EU-TURKEY

ECONOMIC CHALLENGES OF THE NEXT SIGNIFICANT ENLARGEMENT

A NEW GLOBAL INSIGHT STUDY

OVERVIEW

Despite some remaining political stumbling blocks, the European Union (EU) invitation to begin accession negotiations with Turkey will have profoundly positive effects on that country's economy. **As laid out in the Presidency Conclusions of the Brussels European Council meeting on December 16–17, 2004, Turkey is set to open final accession negotiations on October 3, 2005.** The mood after the announcement was not one of euphoria, but of continuing determination. The road has been long for Turkey's EU candidacy. The country signed its first protocol with the Union in 1963, but was not acknowledged as a candidate until 1999.

The European Council (EC) reconfigured several key areas of its framework for negotiations—with Turkey's candidacy primarily in mind. First, the EC emphasized that the transition could be long. In the case of Turkey, membership is unlikely to occur any earlier than 2014, and will more than likely not happen until 2015 or later. Second, it was stressed that the accession transition be "open-ended," meaning that negotiations would not automatically lead to eventual membership. Third, EU leaders inserted the possibility that permanent "safeguard clauses" could be initiated in such areas as freedom of movement of persons, structural policies, or agriculture.

Although some West European politicians were quick to call for a slowdown or stop to the enlargement process following the rejection of the EU Constitution in France and the Netherlands and the latest impasse during the June 16–17 summit, the negotiations are quite likely to start under the UK EU presidency as planned on October 3.

Despite the lingering contentious issues, the more-certain prospects of EU membership will have a significantly positive impact on the Turkish economy, both in the short and longer term. Primarily, a period of sustained economic growth in 2005–15 should double Turkey's GDP per capita, from $4,265 at market exchange rates in 2004 to $11,538 in 2015. At the moment of accession, though, Turkish GDP per capita will still be comparable only to the poorest EU-28 members, such as Bulgaria and Romania.

Booming investment is likely to become the primary engine of economic growth during 2004–15. The beginning of negotiations should lead to accelerating growth in investment throughout this period. As a consequence, new investment is projected to increase total production capacity (particularly in manufacturing), boost industrial growth, and further broaden the service base of the Turkish economy. Both investment and consumption growth could very well exceed that in the other EU accession countries on an annual basis. Still, larger inflows of foreign capital will be instrumental in accelerating growth in domestic demand.

The structure of the Turkish economy will undergo a major qualitative change, with the service sector taking an expanding share in GDP creation over the next ten years. Sustained private consumption growth will boost retail trade activity. The development of the tourism sector, coupled with a calming of political tensions — both within Turkey and in surrounding countries — will boost activity not only in retail trade, but also in transportation and communications. **The agriculture share of GDP is projected to decline through 2015 and be considerably lower than that in Romania and Bulgaria at the time of their accession in 2007–08.** The industrial sector, particularly manufacturing, will generally maintain its current share of gross value added throughout the transition process.

EU convergence will demand the continuation of prudent economic policy, which should ensure stabilization of macroeconomic conditions, reduce risk for investors, and lead to a gradual convergence of key macroeconomic indicators with the EU-28. The Central Bank of the Republic of Turkey announced that inflation targeting would begin in 2006. By 2015, consumer price inflation should be very low, providing an excellent starting point for a post-accession convergence process with the EU economies. To sustain this stability, fiscal issues must still be addressed. The heavy burden of debt servicing on the state budget requires that the Turkish government pay particular attention to expanding the revenue base, increasing the efficiency of its tax collection, and further streamlining its non-debt-related expenditures. Already, Ankara is initiating a major tax system overhaul, aimed at reducing the shadow economy and improving efficiency. Adherence to fiscal targets negotiated with the International Monetary Fund and improved efficiency in revenue collection are essential to EU convergence.

The road to final EU membership for Turkey remains long and uncertain. Despite its recent achievements, Ankara must sustain economic reform momentum or risk jeopardizing its accession chances. Nevertheless, this now-more-palpable possibility of Turkish membership in the EU will not only help to maintain reform efforts, but will also trigger greater economic prosperity and stability over the next ten years.