IS IT TIME TO RECONSIDER THE TURKEY-EU CUSTOMS UNION?

In light of recent analyses on the possible economic impacts of deeper integration between Turkey and the EU, this article examines the Turkey-EU economic relationship through the lens of the changing global context of the past few years. With the change in global trends, geopolitical uncertainties, as well as the impact of COVID-19, EU companies are likely to seek source inputs and equipment closer to home, which means that Turkey needs to be proactive and take advantage of potential opportunities to secure its place as an economic partner of the EU.

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The global trade system as we know it today stems from the early post-war period when liberalization was the new paradigm, and tariffs were progressively slashed under the General Agreement on Tariffs and Trade (GATT), which supported the development of international supply chains and the process of globalization. Global trade received a significant boost in the two decades leading up to the Global Financial Crisis (GFC) of 2008 thanks to technological advances, notably in transportation and communications, and lower trade barriers associated with the opening up of Eastern Europe, the creation of NAFTA, China joining the WTO, and EU expansion.

Since the GFC, we have seen something of a shift in the sands of the globalization trend. There are several reasons for this. First, there have been fewer opportunities to strike new trade agreements. In addition, initial returns to trade diminished as labor costs increased; emerging markets moved up global value chains; and non-tradables, in particular services, retail, trade, and construction, made up a larger share of global activity. We have also seen a global trend toward a more aggressive approach to foreign policy with the increased use of sanctions and tariffs, most notably manifested in the eruption of a trade war between the US and China. The latter has shown how complex supply chains have become as well as the costs associated with interdependence in an era of increased uncertainty.

The emergence of the COVID-19 pandemic in early 2020 further emphasized the challenges associated with globalization, highlighting the excessive concentration of suppliers associated with the development of global supply chains. China is responsible for 20 percent of global production and lies at the heart of many global supply chains. In fact, 300 of the world's top 500 companies have facilities in Hubei's capital, Wuhan—the first province of China hit by COVID-19.

As supply chains have been interrupted, the risks of a zero inventory approach have become clear. The importance of resilience, which comes from both proximity and security, has taken precedence over efficiency for sourcing inputs. It is not just manufacturing; food security concerns, which have been on the agenda of many countries over the past decade, are seen in a fresh light, leading to a new focus on agricultural trade.

Shift in Globalization

As a result of the experiences of the past few years, the face of globalization is changing. Uncertainty has been prompting firms to shorten their supply chains, resulting in the intensification of the regionalization trend that has already been going on since the GFC. Firms are increasingly adjusting their risk assessments of investments in certain countries or industries.

> *"The increasing division of the globe into regional trading blocs raises questions about the relationship between the EU and its neighbors."*

The potential this may provide for emerging markets as trade diverts away from China has been widely reported. As part of a recent Regional Economic Prospects study,[1] the European Bank for Reconstruction and Development (EBRD) looked into the extent to which countries could benefit from a shift of supply chains away from China, using the concept of Revealed Comparative Advantage (RCA).[2] The EBRD's study finds that among its countries of operation, Turkey has an RCA in the largest number of product groups, no less than 189, with apparel and textiles standing out as a particular sector in which Turkey could enjoy diversification away from China. According to the Turkish Clothing Manufacturers' Association, Turkey's clothing sector exports stood at almost 18 billion dollars last year compared to China's 170 billion dollars. This clearly shows that there is scope for trade diversion, particularly as Turkey has a significant delivery deadline advantage compared to the Far East.

The increasing division of the globe into regional trading blocs raises questions about the relationship between the EU and its neighbors. Of course, there are both geopolitical and economic considerations here, and they are highly interdependent. A recent article in Foreign Policy[3] highlights the importance of the EU engaging with its neighboring countries to help address some potential political challenges neighboring countries are likely to face by the economic impact of the COVID-19 crisis. Political troubles on Europe's periphery mean trouble for the EU, which is a strong incentive for the EU to provide support.

The Turkey-EU Customs Union

The relationship between Turkey and the EU goes back a long way, but a significant moment in the economic relationship came with the agreement of the Turkey-EU

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[1] European Bank for Reconstruction and Development, "Regional Economic Prospects," April 2020, https://www.ebrd.com/cs/Satellite?c=Content&cid=1395289845931&d=&pagename=EBRD%2FContent%2FDownloadDocument

[2] RCA is measured as the ratio of a product's share in a country's total exports and the share of that product in global trade.

[3] Sinan Ulgen, "The Coronavirus is Creating a Crisis on Europe's Borders," *Foreign Policy*, 1 May 2020, https://foreignpolicy.com/2020/05/01/the-coronavirus-is-creating-a-crisis-on-europes-borders/

Customs Union on 31 December 1995. The Customs Union removed all customs duties and quantitative restrictions on bilateral trade between the EU member states and Turkey for industrial goods and industrial components of agricultural products, and imposed a Common External Tariff (CET) for goods covered under the agreement.[4]

The Customs Union was also a prelude to the EU accession process; together the two had a transformative effect on the Turkish economy in the early 2000s. The accession process offered stability and predictability, something that made Turkey highly attractive to investors. According to a World Bank study from 2014, bilateral trade increased fourfold following the establishment of the Customs Union.[5] Turkey saw a significant increase in Foreign Direct Investment (FDI) from the EU, and there was a deeper integration between Turkish and European firms along with production networks. The Customs Union also helped improve Turkey's productivity through a reduction in import tariffs on most industrial products. Today, the EU is Turkey's most important trading partner, accounting for around 40 percent of Turkey's global trade, while Turkey is EU's 5th largest trading partner, accounting for around 4 percent of EU foreign trade.

The 2014 World Bank study also shows that the Customs Union has helped Turkey align with the EU Acquis, improving the quality of infrastructure and reforming technical regulations in Turkey to the benefit of Turkish consumers. It has also provided the impetus for trade facilitation and customs reform in Turkey, including modernization of the Turkish customs administration. These improvements lie at the heart of Turkey's strong export performance over the past decade.

There are two well-known limitations to the EU-Turkey Customs Union. One is the scope: The agreement does not cover agricultural products, coal and steel products, or public procurement, nor does it cover services. Second, there are structural issues, stemming from the fact that it is a customs union between a country and an existing customs union. This not only means that Turkey must accept the terms of free trade agreements (FTA) negotiated between the EU and third parties, but since Turkey itself is not a party to those FTAs, it also means that there is little incentive for third countries to negotiate an FTA with Turkey if they already have tariff-free access to Turkey's markets. Past efforts to expand the Customs Union by addressing the limitations of the existing structure and expanding coverage have stalled.

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[4] Delegation of the European Union to Turkey, "Decision No 1/95 of the EC-Turkey Association Council of 22 December 1995 on implementing the final phase of the Customs Union (96/142/EC)," https://www.avrupa.info.tr/sites/default/files/2016-09/Custom_Union_des_ENG_0.pdf

[5] The World Bank, "Evaluation of the EU-Turkey Customs Union," 2014, http://documents.worldbank.org/curated/en/298151468308967367/Evaluation-of-the-EU-Turkey-customs-union

However, the changing global trade environment over the past years, plus the impact of the COVID-19 pandemic, has cast a new light on regional trade agreements. Changes to the Turkey-EU Customs Union could make it work better for both parties and allow them to fully benefit from the changing global trade environment. With the post-COVID context of increased regionalization trends, the shortening of supply chains, and geopolitical uncertainties, the development of closer relationships would be mutually beneficial.

"With the emergence of global value chains, and the interdependence between trade, investment, and services, services trade has especially become important for both the EU and Turkey."

What is potentially at stake? Agriculture remains important to Turkey's economy: while it accounts for around 7 percent of GDP and 18 percent of employment, agricultural commodities account for 10 percent of exports. Turkey's agricultural trade with the EU has been detrimentally impacted by many of the FTAs negotiated by the EU in recent years, which have primarily concerned agriculture. Despite this, according to the WTO, the EU remains the single most important market for Turkish agricultural exports, accounting for 32 percent of the total. Turkish agriculture benefits from high import tariffs, averaging around 42 percent. Given that the EU's average import tariff is only around 14 percent, adopting the EU CET for agriculture would imply a significant fall in import protection for certain products.

With the emergence of global value chains, and the interdependence between trade, investment, and services, services trade has especially become important for both the EU and Turkey. Services now account for over 60 percent of GDP in Turkey, and the country is a net exporter because of its tourism industry. However, services trade is still below potential, at only around 10 percent of GDP.

During the discussions to modernize the Customs Union in 2016, an impact assessment was commissioned by the European Commission[6] to look at future options. An EU-Turkey Officials High Level Working Group endorsed an option of modernizing the existing Customs Union, on the basis that it would be the most beneficial for both sides in both economic and political terms. The figures were compelling, as

[6] BKP Development Research & Consulting in consortium with Panteia and AESA, "Study of the EU-Turkey Bilateral Preferential Trade Framework including the Customs Union, and an Assessment of Its Possible Enhancement," 26 October 2016, https://ec.europa.eu/smart-regulation/impact/ia_carried_out/docs/ia_2016/turkey_anx6_en.pdf

they showed positive outcomes for both sides. Their analysis estimated that under the extended Customs Union, the EU's real GDP would increase by close to 0.01 percent, economic welfare would rise by 5.4 billion euros, and EU exports to Turkey would increase by 27.1 billion euros. Turkey's real GDP would increase by 1.44 percent and welfare by 12.5 billion euros, while exports to the EU would grow by 5 billion euros. The primary cost related to transitional unemployment in some sectors, notably in the rice and cereals sectors. The findings for the agricultural sector are corroborated by a more recent study commissioned by EBRD in 2018,[7] in which the Frankfurt School of Finance and Management used a partial equilibrium agricultural sector model to simulate the impact of several policy scenarios on the Turkish agricultural sector.

However, the proposals did not proceed any further, and relations between Turkey and the EU have been tense in the past few years. We can assume that the additional benefits that would arise from the recent trend of regionalization of trade would only make updating the Customs Union more compelling.

Turkey: An Alternative Link in Global Supply Chains

Updating the Customs Union to address existing flaws and include agriculture and services is not something that would happen overnight. But this does not preclude steps being taken within the existing framework to enhance Turkey's attractiveness as an alternative link in global supply chains as regionalization increases. This is particularly important, considering the competition from the countries of southeast Europe, which offer a number of Turkey's cost advantages while already being members of the EU.

An important first step would be to recognize the importance of moving up existing value chains. While Turkey's trade is well integrated into supply chains, it lags behind its international peers in terms of forward integration, in other words, the capacity to provide intermediate inputs to other countries' exports.[8] At the same time, its backward integration—the extent to which it incorporates foreign inputs into its exports—has been on the rise. A reliance on backward integration is a common characteristic of middle income countries whose involvement in supply chains has relied on importing technology and using low cost labor for assembly-type production. Forward integration is key to avoid getting stuck in the so-called middle income trap.

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[7] Frankfurt School of Finance and Management, "Mapping Agribusiness Support Measures Towards Improved Sector Competitiveness in Turkey," 2018.

[8] Volker Ziemann and Béatrice Guérard, "Reaping the Benefits of Global Value Chains in Turkey," OECD Economics Department Working Papers No.1366, 19 December 2016.

Moving up the value chain requires investment in innovation, R&D, and knowledge-based capital, as highlighted in EBRD's recent Turkey Diagnostic Study.[9] The creation of the Ministry of Industry and Technology—which allows closer cooperation between government bodies working in these areas—is an important step in the right direction, which EBRD is supporting in an advisory capacity. But there are also important steps that can be taken to improve the investment climate, in particular to attract FDI and the associated technology transfer. To this end, the EBRD has been working with the Turkish Business and Industry Association. EBRD has already commissioned a study looking at factors affecting firms' willingness to invest in Turkey to provide recommendations to improve the investment climate. The findings of this study, which are not yet publicly available, will feed into a new investment law that is currently under discussion.

The EU has been, and remains to be, Turkey's economic anchor, notably in terms of trade, investment, and technology. The benefits of the accession process, particularly in the period up to 2008, were significant. The notable drop in FDI since those years exhibit the benefits that the prospect of EU accession had on economic relations. The benefits of the relationship are not just economic: Engagement with Turkey offers the EU an increased capacity to manage potential geopolitical threats in a neighboring country that might otherwise have negative spillover effects. Changing global trade trends, plus the impact of the COVID-19 pandemic, mean EU companies are likely to seek source inputs and equipment closer to home. Turkey is well-placed to take advantage of this due to its size, sophistication, and its demonstrated flexibility in production. It is important that Turkey takes advantage of these potential opportunities in order to not lose out to other countries, such as the countries of Central and Eastern Europe that are already heavily integrated into European supply chains. This will involve taking steps to enhance the investment climate and continuing along the path to help Turkey become a knowledge economy.

9 Roger Kelly and Ali Sokmen, "Turkey Diagnostic," *EBRD,* April 2019, https://www.ebrd.com/documents/policy/country-diagnostic-paper-turkey.pdf?blobnocache=true