THE RED SEA CRISIS AND TURKEY

— OPPORTUNITIES AND CHALLENGES FOR STRENGTHENING THE EUROPEAN SUPPLY CHAIN —

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SUMMARY

- Numerous attacks on merchant ships in the southern part of the Red Sea by Yemen's pro-Iranian Houthi militia have increased shipping costs on the Suez Canal route between Asia and Europe and have also caused delays in the arrival of some cargoes in Europe.

- Given the geopolitical risks in the Red Sea and related supply chain issues, it is worth considering Turkey as an alternative production and export hub for European markets. Turkey produces and exports the types of products for which the Red Sea crisis has delayed shipments, and also seeks to manufacture high value-added products for which Europe relies on imports from China.

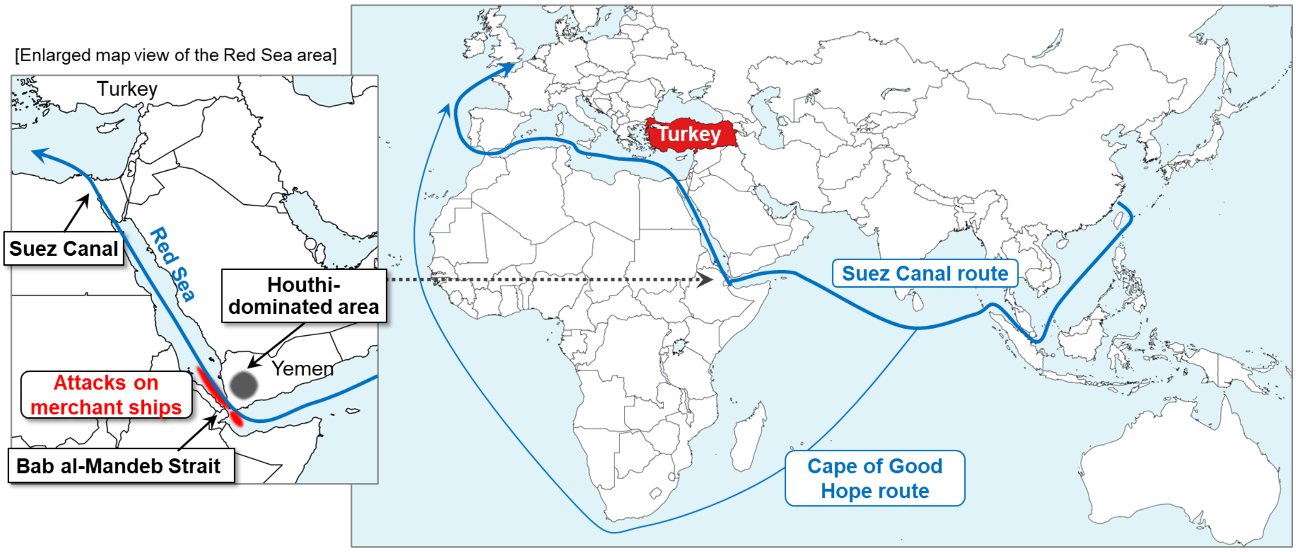
- Turkey, however, is struggling with high inflation and currency depreciation. While the Erdogan administration is working to curb inflation and stabilize the exchange rate by tightening monetary policy, it remains to be seen whether the desired effects will become evident by the end of 2024.

1. IMPACT OF THE RED SEA CRISIS ON THE ASIA-EUROPE SUPPLY CHAIN

The military conflict between Israel and Hamas that began on October 7, 2023 provoked the Houthis, a pro-Iranian armed group in Yemen, to launch attacks against Israel-associated merchant ships[1] in the vicinity of the Bab al-Mandeb Strait in the Red Sea (Figure 1). The result has been a rise in shipping costs on the Suez Canal route of the Asia-Europe trade corridor. In light of the potential for a prolonged Red Sea crisis, this report examines the prospects and challenges for Turkey. The country merits attention not only for its proximity to Europe but also for its well-developed manufacturing industry. Can Turkey become a manufacturing and export hub for Europe, thereby mitigating the risks associated with passage through the Suez Canal route?

[1] Merchant ships associated with Israel means vessels bound for Israel, flying the Israeli flag, operated by Israeli companies, owned by Israelis, or owned and operated by companies of Israel's allies. However, merchant ships not falling under any of these categories were also attacked. For example, the Houthis (perhaps mistakenly) attacked tankers carrying Russian oil and Chinese-owned oil tankers.

Figure 1: Asia-Europe sea lanes—Suez Canal route and Cape of Good Hope route, and the area where merchant vessels are attacked

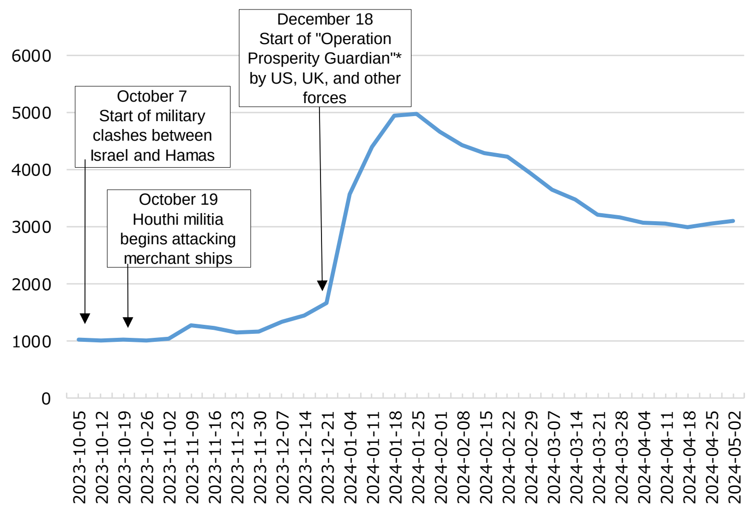


Source: Compiled by MGSSI based on MapChart

1-1. Rising shipping costs on Asia-Europe routes

When the Houthi attacks began in late October 2023, cargo insurance premiums on the Suez Canal route of the Asia-Europe sea lane edged up, and container ships were diverted to the Cape of Good Hope route. As a result, by January 2024, ocean container freight rates on the route had risen to approximately five times pre-attack levels (Figure 2). Since then, freight rates have declined moderately as the balance between shipping supply and demand has been restored, but Houthi attacks continue to occur to this day, and major shipping lines continue to avoid using the Suez Canal route.

Figure 2: Container freight rate index from Shanghai to Rotterdam



Source: Compiled by MGSSI based on the Drewry World Container Index
*A military operation by a multinational coalition, including the US and UK, to contain Houthi attacks on merchant ships.

The Houthis insist on an end to Israeli attacks on Gaza as a condition for ending their attacks on merchant ships, but there is little likelihood that an Israel-Hamas ceasefire agreement will be reached. Even if a ceasefire agreement is reached, it is highly likely that Israel will continue its assault on Gaza, in which case the Houthis will continue to attack merchant ships. Recently, tensions between Iran and Israel have also heightened, making it more likely that the Houthis will continue to attack merchant ships in the Red Sea as a proxy force for Iran. The attacks on merchant ships and high shipping costs are expected to continue for some time.

1-2. Impact on supply to Europe

The Red Sea crisis caused delays in the arrival of some cargoes shipped from Asia to Europe in January 2024. For example, automotive companies Tesla, Volvo, and Suzuki were forced to suspend vehicle production in Europe for days or weeks due to delays in the arrival of parts shipments, and tire manufacturer Michelin had to halt production at its plant in Spain for several days[2]. Sportswear manufacturer Adidas, apparel company H&M, and food company Danone also reported delays in the arrival of some shipments[3].

Those companies affected by supply from Asia appear to have modified their procurement lead times by adjusting inventories and using air transportation[4]. However, as geopolitical risks in the Middle East remain high and attacks on merchant ships by the Houthis are likely to continue, it is worth considering Turkey as an alternative production hub for Europe, given its proximity to Europe and well-developed manufacturing industry.

2. TURKEY AS AN ANSWER TO DEFLECTING GEOPOLITICAL RISKS

2-1. Turkey's economic scale

In 2022, Turkey's GDP was US$905.8 billion, making it the 19th largest economy in the world, and its GDP per capita was US$10,622. The country is one of the emerging economy members of the G20. Turkey marked GDP growth of 5.5% in 2022 and 4.5% in 2023, and it is projected to achieve growth in the 3% range from 2024 onward[5]. Turkey's main export destinations are countries in Europe, and the country domestically produces and exports automobiles, machinery, steel, apparel, electrical equipment, and chemical products (Figure 3). Manufacturing labor costs in Turkey are lower than in Eastern European countries (Figure 4).

Figure 3: Turkey's main export items and export destinations (2023)

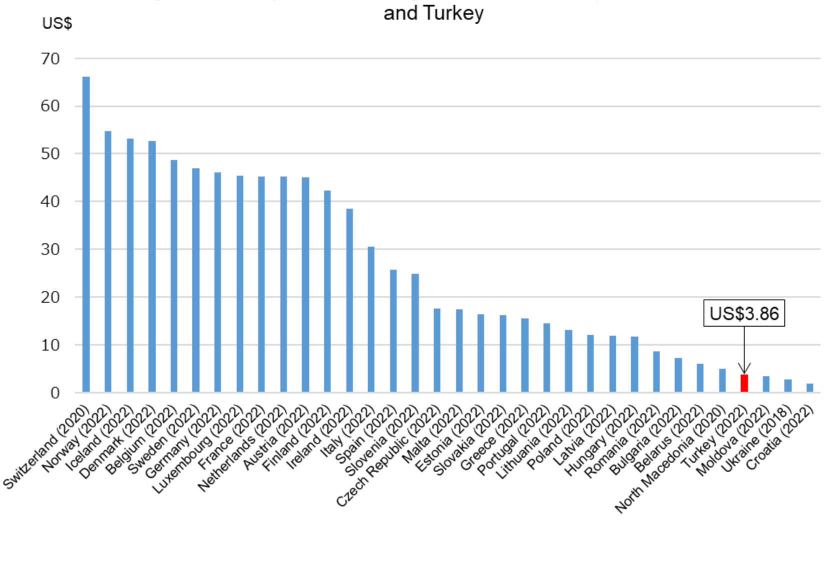
	Export item	Export value (US$ mn)
1	Automobiles	30,837
2	Machinery (home electronics, engines, etc.)	25,227
3	Steel and steel products	18,926
4	Apparel	18,322
5	Mineral fuel (mainly petroleum)	16,409
6	Electronic goods	15,351
7	Precious metals, pearls, precious stones, etc.	13,650
8	Plastic products	10,590
9	Edible fruits	5,370
10	Aluminum products	5,318

	Export destination	Export value (US$ mn)
1	Germany	21,092
2	US	14,826
3	Iraq	12,786
4	UK	12,468
5	Italy	12,382
6	Russia	10,921
7	France	10,297
8	Spain	9,777
9	UAE	8,594
10	Netherlands	7,873

Source: Compiled by MGSSI based on International Trade Center data

[2] Tesla, Volvo Car pause output as Red Sea shipping crisis deepens, Reuters, January 13, 2024.; Hungary's Suzuki plant to stop production for a week over supply-chain issues, Reuters, January 15, 2024.; Red Sea crisis forces Michelin to halt output in Spain next weekend, Reuters, January 16, 2024.
[3] How companies are responding to attacks on ships, Reuters, March 28, 2024.
[4] See note 3.
[5] IMF, World Economic Outlook. April 2024.

Figure 4: Hourly manufacturing labor costs in European countries and Turkey



Source: Compiled by MGSSI based on ILO data

2-2. Turkey exports automobiles, textiles, and apparel to Europe

As described earlier in section 1-2, the European automotive sector is being impacted by the Red Sea crisis, but Turkish companies as well as companies from other countries, such as Ford, Hyundai, Renault, Toyota, Mercedes Benz, Man, Anadolu Isuzu, Tofaş, TürkTraktör, Karsan, Otokar, and Temsa, have production plants in Turkey and export to Europe from those hubs[6]. As much as 70-80% of the automobiles produced in Turkey are destined for export[7], and the system for exports to Europe is well established.

Another industry affected by the Red Sea crisis, apparel, also has production hubs in Turkey that export to Europe. By 2023, Turkey had become the third-largest supplier of textiles and clothing to Europe[8], with production plants of world-class apparel brands, including H&M, Mango, Zara, Adidas, and Puma, located there. Consequently, for those sectors experiencing logistical challenges due to the Red Sea crisis, Turkey offers a production and export system, positioning it as a potential alternative hub for European production and exports.

2-3. Government supporting the growth of high value-added industries

It is also important to note that the Turkish government is actively promoting growth of high value-added industries. European countries depend on Asia, especially China, for about half of their imports of high value-added products, such as smartphones, personal computers, storage batteries (including lithium-ion storage batteries), and semiconductors (including solar panels) (Figure 5). Turkey itself also currently depends on imports from China for these products. However, in its Medium-Term Program 2024-2026 announced in September 2023, the country has identified economic growth through the development of high value-added industries, export promotion, and advancement of green transformation (GX) and digital transformation (DX) as part of its agenda[9].

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[6] Automotive Manufacturers Association (OSD), Automotive Industry Monthly Report, February 2024. p.15.
[7] OSD, Automotive Industry Monthly Report, February 2024. p.14.

[8] European Apparel and Textile Confederation (Euratex) , Facts & Key Figures of the European Textile and Clothing Industry (2024 edition). p.19. China ranked first and Bangladesh second.

[9] Presidency of Strategy and Budget, The Medium Term Program (2024-2026).

Figure 5: Major Imports from China by 28 European Countries (2023)

	Import item	Imports from China		Percentage of imports from Asia
		Value (US$ mn)	Percentage	
1	Smartphones and telephone devices	79,274	41.4%	60.2%
2	Personal computers	60,439	42.3%	56.3%
3	Storage batteries (lithium-ion storage batteries, etc.)	30,474	41.2%	48.7%
4	Semiconductor devices (solar panels, etc.)	27,956	55.7%	66.0%
5	Passenger vehicles	25,093	6.2%	14.1%
6	Transformers	19,400	33.0%	44.4%
7	Heterocyclic compounds	16,070	19.4%	28.1%
8	Game consoles	11,780	53.2%	62.4%
9	Monitors and projectors	10,387	31.9%	42.6%
10	Electric heaters	8,722	32.0%	37.8%

Source: Compiled by MGSSI based on International Trade Center data

Turkey wants to focus its efforts on the domestic production of EVs and EV batteries, which are industries that combine GX and high value-addedness. In 2018, under President Erdogan's initiative, the domestic EV manufacturer Togg was established. In 2022, the automaker began operating its EV assembly plant (Gemlik, Bursa Province) and rolled out its first domestic EV model, the Togg T10X. Although EVs accounted for only 6.9% of new passenger car registrations in 2023, the launch of the Togg T10X increased new EV registrations by 7.9 times from the previous year[10]. According to data from research firm BMI, domestic EV sales are expected to expand by an average of 24% annually through 2032[11]. Togg plans to begin exporting to Europe in 2025[12].

As for EV batteries, in February 2023, US automaker Ford Motor, South Korea's LG Energy Solution, and Turkey's Koç Holding signed a memorandum of understanding to establish a joint venture to build the largest EV battery production plant in Europe, which is to be located in Ankara. Commercial production is expected to begin in 2026. The initial annual production capacity is projected to be 25 GWh, with plans to expand capacity to 45 GWh in the future. In March 2023, Siro, a joint venture between Togg and China's Farasis Energy, began producing batteries to be installed in Togg's EVs at its plant in Gemlik. Currently, the annual production capacity is 3 GWh, but the company plans to expand this to 20 GWh by 2031. President Erdogan has stated that Turkey will become a production hub for EV batteries for Europe by 2030[13].

As such, the EV industry, in which Turkey is encouraging investment as a national policy, is still in its infancy. Clean energy-related business is of great interest to Japanese companies operating in the Middle East[14]. As Japanese companies can contribute their technology and expertise in this area, there is ample potential for them to collaborate with Turkish and other foreign companies.

3. TURKISH ECONOMY: CURRENT STATUS AND OUTLOOK

The problem, however, is that foreign investors' confidence in the Turkish economy has not yet been restored due to persistently high inflation and currency depreciation brought about by years of an abnormally low interest rate policy directed by President Erdogan[15]. Inflation raises domestic costs, and unstable exchange rates create foreign exchange risks that make foreign companies reluctant to invest. In June 2023, after his reelection,

[10] Toshihiro Nakajima, No. 93: "EV Sales Go into Full Swing in Turkey—Togg Leads the Way" (in Japanese) EMB Business News (accessed February 29, 2024)

[11] Calculations by the author based on the following report. Turkiye EV Profile: Increased Incentives Necessary To Stimulate EV Adoption, BMI, July 4, 2023.

[12] Turkey's EV production finally gets into gear, Arabian Gulf Business Insight, December 29, 2023.

[13] 'Türkiye aims to become major player in EV, battery production', Hürriyet Daily News, November 6, 2023.

[14] In a December 2023 JETRO survey of Japanese companies operating in 10 Middle Eastern countries, 52.8% of those polled responded that the most promising business field is "resources and energy," which includes hydrogen, fuel ammonia, renewable energy (solar), and other decarbonization-related products.

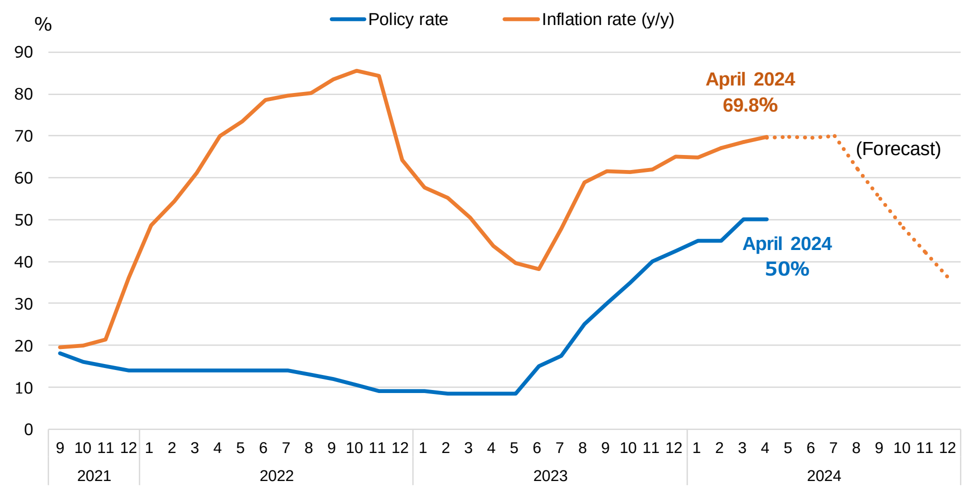
[15] President Erdogan insisted on a policy of low interest rates even in the face of rising inflation, aiming for economic growth through increased investment, production, employment, and exports.

President Erdogan appointed Mehmet Şimşek, former deputy prime minister and finance minister, as treasury and finance minister; Cevdet Yılmaz, former economic development minister and deputy prime minister for economic affairs, as vice president; and Hafize Gaye Erkan[16], former top executive of a major US bank, as governor of the Central Bank. He then accepted the rational monetary policy advocated by his new economic team, aiming at price and exchange rate stability. Now that it is one year later, has the tightening of monetary policy had any effect?

3-1. Shift to a rational monetary policy

Treasury and Finance Minister Şimşek declared a return to a rational economic policy, aiming to dampen domestic consumption and real estate investment and curb inflation by raising interest rates[17]. The central bank hiked interest rates nine times between June 2023 and March 2024, raising the policy rate (one-week repo rate) from 8.5% to 50%. Although inflation has remained high, with the rate reported at 69.8% YoY in April 2024, interest rates were negative in real terms (Figure 6).

Figure 6: Turkey's annual inflation rate and policy rate



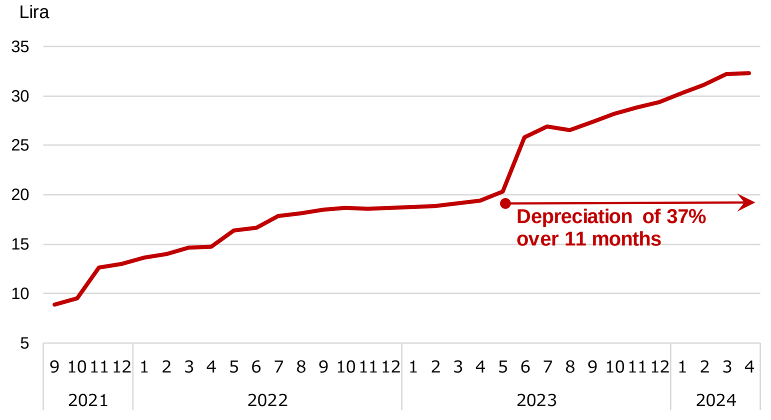
Source: Compiled by MGSSI based on data of the Central Bank of the Republic of Turkey and the Turkish Statistical Institute

One of the factors pushing prices higher is the depreciation of the country's currency, the lira. The lira continued to weaken during the low interest rate policy period and depreciated a further 37% in the 11 months even after monetary tightening was adopted (Figure 7). One contributing factor to the continued depreciation of the Turkish lira is the lack of confidence among international financial and business communities in Turkey's monetary policy. This is due to the unpredictability of the direction of the Turkish economy, which has been shaped by the unorthodox monetary policies implemented by the Erdogan administration. Another factor is the stimulation of domestic demand through the increase in the minimum wage and public employee pension payments by over 40%, despite the tightening of monetary policy.

[16] Central Bank Governor Erkan resigned for personal reasons in February 2024. She was replaced by then-Deputy Governor Fatih Karahan.

[17] Yasushi Hazama, "Turkey in Erdogan's Third Term: 'Return to Economic Rationality'" (in Japanese) IDE Square (Institute of Developing Economies), February 2024.

Figure 7: Turkish lira's exchange rate against the US dollar



Source: Compiled by MGSSI based on data of the Central Bank of the Republic of Turkey

The current monetary policy will remain in place until disinflation is assured. This is due to the persistent price increases in the energy and service sectors, which are highly dependent on imports. In addition, there have been price increases for food products, as well as inflationary expectations and geopolitical risks.

It should be noted that in the recent local elections held on March 31, 2024, the ruling Justice and Development Party (AKP) lost the national vote to the largest opposition party, the Republican People's Party (CHP), and this defeat was due to the AKP's economic policy failures. To regain the support of the public, Erdogan's administration must work to stop the lira from depreciating and control inflation by tightening monetary policy. With the next round of national elections not scheduled until 2028, it remains to be seen whether the country can implement painful reforms and rebuild its economy over the next four years.

4. SUMMARY

As stated above, Turkey's geographical proximity to Europe, its established domestic production and export system for products that Europe imports from Asia, and its push to develop high value-added industries make it a suitable production and export hub to avoid security risks in the southern part of the Red Sea. However, the instability of the Turkish economy is a challenge. In the wake of the bitter defeat in recent local elections, Erdogan's administration needs to normalize the economic situation. It is expected to work to rebuild the economy through rational economic policies. Given the size of Turkey's economy, its strategic geographical location, and the strength of its manufacturing sector, foreign investors are expected to return to Turkey as soon as inflation subsides and the lira shows signs of stabilizing. As the Red Sea crisis is expected to be protracted, it is worth reiterating the importance of Turkey as an option for avoiding geopolitical risks.