



Policy Brief

Turkey's EU integration at a crossroads

What consequences does the new EU trade policy have for economic relations between Turkey and Europe, and how can these be addressed?

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Our Findings in Short

- Trade with the EU and welfare in Turkey have increased steadily so far under the EU-Turkey Customs Union.
- New EU trade deals such as the TTIP threaten to create discrimination against Turkey. Turkey would be forced to adjust its external tariffs to the third party countries according to the rules of the Custom Union, while in return as a non EU-member state having no equal share in the agreements' benefits.
- Rolling back the Custom Union into an EU-Turkey bilateral trade agreement would be a subpar solution as both Turkey and EU states would experience welfare losses as a result.
- Deepening the Custom Union, on the other hand, to include agricultural and service sectors would yield significant welfare effects in Turkey and the EU, both with and without new EU trade agreements with third party countries.
- Maximum positive welfare effects can be achieved in a combination of a deepening of the Customs Union and the implementation of the planned EU free trade agreements in the short term, followed by trade deals between Turkey and the other EU trading partners.
- Ideally, along a deepening of the customs union, the agreement should be formally expanded in conjunction with free trade agreements between the EU and third countries, so that tariff-easing negotiated for European firms in third countries can also apply to Turkish firms.

Introduction

The integration of Turkish industry into the European Customs Union has led to a steady increase in bilateral economic relations between the EU and Turkey. Particularly since 2002, Turkish industry has been increasingly integrated in European production networks. The EU is by far Turkey's most important trading partner and, in turn, Turkey is the EU's sixth largest trading partner. Germany in particular has fostered enduring economic relations with Turkey. While 9 percent of Turkish exports go to Germany, approximately 10 percent of all Turkish imports are from Germany.

In May 2015 the Turkish government, together with representatives of the European Union (EU), issued a Memorandum of Understanding with the objective of modernizing and expanding the existing customs union (CU) between the two parties.* This desire to deepen economic policy relations between the EU and Turkey separately from the stagnating *acquis communautaire* may at first glance seem surprising, but it represents a possible step toward preventing the impending breakdown in economic and trade relations between the two regions.

The fear of such a collapse is based in the changing face of European trade in the wake of mega-regional trade agreements like the TTIP and in the nature of the EU-Turkey Customs Union itself. As a result of the Customs Union agreed with the EU and the corresponding principle of joint customs harmonization for third countries, Turkey is obliged to open its market to these third countries if the EU signs a free trade agreement with them. In return, Turkish companies can establish free commodity trade with the EU28 states, but cannot receive the benefits that were negotiated for European exporters to third countries. Discrimination against Turkish exports arises technically where there are free trade agreements with third

countries, since EU trade agreements are negotiated at EU level and Turkey has no right to participate in drawing up these agreements, even when their effects – as in the case of the customs union – have dramatic economic implications for the country.

Consequently, Turkey faces significant trade disadvantages both in third countries and in the EU. Two possible short-term corrections are theoretically conceivable to remove the asymmetry Turkey experiences in the customs union. A) Turkey converts the customs agreement with the EU into a free trade agreement and thus regains full sovereignty over its trade. B) Turkey expands the existing customs agreement to include the agricultural and service sectors. In the long term, Turkey must offset the EU's free trade agreements with third countries by concluding its own free trade agreements with the same countries.

* EU-Turkish Memorandum of Understanding: http://ec.europa.eu/commission/2014-2019/hahn/announcements/eu-and-turkey-announce-modernisation-custom-union_en.

Quantitative Results

What happens without a solution?

Under the existing customs agreement, the EU's new free trade agreements (e.g. the TTIP) have negative consequences for Turkish welfare. Although the cumulative negative effects are not too great at first, it becomes clear at a sectoral level that important export sectors in Turkey are experiencing a very significant drop in trade. The asymmetrical customs agreement, which disadvantages Turkish exporters on the markets of the EU's new trading partners, is the cause of this sharp sectoral fall in exports. The negative effects for Turkish companies are particularly marked if the EU's new partner countries already have a strong industry in the respective

sectors. In important industrial sectors, in particular, such as the automotive and machinery-construction sectors, falls of up to 10 percent and 4 percent, respectively, are to be expected for Turkish exports to the EU's new partner countries.

Deepening the EU-Turkey Customs Union

An extension of the EU-Turkey Customs Union to the agricultural and service sectors would have a strong positive welfare effect on the Turkish economy. The gross domestic product could rise by an additional 1.84 percent. Turkish exports to the EU could increase by almost 70 percent. However, the rise in exports

Table 1: Effects of various trade agreements on Turkey

Scenario 1B) TUR	TTIP	Japan	CETA	India	MERCOSUR	ASEAN	Combined (1-6)
ΔGDP (USD billions)	0.04	-0.03	0.01	-0.03	-0.02	-0.07	-0.08
ΔGDP per capita (USD)	0.51	-0.36	0.09	-0.33	-0.22	-0.89	-1.08
ΔWages (%)	0.02	0.01	0.00	-0.01	0.01	0.00	0.02
ΔWelfare (%)	0.01	0.00	0.00	0.00	0.00	-0.01	-0.01
ΔExports TUR - EU28 (%)	-0.27	-0.50	0.10	-0.11	0.43	-0.19	-0.51
ΔExports TUR - RoW (%)	-0.15	0.23	-0.10	-0.14	-0.28	0.15	-0.29
ΔExports TUR - FTA (%)	-1.28	-2.82	-1.20	-7.04	-8.05	-0.72	-2.56
ΔImports TUR - EU28 (%)	-0.77	-0.59	-0.14	-0.24	-0.26	-0.33	-2.27
ΔImports TUR - RoW (%)	0.10	0.12	0.08	0.02	0.23	0.13	0.66
ΔImports TUR - FTA (%)	5.05	13.05	2.72	0.86	3.86	8.42	5.17

Table 2: Effects of Customs Union extension to agricultural and service sector in Turkey

Scenario 2) TUR	2A) Agricultural	2B) Services	2C) Agricultural and services
ΔGDP (USD BN)	4.91	8.16	13.30
ΔGDP per capita (USD)	63.17	104.97	171.10
Δwages (%)	0.86	1.48	2.40
Δwelfare (%)	0.68	1.13	1.84
Δexports TUR - EU28 (%)	10.90	57.58	69.86
Δexports TUR - RoW (%)	2.62	-9.98	-7.83
Δimports TUR - EU28 (%)	13.17	26.36	40.12
Δimports TUR - RoW (%)	-2.55	8.22	5.60

Table 3: Results of extended Customs Union in combination with EU trade deals for Turkey

Scenario 3.1A) TUR	TTIP	Japan	CETA	India	MERCOSUR	ASEAN	Combined (1-6)
ΔGDP (BN USD)	13.48	13.32	13.34	13.31	13.49	13.25	13.66
ΔGDP per capita (USD)	173.36	171.38	171.58	171.22	173.50	170.43	175.70
Δwages (%)	2.49	2.42	2.41	2.40	2.46	2.42	2.61
Δwelfare (%)	1.87	1.84	1.85	1.84	1.87	1.83	1.89
Δexports TUR – EU28 (%)	70.45	69.70	70.16	69.95	70.96	69.87	71.77
Δexports TUR – RoW (%)	-7.94	-7.74	-7.96	-8.05	-7.90	-7.62	-8.06
Δexports TUR – FTA (%)	-10.61	-13.47	-9.76	-15.72	-15.82	-11.28	-11.93
Δimports TUR – EU28 (%)	38.61	39.22	39.91	39.86	38.99	39.26	35.59
Δimports TUR – RoW (%)	6.44	6.02	5.79	5.70	6.71	6.15	8.59
Δimports TUR – FTA (%)	16.77	18.91	15.42	10.90	43.81	26.53	18.95

Table 4: Results of an EU-Turkey bilateral trade agreement in combination with EU trade deals for Turkey

Scenario 4B) TUR	TTIP	Japan	CETA	India	MERCOSUR	ASEAN	Combined (1-6)
ΔGDP (USD BN)	-6.95	-7.06	-7.07	-7.10	-7.08	-7.09	-6.93
ΔGDP per capita (USD)	-89.45	-90.85	-90.89	-91.30	-91.14	-91.19	-89.13
Δwages (%)	-0.96	-0.96	-0.95	-0.96	-0.96	-0.96	-0.97
Δwelfare (%)	-0.96	-0.98	-0.98	-0.98	-0.98	-0.98	-0.96
Δexports TUR – EU28 (%)	-17.29	-17.11	-16.84	-17.00	-16.65	-17.34	-17.48
Δexports TUR – RoW (%)	0.83	1.08	1.10	1.07	0.95	1.24	0.20
Δexports TUR – FTA (%)	0.36	1.88	-0.95	-7.22	-7.84	3.79	-1.18
Δimports TUR – EU28 (%)	-15.22	-15.27	-15.06	-15.16	-15.16	-15.09	-16.20
Δimports TUR – RoW (%)	0.34	0.64	0.66	0.61	0.74	0.48	0.53
Δimports TUR – FTA (%)	0.15	10.18	-0.05	-0.16	-4.27	-0.62	0.61

would vary from sector to sector. Whereas exports to the EU could increase by 95 percent for the agricultural sector and 430 percent for the service sector, a fall in exports is to be expected in industrial sectors. By deepening the customs union there will be a reallocation of resources away from industry toward the service sector. Furthermore, the increase in exports to the EU will be the result of a sharp decline in Turkish exports to other countries. The deepening of the customs agreement could lead to per capita income growth of USD 171.

Following the deepening of the customs union, Turkish exporters can compensate for the problem of asymmetry in the event of new EU free trade agreements. The conclusion of the six EU free trade agreements under consideration would result in a

1.89 percent growth in GDP for Turkey, which is higher than would be the case under a deepening of the customs union alone, without the new trade agreements. It is the growth in exports to the EU in the service sector in particular that will compensate for a fall in Turkish exports to the EU's new partner countries. Although deepening the customs union will offer medium-term compensation for the problem of asymmetry, there is still the possibility for Turkey in the long term to improve welfare insofar as the existing tariff asymmetry is balanced out by free trade agreements with the EU's new partner countries.

Such a deepening of the EU-Turkey Customs Union and the conclusion of basic free trade agreements between Turkey and the EU's new trading partners could result in a 2.13 percent rise in welfare for Turkey. This could increase per capita income in Turkey

by almost USD 200. If Turkey is able to conclude free trade agreements as comprehensive as those concluded by the EU with the third countries in question, there will be a potential GDP growth of 2.5 percent. This would currently correspond to a nominal GDP increase of USD 18 billion.

Changing the EU-Turkey Customs Union into a bilateral free trade agreement

The rollback of the EU-Turkey Customs Union to a bilateral free trade agreement represents another trade policy option; however, this would result in a fall in welfare in Turkey. There would be a drop in GDP of 0.81 percent. In addition, new EU free trade agreements would lead to a further drop in welfare (of 0.96 %). The main reason for this is the decline in European-Turkish production networks resulting from a rollback of the customs union to a free trade agreement. Due to the need for certificates of origin in free trade agreements, European companies deem

Turkey to be an increasingly unattractive location for the production of intermediate goods. Even if Turkey concludes free trade agreements with the EU's new partner countries in such a scenario, this will not lead to better welfare effects than in all of the other scenarios previously considered. Although Turkish exports to the corresponding third countries will increase, since the problem of asymmetry will no longer exist, trade with the EU will decrease, which is of greater importance due to current trade volumes. A rollback of the customs union to a free trade agreement is not a wise trade policy for Turkey in comparison to the alternative of deepening the customs union.

Similarly a deepening of the customs union with Turkey leads in Germany and the EU to welfare gains, while a rollback of the customs agreement to a free trade accord is accompanied both in Germany and in the EU with negative welfare effects.

Conclusions and Recommendations

This study shows that the economic integration of Turkey via the EU Customs Union has so far had very positive effects. The success of this economic integration has been at risk for some time, since institutional weaknesses in the way the European customs union is organized in Turkey's case bring about increasingly negative consequences for Turkish industry.

If no measures are taken in the short term, there is the risk of a marked deterioration in European-Turkish economic relations. It is also clear based on other, external factors that there is an urgent need for political change. The Russian president, Vladimir Putin, has offered Turkey membership of the Eurasian Customs Union. Turkish politicians are increasingly discussing this option as an alternative to the European Customs Union.

Alternatively, conservative politicians in Turkey are calling to be released from the unilateral customs union with the EU and to establish a European-Turkish free trade agreement instead. However, the results of this study clearly show that, if Turkey turns away from the EU, such as by rolling back the customs union to a free trade agreement, this will be accompanied by considerable welfare losses for the country.

On the other hand, deeper economic integration in the customs union is a realistic policy option for Turkey, first of all because the country could expect a clear gain in welfare and also because the negative trade effects caused by the problem of asymmetry would be compensated for. The study findings project possible gains in welfare of up to 1.8 percent or USD 13 billion for GDP.

Basically, by deepening the customs union, Turkey has the opportunity to correct the problem relating to third countries arising from the Ankara Agreement. Inclusion of the Turkish agricultural and services sectors in the European Customs Union also offers economic opportunities for EU states, as it provides an incentive to remove the problem of asymmetry in the Ankara Agreement. The agreement should be formally expanded in conjunction with free trade agreements between the EU and third countries, so that tariff-easing negotiated for European firms in third countries can also apply to Turkish firms. With a deepening of the customs union Germany and the EU would experience also a significant GDP growth.

The study demonstrates that such an adaptation of the Ankara Agreement can be expected to boost Turkish welfare by up to 2.5 percent. This would correspond to a USD 18 billion rise in GDP. This growth would compare with a decrease in GDP of USD 20 billion if the EU and Turkey take no action. These challenges to the EU-Turkey Customs Union, which is barely discussed in public, show that Turkey is caught between the European and Asian economies and at risk of drifting away from the EU, if the country is not offered any realistic adaptation of the customs agreement by the EU.

The institutional weaknesses shown above in the EU-Turkey Customs Union are ultimately a symptom of more serious and fundamental problems in Turkey's integration process into the EU. Setting aside the question of whether and when Turkey can become a full EU member – a question which is not assessed in this study, since a comprehensive analysis would be required – it is clear from current policy decisions that long-term agreements with unknown consequences have been entered into by representatives both from the EU and from Turkey, and that very real and serious economic challenges also remain undressed in the short term.

As an increased number of countries struggle with their respective role or level of integration within Europe – Brexit being only the last in a string of examples – we are facing more and more a multi-speed Europe. For candidate countries such as Turkey, such a prospect means that integration is promoted primarily in the economic or political spheres first of all, which is meaningful and achievable both from a national and from a European point of view. Based on this logic, therefore, Turkey should aim to deepen the customs union. The advantages of this policy are not only economic: if implemented successfully, it offers politicians room for manoeuvre for further reforms in the future, in addition to the welfare effects.

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