

Turkey in Transition to EU Membership: Pros and Cons of Integrating a Dynamic Economy

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Summary

The question as to whether and when the European Union (EU) should open accession negotiations with Turkey has given rise to a heated debate not just among the political and academic communities, but also among the European public at large. Whereas some expect major economic and geopolitical benefits from Turkish EU membership, others fear that it would change the nature of the European project and destroy its original rationale. This contribution throws some light on the issues with an eye on economic theory of optimum integration areas.

Keywords

Agricultural policies, banking system, demographics, EU Integration, Turkey, optimum integration area, migration.

Introduction

In its December 2004 meeting, the European Council decided to start negotiations with Turkey culminating in full membership without delay in 2005. This was undoubtedly a historic step, the fulfilment of the Turkish Republican dream and -above all- a signal that the Europeans want to abolish religious barriers to modernity, freedom and the consolidation of peace. Some even call it the new world of the 21st century on the basis of common values. But there actually is also some water which blurs the wine. For instance, there is the danger that a rational economic discussion of the economic progress of Turkey during the negotiation period will be superimposed by quarrels about the new Constitution and the redefinition of the Growth and Stability Pact and other aspects concerning the Euro Area, not to speak of unanimity with respect to common foreign, security and defence policies as well as the inclusion of the Balkan region in the EU. However, the area where most prejudices and misperceptions stem from is economics. To check for this, one has to look in detail at the economic issues likely to emerge during the process of negotiations, assuming that they will start soon. A recent important and excellent publication by the Brussels Centre for European Policy Studies titled "The European Transformation of Modern Turkey" analyses the challenges and opportunities arising in the fields of

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foreign policy, security policy, justice and home affairs, domestic governance, macroeconomic policy and income convergence, energy, banking and agriculture. The main results related to economic challenges which are in my view representative of other studies in the field can be summarised as follows.¹

General Economic Considerations

If one inspects Turkey's economic performance pattern more deeply, an extremely heterogeneous picture emerges. Some areas like trade integration reveal that Turkey even leads the new member countries in some economic fields. However, with respect to other important issues like, e.g., formal education of the population, Turkey still suffers from severe backlogs to be eliminated urgently within the next years. Hence, Turkey should be classified as a typical transition country which is just moving away from a highly distorted boom-and-bust economy to a stable market economy. It seems fair to say that Turkey today is rather open to international trade and foreign investment and offers the potential for rapid and sustainable growth. However, it remains to be seen whether Turkey's reform path adopted since 2001 is really sustainable and whether the reforms will be fully implemented. In this respect, there is significant uncertainty left and the Turkish economy still strongly depends on international financial markets. Any policy action assessed as inconsistent by the markets inherently bears the danger to lead to strong depreciation of the lira and an increase in interest rates which could immediately endanger macroeconomic stability.

Despite all these imponderableness, some clear statements can and should be made in the context of the discussion about the potential start of negotiations with Turkey on EU-membership. On the one hand, the accession of Turkey would resemble earlier EU enlargement rounds since the realisations of the relative GDP per capita and of the weight of agriculture in employment are similar for Turkey and for the less advanced Central and Eastern European (CEEC) EU members and candidates. As measured by its current economic importance and by its future economic weight in terms of current population, Turkey is about twice the prospective 2007 EU-entrants Bulgaria and Romania. Since both indicators serve as proxies of the gross receipts of Turkey within the framework of the Structural Funds and the Common Agricultural Policy (CAP), the budgetary cost of Turkey entering the EU

¹ This contribution heavily relies on Kemal Derviş, Michael Emerson, Daniel Gros and Sinan Ülgen (2004): *The European Transformation of Modern Turkey*, Brussels, Centre for European Policy Studies (hereafter CEPS), Istanbul, Economics and Foreign Policy Forum, 2004, and the papers presented at the Conference on "Macroeconomic Policies for EU Accession", Ankara, May 6-7, 2005. Further sources among others are Ansgar Belke and Nilgün Terzibas, "Die Türkei und die Europäische Union - Meilensteine und Nettonutzen der Integration einer kleinen, aber dynamischen Volkswirtschaft", forthcoming in: *Die Weltwirtschaft*, No. 4, Institute of World Economics, Kiel, 2005; Hadi S. Esfahani, "Fatal Attraction: Turkey's Troubled Relationship with the European Union", *The Quarterly Review of Economics and Finance*, Vol. 43, No. 5, (Winter 2003), pp. 807-826 and Harry Flam, "Turkey and the EU - Politics and Economics of Accession", CESifo Working Paper No. 893, 2003, Munich. I am grateful for valuable comments from anonymous referees.

might, thus, as a rule-of-thumb amount to relatively modest values (independent of, e.g., phasing-in issues).² On the other hand, there are some aspects which legitimise to consider the Turkish case as quite distinct from previous enlargements.

Advanced but asymmetric trade integration

The first key property of the Turkish economy is advanced trade integration. Through its asymmetric 1995 customs union agreement with the EU economy which is 20 times larger, Turkey participates already now in the EU internal market for goods (but not for labour-intensive services) and will anyway adopt significant parts of the *acquis* independent of the state of accession decisions. Thus, the country has arrived at a higher degree of EU integration than the CEECs at a comparable stage before their accession, although trade with the EU is somewhat less important for Turkey than for some of the larger new member countries. As indicated by the increasing share of overall exports to GDP and the constant share of the EU in overall Turkish trade, the customs union with the EU did not lead to trade diversion but mainly to trade creation.³

Human capital endowment capable of development

Second, Turkey is endowed with a rather low degree human capital. In this respect, Turkey's scores in variables like total expenditure on education in percent of GDP, the percentage of adult population with upper secondary education (e.g., by age groups) deserve a closer look. In terms of investment in and output of education, Turkey's performance is certainly much worse than in the EU. However, according to the same criteria, the CEECs perform like the EU average. These deficits appear even larger in view of the exceptionally high share of the Turkish school age population and its high importance for Turkey's future growth prospects. Of course, such a lack of quality might have important negative consequences for Turkey's future growth path.⁴

Demographics giving leeway for more growth

Third, Turkey is characterised by demographic dynamism. Turkey's labour force will continue to experience growth rates of more than 1 percent per annum for at least one more generation. In contrast, it currently tends to shrink in many CEECs. This huge discrepancy gives Turkey potentially

² For details see Wolfgang Quaisser and Alexandra Reppegather, „EU-Beitrittsreife der Türkei und Konsequenzen einer Mitgliedschaft“, Working Paper No. 252, January 2004, Osteuropa-Institut, Munich.

³ See Sinan Ulgen and Yiannis Zahariadis, “The Future of Turkey-EU Trade Relations: Deepening vs. Widening”, Centre for European Policy Studies EU-Turkey Working Paper, No. 5, August 2004, Brussels, and Felicitas Danzinger et al. (2005), “The Impact of a Customs Union between Turkey and the EU on Turkey's Exports to the EU: A Reassessment of the Paradox”, DIW Discussion Papers Series, German Institute for Economic Research Berlin, 2005.

⁴ See Kemal Derviş, Daniel Gros, Faik Öztrak, and Yusuf Işık, “Relative Income Growth and Convergence”, EU-Turkey Working Paper No. 8, August 2004, CEPS, Brussels.

much more dynamism and leeway for growth - not to forget a more founded right to say in different EU institutions. Moreover, Turkey's working age population is currently increasing by 1.5% more than the total population. This implies ample room for redistribution, pension payments etc. until Turkey will experience the same demographic transition to lower demographic dynamics as experienced by the EU countries some decades earlier.⁵

Modern and underdeveloped sectors coexist

Fourth, Turkey is a textbook example of a so-called dual economy. On average, Turkey's GDP per capita is comparable to the Bulgarian and the Romanian one. But an inspection of sectoral and regional data reveals that the Turkish economy is divided into a tiny, but exceptionally well-performing progressive sector outside agriculture (mainly industry and some services) in some Western regions which is more productive than even some of the new member countries and a large and poor rural sector covering approximately half of the labour force. In the emerging markets literature this is typically called a dual economy.

Crisis-prone domestic banking system on the road to recovery?

Fifth, the domestic banking system is significantly changing now and its development towards a supporting pillar for future growth is crucial. As is well-known, foreign banks dominate the banking system in most CEECs by now and, thus, tend to import financial stability. However, the structure of the Turkish banking system has been more complex for some time with some very profitable private banks. However, macroeconomic instability and significant political influence on bank management and on the lending culture of public banks during the 1990s until recently contributed to the malfunctioning of this sector. The fifth and up to now last major macroeconomic instability crisis in Turkey since the late fifties happened in 2001. In retrospect, it can best be characterised not as a balance-of-payment-crisis like the precedent four crisis episodes but as the consequence of a persistently high real interest burden on an increasing public debt combined with a premature financial sector liberalisation. Doubts about the health of the Turkish banking system joint with debt-event fears finally induced attacks on the Turkish lira. However, this deep banking crisis and its highly visible damaging effects on the economy paved the way for unprecedented comprehensive legal and institutional reforms. If stabilisation is continued, regulation is effective and banks are supervised along EU norms, the banking system might give pervasive support to the further development of the modern part of the Turkish economy. But it is essential for sound growth that financing investment, trade and additional employment is the driving force of bank balance sheet growth. The significant

⁵ See Derviş, Emerson, Gros and Ülgen, *The European Transformation of Modern Turkey*, pp. 77ff.

progress of the Turkish banking system in terms of productivity and efficiency over the last three years, as measured by the non-interest cost to total asset ratio and the operating-cost to income ratio, gives some cause for optimism. Merely in the area of sophisticated capital market products and the full use of global capital markets there is ample room for improvement in the Turkish banking sector.⁶

Is Turkish government debt overstated? The role of capital flight

Sixth, external debt and capital flight has been a key feature of the Turkish financial performance for decades now. Turkey's foreign debt burden is higher than for most other new EU entrants or EU candidate countries. According to IMF figures, it amounts to around 80 to 100 billion EUR. Most of it, around 70 percent, is government debt. Since cumulated current-account deficits since 1963 have been only slightly above 40 billion, one-half of Turkey's external debt appears to be the result of a significant capital flight, i.e. residents who do not trust their government anymore. This pattern even continued recently in spite of exceptionally high real interest rates. It again stands in sharp contrast with countries like Romania and Poland which have not experienced significant capital flight in spite of continuing current-account deficits. However, this constellation offers a great opportunity: if parts of this flight capital could be repatriated it would soon become clear that government debt is overstated. This in turn would give Turkey ample room for future capital imports and, thus, for high growth.⁷

Dominance of the agricultural sector

Seventh, the agricultural sector still is a big player in the Turkish economy. Turkey is strongly similar to other CEECs (above all Poland and Romania) in that a large part of the work force is officially employed in agriculture. One-third of the Turkish labour force is employed in this sector but accounts only for about 12 percent of GDP. Like in other EU countries, this indicates bad labour productivity performance of this sector and -to a certain extent- also some potential labour-shedding and emigration potential. However, a marked difference to other candidate countries consists of the fact that Turkey runs a significant trade surplus vis-à-vis the EU in agricultural goods. The main reason is that Turkey - due to a favourable climate - is one of the few countries which specialise in products for which the EU does not significantly hamper imports (i.e., fruits, vegetables and nuts). In addition, deviating from the CEEC case, some Turkish agricultural products have been protected even more heavily than by the EU. In case of Turkish EU membership protection of this sector would be abolished and would, for instance, mean increasing farm sizes. Hence, human capital problems in

⁶See Alfred Steinherr, Ali Tukul and Murat Ucer, "The Turkish Banking Sector: Challenges and Outlook in Transition to European Union Membership", EU-Turkey Working Paper No. 4, August 2004, CEPS, Brussels.

⁷See Dervis, Emerson, Gros, and Ülgen, *The European Transformation of Modern Turkey*, pp. 93ff.

these sectors will become even more virulent in the future. The dualistic structure of the Turkish economy becomes obvious again, this time in the area of agriculture. A large amount of Turkish exports to the EU can be traced back to a minor but progressive sector. At the same time, the remaining⁸ sectors employ the vast majority of the labour force but are not competitive.

The migration issue: often overstated and misunderstood

Eighth, emigration from Turkey will not be a menace to the incumbent EU countries. Any assessment of this (surprisingly) hotly debated topic should start from an assumption with respect to the degree of liberalisation of labour flows between old and new EU-members. There is no reason to assume that Turkey will be treated any better or worse than the recent new member states. The incumbent EU-15 member states introduced a transition period lasting up to seven years (2 plus 3 plus 2) after accession with limited freedom of movement of labor from the 10 new member states in order to prevent the CEECs from exerting 'wage dumping' strategies. Under these circumstances, an EU-entry of Turkey in 2015 would imply that Turkey's labor force would be fully mobile not earlier than 17 years from now. However, at that time a new scenario will prevail. First, due to population ageing, not only the EU-15 but also the new member countries will be plagued by labour shortages instead of unemployment. Second, due to income convergence, emigration will not appear as worthwhile as before to Turkish workers. Seen on the whole, the current public debate on how large Turkish emigration flows will actually be, seem to be exaggerated and misplaced. On the contrary, it might even be the case that any slowdown or suspension in Turkey's accession process will cause lower growth and higher unemployment in Turkey. In this case, the reform process will tend to slow down or will even be reversed. Both events would be drastically enlarge the number of potential migrants. A considerable proportion of them would be finding their way into the EU - as experience has shown irrespective of legal restriction. It is thus a realistic scenario that if Turkey gets rid of the membership perspective, the EU may end up having even more immigrants than under a regime of free movement of labour with a prosperous EU member Turkey.⁹

The outstanding importance of institutions and governance

Ninth, enhancing the quality of Turkish institutions will be crucial for exploiting Turkey's growth potential. The main idea behind the transfer of the *acquis communautaire* to the new EU member states is that the full gains of EU membership can only be reaped if the quality of government institutions in the member states is broadly the same. However, improving the quality of

⁸See Erol H. Cakmak, "Structural Change and Market Opening in Agriculture", EU-Turkey Working Paper No. 10, August 2004, CEPS, Brussels.

⁹See Refik Erzan, et al., "Growth and Immigration Scenarios Turkey - EU", Centre for European Policy Studies EU-Turkey Working Paper, No. 13, Brussels, 2005.

governance will also lead to a growth dividend as confirmed by a large strand of empirical literature on domestic institutions as a determinant of growth. According to the World Bank's well-known indicators of quality of governance (significant control of corruption, effective government, political stability, regulatory quality, rule of law and voice and accountability)¹⁰, there is still a long way to go for Turkey. This is valid not only vis-à-vis the EU-15 countries, but also in comparison with the newer member countries. However, if the quality of governance in Turkey is low exactly because the level of development of the country is low this would be no drawback for Turkey. Institutions in poorer countries are generally weaker and will become stronger in the wake of growth and development of the country. However, Turkey's realisation of the 'rule of law' indicator is even below the level which would correspond with its low present GDP per capita. If one considers the change in the World Bank's composite quality of government indicator from 1996 to 2002, it even becomes clear that Turkey is one of the few among the current EU member countries experiencing a deteriorating composite index of the quality of governance. However, if one tries a final judgment on the quality of Turkey's institutions one should always take into account that the registered improvements in case of the CEEC accession countries were mainly achieved in the wake of the accession negotiations. From this point of view, starting membership negotiations with Turkey could represent a great chance for improving the quality of governance in this country.¹¹

Economic Outlook

Negotiations with Turkey will turn out to be not easy and full membership will be achieved not earlier than after ten years, not at least because European governance is currently quickly changing, and Turkey's sheer size corresponds to that of the 10 EU acceding countries. However, Turkey's potential for strong growth and, hence, rapid convergence gives cause for optimism. In the past, Turkey could best be described as a boom-and-bust economy whose macroeconomic volatility especially in the 1990s lead to an option value of waiting with important employment and investment decisions and, thus, reduced growth prospects. In the future, if macroeconomic volatility will be removed, Turkey could converge quickly by investment in physical capital, investment in human capital and population growth.

¹⁰ See World Bank, Worldwide Governance Research Indicators Dataset 1996-2002, and Arjan M. Lejour, and Ruud de Mooij, "Turkish Delight: Does Turkey's Accession to the EU Bring Economic Benefits?", *Kyklos*, Vol. 58, No. 1, 2005. However, there are also significant adjustment costs associated with the adoption of the *acquis communautaire*. See exhaustively Sübidey Togan, "Turkey: Toward EU Accession", *The World Economy*, Vol. 27, No. 7), p. 1013-1045, 2004.

¹¹ See World Bank, Worldwide Governance Research Indicators Dataset 1996-2002, and Arjan M. Lejour, and Ruud de Mooij, "Turkish Delight: Does Turkey's Accession to the EU Bring Economic Benefits?", *Kyklos*, Vol. 58, No. 1, 2005. However, there are also significant adjustment costs associated with the adoption of the *acquis communautaire*. See exhaustively Sübidey Togan, "Turkey: Toward EU Accession", *The World Economy*, Vol. 27, No. 7), p. 1013-1045, 2004.

With respect to demographics, the favourable evolution of population composition with an increasing proportion in working age is a clear advantage of Turkey. In addition, underemployment of labour, above all in the rural areas and among women, can be transformed on a large scale into higher productivity activities in industry and services. This factor may account for an additional increase of Turkish GDP per capita close to 1% per annum and, hence, is a typical example of the enormous benefits of integrating two regions with significantly different factor endowments. Finally, there is also a potential of acceleration of total factor productivity by means of an increase of technology transfers, i.e. by higher FDI. Taking all three growth-enhancing factors together, the consensus view appears to be that Turkey has the potential to grow faster between 3 and 6% per annum than the EU-15 and between 1 and 3% per annum than the new EU member states.

Seen on the whole, the economic outlook for Turkey is rather promising and the start of accession negotiations might be self-enforcing. On the one hand, Turkey is still a very poor country. On the other hand, its economy is significantly more dynamic than that of the present EU members. Full convergence in terms of income per capita will not be reached in the foreseeable future. But this should be no reason to be concerned about the EU accession of Turkey because the recent history of the EU and also the EMU has clearly demonstrated that „small is beautiful”. So far, rich 'core' member countries with very low growth rates like, e.g., Italy and Germany with their permanent failure to stick to the Stability and Growth Pact today, have caused significantly more problems up to now than poorer but more quickly growing and more dynamic 'periphery' states like, e.g., the CEECs.

Several turning points indicate that Turkey should now be on the edge of a more prosperous period during which the huge income per capita differential vis-à-vis the EU will be reduced to a significantly lower level. This, in turn, will render Turkey's accession to the EU politically more undisputed. The country has launched structural reforms in 2001, experiences inflation rates at low levels not seen for decades now and envisages an accession negotiation process which might represent a credible anchor for politics (including policies geared towards the adoption of the euro) and prevent populist politicians from withdrawing and watering down the reforms. However, the main challenge consists of the extraordinary heterogeneity of the Turkish economy.¹²

¹² See Belke and Terzibas, "Die Türkei und die Europäische Union - Meilensteine und Nettonutzen der Integration einer kleinen, aber dynamischen Volkswirtschaft", Erzan et al., „Growth and Immigration Scenarios Turkey - EU", and Josef Pöschl et al., Turkey: Macroeconomic Vulnerability, Competitiveness and the Labour Market. Vienna: Wiiw's Current Analyses and Country Profiles, No. 21, 2005.

Conclusions

Seen on the whole, one of the biggest economic challenges for Turkey is to make its recent macroeconomic stabilisation sustainable. Of utmost importance in this respect is a significant catch-up of quality of institutions and governance to the EU level. Although starting with a small GDP, Turkey could significantly contribute to high growth rates of the EU as a whole (as already aimed at by the Lisbon agenda). The analysis of Turkey's human resources identified a large gap in human capital formation and its central role for backlogs in convergence between Turkey and the EU. Hence, one important policy conclusion would be to link up pre-accession financial support with the accumulation of human capital instead of the usual support of standard infrastructure projects. Another example would be in the area of trade integration. For instance, enhancing the currently existing customs union with Turkey into the direction of free trade of services should generate benefits to Turkey and to the EU which should not be underestimated. Finally, one could imagine the implementation of joint and specific transition policies in the areas of energy, agriculture and education.

If Turkey will be able to strictly stick to its reform-oriented path of modernisation, nothing prevents us from expecting enormous benefits of integrating two regions with significantly different factor endowments - a straightforward economic insight not often well understood by politicians and the public.

