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Turkey-Europe: From a Customs Union to the European Union

European Council held on 15 December 2004 opened the way to membership negotiations between the European Union and Turkey. The Lettre du CEPII *published last September*[1] *indicated how this process was likely to consolidate the macroeconomic stabilisation and reforms presently underway. It should also deepen Turkey's regional integration. This integration, which was reinforced by the customs union of 1996, is taking place in an original way that is different from that of the other new Member States of the Union or other candidate countries. The two sectors which account for most of Turkey's exports – textiles & clothing and vehicles – are experiencing a transformation in competitive conditions in both the national and international markets. In both cases, trade liberalisation within the Euro-Mediterranean area and the adoption of the* acquis communautaire *will play a key role in defining Turkery' new trade specialisations.*

Opening up and Specialisation

Several stages have led the Turkish economy from being very closed at the end of the 1970s to a level of openness which is comparable to that found in the large European countries: 29%[2] for goods and services (23% for goods). At the start of the 1980s, promoting exports (through devaluation and significant export subsidies) was one of the central elements of the radical economic policy change that led to Turkey entering global and especially European markets. The country nevertheless remained strongly protected from foreign competition by high customs and tax levels. In January 1996, the implementation of the customs union with the European Union meant that Turkey had to eliminate customs duties on industrial products imported from the EU and adopt the common external tariff of the Union. From 1999 onwards, the scale and structure of trade experienced several shocks, due to deep recessions (-4.7% in 1999 and -7.5% in 2001), the banking crisis and depreciation, followed by the upturn in growth since 2002.

Harmonised data on international trade make it possible to situate Turkey relative to other exporters[3], for the years 1995-2002. In terms of export growth, Turkey was in 9th place world-wide during this period, despite the fact that its initial trade structure, both geographic and sectoral, placed it in a mediocre position to benefit from the most dynamic components of international demand. Leaving aside this initial position, Turkey's "performance" put it in 7th place, due mainly to its competitiveness[4] (in this field, Turkey is led only by Hungary and Poland among the European countries). Turkey's share of world exports has therefore grown, so that at 0.6% in 2002, it was roughly the same as the Czech Republic and a little less than Poland.

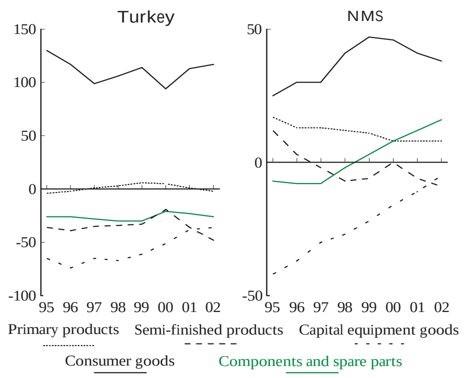
The EU15 share in Turkish trade has not much changed in recent decades[5] and remains at around 50%. This is low when compared to levels observed for trade among the new Member States (NMS) or for neighbouring countries (e.g. 68% for Poland and 64% for Romania). Outside the EU, Turkish trade favours countries close by Eastern and Southern Europe, the Middle East and North Africa). The share of the US market is smalleler

1. J. Sgard, D. Ünal-Kesenci & Y. Zlotowski (2004), "Turkey at the Crossroads", *La Lettre du CEPII*, No 237, September (available at <www.cepii.fr>).
2. Average of exports and imports in % of GDP.
3. Turkey is compared here with 77 other countries of varying levels of development. The data are taken from the CEPII's BACI database.
4. Apart from "competitiveness", the other component of "performance" comprises "geographical and sectoral adaptation" (*cf.* A. Cheptea, G. Gaulier & S. Zignago, "The World Market: Market Shares and Export Performances", *La Lettre du CEPII*, No 231, February 2004 (available at <www.cepii.fr>).
5. Except during the early 1980s when the second oil shock and strong demand in the Middle East increased trade between Turkey and this region.

in Turkish exports than in world exports (8.7% and 18.4% respectively in 2002), significantly more important than it is for exports from Poland (2.7% of Polish exports go to the US) or even from the whole of Central and Eastern Europe (4.2%).

The geographical diversity of Turkey's export markets partly explains the diversity of the exported products. Using a classification which combines 36 sectors with three quality ranges[6] places Turkey on a par with France and Germany (and ranks it 6th worldwide[7]). For the European market, the sectoral structure of Turkish exports for 1995 to 2002 demonstrated somewhat less "mobility"[8] than the world average, and considerably less than that of Romania and Bulgaria, and even than the other NMS. For the latter, a dramatic change in their division of labour within Europe is currently taking place: having reinforced their position in consumer goods up until the present decade, these countries have subsequently reduced this trend, in favour of components and spare parts. Similarly, their weakness in capital goods has been cut significantly (Graph 1). In contrast, Turkey's specialisation by stage with respect to the European Economic Area is characterised by the dominance of consumer goods: the reduction in the deficit relating to capital equipment goods has been marked since 1998.

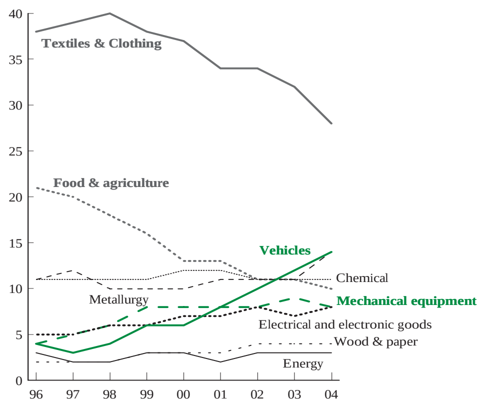
Graph 1 – Specialisation by stage* relative to the European Economic Area**



* Contributions to the trade balance in thousandths of total trade, using the BEC classification of the United Nations. ** EU15 + EFTA
Source: Authors' calculations based on the CEPII's BACI database.

Looking at the sectoral structure of Turkish exports to all its trade partners shows up significant changes. Since the start of the 1980s, exports have been dominated by textiles & clothing: once policies promoting exports made labour-intensive products competitive, this sector supplanted food & agriculture. But since 1998 (Graph 2), other industries have recorded progress which has significantly modified the hierarchy of exporting sectors: henceforth the export of vehicles takes second place (14% of total Turkish exports in 2004), though it is still someway behind textiles & clothing. The vehicle sector includes both consumer goods (private vehicles), components (parts) and investment goods (commercial vehicles). Their export has not yet transformed Turkey's place in the division of labour in a very visible manner, but they do result from the country's integration into multinational production networks. Will the trends which have been observed up until 2004 continue? The answer depends on how these two branches will respond to changes in competitive conditions currently taking place in the domestic and international markets.

Graph 2 – Turkey's export structure by sector (*in %*)



Source : Authors' calculations based on data from Turkey's State Institute of Statistics (DIE).

Competition in Textiles

Turkey is one of the countries whose market share is threatened by the total elimination of quantitative restrictions for textiles & clothing trade, once the WTO's ATC[9] runs out. Its market access has been relatively little restrained by quotas, especially for the European markets. As a result, Turkey has benefit from a relative advantage, compared to more restricted countries. Hence, according to the WTO[10], Turkey could lose 8% of its share of the European market for textiles, and up to a third for clothing, especially to China and India[11]. As for its domestic market, which has been protected by quotas since the country joined the customs union of the EU, competition from Asian exporters will be reinforced too. The tariffs imposed by Turkey are much less than those of other developing countries,

6. Classifying goods by quality range (low, mid- and up market) is done by comparing unit values of exports with the world average for the particular product.
7. Among 98 exporting countries, and using the Herfindhal index. Turkey is ranked 8th among the ten most-exported products and 15th among the top 50.
8. The mobility of a country's exports is measured by the sum of the spread of absolute values between the shares of each product in exports, between two dates.
9. The Agreement on Textiles and Clothing was concluded in January 1995 by the WTO to organise the progressive dismantling of quotas. The process is to be completed as of 1 January 2005.
10. H.K. Nordas (2004), "The Global Textile and Clothing Industry post the ATC", WTO Discussion Paper, No 5.
11. For these two countries, the tariff equivalent for quotas was 12% for textiles and 15% for clothing; *cf.* Nordas (2004), Table 10, page 25.

because of the customs union. It is therefore easy to understand concerns about this sector, which accounts for 21% of manufacturing employment.[12]

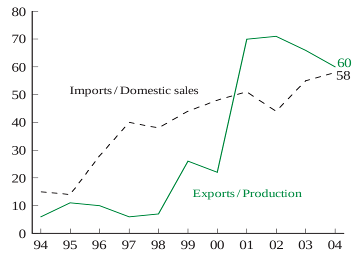
That said, the fall in market shares could partly be offset by the expansion of markets following liberalisation. Furthermore, Turkey' quality specialisation and its proximity to the European market could help protect it from Asian competition. Half of Turkey's clothing exports to the EU are in up-market product ranges[13], and judging by the similarity of exported products[14], then Turkey would seem to be relatively little-exposed to Chinese competition in this market, and in any case less so than the NMS or East European countries. Furthermore, in contrast to other exporters physically close to the EU, Turkey's textile & clothing industry is largely integrated. As the world's fifth largest cotton producer, Turkey has a long industrial tradition in spinning and weaving. Also, apart from India, Turkey is among the world's major clothing manufacturers, and Turkey's clothing exports have the lowest content of intermediate imported goods in the world[15]. As for Turkish clothing manufacturers, they have managed to acquire a certain degree of independence *vis-à-vis* European ordering parties by developing their own collections[16], thus allowing them to raise their share of value added in final goods.

The elimination of the main component of trade preferences in this sector runs against the trend to regionalisation which has been observed over the last thirty years in the major protected markets (North America and Europe). At the same time, the progressive proliferation of bilateral, free-trade accords between the European Union and its favoured partners should stimulate Euro-Mediterranean trade. Since 1 January 1999, Turkey has been part of the diagonal, pan-European system allowing for the accumulation of rules of origin for industrial goods. The extension of this system to Mediterranean countries was adopted in July 2003. Its implementation allows all countries concerned (about forty) to acquire supplies from an
y other member while at the same time benefiting from customs-free market access for final products. Within the regional framework in particular, Turkey could play a central role in developing its advantage in upstream textile production and in the competencies it has acquired downstream. Projects for developing cotton production (which falls within the regional development framework of Anatolia), and the fact that, after China, Turkey is now the world's leading importer of textile machinery (apart from sewing machines), accounting for 12% of the world market (compared to 8% in 1995), indicate that Turkey is continuing to invest in this sector.

Vehicles: The Impact of Trade Openness

As a sector much affected by the business cycle, vehicle production is also undergoing important transformations linked to its opening up. Can this sector become another strong point for Turkey's trade specialisation and an area allowing for the regional integration of the country? The sector has opened up much since the middle of the 1990s (Graph 3). The customs union has greatly strengthened competition within the domestic market. Of all the vehicles sold in Turkey (private and commercial), the share of imported vehicles has risen from an average of 17% for 1987-1996, to more than 55% for 1997-2004. The channelling of Turkish production to foreign markets occurred somewhat later. Up until the 1990s, foreign companies acting through joint-ventures with Turkish firms[17] concentrated mainly on the local market: only 10% of output was exported. However, the collapse of the Turkish car market during the 1999 to 2001 recessions pushed sales overseas. This new trend continued through to 2004[18], despite the upturn in domestic demand, and 60% of sales were carried out abroad. It marks the maturing of major investments which were made during the 1990s, both in capital equipment and manpower. Such investments were carried out in liaison with foreign producers, without whose cooperation Turkey's vehicle industry would not have been able to break into international markets, given their competition and strict production standards.

Graph 3 – Openness of the vehicle sector in Turkey
(% of the total of vehicles)



Source: Authors' calculations based on data from the OSD (Otomotiv Sanayi Dernegi).

12. The Istanbul Declaration Regarding Fair Trade in Textiles and Clothing was signed by several dozen trade associations from the North and the South and submitted to the WTO in March 2004. It called for the elimination of quotas to be postponed for three years, and for the conditions of liberalisation to be re-examined: <http://www.fairtextiletrade.org/>.
13. Defined according to the unit value of traded goods, with up-market products accounting for about the top third of articles imported by the EU.
14. The similarity is calculated at a very detailed level, with item headings combining products (at the 6-digit level of the Harmonised System) and 3 quality ranges.
15. Less than 5%, which is a little less than China and a lot less than Morocco (38%) or Romania (32%). Source: H.K. Nordas (2004), page 9.
16. *Cf.* Institut français de la mode: <ifm.org>.
17. The main producers in Turkey are Renault and its joint-venture with OYAK (a cooperative of Turkey's armed forces), Fiat and Tofas (of the Koç corporation), Toyota and the Sabanci corporation, and lastly Ford together with Otosan.
18. The figures are based on the first 11 months of 2004.

The greater openness of the Turkish automobile sector has modified the nature of trade. More than half of all trade with Europe is now intra-branch trade; a detailed trade specialisation by product varieties and qualities is emerging with European countries both for private vehicles and component parts. Competition has indeed led to a greater diversity in the car models produced and sold in Turkey. Such diversity has also affected the production of component parts and has led to cross-trade. Nevertheless, Turkey still runs up large deficits in these intermediate products, especially *vis-à-vis* the EU, even though its trade is closer to equilibrium for finished products, private or commercial vehicles. This latter fact is due to the trade surpluses Turkey has with the NMS and the Mediterranean countries.

Turkey is especially integrated in mid-range market segments, in regional trade. Its exports in the automobile sector are amongst the most concentrated in the Euro-Mediterranean region: 80% of all foreign sales go to this region (compared to 64% on average for all products); fully 26% are exported to Central and Eastern Europe as well as the Mediterranean (compared to an average of 12%). In this area too, the free-trade agreements already concluded or under negotiation in the region are likely to enlarge outlets for Turkey's output, given that it is the only country in the Eastern Mediterranean to have a large production base in vehicles.

European Rules and Standards

Turkey's specialisation in textiles & clothing as well as vehicles is not only based on the advantage of labour costs which are significantly lower than in Europe. But its trade specialisation is also founded on a industrial base that was built up during the years of import substitution. The opening up of the country and the stages of regional integration have transformed Turkey's specialisation in an original way, which differs from that of other emerging countries, notably in Asia. While still similar from this point of view to countries like India and Morocco given the importance of textiles, Turkey is henceforth shifting towards more advanced European countries such as Poland, Portugal or Spain. Given its level of development and geographic location, Turkey could take an intermediate place in Euro-Mediterranean trade. Turkey could also benefit from the development of regional free trade, especially in textiles and automobiles.

The application of the *acquis communautaire*, partially launched within the framework of the customs union, is henceforth taking place within prospect of EU membership. The *Lettre du CEPII* of September 2004 pointed to the risks a country like Turkey faces in adhering to the rules of a game fixed by highly-developed economies. Industrial activity will run up against new constraints, but could also benefit from an institutional rapprochement with the EU. For vehicles in particular, investments are very sensitive to the reduction of uncertainties and of transaction costs (linked, for example, to administrative and technical barriers). The industry will also benefit indirectly from the application of the *acquis communataire*, which provides extra incentives for reforming network industries: energy, transport and telecommunications. Turkey suffers from a very fragile electricity sector and a price per kWh which is three times the OECD average. Its transport and communications infrastructures are also deficient. In 2002, prices for company communications were more than 80% higher than average prices in the OECD. Investments in these fields however are dependent on new regulations being put into place. In particular, for textiles & clothing, cuts in telecommunications and electricity prices are vital in allowing Turkey's production capacity to react rapidly and benefit from its proximity to European markets, thus enabling Turkey to strengthen its up-market product specialisation.

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