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Focus

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Germany and Turkey in Europe: Strategic Outlook

Introduction

Erdal Yalcin*

Germany and Turkey are unique partners in Europe, who are tied to each other through a variety of economic and political links. Germany has been Turkey's largest trade partner for decades and its leading foreign investor. Intensive cooperation between the two countries takes place under the umbrella of various major international organisations. The launch of the German-Turkish Strategic Dialogue Mechanism in 2013 and the recent announcement that regular intergovernmental consultations will be held as of 2016 highlight the intensity of political dialogue between Germany and Turkey, and both countries' ambitions to find joint solutions to common challenges. This more frequent dialogue is not surprising given the fact that the German-Turkish partnership is currently at a crossroads as a result of various challenges facing Europe. While the political accession negotiations between Turkey and the EU have stagnated in recent years, economic cooperation has steadily improved, particularly after Turkey joined the European Customs Union. However, the negotiations on several free trade agreements recently initiated by the EU uncover a fundamental misalignment in the existing contractual economic relation between Turkey and the EU.

A core question in light of the recent developments is how Germany and Turkey will proceed in an EU that looks for new strategic economic partnerships on the bilateral or plurilateral level. With the aim of shedding light on this question, the Ifo Institute and the Istanbul Policy Center (IPC) organised a joint conference in April 2016 and brought together stakeholders from political and private institutions, German companies, academics and diplomats, to scrutinise the current *status quo* in the German-Turkish partnership, taking into account the recent economic and political challenges.[1] The following articles represent a collection of selected contributions that were presented and discussed during the conference.

Germany and Turkey are increasingly the focus of both public and political attention. The recent public debate has focused on the refugee crisis and the role of Turkey, but there are other important topics that need to be addressed, particularly from an economic point of view. A crucial question at this juncture is how the EU's recent trade policy (e.g. the Transatlantic Trade and Investment Partnership, TTIP) will affect Turkey's economic relationships with the EU, the rest of the world, and particularly with Germany. The importance and relevance of this economic aspect is dealt with in the first three articles of this issue.

Departing from an economic perspective the remaining two contributions discuss the question of whether the recent refugee crisis really changed Turkey's political and economic integration path into the EU. Işik Özel, Associate Professor at Sabancı University, explores the institutional foundation of Turkey's widely praised 'success story' in the 2000s, and then discusses a potential erosion in institutions that may have contributed to the slow-down and increasing vulnerability of the Turkish economy over the last five years. Besides the institution-based analysis, Professor Özel also compares Turkey's economic situation with that of other emerging countries and elaborates a comparative perspective.

Helge Tolksdorf, Director of the Division for EU-Enlargement, Southeast Europe, Turkey, at the Federal Ministry for Economic Affairs and Energy discusses the economic relations between Germany and Turkey. After a concise overview of how economic relations have developed over the past decade, several key challenges with a focus on economic affairs are presented before a final, brief discussion of ongoing political and institutional efforts.

Erdal Yalcin, Deputy Director of the Ifo Center for International Economics, enriches the economic analysis by illustrating how the European-Turkish customs union has benefited both the EU and Turkey in the past. After his positive analysis, he adopts a broad-

* Ifo Institute.

[1] The conference (Germany and Turkey in Europe) is available as a video stream in the CESifo Group's media library.

er perspective by accounting for the EU's recent trade policy agenda and discusses its implications for Turkey and EU-Turkey relations. A major emphasis is placed on elaborating how the EU and Turkey may mitigate the existing flawed customs union in the light of the increasing economic regionalism observed.

Nilgün Arısan Eralp, Director of the EU Studies Center, at TEPAV in Ankara extends the discussion by addressing how the recent refugee crises has changed Germany's and the EU's partnership with Turkey. By analysing the so-called refugee deal she elaborates on its implications for cooperation between Germany, the EU, and Turkey.

Ebru Turhan, Assistant Professor at the Department of Political Science and Public Administration of the Turkish-German University in Istanbul presents a broader analysis of how Germany influences and shapes EU-Turkey relations. After analysing the changing role of Germany in the EU during recent crises such as the financial and migration crisis, Turhan examines its implications for Turkey's future in the EU.

For years now, Turkey has been involved in a process of economic and political integration process with the EU. The economic integration of the country over the past decade, in particular, has been very successful and supported by the European-Turkish customs union. Today, however, Turkey's long-standing bid to become an EU member appears a long way from being realised any time in the near future. The successful future integration process involves many challenges both for the EU and for Turkey itself. The EU's new trade policy agenda in the form of new free trade agreements on a bilateral or plurilateral level such as TTIP has highlighted institutional weak points in what was previously a successful customs union between Turkey and the EU. Moreover, reform processes in Turkey have changed substantially, fostered by difficult political developments in regional neighbouring countries like Syria. At the same time, the EU is struggling with an internal crisis that has prompted scrutiny of the EU's administrative structure. The question of Turkey's future in the EU has undoubtedly reached a critical stage in which Germany plays a crucial role both economically and politically. The following contributions aim to shed light on urgent economic and political issues.

From 'Rising Star' to Fragile Market Trapped in Middle-Income: An Overview of the Turkish Economy

Işık Özel*

The Turkish economy is often praised for its impressive growth performance since the early 2000s, which has resulted in almost a nearly three-fold increase in its per capita income. Turkey's track record is in line with the process of positive decoupling experienced by a number of middle-income countries that have achieved fairly impressive growth rates within the last two decades. When the instabilities in advanced countries – as well as negative growth in some cases – are taken into account, the leverage of large middle-income countries becomes more striking, since not only did they sustain growth – albeit at diminishing rates – but they also weathered some of the recent storms in the global economy.[1]

Fostered by burgeoning self-confidence based on such resilience in a context where successive crises shook the global economy, these countries began to increase their voice in international fora and enhance their influence in diverse geographies. Turkey was included in this group together with Russia, China, Brazil, amongst others, which became generous donors in Africa, Asia and Latin America, while the firms (public and private alike) based in these countries undertook giant investments in the latter regions. Nonetheless, this rosy picture did not last very long, as growth in these markets began to slow down and most of these rising stars of the previous decade got 'trapped' in the middle-income category (Aiyar *et al.* 2012; Agenor *et al.* 2012; Kharas and Kohli 2011).

Focusing on the Turkish economy, this paper will begin by exploring the institutional underpinnings behind its widely-praised 'success story' in the 2000s, and then discuss the ongoing erosion in those institutions, which have contributed to the slow-down and increasing vulnerability of the Turkish economy over the last five years.

Trapped in middle-income: Turkey's economy from a comparative perspective

Following a remarkable growth performance where the Turkish economy grew by 4 percent in terms of per capita income, and about 6 percent in terms of gross domestic product (GDP) on average between 2002 and 2015, its GDP reached 798 billion US dollars, making Turkey the 16th largest economy in the world; and thus one of the G20 and the sixth largest economy in Europe.[2] This performance, however, has not been good enough to move Turkey out of the middle income category, currently composed of 104 countries whose GDP per capita ranges between 1,046 and 12,745 US dollars, involving a diverse range of countries from Bangladesh and China to Bulgaria and Turkey. With a GDP per capita of 10,515 US dollars by 2014, Turkey is placed at the higher end of the upper middle-income group (delineated as ranging between 4,126 and 12,735 US dollars measured in terms of per capita GDP) alongside Brazil (11,727 US dollars), Mexico (10,326 US dollars), Romania (10,000 US dollars). Figure 1 shows Turkish GDP per capita in comparison with distinct groups, including the new EU members (through the enlargement in 2004 and 2007) along with individual countries.

Figure 1 demonstrates that Turkey's per capita GDP is, indeed, above the levels of seen in the new EU members that joined in 2007, as well as those of current candidates. Its per capita income is lower than the average per capita GDP of the Central and Eastern European Countries (CEECs) that acceded to the EU in 2004. When the new members' growth performance is examined over the course of the last couple of dec-

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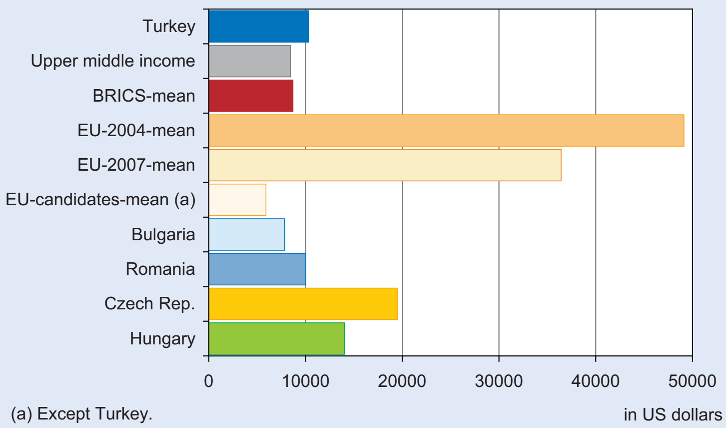
[1] See also http://www.imf.org/external/pubs/ft/weo/2012/02/index.htm.

[2] Based on current prices and 2014 figures – see World Development Indicators, http://data.worldbank.org/indicator/.

Figure 1

GDP per capita for Turkey and selected countries, 2014

in current prices



(a) Except Turkey.

Source: World Development Indicators.

ades, however, the correlation between EU accession and GDP growth can be easily observed. For instance, Turkey's per capita GDP was slightly higher than that of Poland back in 1994 (5,101 vs. 4,902 US dollars expressed in constant 2005 prices), at the time of its accession to the EU, Polish GDP per capita had already surpassed that of Turkey. Figure 2 also compares per capita GDP of Turkey and the new EU members, as well as China in 1994, 2004 and 2014.

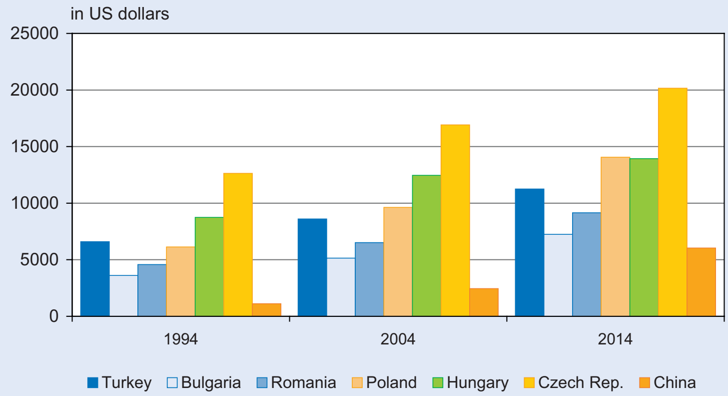
Explaining recent performance: between institutionalisation and de-institutionalisation

A key element behind the high growth and relative resilience attained by the Turkish economy in the previous decade was the institutional strength along with the apt environment facilitated by global liquidity during the time period in question. The institutional strength of the Turkish market was brought about by substantial reforms carried out in the aftermath of the 2000–2001 home-grown crisis, under the aegis of multiple external anchors, the most important of which were the EU and the IMF (Öniş 2007).

Figure 2

GDP per capita for Turkey and selected countries

in constant 2005 prices



Source: World Development Indicators.

In contrast to the EU's impact on the CEECs as of the 1990s when these markets began to liberalize, when the EU accession negotiations started in 2005 (and also at the time of Turkey's candidacy in 1999), the Turkish economy had already liberalized to a great extent through a process launched back in 1980. Although launched much earlier than that of the CEECs, the process of liberalisation and stabilisation of the Turkish economy proceeded in a more protracted and zigzagging fashion. Following a 50-year period of state-led economic development (within the domain of capitalism, as a different feature compared to the CEECs) based on high levels of protectionism, it adopted a comprehensive liberalisation and stabilisation program in 1980, becoming one of the pioneers in its peer group. Turkey's bold market reforms were initially applauded by international organisations like the IMF and the World Bank, which provided considerable financial support for structural adjustment (Nas 2008). Yet such support did not prevent the Turkish economy from succumbing to successive crises between the late 1980s and early 2000s, a period marked by excessive financialisation, prevalent regulatory failures and substantial macroeconomic instabilities. In this period, institutional reforms were largely disregarded and the existing institutions were bypassed through pragmatism and populism (Öniş 2007; Özel 2014).

In a way the 2000–2001 economic crisis created a window of opportunity for institutional change, as the power of veto players had weakened in the context of the crisis (Özel 2012 and 2013). A comprehensive reform program was launched addressing important changes in a broad range of institutions and policies, introducing regulatory governance, constraining executive discretion, while bringing about fiscal discipline and macroeconomic stability, along with many new institutions and policy instruments. This was, indeed, the outcome of a prolonged learning process out of successive crises between the late 1980s and 2001. Although the external anchors and their direct pressures for such major changes mattered, the enactment and implementation of reforms was only possible through political commitment and such commitment was formed in the context of a coalition government and a highly-divided parliament, challenging the prevalent arguments against the efficiency of coalition governments with regard to economic policy-and reform-making. Hence, in an environment where the stakes were very high, 'the Transition Program to a Strong Economy' was adopted in 2001, under the leadership of Kemal Derviş the Minister of State in charge of economic affairs. Often referred to as the 'Derviş' reforms', these institutional changes began to yield credible signals to international organisations and investors (Bakır and Öniş2010; Özel 2014).

Engendering a major turning point in terms of both economic governance and macroeconomic stability, these reforms included – but were not limited to – the independence of the Central Bank, establishment (and restructuring) of independent regulatory and supervisory agencies in several sectors, public debt management, transparency of public procurement, changes in the subsidy regime, re-structuring of the public banks, amongst others. At odds with the centralised and unitary bureaucratic structure in Turkey, nine independent regulatory agencies (IRAS) (ranging from banking to energy) were either established or restructured in the aftermath of the crisis and endowed with considerably high levels of autonomy and authority (Sosay 2009). These agencies took significant authority away from the control of political players, hence, caused severe reaction from the politicians in a polity marked by the prevalence of executive discretion over the institutions and decision-making mechanisms (Özel and Atiyas 2011; Özel 2012).

Hence, the first Justice and Development Party (AKP) government (2002–2007) inherited a solid institutional environment, which was drastically different from that of the earlier periods. Often referred to as the 'second-generation reforms', the institutional transformations undertaken in the aftermath of a severe crisis yielded increasing credibility, contributing to the positive decoupling of the Turkish market from its peers (Atiyas 2012). A strong banking system brought about by a well-designed regulatory framework, robust public finances, and sound monetary policy played central roles in the partial resilience of the Turkish economy in the context of the global financial crisis. It should be noted, however, that the first AKP government mostly sustained – and even furthered – most of these reforms. The institutional erosion emerged later in the game, with some of those institutions that helped to guard the Turkish economy against global and regional crises being dismantled recently.

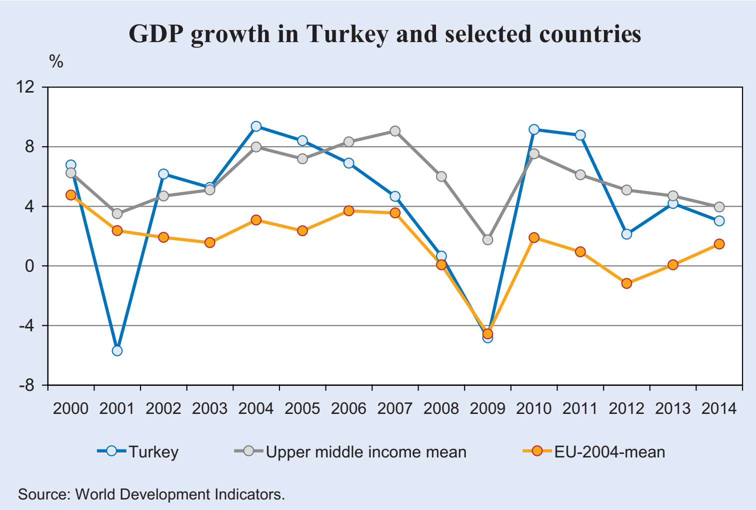
The recent slow-down: an end to the good-old-days?

Evidently, 'the good old days' of the 2000s could not be sustained for a long time, as the slow-down that hit the Turkish economy was also brought about by several dynamics, including the impact of volatilities induced by the global markets, structural problems shared with other middle-income economies and institutional erosion. Turkish economic growth staggered in the last five years (from 8.8 percent in 2011 – nearly comparable to that of China that year – to 2.9 percent in 2014); the volatility of the market increased, paralleling the slow-down in most middle-income countries, including China (see Figure 3).

External dynamics: volatilities in the global markets

In addition to the slow-down in growth, exchange rate volatility increased, private sector debt became a

Figure 3



Source: World Development Indicators.

severe problem and capital outflows increased the vulnerability of the Turkish market. In 2015 Turkey was included in the group of the 'fragile five', along with Brazil, Indonesia, India, South Africa due to their common problems of current account deficits and dependence on foreign capital inflows.[3] These markets became highly sensitive to the signals yielded by global markets. A good example of this sensitivity was the 'tapering tantrum' when the Federal Reserve cut its bond purchase which triggered the first big wave of capital outflows from these markets, including Turkey.

Nevertheless, some of the instabilities in the global markets, such as the drop in commodity prices, and especially that of oil, affected these markets in different ways. In the case of Turkey, given its dependence on oil imports, declining prices helped diminish its current account deficit (CAD) — with its CAD/GDP ratio falling from an alarming 9.7 percent in 2011 to 4.5 percent in 2015. Other instabilities induced by global markets including changing interest rates in the United States and the resulting capital outflows from middle-income countries, along with declining demand, inevitably hit the Turkish market as well. In addition, increasing geopolitical risks and their pricing by investors also had a major impact due to Turkey's geostrategic positioning, as well as the recent crisis with Russia.

Structural restraints of middle-income countries

The structural restraints faced by middle-income countries like Turkey also contributed to the recent slow-down. Underlining the inevitable nature of growth slowdowns, Eichengreen *et al.* (2013) assert that two income brackets are particularly subject to such slowdowns: namely, those between 10,000–11,000 US dollars and 15,000–16,000 US dollars. Falling down to the first bracket with its stagnating income per capita in the last four years, the Turkish economy suffers from problems common to the other middle-income countries clustered in a fragile equilibrium of low levels of education, limited skills, low productivity and low value-added production. It thus faces challenges in terms of upgrading in global value chains (Eichengreen *et al.* 2013; Gill and Kharas 2007). Existing literature on this topic suggests that the comparative advantage of these countries dwindles as real wages increase, leading to diminishing rates of growth and, in turn, resulting in the infamous middle-income trap, and leaving these countries unable to shift to knowledge and innovation intensive commodities (Aiyar *et al*. 2013; Agenor *et al.* 2012; Eichengreen *et al.* 2013; Felipe *et al.* 2012; Gill and Kharas 2007). Paradoxically, the very conditions that facilitated these economies' high rates of growth earlier, subsequently prevent them from passing the threshold of high-income. The Turkish economy is no exception as far as these challenges are concerned.

Abdon *et al.* (2012) posit that it takes 28 median years to move from lower-middle-income to upper-middle-income group, and 14 years to graduate from the upper-middle-income to the high-income category. In fact, out of 101 countries that were in the middle-income group in 1960, only 13 were able to pass the threshold of high income by 2008. Greece and Ireland, as well as South Korea, are good examples of graduation from the middle-income group. Turkey, however, graduated from the low income category back in 1955, and had been situated in the upper middle income group since 2005. Given these set average years, the performance of the Turkish economy was fairly mediocre, as it took 50 years rather than 28 to reach the upper-middle-income bracket. Although the Turkish economy has not completed 14 years in the upper-middle-income group to date, it is considered to be stuck already, because its current growth performance does not indicate that any such leap is possible within a few years.[4]

A typical example of success in terms of speedy graduation from the middle-income category often cited is South Korea, whose per capita GDP was lower than that of Turkey back in 1960. Nonetheless, there are geographically closer examples, such as Greece, Cyprus and Portugal, which can be contrasted with Turkey given their comparable per capita income values half-a-century ago. Besides these countries, Japan, Hong Kong and Taiwan in East Asia; as well as Chile and Uruguay in Latin America, have graduated from the middle-income to high-income bracket within the last fifty years, whereas Turkey failed to do so.

[3] See *Breakout or Breakdown? Emerging Markets Strategy,* JP Morgan Asset Management, August 2015. http://www.jpmorganassetmanagement.lu/dms/Emerging_Markets_Strategy-Breakout_or_breakdown.pdf.

[4] According to Abdon *et al.* (2012), the Turkish economy needed to grow at a rate of 4.7 percent on average to leave the middle income group by 2019. For a further discussion of Turkey's middle-income-trap, see Yeldan *et al.* (2013).

Institutional dynamics: democracy and good governance

Another important factor in the recent slow-down of the Turkish economy was the institutional parameters embedded in both economic and political spheres. In the former, institutions of good governance, commonly considered conducive to economic growth, began to deteriorate. In the latter, the trend is downward and exemplified by the weakening of democracy indicators, along with other parameters. Although Turkey is classified as democracy in some indices such as the Polity-IV (where Turkey's score is 9 out of 10), others which rely on different conceptualisations of democracy have lowered Turkey's scores. Table 1 compares Turkey's values with respect to scores in democracy indices and rule of law, as well as human development, education, income per capita and growth, indicating some of the precursors of the middle-income trap (such as education).

Institutional erosion and increasing volatility

There is a growing consensus in both academic and policy circles as to the central role played by the institutional framework and economic development, which highlights the growth-inducing impact of particular economic and political institutions particularly those enhancing credibility and facilitating predictability for all players. Some of the most important institutions underlined with respect to their impact on economic development are the credible constraints on the executive, and the separation of power along with property rights and the rule of law (Clague *et al.* 1997; North 1990; North and Weingast 1989; Acemoğlu and Robinson 2006, 2008 and 2012). In addition, the important roles played by democratic institutions *per se* in fostering economic growth have been widely emphasised (Levi *et al.* 2008). Changing the direction of causal arrows between development and democracy, Acemoğlu and Robinson (2012) assert that democratic institutions are not necessarily the outcomes of economic development, but they are, indeed, the causes.

In the Turkish context, in a rather paradoxical fashion, some of the institutions that yielded signals of credibility thus contributed to the relative resilience of the Turkish economy have been weakening recently. Arbitrary political interference in these institutions has been a central dynamic behind such erosion, exacerbated by the weakening of the EU-anchor due to the stalling of the negotiations with the EU. Whenever the institutional set-up did not fit in with the policy objectives of political players, there was interference followed by a dismantling of these institutions. Various politicians' attempts to interfere with Turkey's Central Bank exemplify this process and has created a consid-

Table 1

Growth, education and democracy, Turkey and its peers

	GDP per capita (USD)	Growth rate (%, 2012–2014 ave)*	Human development (2013)**	Education (Mean school years)	Rule of law (0–16) ***	Freedom House (1–7) **** PR	Economist Intelligence Unit (0–10)	Polity IV (– 10 + 10)
Turkey	10.543	3.1	0.759	7.6	7	3	5.12	9
EU-2004	18.851	1.4	0.838	11.6	13.3	1.2	7.578	10
EU-2007	8.855	1.5	0.781	10.6	11	2	6.705	9
EU-candidates	5.878	1.1	0.746	9.4	9.25	3	61.425	9
BRICS	8.010	3.9	0.697	8.1	6.6	3.8	5.902	5
Brazil	11.613	1.6	0.744	7.2	10	2	7.38	8
China	7.594	7.6	0.719	7.5	2	7	3	– 7
India	1.631	6.7	0.586	4.4	9	2	7.92	9
Russia	12.736	1.8	0.778	11.7	2	6	3.39	4
South Africa	6.478	2.0	0.658	9.9	10	2	7.82	9
Bulgaria	7.713	1.1	0.777	10.6	10	2	6.73	9
Rumania	9.997	1.9	0.785	10.7	12	2	6.68	9
South Korea	27.971	2.8	0.891	11.8	13	2	8.06	8

(*) Mean of the last three years based on nominal values; (**) Overall score in Human Development Index – see http://hdr.undp.org/en/content/human-development-index-hdi; (***) Freedom House scores; (****) 1 is the highest; 7 lowest according to Freedom House indices.

Source: World Development Indicators, United Nations Development Program; Freedom House (2015); Economist Intelligence Unit (2015); Polity IV (2014).

erable tension since 2013. The process was specifically catalysed by the reaction of the Ministers of the Economy, the Prime Minister, and even by President Erdoğan himself, to the allegedly high interest rate policy pursued by the Central Bank of Turkey (CBT).[5] This tension climaxed in March 2015 with the President's labelling the former Governor of the CBT as 'a traitor' for not having lowered interest rates in line with his directives.[6] Although the ensuing conflict was deescalated by the President retracting his comments, the fact that it was already priced in by market players meant that it was registered as a risk factor signifying institutional instability.[7]

In a similar vein, the independence of regulatory agencies was successively contested, ultimately leading to the erosion of some of their core principles; and most importantly of their independence from political interference. In line with the general trend towards increasing centralisation and intensifying use of executive discretion, the independence of these agencies has been curtailed (Özel 2012 and 2014). Executive control over the regulatory agencies started with *de facto* interference in their day-to-day practices, and later continued with de jure changes.[8] The centralisation of policy making and the use of discretionary mechanisms can also be observed through the decay of institutions of coordination, which were established/reformed in the aftermath of the 2001 crisis; and played central roles between 2002 and 2012. These institutions include the Board of the Assessment of Economic Issues (ESDK), the Economic Coordination Board (EKK) and the Coordination Council for the Improvement of Investment Environment (YOIKK) (Özel 2014). The centralisation of decision-making not only has an adverse effect on the coordination between state and non-state actors, but also endangers intra-state coordination. As a recent signifier of the centralisation of decision making within the state, the Prime Minister Binali Yıldırım changed the institutional structure of the EKK immediately after he taking power in May 2016, making the EKK attached to the Prime Ministry's Office, rather than to the Ministry of Finance.

The changes in the status of the regulatory agencies and the institutions facilitating coordination, as well as the attempts to interfere in the proceedings of the Central Bank are only a few examples of the ongoing process of institutional weakening in Turkish economic governance. Constant conflict between institutionalisation and de-institutionalisation, as well as executive discretion and centralisation have been parts of the historical legacy of Turkish economic governance and they have only intensified over time (Özel 2014). Increasingly prevalent since the 1980s, executive discretion has involved governments undermining parliament through the use of decrees (Özbudun 2000). Lately, the semi-presidentialist regime, which has been intact since 2014 (and operates like *de facto* presidentialism) has fostered the prevalent use of executive discretion. In tandem with the evolution of the political regime, Turkish economic governance has increasingly adopted a distinct trajectory in which political actors often intervene in the market through the use of diverse instruments. Meanwhile, good governance institutions are weakening; while patronage distribution is becoming common practice (Kalaycıoğlu 2014; Müftüler-Baç and Keyman 2015; Özel 2014).

Concluding remarks

Despite the sweeping liberalisation process of the last three decades resulting in a drastic change in policies and institutions, Turkish economic governance has embarked on an illiberal trajectory, reflected in intensifying executive control over economic transactions and actors. The prevalence of executive discretion at times undermining legislative mechanisms and a highly-centralised decision-making process resulted in the weakening of those institutions that helped the Turkish economy recover from severe crises and achieve impressive performances up until 2011. All of these processes raise major doubts about the sustainability of growth even in the medium term, blocking Turkey's chances to graduate from the middle-income country group.

[5] Former Prime Minister Ahmet Davutoğlu was an exception regarding the political interventions in the CBT. Whereas, Zafer Çağlayan, the former Minister of Economy was unapologetically vocal about his reaction against CBT's policies as well as his instructions to act otherwise. See *"Çağlayan, Başçı'ya tepkisini sertleştirdi"* [Çağlayan,'s reaction against Basci has gotten tougher], Dünya, 4 February 2013, p. 1 and 4.

[6] Although the reasoning behind such demands are evidently based on Islamic principles, that interest is forbidden, the common interpretation points out the special interests benefiting from low levels of interest rate. For the reaction of the President Erdoğan, see "*Erdoğan, Babacan'ı açık açık hedef aldı",* [Erdoğan, openly targeted at Babacan], Cumhuriyet, 2 March 2015. http://www.cumhuriyet.com.tr/haber/ekonomi/224649/Erdogan__Babacan_i_acik_acik_hedef_aldi.html

[7] "Erdoğan,'dan Merkez Bankası yorumu: Tatlıya bağladık," *BBC Türkçe,* 12/03/2015, http://www.bbc.co.uk/turkce/ekonomi/2015/03/150312_erdogan_mb_aciklama.

[8] According to the Decree #KHK/649 (17 August 2011), "the [respective] minister has the authority over all transactions and activities of the related, attached and affiliated agencies" which, by definition, include the IRAs. http://mevzuat.dpt.gov.tr/khk/649.pdf. See also Decree #KHK/643 of 3 June 2011, http://mevzuat.basbakanlik.gov.tr/Metin.Aspx?MevzuatKod=1.5.3046&sourceXmlSearch=&MevzuatIliski=0.

A major risk caused by the institutional erosion is embedded in the increasing volatility of the Turkish market. Intensifying – and arbitrary – political interference in economic institutions further aggravates the perception of volatility, as it combines with diminished policy credibility signified by indicators like a rising inflation rate, unemployment rate and current account deficit. For a market highly dependent on foreign capital inflows, yielding positive signals matters substantially and institutional degrading jeopardizes such signals, since politicised institutions, along with weak indicators are priced by investors. The stalling of the EU accession process, which used to endorse Turkish market's credibility, is contributing to this downward spiral of institutional degrading, as Turkey loses its anchoring capacity for institution building and sustainability.

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Economic Challenges and Opportunities for Turkey and Germany – A German Perspective

Helge Tolksdorf*

Economic relations between Germany and Turkey have a long tradition and are already well developed. Germany is Turkey's most significant business partner, and accounts for a quarter of total EU trade with Turkey. German investors create important jobs in Turkey, deliver cutting-edge technology, and transfer valuable expertise. But the challenges faced by both countries are growing. One example is the globalisation of the world economy. The centres of gravity of growth are shifting, international competition is getting tougher, the pace of innovation is accelerating, and structural change is picking up speed. In addition to the economic trends, new social challenges are emerging, including ageing societies, mobility and climate change. Foreign policy developments such as the Ukraine crisis, Syria, or the international danger of terrorism are also forcing Turkey and the EU with new decisions.

We need new answers. These answers need to be reflected in the institutional cooperation between Turkey and Germany and in the cooperation with the EU. The strategic dialogue now underway is an important step at the intergovernmental level, and must be backed up by various forms of cooperation at an expert and working level. Examples for the economic sector are the German-Turkish Energy Forum and JETCO. The plans to revitalise the EU accession process will foster this process of increasing cooperation in the economic field.

We are following the political and economic developments in Turkey with great interest. Turkey continues to be a major anchor of stability and a key strategic partner in the region for the EU. It is important that the cooperation between the EU and Turkey has a healthy and robust economic basis. Turkey has made enormous economic progress in recent years. Average growth rates of 5 percent and a tripling of the per-capita gross domestic product (9,290 US dollars) in the last 10 years are clear proof of these advances. Moreover Turkey's economy is continuing to grow – GDP is expected to expand by 4 to 5 percent in both 2016 and 2017.

One major reason for the dynamic development of Turkey's economy is its massive market potential. The country's population is close to 80 million, and its consumers like to spend their money. Turkey's young population (average age 30 years) will continue to stimulate the economy in the coming years by generating high domestic demand. This factor is likely to be enhanced by the recent 30 percent increase in the minimum wage and by falling inflation (2014: 8.9 percent; 2015: estimated 7.4 percent). The unemployment rate stands at roughly 10.3 percent. This gives cause for concern – but also shows what untapped potential exists to boost economic output, if there is higher employment and thus higher consumption.

A further key to the economic success of the country on the Bosphorus is certainly the reforms implemented since 2001. The commencement of EU accession negotiations on 3 October 2005 makes the EU the main anchor and yardstick for Turkey's political and economic reforms. It must be remembered that the reform agenda to take on the *acquis communautaire* is not an end in itself, but is very much in the interest of a prosperous Turkey.

The dynamic economic upswing in Turkey is going hand in hand with rising energy demand. Alongside the need to secure its energy supply, Turkey is also facing major challenges in terms of attaining the climate targets. In strategic terms, the decoupling of economic growth from the rise in energy consumption and the shift to a low-carbon economy remain important parameters for the global competitiveness of the Turkish economy.

* German Federal Ministry for Economic Affairs and Energy.

In addition to the construction and transport sectors, both of which are developing dynamically, Turkey has a broad industrial base. There is a massive need for investment in economic modernisation and diversification. More specifically, export-oriented companies in the automotive sector, metal processing, foodstuffs, and textiles and clothing need to boost their competitiveness and modernise their machinery.

Turkey has a structural deficiency in view of its dependence on imported raw materials, fuels and semi-finished goods. Since many semi-finished products need to be imported so that goods can be manufactured for export, rising exports automatically result in rising imports. This has a negative impact on the trade balance. Turkey has had a trade and current account deficit for a long time now (2015: approx. 4.5 percent of GDP). Further problems include a lack of spending on research, inefficient vocational training, and a low domestic savings rate. Turkey therefore needs more foreign direct investment. But this requires political stability and a reliable business environment.

Germany continues to be a reliable partner for Turkey's economic development. We regard this as a partnership of equals. German firms are well-positioned to make attractive offers to Turkey across the board. This is one of the reasons why Germany was Turkey's most important European trading partner last year, with trade in goods totalling nearly 37 billion euros. This volume of trade amounts to a quarter of Turkey's trade in goods with the EU. Since the turn of the millennium, our trade in goods has more than doubled.

Due to the negative effects of the Middle East conflict and the Russian sanctions against Turkey, our role as a strategic business partner is continuing to grow. With a stock of 12 billion US dollars in investments, Germany is the largest foreign investor in Turkey. German companies can see a great deal of opportunity in Turkey, particularly in the country's energy sector. However, many companies feel uncertain in view of the current political situation and are delaying planned investments. An immediate ceasefire and the return to negotiations in the so-called peace process, as called for by the European Commission, would send out an important political signal to potential investors.

There are significant future challenges that Turkey and the EU need to tackle together if they are to maintain the dynamism of their economic relations. Three of the many key issues are:

- Maintaining legal certainty for investors,
- Reducing existing and avoiding new barriers to trade, and
- Promoting the adequate development of infrastructure in Turkey.

The revitalisation of the accession negotiations agreed in the EU-Turkey Action Plan is feeding through into specific action. For example, Chapter 17 – Economic and Monetary Union – was opened at an intergovernmental conference at the end of last year. Under the Dutch EU Council Presidency, efforts are being made to open Chapter 33 – Financial and Budgetary Provisions. The Commission is pressing ahead with preparatory work to open five further chapters for negotiation, including Chapter 15 on Energy and the chapters on the rule of law, 23 and 24. By making further efforts to meet the criteria for the opening of Chapters 5 (Public Procurement), 8 (Competition) and 19 (Social Policy and Employment), the Turkish government can generate further momentum in the accession talks. The full implementation by the Turkish government of the Ankara Protocol on the application of the EU-Turkey Customs Union in all EU member states would make progress possible on 8 additional chapters.

The impact of the TTIP negotiations on Turkey, which is linked to the EU *via* the Customs Union, is another important issue. The German Federal Ministry's for Economic Affairs and Energy's offer of talks to the Turkish side can help to keep the debate realistic and to alleviate unfounded fears. Whilst trade in goods between the EU and the United States rose to 699 billion dollars in 2015, Turkey's trade with the United States in the same year amounted to 17.5 billion dollars.

We take the view that we can cope successfully with the challenges arising from the TTIP negotiations through the further development of the EU-Turkey Customs Union. The relevant World Bank study provides a good basis for this. However, if a negotiating mandate for the European Commission is to be adopted at the end of this year, it seems necessary to establish a constructive atmosphere by overcoming various protectionist measures by the Turkish government, and thus stopping the process of erosion of the customs union. These issues and specific projects were covered by the talks held by the German Federal Minister for Economic Affairs and Energy in Berlin on 22 January 2016 with his Turkish colleagues Deputy Prime Minister Simsek and Economy Minister Elitas.

The Joint Economic and Trade Commission (JETCO), as agreed in 2013, and the continuation of our joint work in the German-Turkish Energy Forum, have established appropriate forums to respond to the interests of the companies. Furthermore, our traditional instruments of external economic promotion, such as Hermes export credit guarantees, investment guarantees, and the services of our bilateral chamber of commerce in Istanbul and of Germany Trade and Invest, are also available. Our traditionally good German-Turkish relations, our fellow citizens of Turkish origin, and our many links in tourism, culture and science are additional guarantors of consensus-based cooperation and also form a robust foundation for our joint efforts to tackle future challenges.

EU-Turkish Customs Union: A Reasonable Roadmap

Erdal Yalcin*

While political negotiations on Turkey's accession to the EU have not made much progress in recent years, bilateral economic relations have developed positively, despite the fact that Turkish membership of the customs union is initially restricted to industrial goods and processed agricultural goods. However, new EU trade agreements (e.g. CETA, TTIP, or with Japan) will adversely affect Turkey as a non-EU member and this calls for adjustments to the existing customs union. The EU and Ankara have to come up with a policy decision in due course on how to further integrate Turkey into the EU Customs Union.

The Ifo Institute has produced a comprehensive economic policy study in which different policy options for a new EU-Turkish trade relation are analysed. The report's key findings are summarised in this article.[1] The starting point for the positive EU-Turkish economic developments was the Association Agreement between Turkey and the former European Economic Community, the so-called Ankara Agreement. Initiated in 1963, it resulted in the signing of the present customs union in 1995, which came into effect a year later in 1996. Turkish industry has therefore been increasingly linked to the European economy since then. In particular, German companies use the customs union with Turkey to produce intermediate goods cost-effectively in the country and then re-import them for further processing in Germany. The EU, meanwhile, is by far Turkey's most important trading partner and, in turn, Turkey is the EU's sixth largest trading partner. Turkey enjoys strong economic relations with Germany in particular. While 9 percent of Turkish exports go to Germany, approximately 10 percent of all Turkish imports are from Germany.

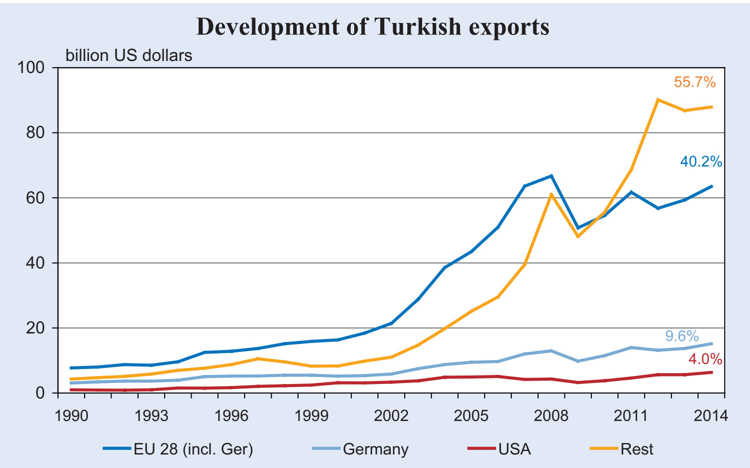
Economic relations between the EU und Turkey – a few facts

Figures 1 and 2 illustrate the strong growth both in exports and in imports in Turkey since 1996. In particular, German companies use the customs union with Turkey to produce intermediate goods cost-effectively in the country and then re-import them for further processing in Germany. It is therefore unsurprising that the majority of foreign direct investment in Turkey comes from German companies.

Moreover, Figure 3 presents the composition of annual Turkish exports to the EU by making a distinction between high, mid-high, mid-low, and low technology goods. It becomes very clear that the introduction of the customs union led to a significant rise in exports to the EU, which is categorised as occurring in mid-high and mid-low technologies.

The integration of Turkish industry into the EU economy becomes even clearer when trade in finished and intermediate goods is examined more closely at a dis-

Figure 1

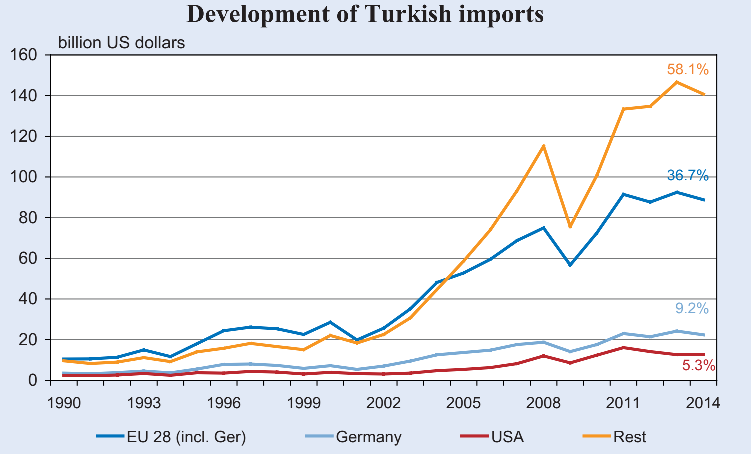


Source: OECD STAN; author's own illustration.

* Ifo Institute.

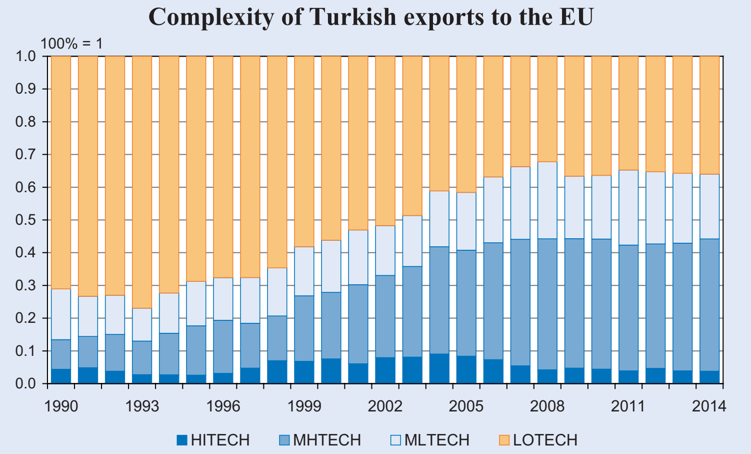
[1] Aichele *et al.* (2016). A short summary of the results has been published on VOXEU.

Figure 2



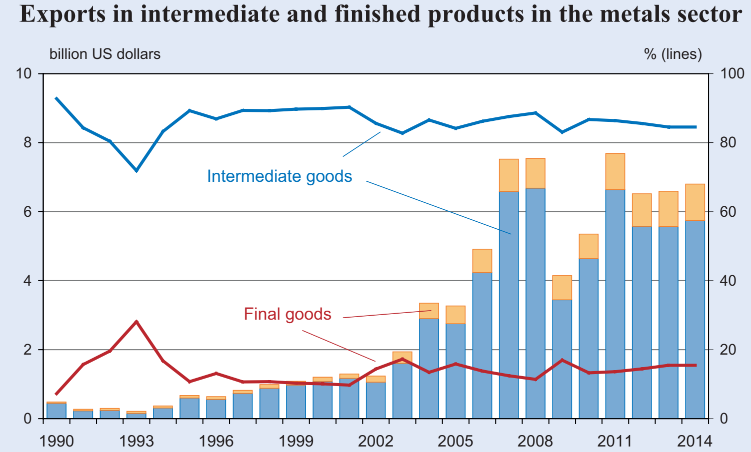
Source: OECD STAN; author's own illustration.

Figure 3



Source: OECD STAN; author's own illustration.

Figure 4



Source: OECD STAN; author's own illustration.

aggregated level. Figure 4 demonstrates that in the Turkish metals sector, for example, approximately 85 percent of exported metal goods to the EU are intermediate goods. A similar bilateral trade pattern can also be found in the chemical industry. Strong European-Turkish trade in intermediate goods also occurs, to a lesser extent, in the automobile sector.

These descriptive statistics clearly illustrate that Turkey is increasingly being used by European companies as a production location for intermediate goods where components are improved and subsequently re-imported into the EU. With the customs union, Turkey has become an increasingly important part of European production chains.

The success of this economic integration, however, has been under threat for some time, since institutional weaknesses in the organisation of the European customs union with Turkey have had an increasingly negative impact on Turkish industry. The European Commission's focus on signing new regional trade agreements with the United States (Transatlantic Trade and Investment Partnership, TTIP), Japan and Canada, for example, has highlighted institutional weaknesses in what was previously a successful customs union between Turkey and the EU.

As a result of the customs union agreed with the EU, and the corresponding principle of joint customs harmonisation for third countries, Turkey is also obliged to open up its market to these third countries when the EU signs free trade agreements with them. In return, Turkish companies can establish free commodity trade with the EU28 states, but cannot receive any of the benefits that are negotiated for European exporters to third countries. Technically there is discrimination against Turkish exports in free trade agreements with third countries, since EU trade agreements are negotiated at an EU level and non-members have no right to participate in them, even when the effects of these agreements – as in the case of the customs union – have dramatic economic implications for those states involved in the integration process with the EU.[2]

Table 1

Long-term welfare effects after the TTIP in %

EU average	Germany	USA	Turkey	Non-TTIP	Global average
3.90	3.50	4.90	– 1.50	– 1.00	1.60

Source: Felbermayr *et al.* (2015).

The underlying analysis (Aichele *et al.* 2016) clearly illustrates that without a modernised EU-Turkey trade agreement, Turkey faces the threat of significant foreign trade losses. The estimated potential welfare loss in the medium term, totalling around 0.01 percent of Turkish GDP, appears to be relatively small, but certain Turkish export sectors can expect substantial losses. The automotive and mechanical engineering sectors could experience 10 percent and 4 percent declines in their trade volume respectively. If further long-term adjustments of the EU's free trade agreement with third countries are accounted for, welfare losses equivalent to over 1.5 percent of Turkish GDP are possible (see also Egger *et al.* 2015).

Potential long-term welfare effects for Turkey in the coming years

The quantification of the welfare effects between Turkey and the EU presented above has not yet been considered systematically. Several studies, however, have analysed the potential long-term cumulative welfare effects of a comprehensive agreement between the EU and the United States, and have identified the cumulative welfare effects for Turkey in the process. Felbermayr *et al.* (2015), in an empirical study, determined the long-term effects for Turkey, among other countries, in cumulative form. Alignments at industry level were not analysed in greater depth. Instead, greater consideration was given to a situation in which Turkey would have a new trade and welfare equilibrium following a 10-year alignment period (see also Egger *et al.* 2015).

[2] In addition to Turkey, Andorra and the Republic of San Marino have the same asymmetrical treaty obligations and rights in free trade agreements between the EU and third countries.

It is clear from existing studies that a comprehensive trade agreement between the United States and the EU, for example, would lead to considerably more negative welfare effects for Turkey in the long term than it would in other countries not participating in TTIP. A possible reason for these above-average effects can be found in the asymmetrical trade agreement between Turkey and the EU. TTIP will certainly have a positive effect for Turkey at first, since cheaper US imports to the EU Customs Union will also be passed on to Turkish consumers. At the same time, however, Turkish companies will also notice a large fall in their sales in the United States, as – unlike EU firms – they will continue face American trade barriers. At the same time competition in the EU market, as well as in their domestic market, will intensify for Turkish companies. As for Turkish producers of intermediate goods, there is a chance that they too will profit from higher levels of exports by European companies to the United States. However, the long-term cumulative simulations point towards the fact that this positive effect will be less marked than the accompanying negative trading effects.

The study by Felbermayr *et al.* (2015) and other analyses have provided no indication to date of how Turkish industrial structures, especially in the medium term, will be affected by TTIP and the other EU free trade agreements currently under negotiation.

In the light of these negative economic effects it is only possible to understand the customs union agreement between Turkey and the EU, which is increasingly regarded as being asymmetrical and unsustainable, in its historical context. Turkey signed the agreement regarding integration into the European customs union in the belief that it would soon gain EU membership and did not foresee the consequences that future EU trade agreements would have for its external trade relations. The scope of the regional free trade agreements currently being negotiated is a great surprise from the perspective of the 1990s, since *multilateral* economic reforms took precedence back then when the World

Trade Organisation was founded.[3] By signing the customs agreement, the Republic of Turkey subsequently yielded some of its autonomy in terms of trade policy, without adequately taking into consideration the consequences of new EU free trade agreements.

Alignment options under discussion for EU-Turkish trade relations

Turkey is in a poor position to negotiate its own free trade agreements with the EU's new free-trade partners in order to overcome the threat of imbalance. Various political alignment options are currently being discussed in Turkey, although it is questionable whether some of the proposals can be accomplished in a timely manner. Four scenarios are possible over the coming years.

a) EU membership for Turkey

The prospect of EU membership, which would integrate Turkey into all EU trade agreements on an equal footing, is not realistic in the foreseeable future. In the last five years of accession negotiations, the EU member states and Turkey have agreed to open two negotiating chapters (Chapter 12: Food Safety, Veterinary and Phytosanitary Policy; Chapter 22: Regional Policy and Coordination of Structural Instruments). The opening of other chapters was negotiated in the light of the recent refugee crisis, but the prospect of Turkey gaining full EU membership in the near future continues to look unlikely.

b) Adoption of EU mandate for Turkey

There is a theoretical possibility of Turkey participating in all EU trade negotiations with third countries on an equal footing without the country having full EU membership. This approach would substantially compensate for the existing problem of asymmetry, since access to the US market would also be facilitated for Turkish companies. In practice, however, such a contractual adjustment would be difficult to imagine, as the European Commission conducts European free-trade negotiations and will not adopt a political mandate for a non-member state. Furthermore, the EU's Trade Commissioner, Cecilia Malmström, has clearly stated that negotiations on new free trade agreements can only take place between the EU and the relevant third countries.

[3] In 1995, the World Trade Organisation (WTO) was founded in Geneva as a successor to the General Agreement on Tariffs and Trade (GATT). One of its primary objectives was defined as the continual liberalization of global trade under the supervision of the WTO.

c) Rollback of the customs union to a free trade agreement

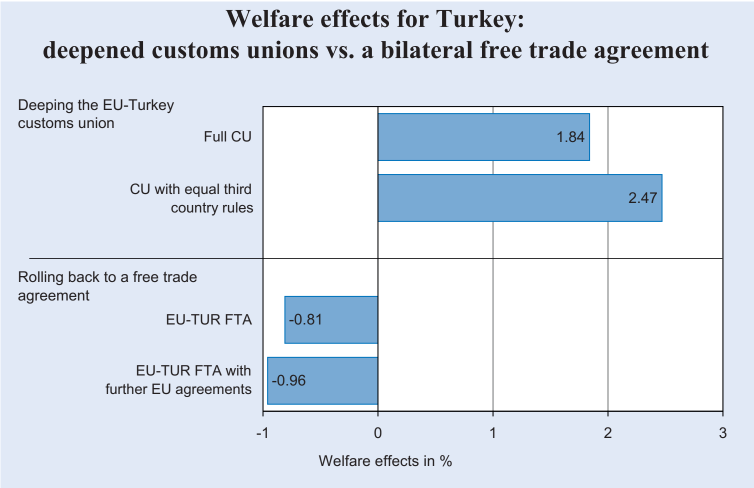
From Turkey's point of view, a third institutional reform that would eliminate the previously outlined problem of asymmetry is the rollback of the customs union to a free trade agreement. This possibility has been repeatedly announced by the Turkish Minister of Economic Affairs as a realistic policy option. Such a reform would mean a setback to Turkey's process of EU integration in terms of economic policy, since Turkey would obtain greater autonomy in international economic policy. At the same time, there would be negative effects for Turkish industry in the event of an EU-Turkey free trade agreement, since expensive checks would be required to ascertain the origin of the goods traded with the EU. In the case of a free trade agreement, determining which goods can continue to be traded between the EU and Turkey without tariffs is possible only by means of such rules of origin.

d) A more comprehensive customs union

A viable and realistic way of avoiding the disadvantages caused by the Ankara Agreement is to deepen the existing customs agreement further so that the advantages for Turkey outweigh the disadvantages. To this end, services and agricultural products, which were previously excluded from the tariff exemption, must be included in the agreements. Furthermore, the European customs agreement could be expanded with a passage in which all of the EU's trade agreements with third countries are automatically extended to customs-union members too.

Out of these policy options two appear to be viable. One theoretical option to balance trade in an increasingly regionalized world is to dissolve the mutual customs union between Turkey and the EU and transform it into a bilateral free trade agreement. However, that would be a step backward for Ankara's economy, as our analysis shows. The imbalance resulting from asymmetric customs duties in trade relations would be eliminated, but without a customs union, the Turkish economy would face an end to its privileged access to the European market, which, in turn, would have serious repercussions. Termination of the current EU-Turkish customs union would lead to a decline in Turkish GDP of 0.81 percent. The effects of a new EU trade agreement would then cause Turkish GDP to fall by another 0.96 percent. The EU could also expect some losses in such a scenario too.

Figure 5



Note: A full CU refers to a situation in which the EU and Turkey include the agricultural and service sectors into the existing customs union agreement. Equal third country rules considers a situation, whereby Turkey receives equivalent trade access to third countries as EU exporters. EU-TUR FTA considers a scenario whereby the EU and Turkey transform the existing customs union into a bilateral free trade agreement covering all sectors. The last scenario assumes additionally FTAs between the EU and further six regions (TTIP, CETA, Japan, India, MERCOSUR, ASEAN).

Source: Author's calculation based on Ifo trade model.

A possible alternative solution is to enhance the existing customs union accord. Its expansion to include agriculture and services may not only offset the negative effects of the asymmetry for Turkey, but may also result in gains for both sides. Expansion of the customs union could lead to a 1.84 percent increase in Turkish GDP. Agricultural exports to the EU are forecast to rise by 95 percent and exports of services by as much as 430 percent over the next decade.

Should the new trade agreements of the EU, such as TTIP or CETA be signed, the income level in Turkey would continue to rise thanks to higher demand for services in the EU. Expansion of the customs union plus a signature of the currently planned agreement could generate a 1.95 percent increase in Turkish GDP. Per capita income would rise by nearly 200 US dollars. If Ankara signs its own trade agreements with new partners in the EU, GDP could rise by an additional 2.5 percent, which would correspond to a nominal increase of 18 billion US dollars.

Conclusion

The most recent agreement between the EU and Turkey in the context of the current refugee crisis has given the country the perspective of five new chapters in the EU membership negotiations being opened. Setting aside the question of whether and when Turkey can become a full EU member, it is clear from current policy decisions that long-term agreements with unknown consequences have been entered into by representatives of both the EU and Turkey, and that very real and serious economic challenges also remain unaddressed in the short term.

Expressed in more general terms, negotiations over Turkey's long-term full membership of the EU on the one hand, and the simultaneously initiated discussion regarding a possible economic connection for the country with Europe on the other, represent increasingly incompatible policy options in the light of EU trade policy.

In both Europe and Turkey, the focus on initiating full political EU membership for the country without addressing the urgent need for reforms to the customs union in the short term threatens not only the economic integration of Turkey in the EU achieved to date, but also the country's long-term political integration as a full EU member. One implication of the underlying study is that the EU should concentrate on consolidating and then expanding Turkey's economic integration in the EU in the years ahead. Given the EU's current trade policy and the related economic and political new order, not only in Europe but around the world, such an economic and political goal is a great challenge in itself.

Establishing a lasting and functioning customs agreement between the EU and Turkey has a clear goal: namely to prepare for the next step in European integration. This bottom-up approach in which there is no comprehensive reform package (e.g. the *acquis communautaire*) to be implemented also represents an achievable economic and political goal. The integration process adopted during the refugee crisis is increasingly confronting Turkey with the need to balance very different conflicts between reforms. An agreement on liberalising visa regulations between the EU and Turkey which is, for example, urgently needed to facilitate the smooth exchange of managers to promote economic integration, has been linked with further EU *acquis* chapters and the refugee crisis by the

EU. As a result, the long-term political reforms called for threaten to roll back the economic integration achieved to date.

The complexity of the European integration process is a problem not only for Turkey, but is increasingly observed in other countries in various ways. The most recent developments and the position of the EU and its member states show a tendency towards 'differentiated integration' based on a new Europe. This can also be referred to as a multi-speed Europe. For current members, such a political change would partly mean rolling back integration reforms. Britain's decision to end its full membership of the EU, for example, could be the first serious development. For candidate countries such as Turkey, a multi-speed EU 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, such a policy would offer politicians room for manoeuver to implement further reforms in the future, in addition to the welfare effects.

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Challenges of the German-Led Refugee Deal between Turkey and the EU

Nilgün Arisan Eralp*

Germany and the EU have both taken a far greater interested in Turkey as a so-called strategic cooperation partner since the beginning of the recent refugee crisis:

- The war in Syria has created over 5 million refugees. Last summer, Europe was overwhelmed with these mass population movements. Approximately 1.5 million people entered the EU illegally in 2015.
- According to the FRONTEX, just under 900,000 refugees and irregular migrants crossed the EU's sea borders *via* the Eastern Mediterranean route in 2015.[1]
- Some forecasts predicted the arrival of up to three million in the EU this year.

As a response, the EU led by Germany has attempted to stem the disorderly flow of migrants to Europe and establish a process whereby some limited, legitimate asylum seekers could enter the EU in an orderly manner through resettlement. Turkey, meanwhile, has pursued an 'open door' policy toward Syrian migrants since 2011, hosting over 2.7 million Syrian refugees (as 'guests' in Turkey) with limited international support.

As more refugees have started to flow to Europe, Turkey has been criticised for its inability to manage its borders effectively and for becoming a 'highway' for the transit of refugees, as well as irregular migrants. Facing the most serious refugee crisis in their history since World War II, which has turned into an almost an solidarity crisis for the entire Union, the EU and, above all Germany, have been obliged to cooperate with Turkey in its efforts to respond to the crisis.

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[1] http://frontex.europa.eu/trends-and-routes/eastern-mediterranean-route/.

The reluctance of many EU countries to accept refugees also played a role in the EU's turning to Turkey.[2]

Why has Germany been leading this initiative?

If we examine Germany's lead in forging a 'refugee deal' with Turkey, the following factors emerge:

- Germany has been carrying the bulk of the refugee burden;
- Against all the odds and despite the opposition that she has encountered to date, German Chancellor Angela Merkel has persisted with her efforts to find a common European solution to the refugee crisis in order to prevent an existential solidarity crisis in the Union;
- Germany wishes to combat xenophobia and anti-immigrant sentiment, which has further strengthened the extreme-right in Germany and in other parts of the EU.

Why Turkey accepted such a deal?

When Turkey's motives for accepting a refugee deal with the EU are called into question, the following issues spring to mind:

- There has been an urgent need for rapprochement with the West, as the country finds itself increasingly isolated in its own highly instable region in which it has become extremely vulnerable to ISIS and Russia;
- In order to curb its economic slowdown, Turkey needs the EU anchor, which creates the impression that the re-vitalisation of the accession process is important;
- Visa-free travel would be especially good for Turkey's domestic politics. This is a 'psychological

[2] In September 2015, the EU pledged to relocate up to 160,000 refugees from Italy and Greece to other states in the Schengen area. To date, fewer than 1,000 of them have been resettled, as member states have accepted far below their pledged quotas or have refused to take any refugees at all. Some have even reintroduced border controls, at least temporarily dismantling the Schengen area.

threshold'[3] for the citizens of Turkey, as it would make them feel like recognised citizens of a respected EU partner.

- Although it is not as crucial as the other aforementioned factors, Turkey would welcome additional EU funds to spend on Syrian refugees.

Overview of the refugee agreement between Turkey and the EU and what it has delivered todate

After three summits held between Turkey and the EU since October 2015, negotiations gave rise to into a formal agreement on 18 March 2016.[4] The main components of the agreement include, for example, commitments to:

- Return all irregular migrants crossing from Turkey into the Greek islands after the 20th of March 2016, but before being sent back each person will be entitled to an individual assessment. *There was a sharp decrease in the number of people irregularly crossing the Aegean from Turkey into Greece from 1,150 each day to less than 160 a day in the first two weeks of April. In the first three weeks of the implementation of the deal as of 4 April, 325 irregular migrants were also returned to Turkey.*[5]
- to resettle a Syrian from Turkey in an EU member state (mainly in Germany) for every Syrian readmitted by Turkey from the Greek islands with a cap of 72,000. *The number of people sent back to Turkey under the agreement in April and early May was lower (386) than the number readmitted to Turkey in the first two weeks of March (398), when there was no agreement. So far not a single person who submitted an asylum claim in Greece after 20 March 2016 has been returned to Turkey.*[6]
- To lift the visa requirements for Turkish citizens by the end of June 2016 at the latest, provided that Turkey fulfils all conditions in the visa liberalisation road map by the end of April 2016. *Turkey could not fulfill the conditions regarding the fight against corruption, data protection, judicial cooperation with all member states, enhanced cooperation with EUROPOL and revision of the legislation and practices on terrorism. On the 4h May, however, the European Commission proposed to lift the requirements for Turkish citizens conditional to Turkey fulfilling the remaining criteria.*[7]
- To speed up the disbursement of the initially allocated 3 billion euros to finance the first set of projects and decide on additional funding of 3 billion euros if necessary. *In addition to 1 billion euros from the EU budget, 16 EU member states have now sent in their contribution certificates, covering 1.61 billion euros out of the 2 billion euros pledged for 2016-2017. The first contracts under the Facility (worth 77 million euros in total) were signed on 4 March and the first payments were made on 18 March.*[8] *The first installment has been used mainly for food and to upgrade the Syrian refugee camps, which currently accommodate just 15 percent of Syrian refugees.*
- To revitalize the aceesion process by opening new chapters in the accession negotiations as soon as possible. *Chapter 17, Economic and Monetary Policy was opened at the end of 2015 and Chapter 33, Financial and Budgetary Provisions are expected to be opened by July 2016.*

Challenges

Although very high hopes have been desperately pinned to the EU-Turkey deal, it has raised a number of question marks. It is fairly often referred to as controversial and there is little faith that this cooperation will work. Let us take a look at the challenges to be addressed with this deal if it is not to be reduced to pseudo solutions.

The first challenge is related to the institutional capacity of Greece to implement the deal. The task is even more difficult now that the United Nations High Commissioner for Refugees (UNHCR) has withdrawn some of its support from the Greek islands in protest against the transformation of certain refugee arrival points into detention facilities.[9]

The second challenge concerns the doubts regarding the legality of the agreement. For the refugee agree-

[3] The then Prime Minister of Turkey, Ahmet Davutoğlu made this statement immediately after striking a refugee deal with the EU on 18th of March 2016. http://www.karar.com/gundem-haberleri/davutoglu-ab-ile-tarihi-anlasmayi-degerlendirdi-psikolojik-esik-asildi-81895#.

[4] EU-Turkey Statement, 18 March 2016, The European Council, http://www.consilium.europa.eu/en/press/press-releases/2016/03/18-eu-turkey-statement/.

[5] European Commission Press Release: "Managing the Refugee Crisis: Commission Reports on Implementation of EU-Turkey Statement", 20 April 2016

[6] European Stability Initiative Newsletter, "Sailing in the Dark – 300 with a Mission – Visa, Terror and The Aegean Refugee Agreement", 19 May 2016.

[7] See also European Commission, *Third Report on Progress by Turkey in Fulfilling the Requirements of Its Visa Liberalisation Roadmap,* COM(2016) 278 final, 4 May 2016.

[8] European Commission Press Release: "Managing the Refugee Crisis: Commission Reports on Implementation of EU-Turkey Statement", 20 April 2016.

[9] REUTERS, "UNHCR Says Won't Work in Greek 'Detention Centres' in Swipe at EU-Turkey Deal", 23 March 2016, http://uk.reuters.com/article/uk-europe-migrants-greece-unhcr-idUKKCN0WO0S3.

ment to be legal, Turkey has to be recognised as a safe third country, but it is not accepted as such by some institutions like the UNHCR[10] and the Council of Europe.[11] Turkey does not apply the 1951 UN Convention Relating to the Status of Refugees to refugees coming from countries outside of Europe and has a weak and rapidly deteriorating record on human rights. This makes the country questionable as a 'safe third country'. Furthermore, Amnesty International claims that mass returns of Syrians from Turkey to Syria have begun.[12] In addition, there is a dangerous trend towards the reversal of public sentiment in the country towards its 'Syrian guests'. According to a new poll by the German Marshall Fund, 81 percent of Turks think that the migrants have failed to integrate well into society, while 68 percent believe that the government needs to take a more restrictive attitude to refugees.[13]

The third challenge concerns the one-to-one scheme. Under the terms of the 'one in, one out' scheme, Ankara is allowed to send one Syrian refugee to Europe only after it accepts a different Syrian refugee that has been returned to Turkey from Greece. Even if the EU does resettle 72,000 refugees through this swap, there is no legal obligation for Europe to take more, and, if the number is exceeded, the deal will be discontinued. Germany, which is expected to accept 15,000 refugees, hopes to create a 'willingness'-coalition with its EU partners, who accept refugees voluntarily. Such partners, however, have been thin on the ground and such a voluntary distribution seems more unlikely after the terrorist attacks in Paris and Brussels.

The fourth challenge is the possibility that migrants may try to reach EU countries *via* other means, as they see longer term-perspective in the EU. This has already started, with an increase in the number of migrants who are choosing Italy as a route to EU.

The fifth challenge is related to the pledge on visa liberalisation. In this context one should bear in mind that the EU has not committed itself to opening the way for visa free travel *via* waiving Turkey's obligations: it has promised to speed up the process conditional to Turkey's fulfillment of all 72 conditions of the 'Visa Liberalisation Road Map' that was accepted by all parties at the end of 2013. Furthermore, the public in Turkey has received little information about the decision-making process in the EU regarding visa-free travel, which has to be approved by the Council of Ministers and European Parliament. In its report where it proposed to lift the visa requirements if Turkey meets all the conditions, the European Commission draws attention to the aforementioned remaining criteria. The President of Turkey and other high level officials have already declared that 'revision of the legislation and practices of terrorism'[14] can not be accepted by the country and have signalled that Turkey may end up not implementing the re-admission agreement, in which case the whole deal would collapse. Hence the way the recent stance of the EU is presented to the citizens of Turkey is that the EU is not delivering on its commitments to Turkey regarding visa-liberalisation. This seems to be quite counter-productive. Turkey's refusal to change its legislation and terrorist practices is regarded as a further indication of the country moving away from the fundamental rights and rule of law dictated by the European Parliament, which stopped working on the visa liberalisation with Turkey.[15] In addition to all these factors, the 'suspension clause' included in the European Commission's abovementioned report by France and Germany exacerbates the risks of the visa-liberalisation process.

The sixth challenge is related to the financial assistance to be provided by the EU to Turkey. Unfortunately, there is a misperception in Turkey that the money will be given to Turkish authorities in bulk to spend on refugees, rather than distributed on a project basis. The EU's insistence on project-based funding is

[10] Financial Times, "UN Warns on Legality of EU Deal to Return Migrants to Turkey", 6 March 2016, https://next.ft.com/content/cf5c1c3a-e21d-11e5-9217-6ae3733a2cd1.

[11] Parliamentary Asssembly of Council of Europe, *PACE Raises Human Rights Questions over EU-Turkey Migrant Deal,* 20 April 2016, http://www.assembly.coe.int/nw/xml/News/News-View-EN.asp?newsid=6132&lang=2&cat=".

[12] Amnesty International, *Illegal Mass Returns of Syrian Refugess Expose Fatal Flaws in EU-Turkey Deal*, https://www.amnesty.org/en/press-releases/2016/04/turkey-illegal-mass-returns-of-syrian-refugees-expose-fatal-flaws-in-eu-turkey-deal/

[13] Seufert, G. (2016), "Turkey as Partner of the EU in the Refugee Crisis" SWP Comments, German Institute for International and Security Affairs, January.

[14] What is demanded here by the EU is the following: "Turkish legislation on terror is drafted in a way that seems to allow for an overly broad application of the term of terrorism. This is problematic because if terrorist offences are not defined precisely and relate to crimes of a significant level of severity, they may entail serious restrictions upon human rights and fundamental freedoms. The principle of proportionality, enshrined in European and international law should also be enshrined in Turkish legislation", and "in addition to legislation, attention needs to be paid to courts' interpretation of anti-terror legislation. Participants in demonstrations have been convicted for being members of a criminal or a terrorist organisation even though a link with the organisation was not demonstrated. There were also frequent restrictions on freedom of expression and media, freedom of association and impunity. The recurring arrests and prosecutions of journalists and academics on terrorist-related charges, including the provision on 'making propaganda for a terrorist organisation' have a detrimental effect on freedom of expression and lead to self-censorship, as noted by the Commissioner for Human Rights in his recent statements on Turkey".

[15] EU Observer: "EP Stops Work on Turkey Visa Waiver", 10 May 2016.

mispresented to the Turkish public as reflecting its financial reluctance co-operate with Turkey to improve the Syrians' situation.

The seventh challenge involves the revival of Turkey's accession process to the EU. Although the EU has expressed its intention to accelerate the accession process by opening some new Chapters, this does not seem likely to happen in reality. A real revival of the accession process depends on three factors:

- Domestic developments in Turkey; especially in the areas of the rule of law and the status of fundamental freedoms as prioritised in the enlargement strategy;
- The politics of enlargement in key EU states and the future of the European project itself; and
- A resolution of the Cyprus issue.

The Chapter that was opened at the end of December 2015 had to be opened nine years ago when the EU's German Presidency invited Turkey to present its negotiation-position document, after stating that there was no opening benchmark for Turkey to initiate negotiations in this Chapter. After Turkey presented its negotiation-position document, this Chapter was included among the five Chapters that were blocked by French President Nicholas Sarkozy because of their direct bearing on membership. The Chapter that is expected to be opened, Chapter 33 on Financial and Budgetary Provisions covers the rules concerning the financial resources necessary for funding of the EU budget after membership. Hence it does not play a crucial role in accession negotiations. Whereas, the crucial chapters in the aceesion process like Chapter 23 (Judiciary and Fundamental Rights) and Chapter 24 (Justice, Freedom and Security) remain unilaterally blocked.

The eighth challenge concernsthe ambiguous part of the agreement that is "to work with Turkey in any joint endeavour to improve humanitarian conditions inside Syria". Some scholars claim that Turkey might try to use its leverage regarding the refugee crisis to compel the EU to set up safe zones in Syria.[16]

Conclusion

The so-called refugee deal was necessary, despite the many challenges that it involved. Turkey is vital in dealing with the migration/refugee crisis, and no other EU member state would have been willing to lead negotiations, if Germany had not volunteered. If the deal can be implemented properly, it might very well represent a breakthrough in the crisis and create a relationship built on trust between Germany, the EU and Turkey that can also pave the way for cooperation in other areas. Cooperation, however, requires trust and, despite the official press statements, mutual trust between the parties appears to be rather low, as demonstrated in this paper. This fact complicates such Germany-Turkey cooperation efforts significantly.

[16] Özkan, B. *Is Erdoğan Holding Europe Hostage?,* 24 May 2016, https://de.scribd.com/document/313596154/Is-Erdo%C4%9Fan-Holding-Europe-Hostage.

Europe's Crises, Germany's Leadership and Turkey's EU Accession Process

Ebru Turhan*

The unique and deep-rooted relations between Turkey and Germany rest upon a variety of political, economic and societal linkages. Germany is defined as Turkey's leading trading partner, with bilateral trade volume reaching a new record of 36.8 billion euros in 2015. For decades, Germany has been the biggest foreign investor in Turkey. The number of Turkish and German companies with German capital operating in Turkey has risen to approximately 6,500, while Turkish companies have been increasingly involved in foreign direct investments in Germany and setting up businesses in sectors of strategic importance for both parties.

As far as foreign policy and security-related political dialogue is concerned, the two countries collaborate within the framework of various leading international organizations such as the North Atlantic Treaty Organization (NATO), G20 and the Organization for Security and Cooperation in Europe (OSCE). In May 2013, German and Turkish foreign ministries launched the German-Turkish Strategic Dialogue Mechanism in order to foster bilateral cooperation on key issues of common interest such as the supply of energy security, foreign and security policy as well as the fight against terrorism and extremism (Auswärtiges Amt 2013). The German and Turkish governments also announced in January 2015 that they had agreed to hold regular intergovernmental consultations starting from 2016 (Presse- und Informationsamt der Bundesregierung 2015). The first German-Turkish intergovernmental consultations took place in Berlin on 22 January 2016 and tackled the potential for German-Turkish cooperation on common challenges such as the management of the refugee crisis and the war against terrorism (Die Bundesregierung 2016). Such initiatives point to both parties' intention to take the bilateral political dialogue to the next level. As far as societal links are concerned, the existence of nearly three million people of Turkish origin residing in Germany has long been an important aspect of the German-Turkish dialogue and brings issues related to migration, Turkey's compatibility with Europe's 'common' identity and integration to the forefront of bilateral relations.

The official German position on Turkish membership in the EU also constitutes an important aspect of German-Turkish bilateral relations. Throughout Turkey's prolonged EU accession process, successive Turkish governments have paid particular attention to the official German position on Turkish membership in the EU, and held German governments responsible for both ebbs and flows in Turkey's EU accession process, which has greatly influenced bilateral relations between Turkey and Germany.

This paper examines Germany's role in the formation of the scope, content and particulars of Turkey's EU accession process. It studies Germany's impact on the latest developments in the Turkey-EU dialogue, including the opening of Chapter 22 in Turkey's accession talks and the finalisation of the EU-Turkey 'deal' of 18 March 2016 concerning the management of the refugee crisis. The paper therefore pays particular attention to the implications of the institutional architecture of the EU's decision-making processes pertaining to its widening; and Europe's multiple crises for Germany's 'leadership' status within the EU.

The German 'factor' in EU-Turkey relations

Important decisions related to the EU's widening are taken by two EU institutions with a highly intergovernmental character: the European Council and the Council of the EU (Council of Ministers). The institutional architecture of these two EU institutions highlights the role played by member states in the formation of candidate countries' accession processes.

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The European Council and the Council of Ministers are the EU's main intergovernmental institutions, which mainly consist of the heads of state or government, as well as ministers of member states who tend to act on behalf of their domestic constituency and safeguard their conflicting national interests (Lelieveldt and Princen 2015). In such intergovernmental bodies, decisions are taken by means of interstate strategic bargaining and negotiations, where larger member states with greater structural capabilities (economy, population, military, geography etc.) tend to have a greater leeway for power politics.

With its cumulative structural capabilities in both political and economic terms, Germany has been assuming a leadership role, alongside with France and Britain, in interstate bargaining processes in the EU, which culminate in the development of common policies (Moravcsik 1998). This is also true for the decision-making processes in terms of determining the EU's enlargement politics *vis-à-vis* Turkey. Germany acts as a major player in the formation of EU-Turkey relations in general, and Turkey's EU accession process in particular. This proved true not only when Turkey was granted candidacy status at the December 1999 Helsinki European Council following the shift of power in Germany with the formation of the red-green coalition government in 1998, but also throughout the recent slowdown in Turkey's EU accession process, when Germany unilaterally blocked the opening of Chapter 22 related to regional policy and the coordination of structural instruments in June 2013. The European Council has been in a position to make a positive decision on the acceleration of Turkey's EU accession process only at times when Germany has explicitly spoken up on Turkey's behalf (Turhan 2012). As a result, throughout Turkey's prolonged EU accession process, successive Turkish governments have paid particular attention to the official German position on Turkish membership in the EU, and have held German governments responsible for both ebbs and flows in Turkey's EU accession process, which has greatly influenced bilateral relations between Turkey and Germany (see also Reuters 1998).

Europe's crisis, Germany's leadership

Germany's steering role in the formation of common EU policies in general, and the EU's enlargement politics *vis-à-vis* Turkey in particular, has become more evident in the crisis era. With the outbreak of the Eurozone crisis in late 2009, German influence in the EU took a new turn. Germany had been less affected by the Eurozone's problems than most of the other member states. Its aggregate capabilities accompanied by its net contributor status put the country at the epicenter of the debates over possible solutions to rescue the euro. The shifting balance of power in Europe has made German leadership in the EU widely desirable, if not inevitable. Since the onset of the crisis the country has been regarded as "the only economy that can keep Europe afloat" (Hallerberg 2013, 263), since nothing can happen in the EU without the active support of Germany's chancellor, Angela Merkel (The Economist 2013). German leadership and aid came with hard conditions attached, and willingness to undertake unilateral actions, if necessary; in other words, the readiness to go it alone *(Alleingang)*. German willingness to go it alone has been evident in some unilateral actions such as the rejection of debt mutualisation in Europe with the introduction of Eurobonds and policies that bolster domestic spending in insolvent member states; the initial reluctance to contribute to a 750-billion-euro aid package in order to set strict rules for financial aid and include the IMF in the troika of creditors; and unilateral statements like, for example, that Greece should not have been allowed into the euro (Trotman 2013).

German veto on Chapter 22 in Turkey's EU accession talks

The crisis era for European economies has also witnessed a Germany that did not abstain from imposing its position pertaining to Turkey's EU accession process on other EU member states. German *Alleingang vis-à-vis* Turkey was particularly demonstrated by the attitude of the German federal government towards the launch of accession talks on Chapter 22 related to regional policy and the coordination of structural instruments. The chapter had been blocked by France since 2007, along with four additional chapters,[1] as they were considered directly related to full membership, which was not favoured by the then French President Nicolas Sarkozy. After François Hollande's presidential victory, the French government lifted its veto on Chapter 22 in February 2013. Following the withdrawal of the French veto, the German government had an inconsistent attitude towards the opening of Chapter 22. German Chancellor Angela Merkel

[1] Chapter 11-Agriculture and Rural Development, Chapter 17 – Economic and Monetary Policy, Chapter 33 – Financial and Budgetary Provisions, and Chapter 34 – Institutions.

first called for the opening of the chapter in February 2013. One day ahead of her visit to Turkey accompanied by an exceptionally high-level business delegation,[2] the Chancellor declared her support for the opening of a new chapter in Turkey's accession negotiations with the EU, regardless of her personal doubts about the matter: "although I am skeptical, I have agreed with the continuation of membership discussions. Recently, they have become stuck, and I am in favour of opening a new chapter in these negotiations in order to move forward" (Die Bundsregierung 2013a). She re-confirmed her support for the opening of the chapter related to regional policy during the meetings in Ankara (Die Bundesregierung 2013b).

Merkel's backing for the revitalization of Turkey's dormant EU accession process after a three and a half-year freeze came at a time, when key representatives of the German business world intended to deepen bilateral economic ties with their Turkish counterparts during the visit. The economic dimension of the trip was also reflected in the realisation of a Turkish-German CEO Forum with Merkel's attendance. The forum that was jointly organised by the Association of Turkish Industry and Business (TÜSIAD) and its German counterpart the Federation of German Industries (BDI) brought together top CEOs from both countries to discuss the present and future of German-Turkish economic partnership with special emphasis on energy and innovation sectors. During his talk at the forum, BDI President Ulrich Grillo demanded a quick decision with regard to Turkey's membership of the EU and expressed his support for the continuation of accession negotiations pointing out that the future architecture of both the EU and the Eurozone might 'offer the opportunity for a new European geometry' (BDI 2013). German industry's explicit call for a quick decision pertaining to Turkey's EU bid precisely during Chancellor's trip to Turkey and under her watchful eyes was a premiere. The plea came at a time, when German economy recorded zero growth in the first quarter of 2013 after shirking 0.5 percent in the last three months of 2012 and when German companies were urged to look for other stable markets in view of the clouds gathering over their key export market, the Eurozone. The German industry's call for a quick decision on Turkish accession process is likely to be regarded as an effort to influence the German federal government's policies to eliminate the negative externalities arising from the Eurozone crisis.

Following the shift in the German federal government's position on the progression of Turkey's accession process that was backed by German industry, many in Turkey and Europe expected a smooth re-launch of accession talks with Turkey in June 2013, as originally promised by the EU. However, in late June 2013, the German federal government emphasized its strong objection to a quick re-launch of the negotiations. It grounded its veto on Chapter 22 inexplicitly on the Turkish government's handling of the Gezi Park demonstrations, which started in late May 2013 to protest against the urban development plans for Istanbul's Taksim Square. A spokesperson of the German Foreign Affairs Ministry stated that the timing of this chapter's opening was a 'technical issue' and not directly related to the demonstrations in Turkey. However, he added, "there is of course an overall political context, and as is always the case in life, everything is ultimately connected with everything else" (Sattar and Busse 2013). While the German government inexplicitly referred to the domestic political turbulence in Turkey as a reason for its veto on Chapter 22, others like Carl Bildt, Sweden's former Foreign Minister, criticised the German government's suddenly sceptical stance towards Turkey and its putting forward the 'Turkey card' ahead of the upcoming German federal elections (see Waterfield 2013).

For whatever reason Germany may have blocked the opening of Chapter 22, the fact remains that it succeeded in imposing its stand towards Turkish accession process on the rest of the EU. Although it came into conflict with the other 24 member states that adopted a common position to open the talks on Chapter 22 as its veto was supported by just two member states, the Netherlands and Austria, the heads of state or government of member states agreed to the German proposal to postpone talks with Turkey until after the presentation of the progress report on Turkey. The release of the report was handily scheduled for after the German federal elections.

The refugee crisis and Germany's role in the finalisation of the EU-Turkey deal

The German 'factor' in EU-Turkey relations has become more evident throughout the process that led to the finalisation of the EU-Turkey 'deal' of 18 March

[2] The delegation included heads of the executive boards of leading German companies such as E.ON, EnBW, Siemens, Deutsche Bank, Deutsche Lufthansa, Fraport, ALBA Group and the President of DIHK, Hans Heinrich Driftmann.

2016, which sets out the conditions for the cooperation between Turkey and the EU on tackling the refugee crisis and managing the flow of irregular migration into the EU. By means of unilateral statements, as well as bilateral and mini-lateral meetings with relevant EU top officials, heads of state or government of related member states and her Turkish counterpart, Chancellor Merkel played a leading role in constructing the bilateral dialogue between Turkey and the EU with regard to the refugee question and the definition of the scope, conditions and particulars of the collaboration between Turkey and the EU.

Table 1 illustrates Merkel's interaction with the then Turkish Prime Minister Ahmet Davutoğlu, key representatives of the EU institutions such as European Commission President Jean-Claude Juncker and European Council President Donald Tusk, as well as heads of state or government of member states and third countries located on the so-called Balkan route ahead of important European Council gatherings and EU-Turkey Summits.

Five important remarks pertaining to Germany's role in the identification of the particulars of the EU-Turkey cooperation on the management of the refugee crisis can be made following a closer look at the Table 1:

1. By means of important bilateral and mini-lateral talks behind closed doors Chancellor Merkel actively prepared the ground for the conclusions of the European Council meetings and EU-Turkey summits concerning the Syrian refugees and the management of irregular migration to Europe. The EU-Turkey 'deal' of 18 March 2016 was largely prepared and shaped by the 6 March trilateral meeting between Merkel, Davutoğlu and Mark Rutte, the then leading representative of the Dutch Presidency of the Council. The final version of the deal as approved by the 18 March EU-Turkey Summit included the decision to open Chapter 33 related to financial and budgetary provisions, disregarding the 6 March proposal to launch talks on additional chapters unilaterally frozen by Cyprus, while adopting all the other elements of the draft trilateral proposal (see also Turhan 2016).
2. Throughout the process that led to the EU-Turkey 'deal' on the management of irregular migration, Chancellor Merkel collaborated mainly with Commission President Juncker, rather than with European Council President Tusk, which was criticised by many EU politicians and officials, and which indicated Germany's increasing policy of going it alone *Alleingang* in the European Council.
3. The Franco-German axis did not act as the 'steering wheel' for identifying the scope, content and conditions of the EU-Turkey cooperation on the refugee crisis. Between October 2015 and March 2016 Merkel and Hollande only twice made a joint declaration on the management of the crisis, whereas the French President did not participate in the mini-summits initiated by Merkel and Juncker.
4. Chancellor Merkel was the first top EU politician to announce the opening of new chapters in Turkey's accession talks with the Union after the European Council summit of 15 October 2015. Although neither the European Council conclusions nor the post-summit statements of top EU officials such as Juncker or Tusk made any explicit

Table 1

Bilateral/mini-lateral talks between Germany and member states/Turkey/top EU officials ahead of EU/EU-Turkey summits on the management of the refugee crisis

7 October 2015 Merkel-Hollande in the European Parliament / speech on how to tackle the refugee crisis Merkel: "Turkey plays a key role"	15 October 2015 European Council agrees on the Joint Action Plan Merkel: "EU is ready to open new chapters"	18 October 2015 Merkel's Turkey visit "Germany is ready to open Chapter 17 and make preparations for Chapters 23 & 24"
23 October 2015 Merkel-Anastasiades meeting to discuss chapters to be opened	25 October 2015 Merkel-Juncker mini summit with member states on Balkan Route	29 November 2015 EU-Turkey Summit, Activation of the Joint Action Plan
17 December 2015 Merkel-Juncker mini summit with Turkey & 8 member states	22 January 2016 1st German-Turkish intergovernmental consultations	8 February 2016 Merkel's visit to Turkey
4 March 2016 Merkel-Hollande meeting / joint press conference	6 March 2016 Merkel-Davutoğlu-Rutte meeting Preparation of a 'trilateral' proposal for EU-Turkey cooperation on the management of irregular migration	7 & 18 March 2016 EU-Turkey Summits / EU-Turkey 'deal' of 18 March 2016

Source: Author's conception.

reference to the opening new negotiation chapters, Merkel unilaterally announced the speedy opening of new chapters in Turkey's accession talks during a press conference after the summit (Die Bundesregierung 2015), which hinted at German leadership in defining relations between Ankara and Brussels.

5. Germany is no longer acting as a 'reluctant hegemon' (Paterson 2011) within the EU, applying an over-cautious and hesitant approach at times of crisis and exercising leadership that is more or less limited to the economic sphere.

Conclusion and future outlook

German preferences play a leading role in the formation of EU-Turkey relations in general, and Turkey's path to the EU in particular, due to the intergovernmental architecture of the two EU institutions of key importance for the enlargement process of the EU: the European Council and the Council of Ministers. Germany's aggregate structural capabilities and the asymmetrical interdependence between Germany and the (particularly small) member states of the Union provide the country with a greater leeway for power politics in these two intergovernmental institutions. Following the outbreak of the Eurozone crisis and the refugee crisis, Germany's leadership role in the EU took a new turn, which also affected state of relations between Ankara and Brussels.

The EU has entered an era of multiple crises. Although there has been a gradual recovery from the Eurozone crisis, many challenges still need to be addressed. Alongside more 'traditional' financial crises, the EU faces some 'new generation' crises such as the refugee crisis, the rise in intra-European terrorism, as well as the democratic-legitimacy problem. In this era of multiple crises with uncertain solutions Germany – with its aggregate structural capabilities – is likely to continue to take a leading role within the EU, and accordingly, make a large contribution to defining the dialogue between Turkey and the EU.

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Brexit: Why, What Next and How?

Iain Begg*

Now that the unexpected has occurred, what about half the British electorate regard as the unpalatable process of leaving the EU is likely to happen. In fact, it could be more than half if those who voted in protest, rather than out of conviction are counted. There are even commentators in Britain who query whether Brexit will go ahead. In this regard, the lack of a written constitution in this country could well be critical, because the very absence of a clear pathway means that much is possible. However, the unprecedentedly rapid anointment of Theresa May as David Cameron's successor and the mix of cabinet ministers she has appointed suggest that for her government, at least, there can be no turning-back. Yet there are still many unknowns about how Britain will go about disengaging itself from the EU, the timetable and what the most likely outcome will be, and what it will imply for the future of European integration.

Britain has long had a much more transactional and less political approach to EU membership than most other Member States. Having been present at the Messina talks in 1956 that led to the Treaty of Rome, Britain chose not to participate in the founding of the European Economic Community, but by the 1960s the strategic economic case for shifting from the Commonwealth as a key trading partner to the (then) dynamic market of continental Europe was increasingly compelling. Not joining the euro was, similarly, more of an economic calculation based on Gordon Brown's 'five economic tests'[1] than an overtly political decision (see also Brown 2016).

This stance has meant that Britain has often been at odds with its EU partners, although it frequently gave voice to views others were reluctant to express. Even so, the deal negotiated by Cameron in February gave fresh impetus to British exceptionalism, albeit with the ironic outcome that it barely featured in the campaign. The deal now lapses following the vote for Brexit, yet it is an open question whether the genie of differentiated integration is now out of the bottle.

This paper looks at the economics of Brexit, considers why the referendum resulted in the vote to leave and explores what the ramifications are for both Britain and the future of the European Union.

The economics of Brexit

As the referendum campaign proceeded, studies of the likely impact of Brexit proliferated. Few readers will be surprised that some of the more positive assessments emanated from supporters of Brexit (for example, a group of *Economists for Brexit*[2]) and *vice versa.* International organisations such as the IMF and the OECD also weighed into the debate, though more from the standpoint of assessing global risks, while the Bank of England, in various interventions, stressed its duty to speak up on risks, especially to financial stability. There were also studies looking only at certain facets of Brexit. Examples include analysis of the direct effect of Brexit on the Britain's public finances,[3] assessments of the regulatory burden on this country and the impact on jobs.

A lengthy study by HM Treasury[4] represented the official government position and can be placed within the mainstream. Other influential mainstream studies included a series of papers by economists at the Centre for Economic Performance at the London School of Economics, Oxford Economics and the National Institute for Economic and Social Research. What these studies all found was that the long-term effect of Brexit will be to reduce UK GDP compared with the

* London School of Economics and The UK in a Changing Europe Initiative.

[1] http://webarchive.nationalarchives.gov.uk/+/http:/www.hm-treasury.gov.uk/documents/international_issues/the_euro/assessment/report/euro_assess03_repintro.cfm.

[2] http://www.economistsforbrexit.co.uk/.

[3] See e.g. http://ukandeu.ac.uk/wp-content/uploads/2016/01/Who-pays-for-the-EU-and-how-much-does-it-cost-the-UK-Disentangling-fact-from-fiction-in-the-EU-Budget-Professor-Iain-Begg.pdf.

[4] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/517415/treasury_analysis_economic_impact_of_eu_membership_web.pdf.

counterfactual of staying in the Union, but with the extent of the loss contingent on the terms of the post-Brexit trade and investment regime.

Although there are inevitably differences in methodologies and assumptions between different studies, the HM Treasury study is fairly representative in setting out three scenarios reflecting possible reconfigurations of the post-Brexit UK relationship with the remainder of the EU (rEU). These are: an arrangement similar to Norway, with nearly the same market access; a 'Canada model' akin to the one currently in the concluding stages of negotiation between the EU and Canada; and a 'WTO model' in which Britain has only the same most favoured nation status as other third countries. The Treasury's conclusion is succinct: "the UK would be permanently poorer if it left the EU and adopted any of these alternative relationships".

Work by Minford,[5] using a rational expectations model, secured attention as the main alternative view, finding that the UK economy could prosper outside the EU. His reasoning is, in part, the rational expectations one that Brexit is so far-reaching a regime change that previous statistical regularities have little relevance – a classic Lucas critique argument. The analysis also relies on the assumptions that British consumers will gain from switching from producers protected by EU trade restrictions to cheaper world prices, while UK businesses can benefit from avoiding costly regulations imposed by 'Brussels'. According to Minford, these factors will add up to a four percent gain in GDP.

In a further study, HM Treasury[6] suggests considerable short-term risks from Brexit, including the possibility of triggering a recession. The main reason is that a decision to leave would inflict a negative shock on the economy, although in the most optimistic scenario it might be short-lived. However, the study also noted that there were already signs of some of these factors weighing on the UK economy in the form of higher risk premia for UK debt and a decline in business confidence. The three distinct components of the expected shock are:

- The direct 'transition effect' of shifting to less open trade and investment regimes. Employers reliant on the current trade regime would be faced with pressures to reduce costs and would be expected to reduce investment.
- An uncertainty effect leading investors to put off decisions on new projects, leading to lower demand in the economy.
- A financial stability effect resulting from a reassessment by financial markets of the riskiness of UK assets.

A mild 'shock' scenario results not only in a loss of 3.6 percent in GDP over two years, compared with what would otherwise happen and a jump in unemployment, but also higher inflation because of a fall in the pound – something that has already happened since the 23rd of June. Under the 'severe shock' scenario, GDP would be some 6 percent lower after two years and the unemployment and inflation effects would be greater. Moreover, the Treasury does not allow for what it calls 'tipping-points' such as a sudden stop in the willingness of financial markets to finance the already large UK deficit on the current account of the balance of payments.

Unsurprisingly, the analysis was criticised as scare-mongering, yet the Treasury findings are consistent with others (even the *Economists for Brexit* accept some short-term disruption) in pointing-out that the conjunction of uncertainty about the outcome and the dislocations that will arise from Brexit will reduce GDP. What distinguishes the various protagonists is, first, whether it is by enough to result in recession, and second, whether it has an enduring impact or is only a transitional cost likely to be rapidly overcome.

According to the IMF in its routine Article 5 report for 2016 on Britain,[7] 'the largest near-term risk relates to the referendum on EU membership', explaining that Brexit would create uncertainty about future UK trading relationships with rEU, the sixty other countries which are covered by collective EU deals and a further sixty-seven currently under discussion. Like many other commentators, the IMF argues that negotiating new deals for an independent Britain would be a lengthy process. A distinctive element in the IMF assessment is that Brexit could well accentuate some of the other risks to the UK economy, such as weak productivity, the housing market and the sizeable balance of payment deficit on current account. Kierzenkowski *et al.* (2016) express concern that a slowdown in inward investment would aggravate an already poor productivity record, undermining potential growth.

[5] http://www.economistsforbrexit.co.uk/.
[6] https://www.gov.uk/government/publications/hm-treasury-analysis-the-immediate-economic-impact-of-leaving-the-eu.
[7] http://www.imf.org/external/pubs/ft/scr/2016/cr16168.pdf.

Competing methodologies

These various exercises raised methodological questions about how a change as profound as Brexit can best be modelled. Several of the mainstream approaches use ‘gravity models’ predicting more intensive trade and investment flows between countries geographically close to one another. There is both a strong theoretical basis for this and, as a paper from the LSE’s Centre for Economic Performance (CEP)[8] stresses, empirical evidence. However, Minford remains highly critical of gravity models, despite the evidence that they predict the levels of trade well in a statistical sense, but only as long as the basic assumption that everything else is held constant is true – i.e. all the shocks and fixed assumptions implicit in the underlying empirical analysis, such as other tariff and policy changes and technological developments. He goes on to argue that when there is a wide-ranging change not only in the trade regime, but also in the nature of regulation, the statistical regularities on which the gravity models depend cease to be reliable. He also asserts that the nature of the relationships will differ depending on the sort of change and its magnitude. By implication a small change in, say, a tariff (such as reducing it from 10 percent to 8 percent) can be analysed using these tools, but a wholesale change in the regime cannot.

In its hard-hitting rebuttal of the Minford critique, the authors from the CEP observe that to take the position that since no econometric work can be perfect, all inconvenient facts should be ignored is poor scholarship and bad science. They also assert that the argumentation by Minford is flawed because it relies only on theoretical propositions of dubious merit. The core of Minford’s argument is that, because the EU is a customs union, the tariffs it imposes on imports from the rest of the world, together with regulatory restrictions (especially on service industries) are trade-reducing.

The influence of movement of workers

One dimension worth stressing is that immigration has been a major driver of growth in Britain, accounting for perhaps half of recent growth according to Kierzenkowski *et al.* (2016). Yet, this is precisely the point that opponents of free movement highlight: the higher growth does not necessarily benefit indigenous people. EU migrants (who ought, in any case, to be described more accurately as mobile workers) have a higher employment rate than indigenous workers, make a net contribution to public finances and help to fill labour shortages in industries such as health care and agriculture). Many of those classed as immigrants from EU countries are, moreover, students and thus constitute invisible exports by a globally competitive UK industry: the university sector.

[8] http://cep.lse.ac.uk/pubs/download/brexit06.pdf.

According to data summarised by Lisenkova and Sanchez-Martinez (2016), the share of migrants in the working-age population doubled between 1995 and 2014 to 17 percent. However, this has not had an adverse effect on the unemployment rate of indigenous workers, even amongst lower skill groups, although there is some evidence of a small downward pressure on wage rates.[9] Migrants have also consistently made a net contribution to the public finances according to Dustmann and Frattini,[10] although it has to be recalled that this finding aggregates very high earning professionals alongside agricultural workers paid the minimum wage.

Nevertheless, migration ultimately became the biggest factor influencing the outcome of the referendum for an obvious, if under-appreciated reason: the claims of aggregate gains simply did not resonate at the level of the individual. Pressure on school places, health services or (the limited) stock of social housing meant that, in many localities citizens could point to direct adverse consequences for them, whereas the macroeconomic benefits were much more abstract. Those who pointed out that if public services were not keeping pace with the additional demands, it was the government’s fault, not the migrants’, were unable to make headway with their argument.

There is, arguably, a lesson here about the use of aggregates. Whether it is the economic effects of migration or claims about changes in GDP, they can be very remote from the circumstances of the individual. In the end, none of us is average and quoting averages can be counter-productive.

Can the vote be explained?

Although the foregoing economic analysis featured prominently in the campaign and was generally seen

[9] However, as wage rates were the principal channel for adjustment of the UK labour market during the crisis years, this effect will have been marginal by comparison.

[10] http://www.cream-migration.org/files/FiscalEJ.pdf.

as among the more powerful of the 'remain' arguments, it gave rise to a narrative labelled 'project fear', enabling the opposition campaigns to portray Brexit in much more positive terms. Through a combination of disciplined focus on the compelling slogan 'take back control' and, it has to be said, cynical misrepresentation of facts about, for example, the potential budget savings from Brexit and of the prospect of waves of Turkish migrants arriving in Britain, the 'leave' side was able to project a more positive case.

The vote for Brexit was unusual in the nature of the groupings on either side, reflecting a range of different cleavages within British society. Older people and the less well-educated wanted Brexit, while youths and those with university degrees favoured remain. London and Scotland voted very emphatically for remain, and there was a majority for it in Northern Ireland, but much of the rest of England voted leave, as did Wales. One particular group that probably proved decisive was the core Labour party supporters in England who seem to have rejected their party's line to support 'remain'. In places this was something of a puzzle given the specialisation of the local economy: in Sunderland, home to the giant Nissan factory which exports more than half its output to other EU countries, barley a third of voters went for remain. The implication is that economic self-interest was being over-shadowed by other considerations.

One interpretation of the result is that British voters have ignored their leaders, rejecting warnings from experts about likely negative consequences. This echoes developments in other mature economies. In France, Germany and the Netherlands, nationalist parties have made significant progress, while in Greece and Portugal, parties that reject current economic orthodoxies have made rapid advances. Similarly, the success of the anti-establishment campaigns of Trump and Sanders in the United States testifies to a widespread disenchantment about globalisation. It is probably too early to sound the death-knell for globalisation, but it is worth recalling that the globalisation of a century ago went into reverse.

The polls struggled to track voters' intentions and were quite volatile throughout the campaign, but by the day of voting, seemed to signal that 'remain' would win, as did the bookmakers. That they were proved so decisively wrong is due to a combination of reasons. A first is misunderstanding the depth of hostility to migrants, especially among working-class Labour voters. Second, because there is no real tradition of referenda in Britain, the pollsters have very little history to draw upon in interpolating from their surveys, in contrast to general elections. More fundamentally, the result reflects a new mood in the electorate of antagonism to elites and experts, and even the polling organisations may be regarded as part of this elite and thus not to be trusted.

The tone of the campaigns made a difference. Brexit was able to sound positive, whereas remain came over as defensive and focused on what could go wrong if Britain left the EU, with too few of its representatives setting out positive reasons for staying. With hindsight, years of Brussels-bashing across the political spectrum in Britain took a toll and meant that those politicians trying to make the case for EU membership came over as lukewarm and unconvincing. Two examples illustrate this. First, prior to concluding the February renegotiation, David Cameron made clear that unless a satisfactory deal could be reached on what were, after all, relatively minor demands, he would recommend a Brexit. When he subsequently spoke of Brexit as a risk to world peace and laid out all the risks he foresaw, it was not exactly persuasive. Second, the Labour leader, Jeremy Corbyn, had been associated with the left campaigns in the 1980s against European integration and, when asked on one occasion[11] about his new enthusiasm for the EU, said he gave the EU 'seven, seven and a half, maybe seven' out of ten. In the same interview, Corbyn also explained his refusal to share a platform with David Cameron as being because his case for the EU was entirely different.

It is no surprise, therefore that potential 'remain' voters were confused, especially among working-class Labour voters who had trouble deciphering their own party's message. In the end it seemed to come down to a choice between the emotional appeal of regaining identity, the right to control borders and to curb immigration, on one side, against the likelihood that Brexit would be economically damaging, on the other.

What next?

It is hard to know what Britain wants and, more importantly, can plausibly expect from a new deal with its erstwhile EU partners. The models examined in the economic studies are all potential options, but all have potential shortcomings. The Norway model would al-

[11] http://www.bbc.co.uk/news/uk-politics-eu-referendum-36044383.

low Britain to retain much of the market access it currently enjoys to rEU, but with three substantive complications from a UK perspective. First it would mean Britain continuing to make a net contribution to the EU budget. Second, it means accepting freedom of movement and, third, it would mean accepting substantial amounts of regulation with a diminished capacity to influence the rules. Given that savings on the EU budget, curbs on free movement and 'taking back control' were core themes of the 'leave' campaign, the Norway model as an alternative looks unappealing. It is also likely to be resisted by rEU, if only to deter other Member States from seeking such deals.

The 'Canada model' would entail a free trade agreement, with few restrictions on trade in goods, thereby enabling major UK exporters to avoid what could be significant tariffs on exports to the rEU that could result from the 'WTO model'. Carmakers, in particular, would be deeply concerned if they were subject to the EU's ten percent common external tariff. However, the Canada model does not cover many of the non-tariff barriers that could inhibit UK exports of services, especially the financial and business services produced by the City of London. It is no surprise, therefore, that the City is apprehensive. It is also too easily forgotten that in both the Canada and WTO models, trade between Britain and rEU is expected to shrink, probably with mutually negative damaging effects.

It will certainly be harder outside the EU for the City to be the principal financial centre for the Eurozone and the European Central Bank may press for some activities, such as clearing, to be located only inside the EU. In addition, some leading banks have stated that they will need to shift jobs from London to centres inside the Eurozone, all of which points to a steady loss of activity for London. However, the City is a global financial centre and has, when challenged in the past, shown a capacity to reinvent itself. Other European financial centres – not least Frankfurt and Paris, may gain marginally from what London loses, but considering the global dimension, it is more likely to be a negative sum game than a zero-sum one.

The future relationship in other policy domains has been given much less attention but is nevertheless important. Britain has been one of the leading actors in EU security policy and in international relations. Some new arrangement will be reached in due course, but it will not be easy because the Brexit process will have eroded trust between Britain and its current EU partners. In some ways, Britain will go on as before. It will retain its seat on the UN Security Council, have a strong voice in the IMF, still be a leading member of NATO and be a major economy. But it risks becoming isolated, rather than being a leading actor in the world's largest trading bloc.

Economic spillover

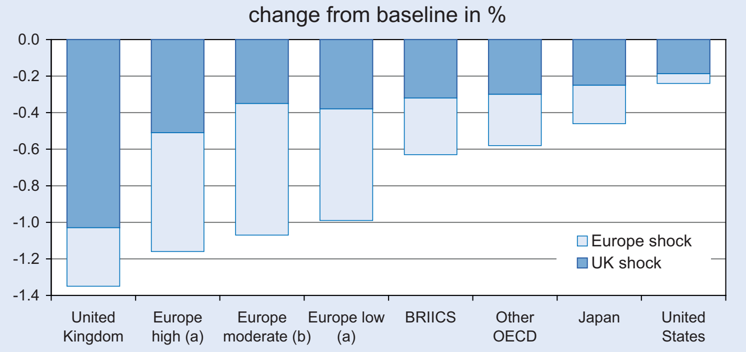
International institutions, notably the OECD and the IMF, produced a series of analyses highlighting both the risks to the UK economy and to global economic prospects. In its latest Economic Outlook, the OECD (2016) identifies Brexit as a major downside risk for the global economy, even before the vote occurred, and commented that it was on the basis that the verdict would be 'remain'. The analysis suggested that the 'leave' vote would worsen financial instability and cause some loss of asset values. Even Janet Yellen of the Federal Reserve,[12] speaking in Philadelphia in June 2016, cited Brexit as one of the downside risks for the US economy, with the corollary that normalisation of monetary policy will again be postponed.

The effects on other parts of the world of Brexit (by 2018) have been calculated by the OECD, distinguishing between the effects of the shock on Britain and on the EU. The main channels are through the financial effect, the trade effect and an effect on FDI. Figure 1 shows these calculations and reveals that the UK shock is more significant for other parts of the world than the direct effect of an EU shock. By contrast, inside Europe, albeit to differing degrees, it is an EU shock that will dominate. In the OECD analysis, the EU countries are classified into three groups according to the strength of their linkages to Britain on three sets of metrics – import demand from Britain as a share of the country's GDP; the stock of FDI from the country in Britain, again as a proportion of GDP; and what is referred to as a 'big data indicator of linkages from Google trends'. Ireland and the Netherlands, unsurprisingly are assessed as being most exposed, as is Luxembourg, whereas Italy and much of central and eastern Europe are least exposed. A middle group includes Germany (which has, so far, made sympathetic noises about how to accommodate the likely post-Brexit demands from Britain), but also France and Spain which have been signalling a less supportive stance.

[12] https://www.federalreserve.gov/newsevents/speech/yellen20160606a.htm.

Figure 1

Impact of Brexit on GDP in different regions by 2018



(a) Ireland, the Netherlands, Norway and Switzerland.
(b) Austria, Belgium, Denmark, Finland, France, Germany, Greece, Spain and Sweden.
(c) Czech Republic, Estonia, Hungary, Italy, Latvia, Lithuania, Poland, Portugal, the Slovak Republic and Slovenia.
Source: OECD (2016).

Public finances

The departure of Britain will mean a reduction of up to the full UK gross contribution to the budget, depending on whether the future relationship between Britain and rEU includes some continuing financial contribution, as with the EFTA countries. To put it in perspective, the loss of the British gross, post-rebate contribution is equivalent to most of the budget for line 1a, 'Competitiveness for growth and jobs', or to around a third of the budget for Cohesion Policy.

From this UK contribution, some spending from EU programmes accrues to Britain, such that the net contribution is lower, but the loss of the UK payment would still leave a big hole to be filled, prompting an obvious question: will the other net contributors agree to pay more, or will today's net recipients be obliged to accept less. Formally, the EU's spending plans are embodied in the Medium-Term Financial Framework (MFF) in which the agreed expenditure determines how much Member States have to contribute. Unless the current MFF is over-ridden, the net contributors (not least Germany) will face a higher bill for the EU at a time when this could prove politically awkward.

However, these direct effects will be relatively trivial if the wider economic effect of Brexit is adverse. Lower GDP means, *ceteris paribus,* lower public revenues and higher demands on public spending, not just in Britain but also in rEU, suggesting a plausible lose-lose economic scenario, dominating the direct effects of EU budget changes.

A word on Scotland

There has been speculation about a possible break-up of Britain because of the very strong support for remain in Scotland and, to a lesser extent, Northern Ireland. The Scottish Nationalists face a trilemma. They have a clear political opportunity afforded by the message that England has taken the Scots out of a Europe to which they want to belong and the possibility that resistance to rapid Scottish accession to the EU would be muted. At the same time, it is questionable whether enough of the 55 percent of Scottish electorate who voted against Scottish independence in September 2014 will have changed their minds, despite the subsequent electoral success of the nationalists.

The third issue is the economy and its implication for the public finances. In the 2014 Scottish referendum, a weakness of the 'yes' campaign was that it was unclear what currency arrangement would ensue from independence and there were doubts about the public finances. Since then the steep fall in the oil price has slashed revenue from oil on which an independent Scotland would rely, to the extent that an independent Scotland today would face a dangerously high deficit and maybe even a bailout.

Assessment

Despite the polls showing how tight the vote was likely to be, not only was the result generally regarded as a surprise, but it was also clear that there was no real plan for what happened next. There has been much debate about Article 50 of the Lisbon Treaty, the provision that enables a country to leave the EU. It has to be triggered by the Member State seeking to exit and, although there have been evident signs of impatience in Brussels (and in a number of national capitals) that it did not happen immediately, there is little the EU institutions can do to accelerate it. With the caveat that in the current febrile political context the unexpected has become the normal, making any prediction hazardous, the signals emanating from Westminster, both from Theresa May and David Davis, the Minister she has appointed to pursue Brexit are that Britain will not invoke Article 50 before the end of 2016.

Financial volatility has already been evident since the referendum vote, adding to a slowdown identified by the IMF prior to the vote in property transactions and prompting the Bank of England at its July 2016 rate-setting meeting to signal monetary easing later in the summer. For rEU, some adverse effects are already surfacing, not least the extent of the pressure on Italian banks. It could be argued that their problem of non-performing loans was always going to have to be confronted and that it has little to do with the pro-Brexit vote. However, the erosion of confidence associated with the uncertainty about what happens next manifestly has not helped.

Paradoxes abound in the Brexit decision. A first is the general agreement that the UK economy has recovered better than most from the great recession in 2008, despite being so closely tied to the EU. In addition, the UK economy has achieved something of a turnaround since joining in 1973, with the implication that membership has been good for the economy, although a standard retort from the 'leave' side is that the success of the British economy is due not to EU membership, but to the extensive supply-side reforms of the Thatcher era.

Second, the EU has, in several respects shifted its preferences very much towards those of Britain and, to their dismay, away from those of countries like France. The single market, better regulation and a global outlook are all watchwords for what Britain wants, and federal ambitions have waned, making it all the more odd that this country has chosen to leave now. A further paradox is that areas which have benefitted from EU membership – including the parts of Wales and England in receipt of the highest flows from EU Cohesion Policy – have proved to be hostile.

Yet another paradox is that hostility to migrants – one of the key themes of the 'leave' campaign – is not well correlated with where migrants are concentrated. London, with a high migrant share, voted strongly to remain, while many parts of *l'angleterre profonde* where there are few migrants voted to leave. Equally, in certain localities where low-skilled migrants are numerous, such as Boston in the East English county of Lincolnshire, opposition to migrants was a critical reason for high votes to leave. The explanation can be simply stated: migrants crowd-out locals in accessing public services and are blamed for depressing wages at the bottom end of the wage distribution. These phenomena are strong negatives for those who see themselves as losers from globalisation/economic integration.

For the EU as a whole, constitutional and political issues arise as a result of the UK decision, as well as the direct economic consequences. The challenge can be framed in stark terms: will Brexit be the catalyst for an unravelling of the European integration project, or, with the removal of a member that has long been the awkward partner, an opportunity to move forwards. In this regard, an underlying question is whether it is time to move on from the old debate between more or less Europe. Jean-Claude Juncker, in his 2015 state of the union speech,[13] remarked that "our European Union is not in a good state". He went on to say, somewhat delphically, "there is not enough Europe in this Union. And there is not enough Union in this Union".

In some domains, he is correct: for the Eurozone to function effectively, it will require increased integration, notably in relation to many of the proposals for fiscal and political union raised in the Five Presidents' Report. Thus far, these plans have been side-lined and discordant views are being expressed by Europe's two presidents (Juncker and Tusk), as well as national leaders about the wisdom of new integrative steps. A further paradox is, though, that they will have to be confronted before long if the EMU is to be completed. However, in other respects, the 'federal Europe' project was yesterday's and it is more probable that the Union of the future will increasingly take the form of differentiated integration (Schimmelfennig and Winzen 2014). This may be the true legacy of Brexit.

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[13] http://ec.europa.eu/news/2015/09/20150909_2_en.htm.

Brexit: The Economic Impact – A Survey

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Introduction

The results of the British referendum in favour of a Brexit have left the British public in dire need of reliable insights into the economic impact of this historical caesura. In the short term, higher uncertainty has already dented investor and consumer sentiment and has also led to a significant fall in the British pound. As far as the impact in the longer term is concerned, the Brexiteers allege that a Brexit will benefit Britain while 'Remain'-campaigners have warned of considerable economic damage. Such diverging forecasts call for sound economic research to clarify the net effects of a Brexit.

Many analyses attempt to quantify the longer-term economic effects of a Brexit (or of EU membership) for Britain. The results range from significant advantages to marked losses. At one extreme, estimates suggest that Britain would be roughly 11.5 percent of GDP worse-off due to EU membership and would thus benefit from a Brexit to this degree (Congdon 2014). The other extreme is covered by studies that estimate the possible benefits of the Brirain's EU membership to be in the range of 20 percent (GDP per capita) or higher (Henrekson *et al.* 1997; Badinger 2005; Campos *et al*. 2015). Britain stands to lose a sizeable amount of these benefits in the case of a Brexit. Results of up to 30 percentage points certainly appear dissatisfactory and call for a deeper comparative analysis.

With a thorough survey (Busch and Matthes 2016b), we rise to this challenge. Our study portrays the various economic effects of a Brexit in a qualitative way and provides a systematic overview of the main studies (published prior to early April 2016). We distinguish between theory-based forward looking *(ex ante)* studies (many, but not all of which are based on our own models) and backward looking *(ex post)* studies. Overall, our comparison shows that the diverging results can be explained by significantly different methods and assumptions, as well as a varying coverage of effects.

Only moderate and manageable effects!?

A sound basis for summarising conclusions is only provided by studies that include the positive and the negative effects of a Brexit. On the positive side, fiscal savings due to the (partial) elimination of EU contributions are possible. In addition, lower economic distortions could be effected because Britain could lower external EU trade barriers and withdraw from the Common Agricultural Policy (CAP) in case of a Brexit. On the negative side, there will be losses due to reduced trade integration. These disadvantages will be augmented by future losses from foregone new EU trade agreements and from foregone reductions in non-tariff barriers in the Internal Market. Our overview portrays the various effects covered (or not covered) by each study. It shows that no forward-looking study covers all relevant aspects at the same time in sufficient detail.

Based on those *ex ante* model-based studies that are considered relatively reliable and comprehensive,[1] a certain consensus seems to have emerged. Firstly, the disadvantages of a Brexit resulting from poorer economic integration appear to outweigh the economic advantages. This is a result of most pertinent *ex ante* models. However, the size of net costs is considered to be only moderate. Several reviews come to similar (mainstream) conclusions that the net economic costs of a Brexit should lie in the lower single digit range of between 1 and mostly significantly below 5 percent of GDP in the longer term (e.g. CEBR 2015; CBI 2013).

* Cologne Institute for Economic Research. This article is based on Busch and Matthes (2016b); short articles summarising the study's results have appeared in two blogs (Busch and Matthes, 2016c; Busch and Matthes 2016e) and a British journal directed at the global (financial) business community (Busch and Matthes 2016d).

[1] See e.g. Ottaviano *et al.* (2014a and 2014b); Open Europe (2015); Aichele and Felbermayr (2015); Dhingra *et al.* (2016) for CGE trade models, and Pain and Young (2004); PwC (2016); Oxford Economics (2016) for general CGE macroeconomic models.

Thus, from this point of view, the economic effects of a Brexit seem manageable and the decision to leave the EU appears to be mainly a political consideration related to sovereignty and self-determination.

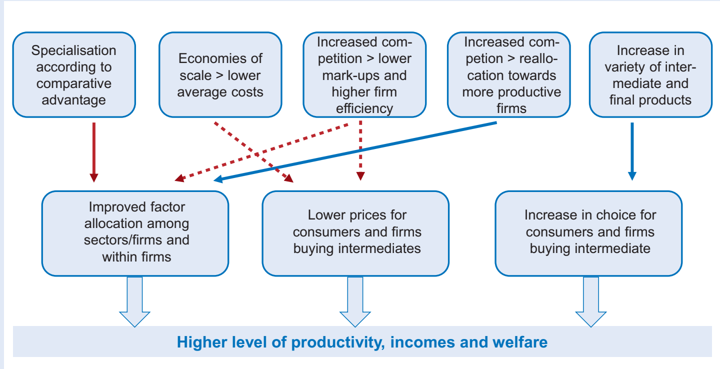
Doubts and warnings

We raise serious doubts about this mainstream conclusion, as there are important shortcomings in the mainstream methods that are likely to conceal significantly higher risks. Even the more reliable forward-looking model-based studies are unable to cover all relevant channels by which economic integration raises welfare. Figures 1 to 3 provide an overview of the effects that are hardly covered: positive static and dynamic trade effects on welfare and growth, as well as the additional non-trade effects of economic integration. More specifically, the positive effects from higher competition on innovation and on firm selection induced by more trade and FDI are hardly covered. We thoroughly take stock of the substantial theoretic and empirical support for these additional welfare and growth effects (for details and citations of a selection of the relevant literature, see Busch and Matthes 2016b). In doing so, we point out, however, that the available empirical evidence concerns only each individual effect, and barely focuses on European integration or the case of a Brexit.

Unfortunately, there is no universally accepted theory-based *ex ante* estimation method available to integrate all of these specific effects in a comprehensive way. Going beyond the available for-

Figure 1

Selected static effects of trade on welfare levels

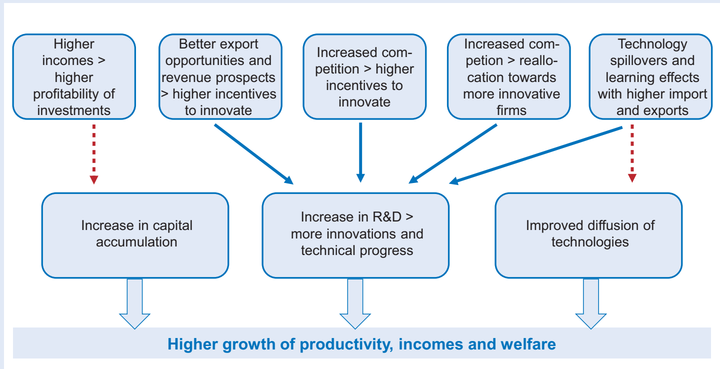


Note: (1) Red arrow: effect covered in most *ex ante* CGE and NQTM trade models (not in non-trade CGE models for UK); (2) Dotted red arrow: effect covered in at least one, but only a few *ex ante* models; these models only cover selected effects; (3) Blue arrow: effect not covered in *ex ante* models.

Source: Authors' conception.

Figure 2

Selected dynamic effects of trade on growth

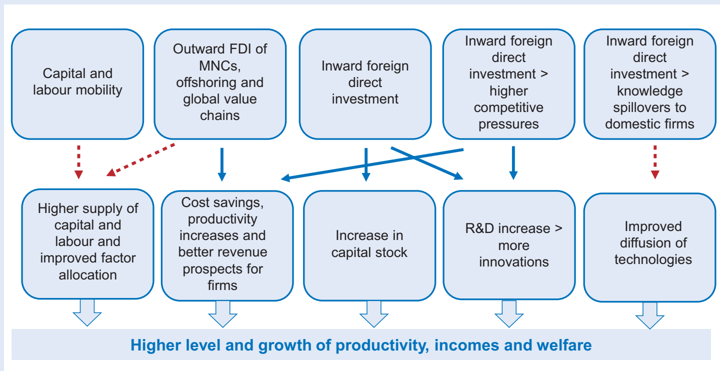


Note: (1) Dotted red arrow: effect covered in at least one, but only a few *ex ante* models; these models only cover selected effects; (2) Blue arrow: effect not covered in *ex ante* models.

Source: Authors' conception.

Figure 3

Selected effects of non-trade economic integration



Note: (1) Dotted rot arrow: effect covered in at least one, but only a few *ex ante* models; these models only cover selected effects; (2) Blue arrow: effect not covered in *ex ante* models.

Source: Authors' conception.

ward-looking methods towards *ex post* analyses implies moving onto somewhat less solid ground. Nevertheless, we consider it necessary to also include the results from these studies in order to come closer to an objective and realistic view. We therefore present several backward-looking studies that use existing data. These studies attempt to quantify the comprehensive welfare effects of EU integration or of a Brexit. However, they are only able to do so in an implicit and less theoretically explicit way. All of these attempts can be criticised to some extent, because it is notoriously difficult to ascribe welfare effects to EU integration, as many other factors influence welfare at the same time. However, the overall take on backward looking studies suggests that a Brexit could cause a significantly worse economic impact in a more pessimistic scenario than the mainstream conclusions indicate.

Results from backward-looking studies

Trade effects of economic integration tend to be underestimated by theoretical forward-looking trade models. In fact, *ex post* studies tend to find significantly larger trade effects of trade agreements than *ex ante* models, such as CGE models (Rosa and Gilbert 2005; Baier *et al.* 2008; Pelkmans *et al.* 2014). Recently developed methods tend to increase this divergence. A relatively new strand of the literature argues that traditional gravity models – the workhorse for *ex post* analysis of trade agreements – also tend to underestimate trade outcomes (Baier and Bergstrand 2007; Egger *et al.* 2011). A more modern gravity approach finds significantly larger results. For example, Baier *et al.* (2008) estimate that membership of the EU (and of its institutional predecessors) has increased trade between members by 100 to 125 percent over a 15-year period alone.

Based on these insights, Busch and Matthes (2016b) describe three strands of backward-looking studies that attempt to quantify income or growth effects in a more encompassing (but necessarily only implicit) way:

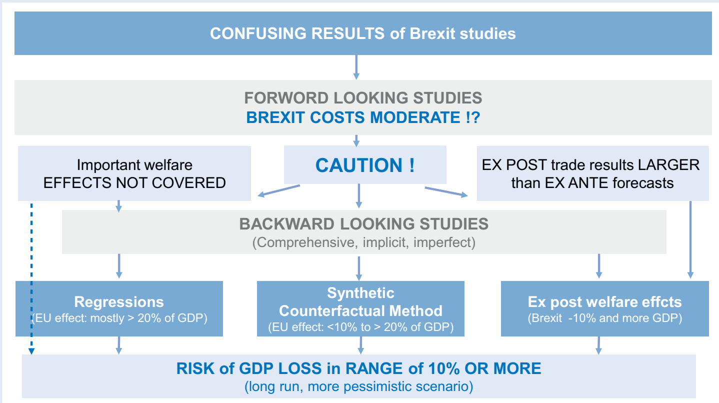
- Using recent forecasts of the negative effects of a Brexit on bilateral trade between Britain and the EU, the induced income decline can be quantified in a tentative way. Based on a general *trade-income-relationship* calculated by recent thorough studies, three studies estimate that Britain's incomes could possibly decline by around 10 percent or more in a more pessimistic scenario (Ottaviano *et al.* 2014a and 2014b; Aichele and Felbermayr 2015; Crafts 2015). An important shortcoming of these attempts lies in the fact that the trade-income relationship could not be tailored specifically to Britain.
- Several studies employ r*egression analyses* (Henrekson *et al.* 1997; Badinger 2005; Crespo Cuaresma *et al.* 2008). Even although the results differ in their details, these studies identify the sizeable effects of EU membership on the level of GDP in the long term – mostly in the range of 20 percent or more. However, some uncertainties remain, as the results are in part not completely robust and as growth regressions are notoriously difficult to make watertight.
- Campos *et al.* (2014 and 2015) apply a relatively new *synthetic counterfactual method* (SCM), which was developed by Abadie and Gardeazabal (2003). Mimicking the approach of clinical studies, the authors construct an artificial synthetic control group by selecting countries with a similar economic performance to Britain over a longer time before EU accession in 1973 (pre-treatment period). The effect of EU membership (treatment) can be deduced from the difference between the economic outcome for Britain and that for the control group. Campos *et al.* (2015) estimate that in the long run (between EU accession of Britain up to 2008), real GDP per capita in Britain is nearly 24 percent higher than in the synthetic control group. However, this result is not very robust. Focusing on the findings of various robustness checks on productivity increases over a ten year horizon, the respective results lie in the higher single digit range (up to 10 percent). This is still a substantial result, particularly when taking into consideration that benefits may increase further over time.

Summary of the potential net costs of a Brexit

Figure 4 provides an overview of our approach. Based on this approach, we warn that – in a more pessimistic scenario – the risk of Britain sustaining GDP losses in the broad range of 10 percent or more cannot be ruled out in the long run in the case of a Brexit. Such negative effects would be significantly higher than suggested by the moderate net costs estimated by the mainstream studies.

Figure 4

Approaches of the survey of existing studies on a Brexit



Source: Authors' conception.

Economic relations to the EU and the impact of a Brexit

The key question arises of whether a more pessimistic scenario is likely. This will depend on legal basis upon which Britain will continue to do business with the EU and with the rest of the world after a Brexit. Different scenarios that will be outlined below should be compared to the current economic relations between Britain and the EU.

In fact, the EU is the main trading partner for the British economy – it is the destination for around 45 percent of all British exports of goods and around 38 percent of total exported British services. While Britain has a significant deficit in goods trade with the EU, it obtains a sizeable bilateral surplus in services trade. Around half of all service exports to the EU are accounted for by financial and other business services. The reliance on service exports renders Britain vulnerable to a loss of access to the internal market of the EU.

Looking solely at the trade shares with the EU, the importance of membership in the EU is underestimated. Around 60 percent of Britain's external trade is with countries either in the EU or with an EU trade agreement (TheCityUK 2014). This share will rise to around 85 percent if current EU trade negotiations are successful. In the case of a Brexit, trade relations with third countries could be negatively affected, as existing trade agreements would no longer be applicable until they were renegotiated.

Depending on the institutional arrangement between Britain and the EU, a Brexit would imply higher EU trade barriers. Trade transaction costs would rise and customs clearance requirements would lead to delays for British firms exporting to the EU. Thus, EU companies could be inclined to cut British firms out of their (just-in-time) cross border value chains due to higher trade costs and time delays. Moreover, Britain would partially lose access to the EU internal market, which would particularly affect the freedom to provide services and the right of establishment in the EU. Higher EU trade barriers could also induce British and foreign companies to shift jobs from Britain to the continent. Britain (and in particular the City of London) could suffer from relocations, as especially US companies use this country as a bridgehead for the EU, which would be far more complicated after a Brexit. Moreover, trading in euro-denominated financial transactions is likely to be relocated from London towards the euro area (i.e. to Frankfurt, Paris or Dublin).

Different models for economic integration with the EU after a Brexit

After withdrawal, alternative bilateral institutional arrangements are possible between Britain and the EU. Four options are briefly discussed here (Booth and Howarth 2012; CBI 2013; Etzold 2013; House of Commons 2013; House of Commons Foreign Affairs Committee 2013). Table 1 provides an overview of these options.

As members of the EFTA (European Free Trade Association), Norway, Iceland and Liechtenstein are also members of the EEA and are thus part of the EU's internal market. The EEA is an in-depth free trade area between the EU and has expanded the internal market to these three countries. It guarantees the free movement of goods, persons, services and capital. However, participation in the internal market is not free. The EEA countries are bound by the internal market rules of the EU, but they have no real say in the making of these rules (Booth and Howarth 2012). In addition, the EEA countries have no influence in the European Parliament. According to a re-

Table 1

Possible alternatives to EU membership and their consequences

		Norway (EEA)	Switzerland	Turkey	WTO
Disadvantages of a Brexit for UK					
Loss of access to the single market	No tariffs / free movement of goods	No	Largely	Largely	Yes
	Free movement of persons	No	Largely	Yes	Yes
	Free movement of capital	No	Yes	Yes	Yes
	Free movement of services	No	Partially	Yes	Yes
Renegotiation of FTAs		Yes	Yes	Yes	Yes
Loss of decision making rights in the EU		Very largely	Yes	Yes	Yes
Advantages of a Brexit for UK					
Avoidance of EU protectionism		Possible	Possible	No	Possible
Avoidance of compliance with EU-regulations		Very limited	Limited	Partially	Yes
Avoidance of financial contributions to the EU		Very limited	Limited	Yes	Yes

Source: House of Commons, 2013; Cologne Institute for Economic Research.

port by the Norwegian government, Norway has adopted over 75 percent of all EU laws (ONR 2012).

For Britain, an EEA agreement would mean that it has to maintain social and employment regulations such as the working time directive (CBI 2013), as this area of policy is also part of internal market regulations. Moreover, the country would remain bound by the regulations of the EU financial markets if the City of London were to be allowed free movement of capital in the EU. What is more, the free movement of persons would still apply and Britain would have to continue to finance the EU budget to a sizeable degree (Busch and Matthes 2016b). All in all, the country would have to maintain those arrangements that are seen particularly critically – without the ability and scope to participate in shaping them. Thus, Britain would have to give up even more of its sovereignty if it decided to go for the Norwegian option. Another disadvantage concerns higher trade costs. The EEA is not a customs union. Therefore, rules of origin on goods traded with third countries would have to be complied with and customs procedures are required for trade between Britain and the EU (Oppermann 2009; House of Commons 2013; House of Commons Foreign Affairs Committee 2013).

Switzerland's relationship with the EU is regulated by the free trade agreement of 1972 and a number of sectoral bilateral agreements: Bilateral Agreements I and Bilateral Agreements II. The subjects of Bilateral Agreements I are primarily liberalization and market opening. With Bilateral Agreements II, economic cooperation has been strengthened and extended to cover further areas (Swiss Confederation 2015). Around 120 bilateral agreements and amendments with the EU are in force, of which 20 are crucial to relations. Overall, the level of EU integration in the case of Switzerland is well below the level that the EEA has reached with the EU (Tobler *et al.* 2010). In particular, a comprehensive agreement between the EU and Switzerland could not be reached with regard to the free movement of services.

Such a situation could prove to be disadvantageous for Britain due to its particular strength in the service sector. With special regard to financial services, there is only one small bilateral agreement between Switzerland and the EU, i.e. on non-life insurance. Swiss banks cannot generally access the internal market for financial services, as the EU obtains regulatory barriers to entry *via* third countries, particularly for cross border service delivery (Booth and Howarth 2012). Therefore, Britain would probably want to negotiate a broader service agreement with the EU focusing on financial and business services. However, as an 'applicant' its negotiating position does not appear very strong. Moreover, Switzerland contributes financially to the EU's cohesion policy.

One advantage of the Swiss option for Britain might be that it would no longer have to comply with the EU social and employment regulations and would not be included in the CAP and regional policy. All in all, the Swiss option is not very popular in the EU. Migration issues pose a serious problem: Switzerland's relations with the EU suffered after the Swiss voted in a referendum (February 2014) against the free movement of persons. It is thus highly questionable whether the EU is willing to accept a similar relationship with Britain.

Since 1996, the EU and Turkey have formed a customs union, which includes the tariff-free movement of manufactured goods and processed agricultural products. Other agricultural products, as well as coal and steel products, are not included. Rules of origin are not required (Booth and Howarth 2012). Compared to the EEA, the institutional arrangements with Turkey include significantly less far-reaching rules on the freedom of persons and services (Tobler *et al.* 2010). Turkey is outside the full internal market (House of Commons Foreign Affairs Committee 2013). The country does not contribute to the EU budget.

The Turkish option can be characterised as a privileged partnership. An important advantage for Britain would be that the free movement of goods could still be maintained. However, the free movement of services, capital and persons is not included in the Turkish option. While this would offer the possibility of restricting immigration from the EU, Britain's service sectors, and especially its financial industry, would be excluded from the internal market of the EU. To tackle this substantial drawback, Britain would have to negotiate an agreement on the freedom of services and capital with the EU, in addition to the customs union.

All in all, it appears doubtful whether economic relations between Britain and the EU would be sufficiently structured with a customs union. Duties have decreased in importance and non-tariff barriers are all the more important. Thus a lack of access to the internal market weighs heavily in many respects. This is all the more relevant, because in contrast to Turkey, the British service sector is much more important. However, a customs union agreement does not cover the service sector. It is also questionable to some degree whether the EU would accept a customs union as an option for an exit; the customs union with Turkey was certainly intended as a precursor for eventual membership (CBI 2013).

Britain's membership of the World Trade Organisation (WTO) would remain as a fall-back position in the case of a withdrawal from the EU. WTO membership offers only limited access to the EU market based on Most Favourite Nation (MFN) treatment. This means that the country's market access is granted under the same rules and conditions as that of all other WTO members without preferential trade agreements with the EU. However, the MFN principle ensures that Britain could not be charged higher tariffs than those imposed on the same product imported from another WTO member state (CEPR 2013).

British companies would have to pay the EU import tariffs if they wanted to export to the EU. While the average EU external tariffs are relatively low at around 4.2 percent, 90 percent of British export values in the EU would be affected by duties (House of Commons 2013). For some products, EU tariff rates are significantly higher: 10 percent for passenger cars and as much as 15 percent for food products (Springford *et al.* 2014).

Moreover, British exporters would have to comply with new non-tariff barriers due to the limited access for goods to the internal market. The other freedoms of the internal market would also be affected. The GATS of the WTO only allows a much lower degree of market access than the rules of the internal market (CBI 2013). More specifically, British companies would no longer have an automatic right of establishment in a member state of the EU. Moreover, an end to the freedom of movement for persons would hinder both the British citizen and British companies that do business with the European mainland. New rules would also apply to trade with third countries, as Britain would have to renegotiate existing FTAs.

Moreover the conditions of Britain's membership in the WTO would have to be renegotiated, as the Director-General of the Organization recently declared (Azevedo 2016; FT 2016). Britain has to re-establish its commitments with the WTO. A deal would be necessary, *inter alia*, on the customs duties imposed on goods, quotas in the agricultural sector or subsidies to British farmers. As there is no blueprint, these negotiations could take several years to be completed.

On the positive side, Britain would regain full regulatory sovereignty with regard to the competences that are now communal at the EU level and that have been criticised as an unnecessary burden for the country. Moreover, British payments to the EU budget would be brought to an end. The fall-back position of WTO membership could be considered if it proved impossible to negotiate an agreement with the EU within the two-year period of the TEU.

Dangerous misconceptions

Contrary to suggestions by Brexiteers, Britain would not be able to optimally balance the advantages and disadvantages of a Brexit. It undoubtedly has some freedom to construct a tailor-made solution in the form of a more or less comprehensive preferential trade agreement. However, even with a tailor-made solution, an important trade-off cannot be evaded: the higher the degree of integration between both sides (and the better the market access for British firms to the EU market), the less the perceived burden of EU regulations, migration and financial contributions would be alleviated and the less regulatory sovereignty could be regained by Britain. This clearly shows that in the pre-referendum debate, the Brexiteers dishonestly promised British citizens that they could have their cake and eat it at the same time.

Additional misconceptions have to be highlighted:

- The Brexiteers suggested that the negotiating position of Britain would be not bad due to its merchandise trade balance deficit with the EU and based on the expectation that the EU would want to maintain good political relations. This optimism may be misleading: Britain would probably be in a defensive position, because it would rely far more heavily on access to the much larger EU market than *vice versa.* Moreover, the EU is not likely to offer generous conditions for market access, as this precedent could invite other members to withdraw from the EU. The recent signals from Brussels and several EU capitals have been clear in this respect: 'cherry picking' will not be possible for Britain.
- The proponents of a Brexit often argue that Britain can liberalise its trade policy *vis à vis* third countries to the benefit of British consumers and that, at the same time, it can secure attractive market access conditions in these countries for British firms. However, this might appear overly optimistic, because Britain is only able to offer a significantly smaller market than the EU and would be in a defensive position. Moreover, Britain also faces a certain dilemma: in order to reap the welfare benefits of free trade, Britain would have to unilaterally reduce its trade barriers sooner rather than later. Yet, if it does so, it loses important bargaining chips that are necessary to obtain significant market access in the 'give and take' of bilateral trade negotiations.

In view of these considerations, a more pessimistic future integration scenario does not seem implausible. We therefore reiterate our warning of sizeable net economic long term costs to Britain.

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Historical Ifo Business Cycle Data

Vera Sommer and Klaus Wohlrabe*

The Ifo business climate is one of the most important indices for German business cycle analysis. The Ifo institute has been publishing results of the Ifo Business Survey – Ifo Konjunkturumfragen (Konjunkturtest) – for more than 60 years: for manufacturing since 1949, for retailing and wholesaling since 1950, and for construction since 1956. Yet, results of the first surveys are often not digitised. At the moment, some providers are offering data for Germany from 1991 onward. For an analysis of historical (business cycle) data, however, it would be helpful to have longer time-series at hand. The latter could also be used as a proxy for missing official data, like for instance production or sales figures.

Based on past publications of the Ifo Schnelldienst and of the Ifo Konjunkturperspektiven, historical time-series have been digitised. They are now available as tables in Excel-format. Data from 1957 to 1973 relies on publications in the respective Ifo-Schnelldienst. From 1974 on, monthly values are reported in the Ifo publication Wirtschaftskonjunktur (Konjunkturperspektiven).

Table 1 lists the availabilities of the data for the different economic sectors. Monthly data since January 1962 on business situation and expectations for manufacturing (without food and beverages industry) is now accessible. For retailing and wholesaling as well as for their food and beverages sector, monthly data on business situation and expectations goes back to January 1960 and January 1962, respectively. Moreover, quarterly data on the business situation in retailing and wholesaling is provided for the time between 1957 and 1959. The time-series of the business situation for construction starts in January 1960, the series of the business expectations starts in January 1963. The Ifo business climate was developed in the 1970s. Therefore, it was calculated retrospectively for the time-series. All values refer to West Germany.

The time-series are original series, i.e. they are not seasonally adjusted.[1] Moreover, when analysing the time-series up to recent data, one should take possible structural changes due to NACE revisions into account. Rarely, values in different Ifo publications were non-concordant. In this case, the mean of the values were taken.

The data can be requested from umfragedaten@ifo.de.

* Ifo Institute.

[1] When adjusting for seasonal effects, the seasonal adjustment procedure should be applied first to the business situation and business expectations series. Then, the Ifo business climate should be calculated based on these values.

Table 1

Overview over availabilities of historical time-series for economic sectors

		Business situation	Business expectations	Business climate
Construction		01/1960–06/2008	01/1963–06/2008	01/1963–06/2008
Retailing		01/1960–01/2006 1957–59 quarterly	01/1960 –01/2006	01/1960–01/2006
	Food and beverages industry	01/1962–11/1990	01/1962–11/1990	01/1962–11/1990
Wholesaling		01/1960–01/2006 1957–59 quarterly	01/1960– 01/2006	01/1960–01/2006
	Food and beverages industry	01/1962–11/1990	01/1962–11/1990	01/1962–1/1990
Manufacturing		01/1962–06/2008	01/1962–06/2008	01/1962–06/2008

Source: Ifo Institute.

World Economic Growth Outlook for 2016 and 2017

Chang Woon Nam*

According to the IMF's latest World Economic Outlook published in April 2016,[1] the global recovery appears to be continuing, albeit rather slowly. The baseline projection for global growth in 2016 is a modest 3.2 percent, broadly in line with last year, and the recovery is expected to gather strengthen slightly in 2017 and in the future (see Table 1).

* Ifo Institute.

[1] IMF (2016), *World Economic Outlook,* April, Washington DC, available at: http://www.imf.org/external/pubs/ft/weo/2016/01/pdf/text.pdf.

Table 1

IMF's World Economic Growth Projections 2016–2017 (%)

		Projections	
	2015	2016	2017
World output	3.1	3.2	3.5
Advanced economies	1.9	1.9	2.0
United States	2.4	2.4	2.5
Euro area	1.6	1.5	1.6
Germany	1.5	1.5	1.6
France	1.1	1.1	1.3
Italy	0.8	1.0	1.1
Spain	3.2	2.6	2.3
Japan	0.5	0.5	– 0.1
UK	2.2	1.9	2.2
Canada	1.2	1.5	1.9
Other advanced economies	2.0	2.1	2.4
Emerging market and developing economies	4.0	4.1	4.6
Commonwealth of Independent States	– 2.8	– 1.1	1.3
Russia	– 3.7	– 1.8	0.8
Excluding Russia	– 0.6	0.9	2.3
Emerging and developing Asia	6.6	6.4	6.3
China	6.9	6.5	6.2
India	7.3	7.5	7.5
Asean5 (Indonesia, Malaysia, Philippines, Thailand, Vietnam)	4.7	4.8	5.1
Emerging and developing Europe	3.5	3.5	3.3
Latin America and the Caribbean	– 0.1	– 0.5	1.5
Brazil	– 3.8	– 3.8	0.0
Mexico	2.5	2.4	2.6
Middle East, North Africa, Afghanistan and Pakistan	2.5	3.1	3.5
Saudi Arabia	3.4	1.2	1.9
Sub-Saharan Africa	3.4	3.0	4.0
Nigeria	2.7	2.3	3.5
South Africa	1.3	0.6	1.2

Source: IMF (2016), World Economic Outlook, April.

While growth in emerging market and developing economies accounts for the major share of forecast world economic growth in 2016 (4.0 percent), prospects across the countries in this group remain heterogeneous, partly for the following reasons:

- Large emerging countries like Brazil and Russia are still suffering from deep recessions.
- Several oil-exporting countries face sharply weaker terms of trade and tighter external financial conditions.
- Trade growth in China and India has slowed down noticeably.[2]

Growth in advanced economies will remain modest and comparable to the rates seen in 2015. Unfavourable demographic trends, low productivity growth, and the slow recovery of some EU nations from the global financial crisis (as well as their large debt overhang) seem to continuously curb economic activity in these countries. While expansive monetary policy and lower oil prices will generally stimulate domestic demand, persistent weak external demand and exchange rate revaluation (particularly in the United States) will negatively affect the recovery.

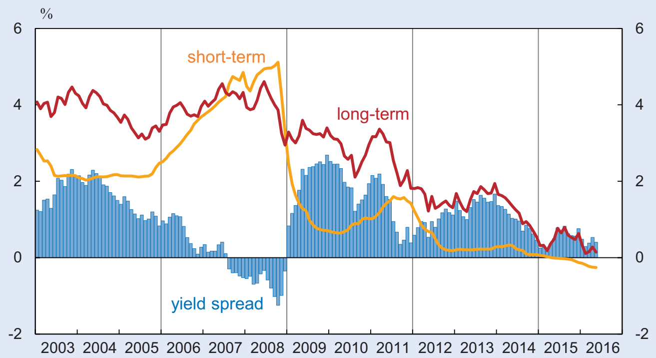
The slight increase in economic growth projected in 2017 (3.5 percent) can also mainly be attributed to the strong economic performance foreseen in emerging markets and developing economies. Yet one should bear in mind that this 2017 outlook is computed under the following assumptions:

[2] The slowdown of trade is related to the decline in investment growth across emerging market economies, which reflects rebalancing in China but also the sharp reduction of investment in commodity exporters, particularly those with difficult macroeconomic conditions.

- A gradual normalization of conditions in several economies currently under stress,
- A successful rebalancing of China's economy with trend growth rates which remain high,
- An improvement in economic activity in commodity exporters in general, and
- Resilient growth in other emerging market and developing economies.

FINANCIAL CONDITIONS IN THE EURO AREA

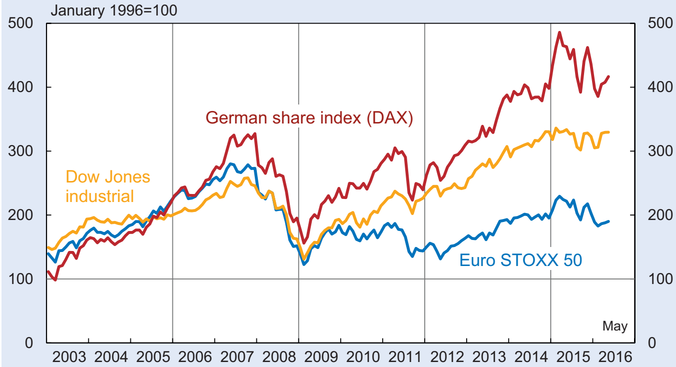
Nominal Interest Rates a)



a) Weighted averages (GDP weights).

Source: European Central Bank.

Stock Market Indices

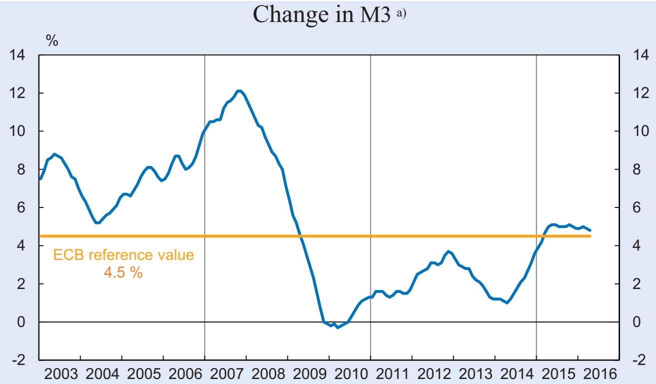


Source: Deutsche Börse; Dow Jones; STOXX; Datastream.

In the three-month period from March 2016 to May 2016 short-term interest rates decreased: the three-month EURIBOR rate declined from – 0.23% in March 2016 to – 0.26% in May 2016. The ten-year bond yields also slightly decreased from 0.16% to 0.15% in the same period. The yield spread reached 0.40% in May 2016, up from 0.38% in March 2016.

The German stock index DAX increased in May 2016, averaging 10,263 points compared to 9,966 points in March 2016. The Euro STOXX also grew from 3,005 to 3,063 in the same period of time. The Dow Jones International increased as well, averaging 17,787 points in May 2016, compared to 17,685 points in March 2016.

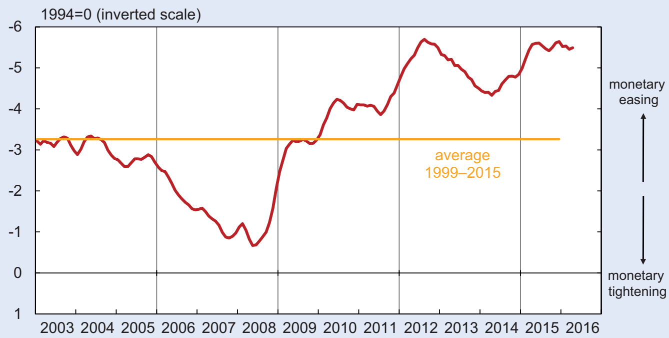
Change in M3 a)



a) Annual percentage change (3-month moving average).

Source: European Central Bank.

Monetary Conditions Index



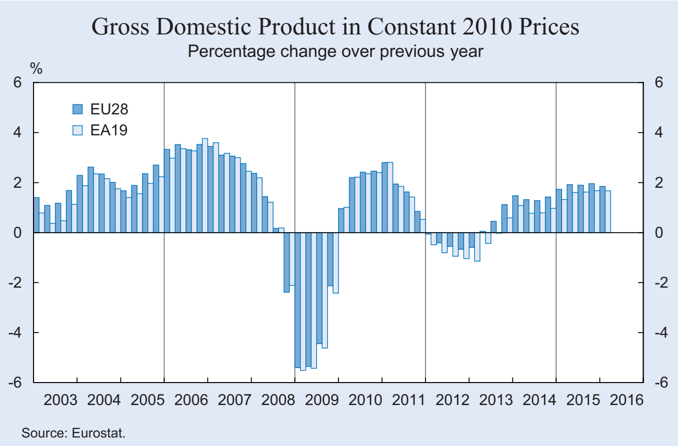
Note: MCI index is calculated as a (smoothed) weighted average of real short-term interest rates (nominal rate minus core inflation rate HCPI) and the real effective exchange rate of the euro.

Source: European Central Bank; calculations by the Ifo Institute.

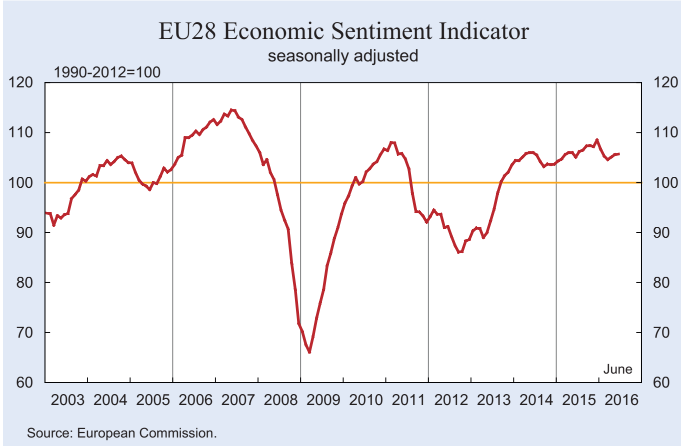
The annual growth rate of M3 increased to 4.9% in May 2016, from 4.6% in April 2016. The three-month average of the annual growth rate of M3 over the period from March 2016 to May 2016 reached 4.8%.

Between April 2010 and July 2011 the monetary conditions index remained rather stable. This index then continued its fast upward trend since August 2011 and reached its peak in July 2012, signalling greater monetary easing. In particular, this was the result of decreasing real short-term interest rates. In April 2016 the index started to slightly fall again while such minor fluctuations have been observed in last months.

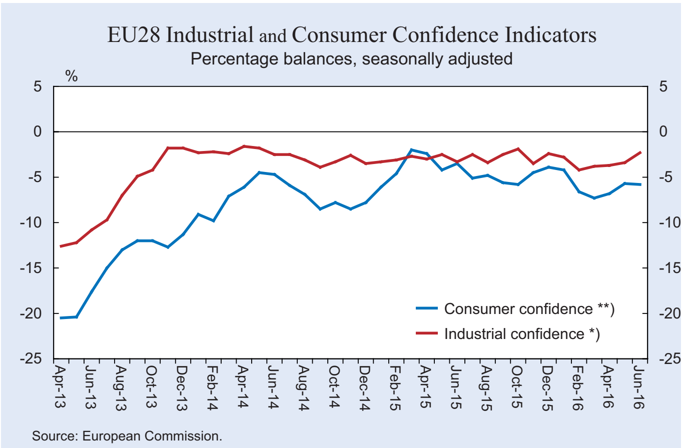
EU SURVEY RESULTS



According to the Eurostat estimates, GDP grew by 0.6% in the euro area (EA19) and by 0.5% in the EU28 during the first quarter of 2016, compared to the previous quarter. In the fourth quarter of 2015 the GDP grew by 0.4% and 0.5% respectively. Compared to the first quarter of 2015, i.e. year over year, seasonally adjusted GDP rose by 1.7% in the EA19 and by 1.8% in the EU28 in the first quarter of 2016.

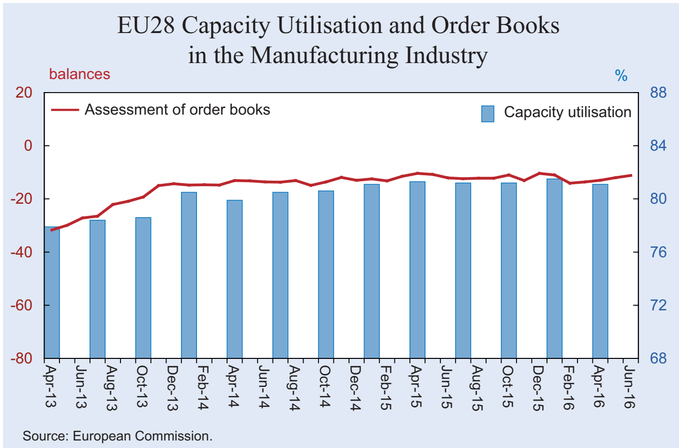


In June 2016 the Economic Sentiment Indicator (ESI) remained broadly unchanged in both the euro area (by – 0.2 points to 104.4) and the EU28 (by + 0.1 points to 105.7). In both the EU28 and the EA19 the ESI stands above its long-term average.



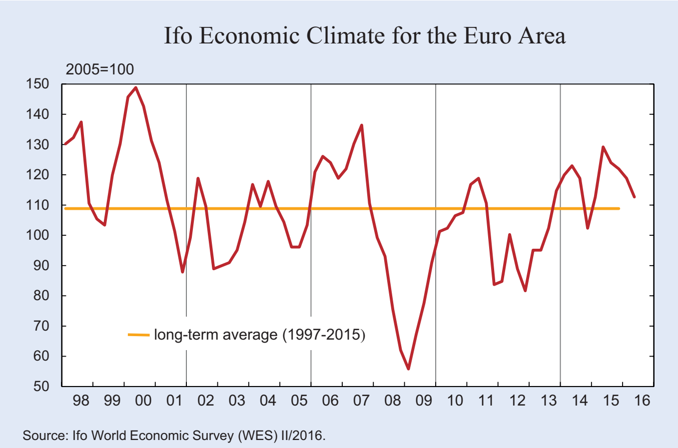
* The industrial confidence indicator is an average of responses (balances) to the questions on production expectations, order-books and stocks (the latter with inverted sign).
** New consumer confidence indicators, calculated as an arithmetic average of the following questions: financial and general economic situation (over the next 12 months), unemployment expectations (over the next 12 months) and savings (over the next 12 months). Seasonally adjusted data.

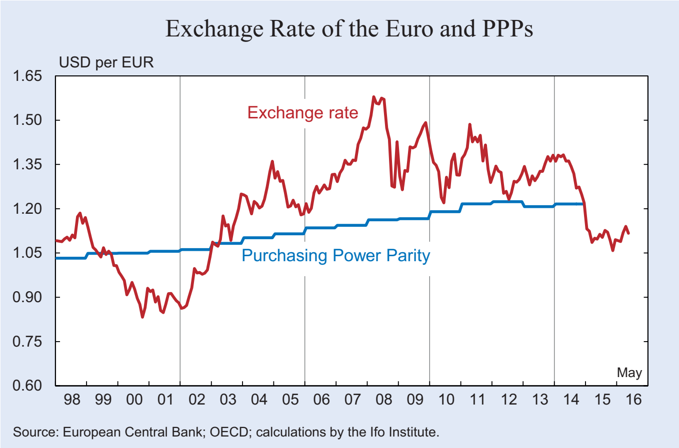
In June 2016, the *industrial confidence indicator* increased by 1.1 in the EU28 and by 0.8 in the euro area (EA19). On the other hand, the *consumer confidence indicator* decreased by 0.1 in the EU28 and by 0.3 in the EA19.



Managers' assessment of *order books* reached – 11.2 in June 2016, compared to – 12.0 in May 2016. In April 2016 the indicator had amounted to – 13.0. *Capacity utilisation* reached 81.1 in the second quarter of 2016, down from 81.5 in the first quarter of 2016.

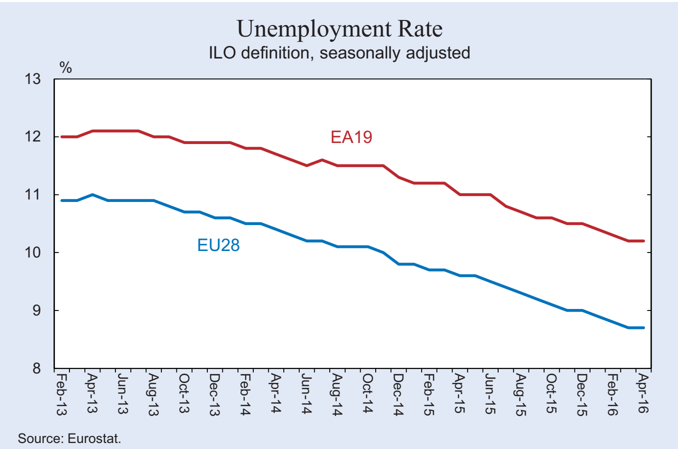
Euro area indicators

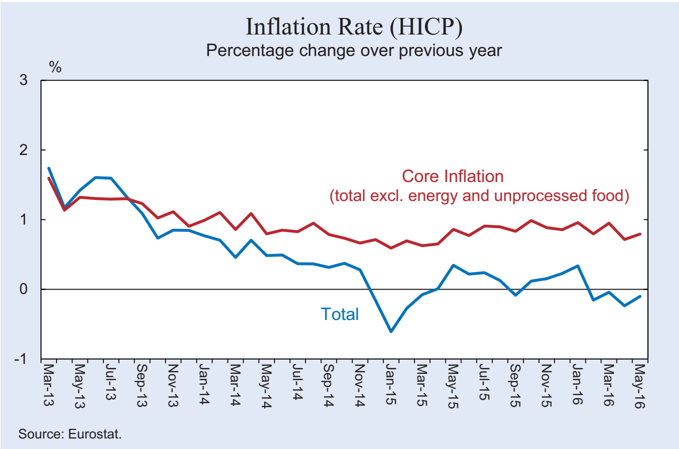




The Ifo Economic Climate Indicator for the euro area (EA19) continued to fall, declining from 118.9 points to 112.7 points in the second quarter of 2016. The index nevertheless remains above its long-term average. The economic climate deteriorated due to both less favourable assessments of the current economic situation and slightly more sceptical business expectations. There are still no signs of a sweeping economic recovery in the euro area.

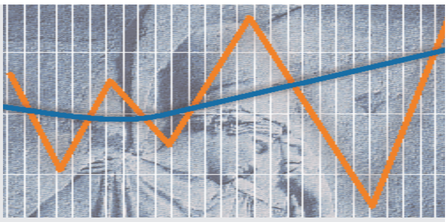
The exchange rate of the euro against the US dollar averaged approximately 1.13 $/€ between March 2016 and May 2016. (In February 2016 the rate had amounted to around 1.09 $/€.)





Euro area (EA19) unemployment (seasonally adjusted) amounted to 10.2% in April 2016, stable compared to that of March 2016. EU28 unemployment rate was 8.7% in April 2016, down from 8.8% in March 2016. In April 2016 the lowest unemployment rate was recorded in the Czech Republic (4.1%), Germany (4.2%) and Malta (4.3%), while the rate was highest in Greece (24.2%) and Spain (20.1%).

Euro area annual inflation (HICP) was – 0.1% in May 2016, up from – 0.2% in April 2016. A year earlier the rate had amounted to 0.3%. Year-on-year EA19 core inflation (excluding energy and unprocessed foods) slightly increased to 0.8% in May 2016, from 0.7% in April 2016.



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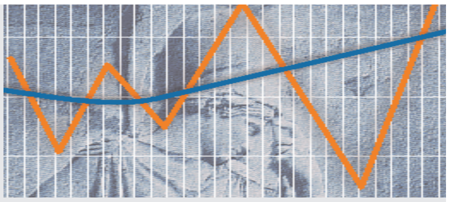

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