SETA PERSPECTIVE

NO: 8
MAY 2014

What The Revival of Turkey-EU Trade Relations Puts Forward: Re-Thinking The Customs Union

HATİCE KARAHAN

- **What are the main drivers of Turkish exports?**
- **What are the dynamics behind the exports to the EU?**
- **What does the recent revival of the Turkey-EU trade relations indicate?**

INTRODUCTION

The year of 2013 has drawn attention as a period of revival of the Turkey-EU trade relations. Indicators for the first months of 2014 as well as the forecasts for the near future imply that this upward inclination will get strengthened as the EU economies recover. In this regard, this study first explores how the GDP growth in partner countries affects Turkish exports and then focuses on the recent trend observed within the context of European markets. The paper then establishes a link to the importance of the Customs Union framework based on the regeneration of bilateral trade relationships.

MAIN DRIVERS OF TURKISH EXPORTS

Export performance of a country depends on various factors, including both internal and external ones. Among these, one can mention productivity, diversification of goods and markets as well as the supply of technology-intensive products. However, particularly in the short run, what seems to matter most are price and income effects. Price effect measures how a change in the relative price of a good affects the demand for it by the foreigners, whereas income effect focuses on the relevant results of a change in the gross domestic product (GDP) of a partner country. At this point, it should be underlined that exchange rate movements are closely associated with the price effect as they change the relative affordability of a product in international markets. Hence, in theory, the level of a country's exports is mainly determined by the relative prices of national exports and the income levels of trade partners. That is why analyzing the development of Turkish exports based on these two effects carries great importance in order to clearly understand the dynamics behind.

Prior to evaluating the determinants of national exports, one point should be well underscored: The degree of the so-called effects basically depends on their elasticities. In other words, price and income elasticities of exports induce their respective impact levels. If a higher (lower) income elasticity prevails for a country's exports, then a change in the GDP of a partner economy ends up with a higher (lower) degree of reaction

HATİCE KARAHAN
Hatice Karahan received her BA degree in Business Administration from Bogazici University in 1999. Having had earned her MA degree in Economics from Bogazici University in 2001, Karahan went to the US where she got her PhD degree in Economics from Syracuse University in 2006. She taught various economics courses and conducted research at the Center for Policy Research within the same university. Karahan later worked as the Deputy Secretary General as well as an economic consultant at MUSIAD between the years of 2010 and 2012. She has published on the areas of Turkish economy, development, energy, R&D and labor economics in various national and international journals, books and reports. Kara-han has been conducting her studies at TUBITAK since 2012. Besides, she currently teaches at the Department of Economics at Istanbul Bilgi University and serves as an economic con-sultant at Turkish Exporters' Assembly (TIM).

on demand. Similarly, a higher (lower) price elasticity of export demand leads to greater (smaller) percentage changes in the quantities exported compared to those in the prices. What this argument follows is that a real devaluation of national currency promotes exports, in case the price elasticity is high.

Various academic studies have been conducted on measuring the implications of these two integral effects on world's exports. In this sense, research demonstrates that greater than unitary income elasticities to export and import have characterized the global trade since World War II[1]. It can also be stated that studies focusing on both industrialized and developing countries generally conclude that exports highly react to movements of worldwide real income levels, especially in the short-run. What this implies is that economic growth serves as a powerful engine of global export demand. On the other hand, findings on price elasticity vary considerably. While some studies find out that exports significantly react to relative prices and hence a real devaluation in national currency promotes exports[2], others indicate that economic growth of trading partners is a more significant factor for the performance in question. At this point, the effectiveness of a real devaluation in increasing exports turns out to be a big matter of interest.

Besides the globally-based studies, literature also provides research investigating the elasticity of Turkish exports. Empirical analyses conducted in this regard seem to mainly obtain income elastic export demand for Turkey both in the long- and the short-run, with a low elastic or inelastic price and/or real exchange rate effect. Such findings point out that demand for aggregate Turkish exports is mostly foreign income elastic and therefore growth in trade partner countries may affect them positively and significantly[3].

1. U.S. International Trade Commission (1998), "The Income Elasticity of Trade: Theory, Evidence, and Implications"

2. Senhadji, A.S. and Montenegro, C.E. (1999), "Time Series Analysis of Export Demand Equations: A Cross-Country Analysis", IMF Staff Papers, 46 (3)

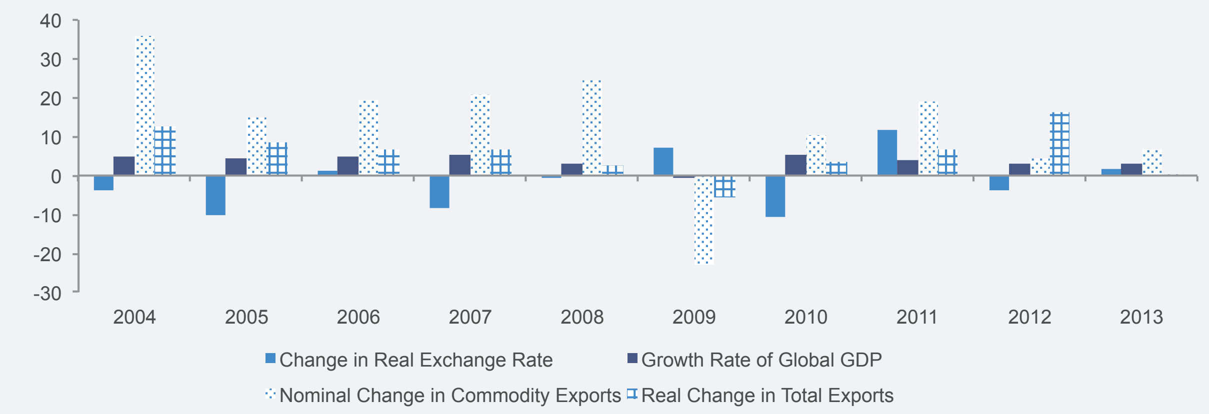
3. Coşar, E. (2002), "Price and Income Elasticities of Turkish Export Demand: A Panel Data Application", Central Bank Review 2, 19-53

As well known, Turkey has experienced a conspicuous growth period in the 2000's and exports have played a notable role in that adventure. While the development process has inevitably contributed to various aspects of exports in terms of production, foreign policies have also been on the stage to help diversify the markets. Still, it would not be sufficient to evaluate the export performance in that period without looking into income and price effects. Hence, analyzing the pattern of national exports along with real exchange rate changes and global economic activity would serve as a helpful approach.

For this purpose, Graph 1 provides a snapshot of the related variables for the last 10 years. What this simple graph shows is that there exist many factors affecting the export performance of Turkey but if one focuses on price and income variables, income seems to have a more elastic impact on Turkish exports. This is clearly seen in the global crisis period: In the year of 2009, the contraction of the world economy in the rate of -0.5% turned into a 23% and 5.4% decrease in national exports in nominal and real terms respectively, although Turkish Lira depreciated and hence Turkish goods gained a price advantage in foreign markets. On the other hand, exchange rate does partly seem to have positive effects throughout the period. However, the fact that exports keep increasing or even accelerating in certain years when the exchange rate goes down creates mixed signals on the price elasticity of Turkish exports. The ambiguity is observed both in gold-including and –excluding calculations.

There is no doubt that this point deserves a comprehensive empirical analysis which is beyond the purposes of this commentary note. Nevertheless, what one can simply conclude here based on the trend the graph indicates is that exchange rate changes do not seem to be the main determinant regarding the export performance in Turkey. This is because without a reasonable growth in global GDP, exports do not appear to be highly promoted through price advantages. At this point it is important to once more emphasize that other factors excluded in the context

GRAPH 1. CHANGES IN EXCHANGE RATE*, GLOBAL GDP AND NATIONAL EXPORTS (%, ANNUAL)**



Source: TCMB, TIM, IMF, Author's calculations
*Calculated based on the yearly average of real effective exchange rate of Turkish Lira
**Gold trade is excluded in calculations of commodity exports

of this note certainly step in for the final export demand but it can still be claimed that Turkish exports appear to grow with foreign demand and hence be basically income elastic. Foreign exchange effect, on the other hand, turns out to be secondary as well as inelastic or less elastic.

What this simple approach implies is that a further analysis is definitely needed to capture the net effects of all related determinants, but economic activity in partner countries has undeniable consequences for the briskness of Turkish exports. That is why foreign demand can be considered a fundamental dimension of the export tempo of Turkey. On the other hand, the possibility of regional variabilities in the effects of interest should not be ignored. In this framework, it should be stated that recent empirical studies focusing on this issue have findings pointing at the foreign income elastic nature of Turkish exports in the European markets.[4] Such findings also imply that in the markets that products with higher unit prices are exported to, income effect might dominate exchange rate effect.

4. Culha, O.Y. and Kalafatcilar, M.K. "Türkiye'de İhracatın Gelir ve Fiyat Esnekliklerine Bir Bakış: Bölgesel Farklılıkların Önemi", *TCMB Ekonomi Notları*, April 2014

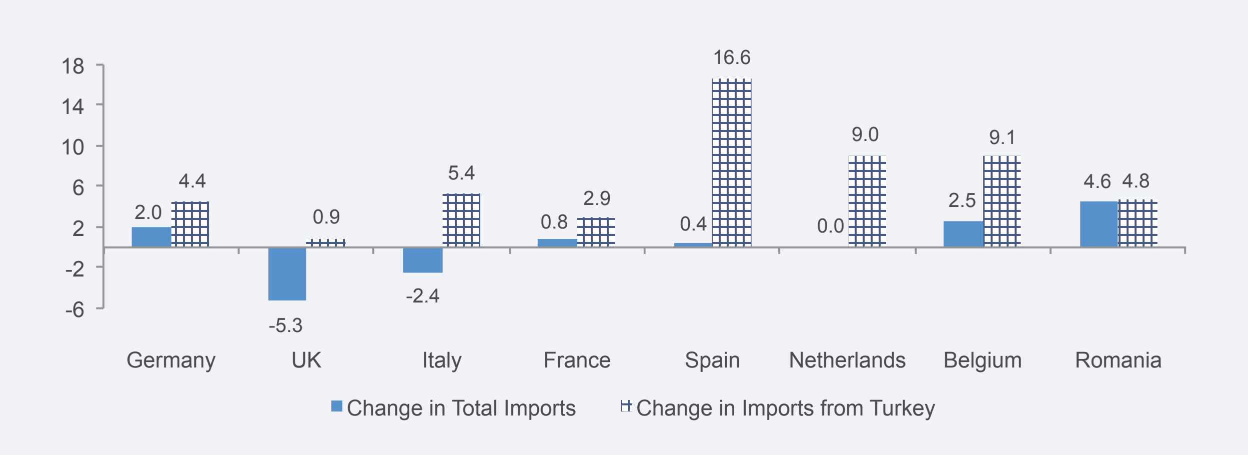
EXPORTS TO THE EUROPEAN UNION

Having stressed the importance of foreign income for Turkish exports, it would now be meaningful to take a quick look at the recent trade relations of Turkey with the European Union (EU) in that regard. Although total national exports have experienced an annual contraction of 0.4% in 2013 due to the negative base effect of gold, commodity exports excluding gold have recorded a 6.7% of growth in that period, as shown in Graph 1.

Calculations[5] based on trade data show that EU has been the main contributor to the growth of Turkish exports in the year of 2013. At this point, relevant analyses clearly point out that a great deal of this overall performance is associated with the demand in the European markets since the EU-28 region contributed by 2.4 percentage points to the speed of total national exports which went down by 0.4% and therefore served as an engine. This results from the fact that demand in the EU markets increased by 6.4% for Turkish exports in the period of interest. While such remarkable performance might have taken advantage of the depreciation of Turkish Lira to a certain extent, the argument that exports of Turkey

5. Author's calculations using TUIK and TCMB data.

GRAPH 2. CHANGES IN IMPORTS OF TURKEY'S LEADING* EU PARTNERS (%, ANNUAL, 2013)



Source: WTO, TUIK, Author's calculations
*EU countries ranked within the top 20 export partners of Turkey

are more elastic to foreign income deserves a close examination here.

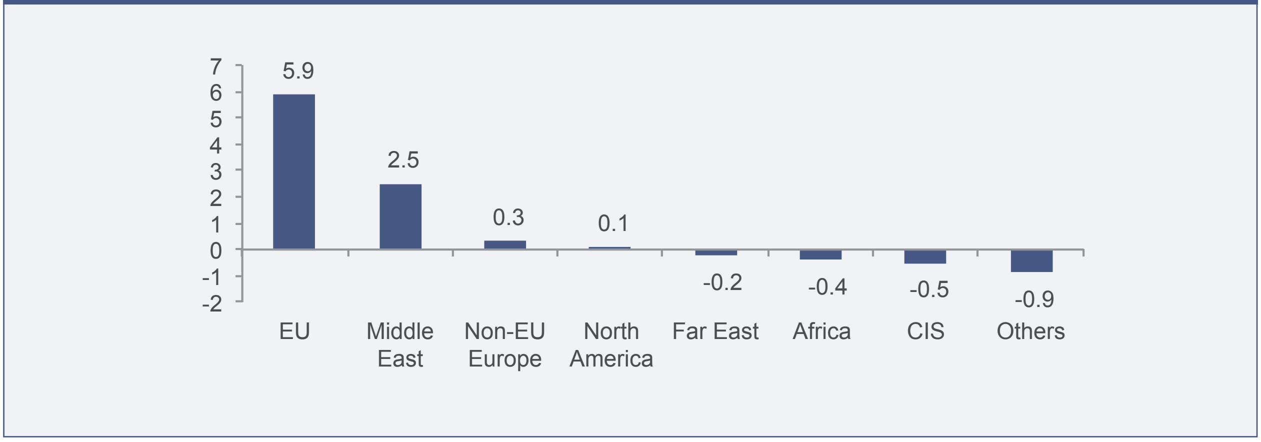
As well known, the EU economy went through a recovery process and got out of recession in 2013. Despite the fact that the so-called recovery can be described as quite slow, most core economies in the area have broken free from economic contraction while others have continued to grow. It is important to note at this point that the wiggle in many countries of the zone has also been reflected in the import figures. Data show that in many EU countries import demand gained a momentum in 2013, compared to the previous year when imports had exhibited negative growth rates. In this sense, most countries experienced a strong rise in imports in that period.

What is more critical to emphasize here is that the upward movement in the area's imports ended up with a more powerful reaction on Turkish goods. Graph 2 demonstrates the growth rates of imports by the main European trade partners of Turkey for this purpose. What the graph clearly presents is that the changes in imports from Turkey are clearly much higher than the overall import growth of the countries. This implies that the briskness of economic activity in the EU countries in the year of question brought together a higher than average demand for Turkish products.

As a result, it can be concluded that the developments regarding trade with the EU in 2013 appear to bear the assertion on the income elastic nature of Turkish exports. Hence, economic recovery and growth in the EU zone can be described as a valuable opportunity for Turkey's export performance. In that regard, considering the improving outlook of the EU economy in 2014, this opportunity seems to have a big potential as signaled by data on the first 5 months of the current year. Calculations indicate that commodity exports[6] to the EU have increased by 14.1% in that period. In this sense, total exports of Turkey excluding gold have risen by 6.8% in the January-May period, 5.9 points of which has come from the EU markets. So, as shown in Graph 3, the growth of Turkish exports is heavily supported by the European partners' demand in the year of 2014, as well. Furthermore, forecasts point out that the EU countries will keep growing in terms of GDP and trade. That is why the current and future potential revival in the region that has been strongly reflected on its trade relations with Turkey looks quite promising for Turkish exports.

6. Total exports excluding gold, based on data obtained from TIM (Turkish Exporters' Assembly)

GRAPH 3. CONTRIBUTION OF COUNTRY GROUPS TO COMMODITY EXPORT GROWTH OF TURKEY (ANNUAL, % POINT, JANUARY-MAY 2014)



Source: TIM, Author's Calculations

CONCLUSION: WHAT THE REVIVAL PUTS FORWARD

Just at this juncture, the recent regeneration of the trade relations between the two parties puts forward a critical issue that has been exerting certain unfavorable effects on the Turkish side: The Customs Union. There is no doubt that relations between Turkey and the EU have gained a whole new dimension upon the implementation of the Customs Union agreement signed in the end of 1995. Bilateral trade has increased by more than 3 times in nominal terms within the preceding 18 years. Nevertheless, certain flaws within the system have burst on the scene in the recent period, causing the bilateral potential not to be fully realized. Among these, visa limitations applied to Turkish businesspeople and transportation quotas on Turkish exports can be mentioned. Besides, the asymmetries Turkey is exposed to when the EU signs free trade agreements with third countries in an autonomous way have the potential to cause a disadvantage for Turkey in terms of exports and trade revenues. All these factors obviously work against Turkey but also erect barriers for both parties to reach optimal trade levels.

Taking into account the fact that the member countries exhibit a considerable inclination towards Turkish goods as they recover, there is no time like the present for the EU to re-think the restrictive design of the Customs Union agreement and ameliorate it. Plus, in an era of modern Cold War symptoms, Europe should recognize the pivotal geo-political role of Turkey and adopt a strategic approach. In this respect, beyond any doubt, it is high time for the EU crossed the bridge and treated fairly to its long-standing partner.

SETA
SİYASET, EKONOMİ VE TOPLUM ARAŞTIRMALARI VAKFI
FOUNDATION FOR POLITICAL, ECONOMIC AND SOCIAL RESEARCH
مركز الدراسات السياسية والاقتصادية والاجتماعية

www.setav.org | info@setav.org | @setavakfi

SETA | Ankara
Nenehatun Caddesi No: 66 GOP Çankaya
06700 Ankara TURKEY
Tel:+90 312.551 21 00 | Fax :+90 312.551 21 90

SETA | Washington D.C.
1025 Connecticut Avenue, N.W., Suite
1106 Washington, D.C., 20036 USA
Tel: 202-223-9885 | Fax: 202-223-6099

SETA | İstanbul
Defterdar Mh. Savaklar Cd. Ayvansaray Kavşağı
No: 41-43 Eyüp İstanbul TURKEY
Tel: +90 212 395 11 00 | Fax: +90 212 395 11 11

SETA | Kahire
21 Fahmi Street Bab al Luq Abdeen
Flat No 19 Kahire EGYPT
Tel: 00202 279 56866 | 00202 279 56985