal of intra-industrial specialization seems to be driven by competition of this sort rather than by competition between a few firms with great market power.

A second aspect concerns intra-industrial specialization between countries with significantly different profiles of factor endowments, in particular, specialization of this type between developing and developed countries. Here empirical results indicate that vertical product differentiation or differentiation in terms of quality plays a major part in intra-industry trade.[15] A plausible explanation of this empirical finding seems to lie in a factor-abundance theory of certain forms of intra-industry specialization. According to this theory a capital-abundant developed country has a competitive advantage in higher-quality versions, a labour-abundant developing country in lower-quality versions of the products of a given industry. The result is trade along the lines of this pattern of vertical differentiation.

5. Some Policy Implications

As was pointed out previously, the empirical results on international competitiveness reported above are relevant to several types of policies for competition or competitiveness. While they are not sufficient in general to suggest specific measures to strengthen competitiveness of a given industry, they can provide useful insights into priorities, interrelationships and complementarities among different policy options.

From the results presented in Section 2 the conclusion arises that comparative advantage still has a role to play as a determinant of international competitiveness. In general, it may be

assumed that policies which increase competition in a given country also reinforce the impact of comparative-advantage forces on the country's international competitiveness. And to the extent that comparative advantages are based on factor abundance, policy makers need to take heed of developments in factor supplies in tandem with their efforts to foster competition in domestic and international markets.

Regarding the important role of physical capital in determining comparative advantage in manufacturing as a whole the following points appear to be particularly relevant to the case of Turkey. The enhancement of competition, for example, due to a continuing liberalization of international trade is likely to lead to more export specialization of the same type, i.e., specialization in relatively labour-intensive industries. While an increase in this type of export specialization would lead to the usual static efficiency improvements, the long-run consequences of such developments have to be seen in light of the important role that physical capital plays in the realm of industrial competitiveness.

Here one feature in the picture of recent developments in Turkey's manufacturing industry seems to be particularly interesting. All reports on the country's export performance over the past decade highlight the unprecedented expansion of manufactured exports in which labour-intensive industries functioned as the motor, in particular as regards exports to the industrialized countries[16]. At the same time it is stressed, however, that this impressive export performance has largely relied on existing capacity and has not led to any sizeable new investment in the industries concerned. In other words, there seems to be a great likelihood for trade liberalization to lead to substantially increased efficiency in the use of existing capacities while at the same time it may make only a small immediate contribution to the long-term goal of strengthening the industrial base, in particular, its important physical-capital component.

Important implications for policy making in the areas of competition and competitiveness stem from the empirical finding that semi-skilled labour is of overriding significance as a determinant of industrial competitive advantages. As a consequence of this result, competition policies are expected to pay special attention to this factor, mainly with regard to its mobility both within and between industries.

Concerning resource mobility, restructuring policies generally deal with the problem of barriers to an efficient reallocation of inputs[17]. In view of the special importance that attaches to semi-skilled labour, these policies should be designed in such a way as to facilitate the movement of this resource between firms and - to the extent possible - also between industrial subsectors. Usually there are regulatory barriers to labour mobility that tend to increase the costs of reallocation to firms. In addition workers themselves may face adjustment costs in the form of costs of exit and re-entry. Taking into account the importance of increased mobility of semi-skilled labour for a flexible adjustment to evolving patterns of international competitiveness, policy makers seem to be well advised to help reducing the costs to both firms and workers of reallocating this particular resource.

While governments have a role to play in easing the restructuring costs of exit and re-entry of all categories of labour, policies directed towards semi-skilled labour appear to be particularly important for the reasons mentioned previously. In this respect measures that are aimed at facilitating re-entry deserve special attention. For restructuring decisions in general the ease with which labour - in particular that with a higher skill content - can move to new employment is a crucial factor. This ease in turn is determined by the search costs for new jobs and the match between existing skills and those demanded by potential new employers. Since private markets often fail to deal efficiently with problems surrounding job search and retraining, public assistance is usually needed in these areas. Part of this assistance would relate to a social security network, in particular, to schemes for unemployment compensation.

Assistance directed at re-entry of semi-skilled labour can prove to be a formidable task, if one takes into account the often high specificity of skills[18] and the consequently considerable barriers to reallocation, in particular among different subsectors. Thus re-training activities meant to facilitate skilled-labour movements may consume a sizeable amount of resources mainly due to factor specificity. And yet substantial public support in this area appears to be more than justified in view of the proven significance of semi-skilled labour for industrial competitiveness.

While restructuring is comparatively most difficult when it involves different industries - not least due to interindustrial barriers to mobility of semi-skilled labour - it can be assumed to pose lesser problems when it takes place within industries. In this connection the worldwide gradual shift to more intraindustrial specialization and trade signals greater ease for the process in the future. These projections seem to be particularly relevant for a semi-industrialized country like Turkey whose intraindustrial specialization can be assumed to grow rapidly in the near future. Nevertheless, even in an environment where adjustment to competitive trends takes place within rather than between industries restructuring policies retain their prime importance as instruments to strengthen international competitiveness.

Finally, the empirical findings on major determinants of intra-industrial competitiveness also have implications for competition policies. One probable consequence of increasing competition sectorwide due to implementing such policies is a reduction of industrial concentration in several subsectors. Intuition and certain theoretical arguments suggest that such de-concentration could diminish competitive strength of the "new" type that is characteristic of imperfectly competitive industries and their intraindustrial specialization. Contrary to this assertion empirical evidence on competitiveness of the intra-industrial type supports the view that less industrial concentration - in the wake of more competition - rather leads to more intense participation of industries in the "new" forms of international specialization.

Notes

1. I am grateful for comments and suggestions from Refik Erzan, Dani Rodrik and Raed Safadi on an earlier draft.

2. All empirical results presented throughout this chapter are based on, if no other source is cited, research carried out in UNIDO by use of the Organization's various data bases. In particular, Forstner and Ballance (1990) served as a major source of empirical material presented here.

3. A concise presentation of the formal background of both "old" and "new" results on trade policy is contained in Baldwin (1992). The paper also argues convincingly that the new theorizing is likely to be integrated into the framework of the traditional theory of commercial policy rather than replacing it.

4. Deardorff (1982) gives a detailed account of the new kind of relationship between factor abundance, factor intensities and net trade in the general model with many goods, factors and countries. This relationship can be used as the basis for empirical tests of the generalized factor abundance proposition as will be shown later in the chapter.

5. Throughout the present discussion references are to output measured in terms of value added.

6. While at the beginning of the 1970s the DMEs accounted for about three-quarters of world industrial production their share had fallen to less than two-thirds towards the end of the 1980s.

7. Heckscher-Ohlin goods are produced with technologies that are everywhere the same. Economies of scale are assumed to be absent and product specifications are simple and universally accepted. As a consequence H-O goods represent a fairly orthodox set of manufactures where the ability to compete in international markets largely depends on a country's availability of labour and capital.

8. These exporters include all developed market economies, the Newly Industrialized Economies (NIEs), a group of second-generation NIEs and a sample of ten other developing countries. For details on the composition of country samples see Forstner and Ballance (1990).

9. In 1970 Turkey's shares in world supplies of physical capital, high-skill labour, semi-skilled labour and unskilled labour were 0.40, 1.12, 1.71 and 3.47 percent, respectively. By contrast, the corresponding shares in 1985 were 0.51, 1.21, 2.31 and 2.03 percent.

10. The RCA measure referred to here is the ratio between the country's share in world exports of a given product group on the one hand and the corresponding share in manufactured exports on the other.

11. The most comprehensive collection of empirical results of this type together with a thorough examination of methodological questions can be found in Leamer (1984).

12. Here "industries" are defined in terms of 3-digit groups of the Standard International Trade Classification (SITC) Typical representatives of this industry concept are plastic materials, electrical machinery or aircraft.

13. The particular measure on which the discussed results are based is that of size elasticity of output per worker.

14. An impression of the effects of entry barriers can be obtained by considering the increase in the number of firms in an industry in relation to its growth of output.

15. For more theoretical and empirical details on this point see Ballance, Forstner and Sawyer (1992).

16. More details on Turkey's recent export performance can be found in Aricanli and Rodrik (1990).

17. The broad conceptual framework for an analysis of restructuring policies is outlined in Atiyas, Dutz and Frischtak (1992).

18. Ng and Tyers (1992) give an example of both theoretical and empirical analysis of the role of skilled labour as a specific factor in production and trade.

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CHAPTER X

THE INTERNATIONAL SETTING

Patrick Low[1]

1. Introduction

For more than thirty years Turkey has defined its external economic relations primarily in terms of its links with Western Europe, and the EU in particular. The relationship with the EU has gradually evolved, with ups and downs, but not to the point of full membership. In addition to its associate status with the EU, Turkey recently negotiated a trade agreement with the member states of the EFTA. History, geography and long-standing political objectives have dictated the West European focus in Turkey's foreign trade policies, but that focus has not altogether excluded other trading arrangements and relationships.

Turkey was one of the earliest contracting parties of the GATT, joining in 1951, less than four years after the founding of the GATT. GATT-type relations have dominated Turkey's trade links with several of its major trading partners, including the United States, Japan and Canada. Turkey has also maintained systems of trade preferences with several developing countries under the GATT-based Protocol Relating to Trade Negotiations Among Developing Countries. In addition, Turkey maintains tariff preferences with Iran and Pakistan under the Economic Cooperation Organization. Most recently, the Black Sea Economic Cooperation Zone has begun to define Turkey's economic and political relations with the states that emerged from the former Soviet Union.

Two basic questions are addressed in this chapter. First, how important have these different arrangements been in defining Turkish trade policy, and its economic policies more generally? Second, what does the shifting international situation imply for Turkey's future policy options? Can Turkey continue to rely on the existing thrust of its trade and economic policies, or does rapid change in Europe, and growing doubt about the multilateral underpinning of international trade relations suggest that new avenues must be explored?

The chapter is divided into three main sections. The first of these examines some of the salient details of the preferential trading arrangements mentioned above. The second section discusses the multilateral context, and in particular issues raised by the Uruguay Round of multilateral trade negotiations, and growing worldwide tendencies towards regionalism. The third section looks at antidumping policies and competition policies which have become more important in Turkey in recent years. The concluding section discusses how the current international setting may influence Turkey's own choices and options in the field of trade and competition policy.

2. Turkey's Preferential Trade Arrangements

Relations with Western Europe The EU and EFTA between them accounted for 47 percent of Turkey's imports and 59 percent of its exports in 1990 (Table 10.1). The bulk of this trade was with the EU, and reflects many years of close association. The story of EU-Turkish relations starts with Turkey's application for EU membership three decades ago. This led to the Agreement of Association, also known as the Ankara Agreement, signed in September 1963.[2]

In its Article 2(2), the Ankara Agreement explicitly envisaged "the progressive establishment of a customs union". This was to be a gradual process, divided into preparatory, transitional, and final stages. The preparatory phase was to last between five and eleven years. As part of this phase, the EU extended preferential tariff quotas on certain agricultural products, together with financial assistance, whereas no specific action was required from Turkey. Instead, Turkey undertook to implement the necessary measures in order to prepare its economy for the subsequent phases of integration. As discussed by Ilkin (1990) and Bourguignon (1990), the idea of an association agreement met with overwhelming approval in Turkey in the early 1960s.

It was not until the initiation of the transitional phase, through the Additional Protocol of 1970, that doubts set in. In part this reflected the fact that limited action had been taken during the preparatory phase explicitly to prepare for integration with the EU. The desire to move to the second stage was largely political, driven by the foreign policy goal of joining up with Europe at the earliest opportunity. But on the economic front, there was concern from some quarters that Turkey's industrialization efforts would meet a premature end, if the country was forced to open up to manufactured exports from Western Europe.

The Additional Protocol called for balanced and reciprocal obligations from both parties, and for Turkey to harmonize its policies to the extent necessary to participate in the EU, and to eliminate tariffs and nontariff barriers to trade. The EU was to eliminate all tariffs on industrial products (except on some petroleum products and textiles), and to provide further financial support. There were also provisions designed to ensure the free flow of labour by 1986.

The history of integration efforts in the 1970s and 1980s is a mixed one, with long periods of inaction, punctuated from time to time by declarations of resolve and new commitments. Politics have frequently intervened, and for the EU in particular, other objectives and priorities have cut across its relations with Turkey. Successive EU enlargements and the extension of preferential arrangements to developing countries and to neighbouring countries in the Mediterranean region have undermined the value of trade preferences, and dimmed Turkey's prospects for full integration within the EU. More recently, the disintegration of the former Soviet Union, EU attempts to absorb EFTA, and the EU's own efforts towards fuller integration, through the "Europe 1992" process and the Maastricht Treaty, have all distracted

EU attention from its bilateral relationship with Turkey. For Turkey, the EU has been a moving target.

In retrospect, the question is bound to be asked whether the EU was ever seriously committed to embracing Turkey as a full member. The EU has always had to react to Turkish initiatives seeking closer economic and political association, and has felt politically constrained to respond positively, but at the same time reluctant to meet the challenge of absorbing a country so different from most EU member states. Political factors, such as the Turkish occupation of part of Cyprus in the early 1970s, continued tension between Turkey and Greece, and the military coup in 1980, have all complicated the relationship, but there are also underlying economic factors that have proven problematic.

Perhaps the greatest economic difficulty for the EU is how Turkey could become a full participant in the common agricultural policy (CAP), considering Turkey's size and the dominance of agriculture in the economy. If Turkey became part of CAP arrangements, the EU land area under agriculture and the number of agricultural holdings would increase by more than half, and the farming population would almost double. The EU's success in absorbing Greece, Spain and Portugal is attributable in significant part to the financial transfers that accompanied membership. Would such resources be mobilized for Turkey, a country of over 55 million people whose per capita income is around 20 percent of the EU average? A related issue is migration, where agreement in the early 1970s that there would be free movement of labour between Turkey and the EU by 1986 remains far from realization.

Turkey has always been haunted by the spectre of second-class status within the EU. The 1987 application for full EU membership must be seen partly in this light, although the impressive and far-reaching economic and trade liberalization that Turkey has undertaken over the last decade or so should not be ignored. Turkey is one of several countries that have applied for EU membership. In addition to the treatment given to other applicants, the fate of Turkey's application will be influenced by what develops in relations between the EU and the East European countries formerly falling within the sphere of Soviet influence, including Hungary, Poland, and the Czech and Slovak Republics.

As already noted, changes in the EU's own integration ambitions will also play a crucial role in determining future relations with Turkey. If monetary union is a serious prospect – despite doubts about the commitment of existing EU member states to the Maastricht Treaty — then countries like Turkey have a considerably higher hurdle to clear in order to acquire full membership status, and the process is likely to take much longer. It is perhaps worth noting that the convergence criteria and macroeconomic policy discipline implied by monetary union pose significant problems even for existing EU members, only three or four of whom would meet the standards required, if monetary union were declared tomorrow. This may mean that the notion of concentric circles, with differential degrees of integration occurring between the core members of the EU and countries on the periphery, will be more explicitly promoted. Developments in this direction will pose a challenge to Turkey, demanding a more

complex vision of the country's external economic relations than the single-minded historical ambition of integration into the EU.

Seemingly in anticipation of full integration between the EU and EFTA, expected to result either from the creation of a European Economic Area, or through accession by EFTA states to the EU, Turkey signed a free trade agreement with the EFTA states on December 10, 1991. This agreement contains similar provisions to Turkey's Association Agreement with the EU. To all intents and purposes, Turkey has now established a unified trade regime with the states of Western Europe.

Turkey is committed to creating the trade conditions for a customs union by eliminating barriers against EU exports and by adopting the EU's external tariff structure in respect of third parties. It is notable that Turkey's stamp duty, which amounts to a tax of some 10 percent on imports, was eliminated at the end of 1992. Considering the share of EU and EFTA imports in Turkey's total imports (Table 10.1), current arrangements with Western Europe imply a substantially open Turkish economy, although it should be noted that significant tariff cuts are still required by Turkey in order to establish the same external tariff as the EU.

What of the benefits that Turkey has gained on the export side over the years as a result of its arrangements with the EU? Access for manufactured goods has been duty-free for almost twenty years, with only a few exceptions. Turkey's exports are concentrated in three product groups — vegetables and fruits, textiles and clothing, and iron and steel — which between them accounted for over 60 percent of total exports in 1990 (Table 10.2). These products are among the most severely affected by protectionist measures in world trade, but Turkey has benefitted to some degree from special arrangements in these areas in its relations with the EU. There are some preferences for agricultural products, but against the backdrop of high protection levels under the CAP. Textiles and clothing have been subject to restrictions outside the Multifibre Arrangement (MFA), involving export restraint agreements between Turkish exporters and the Commission of the European Union. These restrictions have been less stringent than MFA quotas. Steel exports have been occasionally subjected to antidumping duties. In the United States, by contrast, the MFA quotas are applied, and steel has faced "voluntary" export restraints for many years.[3]

Although Turkey's trade policies, and economic policies more generally, did not seem to be greatly influenced through association with the EU in the 1960s and 1970s, liberalization in the 1980s has to an important degree been built around the EU relationship. Turkey's reforms have been facilitated by its links to the EC. What are the advantages and disadvantages of continuing to define trade policy primarily in relation to the EU? What are the alternatives? Full EU membership will remain elusive for a long time to come, but favourable access to the biggest market in the world obviously carries significant advantages.

A question for Turkey must undoubtedly be how to negotiate with other trading partners while at the same time remaining tied in to the EU's external tariff structure. This will hardly be

a satisfactory arrangement if Turkey is not a full member of the EU. Some variations in the tariff will result from preferential arrangements that Turkey establishes with other trading partners (see below), but the basic structure will not be affected. Since the EU external tariff structure is tailored to EU interests, there is a question whether Turkey's own trade liberalization might be hampered in certain product areas by the commitment to a common structure. On the other hand, the objective of aligning Turkey's tariffs to those of the EU external tariff has provided a powerful stimulus to trade liberalization in many sectors. The benchmark of uniformity with the EU will also serve as a discipline against trade policy regression in the future.

Trade preferences with other countries As noted above, Turkey belongs to two other preferential trading arrangements, neither of which appears to have been significant as a mechanism for expanding trade. One is the 1973 **Protocol Relating to Trade Negotiations among Developing Countries**, developed under GATT auspices. In addition to Turkey, the Protocol has been signed by Bangladesh, Brazil, Chile, Egypt, India, Israel, Mexico, Pakistan, Peru, the Republic of Korea, Paraguay, Romania, Tunisia, Uruguay, and Yugoslavia. These sixteen countries have exchanged tariff concessions. In Turkey's case only some 40 products are involved, and preferential trade flows amounted to a mere US$55 million in 1990. This is considerably less than one percent of Turkey's total imports, and about 12 percent of imports of the items on which preferences are granted to Protocol signatories. In short, despite its twenty-year existence, the Protocol is of marginal significance to Turkey's trade relations.

The other preferential agreement, the **Economic Cooperation Organization** (ECO), was signed in May 1991 by the Governments of Turkey, Iran and Pakistan. Each country has drawn up a list of items on which tariff preferences are to be granted, and in the first instance the preference margin to be granted is 10 percent. Turkey's list comprises over 80 products, and includes marble, pharmaceuticals, detergents, leather articles, paper and paperboard, canvas, pumps, compressors, certain machinery, and sports goods. The immediate effects of these arrangements will be modest, but it remains to be seen whether trade-expanding opportunities will be created over time. The ECO agreement envisages the possibility of participation by other developing countries in the preferential arrangements.

The Black Sea Economic Cooperation Zone The Black Sea Economic Cooperation Zone (BSECZ) is a new regional initiative, sponsored by Turkey in 1990. Founding members of the grouping include Bulgaria, Romania, Ukraine, Russia, Georgia, Turkey, Moldova, Armenia, Albania, Greece, and Azerbaijan. There is great diversity among these countries, and the original conception for BSECZ was largely political, reflecting rapid change in the region. No trade preferences are envisaged among the members, but closer economic cooperation is an objective of the organization. It remains to be seen whether BSECZ will develop into a trade agreement.

3. The Multilateral Context

Turkey in the GATT Although Turkey has been a member of GATT for over forty years, the extent of its participation in GATT affairs has been influenced by the relationship with the EU. Since Turkey's trade relations were defined predominantly in terms of the objective of becoming part of the EU, there has been limited scope for, or interest in, an active role at the multilateral level. Turkey has bound a significant share of its tariff schedule under GATT, but these bindings are in many cases higher than applied rates. Applied rates have come down as a result of Turkey's unilateral trade liberalization efforts, and moves towards the target of adopting the EU's external tariff structure.

As far as nontariff barriers are concerned, Turkey has defined itself as a developing country in the GATT context, and has therefore had access to various GATT provisions that aim to accommodate the special interests of developing countries. The most important of these to which Turkey had recourse was the balance-of-payments provisions of Article XVIII:B, which permit countries to maintain quantitative trade restrictions in order to confront a situation of scarce foreign exchange reserves. Turkey invoked Article XVIII:B throughout a good part of the 1980s. Relaxation of foreign exchange controls, combined with the phased elimination of quantitative import restrictions would now make recourse by Turkey to GATT's balance-of-payments exception an unlikely event.

In the Tokyo Round (1973—79), several nontariff barrier codes were negotiated, mainly as clarifications or extensions of existing GATT provisions. The areas covered by these agreements were subsidies and countervailing duties, antidumping, customs valuation, technical barriers to trade, import licensing and government procurement. Turkey has acceded to the Subsidies Code and to the Customs Valuation Code, and enjoys observer status under all the other codes. The Subsidies Code imposes certain disciplines on the use of subsidies and on the application of countervailing duties. Upon signature of the Code in 1984, Turkey undertook to phase out tax and financial programs containing export subsidy elements by the end of 1989, not to introduce any new export subsidy programs, and to ensure that all subsidy programs were consistent with the Subsidies Code.

The reason for making this declaration was that the United States interprets the code to require that developing countries commit themselves to a program for the elimination of export subsidies. This is a contested interpretation of the code's provisions, but the United States gives force to it by denying the injury test on dutiable imports from developing countries that have refused to make such an undertaking. Turkish exports have been subject to countervailing duty actions from time to time in the United States. Turkey has not applied countervailing duties on imports from its trading partners, preferring instead to use antidumping measures.

Upon signing the Customs Valuation Code in 1989, Turkey undertook to adopt the GATT method for valuing imports. This is a transactions-based methodology, which takes declared invoice values as the basis for valuation, and gives customs authorities the right to question

invoice values only where they have grounds for believing that the invoice price is influenced by non-commercial considerations. The GATT Code is widely viewed as a significant improvement over alternative valuation methods, since it reduces the scope for manipulating import values for customs duty purposes and places the burden of proof on the customs authorities in the event that they wish to adjust a declared value.

Many developing countries have complained that the code is insensitive to their situation, since they have to contend frequently with fraudulent customs practices, in particular under-invoicing. For this reason, many developing countries have preferred to retain the Brussels Definition of Value (BDV) for customs purposes. Under BDV, the customs authorities determine the "actual value" of merchandise, which is the price the item in question should fetch in the ordinary course of trade under fully competitive conditions. Under BDV, then, the customs authorities enjoy considerably greater scope for determining dutiable values. By signing the code, Turkey has undertaken to apply the transactions-value methodology within five years from signature, which is a significant trade policy discipline.

By virtue of its membership of the Subsidies Code, Turkey has submitted its recent legislation — the Law on the Prevention of Unfair Competition in Importation — for scrutiny by the Code Committee. Much of this law concerns antidumping, and so the antidumping provisions will be examined in GATT even though Turkey has not signed the Antidumping Code.

The codes on import licensing and technical barriers to trade also contain rights and obligations which it would be logical for Turkey to adopt in the context of its open trade policy. There would not appear to be any major inconsistencies between Turkish policy and code requirements in these areas. The Procurement Code would allow a gradual approach to the opening up of government contracts to international competitive bidding. Participation in the code would create export opportunities for Turkish industry via international tendering, as well as introducing greater competition in the domestic procurement market.

The Uruguay Round Differences among the major trading nations made it impossible to complete the Uruguay Round on schedule in December 1990. Despite high-level declarations of support, governments for a long time failed to take the necessary steps to complete the negotiations. Many smaller trading nations were forced to watch from the sidelines, as the United States and the EU jousted over agricultural reform and some of the other issues that divided them.[4] The spectacle has been frustrating for the many countries that have liberalized their trade regimes recently, and were hoping that the trade opening measures promised by the negotiations would provide them with further benefits, making their own liberalizations easier to defend domestically.

Some of what is expected from the completion of the Uruguay Round was discussed above, including the generalized adoption of the Tokyo Round codes (except government procurement). Reductions of some 30 percent in tariff and nontariff barriers will also be forthcoming. Agriculture will be subject to meaningful international discipline for the first time ever, even if the agricultural results will not be as far-reaching as hoped for by some

countries. For Turkey, a result of major importance will relate to textiles, where the MFA will be phased out over a given period. This is important for Turkey's exports to the EU as well as the United States, as extra-MFA measures will also be removed. In the case of textile and clothing exports to the EU, however, there is the question whether Turkey will lose some preferential advantage, to the extent that its own arrangements are less restrictive than regular MFA quotas. There will be new disciplines in the services area, although doubts remain about the substance of the services results.

Another area where the results may not be attractive to all countries is that of intellectual property. Led by the United States, industrial countries have pushed hard for disciplines across a broad range of intellectual property rights, including copyright, trademarks, patents, industrial designs, geographical indications, and layout-designs of integrated circuits. The results of the intellectual property negotiations establish international standards of intellectual property protection, and the means to enforce these rights. Intellectual property rights are designed to ensure that innovations receive a commercial return, but in the process these laws establish monopoly rights for enterprises. This means that any benefits accruing to countries from these new arrangements must be assessed in terms of trade-offs between the welfare costs of awarding monopoly rents on the one hand, and the incentives to industrial innovation and future investment on the other.

The cornerstone of the GATT system is the principle of non-discrimination, as laid out in the most-favored-nation (MFN) clause of Article I of the General Agreement. In economic terms, this may be defended as an efficiency principle under perfect market conditions, where the inability of governments to discriminate among supply sources ensures that least-cost supplies are available. In political economy terms, MFN is important as an instrument for keeping politics out of trade and for making protectionist actions harder to take than they would be when individual countries can be picked on. In many areas of trade policy, commitment to the MFN principle has weakened over the years, and it is unclear how much the completed Uruguay Round can do to repair the accumulated damage.

Under the proposed safeguards agreement, which regulates the circumstances under which temporary action may be taken against imports in order to assist a domestic industry, there is a commitment to eliminate voluntary export restraints. However, there is also a provision that permits countries to take safeguard measures on a discriminatory basis in some circumstances. This is a breach of a long-standing principle, where despite pressures to allow selective safeguards, many countries have insisted that such measures should only be taken on an MFN basis. The assault on MFN has taken an insidious and much less direct form via the antidumping and countervailing duty provisions of GATT. The abuse of antidumping in particular, through cumulative modifications to law and practice, has made it possible for measures taken ostensibly to protect domestic producers from anticompetitive behaviour to secure surreptitious and selective protection from imports. Finally, MFN is under growing assault from regional trade initiatives. How much this matters in terms of the trading system or to countries outside regional trading blocs is the subject of the following discussion.

Regionalism and the multilateral trading system Interest in regionalism has burgeoned in the last few years. A major turning point was reached in the early 1980s, when the United States abandoned its long-standing commitment to maintaining its trade relations on an MFN basis. Having reluctantly agreed to preferential tariffs for developing countries under the Generalized System of Preferences in the mid-1970s, the United States started to promote its own preferential arrangements in Central America and the Caribbean in the early 1980s, and also made legal provision for the establishment of free trade agreements. The agreements with Israel, Canada and Mexico are now seen as forerunners of a much broader framework of regional trading agreements embracing the entire Western Hemisphere and perhaps selected European and Asian countries as well.

Moves towards further European integration via customs unions and free trade areas were discussed in the first section of the paper. Among developing countries, there are numerous regional arrangements, which have functioned with varying degrees of effectiveness. The GATT has not been successful in mediating between regional groupings and the rest of the international trading community. GATT's Article XXIV stipulates that customs unions and free trade areas must eliminate substantially all barriers to trade between the parties and not, on average, raise additional barriers against the trade of third parties. Ever since the formation of the EU in 1957, when a GATT Working Party did not reach a conclusive finding as to whether the EU was a conforming agreement, it has proved virtually impossible for definitive conclusions to be reached on any other regional arrangement examined by the GATT.

Part of the difficulty is the imprecise nature of the conforming criteria, which talk of averages and "substantially all" trade. Another difficulty is that there is no way of establishing **a priori** how much third parties will suffer as a result of geographically selective trade liberalization. In a simple static sense, a combination of trade creation and trade diversion is likely to occur, with a neutral or negative result for third parties. But the dynamic effects of liberalization could have a positive impact on outsiders, in terms of increased trade flows and investment demand resulting from higher growth. An economic case for selective liberalization would have to rest on particular market assumptions, relating to such conditions as the presence of scale economies or monopolistic advantage.

Regional integration may be attractive for strategic, or geopolitical reasons. Moreover, countries may find that the transactions costs of international negotiations are lower among fewer countries. There may be areas of economic activity unregulated by GATT where cooperation is desirable in the context of a trade agreement. In addition, experience suggests that it takes a shorter time to achieve negotiating results regionally than multilaterally.

Governments that do not want to sully their multilateral credentials insist that regional arrangements are a half-way house, or stepping stone, to global agreements. For the reasons given above, this conception of regionalism could be valid, provided that regional agreements do not conceal deals designed to shut out third parties from the benefits of trade liberalization. Unfortunately, part of the attraction of geographically selective trade liberalization appears,

precisely, to be that it creates an exclusionary situation. Under customs unions, exclusionary devices tend to be fairly transparent, since they are applied at the frontier, and take the traditional form of tariffs or nontariff barriers.

In free trade areas, however, where the external tariffs of the parties remain a matter for decision at the national level, rules of origin play a key role in determining who will benefit from the liberalization, and by how much. Multiple transformation rules, such as those encountered in the North American Free Trade Agreement (NAFTA) for textiles and certain other products, create production sharing arrangements that will limit trading and investment opportunities for outsiders in ways not altogether obvious to the naked eye.

Given the complexity of the trade effects of selective liberalization, ground rules going beyond existing GATT disciplines would clearly be useful. In the meanwhile, a litmus test of the intent of regional arrangements turns on the question of how established agreements would have to be modified in order to allow additional countries to become part of them. Open-ended arrangements that establish the conditions for entry on an **a priori** basis are unlikely to be protectionist, and would fit the stepping-stone description of regionalism. In these cases, all that would be required is that acceding countries meet the standards already set for trade liberalization. By contrast, where complicated accession negotiations would be required in order to re-specify exclusionary market-sharing deals, then it is harder to defend regional arrangements as trade-liberalizing.

Turkey's concern with EU accession has meant that a regionally-based approach to trade relations has been far more important than a multilateral focus. The concentration of Turkey's exports and imports on Western European markets has meant that the disadvantages of a regional over multilateral orientation have not been as significant as they might have been with greater dependence on diverse markets. On the other hand, Turkey has not enjoyed free access for its agricultural exports in Western Europe. If it is true that Turkey will not attain full EU membership in the near future, then it would seem important to ensure that whatever partial integration arrangements are made do not deny Turkey the benefits of multilateralism without adequately providing those of regional integration.

4. Turkey's Antidumping and Competition Policies

Antidumping Until a few years ago, antidumping policies were associated overwhelmingly with a few industrial countries, most notably Canada, the United States and the EU. Since then, however, many more countries have developed antidumping statutes and are using these measures as an important instrument of commercial policy. One obvious reason why antidumping is in vogue in many countries is that pressures for instruments of protection against imports have increased as tariff and nontariff barriers have been reduced. Antidumping is a favourite candidate, since it avoids the political awkwardness of antisubsidy actions, where one government has to accuse another of malfeasance. Antidumping is also more attractive than safeguards, because it explains all the ills of domestic industry in terms of unfairly traded imports, obviating the need for governments to face up to the possibility

that a domestic industry is in trouble for reasons other than the perfidious behaviour of foreigners.

As discussed above, antidumping policy has gained notoriety as an instrument of protection masquerading as a defender of honest commercial values.[5] In the United States and the EU in particular, antidumping law and practice have evolved in ways that blur meaningful distinctions between acceptable and unacceptable commercial behaviour. Petitioners have seen their chances of success improved over time through incremental adjustments to the statutes and regulations that bias the outcome in their favour, and give administrative discretion to the authorities.

In analytical terms, antidumping actions should respond to predatory behaviour by monopolists, designed to destroy budding competition. But predation is hard to prove, and probably does not occur frequently, particularly in internationally contestable markets that can be supplied from multiple sources. The trouble with the definition of dumping in use in the GATT and in national legislation is that it equates any price discrimination between segmented markets with predation. Methodologies for calculating dumping are set to defaults that will identify a positive dumping margin at the slightest provocation, or suggestion of price discrimination.

In partial recognition that there might be virtue in low import prices, antidumping rules also require an injury test, such that injury to a domestic industry must be demonstrated before an antidumping duty can be levied. It is essential to show causality between dumped imports and injury before imposing a duty. But it is difficult to establish consistent and objective standards of proof of injury, so this determination also lends itself to manipulation for protectionist ends.

Turkey introduced an antidumping and antisubsidy statute, the Law on the Prevention of Unfair Competition in Importation, in June 1989. In the first three years of use, Turkey initiated some 35 antidumping cases, of which more than two-thirds appear to have ended with the application of a provisional or definitive antidumping duty. A point to bear in mind with antidumping cases is that the mere act of initiating a case will have an inhibiting influence on trade, irrespective of the final decision that is taken. It is noteworthy that only rarely have antidumping cases been brought against Western European countries, even though they dominate Turkey's imports. Is this a reflection of a policy of restraint in respect of Europe, or is it that European producers do not dump? An important question to investigate is whether the cases brought have tended to involve industries with monopoly power in the domestic market that saw their opportunity to earn monopoly profits eroded by trade liberalization. Antidumping can provide a convenient instrument for recovering some of that market power.

A positive correlation between monopoly power and recourse to antidumping action is borne out by Mexican data on antidumping cases. Of the 61 cases initiated in Mexico between 1987 and early 1992, over 50 percent were petitions by monopolies. A further seven percent

of the petitions were brought by duopolies, and 35 percent more by oligopolies (defined as industries where three or four firms account for four-fifths or more of domestic output). Mexican industry is almost certainly less concentrated than this, and these data make the point that it is monopolistic industries who try hardest to use the antidumping system to recuperate the market domination they enjoyed prior to trade liberalization.

In a world where a growing number of countries are adopting antidumping statutes, and where perhaps political exigencies dictate the need for an instrument like antidumping to act as a safety valve that will sustain trade liberalization, it is unrealistic to argue that countries should simply eschew antidumping altogether. The challenge then is to design an instrument and establish practices that keep the disruptive and protectionist damage caused by antidumping actions to a minimum. The GATT Antidumping Code only offers limited help in this regard, since the standards it sets are not as high as they could be, and the provisions are too general to provide guidance on key points. Indeed in the GATT examination of Turkey's 1989 legislation only two fairly minor definitional points were raised. The Uruguay Round text offers some significant improvements on the GATT text, and on the practice of many countries.

How does Turkey's antidumping law measure up with a "best practices" standard? There are a number of points on which improvements of provisions, or perhaps clarifications, could be made. The Turkish laws and regulations have closely followed those of the EU. Several relatively simple operating rules and definitions, which may or may not already be incorporated in the Turkish system, can help to minimize protectionist capture of the antidumping statute.

In a dumping determination, for example, averaging procedures should not be manipulated so as to increase the size of the dumping margin. Average prices that are to be compared should be calculated on an identical basis. Second, when prices have to be constructed because there are no sales that can be used for comparison, the necessary calculations should not be based on full average cost pricing — this seems to be the practice in some national systems. There are many reasons why a firm might sell below average cost for a certain period of time, and the dumping investigation should take a more flexible approach to the time during which a firm's behavior is observed, so that short-term elements in a longer-term price strategy are not taken to define a firm's prices. Third, in calculating imputed values, where direct data are not available, arbitrary and fictitious cost factors should not be relied upon in the investigation.

In the injury determination, careful consideration should be given to causality — it is not enough to show that a firm's profits have fallen and imports have increased. The definition of injury should also be based on clear criteria. Like EU law, the Turkish statute applies the lesser duty rule, meaning that the amount of antidumping duty levied should only be that necessary to cover injury if the injury margin is less than the dumping margin. This makes a good injury test even more important.

Other features of an antidumping statute that help to insulate it against abuse include a sensible criterion on standing (how representative of domestic industry petitioners have to be), the way that undertakings are used (never to be accepted or sought before a preliminary positive determination of dumping and injury), and effective measures against frivolous use of the statute by firms in order to harass imports (including the possibility of publishing information about rejected antidumping petitions as well as negative determinations). Another useful feature is **de minimis** provisions, where dumping and injury margins below a certain threshold lead to automatic dismissal of the petition. A sunset clause is also useful, since it creates the presumption that an antidumping action will be terminated by a specific date, unless good cause can be shown for avoiding termination. Finally, antidumping laws should provide for adequate representation of consumer interests, going beyond the existence of an injury test.

The above is by no means an exhaustive listing of the characteristics of a good law, but features such as these define the difference between an antidumping statute that will be used to neutralize trade liberalization and frustrate the gains from trade, and one that will be used in a more measured fashion as a safety valve.

Competition policies Competition policies have attracted more attention in recent years, directly as a result of increased reliance on markets, including privatization and domestic market liberalization in general.[7] Turkey is on the verge of adopting its own competition policy, modelled largely on EU practice. This makes the proposed Turkish statute fairly complex, containing not only rules on forbidden practices (price fixing, exclusionary dealing, and various other entry barriers), and provisions against the abuse of a dominant market position, but also the regulation of acquisitions and mergers.

An important question is whether this degree of sophistication is warranted at this stage in Turkey. Enforcement of competition law requires a high level of technical expertise, especially if policies are to be applied evenly and consistently. There is an ever-present danger that just like antidumping policy, competition policy can be captured by monopolistic forces. Capture is more likely where regulators have discretionary power and interact frequently with those that they are regulating. Astute economic agents will be able to bend the policy towards what they want, eventually making competition policy into another barrier to competition.

Competition policy in the EU plays a different role than in Turkey, most obviously because it has replaced the right to apply antidumping actions among the member states. It represents an attempt to arbitrate economic relations among closely associated states that have yet to submit to a single sovereign authority, and as such has played an important role in unifying the EU market. But even in the EU, there remains a stark contradiction between attempts to free up markets internally, and a seeming determination to frustrate foreign competition through antidumping.

One of the first questions that should be asked is how Turkey's competition policy is supposed to fit in with its antidumping policy. Antidumping measures and competition policies are justified on the same grounds — to deal with anticompetitive or unfair business practices. But antidumping measures have the effect of reducing the scope of market participation by attending to the interests of a subset of established producers, as opposed to production and selling conditions in the market. In other words, antidumping protects selected producers, and not competition. The injury test makes the point quite clear -- consumers should only be allowed to benefit from lower prices if producers do not suffer beyond a certain point. Producer interests come first.

As discussed above, antidumping actions may themselves be used as an instrument for re-establishing a monopolistic advantage following a trade liberalization. Since dumping is defined as price discrimination, all that a monopolistic firm has to do is lower its domestic price, forcing foreign competitors to follow suit, then petition for dumping action, alleging that lower prices in the domestic market are injurious to domestic industry. It takes an alert and well organized antidumping authority to detect this kind of trade harassment.

In framing a competition policy, careful consideration should be given to the role that imports can play in enforcing competition under an open trade regime. In many instances, import competition can be expected to weaken monopolistic market positions and reduce inefficiency. This would not occur if there are distortions in the international market for the good in question, or if the level of import penetration was small despite open trading arrangements. Trade policy would also be ineffective in cases where anticompetitive practices involve nontradeables. In general, however, two questions should be asked about competition policies. The first is what open trading arrangements can do in lieu of competition policy. The second is whether anticompetitive behavior is attributable to government intervention of one kind or another. Where this is the case, it would be better to address directly the anticompetitive effects of such policies rather than impose an additional set of interventions to correct the first ones.

5. Conclusions

The conclusions of this chapter can be summarized in the following points:

The objective of **membership in the EU** has dominated Turkish foreign policy for over thirty years. This focus has acted as a positive influence in driving forward economic and trade liberalization, but Turkey's current policy objectives, together with the dramatic changes that have occurred in the region, argue for a diversified approach. Turkey should not be constrained to adopt exactly the same policies in areas like antidumping and competition policy as the EU, since policies designed in an EU context will not always coincide with Turkish priorities and objectives.

The degree of Turkey's active participation in the **multilateral trading system** has been constrained by an historical focus on the EU relationship. The Uruguay Round package

promises mixed results, many of which would be of benefit to countries like Turkey. Of particular interest are improvements in market access and elimination of the Multifibre Arrangement. Given Turkey's more liberal trade policies in recent years, a more active stance in the GATT may have advantages both in defining trade policy disciplines domestically and enforcing rights in respect of trading partners. Even if the Uruguay Round package does not materialize, Turkey would benefit from strengthening its participation in GATT.

Regional arrangements appear increasingly to dominate trade relations among countries, especially in Europe and the Americas. Despite assertions to the contrary, there are grounds for concern that regionalism will crowd out more globally based arrangements, and encourage the development of hostile trading blocs. This is a source of concern for countries like Turkey, which is unlikely to be fully integrated into a trading bloc in the near future, and it calls for a diversified approach to trade relations. Turkey should ensure that it does not forego the benefits of multilateralism without the protective umbrella of belonging to a large regional trading entity.

Antidumping is increasingly becoming the cutting edge of trade policy in Turkey, as tariffs and nontariff barriers continue to fall. There are significant disadvantages to antidumping, especially when the instrument is used in a nontransparent, protectionist fashion to neutralize prior measures of trade liberalization. A number of features can be written into an antidumping statute and its accompanying regulations in order to minimize the likelihood of arbitrariness and protectionist abuse. It would be desirable for Turkey to review its antidumping policy and administration with these considerations in mind.

As Turkey plans for the adoption of a **competition law**, close attention should be paid to the degree of complexity sought in the law, bearing in mind the considerable administrative costs involved in properly applying a competition law, and the risk of protectionist subversion of the provisions. An analysis should be undertaken of the extent to which trade policy can achieve the objectives of competition policy, bearing in mind the potentially negative impact of antidumping actions on competitive conditions in the domestic market. There should be no presumption that Turkey is required to mirror EU policy in the field of competition law. The policy should be customized to local conditions.

Table 10.1: Turkey's Direction of Trade, 1985-1990
(percent)

	1985		1986		1987		1988		1989		1990	
Partner	Imports	Exports	Imports	Exports	Imports	Exports	Imports	Exports	Imports	Exports	Imports	Exports
EC	34.3	40.3	41.2	43.8	40.0	47.8	41.1	43.7	38.6	46.6	41.8	53.2
United States	10.1	6.4	10.6	7.4	9.7	7.0	10.6	6.5	13.3	8.4	10.2	7.5
EFTA	4.8	4.1	5.9	4.5	5.7	6.2	5.6	4.7	5.7	3.0	5.2	4.8
Japan	4.5	0.5	6.2	1.3	6.1	1.5	3.9	1.8	3.4	2.0	5.0	1.8
Canada	1.5	0.3	1.1	0.5	1.2	0.6	1.7	0.5	1.1	0.6	0.8	0.5
Algeria	1.4	1.4	0.3	2.4	0.9	1.4	0.7	1.9	1.0	2.0	1.3	1.6
China	0.6	0.4	0.8	1.6	1.2	1.0	0.8	1.8	0.5	0.6	2.0	1.1
Iran	11.2	13.6	2.3	7.6	6.7	4.3	4.6	4.7	1.5	4.8	2.2	3.8
Iraq	13.0	12.0	6.9	7.4	8.1	9.3	10.0	8.5	10.5	3.8	4.7	1.7
Korea	0.3	-	0.5	0.1	0.5	0.1	0.6	0.3	0.9	0.2	1.4	0.8
Libya	3.5	0.7	2.6	1.8	2.2	1.4	0.6	1.9	1.8	2.0	2.2	1.7
Saudi Arabia	2.0	5.4	1.6	4.8	1.2	4.0	1.6	3.1	1.3	3.1	3.2	2.6
South Africa	1.2	-	1.9	0.1	1.6	0.1	2.1	0.2	2.9	0.3	1.4	0.4
USSR	2.1	2.4	3.2	1.9	2.2	1.7	3.1	2.3	4.0	6.1	5.6	4.1
Yugoslavia	1.0	0.4	1.1	0.4	1.3	0.2	1.6	0.5	2.4	0.7	1.2	1.1
Other	9.6	12.1	14.1	14.4	11.4	13.4	11.4	17.6	11.1	14.9	11.8	13.3
Total	100	100	100	100	100	100	100	100	100	100	100	100

Source: UN COMTRADE database

Table 10.2: Turkey's Commodity Composition of Exports, 1985-1990
(percent)

SITC Product Group	1985	1986	1987	1988	1989	1990
00 Live animals	2.2	3.1	2.4	2.1	2.2	1.6
01 Meat and preparations	1.1	1.0	0.6	0.4	0.3	0.2
03 Fish and preparations	0.8	1.7	1.2	0.8	0.6	0.5
04 Cereals and preparations	1.7	0.7	0.8	2.9	1.5	0.6
05 Vegetables and fruits	11.8	16.5	14.1	13.6	11.1	13.4
12 Tobacco and manufactures	4.2	3.7	3.1	2.3	4.1	3.4
26 Textile fibers and waste	3.7	3.5	1.5	2.2	2.4	2.1
27 Crude fertilizers, minerals	2.4	2.6	2.2	2.4	2.4	1.9
28 Ores, scrap of ferrous metals	0.7	0.7	0.5	1.0	1.4	0.8
33 Petroleum and products	4.7	2.5	2.3	2.9	2.1	2.1
42 Fixed vegetable oil, fat	0.6	0.9	0.7	0.5	1.2	1.0
51 Organic chemicals	0.4	0.8	1.1	1.6	1.9	1.3
52 Inorganic chemicals	0.8	1.0	1.3	1.2	1.0	0.9
54 Medicinal, Pharm Products	0.2	0.2	0.3	0.4	1.0	0.6
55 Perfumes, cleaning products	0.3	0.6	0.6	0.4	1.2	0.9
56 Fertilizers	0.9	1.7	1.3	2.0	0.9	0.6
58 Plastic materials	0.5	0.9	1.6	2.0	1.6	1.2
63 Wood, Cork Manufactrs Nes	1.2	0.4	0.3	0.2	0.1	0.1
65 Textile yarn, fabrics	13.2	12.6	11.9	11.5	11.5	11.1
66 Nonmetal mineral manufactures	2.8	2.3	1.9	1.9	2.2	2.8
67 Iron and steel	11.0	10.0	7.7	11.5	10.9	11.5
68 Non-ferrous metals	1.2	1.3	1.1	1.9	2.1	1.8
69 Metal manufactures	2.3	1.6	1.8	1.4	1.0	1.2
72 Machines for specialized industries	2.2	0.7	4.1	1.1	0.3	0.3
74 General industrial machinery	2.2	1.5	2.0	1.1	0.7	0.5
76 Telecom. and sound equipment	0.4	0.2	0.3	0.8	1.0	1.8
77 Electric machinery NES	1.2	1.6	2.2	1.8	1.2	1.6
78 Road vehicles	1.4	1.1	1.0	0.9	1.1	1.1
84 Clothing and accessories	15.2	16.7	21.6	20.2	23.6	25.7
89 Misc. manufactures	1.1	0.8	1.0	0.6	0.7	0.7
	8.0	7.1	7.6	6.4	6.6	6.8
Total	100	100	100	100	100	100

Source: UN COMTRADE database.

Notes

1. I am grateful to Sam Laird for helpful comments on an earlier draft.

2. One of the fullest analyses of the EU-Turkey relationship is provided in Evin and Denton, eds., (1990). In this volume, see in particular, Ilkin (Chapter 2), and Bourguignon (Chapter 3).

3. The voluntary export restraint agreements between the United States and most of its trading partners lapsed in early 1992.

4. For an analysis of the difficulties facing the multilateral trading system, see Low (1993).

5. An analysis of these issues in the United States is found in Boltuck and Litan, eds., (1991). See also Jackson and Vermulst (1989). For an analysis of EU practice, see Messerlin (1989).

6. Petitioning industries were predominantly from the chemical, rubber and plastic industries, the steel industry, and machinery and equipment industries.

7. See Kuhn, Seabright and Smith (1992). See also Bradburd and Ross (1991), Boner and Krueger (1991), and Frischtak (1989).

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CHAPTER XI

THE "NEW" TRADE THEORIES AND NEW TRADING OPPORTUNITIES FOR TURKEY

Raed Safadi[1]

1. Introduction

This chapter has two parts. The first one is a brief discussion of recent developments in the theory of international trade with an attempt at identifying policy implications for Turkey, in particular, as regards the expansion of its external trade. The second part reports the results of an empirical analysis of the export market opportunities which the economic transition of the former USSR may open to Turkey. Finally, a policy discussion brings together conclusions from the two previous sections to provide some input for the debate on the future path for Turkey's external sector.

2. The "New Theories" of International Trade

Until a few years ago, standard models of international trade were driven by the assumption that perfect competition prevailed in all markets. Moreover, except for models that analyzed optimum tariffs and retaliation, these standard models allowed only one government to be active in policy making. The general conclusion was that interference with free trade can only be justified for the case of a large country seeking to improve its terms of trade. Though the large country's welfare may be enhanced through these interventionist policies, world welfare as a whole was thought to decline. This approach was criticized by those who observed that the traditional trade theories had neglected or severely played down such real-world phenomena as oligopoly, learning by doing, externalities, scale economies, domestic institutional constraints, and foreign ownership.

Some trade economists reacted to these criticisms by turning their attention to issues of strategic policies and imperfect competition. They have borrowed extensively from recent developments in the literature on game theory and industrial organization, and have produced a much richer body of research, known collectively as the "new" theories of international trade. This new body of international trade theory not only modified conventional wisdom on free trade, but also supplemented the traditional analysis by emphasizing that increasing returns to scale, as much as comparative advantage, might be the engine that drives international trade

The apparent prevalence of intra-industry trade (defined as the two-way exchange of goods in which neither country seems to have a comparative advantage) makes a compelling case

against assuming perfect competition, and hence constant or decreasing returns to scale. Trade economists have advanced two different explanations of why intra-industry trade is observed.

The first one emphasized increasing returns to scale coupled with product differentiation, while the second relied on market segmentation and price discrimination. Although the literature on trade policy under imperfect competition offers a profusion of models and approaches, one common policy implication of these models is that free trade is rarely an optimal policy under oligopoly, but no clear alternative emerges.

One of the most controversial aspects of the new theories of international trade is the possibility that interventionist trade policies may have beneficial "strategic" effects. The pioneering work in this area is that of Brander and Spencer (1983), (1984a) and (1984b) who showed that government policies, in particular export subsidies can serve the strategic purpose of shifting profits of imperfectly competitive industries. That is, export subsidies improve the relative position of domestic firms that are engaged in non-cooperative rivalries with other (domestic or foreign) firms, and thus allow the former to expand their market shares.

The Brander and Spencer analysis has been criticized on several accounts. For example, Dixit and Grossman (1984) pointed out that in a general equilibrium context, an export industry can only expand its output by bidding resources away from other sectors which will consequently experience an increase in their marginal costs. Therefore, the assessment of the net impact of an export subsidy not only requires knowledge of the industry in question but also of all the industries with which it competes for resources. Another critique was offered by Eaton and Grossman (1986) who pointed out that the Brander and Spencer analysis is of limited practical use because the particular policy recommendation depends critically on the assumptions of the model. In particular, Eaton and Grossman showed that replacing the assumption of Cournot competition (which Brander and Spencer used) with a Bertrand-type competition reverses the policy recommendation from an export subsidy to an export tax. Horstmann and Markusen (1986) introduced to the Brander and Spencer analysis the possibility of entry by firms. With this twist, Horstmann and Markusen found that all the benefits accruing from an export subsidy were absorbed either by worsened terms of trade or reduced scale, and thus constituted a loss to the subsidizing country.

Empirical investigations of the potential gain from mild protection in the presence of imperfect competition indicate that national welfare may actually rise, but only when no retaliation occurs. When retaliation is introduced, the costs of mutual protection are magnified by industrial organization effects. In fact the impact of these new models on policy discussions has been to reinforce arguments in favour of free trade. For example, using a general equilibrium application of industrial organization concepts to the "new" theories of trade, Cox and Harris (1985) study the gains from a United States-Canada trade liberalization agreement. They find that a free trade area between Canada and the United States would produce welfare gains of almost nine percent of GNP, more than twice the most conservative estimate using conventional models. Moreover, Venables and Smith (1986) found the industrial organization effects of the removal of remaining obstacles to trade within Europe

to be welfare enhancing. Baldwin (1992) developed an empirical model of strategic trade policy and applied it to the case of EMB-120, a Brazilian-made commuter aircraft which is exported to the United States and Europe, and which is subsidized by the Brazilian government. Baldwin found that this subsidy program resulted in a net loss to the Brazilian economy of $30 million. Finally, all of these empirical models find that the gains that are supposed to ensue when no retaliation is envisaged, are very small. In any case, the results of the empirical investigations of the "new" theories of trade are very sensitive to the underlying assumptions, and as such are unreliable guides to policy.

To the above one must add that while interventionist trade policy in the presence of imperfect competition may produce some small gains (again only in the absence of retaliation), it is assumed that they are made by benevolent governments who are not subject to pressures from special interest groups. In the presence of discretionary authorities who intervene on purportedly strategic grounds, there is a risk that the decision-making process will be captured by protectionist interests.

As Turkey assesses the opportunities emerging from the dissolution of the USSR, particularly in new national markets within the region the question arises about what role, if any, the government might play in forging closer links with these new entities. The "new" trade theories do not offer clear guidance on this issue and, if anything, suggest that a cautious approach should be adopted. On the other hand, there is evidence (Keesing and Lall, 1992) that government assistance made generally available to enterprises seeking to develop new external markets may be useful in the early stages. Such assistance should be designed with clear objectives in mind, and provided in such a way as to ensure that the subsidies are temporary and result in better export performance. Moreover, the assistance provided may best be given in forms such as international marketing skills and R&D which are inputs not readily available to firms moving into new export activities.

3. Transition Economies and Export Opportunities for Turkey

In an attempt to assess the magnitude of new market opportunities in the area of the former USSR a gravity model of trade flows can be utilized. The model provides a counter-factual indication of what Turkey's trade with the area would have been under "normal" market conditions.

The gravity flow model In order to quantify the effects on Turkey's trade of the emergence of new national markets in the aforementioned geographic area a gravity-type equation is used here. Gravity models have been applied successfully to different types of flows, such as migration, commuting, recreational traffic, and interregional and international trade. In the present context, as was pointed out by Helpman and Krugman (1985), gravity equations tend to fit trade patterns better, the more important are increasing returns to scale.

Typically, the log-linear equation used specifies that a flow from origin i to destination j can be explained by supply conditions at the origin, demand conditions at the destination, and economic forces either assisting or resisting the flow's movement.[2]

In its basic form, the equation is written as:

$$T_{ij} = \beta_0 (Y_i)^{\beta_1} (Y_j)^{\beta_2} (D_{ij})^{\beta_3} (A_{ij})^{\beta_4} \epsilon_{ij}$$

where T_{ij} is the US$ value of the flow from country i to country j, Y_i and Y_j are, respectively, nominal GDP in country i and country j expressed in US$, D_{ij} is the distance from the economic center of i to that of j, A_{ij} is any other factor either assisting or resisting trade between i and j, and ϵ_{ij} is a log-normally distributed error term with $E(\ln \epsilon_{ij}) = 0$.

The most relevant applications of the gravity equation in the present context are those that have used it to quantify the trade effects of integration.[3] The present approach is closely related to that of Pelzman (1977), and to an earlier study (Erzan, Holmes and Safadi, 1992). Pelzman investigated the trade-creation and trade-diversion effects of the creation of the CMEA (COMECON, i.e., the former Socialist trading block). He chose a pre-integration period on the basis of which equation (1) was estimated. The estimated parameters were then used to predict intra-CMEA trade during the post-integration period. The excess of actual intra-CMEA trade over the predicted volume of trade is attributed to the effect of integration.

While Pelzman's approach is acceptable when analyzing integration schemes among countries of similar characteristics, it breaks down when one is confronted with a heterogeneous sample of countries. On the other hand, in Erzan, Holmes and Safadi (1992), the effects of changes in the former CMEA area on international trade in manufactures were studied. Using a gravity flow model, the trade-diverting and trade-creating effects of the dissolution of the former CMEA arrangement were estimated. Equation (1) was reformulated by further decomposing the trade effects of the dissolution of the former CMEA area into environmental and policy effects. Environmental effects refer to the physical and economic characteristics of the "newly" emerging countries and their relations with the rest of the world, while policy effects refer to the degree of trade liberalization these countries will follow.

In order to capture these effects, equation (1) has been re-specified as:

$$\begin{aligned} \log T_{ij} = {} & A + \alpha_1 \log GDP_i + \alpha_2 \log GDP_j + \alpha_3 \log GDPPC_i \\ & + \alpha_4 \log GDPPC_j + \beta_1 \log D_{ij} + \beta_2 \log Area_i \\ & + \beta_3 \log Area_j + \gamma_1 BORDER_{ij} + \gamma_2 \log \{ |GDPPC_i - GDPPC_j| \} \\ & + \gamma_3 SHRLNG_{ij} + \gamma_4 SHREG_{ij} + \log \epsilon_{ij} \end{aligned}$$

where

T_{ij} bilateral non-fuel trade flows between countries i and j

GDP_i total output in current US dollars in country i

$GDPPC_i$ GDP per capita in US dollars at purchasing power parity for country i

D_{ij} straightline distance between the economic centres of gravity of countries i and j

$Area_i$ size of country i measured by land area in square kilometers

$BORDER_{ij}$ a dummy variable equal to one if country i and j share a common border and zero otherwise

$SHRLNG_{ij}$ a dummy variable equal to one if country i and j share a common language and zero otherwise

$SHREG_{ij}$ a dummy variable equal to one if country i and j belong to a common trading arrangement and zero otherwise

ε_{ij} a log-normally distributed error term with $E(\ln \varepsilon_{ij}) = 0$.

GDP per capita for the reporter and the partner countries is included in order to capture the effects of each country's level of development. Distance between countries (D_{ij}) and absolute difference in per capita GDP capture the Linder hypothesis (1961) that the intensity of bilateral trade is determined by geographical distance between importing and exporting countries and by similarities in demand structures. The former refers to the distance between the economic centres of the two countries, and the latter is a proxy for economic similarity. The trading arrangements included are the EU, EFTA, LAFTA, and CACM.[4] Finally, a language dummy variable ($SHRLNG_{ij}$) is included as a proxy for cultural similarities. It assumes the value of one if the countries share a common language, otherwise its value is set to zero. The languages included are English, Spanish, French and Arabic.

Estimation of the model's parameters The model described in equation (2) was estimated in natural logarithms since the range of some of the variables is so large that results in levels are easily driven by extreme observations. The double-logarithmic form also gives elasticity results that are easier to interpret. The data used are total non-fuel trade (SITC 0 through 9)

excluding SITC 3) of 95 non-socialist countries from each other during the year 1989 (the latest year for which comprehensive trade data were available).

Moreover, since the values of bilateral trade are only observed for nonnegative values, ordinary least squares estimates would be inconsistent because of censoring bias.[5] Therefore, the Tobit maximum likelihood estimation technique is used.[6] Furthermore, in predicting the trade effect of the emergence of the new markets, McDonald and Moffit's (1980) methodology in interpreting and using the estimated Tobit coefficients is followed. They show that:

$$E(y_i) = \Phi_i \beta' x_i + \sigma \phi_i$$

where ϕ_i and Φ_i are the density and distribution functions respectively of the standard normal evaluated at $\beta' x_i/\sigma$, and σ is the standard error of estimation.

The appeal of this empirical exercise depends on the intuitive appeal of the counterfactual: If bilateral trade of 14 of the above new states[7] were determined in the same way as that of the 95 non-socialist countries in the sample, then it would differ from its current pattern in a predictable way. However, in the present exercise, interest centres on the impact on Turkey, and thus investigations will be restricted to predicting the redirection of Turkey's trade as a result of the emergence of the "new" markets.

The estimated coefficients of equation (2) are presented in Tables 11.1 and 11.2 below. The empirical performance of the model is quite good. Nearly all the variables (except for the per capita GDP of the reporter on the import side α_4) have the expected sign and are strongly significant. Imports and exports increase with the level of GDP of the reporter and partner (α_1 and α_2), and decrease with the size of either (β_2 and β_3). Imports and exports also decrease with distance (β_1) and increase with a common border (γ_1). Sharing a common free trading area (γ_4) enhances trade significantly, and so does sharing a common language (γ_3).

There is nevertheless one puzzling result. The effect on trade of GDP per capita of the reporter (though insignificant on the import side) is negative. Previous research has shown the presence of a quadratic relationship between GDP per capita and the share of trade in GDP (Chenery and Syrquin, 1975, and Khani, et al., 1984). The large semi-industrialized countries appear to be on the downward sloping portion of the GDP per capita-trade intensity relationship.

Simulating Turkey's trade pattern The dissolution of the USSR and for that matter the CMEA will likely have important effects on the pattern of Turkey's trade. To get a feel for the magnitude of this reorientation of trade the estimated coefficients of equation (2) were used to project the level as well as the direction of Turkey's trade. In this exercise, data from the

14 studied markets were collected and added to the matrix of the trading partners of Turkey. Tables 11.3 and 11.4 present the results.

Several interesting points emerge from the projections in the tables. First, Turkey seems to be biasing its trade toward the European Union and against more "natural" partners like those in the Western Asian region. This is consistent with other studies that find intra-regional trade in Western Asia to be very low (Fischer, 1992). Thus, the predicted exports of Turkey to Western Asia are six percent higher than actual exports. Predicted imports are nine percent higher than actual imports. With respect to the EU, Turkey's exports and imports are projected to be six and four percent lower, respectively, than the actual levels.

The emergence of the aforementioned markets, especially those with which Turkey shares a common language (like Turkmenistan) or a common border (like Armenia and Georgia), seems to create a large export potential for Turkey. This is evident from the 90 percent projected increase in its exports to these and other countries and the 75 percent projected increase in imports. It is important to note that these projections take into consideration only actual economic performance of the new republics. In other words, the projections do not take into account future growth of these republics, and hence are lower-bound limits on the potential exports of Turkey to these markets. Once the new countries return to their potential growth path, the growth "dividends" for Turkey may become even larger.

4. Policy Implications

The results shown in Tables 11.3 and 11.4 argue for a more diversified approach by Turkey in light of the consequences of the dramatic changes that have occurred in the region. Turkey should seize the opportunities presented by the emerging markets to develop a coherent and diversified export strategy.

More than two-thirds of Turkey's exports are currently concentrated in manufactures, i.e., trade which has become increasingly globalized. Reductions in the cost of moving goods and, especially, information have encouraged the shipment of semi-manufactures between production sites. The production of labour-intensive goods is increasingly foot-loose, with low fixed costs and easily separable production steps. As is evident from the previous section, geographical and cultural distances between nations also influence patterns of trade strongly, particularly in the case of manufactures because they impose transaction costs on production and trade. Studies suggest that if distance doubles, then trade between countries of equal size declines by two-thirds. A common land border between countries increases trade by a factor close to two. A common language also leads to more trade, as do past political and commercial ties. These figures are consistent with the elasticities estimated in Tables 11.1 and 11.2.

The economic distance between nations -- influenced by geographical location, culture, and history -- is an important factor in assessing the export prospects not only for Turkey but also

for all developing countries. This distance from major markets can be reduced by better infrastructure links to international transport and telecommunications and by more open policies for trade in goods and services, foreign direct investment, and movement of people. Such links permit close interaction with buyers and suppliers in the quest for international competitiveness, and help translate low labour costs into low production costs.

Recent trends in technology have made these international linkages even more important for international competitiveness. New technologies permit more differentiation of products and sale of a wider range of products requires more detailed market intelligence. "Just-in-time" inventory management techniques and the trend toward design from manufacture require close coordination between producers and suppliers, designers, and component manufacturers. The growing interaction between markets, consumers, producers, and suppliers requires more efficient communication.[8]

Increasingly, the "new" trade theories are explicitly recognizing the important role that marketing and informational flows play in international trade. Their role arises from imperfect competition, since in a neoclassical framework sales and information flows are costless and instantaneous. Moreover, the "new" trade theories are beginning to recognize other leading problems of exporting manufactures from developing countries, such as obtaining access to competitively priced inputs, services, and infrastructure.

Recognizing the importance of these issues, the World Bank initiated research to formulate cost-effective public support in developing countries to export marketing, particularly for manufactured goods. Preliminary findings suggest that one particular policy instrument appears to be promising in this respect (see in particular Keesing and Lall, 1992): a fund which provides grants sharing up to one half of the costs of well-designed programs of export marketing involving new products or new markets or quantum changes in the way exports are marketed in demanding markets. Such a fund is provided, for example, by Singapore's Trade Development Board, and others have been included in World Bank operations in India and Indonesia. This facility allows firms to choose what area they want advice on and also to choose service suppliers, not least from the private sector.

Table 11.1: Gravity Model Estimates, Imports

Parameter	Estimate	Standard error	t for H_0: Parameter=0	Prob. > t
A	-19.17	0.35	-53.46	0.00
α_1	1.35	0.03	38.68	0.00
α_2	1.54	0.03	47.96	0.00
α_3	-0.04	0.05	-0.91	0.36*
α_4	0.10	0.04	2.50	0.02
β_1	-0.25	0.01	-19.85	0.00
β_2	-0.29	0.02	-13.93	0.00
β_3	-0.28	0.02	-12.69	0.00
γ_1	1.78	0.23	7.64	0.00
γ_2	0.25	0.03	7.73	0.00
γ_3	1.81	0.12	15.07	0.00
γ_4	1.59	0.12	12.87	0.00

Notes: (*) not significant.

A = constant term
α_1 = GDP (reporter)
α_2 = GDP (partner)
α_3 = GDP per capita (reporter)
α_4 = GDP per capita (partner)
β_1 = distance
β_2 = area (reporter)
β_3 = area (partner)
γ_1 = border dummy
γ_2 = difference in GDP per capita
γ_3 = common-language dummy
γ_4 = common-trading-area dummy.

Table 11.2: Gravity Model Estimates, Exports

Parameter	Estimate	Standard error	t for H_0: Parameter=0	Prob. > t
A	-18.13	0.36	-48.26	0.00
α_1	1.79	0.04	48.72	0.00
α_2	1.14	0.03	33.96	0.00
α_3	-0.22	0.05	-4.63	0.00
α_4	0.13	0.04	2.99	0.00
β_1	-0.28	0.01	-20.73	0.00
β_2	-0.40	0.02	-18.65	0.00
β_3	-0.20	0.02	-8.86	0.00
γ_1	1.49	0.24	6.14	0.00
γ_2	0.22	0.03	6.52	0.00
γ_3	1.77	0.13	14.14	0.00
γ_4	1.74	0.32	12.87	0.00

Note: See notes to Table 11.1.

Table 11.3: Impact of States that Emerged from the USSR on Turkey's Imports

Region	Actual Imports ($ 000)	Change Due to Emergence of New States (percent)	Predicted Imports ($ 000)
South Asia	119,346	-5.4	112,854
East Asia and Pacific	352,686	-8.7	321,843
EFTA	892,088	-3.1	864,387
European Community	5,942,687	-3.6	5,726,296
States emerged from USSR	667,405	75.5	1,171,192
Japan	529,677	-1.3	523,003
North Africa & Western Asia	301,323	8.7	327,500
North America	2,131,572	-0.5	2,119,991
Other developed countries	157,613	-1.4	155,485
South and Central America	435,753	-3.6	420,284
Sub-Saharan Africa	49,569	-1.0	49,073
Total	11,579,719	1.8	11,791,909

Notes: Trade data for the 14 new markets were obtained from "Foreign Trade of Independent Republics and the Baltic Economies," Moscow, Statistical Information Center, 1991 (in Russian). All other trade figures were obtained from the UN COMTRADE Database, United Nations, Geneva. Exchange rates used to convert devisa roubles into US$ were: 1 rouble = US$ 1.74655 for exports and 1 rouble = US$ 1.70855 for imports. "Other developed countries" include Australia, Israel, and New Zealand.

Table 11.4: Impact of States that Emerged from the USSR on Turkey's Exports

Region	Actual Exports ($ 000)	Change Due to Emergence of New States (percent)	Predicted Exports ($ 000)
South Asia	264,144	-3.6	254,740
East Asia & Pacific	147,001	-6.1	138,099
EFTA	450,265	-4.5	429,908
European Community	5,228,056	-5.5	4,943,001
States that emerged from USSR	1,089,000	89.8	2,066,427
Japan	233,133	4.2	242,827
North Africa & Western Asia	2,533,024	5.9	2,682,396
North America	1,022,941	0.0	1,023,206
Other developed countries	79,317	-5.4	75,070
South & Central America	41,718	-7.2	38,694
Sub-Saharan Africa	23,932	-16.1	20,075
Total	11,112,531	7.2	11,914,444

Note: See notes to Table 11.3.

Notes

1. I am grateful to Refik Erzan and Ceyla Pazarbasioglu for their helpful comments on an earlier draft.

2. Tinbergen (1962), and Poyhonen (1963a and 1963b) were the first to apply the gravity equation to models of bilateral trade flows (see Deardoff, 1984, for a survey). Their model was later extended and applied to different contexts in bilateral trade by Linnemann (1966), Aitken (1973), Hewett (1976), Pelzman (1977), Sapir (1981), and Brada and Mendez (1983 and 1985). The equation has been justified theoretically by Leamer and Stern (1970), Anderson (1979), and Bergstrand (1985 and 1989). In fact, Linnemann (1966) asserts that the gravity equation can be derived from a four-equation partial equilibrium model of export supply and import demand, where prices are excluded since they merely adjust to equate supply and demand. This approach, however, has been criticized by Anderson (1979) and Leamer and Stern (1970).

3. These applications include Tinbergen (1962), Aitken (1973), Hewett (1976), Havrylyshyn and Pritchett (1991), Pelzman (1977), and Erzan, Holmes and Safadi (1992).

4. For example, Aitken (1973) found European trade to be significantly influenced by membership in the EU or EFTA and by being neighbours. Srivastava and Green (1986) found cultural similarity, political circumstances, economic union and former colonial status to be significant determinants of trade between nations.

5. See for example Maddala (1983) for a discussion of the bias in OLS estimates in models with limited dependent variables.

6. See Tobin (1958), and Heckman (1976 and 1979) for a discussion and application of this technique.

7. The states included are: Armenia, Azerbaijan, Belarus, Estonia, Georgia, Kazakhstan, Kyrghyztan, Latvia, Lithuania, Moldova, Tadjikistan, Turkmenistan, Ukraine, Uzbekistan.

8. For a thorough treatment of these and other issues related to trade in manufactures, see the World Bank (1992).

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CHAPTER XII

POLICY PRIORITIES

Refik Erzan

In a ranking of policy areas in terms of their importance for shaping the environment for competition the first place may be assigned to macroeconomic policies, an area outside the scope of this study. In the absence of macroeconomic stability most of the more specific policies for competition would have limited impact at best. A partial explanation for this is that high interest rates (resulting from large deficits and high public borrowing) make productive investment expensive and convey an advantage to existing firms, especially the dominant conglomerates. Investment in physical capital, however, plays an important role in determining comparative advantages in manufacturing as a whole — and in the country's international competitiveness in this area. Since the rate of investment largely depends on the cost of funds, high interest rates tend to adversely impact manufacturing competitiveness. Furthermore, inflation distorts the price signals which would ideally indicate relative scarcities as well as opportunities and risks.

The studies comprising this volume do not deal with privatization per se. However, most of the policies discussed here are highly relevant for state economic enterprises (SEEs) and have to take into account privatization. Without examining the role of a factor in the economy as prominent as the SEEs, the conclusions drawn on the basis of the present analysis would be lacking in an important respect.

Privatization is also of high interest in relation to the resources required for some of the proposed measures: Trade liberalization reduces government revenues at a time when investment in physical infrastructure and in human skills has to be financed and restructuring of firms requires additional funds. Hence the issue of privatization appears to be relevant both in connection with the macro resource balance and the micro implementation of competition policies.

The findings of the studies presented here suggest that on the whole greater domestic competition is likely to enhance international competitiveness. More specifically, comparative advantage still seems to have an important role to play as a determinant of international competitiveness. And policies that promote domestic competition generally reinforce the impact of comparative-advantage forces on the country's international competitiveness. Likewise, increased productive efficiency resulting from greater competition works in the same direction. Finally, reduced industrial concentration — in the wake of more competition — leads to more intense participation of industries in the "new" forms of international specialization.

1. Towards a Coherent Strategy

Investment and export encouragement schemes date back to the 1960s, and their complexity has increased manyfold since. As quotas and licensing were dismantled in the early 1980s and foreign exchange restrictions removed, the government lost its most powerful instrument of industrial policy. While the quota and licensing schemes had put the burden of subsidizing industry directly on consumers, their elimination necessitated support through increased tariff and tax exemptions. Given fiscal constraints, the preferred approach would have been a selective one. However, the issuance of certificates for many kinds of investment blurred the idea of an industrial strategy. The main effect seems to have been a reduction of the effective tax rate for large companies to about 10 to 15 percent.[1]

In order to make the cost of capital relatively low to investors and exporters, there seems to be no need to have a complex incentive scheme which runs the risk of promoting rent-seeking and appears to be biased in favour of large corporations. Instead the corporate tax rate could be reduced from currently 46 percent to around 20 to 25 percent, and most deductibles could be eliminated.[2] In general, intervention would best be directed to a limited number of areas where it is expected to be most effective.

The present study does not suggest that Turkey should have an institutional setting characterized by a 'hard' state and strong government discipline over the private sector -- apparently a premise behind the success of the East Asian industrial strategies. The country has achieved outward orientation without a coherent **strategy** and thus proven that lack of the latter does not necessarily prevent the former. The argument here is also not for rolling back or weakening the state proper. Quite to the contrary, all the proposals made would be served best by an efficient state with clear objectives, strong capacity and sharp focus. That requires, among other things, a viable budget as a basis for macroeconomic stability, the building of physical infrastructure and investment in human skills as measures of prime importance.

Concerning human skills, the observation that semi-skilled labour is an eminently important factor of production in industry has clear policy implications. Thus, promoting technical education for which participation of the private sector could be considered as a major objective. As was shown in Chapter IX, it is not only the stock of semi-skilled labour, but also its intersectoral mobility that matters a lot. To enhance this mobility, a comprehensive unemployment compensation scheme should be enacted with a strong emphasis on retraining.[3]

In a comprehensive strategy, there is room for selective action in several areas which seem to deserve special attention. Four such areas are: (i) the promotion of small and medium size enterprises (SMSEs), (ii) restructuring, (iii) regional development, and (iv) export marketing, with special emphasis on the new markets and opportunities in Turkey's neighbourhood.

Promotion of small and medium scale enterprises. Besides their important role in providing employment, SMSEs seem to have a role in maintaining competitive pressure in many sectors. For these enterprises the type of policies discussed presently appear to be crucial. On the one

hand, they suffer more than large enterprises from high inflation, high interest rates, and, generally, from macroeconomic instability. On the other hand, they would benefit more from general support for infrastructure and education. In addition, specific measures can be warranted to improve the access of SMSEs to factor markets -- including capital, skilled labour and technology — as well as product markets, both domestic and international.[4]

It is widely acknowledged that SMSEs are not all playing by the rules of competition. Many of them are big environmental polluters relative to their small production capacity, evade taxes, or do not comply with social security or safety standards. Specific support measures should therefore be designed with the double objective of giving the SMSEs a boost while bringing them under the umbrella of general standards.

A systematic approach to restructuring and exit Rescuing a company in distress cannot be a policy objective in itself. A non-viable firm sits on resources that could be used efficiently in some other activity. Furthermore, the possibility of exit is as important as new entry to maintain and promote competition. The guiding principles of government policies in this area should be the maximization of the value of productive assets, and the internalization of the costs of mismanagement (and eventual restructuring) by the owners of those assets. For state economic enterprises, privatization seems to point a way to fully adhere to these principles.

For efficient restructuring (or liquidation) in the private sector, a number of specific policy proposals can be made: (i) Random bailouts would best be avoided. (ii) Market agents that specialize in company workouts might be promoted. Agents' rewards would be strictly tied to the performance of the firms following restructuring. This could best be secured by their equity participation. To promote company workouts, the government could try to subsidize part of the costs of the feasibility study to determine the viability of a certain firm and the specifics of restructuring. (iii) Reviewing and potentially modifying the Company Rescue Law of 1987, which seems not to have been particularly effective, appears to be advisable. (iv) It may also be necessary to study the Bankruptcy Law (Icra Iflas Kanunu), especially the concordat process, and subsequently reform this law and its administration. (v) Distressed firms in priority development regions seem to deserve special attention. However, the restructuring of these firms would ideally be decoupled from regional and employment objectives. The value of an additional job in the region and the acceptable level of subsidy to maintain it should be established independently of the cost of restructuring. On the basis of these figures, viability of the enterprises concerned should be examined. Those enterprises that prove viable might get direct subsidies. The ones that prove inviable even after subsidies have been taken into account would best be closed down. (vi) Finally, it seems most desirable to enact an unemployment compensation scheme as soon as possible. Such a scheme is a vital component of any major restructuring, be it in the private or the public sector. In the scheme, rewards to retraining and labour mobility should be cornerstones. The plan should also take into consideration regional differences and priorities, both in the amount and duration of compensation.

Adoption of a project-based, coordinated approach to regional development Investment subsidy schemes in priority development regions appear not to have been as successful as expected. A possible alternative would be a project-based approach with a central authority for each region, which coordinates the development efforts of various ministries and agencies. The Southeast Anatolian Project (GAP) is an important test case where the positive role of major population centres, the "magnets", is taken into account. Similar region-based projects might be developed.

Promoting export marketing New markets imply that communication, transportation, banking channels and all other infrastructure for trade and investment have to be strengthened. It may not be privately profitable for market agents to bear the full cost of investment in such infrastructure. Similarly, introducing "new" products in "old" markets can entail large overhead costs.

The countries of the former USSR, in particular, the Turkic-speaking republics offer important new opportunities. The analysis of Chapter XI reveals that Turkey's trade with these countries could be twice as much as it is now. And this estimate may even be a conservative one, given that incomes in these countries are expected to grow quite rapidly.

The main instrument used by the government to reach new markets is that of export credits and transport subsidies to far-away destinations. Subsidized export credits should not be ruled out, but it has to be borne in mind that they represent an indirect and expensive way of dealing with the actual problem. The question is that of finding cost-effective means of public support to export marketing. A government fund providing grants of up to one-half of the cost of well-designed programmes of export marketing firms is working well in a number of countries, including India, Indonesia and Singapore. Turkey already has DEIK (The Council of Foreign Economic Relations) serving the business community with minimal bureaucracy, but funding needs to be strengthened. In addition, the newly established Turkish Cooperation and Development Agency (TIKA), geared to the Turkic-speaking republics, can be made a more commercially oriented unit with participation of the private sector.

Promoting non-exclusionary and market-based regional arrangements is not in conflict with taking an active multilateral stance or with the aspiration of joining the EU. On the contrary, recent improvements in relations with the EU seem to have to do also with Turkey's strengthening its ties with the new transition economies.

2. A Transparent Schedule for the Customs Union with the EU

The tariff unification of January 1993 was indeed an important step, but it was not a transparent process. What happened to the average level of protection with the new regime is difficult to assess. With specific surcharges (as opposed to **ad valorem**) in many tariff lines, it is a formidable task to calculate pre-1993 and post-1993 average **ad valorem** duties. The schedule for the tariff and surcharge cuts to effectuate the customs union has not been

declared. Especially the schedule of phasing out the "Fund" surcharge (which will presumably disappear by 1998) remains unclear.

Opinions about the customs union with the EU are split where the division seems to cut across the business community, the administration, political parties and academia. One argument in the discussion is that Turkey should save the issue for use in negotiations about a tangible schedule to join the EU. However, it appears that there is a strong case for Turkey to declare unequivocally its joining the customs union by 1995/96. The main argument behind such a commitment is independent of whether Turkey will ultimately join the EU, but rather has to do with stability and predictability as important elements of a successful policy scheme (Rodrik, 1989). Turkey's trade regime over the years has been subject to some political and business pressure and as a result has been quite volatile. The customs union with the EU could add to stability of this policy area. In addition, it may be desirable to announce **a transparent schedule for** tariff and surcharge (Fund) reductions and adhere to it strictly. Negotiations with the private sector in the country and also with the EU may have to take place regarding a — preferably brief — list of exemptions.

In purely economic terms the welfare-reducing effect of high protection is sufficiently documented. However, the difference between zero protection and an almost uniform tariff of about 10 to 15 percent may not be significant. Nevertheless, a nominal average tariff of about 30 to 40 percent with an actual average rate of around 10 percent represents a major distortion introduced by exemptions. The elimination of tariffs with the EU and the adoption of the common external tariff (CET) against third parties will render duty exemptions less significant. Besides, there will be a substantial reduction in overall protection which is to be welcomed. The findings of Chapter III show that imports do work "as market discipline". So it might be held that what Turkey had in the 1980s was not too much liberalization in trade, but too little of it.

3. A Review of Antidumping and Antisubsidy Policies

The 1989 "Legislation on the Prevention of Unfair Competition in Importation" has the same shortcomings as other GATT-consistent antidumping and antisubsidy laws. There is some danger of its being used as a protectionist device. In Turkey so far its main target were imports from poorer countries. If trade liberalization and the customs union with the EU proceed as planned, pressure will increase considerably for a wider use of this legislation which may dilute some of the benefits of liberalization. In particular, it can promote collusion between domestic and foreign (particularly EU) firms.

The GATT's Uruguay Round negotiations on antidumping do not seem to yield better disciplines. Consequently, the best approach seems to be unilateral improvement in antidumping rules. In this context, Turkey can adopt the provisions of the antidumping agreement from the Uruguay Round.

In the country the Board which is in charge of implementation of the relevant legislation is not an autonomous body, but potentially subject to political and other pressure. It may not be realistic to suggest major changes in the substance and organization of the law. Short of that, however, a decree or directive might be issued with the following amendments or guidelines: (i) On the cases published in the Official Gazette more information should be provided including the names of complainants, Turkish and foreign firms involved in the case, and their market shares. (ii) In determining "material injury", import surges have so far been the dominant factor. However, decisions of the Board should not predominantly be based on import surges, but other factors should be examined too. (iii) The Board should do its best to obtain actual prices for comparisons, rather than use constructed values. To this end, the resources of the Board should be augmented. (iv) Most importantly, the Board should be directed to consider explicitly the benefit to consumers and industrial users of cheaper imports while investigating the alleged adverse effects on producers.

4. Launching a Public Debate on a Competition Law

In 1992 the minor partner of the coalition government had a competition law drafted and circulated among business associations, public agencies and universities. Initially, there was some reaction from business circles which, however, had subsided by mid-1993. Not only was there no noticeable public reaction, but also lack of knowledge about what a competition law would entail seemed to be widespread. With good intentions the Young Turkish Businessmen's Association had a survey of business ethics in Turkey carried out (TUGIAD, 1992). Nevertheless, the notions of price fixing, or abuse of dominant market power were not reflected in the questions, whereass "unfair pricing" did receive attention in the investigations.

The argument **in favour** of a competition law, based on economic rationale and international experience, seems to be convincing. However, to draft such a law can be a difficult task if it should help to (i) maintain and promote competition also for the sake of improving economic efficiency without hampering international competitiveness, and (ii) devise a machinery for implementing it effectively and with little chance for abuse. (iii) The law should also promote the broad and systematic incorporation of competition principles in government policy-making. (iv) Most importantly, such a legal framework is meant to set a standard of business morality compatible with international practices.

The shortcomings of the Draft Competition Law, as discussed in Chapter VII, lead to the conclusion that adoption of the present draft, even with major amendments, is not advisable. The matter could be put on the national agenda once more. (i) A commission could be set up to produce a detailed study of market structure and conduct, entry barriers, and the perils and merits of different forms of competition legislation, including alternative organizational setups. In this it should not be presumed that Turkey's competiton law and policies should mirror those of the EU. (ii) Following the publication of the reports, there should be an **extensive debate**, in the same way as in Italy. (iii) Input from the business community should be sought at an **early** stage. (iv) In an attempt at building a broad

consensus in support of a competition law, the preparatory phase should be transparent and its results well publicized to serve an important educational function for business and the public at large. (v) Finally, a **transitional period** should be granted so that conduct that used to be legal and morally accepted previously does not become illegal and immoral overnight.

5. Opening of the Banking Sector to Competition through Privatization

Thanks to financial liberalization in the 1980s, and relaxation of entry requirements, a large number of new banks, both domestic and foreign, entered the market. This has improved the quality of financial services, product variety and the technology of the sector in general as well as contributing to the globalization of the Turkish banking system. However, almost none of the new banks entered the retail banking market. The established banks with vast branch networks (developed during the non-price competition era before financial liberalization still) have a predominant hold over the retail market.

Chapter IV shows that market structure is the primary determinant of high bank profitability in Turkey. Furthermore, concentration of the market profits both the large and the smaller banks. The study also finds that effective competition in the banking sector requires that entrants have a certain size. New banks filled certain niches in the market with specialized services, but without a sizeable branch network their impact on competition at retail banking has been limited.

On a number of occasions public banks have been directed to raise their deposit rates when large private sector banks set their rates below those of the smaller banks, and sometimes even below the inflation rate. This is obviously not a long term solution and certainly incompatible with financial liberalization.

Promoting competition in this market requires facilitating rivalry among the top ten or so banks. This in turn necessitates entry of new banks with a reasonable number of branches, that is entry at a certain size. One way to achieve this in the short term, would be (i) to **break up and privatize public banks**, probably excluding the agriculture bank and three development banks. Through this measure concentration would be reduced and competition in the retail market increased (ii) Compared to other OECD countries, Turkey does not seem to be "overbanked". Promoting **savings and loan associations**, **building societies**, and **cooperative and other local banks** is another step to increase competition. Although their size would be small they would effectively compete for deposits. (iii) At the same time, the **supervisory** and **regulatory** powers and capacities of the relevant authorities should be **strengthened** -- a lesson to be learned from the banking crises of the 1980s.

Notes

1. Tax exemption on government bills and bonds to facilitate domestic borrowing also played a major role in reducing the effective tax rate of corporations, especially the banks.

2. In addition to cutting the corporate tax rate and eliminating most exemptions, an upward shift of income tax brackets, cuts in these rates, a move to unitary taxation, and improvements in the tax administration might be considered as components of a reform.

3. There is a draft law on unemployment compensation at the Cabinet of Ministers. See also Toruner's (1992) study on this matter

4. The 1993 investment and export incentive schemes acknowledge the importance of the SMSEs for the first time, and contain some special provisions for them. However, lacking a systematic approach and substantial resources, they seem to be insufficient.

5. A smaller project for the Zonguldak region is considered by the government. Zonguldak is the centre of coal mining, a large state-owned operation. The project is meant to rehabilitate the region.

6. Turkey's foreign economic relations are constrained by a historical focus on the EU relationship.

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Annex I

AN OVERVIEW OF ECONOMIC DEVELOPMENTS IN TURKEY

Ceyla Pazarbasioglu[1]

1. Introduction

The Turkish economy went through a substantial structural change since the early 1980s, as growth, higher private investment, and an impressive external performance led to a significant improvement in international creditworthiness. These improvements were brought about by important policy changes concerning interest rate, the exchange rate and trade and capital accounts.

Nevertheless, relatively high growth that characterized most of the 1980s was achieved at the expense of price stability, and given the absence of credible progress toward inflation control, the nominal exchange rate devaluation has been the only instrument available to protect external balances. Since 1991 the nominal exchange rate depreciated broadly in response to inflation differentials between Turkey and its trade partners, indicating that monetary policy has accommodated inflationary policies during most of the 1991-92 period. As persistently high inflation threatens the policy achievements of the 1980s, the economy now faces a difficult challenge.

To provide a perspective for the current debate on competitiveness of Turkish industry, this Annex presents an overview of economic developments in Turkey over the last decade. The pertinent question is how the prolonged domestic imbalances, persistently high inflation and increases in wages have affected Turkey's competitiveness internationally, as well as domestically. Given the substantial changes in policy making during the 1983-92 period, and the important effects on international competitiveness of Turkey, the main focus of this Annex will be on macroeconomic developments during this period.

Section two provides the historical background. The following section reviews trends and developments in the real economy. In Section three public finance and fiscal policies are discussed. Section four reviews developments in the financial markets and monetary policy during the survey period. External sector and exchange rate developments are discussed in the final section.

2. Historical Background

The experience of Turkey in the post-war period can be characterized by persistent macroeconomic instability ending with a near economic crisis every ten years. The two

major crises (1958–60 and 1977–80) were associated with serious balance-of-payments problems and political upheaval resulting in military takeovers. Similar problems were experienced during the early 1970s, though an inflow of foreign exchange in the form of foreign workers' remittances and foreign borrowing prevented a full scale crisis. Although no political upheaval occurred, the close of the 1980s was also characterized by growing macroeconomic imbalances, and in particular, a high and rising rate of inflation.

Turkey followed an inward-looking economic strategy with heavy reliance on government intervention from the advent of the Great Depression through to the end of the 1970s. Growth and structural change during the period 1955–90 is summarized in Table A.I.1. As noted in this table, the share of agriculture declined substantially since the 1970s as the share of industry increased.

An important feature of the 1961 constitution was the introduction of formal economy-wide planning through five-year plans and programs, which significantly improved the effectiveness of development policy. To accelerate Western style industrialization, the government assumed a leading role in the economy by protecting trade and financial flows as well as creating large scale state economic enterprises (SEEs) which had unlimited access to financial resources.

The first two five-year plans, 1963–1972 Import-substitution and capital formation were the key elements of the first two five-year plans (1963–72) that formalized the inward-oriented approach. A highly restrictive trade regime was instituted where restrictions took the form of import and export licensing, quotas, high custom duties and various surcharges. These instruments were used to limit imports to foreign exchange availability rather than creating an increasingly competitive import-substitution pattern in the economy.

During the two five-year plan periods, the objective of achieving a growth rate of seven percent per annum fell short of the target by only a slim margin. The growth rates for the two plan periods were 6.5 and 6.6 percent respectively, while the share of industry in GNP increased from 16 percent in 1963 to 23 percent in 1972. As noted in Table A.I.2, both private and public investment increased significantly during the plan years, with most of the increase financed by domestic savings.

During this period, the exchange rate was fixed and multiple rates were provided for basic imported goods. The maintenance of an increasingly overvalued exchange rate led to the emergence of a balance-of-payments crisis in 1968–70 which was met with a tightening of quantitative import restrictions and a subsequent devaluation of the currency. The 1970 devaluation contributed favourably to export and GNP growth from 1971 to 1973. Exports responded significantly to devaluation, and export growth reached 15 percent in 1971, and 30 percent in 1972. The devaluation also led to a large inflow of the remittances of Turkish workers abroad. These developments led to a considerable rise in foreign exchange reserves, and provided a surplus in the current account of the balance of payments in 1971 and 1972. The strengthening of the external position increased the confidence of foreign

creditors and led to a massive increase in foreign lending to Turkey. Although the macroeconomic imbalances and structural problems that the country faced at the end of the 1960s was very similar to that experienced at the end of the 1950s, the flood of foreign exchange reserves prevented a re-occurrence of an economic crisis. Nevertheless, increasing political instability led to a military takeover in 1971 and forced the government to resign.

The third five-year plan, 1973–1977 The main objective of the third five year plan was import-substituting industrialization in capital-intensive sectors. In the early 1970s, the public sector's share in the value added of the manufacturing sector was about 45 percent, which meant large budgetary transfers and significant deficit financing from the central bank. Given the controls on interest rates and the relatively small volume of the equity and bond issues by the real sectors, credit expansion mainly took the form of monetary growth. Thus, private firms mostly relied on deposit banks and retained earnings for capital formation. However, despite the fact that most private firms were credit rationed in the post-1970 period, private sector investment increased rapidly (Table A.I.3).

In accordance with the third five-year plan, Turkey had a low rate of inflation, rapid economic growth, and an external current account surplus by the end of 1973. The oil crisis of 1974 did not affect the performance of the economy as the deterioration in the terms of trade was not allowed to pass onto domestic prices of energy and other key state-enterprise products because of the imposition of domestic price controls on selected items. During the third plan period, the real growth of the industrial sector reached record levels with about 14 percent per annum. The main factor that contributed to industrial growth was the rise in investment as total investment increased from 19 percent of GDP in 1973 to 24 percent in 1977. Contrary to the first two five-year plan periods, the rise in investment was mainly financed by foreign savings. Thus, the Turkish economy experienced an average growth rate of 7.2 percent during 1973–76 at the expense of expanding internal and external imbalances. The price distortions due to extensive subsidies led to stagnation in exports and a rapid increase in the import-intensity of domestic production.

By 1977 the deterioration in public finances was about 11.3 percent of GNP, compared with about two percent in 1973, which was financed mainly by short-term borrowing, partially under the newly established convertible Turkish lira deposit (CTLD) scheme. Under this scheme, the authorized Turkish commercial banks could accept deposits from foreign banks and Turkish workers abroad under an exchange rate guarantee provided by the Central Bank. By the end of 1977 the stock of external debt tripled totalling $11.3 billion, half of which was in short-term obligations. All these developments, as well as over-borrowing by the private sector precipitated a severe payments crisis by mid-1977 which led to depletion of all reserves and a termination of available bank lines. The subsequent devaluations of 23 percent in 1978, and 41 percent in 1979, and export tax rebate policies were among the steps taken to increase the competitiveness of exports. Policies to decrease public sector borrowing, such as SEE price adjustments, and a reduction in fiscal expenditures did not prove useful given excessively high wage settlements, and the public sector borrowing

requirement (PSBR) remained at 8.5 percent of GNP in 1979. Inflation continued to increase rapidly, leading to highly negative deposit rates and increased disintermediation. The country was for the third time in a severe crisis which brought a military takeover in 1980.

The 1980–1992 period As in the 1960s in the early 1980s — after three years of economic and political instability — Turkey started a development program based on market economy principles. The main objectives of this program were: (i) to change the economic and regulatory environment in order to encourage private savings and investment, and to channel domestic resources into expanding and restructuring the private sector; (ii) to improve the balance of payments and international competitiveness; (iii) to contain inflation; and (iv) to increase the efficiency of public enterprises.

The program consisted of a significant real devaluation of the currency, introduction of extensive export promotion schemes, and gradual liberalization of imports. The impact of these reforms was to increase manufactured exports, which grew in value and volume from 1980 to 1985 at an annual rate of 42 and 46 percent, respectively, and to improve the country's balance-of-payments performance significantly. As a result, external debt declined significantly relative to exports, although it continued to grow in absolute terms as well as relative to GNP.

In anticipation of the elections in 1987, fiscal policy was eased significantly, and expectations for a subsequent devaluation led to a gap of about 20 percent between the official exchange rate and the unofficial rate. Real interest rates became increasingly negative due to the high level of inflation, and currency substitution reached record levels. Foreign currency deposits accounted for about a fourth of total bank deposits by the end of 1987, further increasing the demand for foreign exchange in the unofficial market. Thus the high growth of 1986 and 1987 of 8.0 and 7.5 percent, respectively, was achieved at the expense of accelerating inflation as well as a substantial increase in domestic and external debt (Table A.I.4).

The expansionary financial policies of the period 1986–87 were reversed in early 1988, as an anti-inflationary program was introduced. The program comprised fiscal retrenchment, in particular large cuts in public investments, and a tightening of monetary policy leading to a substantial increase in real interest rates. The growth in real GNP declined to about 3.5 percent in 1988 and was about 2.0 percent in 1989, the lowest level since 1980.

Largely as a result of the sizeable wage increases granted from mid-1989 onward, the economy rebounded in 1990, registering GNP growth of about 9.0 percent for the year. However, the Gulf War and the mid-year change in government increased uncertainty in foreign exchange and financial markets during 1991, depressing private investment and economic activity. Domestic imbalances were further augmented by expansionary fiscal and monetary policies. The rapid expansion in private consumption, mainly as a result of the substantial wage settlements during the second-half of 1991, again led to a recovery in

economic activity for 1992, as GNP growth increased to 6.0 percent. Given that inflation remained high at about 70 percent, recovery of investment was mild. As a result of the expansion in domestic demand, imports of goods and services increased faster than exports did, widening the resource imbalance further.

3. The Real Economy, 1980–1992

In assessing the competitiveness of Turkish industry and the impact of the structural changes during the last decade, an important issue is whether reallocation of resources reflects a shift away from sheltered and less efficient sectors towards industries exposed to international competition. Comparing the periods 1970–80 and 1980–90, a significant change in the composition of industrial production and exports can be observed. During the 1970–80 decade, total output of heavy industries grew while the relative importance of light industries declined, quite in line with the inward-looking strategy adopted during that period. This trend was reversed during the following decade, where the shares of basic metals, non-metallic mineral products, and machinery and equipment industries declined or remained stable, while the shares of chemicals and chemical products and textiles industries increased significantly.

This structural change in production patterns has led to a significant change in the composition of exports. Industrial exports have grown at an annual rate of 20 percent (in dollar terms), increasing tenfold from 1980 to 1990. During the same period, the exports of agricultural and mining products increased at an annual rate of four and six percent, respectively. By 1992, exports of manufactures accounted for about 80 percent of Turkish exports, compared with about 30 percent in 1980. These changes have also been translated into a growth of the import share of metal products, machinery and equipment and thus to a greater reliance on capital goods imports in the 1980s.

Labour market and wages The unemployment rate was quite high in Turkey during the first part of the 1980s, ranging from 10 to 12 percent. Since 1988 the registered unemployment rate has followed a downward trend, reaching about eight percent in 1992. The decline in the unemployment rate has coincided with a decline in the participation rate – from about 67 percent in 1980 to about 57 percent in 1992. This pronounced downward trend in the participation rate may be explained partly by a growing educational involvement. However, in spite of the progress made in promoting education, the rate of general participation in formal education in Turkey still lags significantly behind all the other OECD countries. A major deficiency of the current education system, which has a significant impact on the labour market, is the strong emphasis on general curriculum schools and the severe neglect of technical and vocational schools.[3]

As a result of restriction of union activities by law, workers have suffered from substantial wage losses in the 1981–88 period (Table A.1.5). The real product wage declined considerably from 1978 to 1982, and remained stable thereafter until 1988. The rise in

productivity during the same period, and the subsequent increase in the share of profits in national income meant that wage earners bore the brunt of the adjustment costs of the reform policies of the 1980s.

The "Wage Negotiation Co-ordination Board" was abolished, and liberal wage setting procedures were reconstituted during 1987. A reversal of the downward wage trends took place in the 1989 wage round, and the average nominal wages in the private and public sectors increased by 123 and 113 percent, respectively, amounting to average real wage gains of about one-third. The adjustment of the legal minimum wage did not compensate for the erosion of purchasing power in 1989. In response, both the real legal minimum wages and the average real wages were raised substantially in 1990. Thus, the sizeable gain in labour productivity in 1990 was undermined by the high wage increases, leading to a roughly 70 percent rise in unit labour costs.

The public sector benefitted from considerable pay raises preceding the general election of fall 1991, which had a spillover effect in the private sector wage contracts, leading to an average annual real wage increase of about 50 percent. Stagnant labour productivity together with a nominal wage increase of about 150 percent — far greater than the GNP deflator — meant that unit labour costs more than doubled, and profit shares suffered significantly.

The estimates by the Istanbul Chamber of Industry suggest that the share of labour costs in net value added of the 500 largest member firms fell from over one-half at the beginning of the 1980s to only one-third in 1988. In contrast, during 1990, the weigh' of labour costs increased to 60 percent of net value added (about 50 percent for private and 75 percent for public sector companies). The further in ease in wages in 1991 and the high capital costs due to the rise in interest rates led to substantial losses in both the private and the public sector.

Gross fixed capital formation One of the incentives that was provided by the policies of the 1970s was the increase in foreign borrowing by firms. As the Turkish lira was devalued continuously from 1978 onwards, such firms encountered substantial financial difficulties. This has led to major shifts in the sectoral composition of capital accumulation. In particular, the share of manufacturing investment in GNP has steadily declined over the 1980s, as resources have been shifted towards infrastructure investment and residential construction. The growth of housing investment has been especially rapid in the second half of the 1980s. Another important factor contributing to the decline in manufacturing investment has been the negative impact of higher yields on financial activities, which has reduced the incentives to invest in real assets.

After negative rates of investment between 1987 and 1989, private manufacturing investment has increased substantially in the 1990-91 period (Table A.16). The recent upswing in manufacturing investment is explained by a broader tax relief for manufacturing investment, and import liberalization which has led to a decrease in the cost of imported

intermediate and capital inputs. Also the strong wage increases since 1989 have given additional incentives to substitute capital for labour.

Public sector investment declined steadily since the mid-1980s, with the exception of 1990, from about 13 percent in 1985 to 10 percent of GDP in 1992. The decline has been mainly concentrated in those sectors in which public enterprises operate. The composition of public sector investment has also been changing significantly as there has been a significant increase in infrastructure investments by extra-budgetary funds since 1989. The share of health and education in public investment has also been increasing.

Although the composition of public investment has shifted heavily towards sectors where it complements private sector investment, the rapid rise in the public sector borrowing requirement in recent years has increased instability in the economy by fueling inflationary expectations and keeping interest rates high, thus leading to a potential crowding out of private sector investment.

As noted in Table A.I.7, post-tax real interest rates on deposits had been negative for most of the late 1980s, and only became positive in 1992. Together with declining confidence in domestic money, this has led to a strong expansion of foreign currency deposits held by residents, and thus to currency substitution. Furthermore, increased bond issues to finance the large budget deficit has led to a substantial increase in real bond rates of about 17 percent in September 1992, thus increasing the competition of the public sector for private savings and credits.

Productivity of factor inputs The structure of production patterns in industry has changed significantly during the last decade, characterizing the transition from inward-to outward-oriented trade policies. In theory, as exposure to international competition increases, the resources for production activities should be re-allocated in a more efficient pattern and thus lead to improvements in technological development.

Estimates of labour, capital and total factor productivity (TFP) growth in Turkey were derived for the period 1973–91.[4] Growth of capital inputs declined from about nine percent in the period 1973–79 to about 4.5 percent in 1987–91. The growth of labour inputs was around 1.4 percent, except for a peak of 3.5 percent in the 1985–87 period. However, the labour share in value added has declined markedly in the 1980s.

Average TFP growth during 1973–85 was only about 1.4 percent, where the slow growth was associated with a relatively inefficient use of factor inputs, including excess capacity in plant and machinery, as well as over-manning. Possibly as a result of the liberalization process of the 1980s, the mid-1980s were marked with a very high TFP growth of about 4.5 percent. Since then it has declined sharply, coinciding with weak output growth and weak private investment. This decline in TFP growth is worrisome, and it may suggest that further significant TFP growth in the future will require substantial investment as well as re-training of workers.

4. The Public Sector, 1980–1992

The non-financial public sector in Turkey consists of four main subsectors: central government, extra-budgetary funds (EBF), local governments, and the SEEs. The consolidated accounts of the first three of these subsectors, together with certain revolving funds and social security institutions add up to the general government sector. Fiscal decentralization has been one of the main characteristics of the fiscal policy that was followed during the 1980s. The share of the central government budget in public disposable income has declined from about 95 percent in the 1970s to about 50 percent in the late 1980s. During this time, a large number of extra-budgetary funds have been introduced to increase flexibility in expenditure allocation. The share of these funds in public disposable income has increased to 10 percent by 1990.

While the public sector deficit as a share of GNP has fluctuated around four to six percent during the early 1980s, it has been rising since 1987 (Table A.I.8). In 1990, the PSBR reached 10.5 percent of GNP, the highest in a decade. This was mainly due to the doubling of the SEEs borrowing need, as well as the worsening consolidated financial accounts of EBFs. The PSBR increased even further in 1991, reaching a historically high level of about 14 percent of GNP. It is estimated that the PSBR for 1992 was at about the same level as in 1991.

The authorities have set out three main objectives to reduce the primary PSBR. These included the introduction of a centralized cash management system for the EBFs, enhanced tax collection, and restructuring of SEEs — including privatization. So far, these objectives have not been successfully implemented. The planned centralization of the EBF accounts under the Treasury's supervision has resulted in a significant rise in budget revenues, as the Treasury increased the clawback rate applied to revenues by the EBFs, but this appears to have been offset by increased borrowing by the EBFs rather than reduced spending.

The primary source of Turkish personal income tax revenues are the direct withholdings from wages, placing a heavy burden on the wage earners, while most other income goes unreported or uncollected. In the corporate tax system, the effects of widespread evasion are compounded by a generous system of incentive-related deductions. Moreover, due to lack of inflation accounting, the tax system is highly distortionary in the current inflationary environment. A broad tax reform, with the two main objectives of administrative reform to enhance collection of tax income that goes unreported, and the adaptation of a uniform system for various sources of income is under consideration by the government.

To date, limited progress has been made on the planned restructuring of the SEEs, and their losses have been reduced principally by raising public prices. Due to continuing political divisions on the issue, privatization has been slower than anticipated. Public Participation Administration, which had been in charge of privatization between 1986 and 1991, has sold eight percent of shares of PETKIM (petrochemical industry), 1.6 percent of Turkish

Airlines, 1.6 percent of TUPRAS (refineries), and 4 percent of the Petroleum Office to workers in these SEEs or to the public with a total revenue of $863 million. At the beginning of 1992, the Turkish Autonomisation, Reorganisation and Privatization Board (TOYOK) was established as the sole authority to undertake privatization and to reorganize SEEs. During the first 8 months of 1992, eight SEEs, 29 subsidiaries, and 75 public participations were privatized with a total revenue of $143 million. The estimated revenues for the whole year is about $424 million.

Public deficit financing also went through significant changes in 1991. First, recourse to foreign sources was reduced as a result of a cautious policy approach to external debt as well as relatively unfavourable international capital markets conditions. But given the uncertain political environment of 1991, most portfolio holders preferred to hold more liquid assets, and thus the required increase in reliance on domestic capital markets did not materialize. These developments led to a reversal of the policy on reducing monetary financing of public deficits. It was under this policy that the borrowing from the Central Bank has been decreased from 16 percent of the PSBR in 1988 to 4 percent in 1989, and to as low as one percent in 1990. However, this ratio increased to 28 percent in 1991, the highest in a decade. The government's policy to lengthen the maturity of domestic debt was also discontinued as domestic borrowing mainly took the form of Treasury bills of three to six months maturity. This led to a fall in the share of long-term bonds in total debt from 60 percent in 1990 to only 25 percent in 1991. Lengthening the maturity of public debt is one of the priorities of the government.

5. Monetary Policy, 1980–1992

Excessive growth in the supply of money and subsequent high inflation has been a major problem and an impediment to balanced economic growth in Turkey. The need for a more effective control of monetary aggregates was apparent in the structural reform program of the early 1980s, and in the measures that were taken within the framework of the program. One important measure was the introduction of positive interest rates as an intermediate target of monetary policy. However, given that the Central Bank of Turkey was obliged to fund selective credit programs and the public sector in general, an effective monetary policy required further reforms of the monetary system and of monetary control instruments. By the mid-1980s, important restructuring efforts took place as reforms have been introduced in several areas.

By mid-1986, the reforms in the reserve and liquidity requirement system took the form of establishing a unified required reserve ratio of 15 percent, and a gradual reduction of interest paid on lira bank reserves to zero. To prevent an increase in monetary aggregates via an increase of the reserve money multiplier, the Central Bank obliged commercial banks to keep the freed reserves as an advance on future reserve growth or to invest them in Treasury paper. This implied that three percent of deposits had to be kept in cash and free reserves, and 12 percent in the form of unused rediscount quotas and government securities.

These liberalization measures led to a rapid expansion in the commercial banks' operations in foreign currency.[6] Foreign exchange deposits with deposit money banks have expanded from $83 million at the end of 1983 to about $3 billion by the end of 1986, representing a supplementary liquidity of about 20 percent of M2.[7] The expansion of a broader monetary aggregate, which includes foreign exchange deposits (M2X), has been seen as inflationary. Thus, to control the growth of foreign exchange deposits of residents and non-residents, a 20 percent reserve requirement was imposed on these deposits. The ratio was then lowered to 15 percent in March 1986, following a liquidity crisis experienced by some banks.

In 1986, the conduct of monetary policy was changed as the Central Bank adopted a new policy stance, mainly targeting of monetary aggregates. From 1986 to 1988, the Central Bank targeted the monetary aggregate M2, where the target was based on projections for real income growth, inflation and interest rates. On the basis of an expected real growth in GNP of five percent and inflation by 25 percent (measured by the wholesale price index), an increase in M2 of 35 percent was planned for 1986. Although the outcome for M2 was close to the target in 1986 with a growth of 38.6 percent, the targets were exceeded by large margins in 1987 and 1988 leading to the abandonment of the target.

The Central Bank acknowledged that a more efficient institutional framework had to be established to implement the policy of targeting a broad monetary aggregate. Since 1989, the Central Bank aims at keeping the rate of growth of its total assets and liabilities below the growth rate of nominal GNP, in order to strengthen the net foreign exchange position and to increase the potency of the instruments for intervention purposes. The main objective of this policy is to control money supply more effectively and to set monetary policy on a dis-inflationary course. One important step was to restructure the devaluation account which represents the exchange rate depreciation loss on net foreign liabilities of the Central Bank. Given that it bears a zero interest rate, the rapidly growing devaluation account has been a major reason for the rapid deterioration of the net worth of the Central Bank.

According to the medium-term plan that was presented in early 1990, the weight of the devaluation account was expected to shrink from 43 percent in 1989 to 14 percent in 1994. By the end of 1991, this account had shrunk by 10 percent to about 33 percent, making room for increases both in foreign assets and domestic credits. The medium-term objectives of the plan specify four main growth targets: the overall balance sheet, total domestic liabilities, total domestic assets, and the Central Bank money stock.[8] Central Bank money, the principal target of the authorities, is mainly under the control of the Central Bank and can be interpreted as a target of liquidity expansion.

6. The External Sector, 1980–1992

The key elements of the structural adjustment program adopted in the early 1980s were the promotion of exports and the liberalization of imports and capital flows. Between 1980 and 1982, direct export subsidies were increased to promote exports, where these subsidies

consisted of indirect tax rebates, subsidized working capital loans to exporters, and foreign exchange allocations for duty free imports of inputs for export production.
Within the framework of the 1980 reform package, the over-valued Turkish lira which limited international competition was devalued, and a managed float of the currency was adopted. This exchange rate policy was designed to ensure that the inflation differential between Turkey and its main trading partners would not entail an appreciation of the exchange rate in real terms. In the case of a current account deficit, a real devaluation of the lira was targeted to improve the price competitiveness of exports. This approach led to a real depreciation of the Turkish lira by about 20 percent between 1980 and 1985 (Table A.I.9).[8]

Since 1984, the government's policy shifted towards a reduction of direct export incentives and increased liberalization of imports. Towards the end of 1985, export subsidies, quantitative restrictions and tariffs were further reduced. However, on average, nominal protection on domestically produced goods increased as a result of high levies on consumer goods and higher tariffs on consumer durables. The main intention of the government was to reduce protection on intermediate goods and raw materials.

During the first half of the 1980s the new exchange rate and trade policies were successful. The shifts in production were reflected in the composition of exports as there was a significant shift from exports of unprocessed products to manufactured merchandise exports. Sales to most countries increased vigorously and sizeable gains in new markets, in particular in the Middle East, were achieved as the share of the region in Turkish exports increased from about 10 percent in 1980 to above 30 percent by 1986.

An important policy step that significantly strengthened the competitiveness of the services sector was the liberalization of capital transactions. In addition to improving the country's business environment, the liberalization also had a significant impact on the construction business performed by Turkish companies abroad. Especially after the reforms in Eastern Europe and the former Soviet Union, Turkish companies have been reported to be engaged in a significant number of construction projects.

In 1986, exports were sluggish as import demand from the Middle East declined due to the oil price slide. With the imposition of trade restrictions on important Turkish export products such as textiles and agricultural exports, coupled with lower demand from OECD countries relative to the 1980-85 period, manufactured exports fell by more than 11 percent in dollar values in 1986. However, the 16 percent increase in the exports of agricultural products prevented a substantial deterioration of the trade deficit.

In response to the decline in exports, the authorities reintroduced export subsidies which were reduced during the course of 1985. However, due to the real exchange appreciation during the 1988-90 period, manufactured exports declined significantly. The real appreciation was mainly a result of a high nominal interest differential between Turkey and abroad in the context of liberalized capital markets, which have encouraged short-term

capital movements. Thus the deterioration in price competitiveness of Turkish exports exceeded 20 percent as measured by trade-weighted relative consumer price indices.

The stagnant trend in merchandise exports — in current dollar prices — during the period 1987-90 has been reversed by the end of 1992 as both the agricultural and manufacturing exports accelerated. As a result of a good harvest in 1990, agricultural exports remained buoyant throughout 1991. The growth in manufactured exports, accounting for more that three quarters of total exports, slowed down again in 1991. This slowdown was mainly due to a decline in exports of hides, leather products, and iron and steel. Exports of textiles which account for roughly one third of industrial exports, electrical appliances and processed agricultural products grew rapidly in contrast to the 1987–90 slowdown.

Large inflows of capital attracted by high real interest rates have been sufficient to finance the current account deficit in the 1990s. However, the foreign direct investment which has increased sixfold between 1987-89 has been stagnant during the early 1990s (Table A.I.1').

7. Conclusion

The economic situation in Turkey at the end of 1992 can be characterized by a high rate of inflation, a worsening trade balance, an extraordinarily large public sector borrowing requirement, stagnant investment, and uncertainty over the future course of economic policy. In order to avoid the recurrence of a crisis and secure the growth and development of the Turkish economy, monetary and fiscal policies have to be contained. With a more stable macroeconomic environment, the effectiveness of competition policies, and the prospects for a more competitive industrial sector would be enhanced.

Table A.I.1: Growth and Sectoral Composition of Real GNP as percentage of GNP, 1955–1990[a]

Real GNP Growth		Agriculture	Industry	Services
1955	7.7	45	12	43
1960	3.9	42	13	45
1965	4.9	41	15	44
1970	6.8	34	18	48
1975	7.7	29	20	51
1980	2.6	25	22	53
1985	4.7	19	29	52
1990	6.1	17	26	57

Source: State Institute of Statistics, Statistical Yearbook, various issues, and OECD, National Accounts, Main Aggregates.

Note: a) GNP in 1968 prices. 5 year annual averages. Sectoral composition of GNP also in 1968 prices.

Table A.I.2: Supply and Use of Resources: Real Growth Rates, percent

	1962–67	1968–72
GDP	6.5	6.6
Consumption	5.2	6.8
Private	4.8	5.7
Public	7.7	12.2
Investment	10.5	9.2
Private	9.4	9.3
Public	11.7	9.0
Resource gap	-15.0	3.2

Source: Onis and Riedel (1993).

Table A.I.3: Supply and Use of Resources: Real Growth Rates, percent

	1973–77	1977–80
GDP	7.0	0.3
Consumption	7.1	-2.4
Private	6.8	-3.4
Public	9.6	6.4
Investment	13.8	-7.9
Private	93.8	-4.5
Public	18.4	-11.8
Resource gap	22.3	-27.5

Source: Onis and Riedel (1993).

Table A.I.4: Supply and Use of Resources: Annual Percentage Changes

(1991)	(% of GNP)	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992
		4.1	3.3	5.9	5.1	8.1	7.5	3.6	1.9	9.2	0.3	5.4
Foreign balance	-0.2	-1.7	-1.3	-0.6	-0.7	-3.3	-1.3	-3.2	-0.6	-6.5	2.8	-2.2
Domestic demand	100.2	2.8	4.7	5.2	4.4	11.4	6.0	0.4	2.5	16.0	-2.4	7.5
Investment		3.5	3.0	0.4	16.9	11.0	5.4	-1.3	-1.0	13.9	-0.4	1.3
public	10.4	2.2	1.9	-4.7	23.1	7.5	-3.7	-13.7	-5.8	8.0	3.8	1.1
private	12.2	5.5	4.7	8.4	8.2	16.4	18.6	13.5	3.3	18.8	-3.5	1.4
Stock changes	-0.4	-1.0	-0.2	-0.4	-0.6	-0.6	-0.1	-1.3	-0.2	4.1	-4.0	-0.1
Consumption		3.9	4.7	6.2	1.5	10.9	5.3	2.7	4.1	11.2	2.0	9.5
public	15.9	2.0	1.7	2.1	3.1	6.6	3.8	1.9	3.3	7.0	1.0	1.9
private	61.7	4.2	5.0	6.8	1.3	11.5	6.6	2.8	4.2	10.4	2.1	10.6
Memo. items:												
CPI[a]		34.1	31.4	48.4	45.0	34.6	38.9	75.4	69.6	60.3	66.0	70.1
External debt/GNP		35.0	35.6	41.0	47.5	54.7	59.0	57.5	52.0	44.5	44.6	45.2

Source: OECD, National Accounts: Main Aggregates, various issues.

Note: a) In 1990, the State Institute of Statistics introduced new weights for CPI, and shifted the base year from 1978–79 to 1987.

Table A.I.5: Real Wages and Real Labor Costs: Index 1981 = 100

	Real wages		Real labor costs	
	Public	Private	Public	Private
1981	100	100	100	100
1982	89	96	90	97
1983	86	88	88	90
1984	74	83	76	85
1985	62	78	65	80
1986	54	76	57	77
1987	55	86	68	85
1988	46	81	58	81
1989	64	107	85	104
1990	83	124	106	122
1991	109	186	140	181
1992	119	190	153	185

Source OECD, National Accounts Main Aggregates, various issues.

Table A.I.6: Gross Fixed Investment by Sector: Annual Percentage Changes

	(1991)	1985	1986	1987	1988	1989	1990	1991	1992
Private sector	(distribution, %)								
Agriculture	4.3	-16.4	-12.2	20.5	-12.3	-25.7	46.1	-11.7	2.3
Mining	1.3	25.4	7.9	35.1	7.7	2.1	5.0	0.5	-9.8
Manufacturing	27.7	6.1	3.9	-4.2	0.7	-4.3	63.7	-1.4	1.2
Energy	1.5	-9.1	145.0	-7.2	65.8	29.4	10.9	12.6	-29.4
Transport and communications	13.1	9.2	-5.9	3.9	-5.5	-0.7	55.0	3.7	12.3
Tourism	6.1	81.7	61.8	48.2	44.4	37.8	9.9	-5.0	-14.5
Housing	40.7	14.9	36.7	44.6	29.2	6.3	-8.9	-8.7	1.2
Education	0.7	103.2	35.1	27.5	5.5	27.0	24.6	15.9	-6.0
Health	1.3	140.2	44.5	20.0	-17.6	51.3	58.9	45.6	-1.0
Other services	3.4	8.7	8.6	8.5	3.9	4.5	12.5	0.6	4.6
Total	100(54)	8.2	16.4	18.6	13.5	3.3	18.8	-3.5	1.4
Public sector									
Agriculture	11.3	-6.2	13.6	26.7	-3.8	6.3	-5.5	18.5	-16.1
Mining	3.5	32.0	-27.5	-44.2	-7.0	-33.2	12.6	2.3	-10.2
Manufacturing	5.1	7.3	-19.8	-40.3	-25.7	-27.6	5.8	19.7	3.7
Energy	17.0	9.1	14.2	-6.7	-2.1	4.2	-21.9	-20.0	9.6
Transport and communications	37.0	42.7	13.9	12.4	-23.4	-3.6	20.7	11.1	-8.6
Tourism	1.5	27.1	141.6	-10.1	-17.6	-33.3	18.9	31.9	-4.9
Housing	2.1	28.0	-9.4	-23.9	3.8	-1.9	121.5	-45.2	7.4
Education	6.5	43.2	5.6	27.6	3.3	2.8	23.0	1.3	20.3
Health	2.5	-1.2	15.0	26.7	4.2	16.9	38.6	-4.2	26.4
Other services	13.4	56.2	41.0	5.8	-20.9	-24.5	25.7	25.0	15.7
Total	100 (46)	23.1	7.5	-3.7	-13.7	-5.8	8.0	3.8	1.1
Total gross fixed investment	100 (100)	16.9	11.0	5.4	-1.3	-1.0	13.9	-0.4	1.5

Source: OECD, National Accounts: Main Aggregates, various issues.

Table A.I.7: Pre-and-Post-Tax Interest Rates on Deposits, percent

	1986	1987	1988	1989	1990	1991	1992[a]
Turkish Lira (TL) deposit rates							
Nominal pre-tax, uncompounded							
Sight	10	10	27.9	12.0	12.1	12.3	11.1
1 month	29	28	60.1	39.2	38.7	58.0	58.0
3 month	36	35	66.1	49.1	50.7	69.6	69.0
6 month	41	38	70.8	51.8	52.0	64.8	59.1
1 year	48	56	83.9	58.8	59.4	72.7	74.2
Nominal post-tax, compounded							
Sight	9.4	9.4	28.5	11.4	11.5	11.6	11.3
1 month	29.5	28.3	69.7	41.6	40.9	66.7	67.3
3 month	36.6	35.4	74.1	52.0	54.1	79.0	79.1
6 month	40.3	37.1	73.9	52.1	52.3	66.9	61.0
1 year	43.2	50.2	75.5	52.9	53.5	65.4	67.2
Government bond rates (1 year)	n.a.	n.a.	n.a.	n.a.	55.1	73.2	77.1
Memorandum items:				Percentage Changes			
Inflation (annual CPI)	30.7	55.1	75.2	64.3	60.4	71.1	65.8
Exchange rate (TL/$US)	32.6	31.3	80.8	28.7	24.3	75.9	62.7

Source: Turkey - Recent Economic Developments, IMF, 1993.
Note: a) June 1992 figures. n.a.= not available.

Table A.I.8: Public Sector Borrowing

	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992
					Percent of GNP					
Public sector deficit										
	-6.0	-6.5	-4.6	-4.7	-7.8	-6.2	-7.1	-10.5	-14.4	-12.6
General government	-3.3	-4.2	-1.5	-1.3	-3.6	-3.4	-4.5	-5.3	-10.0	-9.7
Central government	-2.7	-5.3	-2.9	-3.6	-4.5	-4.0	-4.5	-4.2	-7.4	-7.3
Local administrations	0.0	0.1	0.1	0.3	-0.6	-0.5	-0.2	-0.3	-0.6	-0.4
Revolving funds	-0.6	0.0	0.5	0.4	0.8	0.3	0.5	0.4	-0.2	-0.3
Extra-budgetary funds	n.a.	1.0	0.8	2.2	0.7	0.7	-0.3	-1.2	-1.8	-1.7
State economic enterprises	-2.7	-2.3	-3.1	-3.4	-4.2	-2.8	-2.6	-5.2	-4.4	-3.0
					Percent of Total					
Sources of financing										
Central Bank	10.5	11.2	27.3	14.1	20.4	15.8	3.7	1.1	16.4	20.6
Foreign borrowing (net)	16.6	54.1	1.7	58.0	44.2	43.3	15.5	11.9	3.8	1.8
Domestic borrowing (net)	72.9	34.5	71.0	27.9	35.4	40.9	80.8	87.0	79.8	77.6

Source: OECD, National Accounts: Main Aggregates, various issues.
Note: n.a.= not available.

Table A.I.9: Exchange Rates

	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992
Turkish Lira/$												
level	111	163	226	367	522	675	857	1422	2122	2609	4172	8500
percent change	-32	-32	-28	-39	-30	-23	-21	-40	-33	-19	-38	-104
Nominal effective [a] (1980=100)	78	59	47	32	23	15	11	6	5	4	2	1 [b]
Real effective [a] (1980=100)	99	85	82	78	79	66	62	60	66	74	74	74 [b]

Source IFS and IMF Information Notice System.

Notes a) Trade weighed index. Real effective exchange rate based on changes in relative consumer prices.
b) September 1992 figures.

Table A.L10: Balance of Payments, $ million

	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992
Current account												
Exports, fob	4703	5890	5905	7389	8255	7583	10322	11929	11780	13026	13672	13559
Imports, fob	8567	8518	8895	10331	11230	10664	13551	13706	15999	22581	20998	20503
Trade balance	-3864	-2628	-2990	-2942	-2975	-3081	-3229	-1777	-4219	-9555	-7326	-7144
Invisibles balance	1928	1676	1067	1503	1962	1616	2423	3373	5180	6930	7598	6562
Current balance	-1936	-952	-1923	-1439	-1013	-1465	-806	1596	961	-2625	272	-582
Capital account												
of which (net):												
Direct investment	n.a.	55	46	113	99	125	106	354	663	700	783	699
Portfolio investment	0	0	0	0	0	146	282	1178	1586	547	648	1810
Capital balance	1093	1084	706	1727	262	1312	1841	1323	1364	1037	623	1586
Basic balance	-843	132	-1217	288	-751	-153	1035	2919	2325	-1588	895	1004
Overall balance	-5	168	151	-66	124	790	969	890	2762	1308	-1029	954
memo item:												
External debt/GNP	n.a.	35	36	41	48	55	59	58	52	45	45	45

Source: OECD, Economic Surveys, Turkey, 1993.
Note: n.a. = not available.

Notes

1. This Annex bases most of its analysis and results on **IMF, Turkey — Recent Economic Developments**, various issues, and **OECD Economic Surveys: Turkey**, various issues.

2. For a detailed study of the economic crises experienced by Turkey, see Onis and Riedel (1993).

3. **See OECD Economic Surveys, Turkey, 1993**, for a detailed analysis of these labour market issues.

4. TFP growth reflects the portion of output growth that is not ascribable to growth of factor inputs, and is usually attributed to technical progress. This measure is derived as a residual by subtracting a weighted average of capital and labour growth.

5. Substitution of the Turkish lira by foreign currency is favoured by lower and fewer levies on foreign exchange than on domestic currency transactions. Also foreign currency deposits earn high interest rates and are exempt from withholding tax.

6. M2 includes notes and coins, sight deposits and time deposits.

7. The Central Bank money stock is closely related to the concept of reserve money, with the addition of liabilities to banks due to open market operations, as well as public sector credit lines and public sector deposits.

8. The real effective exchange rate based on relative consumer price indices was used.

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Annex II

A FEW LESSONS FOR THE CASE OF EGYPT

Refik Erzan

From a comparison of the economies of Egypt and Turkey in the mid-1980s (Erzan, 1986) it was not difficult to predict that Egypt would shift the orientation of its economy in a way similar to that of Turkey in the early 1980s. This shift actually began in Egypt in the early 1990s. Given a ten-year difference between the two countries, Egypt could draw some lessons from the Turkish experience as described, e.g., in Aricanli and Rodrik (1990). Also, what Turkey has done so far to enhance competition together with the proposals that the present study offers for various areas of competition policy has a direct bearing on countries like Egypt. Below, a brief background note on Egypt is provided together with an annotated list of "lessons" relating to the respective policy areas covered in the present volume

The background: In many respects, the initial conditions in Egypt in the late 1980s were considerably more unfavourable than those of Turkey in the late 1970s. Among these conditions were (i) a relatively high share of the public sector in the economy (amounting to about 65 percent in industry), (ii) substantially more restrictive foreign trade, exchange and payments regimes, and (iii) controls on virtually all prices. In 1990 53 percent of total agricultural and manufacturing output was protected by non-tariff barriers (NTBs) on imports. Import bans alone covered 26 percent of total production and there were multiple exchange rates which differed by wide margins.

The unfavourable initial conditions in Egypt make the adjustment task more difficult. But at the same time, they constitute a greater reserve for quick efficiency and welfare gains, in case Egypt goes through a liberalization process similar to that of Turkey.

Egypt started a major liberalization program in 1990, which is comparable with the Turkish policy reorientation of the early 1980s, both in coverage and magnitude. On some accounts, notably in privatization, it seems even more decisive. By 1991 the NTB coverage ratio has dropped from 53 to 26 percent. Major steps were taken towards a unification of exchange rates and most price controls were abolished. The public sector borrowing requirement (PSBR) is projected to decline with the help of a tax reform, and reductions in subsidies and public sector investment (Giugale and Dinh, 1990).

A few lessons: (i) The major impetus for the export boom in Turkey was the liberalization of the foreign trade and exchange regimes, whereas the net contribution of the export subsidies was questionable (Chapters III and V). Export pessimism is not warranted. However, exporters should be supported in their marketing endeavours (Chapter XI).

(ii) Trade liberalization and increased import penetration increased domestic competition, and if the impact was not felt strongly, it may have partly been due to the liberalization not being forceful enough (Chapter III).

(iii) Antidumping and antisubsidy measures should be avoided because of the danger of introducing an intransparent and arbitrary form of protectionism (Chapter VIII).

(iv) The foreign exchange and payments system could be liberalized without worrying about capital flight. Capital is usually attracted into both portfolio and direct investment (Annex I).

(v) Privatization should be accelerated (Chapter XII). Public enterprises, due to curtailed expenditure in machinery, equipment and technology as well as greater import competition, will become more difficult to sell over time.

(vi) Restructuring and exit policies should be formulated at an early stage before random bailouts become expensive (Chapter VI). (vii) Measures should be taken to facilitate inter-sectoral mobility of labour (Chapters VI and IX).

(viii) A competitive financial market is a prerequisite for adjustment and growth. Entry into this market should be promoted at an early stage, but also the supervisory and regulatory powers and capacities of the relevant authorities should be improved (Chapter IV).

(ix) Finally, a comprehensive study of market concentration and conduct is likely to prove very useful with a view to initiating the debate on competition policies.

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