

EU-TURKISH CUSTOMS UNION: A REASONABLE ROADMAP

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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

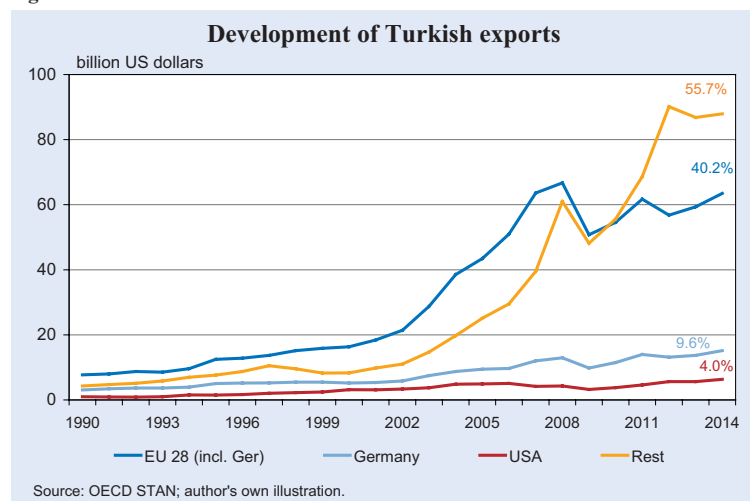
Figures 1 and 2 illustrate the strong growth both in exports and in imports in Turkey since 1996. In particular, German companies use the customs union with Turkey to produce intermediate goods cost-effectively in the country and then re-import them for further processing in Germany. It is therefore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



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

Figure 2

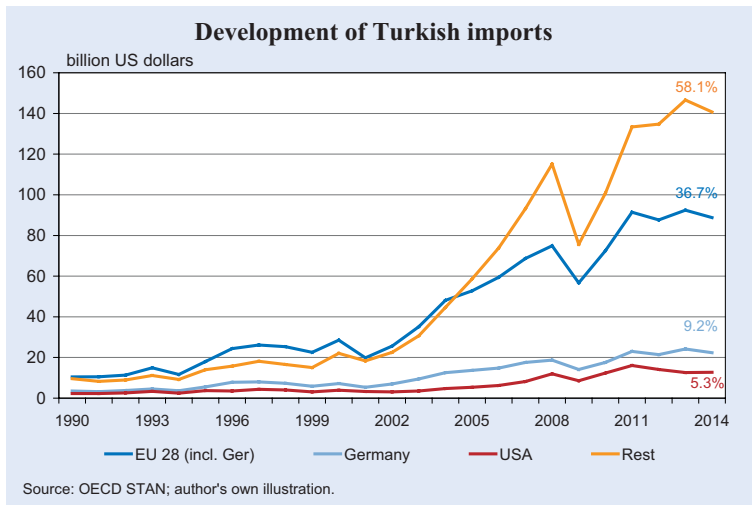


Figure 3

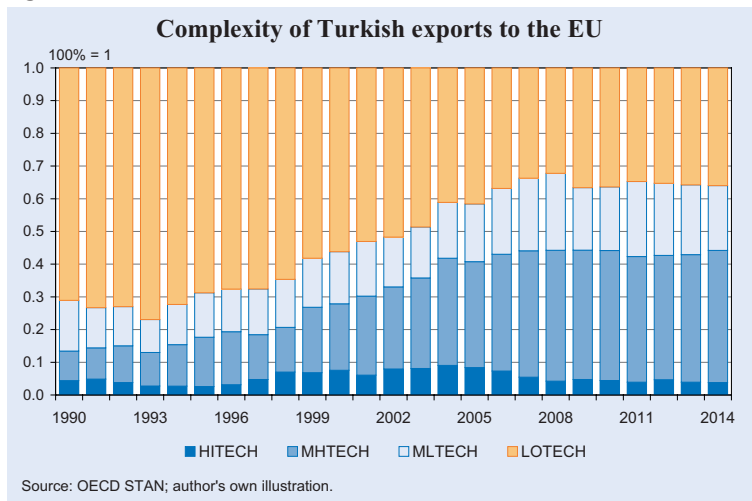
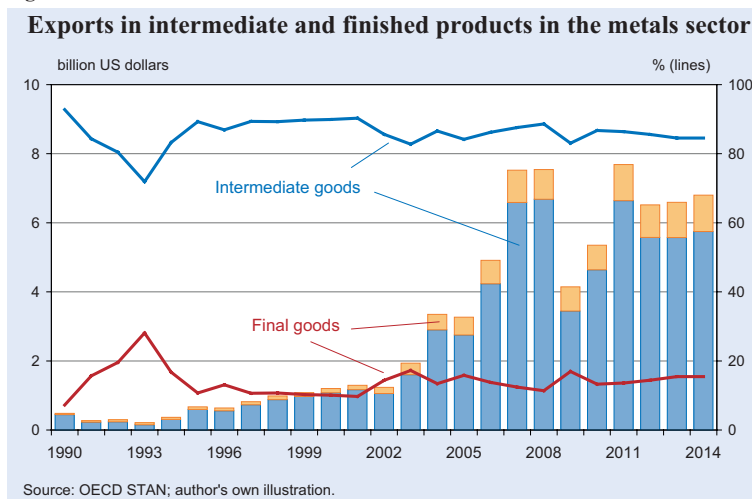


Figure 4



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 compa-

nies 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

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.

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).

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.

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.

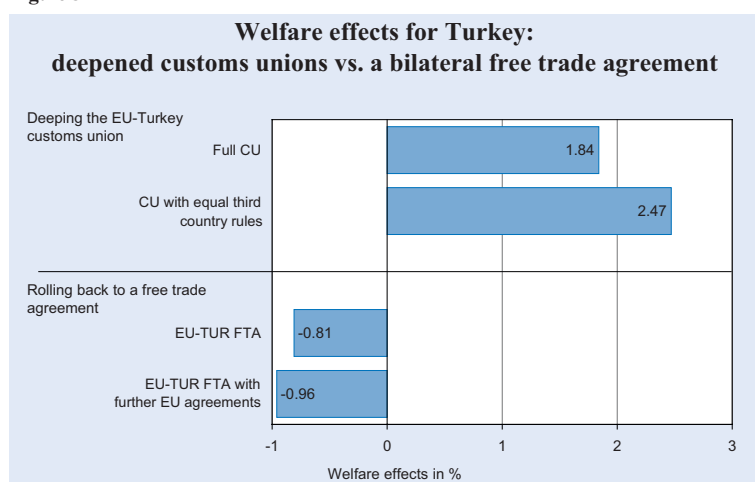
d) A more comprehensive customs union

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.

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.

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 manoeuvre to implement further reforms in the future, in addition to the welfare effects.

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