CENTRE FOR EUROPEAN REFORM essays

EU business and Turkish accession

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Many EU politicians and their voters are unsure about the merits of Turkish accession. Europe's entrepreneurs are not. They are showing confidence by investing billions into the fast-growing Turkish economy, partly because they expect that EU accession will continue to change the country for the better. Given the growing stakes that EU business has in the Turkish economy, it is surprising that so few businesspeople are prepared to speak out in favour of Turkish membership of the EU.

Foreign companies play a big role in Turkey's current economic success. Since the last currency crisis in 2001, Turkey's economy has grown by an average of 7 per cent a year. Annual foreign direct investment (FDI) inflows were a paltry $1 billion or less until 2004. They ballooned to $9 billion in 2005 and $20 billion in 2006 – more than India received that year. One quarter of Turkey's top 500 companies now have foreign investors. Until recently, it was mainly big multinationals that ventured into Turkey's unstable and difficult market. Now they are being followed by a growing number of small and medium-sized enterprises. And as growth spreads from big cities such as Istanbul, Ankara and Izmir into the regions, foreign companies follow. EU countries account for 60 per cent of the total stock of FDI in Turkey. Of the 15,000 foreign companies that have invested there, the vast majority (8,300) come from EU countries. Germany has traditionally been Turkey's biggest foreign investor, while the Netherlands, the UK, France and Italy also have substantial investments there.

A crisis-prone past

Turkey's current boom is all the more remarkable given its long history of economic underperformance and instability. Periods of mediocre growth were interspersed with economic crises. After the most recent one, in 2001, the lira plummeted by 40 per cent, inflation shot up to 70 per cent and the budget deficit exceeded 15 per cent of GDP. From a West European perspective, the country looked poor, peripheral and volatile. Turkey's economy was the biggest obstacle to its EU accession aspirations. West Europeans feared not only a massive influx of unskilled Turks seeking to escape poverty and unemployment at home. They also thought that Turkey's vast, inefficient farm sector would overwhelm the EU's limited budget. In short, Turkey's economy looked like a threat or burden, not an opportunity. The post-2001 recovery has changed this perception, at least in the eyes of the West European business community.

The International Monetary Fund (IMF) has helped Turkey tremendously in its stabilisation efforts. After the 2001 crisis, it lent Turkey $15 billion, while insisting on a package of far-reaching structural reforms. Inflation is now in single digits and the budget deficit is down to 3 per cent of GDP. Perhaps most important were those steps that helped to insulate the economy from politics, such as making the central bank independent, selling off state-owned companies, strengthening competition policy and improving the legal system.

Progress towards EU accession accelerated in parallel with economic stabilisation. Turkey signed an 'association agreement' as far back as 1963 with what was then the European Economic Community. However, it was not until 1995 that the two sides signed a customs union agreement that abolished barriers to trade in goods. In 1999, the EU for the first time acknowledged Turkey as a candidate for membership. It took another six years before the Union decided that Turkey was ready to start accession talks. The negotiations officially began in October 2005, although in December 2006 EU leaders decided to suspend accession negotiations on eight chapters of the *acquis* until Turkey opens its ports and airports to ships and aircraft from Cyprus.

Although Turkey's path towards EU membership has been neither straightforward nor smooth, it has brought clear economic benefits. In the decade following the start of the customs union, EU exports to Turkey tripled to $58 billion a year, while Turkish exports to the EU quadrupled to $48 billion. Today, the EU is Turkey's biggest trading partner, accounting for 42 per cent of Turkish imports and 52 per cent of its exports. For the EU, Turkey is now a more important trading partner than Japan.

A second, less measurable, impact was on investor confidence. In previous enlargements, FDI picked up in the acceding countries well before they actually joined the EU. Once a country is firmly on its way into the Union, investors know that the business environment will keep improving and that they will be able to export from the candidate country to the EU's single market without encountering significant trade barriers. The sudden boom in FDI just as Turkey started accession talks is surely no coincidence.

Investor confidence is particularly important for Turkey, which still has a large amount of government debt (much of it short term) and a worryingly large external deficit. Although this leaves Turkey dependent on short-term capital inflows, this 'hot money' appears less dangerous than in the past. Looking at the experience of Spain, Greece, Poland and others, investors know that the currencies of accession countries tend to follow an upward trend, and they want to take advantage of these 'convergence plays'.

This also seems to be the case in Turkey. Since the start of accession talks, Turkey has gone through two bouts of market instability. But neither resulted in the kind of currency collapse and market meltdown that Turkey had experienced so often in the past. In May 2006, when Turkey got swept up in a general loss of confidence in emerging markets, investors withdrew some $10 billion at short notice. This was more than the outflow that had triggered the 2001 crisis. But this time, the budget looked sound and the banking system had gained resilience. Turkey's now independent central bank raised interest rates by 4 percentage points, and investors soon returned. Similarly, at the end of April 2007, the stand-off between the Erdoğan government and the Turkish army over the presidential election led to a slump in the stock market and the lira. But a partial recovery followed almost immediately, although markets remained jittery as political uncertainty persisited.

From hazelnuts to high-tech

Growing FDI has supported rapid structural change in the Turkish economy. Gone are the days when Turkey mainly sold farm goods, basic steel and cheap T-shirts to Western Europe. Today, four out of ten TVs bought in the EU come from Turkey, and the country is becoming a leading producer of cars and car parts: in 2006, Turkey produced one million cars, busses and trucks, two-thirds of which were exported. Meanwhile, Turkey's more traditional export industries are changing fast. Since the country's garment producers are struggling to compete with cheap Chinese competition, they are moving into higher quality fabrics and fashion items, and many have successfully established their own brands. Foreign investors are rapidly moving beyond the manufacturing sector and into services, in particular banking. Foreign capital in the Turkish banking sector went from practically zero just a few years ago to 40 per cent today. Similarly, foreign companies now control more than half of Turkey's insurance sector.

Foreign investors are attracted to Turkey by a variety of factors, including its fast-growing domestic market, its strategic location between Europe, Asia and the Middle East and its low-cost labour. The continued migration of workers from rural areas (one-third are still in farming) will keep the salaries of low or unskilled workers down. Some 30 per cent of Turks are below 15 years of age, twice the share found in the EU. Turkey's population will continue to grow rapidly, to probably 85 million by 2030. At present, Turkish income per head stands at around 30 per cent of the EU average. But it has been growing fast, and the Turkish government projects it to exceed $10,000 by 2013. This will allow more Turks to buy cars, go on holiday and refurbish their houses. No wonder that many businesses see Turkey as one of Europe's most exciting markets. As wages and incomes rise, Turkey's attraction will depend more on the skills and qualifications of its workforce. It will also depend on the government's ability and willingness to fix the most egregious flaws in the business environment, such as violations of intellectual property rights, stifling bureaucracy and widespread corruption.

EU accession makes Turkey more attractive

The EU accession process will certainly help to make life easier for foreign businesses on the ground. Of the 35 'chapters' of EU law that Turkey needs to adopt before accession, roughly two-thirds are related, directly or indirectly, to the economy. The customs union agreement has already obliged Turkey to take over some EU rules covering the free movement of goods, competition policy and intellectual property rights. The experience with this limited legal alignment has been positive, but could have been better. In the absence of a firm 'accession anchor', compliance has remained patchy. For example, Turkey has built a well-functioning competition authority, but it still does not have a regime for controlling industrial subsidies. Much progress has been made in enforcing patents in the pharmaceutical industry (a big worry for EU drug makers in the past), but Turkey is still one of the world's top five producers of pirated goods.

Moreover, the customs union only covers trade in industrial goods, not services and farm products. Many of the EU rules that matter most for businesses are not included, for example the right of establishment, company law, public procurement, food safety, consumer protection, taxation and environmental rules. Turkey's efforts to implement the *acquis* in these areas will not only improve the regulatory environment, they will also generate new business opportunities. To comply with the environmental *acquis,* for example, Turkey may have to invest as much as €60 billion, which could bring new business for EU companies that sell consultancy services or environmental technology. Turkish industry may need help with adopting EU health and safety standards. And the EU's directives for liberalising energy, transport and telecoms will create investment opportunities in sectors that were more or less closed in the past. Finally, EU assistance worth more than €500 million a year could benefit EU construction companies working in infrastructure.

Although talks in eight chapters (all related to the customs union) remain suspended, the Turkish government in April 2007 adopted a plan for taking over many EU rules by 2014, irrespective of the state of accession negotiations. Moreover, the EU's decision to freeze negotiations on one part of the *acquis* has helped to unblock negotiations in other areas. During much of 2006, the (Greek) Cypriot government had used its veto to stall all progress in Turkey's accession talks. But once the EU had officially sanctioned Turkey by suspending a limited number of chapters, Cyprus conceded that it should withdraw its veto in other areas. During the first half of 2007, negotiations progressed in areas such as industrial policy and finance.

Why EU business should care about Turkish membership

So far, investment flows have not reacted to the ups and downs in Turkey's negotiations with the EU. This optimism is justified in light of Turkey's continued strong economic growth and the government's apparent determination to stick with the reform process and the accession talks. But EU businesses should also be aware of the risks that stem from the uncertain outlook on accession. Any modernisation process – and particularly one that is as fast and as thorough as that required by EU accession – produces losers as well as winners. Among Turkey's potential losers are some members of the old elite, who benefited from the more protectionist and interventionist economic system of the past; the millions of farmers that will have to leave the land and find work in cities and industrial areas; and workers who lack the skills required to benefit from Turkey's economic upgrading. Many of these people prefer a closed Turkey that changes only slowly.

The risk of a nationalist backlash is fuelled by the EU's ambiguous stance on Turkish membership. If the EU closes the door to Turkey, or if a frustrated Turkey walks away from the accession talks, foreign investors in Turkey will forego the substantial benefits that would otherwise stem from continued legal approximation, strong growth and market opening. EU businesses can and do contribute to making the accession process a success in various ways.

★ **Create jobs and sustain growth**. Foreign investment will help Turkey to smooth the transition from an agricultural economy to one that relies on high-value added manufacturing and services. Income growth, low unemployment and economic optimism will make it much easier for future Turkish governments to implement the often painful reforms needed for EU accession. The Turkish government reports that in 2005-06 – the years that FDI took off strongly – the economy created an unprecedented two million jobs outside agriculture. European companies have contributed to this. Take Bosch, the German car part producer, as an example. In 1995 Bosch's Turkish subsidiary employed 2,000 people; today it has 7,000 staff; and by 2010 the number is likely to be 10,000. Foreign investment also creates jobs in the wider economy. Mercedes has around 3,000 people in its factories producing busses and trucks. But its supplier companies employ another 30,000 or so.

★ **Lobby for reform and explain the EU**. Many of the changes needed to get Turkey ready for EU membership are very much in the interest of the foreign (and domestic) companies that operate in Turkey. As explained above, the *acquis* is good for business. But companies can also help to underpin the reform process by reminding the Turkish government and people of the huge potential benefits that EU membership would bring, and by lobbying the Turkish government to adopt economic and regulatory changes. Some of the EU businesses that operate in Turkey are already engaged in lobbying and PR. But most of this work is done by the Turkish business associations, such as TOBB and TUSIAD (respectively the union of chambers and the association of industrialists and businessmen), which have been extremely active in pushing for EU membership at all levels (as explained by Sinan Ulgen in his CER essay 'Turkish business and EU accession' from December 2006). Some of the bigger foreign investors from the EU have joined TUSIAD, but most have stayed out of political and policy debates. If they have complaints about Turkish laws or policies, they channel them through their respective embassies. Few businesses contribute to TUSIAD's and TOBB's efforts to explain to the Turks what EU accession is about. This is a shame, given that they could bring valuable experience from their home countries.

★ **Act as a pro-Turkish voice in the EU**. Perhaps the biggest risk for Turkey's accession process is the dearth of pro-Turkish voices in the EU's debates about enlargement. Very few politicians now speak out openly in favour of Turkish accession. France's new president, Nicolas Sarkozy, campaigned on a promise of stopping Turkey's accession process. Most voters in the EU are either hostile or indifferent. Journalists rarely bother to explain the potential benefits of having Turkey in the EU. EU businesses with operations in Turkey have the unique advantage of experiencing Turkey's transformation on a day-to-day basis. Many West European managers who work in Turkey persuade their bosses at home that the country's accession is a huge opportunity. But this knowledge seldom spreads beyond board rooms. Big European multinationals and their industry federations could be an important voice in the wider debate about Turkey. But few are. Most EU businesses do not lobby for Turkish accession, either in their home countries or in Brussels. Perhaps this is because for most large European companies, Turkey is a relatively small part of their operations. Perhaps some of the leaders of German, Dutch and French multinationals are genuinely concerned about Turkish accession. Or perhaps they think it more important not to contradict the prevalent public and political opinion in their country than to promote their future business interests in Turkey.

Some EU businesses do actively support Turkey's accession process. For example, they pay for West European journalists to visit Turkey, hoping to encourage more balanced press coverage. EU businesses also use trade fairs across the EU to provide information on Turkey as an investment location. They give money to think-tanks, NGOs and foundations to strengthen political and cultural ties between EU countries and Turkey. Such activities would be all the more effective if they were co-ordinated at the national or EU level. Some industry federations have made their voices heard at critical moments in the Turkish accession process. For example, in 2004 UNICE (the EU umbrella business federation, now called BusinessEurope) openly asked the EU to start accession negotiations with Turkey, as soon as Ankara had made sufficient progress on the political conditions. Similarly, Antony Burgmans, chairman of Unilever and head of the enlargement working group of the European Roundtable of Industrialists (a club of prominent business leaders) included Turkey's EU accession in his list of recommendations for the Dutch EU presidency in 2004. When the EU decided to open negotiations in 2005, the Confederation of British Industry and TUSIAD welcomed the step in a joint letter to the *Financial Times*.

The Swedish, Danish and Dutch business federations have also often spoken up in favour of Turkey's full membership once the country fulfils all the necessary criteria. But their German, French and Austrian counterparts have been more cautious. The former boss of the German industry federation (BDI), Michael Rogoswki, used to back publicly rapid Turkish accession. But under his successor since 2005, Jürgen Thumann, the BDI has been advocating a 'privileged partnership' for Turkey, in line with the official stance of the CDU and CSU, the main conservative parties. Similarly, the boss of the German employers' federation (BDA) has said that neither Turkey nor the EU would benefit from Turkey's full membership "for the foreseeable future". The caution of German business federations contrasts oddly with their outspoken policy on Russia, through the *Ost-Ausschuss der deutschen Wirtschaft,* a club of companies that work in and with Russia and other East European countries. There are also signs of growing restraint at the EU level: BusinessEurope confirms that "a good EU-Turkish relationship is essential from an economic viewpoint"; but it adds that at the political level it has decided "to leave to the governments the responsibility of leadership". It says that the reason none of its 60-odd working groups deals with Turkey is that the country is already a developed market economy and, unlike the East Europeans in the 1990s, does not need much Western help for aligning its laws.

Turkey needs the voice of business

Thousands of companies from across the EU are doing very good business in Turkey's booming economy. The people leading these companies are usually in favour of full Turkish membership in the EU. They know that only by joining the EU will Turkey take over the entire single market *acquis* and fully open its economy. If the accession process continues, EU business can hope for a virtuous circle of continued reform, strong foreign investment and high economic growth rates which, in turn, will underpin further reforms. But European managers are also aware that a disruption of the accession process would undermine their business success in Turkey. Here looms the risk of a vicious circle in which pre-accession preparations stall, foreign investment dries up, growth falters and the government reacts with further protectionism. Yet few European business leaders speak out openly in favour of Turkish accession. This is strange, since they experience the fast and positive changes in Turkey on an everyday basis. Their voices are needed if Turkey's accession process is to be sustained.

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