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Customs Union between EU and Turkey: A Success Story to be Nurtured

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Abstract

The Customs Union has been affective in transforming the Turkish economy, both through its direct impact on trade, and more importantly, through the stability and predictability it has provided. Global developments and internal dynamics of EU and Turkey are challenging its design and necessitating an upgrade of this framework. Modernization of the CU appears to be preferable to replacing it with a new generation FTA both for economic reasons and for its transformative importance in integrating Turkey into the EU.

Background

The broad context of EU-Turkey relations can be best described by the *cliché*, "modernization in Turkey has been synonymous with Westernization and that in turn with Europeanization". The Young Turks movement constituting the core cadres of modern Turkey pursued the modernization project that started in the 18th Century by the Ottomans. The adoption of European institutions have intensified in the 1920s after the Republic.

Another milestone in Westernization was the aftermath of the II. World War when Turkey had to liberalize its policies in all fields because of domestic and external developments. The overregulated economy in stagnation and the autocratic single party rule had to be relaxed. The country had to be opened up - in the Western direction – least for the Soviet threat concerning the Eastern provinces of Turkey and the control of Bosporus and Dardanelles straits.

Turkey became a member to all postwar international arrangements such as the OECD (then OEEC), GATT, World Bank, IMF and most notably NATO, spearheaded by the US which emerged as the world leader. Turkey was not alone in this transatlantic love affair. Most European countries were barely recovering to their prewar income levels. The US Marshall Plan contributed significantly to reconstruction of Europe. Turkey was among the beneficiaries. Besides its economic prowess, the US maintained its unchallenged leadership role of the West during the Cold War period due to the strategic defense umbrella it was providing for the NATO countries.

When the European Economic Community[2] (EEC) was founded in 1957, the European Free Trade Association (EFTA) - a looser economic grouping led by Britain - was also in the works. The EEC, led by the previously warring Continental powers of the two devastating world wars, had to be more ambitious by nature. Turkey was aware that NATO, the political and military alliance, had

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[2] Currently, the CU is technically between the European Community (EC) and Turkey. Upon the formation of the European Union (EU) in 1993, the European Economic Community (EEC) was incorporated and renamed as the EC.

to be supported by a strong economic alliance. It was also a fact that over 35 % of Turkish exports were destined to the EEC (the initial six countries). There was some hesitation, but things have accelerated drastically when Greece applied to the EEC in 1959. With Cold War balances in mind, Turkey, benchmarking its external policies to that of Greece, followed suit and within two months applied to the EEC[3].

The Association Agreement

The EEC sought a formula to handle the applications of Greece and Turkey that were at significantly lower levels of development compared to the original six countries. Gradually, a model was agreed upon in the form of "association" stretching the Article 238 of the Treaty of Rome (İlkin 1990). The Association Agreement between the EEC and Turkey - or the Ankara Agreement - was signed in 1963[4]. The agreement would promote strengthening of the Turkish economy and balanced commercial and economic relations, leading eventually to full membership of the EEC. This objective would be achieved by "the progressive achievement of a Customs Union (CU)".

The Agreement contained provisions concerning "progressively securing freedom of movement for workers" (Article 12), "abolishing restrictions on freedom of establishment" (Article 13), "abolishing restrictions on freedom to provide services" (Article 14), "extension to Turkey of the transport provisions" (Article 15), "facilitating movements of capital" (Article 20) to be guided by the respective articles of the Treaty of Rome constituting the Community. Furthermore, the Agreement stated that "The Association shall likewise extend to agriculture and trade in agricultural products in accordance with special rules which shall take into account the common agricultural policy of the Community" (Article 11).

The Association Agreement envisaged three stages: a preparatory stage, a transitional stage and a final stage. The preparatory stage consisted of non-reciprocal commercial concessions for Turkey's exports and development assistance, the so-called "first financial protocol"[5]. This stage would last five years "unless it should be extended", and when the contracting parties agreed, the transitional stage would start where obligations would be reciprocal.

In 1967 Turkey expressed a desire to enter the second stage, essentially due to strategic considerations[6]. Economically, the "import substitution strategy" that it persued in the 1960s "planned period" implied major opposition from the industrialists and labor unions alike as well as from the right and left wing opposition in the parliament. The negotiations were concluded in 1970 and the contracting parties signed the so-called "Additional Protocol". After its ratification,

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[3] As the anecdote goes, The Turkish Foreign Minister of the time announced "if Greece is jumping into an empty pool feet first, Turkey should dive head first".

[4] Entered into force in 1964. The Greek Association Agreement signed in 1961 was meant to serve as a model. The Turkish delay was also due to the military coup of 1960.

[5] 175 million ECU "soft loan" to be disbursed by the European Investment Bank over a period of five years. The commercial concessions were preferential tariff quotas on four major agricultural products: tobacco, raisins, dried figs and hazelnuts.

[6] Turkey wanted to precede the entry of the UK, Ireland, Denmark (and Norway, which later opted out), and to take advantage of ECC's frozen relations with Greece due to its military junta.

as it entered into force the beginning of 1973, a twenty-two year period was set in to motion towards the final stage of CU by 1995[7]. The EEC immediately scrapped “customs duties and charges having equivalent effect” on Turkish manufactures while Turkey would gradually lower and eliminate them according to a predetermined schedule[8]. Also, the Turkish customs tariffs against third parties had to be aligned with the Common Customs Tariff (CCT) during this transitional stage. There was also a “second financial protocol”, to be followed by a third and fourth packages. The Additional Protocol has reiterated the provisions of the Association Agreement concerning agriculture, labor and capital mobility, freedom of establishment, services and transport. Particularly, the free movement of workers was to be achieved gradually between 1976 and 1986, to compensate for the loss of jobs resulting from competition from increased imports from the Community.

Facing major economic difficulties and a severe shortage of foreign exchange, Turkey suspended its tariff reductions in 1978[9]. It took a major crisis to shift policies completely in 1980, heralding an outward oriented economy. In 1987, Turkey applied to full membership to the Community, and in 1988 resumed its tariff reductions. Although its membership bid was turned down in 1989 - declared an eligible European country, but not ready yet - Turkey revitalized the 1995 target for the CU, the final stage of the Agreement.

The Customs Union

With Decision, No 1/95 of the European Community (EC) - Turkey Association Council of 22 December 1995 “on implementing the final phase of the CU” the CU came into force as of 31 December 1995 - keeping the 1995 target. It covered industrial goods and industrial components of agricultural products. Outside the CU agreement, companion agreements on coal and steel and a preferential regime in agricultural goods and fishery products came into force in 1996 and 1998, respectively.

Turkey had to abolish all remaining customs duties and charges having equivalent effect on manufactures. The EC had already scrapped them at the initiation of the Additional Protocol. From that point of view, the CU did not imply any liberalization for Turkish manufactures in terms of customs duties and alike. However, the CU also meant removal of all quantitative restrictions and technical barriers on imports and exports of manufactures between the two contracting parties. Furthermore, Turkey adopted the CCT and came under the obligation to align with the commercial policy and the related legislation of the Community. This involved both the autonomous regimes and the preferential agreements of the Community with third parties.

The initial Association Agreement had stipulated that “provisions on competition, taxation and the approximation of laws contained in Title I of Part III of the Treaty establishing the Community

[7] While the Additional Protocol entered into force in January 1973, with a Provisional Protocol, EECs obligations commenced in September 1971. Furthermore, in 1973, a “Supplementary Protocol” was signed to compensate for preference erosions arising from EEC’s expansion and new FTAs it concluded.

[8] There were two lists, a 12-year list and a 22-year list for sensitive products.

[9] The near freeze in the relations with the Community also resulted in an effective annulation of the labor mobility provisions of the Agreement. The 1980 military coup in Turkey further strained the relations and as a result of a Greek veto, the “fourth financial protocol” worth 600 million ECUs was blocked.

must be made applicable" (Article 16). For the CU, this implied the adoption and/or harmonization of rules on, *inter alia*, competition, state aid, taxation and intellectual, industrial and commercial property rights[10]. As Turkey would be losing a major chunk of its customs duty revenue, a financial compensation package was negotiated, but never realized[11].

Accession Negotiations

Starting with a wave of empathy following a devastating earthquake hitting the most industrialized region of Turkey in 1999, The Helsinki European Council held in December 1999 officially recognized Turkey as a candidate state. This also implied that Turkey would be eligible for benefits under a pre-accession strategy[12]. With the enthusiasm of an achievable target, Turkey embarked upon a major reform program. Based on a report and a recommendation from the Commission, in December 2004, the European Council decided that Turkey fulfilled the relevant criteria and accession negotiations have been launched in October 2005[13].

In the meantime, the1999 earthquake has given the final blow to the unsustainable economic conditions in Turkey. An encompassing IMF stabilization program was launched to reign in macroeconomic imbalances and the decades' long double - at times triple - digit inflation. Implementation of institutional reforms lagged and the fragile banking system collapsed in 2001. A program with an even stronger institutional reform and structural adjustment component backed by substantive IMF resources replaced the initial stabilization program[14]. Conditionality in the IMF agreement and alignment with the EU's *acquis* through the pre-accession program worked in tandem in the implementation of the reforms.

Turkey's EU accession process is conducted in 35 chapters in the context of the Negotiation Framework[15]. Although the screening process of 33 chapters was completed in 2006, so far only16 chapters were opened whereas only one chapter was temporarily closed. The remaining chapters were blocked in the EU Council, essentially due to domestic political concerns of some Member States[16]. The accession negotiations never gained a momentum, and this lack of enthusiasm turned

[10] Turkey legislated a competition law in December 1995 based on the relevant articles of the Treaty of Rome.
[11] The unpaid amount was up to €2.5 billion. Under the Association Agreement, during the 1964-1995 period, with the first, second and third financial protocols and related arrangements (excluding the fourth financial protocol that was blocked), Turkey received about €1 billion, mostly as soft loans from the Community according to the Turkish Ministry of EU Affairs. In the 1996-1999 period, Turkey further received €755 million from the EU under various programs.
[12] A single framework for coordinating all sources of EU financial assistance for pre-accession was created. EU's contribution was €1.3 billion for 2000-2006, €4.8 billion for 2007-2013 and €4.5 billion (allocated) for 2014-2020, reported by the European Commission.
[13] See, e.g., Aydın-Düzgit and Tocci (2015) for an overview of Turkey's accession process. For a review of pertinent economic issues concerning the accession, see, e.g., Hoekman and Togan (2005). For immigration and integration issues, see, e.g. Erzan and Kirişci (2008).
[14] See, e.g. the European Commission (2009) study on growth and economic crises in Turkey.
[15] Chapter 34, Institutions and Chapter 35, Other Issues, concern only the last stage of the negotiations.
[16] Except for 8 Chapters which were blocked due to Turkey's refusal to allow landing of ships and planes originating from the Republic of Cyprus.

into a standstill as the political and judiciary reforms in Turkey were rolled back during the recent years[17].

The Commission prepares an annual progress reports on Turkey where under Chapter 29, compliance to the CU is reviewed. Aside from, pointing to some “trade irritants”, the evaluations in this area have been positive overall[18].

Impact of the Customs Union

The CU has meant a drastic overall liberalized in Turkey’s imports in manufactures. This was due to the combination of the removal of tariffs and other barriers facing the Community, the adoption of the CCT - considerably lower than previous Turkish tariffs - and the preferential obligations of the Community[19]. This implied a strong trade creation impetus rather than trade diversion - a good development from the point of economic efficiency. Preference margins further eroded in the 2000s when the Community expanded with new members from Eastern Europe.

The CU has significantly contributed to liberalization, productivity gains and trade integration in the Turkish economy, not only through reduced protection, but also through the alignment process to the EU’s *acquis*, by institutional reforms, streamlined technical regulations, trade facilitation, and the customs reform (World Bank 2014a). However, parallel to the mechanisms of the CU, there were the two other important motors of reform in the works which reinforced each other. These were the pre-accession legislative agenda and the institutional build-up and structural adjustment components of the IMF program. Consequently, borrowing costs of Turkey declined sharply. Annual FDI inflows gradually surpassed one billion US dollars. With the start of the accession process, they jumped to $10 billion in 2005 and to $20 billion in 2006[20]. An extremely conducive external environment in the early-to-mid-2000s with record high world GDP and trade growth, and other favorable factors such as the abundance of global liquidity for emerging market economies all worked for a “perfect success story”[21].

There was a strong apparent competitive impact of the CU manifested by the spectacular expansion of Turkish manufactured exports in the 2000s. In anticipation of the forthcoming competition, Turkish industrialists who initially opposed the CU had invested heavily in machinery and equipment in the mid-and-late 1990s yielding a leap in the quantity and quality of Turkish manufactures, particularly in motor vehicles and consumer durables.

Turkey’s exports to EU 15 during the CU increased by about fourfold while its exports to the rest of the world expanded more than fivefold. During the same period, Turkey’s imports from the EU

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[17] For a brief update of bilateral relations, see, e.g., Aydın-Düzgit (2017).

[18] The reports are on the progress achieved in preparation for membership. See, e.g., the Commission’s latest Turkey 2016 Progress Report.

[19] In 1995, the CCT incorporated the Uruguay Round tariff reductions agreed upon at the World Trade Organization (WTO). Turkish Ministry for EU Affairs reported that Turkey's weighted rates of protection for imports of industrial products originating in EU and EFTA member states have fallen from 5.9% to 0%, and from 10.8% to 3.5% for similar goods originating in third countries (and to 0% for those covered by FTAs).

[20] See, e.g., Erzan (2007).

[21] See, e.g. the World Bank (2014b) and Acemoğlu and Üçer (2015). This spectacular performance faded away as the reforms in Turkey slowed down and were later reversed.

increased by almost threefold as opposed to a fivefold increase from the rest of the world[22]. The share of EU in Turkey's total trade has declined, particularly after the Great Recession, mainly due to macro-economic developments in that region. The share of EU's exports going to Turkey rose from about 3% to 5% under the CU, while the share of EU's imports from Turkey increased from about 2% to 3%.

When the manufacturing industry was analyzed in detail, it was observed that penetration ratios[23] in all manufactures increased significantly even in the early periods of the CU. Yet, evidence on the "market disciplining role of imports" was not clear when the structure and performance of Turkish manufacturing industries over the 1980-1999 period was studied (Erzan *et al.* 2003)[24].

The product composition of Turkey's exports to the EU during the CU did not change radically except for the reduction of the share of textiles and clothing, the former flag-ship, now replaced by motor vehicles. Deeply integrated production networks emerged between EU and Turkish firms. This has increased intra-industry trade (two-way trade in same products) from 30% to 50% (World Bank 2014a). However, Turkey could not move up from the lower end of the value chains. The share of high-tech products in Turkey's manufactured exports remained at dismal levels, less than 4%[25]. Partially due to comparative advantage effects of the CU, Turkish export growth in services trade was relatively weak, except for tourism, construction and insurance. Turkey's professional business services under performed.

Although difficult to quantify, arguably the most important impact of the CU in expanding production, trade and domestic and foreign direct investment (FDI) was the stability and predictability it introduced to Turkish foreign trade regime and the legal framework governing commerce. The IMF programs and the pre accession efforts reinforced this impact.

Impact Studies

It is difficult to isolate the impact of the CU using trend analysis. Alongside the creation of the CU, there were other factors intermingling: the IMF structural adjustment program, alignment with the EU's *acquis* through the pre-accession undertakings and global developments.

The Commission's study (2016a) gives some proof of the positive effect of the CU by comparing goods covered by the deal with the other products. Bilateral trade in goods that were covered by the CU (and the accompanying agreements in coal and steel and agriculture) grew far more strongly than the bilateral trade in other goods both for the EU and for Turkey.

There were two other methods employed by both the World Bank (2014a) and the Commission's (2016a) studies to isolate the impact of the CU. These were the gravity model approach and

[22] See, e.g. the World Bank (2014a) and the Commission (2016a).
[23] Penetration ratio is the ratio of imports to apparent consumption, which is production plus imports minus exports.
[24] A thorough analysis covering a lengthy period following the CU is hindered by methodological changes in manufacturing statistics in the 2000s.
[25] Based on Turkish Statistical Institute 2016 export data, using the high-tech product definition of the Ministry of Science, Industry and Technology.

counterfactual simulations using a computable general equilibrium (CGE) framework. World Bank also used a partial equilibrium model (SMART) as a third method in an attempt to quantify the impact of changes in the level of protection and other trading costs.

The gravity model is a statistical method where an attempt is made to identify greater trade intensity compared to third parties by controlling for relevant factors such as distance, market size and trade costs. The CGE model makes counterfactual simulations. The Commission's gravity model suggested that the CU promoted two-way trade in the earlier periods whereas the World Bank's estimation did not find a significant effect. Compared to what would have happened in the absence of the CU, the Commission's CGE model estimated a 9% increase in EU exports and a 7% gain for Turkey.

Reduction in trade costs associated with the removal of requirements concerning compliance with rules of origin (ROOs) in the CU was the main factor behind these results. The Commission's study adopted a 2% *ad valorem* estimate for ROOs costs. The World Bank used estimates in the range of 2 to 6% for costs associated with ROOs in partial equilibrium simulations. Accordingly, compared to an FTA, the CU generated an extra 4% in EU exports, and 7% increase in Turkish exports.

The small and medium scale industries (SMEs) benefited disproportionally more from the CU due to the large fixed component of costs associated with ROOs. Furthermore, removal of ROOs induced deeper integration by allowing value chains that require multiple border crossing of goods.

Scenarios

Studies by the Commission, the World Bank and others[26] consider variants of two alternative scenarios for the future of EU-Turkey CU, in addition to the *status quo* - the continuation of the current CU without deepening and remedying the issue of asymmetry. Obviously, this would reduce Turkish exports to the EU and Turkish GDP to the extent that the EU successfully concludes FTAs with third parties. The impact of this scenario would be negligible for the EU, except for the opportunities lost.

The first alternative scenario is essentially a new generation, deep and comprehensive FTA replacing the CU in manufactures and extending to all other goods including primary agriculture and fishery products. The agreement would also cover bilateral trade in services, right of establishment and public procurement, and addresses non-tariff barriers (NTBs). As the FTA replaces the CU in industrial goods, costs arising from ROOs are reintroduced. The asymmetry question is resolved since Turkey can apply its full tariffs to third parties that have FTAs with the EU, but not with Turkey.

Although the assumptions and models adopted in the studies differ somewhat, the results point to some reduction in Turkish exports and GDP (or some insignificant increase in GDP) under this

[26] See, e.g., Yalçın *et al.* (2016) and an impact study commissioned by the Turkish Ministry of Economics, summary results disclosed in a January 2017 press release. For a summary of various scenarios, also see, Akman and Doveri Vesterbye (2017).

scenario. The gains in services and FDI are offset by losses in industrial goods. The EU makes some export gains but (insignificant) GDP losses.

The alternative scenario can be considered as a successful modernization and upgrading of the CU. The scope of the CU is unchanged, covering only industrial products. The current preferential agreements on coal and steel and agricultural and fishery products are expanded into a full-fledged FTA which also covers services, right of establishment, NTBs and public procurement. This benign scenario generates a GDP increase of about 1.5% for Turkey[27]. This figure goes up to 2% or higher if Turkey manages to secure FTAs with its other major trade partners. The GDP impact on EU in percentage terms appears small due to EU's sheer size. However, in absolute terms, this effect is substantial, about half of the amount that incurs to Turkey. In their bilateral trade, both Turkey and particularly the EU make important gains in exports. Turkey also substantially expands exports to third parties.

Given the structure and estimated magnitude of trade costs, it is not surprising that a modernization of the CU would be considerably more beneficial than scrapping the CU and replacing it with a new generation FTA. This is essentially because the CU allows elimination of ROOs requirements and procedures which slashes trade costs.

Issues in Upgrading the Customs Union

Asymmetry in Decision Making and the FTAs

The Association Agreement with the Community conceived the CU as the final stage of the transition leading to Turkey's full membership. That is why the Agreement had all those provisions - making references to the founding Treaty of the Community - for full economic integration covering not only all sectors such as agriculture and services, but the factors of production, namely free mobility of capital and labor, and the right for establishment.

Since it was conceived as the final stage of a transition, rather than an arrangement that would stand on its own, a fundamental asymmetry that existed in its design was overlooked. Turkey is not part of the decision making process concerning the commercial policy and other relevant regimes. The institutional setup does not guarantee sufficient coordination regarding decisions on the common commercial policy as they relate to the CU. Most strikingly, there is an asymmetry involving the autonomous regimes and the preferential agreements of the Community with third parties. The most common manifestation of this asymmetry is in FTAs with third parties. When the Community negotiates a FTA, Turkey has no say in the decision making. Turkey has to launch its own initiative to negotiate and conclude a similar FTA with the country (or group of countries) in question. A "Turkey Clause" was meant to give signal to the third parties but could not force them to negotiate with Turkey, as observed in the case with Algeria and Mexico.

Consequently, without a FTA, goods from that source can enter Turkey duty free via the EU while Turkish goods are at a disadvantage in the third party market. This asymmetry is potentially very costly for both the EU and Turkey, because it risks the introduction of origin controls by Turkey

[27] The World Bank (2014a) estimated that a FTA with the EU in agriculture combined with multilateral services trade liberalization would yield a 0.4% increase in Turkish GDP.

to avoid trade deflection. All impact and simulation studies conducted show that costs associated with ROOs requirements constitute the most important trade costs.

Agriculture

Agriculture - except for the industrial component of agricultural goods - has been excluded from the CU. Turkish primary agricultural goods and fishery products were subject to a preferential trade regime. About two thirds of agricultural tariff lines have been liberalized by the EU for Turkish exports (World Bank 2015a). More than four fifths of Turkish agricultural products exported to the EU enter duty-free. However, there are tariff-peaks in the remaining items. Furthermore, most of these preferences were eroded or will be eroded in the near future as the EU's FTAs with many countries (such as Mexico, South Africa and Chile) include or will include agriculture.

The exclusion of primary agricultural goods from the CU implied a slow structural transformation for Turkish agriculture that generates about 10% of the GDP while accounting for nearly a third of the work force. When liberalized, some sensitive sectors, particularly sheep meat, beef, dairy products, cereals and oil seeds would face severe competitive pressures with important employment implications. Nevertheless, a deeper FTA in agriculture than the one which currently exists appears to be feasible since it would also entail major export opportunities, particularly in fruits and vegetables.

Services

Except for tourism and transportation, Turkey's services exports have been growing slower compared to other upper-middle income countries. Modern producer-related services still account for a relatively small part of Turkey's production and exports. Liberalization of these services would boost production in other sectors. Expanding the CU to include services would bring substantial benefits to both parties. Services account for about two thirds of the GDP in Turkey. The share of services in world trade is increasing due to changing demand patterns and technological breakthroughs.

Turkey can participate in the EU's single market for services. Alternatively, services can be covered by a FTA where both parties make commitments concerning market access and national treatment.

Trade Defense Instruments and Dispute Settlement

As the number of cases and amount of trade subject to Trade Defense Instruments (TDIs) such as antidumping, safeguards and countervailing duties are increasing on imports from both sides, there is a need for greater consultation between the parties before investigations are launched. There is also a need to coordinate the TDIs imposed on third parties. Furthermore, the Dispute Settlement Mechanism (DSM) in the current CU has to be redesigned in line with the new generation agreements. The parties should be able to bring cases on a broader range of issues rather than being limited to disagreements for the duration of a safeguard measure.

Public Procurement

The CU envisaged negotiations aimed at opening of the government procurement markets in a mutual fashion. This market was kept outside the scope of the CU. It was later taken up in the context of accession preparations. Public Procurement Law (PPL) was adopted in 2003 to align legislation with the *acquis*. However, the list of exemptions from the application of the PPL has been increasing ever since. There are public procurement thresholds and domestic price preferences.

Turkey is competitive in construction services. The public procurement market in the EU should be attractive for Turkish entrepreneurs. In turn, Turkey has to review its exemptions from the application of the PPL and the public procurement thresholds and domestic price preferences. This would also increase the effectiveness of public works.

Road Transport Quotas and Permits

Currently this is a major problem. The free circulation of goods subject to the CU necessitate, by nature, the elimination of road transport quotas and transit permits. A road transport agreement may be negotiated. A maximalist approach would be full liberalization of road transport in the context of services trade.

Visa Regime

Finally, the current visa regime applied by EU member states towards Turkish professionals and business people requires extensive paperwork and high fees. This has a restrictive impact on EU-Turkey trade and business relationships. Visa liberalization is essential especially in the context of free movement of services and freedom to provide services.

There was a window of opportunity for reaching an agreement on visa-free travel to the EU countries in the context of resolving the "refugee crisis" in 2016[28]. Fulfilling most benchmarks, Turkey stumbled on a couple of judiciary issues. Until visa-free travel is achieved, a mechanism to issue long-term multiple entry visas with minimal bureaucracy for qualified business people must be devised.

Modernization of the Customs Union

The CU between EU and Turkey is over 20 years old and has become outdated with respect to the new generation "deep and comprehensive" FTAs that the EU has recently concluded or is negotiating with other countries and economic groupings. The EU-Korea FTA of 2011 and the EU-Canada Comprehensive Economic and Trade Agreement (CETA) that provisionally came into force in September 2017 are cases in point. Furthermore, EU-Japan Economic Partnership and EU-Singapore FTA and Investment agreements have been concluded, pending ratification.

[28] Visa liberalization for Turkey was a key component of the Council's "EU-Turkey Statement" of 18 March 2016, dealing with the influx of irregular migration.

With the current impasse in the Doha Round of multilateral trade negotiations under the auspices of WTO, there will be more and deeper FTAs. The costs of the inherent asymmetries in the current CU will increase. Thus upgrading the consultation mechanism to alleviate the impact of the asymmetries will be even more important than now. As the EU concludes new FTAs, to the extent that Turkey will not be able to match them with similar agreements, Turkey will be trying to avoid trade deflection by seeking ROOs documentation in its trade with the EU, thus nullifying the most important single benefit of the CU for both parties. An upgraded CU must include a mechanism to ensure that third parties conduct parallel negotiations with Turkey. One way, proposed by the Turkish side, is a strengthened "Turkey Clause" obliging the third parties to negotiations. More generally, effective participation of Turkey in the decision-shaping mechanisms (i.e. all relevant committees and agencies in areas directly relevant to the new framework) is very important to avoid structural asymmetries[29].

Without a modernization of the EU-Turkey CU, compensating for the disadvantages resulting from being left out of the Trans-Atlantic Trade and Investment Partnership (TTIP) - which was recently suspended by the US in its final stages of negotiation - would have been extremely difficult[30]. As a corollary of that, modernization of the CU with the EU would considerably facilitate Turkey's efforts to conclude deep FTAs with major trading countries such as the US and Canada.

The dialogue between the EU and Turkey concerning a possible modernization of the CU started in 2014, and in 2015, the EU Trade Commissioner and Turkey's Minister of Economy agreed, "to enhance bilateral economic relations and launch the preparations for a future negotiation to modernize and extend the existing EU-Turkey CU". In December 2016, the Commission proposed to modernize the CU. In July 2017, at the EU-Turkey High Level Political Dialogue, both parties agreed that the modernization of the CU was a key priority for EU-Turkey relations. Reminding this, in September 2017, the Commission has reiterated its invitation to the Council "to finalize its work on the Commission's proposal to open negotiations with Turkey on an upgraded bilateral trade framework. This will allow starting the negotiations on an important agreement that, applied to all Member States, would unleash still untapped potential in EU-Turkey trade and economic relations"[31].

Despite the Commission's efforts, as the political atmosphere between EU and Turkey deteriorated, no progress has been made in initiating the negotiations to upgrade and modernize the CU[32].

Final Considerations

The CU has been a considerable success in transforming the Turkish economy, both through its direct impact on the economy, and more importantly, by the stability and predictability it has provided to the foreign trade regime and to commercial life in general. However, its importance

[29] This provision is contained in the CU Decision 1/95, but not enforced by the Association Council or the Commission.
[30] See Kirişci (2015).
[31] European Commission (2017b) Seventh Report on the EU-Turkey Statement, p. 13.
[32] As of end of 2018.

has been diminishing as a result of global developments, making some of its shortcomings more pronounced.

Turkey has been diversifying its exports to new markets in the Middle East, Africa and Asia, especially after the Great Recession. Nevertheless, the sheer size and sophistication of the EU market is unmatched. EU accounts for 45% of Turkey's exports and 38% of its imports. Two thirds of all FDI in Turkey originate from EU countries. For Turkey, there is no meaningful alternative to a close commercial cooperation with the EU.

More importantly, however, the EU project's importance for Turkey is beyond economic considerations. Turkey accepted an asymmetrical CU as a transitional arrangement enshrined in the Association Agreement on the way to a full membership of the Community. This asymmetry was a cost acceptable for stability and predictability and for convergence towards EU's *acquis*. This convergence has taken a more formal path with the commencement of the accession negotiations. Obviously, Turkey's full membership in the Community would resolve this asymmetry in question and remedy the other shortcomings of the CU discussed above by the formation of a common and single market for goods, services and factors of production, including labor.

From the EU's point of view, the commercial ties with Turkey are not easily dispensable either. Turkey is EU's 4th largest export market and 5th largest provider of imports. With a back of the envelope calculation based on the Commission's estimates for overall job creation of EU's external trade, exports to Turkey could be worth about 1.5 million jobs[33]. Furthermore, on average, every €1 billion additional exports would be generating about 14,000 jobs in the EU.

While the share of Turkey in EU's external trade was increasing, the share of EU in Turkey's trade was declining lately. As a middle-income country, catching up with the richer world, Turkey will be growing faster than EU, offering major commercial opportunities.

Upgrading the CU is crucial for Turkey and important for the EU in its own right. Given the immediate economic need for modernizing the CU, negotiations on the CU should start as soon as possible. More importantly, however, as Turkey's EU accession process is technically frozen currently, upgrading the CU may be the strongest endeavor in keeping Turkey anchored in the European sphere. This also has important security implications for the EU in managing migration and in combatting terrorism[34].

Considering the context in which the CU was conceived, an upgraded and modernized CU that stands on its own feet, alone, is not a satisfactory alternative to what has been strived for. The Association Agreement between the EU and Turkey envisaged much stronger mechanisms for

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[33] According to the report of the Commission (2016c) on the effects of exports, EU employment created by its total exports of goods and services to the rest of the world (including indirect exports through inputs) was 31.2 million jobs in 2011. As Turkey accounts for about 5% of this trade, job creation resulting from exports to Turkey could be over 1.5 million.

[34] See, e.g., Aydın-Düzgit (2017) for the political arguments why Turkey's accession negotiations should not be suspended, and why the talks on the modernization of the CU should start as soon as possible.

economic integration and almost succeeded in convergence towards a common legal framework, the *acquis*.

Beyond the current state of affairs, is Turkey's EU membership a realistic vision? Looking ahead, in a rapidly changing world where prosperity depends increasingly on dynamism and competitiveness - to which the EU countries wish to adapt at varying degrees, the emerging structure of the EU might be more conducive for Turkey's membership. The developments point to a multi-speed Europe or a Europe of variable geometry.[35]

[35] This was depicted as an alternative scenario, Scenario 3, in Junker's White Paper (European Commission (2017a)). The White Paper was drafted in connection with Brexit, with implications for Western Balkans, but not involving Turkey. In 2013, Kaleağası had noted the relevance of the concept for Turkey's admission into the EU. "A Europe of variable geometry is emerging on the basis of an already existing reality of Eurozone, Schengen area, defense cooperation, and social policy opt-outs". Kaleağası (2013), p. 3.

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