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Economic Flows between the EU and Turkey: A Dynamic Perspective on Conflictual Cooperation

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Abstract

This TEPSA brief summarises the results of the economics work package of the H2020 FEUTURE[1] project on the future of EU-Turkey relations. This analysis has been conducted in three areas, which are defined as flows that can be seen as economic drivers of EU-Turkey relations. Flows of goods and services, flows of finance, and flows of knowledge are analysed mostly in the post-1980 period using quantitative techniques. The political economy discussions are interpreted as indicators that govern the economic relations between the two parties. The results show that, from an economic point of view, cooperation not necessarily leading to convergence is a more likely scenario for the future of EU-Turkey relations.

Introduction

The economy has been one of the fundamental areas impacting the relationship between Turkey and the European Union (EU). Long before official relations with the EU had started, Turkey had already established economic relations, trading with many European countries. Economic ties have been a central focus and a starting point for official EU-Turkey relations, as exemplified by the Ankara Agreement in 1963, the Customs Union agreement in 1996, and the start of accession negotiations in 2005. In this paper, the authors claim that economic relations are, at least, as important as the political relations (meaning sufficient compliance with the Copenhagen political criteria) in the evolution of EU-Turkey relations. The first chapters that were opened in the first years of the accession negotiations were mainly related to economic relations (e.g., Chapter 25-

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FEUTURE (The Future of EU-Turkey Relations: Mapping Dynamics and Testing Scenarios)

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Science and Research, Chapter 1-Free Movement of Goods, Chapter 3-Right of Establishment and Freedom to Provide Services, Chapter 9-Financial Services, and Chapter 29-Customs Union). It is possible to describe three different scenarios in the context of EU-Turkey relations:

- Conflict – growing clash and competition;
- Convergence – Turkey's membership in a differentiated Union;
- Functional cooperation – engagement without accession (Tocci, 2016).

This TEPSA brief identifies key economic drivers in EU-Turkey relations since 1999, analysing the flow of goods and services (Mertzanis, 2017) as well as finance (Cömert, 2017) and knowledge (Akçomak, Erdil and Çetinkaya, 2017) on the one hand, and the political economy implications of these flows on the other (Berulava, Manoli and Selçuki, 2017). The aim of this brief is to summarise the results of the research on each flow. Our research agenda addresses two questions:

1. What economic drivers are relevant and what constellations of them exist?
2. What are the most prominent drivers both within each flow?

The brief identified four flows and connected drivers namely flows of good and services, flows of finance, flows of knowledge and political economy. It seems that flows of knowledge and flows of goods and services seem to be the most prominent drivers that shape the political economy of EU-Turkey relations.

Flows of goods and services

The value of trade flows between Turkey and the EU appears to have evolved in a less dynamic but more stable fashion relative to that between Turkey and the non-EU sample countries (USA, China, Japan, Russia, and Iran). This implies that any factors that may disrupt the trade process, including political instability, are expected to more likely influence non-EU rather than EU trade in either direction. Further, the fact that bilateral trade flows have become increasingly volatile implies that causes of uncertainty, including political instability, exert a persistent and transient influence on trade flows. This shows that the EU remains a more stabilizing, albeit less dynamic, factor for Turkish trade flows. Thus, given that EU-Turkish trade flows are already high, both partners would have a lot to lose by any future decrease in those flows. Further, to the extent that Turkish trade policy is committed to maintaining higher but also stable levels of foreign trade, a scenario of cooperation between the EU and Turkey is more likely to occur in the coming years.

According to Mertzanis (2017), most of Turkey's trade volume concentrates on intermediate goods. However, given that the share of intermediate goods traded between Turkey and its non-EU partners is higher relative to that with its EU partners, semi-processed materials are increasingly obtained from non-EU countries, which implies that they represent a significant cost advantage. On the other hand, given that the share of trade on consumption and capital goods between Turkey and non-EU partners is lower relative to that with EU partners, consumer preferences in Turkey seem to favour European quality goods and businesses seem to meet their capital needs with European technological products. To the extent that Turkish trade flows are driven mainly by cost/price factors, a diversion of trade against the EU may be expected, which would make a scenario of potential confrontation more likely. This is because EU exporters, facing a loss of business, would tend to lend support

to stricter EU membership policy. If, however, Turkish consumers and businesses remain strong supporters of European quality consumer and capital goods, a scenario of overall mild cooperation may actually prevail.

It appears that the value of EU-Turkey trade will benefit more by raising income levels in Turkey than its EU trading partners. Further, trade will benefit from implementing policies that will bring faster technological progress in Turkey, facilitate the adjustment of the composition of overall demand, and help further align institutional and legal infrastructure relevant to trade. To the extent that the Turkish domestic policies commit to raising income levels and establishing more equitable income distribution in Turkey, a scenario of cooperation is more likely to occur, as Turkish consumers and businesses will be better able financially to stand by their preferences for European quality goods.

The predictions of the econometric model are conditional upon a significant mitigating role of institutional factors in both the EU and Turkey. It should be expected that the role of non-economic and other institutional factors would be more pronounced over the coming years. Their overall impact on trade flows in general and between the EU and Turkey in particular, will be determined by their specific effect on consumer and producer preferences and the overall composition of domestic demand flows of finance. However, the possible political and institutional instability increases the probability of frictions. In conclusion, the assessment of the flows of goods and services points to a high probability for the EU-Turkey cooperation scenario.

Flows of finance

Considering the relationship between the components of financial inflows and GDP growth, although foreign direct investment (FDI) and gross domestic product (GDP) growth seem to have had a weak connection, GDP growth has a very strong link with other flows. This indicates that in the Turkish case, investors making FDI are not significantly sensitive to the short-term fluctuations of GDP growth. Excluding real estate investments of foreigners, Turkey, in total, attracted about 69 billion dollars worth of FDI from all over the world from 2002 to 2009 (from 2010 to 2016). About 50 billion dollars of this originated from EU countries from 2002-2009. From 2002 to 2016 the Netherlands, Austria, UK, Luxemburg, Germany, Belgium, Spain, France, and Greece respectively contributed most to FDI entering into Turkey from EU countries (Cömert, 2017, p.6). Although, the share of the EU in total FDI into Turkey has gradually declined. On average, FDI coming from EU still make up more than 65 percent of the total FDI in the period of 2010-2016 (2002-2009). However, there is a certain degree of increasing diversification in the source countries of FDI. While the role of the EU is gradually declining (but still high), the role of Asia is gradually increasing reaching by about 20% in 2016.

Even in the case of political instability in Turkey, it is argued that FDI from the EU is less likely to be affected. The recent case of potential investment plans of Wolksvagen in Turkey is a good example that supports this argument. The only factor that can affect FDI flows, as well as other flows between the two sides, is some degree of capital market controls, which would reverse the effects of financial liberalization. It is unlikely especially for a country that uses financial flows to pay debt and invest.

Cömert (2017) argues that as a result of very high financial flows, the Turkish economy was able to cover its chronic current account deficits, did not face a debt repayment problem, and started to accumulate considerable amounts of foreign currency reserves. However, when the Turkish economy encountered a sudden stop or financial reversals, it could not avoid significant declines in its GDP growth. The crisis of 1994, 2001, and partially 2009 were directly or indirectly caused by the reversal or stops of financial flows. Furthermore, the main macroeconomic variables have been very sensitive to the movements in financial flows which have been affected by global cycles considerably. As a result, Turkish policymakers have been forced to consider developments in financial flows.

Given global liquidity conditions, there is two-way causality between financial flows and EU-Turkey relations. The future developments in the relations, such as increased integration by re-negotiating the customs union, political tension that may arise due to the presidency system, as well as the specific factors mentioned above, may affect the direction and the magnitude of financial flows. It can also be the case that financial flows are seen as a factor influencing the possible path of EU-Turkey relations. Given the dependence of Turkey on financial flows from the EU for investment and financing debt, Turkish policymakers cannot afford the conflict scenario. EU-Turkey relations are expected to evolve to a state of convergence or cooperation.

Flows of knowledge

To investigate whether there is knowledge convergence within Europe and between Turkey and Europe, Akçomak, Erdil, and Çetinkaya (2017) used EU Framework Programme data from the first round (FP1,

1984-1987) until the last round (FP8 - H2020, 2013-2020). Using FP data has several advantages: the data is rich, enables comparison over the years, and covers a wide range of scientific areas in which the research topics reflect scientific issues at the world frontier. The analyses are based on 80.000 research and innovation projects and about 2 million links between the partners of these projects in about 340 NUTS2 regions spread over 30 countries.

The empirical results of Akçomak, Erdil, and Çetinkaya (2017) show that the increasing number of nodes and links in the EU research network demonstrate that the regions in Europe display an increasing tendency to cooperate and share knowledge. On the other hand, the new participants enter the research network by linking to the partners (thus regions) which are active and display successful performance indicating the role of preferential attachment. While this process increases the sustainability of the structure (i.e., the knowledge hubs in the ERA are persistent over time), diversification of the linked nodes shows that there is at least a minimum level of knowledge convergence that began to be formed among these nodes. Another important finding in Akçomak, Erdil, and Çetinkaya (2017) is that it is more likely and easier for two regions with no links in the past to cooperate in knowledge creation in the future. This demonstrates that the structure is evolving into a direction supporting knowledge convergence. Balland, Boschma, and Ravet (2019) validate these finding at the country level. They investigate cross-country research networks in Europe, using all the project data during FP6, FP7 and H2020 and show that peripheral countries have become more integrated in the core.

The results of the network analysis explained above in Akçomak, Erdil, and Çetinkaya (2017) are supported by a simple

econometric analysis that observes overall convergence. The analysis at the regional level shows that there are signs of convergence in knowledge in Europe. Regions that are less endowed in terms of knowledge tend to build up capabilities to help European integration. Despite the fact, the top performers persist over the years, the convergence is much stronger among the less developed regions. The analysis also shows that there are emerging knowledge hubs in Europe that may play a central role in regional as well as European-wide knowledge flows. Thus, it seems that regions and countries have benefitted from the financial and non-financial opportunities created by the EU for research collaboration such as transnational cooperation and bilateral research agreements, student and staff-exchange schemes. Is Turkey one such country that benefits from such opportunities?

The Turkish story in terms of knowledge convergence is more in line with convergence scenario, as there is a long history of cooperation in knowledge, and both parties seem to extend this relation to another level. For instance, it became easier for foreign researchers to work in Turkey. TUBİTAK (The Scientific and Technological Research Council of Turkey) has various programmes that financially support students and staff exchange between Turkey, and European countries and even application to FP projects are financially rewarded by TUBİTAK. Turkey's efforts have been continuing for at least in the last two decades and have been enriched by introducing new tools that facilitate collaboration with European research bodies. However, there is also a lot to be done in terms of supporting the infrastructure and knowledge base of universities in Turkey. Especially reputable public universities could benefit from a more decentralised decision making to be

able to decide on the research personnel and budget.

As Akçomak, Erdil, and Çetinkaya (2017) report, regions in Turkey have developed partnerships with many regions (287 different regions, from FP5 to FP7). When the performance of the regions in Turkey is analysed, one sees that while Turkey established links with 171 different regions in FP5, it has 266 and 276 links in FP6 and FP7, respectively. On the other hand, while the total number of links established in FP5 was 834, this figure increased to 7,104 in FP6 and 13,561 in FP7. The increase in the number and depth of links between Turkey and the EU, which strengths trust and facilitates tacit knowledge exchange, shows us that knowledge convergence has already been started to establish long ago.

The numerous individual, institutional, and national advantages of such cooperation especially for Turkey would prevent the Turkish side from breaking this cooperation in knowledge creation (i.e., Turkey leaving the European Research Area). Given the political economy dimension that highlight the modernisation of the Customs Union with the TTIP (Berulava, Manoli, and Selçuki, 2018) it is also unlikely that an interruption will occur from the European side. The modernised CU that covers services would mean that Turkey liberalise its services, professional services in particular, which would serve as a new source of productivity gain for the whole economy. The expansion into services, needless to say, would create more opportunities for professional services involving creating and exchanging knowledge.

The political economy dimension

The political economy dimension is viewed as a set of factors that may affect each of the drivers listed above. Berulava, Manoli, and Selçuki (2018) evaluated four different

scenarios that are plausible for the future of EU-Turkey trade relations by complementing the findings of flows of goods and services observed by Mertzanis (2017). Namely, the modernisation of the Customs Union (CU), the European Economic Area Membership (EEA), the Deep and Comprehensive Free Trade Agreements (EFTA), and the Transatlantic Trade and Investment Partnership (TTIP). Finally, as Turkey increases its bid to become a regional and global actor, an assessment of its potential participation in the Shanghai Cooperation Organization (SCO) is also included. This section provides a political economy outlook that complements the quantitative analysis of the flows of goods and services, finance and knowledge summarized in the above sections.

First, it makes sense to evaluate the overall political economy and potential areas of conflict that may pose an obstacle for the cooperation and convergence scenarios. The relationship between Turkey and the EU has been strained for some time now. The ending of membership negotiations is certainly the most conflictual scenario. While it is within the realm of possibilities, it is deemed unlikely that this scenario would unfold without both sides agreeing on a scenario that will replace the negotiations, and set in place a new framework that governs relations (for instance letting the Customs Union go and joining the EFTA). The Eurozone crises led the way to the strengthening of Eurosceptic political streams across EU Member States. The changing political environment has not helped bilateral relations between the Eurosceptic Member States and Turkey. However, at the EU level, concerns over Turkey's adherence to the Copenhagen political criteria are under scrutiny, particularly with regards to the erosion in the quality of democratic institutions and personal freedoms. Apart and away from

these issues, a transactional approach was used with regards to addressing the refugee crisis as a result of the war in Syria. As the Syrian war continues, with an international resolution not yet being negotiated, Turkey and the EU will find themselves in a position to cooperate more in issues regarding refugees and terrorism.The recent situation in Syria and an increasing tension concerning the new wave of refugees call for urgent action. This wider political economy dimension in relation to the political dimension reflects a knifes-edge equilibrium where both parties tend to defend their position strategically while keeping the ongoing economic and political relations intact. This political narrative constitutes a state where the four scenarios mentioned above were open to discussion.

In a recent impact assessment study, the European Commission (2016) set two areas of operational objectives, namely the modernisation of the Bilateral Preferential Trade Frame (BPTF), when addressing the deficiencies of the CU, and the modernisation of the CU. In the context of the first type of operational objectives, this process should address the problems related to the difficulty in achieving a parallel conclusion of FTAs by the EU and Turkey. Second, it should address Turkey`s difficulty in meeting its obligation on legislative alignment to EU law (as it regards both EU commercial policy and EU technical regulations). Finally, it should introduce an effective dispute settlement mechanism.

For the second set of objectives, the CU modernization process should address the problems related to the difficulty in achieving a parallel conclusion of FTAs by the EU and Turkey. Moreover, both the EU and Turkey would aim at improving market access for trade in services and establishments for each other, including

through the elimination, reduction, or prevention of unnecessary barriers. Thirdly, the two parties would enhance access to each other`s public procurement market (in practice, this means that Turkey would have to open up its public procurement to the EU, as in the other direction the EU market is already open, benefitting Turkish bidders). Finally, both sides should agree on a wide range of rules that enable a more stable and predictable environment for bilateral trade and investment (e.g. trade and sustainable development, energy/raw materials, Small and Medium sized Enterprises (SMEs), transparency) (European Commission, 2016:30). The modernisation of CU with the TTIP seems a better and probable option for Turkey, also compatible with the "functional cooperation" scenario of Tocci (2016). The modernisation entails expansion into services, thus it requires the liberalisation of services and professional services in particular, which may result in productivity gain for the Turkish economy and may increase FDI flows to Turkey (Cömert, 2017). This option is also politically feasible as it keeps the EU membership issue on the table. Berulava, Manoli, and Selçuki (2018:20) take a clear stance for this option: "Strategically, it prepares Turkey for "docking-in" to a potential TTIP agreement between the EU and the US in the future. This is crucial for Turkey. Unlike other FTAs that the EU signed with third parties, Turkey would have a difficult time negotiating an FTA with the US and if un-prepared both in terms of sectors and regulations it would be harmed." The combined agreement will ease the process for Turkey at a greater extent.

The Deep and Comprehensive Free Trade Agreement (EFTA) option also provides a higher degree of integration towards cooperation. However, it would also mean ending the Customs Union. Considering that EFTA is a tool for non-EU countries and

CU was a milestone for Turkey for accession, it is highly unlikely that this option would occur, as it would imply a non-membership scenario for Turkey. Given the current economic and political situation in Turkey, this option is also unlikely, as it would harm the political power of the AKP (Justice and Development Party) since it includes non-membership scenario. Moreover, according to this option, both parties will have net welfare losses from the combination of tariff reductions and the `switchover` to an FTA relationship from the CU, which implies a `rules of origin shock`, i.e. a 2% increase in trade costs, while they make welfare gains from the other elements of the DCFTA. In terms of new welfare gains, this option does not seem to be a better alternative as compared to BPTF (EC, 2016:31). In the context of the BPTF option, for Turkey the challenge seems to be achieving liberalization of agriculture, services, government procurement, and investment with the EU, and to observe its rules on dispute settlement and on trade in relation to sustainable development, labor, and the environment. On the other hand, for the EU this is an opportunity to harness the economic and political potential of deeper integration with Turkey through further liberalization of trade in goods, services, agriculture, and public procurement, as well as encouraging investment and sustainable development complemented with appropriate dispute settlement mechanisms.

There may be other factors, especially on the political-economy side, that may affect the relations. However, these effects are hard to assess due to high uncertainty, such as the inclusion in the SCO. Turkey has diversified its export destinations over the last 15 years (Mertzanis, 2017) and has been actively working for a more important regional and global role. Turkey's attempt to consider other regional cooperation

organizations such as the SCO has political as well as economic connotations. However, SCO is yet far from what the EU has achieved and what it can offer for Turkey. For this reason, it is unlikely that Turkey would move from the EU towards other regional cooperation organisations, as the EU is still an important anchor both politically and economically.

Conclusion

In sum, the analysis of economic drivers shows that from an economic point of view cooperation is a more likely scenario for the future of EU-Turkey relations. Deepening trade and economic integration backed by knowledge convergence will eventually have positive social welfare impacts for both sides. If Turkey intends to reach the goals of becoming one of the top ten economies in the world by the centenary of the Turkish Republic, the economic relations between EU and Turkey supported by the common political understanding should deepen, while this deepening cooperation may not necessarily lead to convergence.

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