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New challenging issues for world trade and the world economy
Strategies for the EC-Turkey Custom Union

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Section 1. Assessing the situation: the global environment

The recent crisis has deeply changed the environment in which the EC-Turkey Custom Union (ECT) will develop. The world trade in goods was experiencing its worst collapse in almost a century (a fall of 20 percent in volume in one year, twice more than in 1929-30 for the same time lapse) but it looks also faster back on track [Eichengreen and O'Rourke 2010]. Meanwhile, trade in some services (telecoms, insurance, etc.) has been resilient to the crisis, even during its peak, while trade in the other services (transportation, tourism, etc.) has been hurt, though less than trade in goods.

The good news is that, contrary to initial fears, the world trade regime has been very resilient to the crisis with no wide surge in tariffs, particularly from WTO Members with bound tariffs (much) higher than applied tariffs. That said, there are bad or mixed news. First, there has been a surge in subsidies, particularly in the U.S., EC and China, leading to industrial policies with negative consequences in the longer term. Second, the fate of the Doha Round looks uncertain until 2013—despite the fact that the existing proposals are substantial and balanced, as shown by Table 1.

Last but not least, the macro-economic situation is far to be stabilized, particularly in Europe. The banking crisis is not over: European banks are highly exposed to quasi-bankrupted countries, as best illustrated by the French and German banks (32 and 19 percent of all the foreign claims on Greece, respectively [Scotiabank Group 19 June 2010]). The risks of an

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euro crisis echo bad macroeconomic indicators (public debt/GDP ratios) that have reached levels that could easily generate panics.

Table 1. The various values of the Doha Round

criteria	gains		sources
in terms of productivity	5 percent	average cut of tariff per year of negotiations	Messerlin 2007
welfare gains	50-160	US$ billions	Laborde et al. 2009
full liberalisation of 3 sectors	100	US$ billions	Adler et al. 2009
modest liberalization in services	100	US$ billions	Adler et al. 2009
trade facilitation	385	US$ billions	Adler et al. 2009
value of binding	400-900	US$ billions	Laborde et al. 2009, Productivity Commission 2009

Source: Messerlin 2010.

Of course, such a tectonic shift in the world economy is having a deep impact on global governance, mirrored by the emergence of the G20. So far, the G20 has played a very positive role. It did not try to replace existing institutions. Rather, it assigned tasks to them, such as its request to the WTO-OECD-UNCTAD to document the rise of protection.

That said, the G20 is facing two difficult symmetrical "adjustment" problems, and one problem of "excessive expectations".

Since the mid-1990s, it was clear that the world would dramatically change—for the best of the human kind since hundreds of millions of people are evading poverty and becoming progressively as rich as those living in industrialized countries. The problem raised by the crisis is that it hastens so much two "twin" evolutions that it is making both of them more difficult.

- "Diminishing giants". The US and the EC are insisting heavily on the fact that G20 membership is imposing "new responsibilities", and that the emerging giants should be more fully involved in designing a new global economic framework—suggesting that it has not been the case so far. The evidence does not support this view. Rather, the "core" emerging economies (Brazil, China, India, Korea and Mexico) have already played a decisive role in two key international economic issues – the world trade regime and the management of the worldwide economic crisis – while the jury is still out on the third one – global environment. Few people realize the fundamental contribution of the emerging economies to the success of the current world trade regime, something that has been of great benefit to OECD countries as well as to themselves. During the last three decades, the amazing success of China's trade liberalization has done much more to convince the other developing countries of the gains from trade than all the U.S.-EC exhortations. China has undertaken over the last 20 years a liberalization process that it took 40 years for the U.S. and Europe to do. On crisis management in the wake of the financial meltdown of autumn 2008, the emerging economies have certainly been as diligent and active as the U.S. and the EC, judging by IMF indicators.

- "Emerging giants". China and a few others new giants are torn apart between two feelings: an excessive modesty *à la Deng XiaoPing* during the 1980s and an excessive pride echoing their current successes. The fact that the core emerging economies have already contributed substantially to the shaping of the new global economic framework does not mean that they will not face severe challenges in the coming years, particularly with their domestic huge income discrepancies which put at great risk their long-term growth and political stability.

Rapid adjustments are also made difficult by serious problems of domestic governance. In most democratic developed countries, there is the "tyranny of tiny majorities": during the twenty last years, governments have had to rely on increasingly small majorities which greatly complicate the taking of hard decisions (Britain being the last example) [Messerlin 2007a]. Non-democratic emerging economies are in no better shape, as is illustrated by the factionalism among China's policymakers (supporters of rural versus coastal provinces, of market-based reforms versus state-control). This factionalism has inhibited China from making progress on subjecting the yuan to market forces, has fragmented China's overall stimulus package into sectoral industrial policies and is forcing Chinese people to keep relatively high saving rates for covering health and retirement expenses, hence to maintain global imbalances. All of this is making more difficult the much-needed "rebalancing" of the Chinese economy towards more domestically-based growth.

Last but not least, the G20 is facing a severe problem of "excessive expectations". If the G20 is rarely seen as a "governing" body—a role it has no chance to play—it is subjected to a milder version of such a view: the G20 should deliver "strong" consensus. Such expectations do not make much sense in a world facing so rapid and deep evolutions, hence where, by definition, there is not "one optimal" policy, but a range of "reasonably good" policies. Rather, what should be expected from the G20 is a "limited" consensus—that its main members agree on the broad direction to be taken, but not necessarily on the intensity or the timing of the measures to be taken. One should realize that, by acting in this way in such an uncertain and volatile environment, governments should aim at doing their best to compete in terms of quality when designing their policies.

Section 2. Assessing the situation of the EC-Turkey Customs Union (ECT)

The ECT vigor depends fundamentally upon the fitness of each of its members. I will spend more time on the EC because I know it much better than Turkey.

The EC

The recent crisis reveals openly the EC fundamental weaknesses which were noticeable years ago [Messerlin 2001, 2007b, 2010] but which were hidden by the fact that, during the 1990s, most EC Member States (ECMS) were living beyond their means, and that the Commission was increasingly loosing contact with European realities. The EC is in a deep need for a "drastic review" of the core beliefs on which it has relied. What follows lists some key beliefs.

- *The bigger, the better*. There has been little consideration paid to the increased heterogeneity of the EC. This is unsustainable in the long run if the EC wants to keep its current approach of "one size fits all" and, at the same time, wants to minimize the risk of secessions. Flexibility is the way to solve these contradictions, and it has crucial consequences for reshaping the EC neighborhood policy.
- *The Internal Market requires an ever larger "acquis communautaire"*. In goods, the pendulum seems back to harmonization of norms, despite the fact that it is a very regulatory-intensive, time-consuming exercise, with mixed results (to say the least). In services, the Internal Market was initially believed to be achievable with a few (50) Directives. Today, more than 500 new Directives have been adopted, and yet, the Internal Market in services is an objective far to be achieved [Miroudot, Sauvage and Shepherd 2010].
- *The euro is "the" discipline*. Initially, the euro was seen the necessary and sufficient source of reforms in the eurozone economies. This belief is the twin of the belief in perfect financial markets which prevailed in the U.S. and Britain. The conditions of accession of several countries (from Greece to Italy) to the eurozone, and the progressive neglect of the Maastricht criteria (budget deficit, debt ratio) by all eurozone Members but a few have magnified problem.

- *Regulatory competition among ECMS is systematically perceived as bad*. Adopting the euro should have been accompanied by deep regulatory reforms in most ECMS in order to make domestic markets of goods and services more competitive in order to improve productivity. This did not happen in most ECMS: all the available indicators show no systematic convergence among ECMS in terms of the quality of the regulations, as illustrated by Table 2.

Table 2. No convergence in indicators of good governance in the EC

	Doing Business indicators [a]					Market size at [b]	
	ease of doing business	Non tariff barriers	dealing with licences	registering property	protecting investors	current USD	PPP USD
	1	2	3	4	5	6	7
A. The EC and the cohorts of ECMS [c]							
EC27 (all ECMS)	35.0	32.2	52.6	68.2	62.8	0.0	0.0
EC1958	36.3	27.8	40.2	87.8	72.4	0.0	0.0
EC1973	6.0	25.3	54.4	28.2	9.9	Market size [a	0.0
EC1981	56.5	52.4	60.2	59.3	91.5	at	at
EC1995	20.2	10.5	34.0	22.5	81.0	current	PPP
EC2004	60.8	50.9	111.2	65.0	64.6	USD	USD
Baltics	27.0	21.2	58.2	30.7	69.8	0.0	0.0
EC2007	46.5	55.8	95.4	100.0	38.0	0.8	0.4
B. EC neighbours							
EFTA	16.3	25.8	45.8	11.0	102.2	1.7	0.9
Turkey	59.0	59.0	131.0	34.0	53.0	0.0	0.0
Balkans	101.7	97.0	163.9	93.3	101.3	0.0	0.0
East Eur. & Caucasus							
Armenia	44.0	143.0	42.0	5.0	88.0	<0.1	<0.1
Georgia	15.0	81.0	10.0	2.0	38.0	<0.1	<0.1
Ukraine	145.0	131.0	179.0	140.0	142.0	0.3	0.6
Central Asia	86.6	165.6	151.1	51.3	67.1	at	at

Source: Messerlin 2008. Notes: [a] World Bank. [b] WTO Trade Profiles.

Rather, they show "deep" and "limited" reformers—both in and out of the eurozone. Interestingly, three years after the start of the crisis, deep reformers still enjoy a "premium" (higher average growth rate per capita) compared to limited reformers, even when the crisis has hurt them (Baltics) more severely than limited reformers (Poland, Hungary) as illustrated by Table 3.

- *The need to go fast in institutional building*. The EC has wasted a lot of time in what turned out to be exercises in futility—from the Treaty about the Constitution to the "Lisbon Agenda" to the recent "Europe 2020". They ended up in fiascos ultimately raising doubts about the whole European endeavor. The key issue remains the balance of powers between the ECMS and the EC. The ECMS will remain pivotal for a long time to come. That should not be a serious problem if it is well understood that the ECMS are competing between themselves (and with the rest of the world) for providing the best possible regulations to their citizens, and if the EC *per se* is seen as an useful facilitator of such a competition.

The Lisbon Treaty does not ensure such goals. Rather, it makes the EC machinery more complex, with an implicit power shift to the ECMS combined with more volatility at the EC level due to the enlarged role of the European Parliament. And it leaves aside the key question of the appropriate role of the Commission. Over the two last decades, the Commission has increasingly behaved as it were a government, leaving aside its primary tasks—monitoring the EC (Article 155/211 §1) and benchmarking the ECMS (Article 155/211 §2). The recent crisis shows how crucial are such tasks. Revealing on time Greece's (and others ECMS) frauds in terms of macroeconomic data, delivering on time a much stronger assessment of the ECMS policies in state aid during the crisis, etc., would have considerably reduced the likelihood and the costs of the current situation.

Table 3. Regulatory vs. economic performances

	Doing Business indicators [a]					Market size at [b]	
	ease of doing business	Non tariff barriers	dealing with licences	registering property	protecting investors	current USD	PPP USD
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EC1958	36.3	27.8	40.2	87.8	72.4	18.4	12.0
EC1973	6.0	25.3	54.4	28.2	9.9	6.4	4.0
EC1981	56.5	52.4	60.2	59.3	91.5	3.7	2.8
EC1995	20.2	10.5	34.0	22.5	81.0	2.1	1.3
EC2004	60.8	50.9	111.2	65.0	64.6	1.7	2.1
Baltics	27.0	21.2	58.2	30.7	69.8	0.1	0.2
EC2007	46.5	55.8	95.4	100.0	38.0	0.3	0.5
B. EC neighbours							
EFTA	16.3	25.8	45.8	11.0	102.2	1.7	0.9
Turkey	59.0	59.0	131.0	34.0	53.0	1.0	1.2
Balkans	101.7	97.0	163.9	93.3	101.3	0.3	0.2
East Europe and Caucasus							
Armenia	44.0	143.0	42.0	5.0	88.0	<0.1	<0.1
Georgia	15.0	81.0	10.0	2.0	38.0	2.7	3.8
Ukraine	145.0	131.0	179.0	140.0	142.0	0.3	0.6
Central Asia	86.6	165.6	151.1	51.3	67.1	0.3	0.4
Mediterraneans	104.7	57.1	126.1	114.9	83.0	1.2	2.0

Source: Messerlin 2008. Notes: [a] World Bank. [b] WTO Trade Profiles. [c] Cohorts: ECMS having joined the EC at the same time.

<u>Turkey</u>

The three main problems on Turkey's side [WTO Trade Policy Review on Turkey in 2007] seem the following ones (once again, I should emphasize my very limited knowledge of the Turkish economy).

- *<u>The functioning of the ECT</u>*. There are persistent rumors that the ECT functioning on a day-by-day basis is not fully satisfactory, with notable divergences of views on trade of goods. The fact that the ECT Association Council does not provide a full and transparent information on these matters adds to the difficulties. There are also the pending unresolved issues related to the way that some services tightly related to trade of goods—as best illustrated by the EC stringent visa requirements on Turkish drivers of trucks—are treated by the EC: imposing such visas imposes indirect and costly constraints on trade of goods.

- *The "Global Europe" strategy*. Since 2006, the EC has decided to open negotiations on preferential trade agreements (PTAs) with almost 24 countries. As of today, only the PTA with Korea has been initialed. The logic of the ECT requires that the EC PTA-partners give the same treatment to Turkey than to the EC on the topics covered by the ECT. But, Turkey has notorious difficulties to get this "parallel" treatment, and, during its negotiations with these third parties, the EC is doing little (if any) for ensuring such a treatment.
- *Turkey and the emerging economies*. Turkey's position in the G20 (or in similar fora) is torn apart between, on the one hand, its desire to become a ECMS and its strong trade links with the EC which induce Turkey to support EC positions and, on the other hand, its affinities with emerging economies. As in all the emerging economies, the economic and social progress of the last two decades has generated increased self-confidence, has eroded the borderlines taken as granted during the previous 50 years, and has re-energized perspectives rooted in a far away past (the "Ottoman" sphere in the case of Turkey). The collapse of the former USSR has made these changes even stronger in the case of Turkey.

Section 3. Options for strategies for the next 5 years

What follows aims to be pragmatic. It focuses on what could be done within a short period of time—say 5 years. Such a time constraint makes unplausible any "grand scheme", but it is long enough to offers opportunities to improve the current momentum.

Would the EC be an active partner vis-à-vis Turkey?

I expect the EC to be relatively "inert" because of the many internal challenges following the crisis. But, I also expect the EC to be less assertive and stubborn—in short, more modest—because of the hard lessons brought by the crisis. What follows describes a few forces behind these two changes of attitude.

- The next few years will (hopefully) be years of a "drastic review" of the European endeavor. That means that little else could be done because such a review would require many efforts and a lot of time. But, the worst that could happen is that such a review would not take place at all, that the EC would be unable to break its current mold, including its approach with respect to its neighbors.

- The consequence of the financial crisis will continue to shake the ECMS for a long time. It will do so much beyond narrow macro-economics: lack of trust between ECMS, slow reactions for confronting a crisis possibly followed by excessive re-regulations, Europe-wide anger about banks, markets and austerity programs, unfair distribution of the burden imposed by the past mistakes, etc. All this has the potential to create a strong anti-Europe movement in a number of ECMS. Moreover, as long as the Commission believes that it can play the role of a super-government—as it still does—it will have little impact in such troubled times.
- The EC crisis-related problems are heavily concentrated on Mediterranean countries (Greece, Spain, Portugal, perhaps Italy and France). This will not help the EC to be pro-active in re-opening issues of interest for Turkey in the ECT context (farm products, fisheries, even in some services such as tourism).
- A more predictable Ukraine would have made easier for the EC to be active with Turkey to the extent that it would have helped to re-think a broad European "Östpolitik". Things are probably made even harder with the recent EC inroads in Caucasus (Georgia, Armenia) in a region highly inflammable and sensitive for Turkey.
- All the previous points suggest that the EC may limit its "active" usual neighborough policy to a very narrow region—the Balkans. But, that will not make necessarily easier the EC-Turkey relations.

The key point is the balance between EC inertia and modesty. If inertia dominates, Turkey will look increasingly towards new horizons. If modesty dominates, many opportunities may emerge.

<u>Should then Turkey turn to stricter international rules?</u>

An EC more inert than modest may induce Turkey to turn to international fora, and to try to find in broad international rules the framework that it could not find in the ECT. However, such a strategy is full of obstacles.

- It is not well-suited to times dominated by an on-going shift of the tectonic plates in international economic relations. The combined emergence of new world powers with the diminishing influence of the current powers is not propitious for stricter disciplines. The world's rising powers will increasingly be dis-inclined to accept disciplines that they see as American or European tutelage. At the same time, they themselves are still far from being able either to exert leadership or to introduce more disciplines.

- Moreover, the geographical location of Turkey is not helpful. Turkey does not pertain to a region which has Asia's dynamism. Trade agreements in Asia may be chaotic and discriminatory in many respects, but they continue to open new markets.

<u>Then what could be done by Turkey?</u>

As a result, "leading by example"—a form of unilateralism (with the positive meaning that this term has in economics)—appears the most attractive option, including because it would be attractive to a more modest EC. For Turkey, this option means to adopt a "best ECMS" policy for its own benefits, while improving Turkey's chances to become ECMS, especially if modesty dominates the EC.

A "Best ECMS" policy would consist in adopting the pro-competitive provisions of the EC regulatory body (the so-called *acquis communautaire*) on their own merits—in other words because these provisions are good from Turkey's perspective, not because they are requested by the EC—and in putting aside the rest of the *acquis*.

<u>*Industrial goods*</u>. Turkey could improve its situation by taking both unilateral and bilateral initiatives.

- Turkey has still a complex tariff schedule: more than 18,000 lines, 214 tariff bands, mass housing fund levy, unbound tariffs, an intensive use of antidumping (in 2000-2006, Turkey is the fourth worst antidumping user in the world) [2007 WTO Trade Policy Review]. If this information is still accurate, unilateral reforms should (i) simplify the tariff schedule in order to get a more uniform protection and (ii) bind tariffs on the basis of the Swiss 20 coefficient suggested by the Doha Round. This binding could be provisional (say until 2015) and become permanent if the Doha Round is completed by then. A simplified and more uniform tariff will increase "tariff-neutral" investment decisions from businesses, allowing better resources allocation in Turkey, while a provisional and conditional Doha-like binding will reinforce what has been done *de facto* during the last years, without undercutting Turkey's negotiating position in the Doha Round.
- In addition to such unilateral measures, Turkey could improve its bilateral agreements along three lines: (i) the complete elimination of tariffs already existing with countries with a clear EC accession agenda (Macedonia, Croatia, BiH, Albania) should be

extended to the remaining Balkan countries if it is still not the case; (ii) the complete elimination of tariffs with countries with unclear or no EC accession agenda (Egypt, Israel, Palestine, Syria; Tunisia, Morocco; Armenia, Georgia, Ukraine) should be consolidated ("plurilateralized") in one FTA among all these countries; (iii) the principle of no tariff higher than 15 percent (ECOTA) should be extended to all ECO members, with a view to lower the 15 percent maximum within a reasonable time frame (the 15 percent target is more or less what the Doha Round would provide).

Farm and food products. It may be difficult to do much progress in farm products. But, Turkey should request negotiations on food products (agro-business) and fishery products which represent more than half of the 2000 HS6 tariff lines in the ECT.

Services. Liberalizing services boils down to domestic regulatory reforms. Turkey should adopt as its own the principle of "mutual evaluation" laid down by the most recent EC Directive in services (the "Services Directive"). In this context:

- Turkey should review its own laws in the light of the *acquis*, with the aim of starting to implement the pro-competitive components of the *acquis* as soon as possible. An example of what should be down is illustrated by the EC-Morocco Air Agreement [Bertho and Messerlin 2009]: (i) only a small portion of the *acquis* included in the Agreement has a strong pro-competitive impact, hence would be worth being implemented by Turkey; (ii) a notable portion of the Agreement has a potentially strong negative impact on costs, hence should be left aside.
- Turkey's regulatory reviews would be even more beneficial if they are conducted in a plurilateral framework including countries (for instance, Egypt and Ukraine) with strong links with the EC and facing the same basic problem than Turkey—what to do with the EC trying to impose the whole *acquis* to its neighbors. Such an approach could be extended to additional countries (Central Asia) of particular importance for Turkey.

Such an approach would be beneficial for the EC itself. On the EC external front, it would indirectly allow the EC to expand the pro-competitive part of its regulatory framework to more countries. On its internal front, it would pave the way to a new regulatory approach (not based on "one size fits all") much more appropriate to a very heterogeneous EC (and it will help to avoid basic mistakes, such as allowing the ECMS which need most pro-competitive applications of the Gas Package not to enforce them [Dreyer, Erixon and Winkler 2010]).

Focusing on domestic institutions. One of he main reasons for the Commission's failure to play its full role may have been the absence of domestic support in each ECMS. In other words, the condition for a strong enforcement of international institutions may be strong domestic institutions, as best illustrated by the Australian Productivity Commission.

Concluding remarks

Turkey and the EC are suffering from symmetrical limits inheritated from the XIXth century. During the XIXth century, Turkey has had a long history of deep reforms consisting in importing foreign models, meeting strong domestic resistance and delivering mixed success. I sense this history as having shaped a deep feeling in Turkey that reforms need a very strong foreign push. During the XIXth century, the ECMS have had a long history of reforms which have been relatively successful. This history has shaped a deep feeling of over-confidence in European craftmanship in regulatory matters.

Let us hope that the current crisis is shaping a salutary re-balancing, with a more dynamic and confident Turkey meeting an EC more modest and readier to value neighbors.

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