Summary: There is growing recognition in Turkish academic, bureaucratic, and business circles that Turkey cannot afford to remain outside emerging trading regimes. Upgrading the Customs Union with the EU will not only compensate for the disadvantages resulting from being left out of the Transatlantic Trade and Investment Partnership (TTIP), but also increase the prospects of a bilateral free trade agreement with the United States. The two together would, in effect, be tantamount to Turkey's participation in TTIP.

Why an EU-Turkey Customs Union Upgrade is Good for Turkey

by Kemal Kirişçi and Sinan Ekim

Introduction

The European Union (EU) and the Turkish government have decided to work toward upgrading their Customs Union.1 The decision comes at a time when two major U.S.-led projects, the Trans-Pacific Partnership (TPP) and the Transatlantic Trade and Investment Partnership (TTIP), are slowly but surely progressing. The Obama administration is in the process of seeking trade promotion authority that, if granted, is expected to enable the administration to conclude TPP and launch the next phase in the TTIP negotiations. These two projects, if both successful, would enable greater trade between these blocs of countries that command roughly two-thirds of the world's GDP and trade.2 Not only would they provide economic benefits to the parties of the agreements, but they would also lay down the ground rules for the world's trading regime in the 21st century.

The problem for Turkey is that these developments are occurring at a time when its economy is encountering growing difficulties: its GDP growth has slowed significantly, and the chaos in its neighborhood has resulted in a loss of export markets. The effort to gain access to new markets and sectors is, at least partly, driving the Turkish government's attempts to join the TTIP negotiations.3 There is growing recognition in Turkish academic, bureaucratic, and business circles that an economy that is highly dependent on foreign trade in goods and services cannot afford to remain outside emerging trading regimes. Upgrading the Customs Union will not only compensate for the disadvantages resulting from being left out of TTIP, but also increase the prospects of a bilateral free trade agreement (FTA) with the United States. The two together would, in effect, be tantamount to Turkey's participation in TTIP.

Customs Union and Its Discontents

Since its adoption in 1995, the Customs Union has made Turkey an integral part of the EU's internal market in terms of trade in manufactured goods. This means that these

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2 This is borne out by the datasets for 2013, see, for example, World Bank and IMF Foreign Trade Statistics, 2013.
goods are traded between the two sides freely, without any tariffs or quotas, and Turkey must incorporate the EU’s regulatory standards into its own laws. Essentially, the status of Turkish manufacturers becomes no different than, for example, their British or Italian counterparts. In a report published in March 2014, the World Bank recognized that this “special union” benefitted both sides greatly, but argued that the time had come for it to be upgraded to include new sectors such as agriculture, services, and public procurement, in addition to addressing some of Turkey’s concerns.4

The Customs Union was negotiated with the understanding that it would be a transitional arrangement to strengthen the Turkish economy while Turkey moved toward full membership in the EU. The idea of a customs union did not receive an exuberant welcome in Turkey at the time. Many questioned the benefits of this initiative, asserting that Turkish industries would be unable to withstand EU competition and that Turkey would simply “become a market” in what would evolve into an exploitative relationship rather than a true “partnership.”5 By contrast, there is a greater recognition today that the Customs Union contributed greatly to Turkey’s economic development. Indeed, it benefitted Turkey in a number of ways.

By “encouraging” Turkey to adopt the EU regulatory standards and granting it preferential access to the EU’s internal markets, this economic union increased the competitiveness of Turkish manufactured products. As a result, bilateral trade between Turkey and the EU increased almost six-fold from $28 billion in 1995 to approximately $158 billion in 2014, making Turkey the EU’s sixth-largest trading partner, while the EU became Turkey’s largest. The fact that Turkish manufactured products met EU standards also significantly increased demand for Turkish exports in the immediate neighborhood. These developments led to an almost 20-fold increase in Turkey’s foreign trade in this region between 1995 and 2014, stimulating the regional economy and contributing to its growth.

Moreover, the Customs Union transformed Turkey into what is now referred to as a “trading state” by assisting

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Turkey’s deep integration into the global economy. Turkey’s overall foreign trade increased from $19.3 billion in 1985 to almost $400 billion in 2014 while the “openness” (the ratio of trade in goods and services to GDP) of the Turkish economy also experienced a dramatic increase from 11 percent in 1970 to 59 percent in 2014.

However, this “trading state” is facing a host of challenges. The chaos and instability in the Middle East, compounded by the Russian annexation of Crimea and intervention in Ukraine, are adversely affecting Turkey’s foreign trade within its neighborhood. Turkey’s exports to the Middle East, with the exception of Israel, have dropped dramatically. In the case of Egypt and Iran, for instance, exports have plummeted by 10 and 61 percent, respectively, between 2012 and 2014, while exports to the Arab World in general dropped by 5 percent. Turkey’s exports to Russia and Iraq have not been doing well either. As the Deputy Prime Minister Ali Babacan recently mentioned, “there is civil war in Syria, and an entirely unstable, precarious structure in Iraq. A third of Iraq is now under the control of a terrorist organization.”6 More recently, the deterioration of the situation in Libya has culminated in Turkish businesses being told to leave that country. Turkey’s exports to Russia and Ukraine also fell by 15 and 21 percent between 2013 and 2014.

Given the chaos reigning in Turkey’s neighborhood, these trends are likely to persist. In stark contrast, however, exports to the recession-stricken EU increased by 9 percent and to the United States by 13 percent this past year. Since foreign trade corresponds to almost 50 percent of Turkey’s GDP, the ability to conduct lucrative trade is critical for the country’s economic well-being — which means a closer

engagement with the “Western” markets. This consideration is bolstering the calls for an upgrade of the Customs Union.

Indeed, the upgrade is expected to address some of Turkey’s grievances, and therefore rejuvenate the economy as well as relations with the EU. A wide spectrum of issues dominate Turkey’s negotiating agenda, ranging from having a degree of influence on the EU’s decision-making regarding regulations that affect the Customs Union to Turkey’s adherence to the EU’s common commercial policy. The latter, for example, stipulates that every time the EU negotiates and signs a new free trade agreement with a third party, Turkey has to launch its own initiative to conclude a similar agreement with that country. This is meant to ensure that Turkey enjoys the same set of rights in terms of market access, thereby eliminating the risk of trade diversions. However, in the absence of any clear EU provisions that encourage third parties to negotiate trade agreements with Turkey, this has resulted in third-party goods entering Turkey via the EU without any preferential access being granted to Turkish goods — to the detriment of Turkey’s economy.

An enhanced Customs Union would also help Turkey break out of the “middle income trap” it has been stuck in since 2007.7 To this end, Turkey will need a higher flow of foreign direct investment (FDI) and more robust foreign trade. Once again, this heightens the EU’s importance to Turkey as its largest foreign investor: almost 69 percent of the $83.5 billion of FDI entering Turkey between 2007 and 2013 originated from EU countries. Since this envisioned upgrade is expected to increase FDI-flows from the EU, in addition to expanding trade into a diversified range of sectors, it is likely to offer an effective remedy to the “middle income trap.”

Meanwhile, this “upgraded version” of the Customs Union would tackle many of the issues that U.S. Secretary of Commerce Penny Prizker said during her visit to Turkey in September 2014 that she wished to see resolved — ranging from the protection of intellectual property rights to market access — before the idea of a bilateral FTA between the United States and Turkey could be entertained.8 Additionally, the fact that services would be included in the Customs Union upgrade would bring Turkey’s foreign trade regime much more in line with recent FTAs that the United States has signed with countries such as South Korea. An FTA with the United States, combined with an upgraded Customs Union, would not only remove the negative repercussions of being excluded from TTIP, but also align Turkey with the new standards that are being developed for TTIP. In return, as also highlighted by the Economic Development Foundation of Turkey (IKV), this would increase the possibility of Turkey joining TTIP if the negotiators agree to an “open architecture,” meaning that other states can adhere to the agreement as long as they meet the requirements.9

In the meantime, the decision to work toward upgrading the Customs Unions is in line with the wishes of the Turkish public. One survey conducted by The German Marshall Fund of the United States, for instance, shows a dramatic increase in the number of Turks who believe that joining the EU would be a “good thing,” rising by nearly 10 points between 2012 and 2014.10 Another survey run by Kadir Has University suggests even greater support for joining the EU, at just over 70 percent — an almost 20-point increase from 2013.11 Given that the improved model for the Customs Union would put in place a channel for greater integration

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between the EU and Turkey, the initiative is sure to receive strong support from the domestic audience.

Conclusion

The growing geopolitical and economic challenges facing Turkey are fast undermining the Turkish government’s goal of becoming one of the ten largest economies in the world by 2023 — the centenary of the founding of the Turkish Republic. Acceding to TTIP, modernization of the Customs Union, and concluding an FTA with the United States are projects that can help Turkey overcome the challenges it faces, and once again transform Turkey into a pole of stability and an engine of growth in its neighborhood. As the situation currently stands, and as EU Trade Representative Cecilia Maelstrom and Turkey’s Minister for Economy Nihat Zeybekci have recognized, upgrading the customs union appears to be the most realistic way forward. It will help Turkey break out of its “middle income trap,” rejuvenate the economy, and most importantly, enable the country to stay abreast of the evolving trading order of the 21st century. However, for this to happen, the Turkish government will need to mobilize the political will to adopt the necessary reforms to be able to extend the Customs Union to new sectors, especially public procurement.

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