



Central Bank of Turkey

THE TURKISH ECONOMY AND THE EUROPEAN UNION

Süreyya Serdengeçti

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Distinguished Academicians, Guests,

It is a great pleasure for me to be here with you today at London School of Economics (LSE), and to have an opportunity to give this lecture on such a delicate subject, that is the Turkish economy in the context of the European Union (EU).

I would also like to express my heartfelt thanks for the establishment of the Chair in Contemporary Turkish Studies that, I believe, will play an important role in the relations between Turkey and the EU.

I want to begin my speech by first giving you a simple description of Turkey on its way towards the EU membership. I will be referring to the words of Sir Winston Churchill. On November 10, 1942, after the victory at El Alamein that changed the course of the Second World War, he said, *“This is not the end. It is not even the beginning of the end. But it is, perhaps, the end of the beginning”*. Personally, I think this is exactly how we should see the Turkish membership in the EU as of October 3rd; it is simply the end of a long beginning.

Three important points now: the first one is about the fact that in Turkey, the EU accession has always been a long-term goal.

In historical perspective, as you all know very well, the EU is a *“sui generis”* structure implying a legal, political and economic project of integration shaped around contemporary values. Quoting Prime Minister Tony Blair’s own words; *“This is a union of values, of solidarity between nations and people, of not just a common market in which we trade but a common political space in which we live as citizens.”*¹

On the other side, as Atatürk, the founder of the modern Turkish Republic, clearly stated; *“the contemporary level of civilisation”* has always been Turkey’s main objective since its foundation as a republic out of the ashes of the Ottoman Empire. Therefore, considering the main principles of the EU and Turkey’s desire to reach the contemporary level of civilisation, Turkey’s everlasting willingness to be a member of the EU shouldn’t be surprising.

Accordingly, Turkey had applied to the EU for full membership in 1959. During these 46 years, governments with different political views have been in charge. Despite some delays, setbacks and obstacles in relations with the Union all over this period, our aim of full membership has never changed. Also, the majority of the Turkish society has always been supporting the main goal of full membership. In fact, 68 percent of the public who answered

¹ Blair, T. (23 June 2005). *“PM Speech to the EU Parliament”*. EU Parliament.

the most recent questionnaire of Euro Barometer in 2005 responded in favour of full membership.

The second point I want to make is about the whole process leading to the eventual membership of Turkey to the EU. The eventual membership will depend on a lot of factors, political and economic. Clearly, it is hard to know in advance what the outcome of the process will be. But what I believe is that whatever the outcome, the whole process until the final stage is more important than the outcome itself; and that's because the process will involve serious political, legal and economic reforms that we have to do for ourselves anyway in Turkey.

The third point is that there is a deterministic issue: That is globalisation. As Alan Greenspan indicated in one of his speeches; *"Globalisation has altered the economic frameworks of both advanced and developing nations in ways that are difficult to fully comprehend."*² In other words, it is obvious that we cannot complete our analyses related to the EU and Turkey by disregarding globalisation and its effects on the functioning of the world economy and individual countries.

In recent decades, increasing number of countries have been integrating to the world economy and politics so the world is going through a rapid alteration. Hence, this change brings about new challenges to the international arena that even industrialized countries have difficulties to cope with.

I believe that the notion of enlargement provides a mean for the EU to increase its power both in political and economic environment in the world and to face challenges in the international arena as a global power.

I will refer once again to Prime Minister Tony Blair's words: *"It would be a Europe confident enough to see enlargement not as a threat, as if membership were a zero sum game in which old members lose as new members gain, but an extraordinary, historic opportunity to build a greater and more powerful union. Because be under no illusion: If we stop enlargement or shut out its natural consequences, it wouldn't, in the end, save one job, keep one firm in business, prevent one delocalisation. For a time it might, but not for long. And in the meantime Europe will become more narrow, more introspective and those who garner support will be those no in the traditions of European idealism but in those of outdated*

² Greenspan, A. (10 March 2005). *"Globalization"*. The Council on Foreign Relations, New York, NY.

*nationalism and xenophobia. But I tell you in all frankness: It is a contradiction to be in favour of liberalizing Europe's membership but against opening up its economy"*³

Since its foundation in 1957, the EU has continuously been engaged in a process of enlargement. The process, having begun with the inclusion of the UK, Ireland and Denmark in 1973, has proceeded for the time being with the challenging accession of the ten Central and Eastern European countries on May 1st, 2004. Thus, enlargement has become an important aspect of the EU policy.

Distinguished guests,

Almost in every meeting on the EU and the Turkish economy, I am faced with questions such as *"What can Turkey contribute to the EU, in other words, what will be the advantages of the EU from Turkey's membership?"* or *"What does Turkey expect from being a full member of the Union?"*.

But, there are no easy and quick answers to these questions. Therefore, my answer will rather be a long one.

Apparently, there are very strong arguments in favour of Turkish membership such that Turkey will bring the Islamic world and the Western world together or a larger EU with Turkey will certainly be a much bigger power playing an important role in the world.

Apart from political aspects, it is clear that the debate on the Turkish membership is very much related to the economic structure of Turkey. Hence, I want to make one thing clear: although membership is a political decision in essence, my answers to the questions I mentioned will focus mainly on economic aspects.

Having this in mind, now I'd like to start with the notion of competitiveness on a global level and its implications for both Turkey and the EU.

The 20th century has been a new era in terms of diminishing borders in trade and means of production and led to increasing competition all around the world.

As we all know, Europe and the United States (US) had been the engines of world development in the last few centuries. However, emergence of new actors into the picture in recent decades has changed the global economic environment.

³ Blair, T. (23 June 2005). *"PM Speech to the EU Parliament"*. EU Parliament.

Despite the fact that the role of the US has been continuing with an increasing weight, that of the EU has been rather slow. And hence today together with the US, new global actors are coming to the forefront, for example emerging from Asia such as China and India.

To be more precise, between the years 1980 and 2004, the share of the EU-15 trade in total world trade decreased by 25.3 percent while that of East Asia and Pacific region countries increased by 165 percent. During the same period, the US also increased its share in total world trade by 13 percent.⁴

We observe a similar pattern in terms of growth as well. In fact, the largest rise in shares in total world output since 1980 belong to East Asia and Pacific region countries by 68 percent. However, the share of EU-15's output in total world output decreased by 6.8 percent during the same period⁵.

It is exactly at this point that Turkey comes into the picture of the EU as one of the new actors in the global economy.

So, I will elaborate briefly on the achievements in Turkey in the last four years.

Since the 2001 crisis, a comprehensive stabilization program has been put with determination into practice. Tight monetary and fiscal policies along with an intensive structural reform agenda have been the three main pillars of the program.

Thanks to these policies, firstly, disinflation has finally succeeded. Inflation targets have been reached in three consecutive years; the inflation rate of 73.2 percent in January 2002 is now down to single digits that is 8 percent as of September 2005 after three decades of high and chronic inflation.

Furthermore, not only inflation fell to single digits, but also dynamics of inflation have changed significantly and that ensures the irreversibility of the disinflation process in Turkey.

After so many failures in three decades, the turning point came when the Central Bank of Turkey (CBT) has been granted independence. In May 2001, the CBT Law was amended so that the primary objective of the CBT has been defined as to achieve and maintain price stability, and since November 2001, no credits are extended to the public sector. I should say that these developments have been the milestones of disinflation in Turkey.

⁴ The World Bank. Own calculations.

⁵ The World Bank. Own calculations.

The change in inflationary dynamics also came as a result of a very transparent communication policy, which has been instrumental in changing the expectations of the public about stabilisation. Policies gained credibility; inflation inertia has decreased sharply; the volatility of inflation too has declined. Hence, the inflation target is now a more credible nominal anchor for economic agents.

To sum it up, today, Turkey appears to be catching up with the Maastricht criterion on inflation.

Secondly, the Turkish economy grew by a total of 28 percent between the end 2001 and the first half of 2005. This is the highest rate among the EU countries and the acceding countries such as Bulgaria and Romania, also one of the highest in the world.

A closer look into the spectacular growth reveals the fact that the dynamics of growth have been changing as well. These high growth rates have been attained while inflation was coming down continuously, contrary to the widespread belief in Turkey up to 2002 that inflation made growth possible.

During this new era, the productivity surge in the economy and the private sector have been the engine of the growth performance. Actually, in the last three years the cumulative increase in labour productivity is about 35 percent.

Besides, it is essential to note that exports of goods are contributing to growth with an increasing share. As a matter of fact, the total foreign trade volume has gone up by 120 percent since 2001. This figure is the highest among acceding countries and all members.

Turkey is now focusing on maintaining high growth rates on a sustainable path.

The third point in developments in the Turkish economy is that tight fiscal policy and sound debt management brought substantial improvement to the debt dynamics, which was in the centre of concerns together with inflation four years ago. So, the gross public debt declined from 107.5 percent in 2001 to 74.6 percent by the second quarter of 2005. The Maastricht criterion on gross public debt may be met in the near future.

These achievements on the macroeconomic front, the improvement in the debt dynamics and the positive outlook for growth have brought more resilience to shocks and contributed to financial stability. Volatility in the financial markets has decreased; maturities are now longer; derivatives markets finally begin to develop.

Though it is essentially a political decision, the negotiations between the EU and Turkey would not have started at all if we had not made all these achievements.

Distinguished participants,

Turkey's membership implies an expansion of the EU market. The Turkish economy is among the biggest 20 economies in the world. It is the largest economy in Eastern Europe, the Balkans and the Middle East, second in the Black Sea Basin and sixth among emerging market economies.

Unlike most of the new member states at the start of negotiations, Turkey already has a functioning market economy, which is far advanced in meeting the economic chapters of the *acquis communautaire*. This is because of the start of the development of the market economy goes back to 1950, relationship with the EU back to 1963 and the completion of the Customs Union back to 1995. Indeed, Turkey is the only country that completed customs union without being a member.

In a sense, Turkey is more integrated to the European markets than many new members and other candidates. When you look at the current account, Turkey has the second largest share after Poland in total trade volume towards the EU-15. And as of August 2005, the share of the EU-25 in Turkey's total exports and imports are 52.5 percent and 42.4 percent respectively.

Furthermore, 52 percent of the total number of tourists visiting Turkey so far in 2005 are EU citizens.

Viewing Turkey's capital account, it is noticeable that in the last two years, 85 percent of total foreign direct investment inflows to Turkey came from the EU. That figure was 71 percent on average in the last fifteen years.

In consequence, the Turkish membership to the EU will nourish this close economic relationship further.

Turkey's membership will not only create a market for the EU in favour of both consumers and firms, but also help the EU to become closer geographically to the Middle East, Russia, Black Sea and Central Asia markets and so increase its competitiveness.

As you all know, Turkey is an important regional power at the crossroads of important energy, transportation and communication networks. It can also be said that Turkey is the only country in the region with the necessary institutional structure and capacity for

integrating the region to the world economy through business association networks and partnerships.⁶

In addition to this, in terms of the EU's long-term energy policy including petrol, natural gas and water sources, the increasing importance of the Middle East and Caspian Region has made Turkey a bridge to the energy sources in the region.

With this strategic location, it is in the geo-strategic interest of the EU to have Turkey as a member with regard to the foreign and security policies dimensions. And, I believe that the Turkish accession will be a strategic opportunity for Europe.

Distinguished guests,

Despite the improvements in the Turkish economy, it is obvious that at the present stage Turkey has lower income per capita compared to the new members and acceding countries.

However, we know that income per capita of the new members and acceding countries when they started negotiations was similar to that of Turkey.

Actually, decomposing the equation of income per capita, we see that it is a product of productivity, employment rate, inverse of the dependency ratio⁷ and participation rate.⁸

In other words, increase in income per capita can be accelerated by productivity growth, increase in employment and labour participation rate and decelerated by increase in the dependency ratio. I will use this basic equation as a tool to highlight the areas to be improved in Turkey and Turkey's possible contributions to the EU in terms of productivity, demographic developments and the repercussions of all these in the labour market.

First of all, as Ben Bernanke indicated, *"Productivity growth is the principal source of improvements in living standards"*⁹.

And then, we observe that during the last decades, the EU has lagged behind in productivity growth compared with other industrialized economies.

In particular, labour productivity growth has been weak since the mid-1990's.¹⁰ Thus, while growth in hourly productivity in the 1980's stood at 2.4 percent on average in the Euro area

⁶ Sak, G. (2005). *"EU-Turkey Relations: Time for Contemplation? Time for Reality Check?"*. Berlin.

⁷ Dependency ratio is described as the ratio of total population to working population i.e. aged between 15 and 64.

⁸ Gerald, J.F. (23 April 2004). *"Lessons from 20 Years of Cohesion"*. The Economic and Social Institute, paper presented at the Brussels Economic Forum.

⁹ Bernanke, B. S. (19 January 2005). *"Productivity"*. The C. Peter McCollough Roundtable Series on International Economics, Council on Foreign Relations.

and at 1.3 percent in the US, that trend has been reversed between 1996 and 2004, with an annual average in the Euro area and in the US of 1.3 percent and of 2.5 percent respectively. In the US, productivity growth has even picked up to 4 percent per annum since 2001, despite adverse factors such as September 11 terrorist attacks, the 2001 recession and the recent rise in energy prices.¹¹ Of course, there are several reasons of the EU's lagging behind in the productivity growth. However, they are beyond the scope of my speech today.

When the productivity comparison is made between Turkey and the new EU member states, it is seen that the average gross value added per employee was 10.9 in Turkey for the year 2004, while the same figure was 4.1 for Bulgaria, 4.2 for Romania, 10.9 for Poland, 11.5 for Hungary and 11.7 for the Czech Republic.¹² Turkey is not lagging behind these countries.

It also has to be taken into consideration that some of these countries' figures reflect their positions after accession. But, Turkey has just started the negotiations. Most probably, with the reinforcements of the structural reforms during the accession process, Turkey will be even better off in terms of productivity when the date of accession comes.¹³

In fact in the last four years, as I mentioned before, the cumulative increase in labour productivity has been 35 percent in Turkey. And it is expected that in the upcoming period, increases in total factor productivity will be one of the most important contributors to our growth potential. As a consequence of the envisaged huge productivity increase and according to the baseline scenario on the EU accession process, the Turkish State Planning Organization (SPO) estimates that by the year 2015, the Turkish economy would grow by 82 percent on a sustainable path. This implies an average growth rate of 6.2 percent.¹⁴

The other items in the decomposed income per capita equation are employment, dependency ratio and participation rate which are closely related to a country's demographic factors.

Growth rates of population in the old and new members of the EU are quite low and the slowdown in population growth leads to aging in the EU countries. This implies serious problems for the EU economy in general and its labour market in particular.

¹⁰ Trichet, J. C. (24 June 2005). "Monetary Policy in EU: Views and Challenges".

¹¹ Bernanke, B. S. (19 January 2005). "*Productivity*". The C. Peter McColough Roundtable Series on International Economics, Council on Foreign Relations.

¹² Gros, D. (2005) "Economic Aspects of Turkey's Quest for Membership". CEPS Working Paper.

¹³ Gros, D. (2005) "Economic Aspects of Turkey's Quest for Membership". CEPS Working Paper.

¹⁴ Under Secretariat of State Planning Organization. (November 2004). "*Possible Impacts of the Turkish Membership on the EU*".

First of all, the problem of aging in the EU suggests lower labour participation rates and higher dependency ratios in the future. This will certainly decelerate the potential growth rate of Europe.

Then, fiscal problems due to increase in social security and health care costs as population ages come to the forefront.

On the other hand, Turkey's demographic profile makes it different than both the old and the new members of the Union. Turkey is a relatively large country with a young and fast-growing population. The Turkish accession today would imply an increase of more than 17 percent in the EU population.

Indeed, between 1990-2003, the average population growth rate and the birth rate Turkey have been 1.8 percent and 2.3 percent per annum respectively.¹⁵ The Turkish population is expected to stay young in the foreseeable future. Whereas in the 2000's, the EU-15 has 0.3 percent of population growth rate and 1.1 percent of birth rate on average at highly decreasing trends.¹⁶ According to certain estimations, in the year 2020, the average age in the EU-15 will be 43, while it will be 33 in Turkey¹⁷.

This means that in the future, Europe will probably be experiencing labour shortages rather than the unemployment problems of today¹⁸.

What this argument implies that Turkey's young and expanding population will reduce the negative impact of the EU's aging and diminishing work force in the coming 15-20 years. Turkey with a young population would be an important asset in the long-term in competing with countries such as China, India and the US.

As another variable in the equation, we observe an advantageous position for Turkey regarding the dependency ratio. As a result of a young and growing population, the dependency ratio of the Turkish population is in a decreasing trend. As of the year 2000, the share of the age group of 55 and above in total population is 29 percent in the EU-15 while that of Turkey is a mere 11 percent¹⁹. The International Labour Organization (ILO) estimates that the said ratio will increase to 36 percent in the EU-15 by the year 2020. However, it is expected to be only 16 percent in Turkey by that time.

¹⁵ Under-Secretariat of State Planning Organization

¹⁶ <http://www.europa.eu.int/comm/eurostat>

¹⁷ International Labour Organization

¹⁸ Böttcher, B. (2004). *"Turkish Accession to the EU- The Way is the Goal"*. Deutsche Bank Research.

¹⁹ International Labour Organization

According to another study by the United Nations, the EU would need an average of 6.1 million immigrants a year from 2015 to 2040 to maintain a ratio of three working-age adults for each retiree²⁰. This I believe clearly implies a substantial contribution of Turkey to the EU on the demographic front.

On the other hand, when it comes to labour force participation rate in the income per capita equation, Turkey lags behind the EU.

One of the reasons of Turkey's lagging behind is the low female participation rate in the labour force. Although the female participation rate in banking, legal and medical sectors are among the highest in Europe, the very low participation in rural areas cause the overall female participation rate to remain quite low. Another reason of low participation rates based on official figures is the high share of the unregistered economy.

With the ongoing reform process and their expected effects on the structure of the labour market, the share of the unregistered economy would decrease and then the female participation rate would increase. This will imply further increase in the labour force participation rate in the Turkish labour market in the near future.

Moving on to the employment side of the equation, I will mention some other important points regarding the Turkish labour market.

First of all, although the unemployment rate in the Turkish economy is quite high compared to the EU members, we observe that the total increase in employment throughout the year 2004 was much higher than that of the EU members and acceding countries.

Another notable issue about the structure of our labour market is that Turkey's economy is moving from a labour intensive structure toward a capital intensive one. And it is a natural consequence that during this period some sectors are expanding while others are contracting. What this implies is that the structure of employment has also been changing. In fact, even though it is still high compared to the EU members, the share of the agricultural sector in total employment has been falling while that of services sector has been on the rise. And I believe that Turkey's young and dynamic demographic structure supports easier transfers between sectors and facilitates improvement in the sectoral dispersion of employment.

Having mentioned all these demographic and labour market conditions of the EU and Turkey, I need to emphasize the importance of making further progress on educational reforms in

²⁰ www.un.org

Turkey. It is clear that in order for the young population to be an advantage for us, a very well designed and planned education strategy is a must.

Indeed, the education level of the overall population in Turkey is getting better and Turkey is catching up with several of the new EU members. In the 25-34 age group, 11 percent of population has high level of education, which corresponds to the same level with Slovakia and nearly the same level with the Czech Republic²¹.

Hence, as the older generation leaves the market for the younger generation and the educational reforms are put into practice during the accession process, the education level of the Turkish labour force will increase and both the EU and the Turkish economy will benefit from it.

Ladies and Gentlemen,

Having touched briefly on the advantages of the EU from Turkey's membership, what I'd like to talk about next is the other side of the coin; that is the advantages of Turkey from the accession process and the ultimate membership.

As I mentioned in the early part of my speech, the performance of the Turkish economy for the last four years clearly indicates that Turkey successfully continues the process of economic restructuring.

However, in our view, all the achievements so far now belong to the past. Nowadays, we have to start viewing developments with a longer-term and broader perspective in the context of the adjustment process for the EU membership.

I believe that the EU negotiations process will establish the best conceivable framework not only for the continued reform process, but also for the new reforms within the framework of convergence to the EU. The membership will act as a much needed reform anchor for Turkey.

The membership process is expected to show its very first impact on increase in predictability, or in other words, decrease in uncertainty in policies and the economy.

In a parallel manner, there are two more important benefits of the EU membership process for Turkey. The first one is institutionalisation of policies and the second one is improvement in governance indicators in the country as a whole. Developments in these areas together with increase in credibility would carry the Turkish economy to a better macroeconomic equilibrium point to operate.

²¹ Dansk Industry (December 2004). Turkey and the EU – Perspectives and Opportunities.

In the area of trade, though tariffs on both sides were abolished with the completion of the Customs Union, the accession process and the membership would bring about the elimination of non-tariff, administrative and technical barriers and so foreign trade relations with the EU would further develop.²² This would clearly result in welfare gains not for only Turkey but also for the EU due to trade creation effect.

And according to a study of Capel and his colleagues in March 2004, bilateral trade between Turkey and EU can increase by around one third once Turkey has become a full member of the single European Market²³.

Moreover, thanks to the intensive reform agenda, the investment climate in the Turkish economy would improve for both domestic and foreign investors.

In consequence, it is reasonable to assume that foreign direct investment (FDI) will increase strongly. According to some studies, the EU membership is estimated to result in 2-4 billion Euro²⁴ worth FDI flows per year. This in turn will not only contribute to the strengthening of the economy as a whole, but will also help to deal with current macroeconomic concerns such as the current account deficit.

I have to add that economic benefits of FDI are potentially high because FDI not only brings in long-term capital but also technology, management skills and opportunity to reach new export markets.

In this framework, the membership would give both an opportunity and an obligation for local firms to improve their businesses at the micro level through increasing their productivity, enhancing their management and technical skills together with the quality of labour force and switching to products with high value added.

In short, as the Turkish economy moves along the membership process and converges to the EU economy, we would see a high and satisfactory level of sustainable growth, advance further in economic stability and therefore in the enhancement of the welfare of the society.

Ladies and Gentlemen,

As you all know, we have started negotiations only a few weeks ago. It is obvious that the EU enlargement with Turkey will be very different from the previous enlargements in the sense

²² Commission of the European Communities (2004). "Issues Rising from Turkey's Membership Perspective".

²³ Capel, C.H., Lejour, A.M. and Mooji de R.A. (March 2004). "Assessing the Economic Implications of Turkish Accession to the EU". CPB, No. 56.

²⁴ Backgrounder on Turkey's economy and accession to the EU; Press Conference Turkish Desk. (22 September 2004).

that Turkey is not similar to the other countries in its dynamics including economic, demographic and political ones.

However, a closer look at the enlargement periods of the new members reveals the fact that these periods are associated with both debates and concerns. But, when we look at the results, we see a “win-win” situation for both the EU and the new member states. And I believe that Turkey’s membership will be another “win-win” situation as well.

All in all, I believe that Turkey’s membership will create a synergy in which both the EU and Turkey could enjoy a mutually advantageous conjunction of their different characteristics.

However, one has to remember that during this process, both Turkey and the EU have their own responsibilities. In this respect, each party should make every effort to fulfil its own homework.

Thank you.