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EU-Turkey Economic Relations in the Era of Geo-economic Fragmentation

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The foundation of the European Union-Turkey economic and trade relations lies in the Customs Union and more broadly in the bilateral preferential trade framework, established in December 1995. For over nearly three decades, this partnership has played a pivotal role in integrating Turkish industries into European supply chains, significantly multiplying bilateral trade volumes. However, as the global economic and geopolitical environment has changed and concerns about trade resilience and national security have increased, new trends such as protectionism, offshoring, or friend-shoring are increasingly being discussed. These global developments present new challenges but also opportunities for EU-Turkey relations.

The (geo)political context in which the Customs Union was created was vastly different from today. The end of the Cold War and the triumph of liberal economies over Soviet communism fuelled Western self-confidence in economic and political terms. The United States dominated world trade and signed numerous trade agreements (e.g. the North American Free Trade Agreement (NAFTA) and US-Chile FTA). In Europe, the 1990s saw the launch of the single market (1993), the creation of the European Economic Area (1994), and the introduction of the euro (1999). This period also saw an intensification of EU trade agreements with Central and Eastern Europe and Mediterranean countries. Against this backdrop, Turkey signed a Customs Union with the EU in 1995. Additionally, China's accession to the World Trade Organisation (WTO) in 2001 marked a high point in trade globalisation.

However, the positive climate surrounding global trade started to gradually change with the global financial crisis in 2008. Since then, the political and economic landscape has changed radically. The 2008 financial crisis is seen as the beginning of the end of accelerated globalisation, with a decline in the growth of global value chains and world trade. The period following the 2008 financial crisis has seen much less trade liberalisation. On the contrary, there have been rising barriers to trade. Today, the geo-economic order is being reshaped by geopolitical turbulence, regionalisation trends, and decarbonisation processes. Some even speak of a new phase of deglobalisation defined by pandemic-induced supply chain disruptions, the economic

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decoupling of the US and China, shocks from the Russian war against Ukraine, and economic shifts from decarbonisation efforts aimed at mitigating climate change.

Analysts suggest that a more regionalised world is challenging globalisation, where politics will have a greater impact on economic outcomes than in the past half-century. Geopolitical shifts are leading to major geo-economic shifts, with regionalisation accelerating relocation efforts, shortening supply chains, and reducing dependence on distant suppliers. The concepts of 're-shoring' or 'friend-shoring', which emphasise strengthening regional trade agreements and investments with geographically closer or more "reliable" partners, are becoming more pronounced.

The return of geopolitical concerns in world trade is evident and an emerging bloc logic could divide the globe into two or three blocs, pushing countries to follow approaches that combine foreign economic and security policy. Geopolitical considerations now play a significant role in determining global trade flows, with escalating geopolitical risks leading to increased tariffs, export restrictions, and internal measures indirectly influencing trade flows. Trade-restrictive measures have surged, with approximately 3,000 implemented in 2022 — nearly three times the number in 2019.

While the global geopolitical and geo-economic environment is changing rapidly, Turkey's relations with the EU and the West have also undergone significant changes with a decoupling of threat perceptions, the understanding of global politics, and an erosion of trust on both sides. Despite this, from NATO membership to the Customs Union with the EU, Turkey still maintains strong institutional links with the West — in political, economic, and military terms. How both sides navigate the evolving global order, approach the great power competition between the West and China as well as with Russia, and address security, political, and economic implications of this new era — along with the trust deficit in relations — will significantly impact the future of the relationship between Turkey and the EU. Indeed, the structural changes in the global system and both sides' response to these changes are likely to be the primary shaper of the relations going forward. On a side note, we refer to the West as a uniform block. It is yet to be seen to what extent the US and the EU or different European states will see eye to eye on the great power rivalry, particularly when it involves China. Needless to say, whether there is more unity or fragmentation within the transatlantic alliance will inform Turkey's reading of global politics, including its positioning. Returning to the core subject, this geo-economic shift will be underpinned by two main transformative concepts: economic security and decarbonisation. Therefore, the policies that both sides will develop to adapt to these two paradigm shifts and the political relationship between them will also shape their economic relations in the new process.

Economic security

Recent geopolitical developments and technological shifts have significant implications for the international economic order and the EU's approach to global cooperation. As geopolitical competition intensifies, economic and security interests are increasingly intertwined.

In the heyday of globalisation, economic prosperity was seen as dependent on free trade and economic interdependence as a guarantee of peace and economic benefits. This paradigm has shifted, with governments and the private sector now forced to integrate new geopolitical realities into economic choices and assess security risks.

Reorganising and diversifying global supply chains to reduce dependence on single sources is key to enhancing economic security. This shift is driven by the strategic rivalry between China and the US, which poses challenges to Europe's economy and security. The ongoing US-China economic and trade war may escalate further, especially if Donald Trump is re-elected.

The EU is developing its own economic security strategy in response to this rivalry and broader geopolitical competition. The Covid-19 pandemic underscored the need to diversify supply chains, leading the EU to focus on 'strategic autonomy'. The war in Ukraine has further highlighted the dangers of an over-reliance on Russian energy, especially for Germany.

In this context, resilience, renewed industrial strategy, and de-risking (reducing the EU's economic dependencies) are relevant. The EU aims to strengthen its position in key economic sectors amid global competition, particularly from China and the US. To counter this, the EU has introduced measures like the 'economic security package', the European Chips Act, and the Critical Raw Materials Act to reduce strategic dependencies and enhance economic security.

The normalisation of non-cooperation in a fragmented geo-economic order would definitely place the EU and also Turkey in a precarious situation. They could eventually be forced to choose sides if different economic blocs close their markets to one other. In this context, it remains to be seen how long the EU and Turkey can maintain an open trade policy. Moreover, where economic security is becoming a major issue, political relations between Turkey and the EU are also at a low ebb. In recent years, divergences between security and foreign policy priorities of the two sides have been evident in many areas, from Syria to the Eastern Mediterranean.

Recent developments have led to increased competition rather than cooperation, particularly in the context of regional conflicts. Or, as in the case of Russia's invasion of Ukraine, although their interests and perspectives are aligned, their policies differ. Therefore, Turkey has been the subject of measured or veiled criticism from the West on the issue of sanctions against Russia. As the EU has been critical of aspects of Turkey's policy towards Russia, Ankara has been highly critical of the EU's handling of the Gaza War, which has once again brought to fore broader strategic and normative decoupling between the two sides. According to the European Commission, the level of foreign policy convergence between Turkey and the EU is only 10 per cent.

At a time when economic relations will be increasingly influenced by geopolitics, improving political relations and addressing the mutual trust deficit seem essential for the future of EU-Turkey economic relations.

Decarbonisation and return of industrial policy

Decarbonisation is radically transforming the global economic system. It is creating new areas of competition and dependencies, altering energy flows, and leading to new transmissions of goods. This transformation means that the technological evolution required by decarbonisation increases the intensity of geopolitics and complicates the intersection of economic and security interests. Unless trade, environmental, and industrial policies are not carefully managed, there is the risk that they will pursue conflicting objectives. These policies intersect and are used by different countries to address not only climate change but also geopolitical rivalries, the re-orientation of supply chains, and profound technological changes.

In addition, heightened geopolitical tensions and the climate crisis have raised concerns about the resilience of supply chains and economic and national security, leading to a resurgence in industrial policy. While some developing countries continue to use industrial policy through targeted state interventions, most developed countries in the West have not employed it for many years.

Enormous financial resources, both public and private, are needed to finance the decarbonisation of the economy. Consequently, the global race for clean technologies and critical minerals essential for decarbonisation, is intensifying worldwide. For instance, European countries are facing unprecedented dependence on China for solar energy panels, which could extend to electric cars as China increasingly dominates battery manufacturing.

Subsidisation is a growing trend. The increasing adoption of subsidy-based approaches risks igniting an arms race in industrial policy. Recent industrial policies include provisions to encourage domestic producers, particularly in technologically advanced sectors, potentially at the expense of foreign producers.

The US Inflation Reduction Act (IRA) is a good example of the return of industrial policy. This flagship green legislation is a monumental energy transition plan designed to encourage the production and development of clean energy in the US through tax credits for businesses and households. It also aims to re-industrialise the country and exclude China-linked companies from the US supply chain. Many view the IRA as a protectionist effort to attract the fast-growing green industry to the US at the expense of other competitors, particularly China and Europe. The IRA is also perceived as violating the rules of the WTO, for which the US has historically been the most powerful sponsor.

The EU's Green Deal industrial plan and the Net Zero Industry Act can be understood as responses to the IRA, aimed at preventing clean energy companies from leaving the EU for the US or other markets. The EU aims to provide a more supportive environment for scaling up its manufacturing capacity and is increasingly integrating climate factors into its external economic relations and trade policy, which will change the way it trades with its partners. With measures such as the Carbon Border Adjustment Mechanism (CBAM), the EU is committed to protecting its domestic industries. Europe's significant market size provides it with substantial normative power, which it is preparing to use to advance the climate ambitions of its trade partners.

The EU has adopted several measures in recent years, such as an investment screening mechanism, an anti-subsidy policy, and an anti-coercion instrument, to ensure a level playing field for European businesses versus non-EU external actors. These measures and decisions raise concerns about their impact on international trade, indicating that climate action and related subsidies will potentially lead to further geoeconomic fragmentation. For instance, the EU has recently launched several trade investigations into Chinese companies, accusing cleantech groups of benefiting from overly generous subsidies.

As trade and decarbonisation become increasingly intertwined, the EU-Turkey economic relationship will evolve based on whether they use decarbonisation processes to strengthen their cooperation or use it as an area of competition in trade and investment relations. However, one thing is clear: CBAM-like measures will affect Turkey's trade relations with the EU because they will have a significant impact on goods and services and all carbon-intensive production. The decarbonisation process will also have substantial consequences for Turkish and European value chains largely integrated through the Customs Union. Turkey needs to accelerate its decarbonisation process to maintain its current trade with the EU and take advantage of new opportunities. While closer harmonisation of legislation, environmental regulations, and standards on decarbonisation between the EU and Turkey could encourage cooperation, the gap in these areas will hinder many joint initiatives.

Implications for EU-Turkey economic ties

Both the EU and Turkey's economic models significantly depend on foreign trade. They heavily rely on external demand for their products and imports in strategically crucial sectors, such as energy, critical materials, minerals, and semiconductors. Turkey's trade openness (i.e., trade as a percentage of GDP) is 67 per cent and the EU's is 97 per cent, compared with the world average of 63 per cent. In contrast, trade openness is only 27 for the US and 37 per cent for China. While trade openness has sharply declined in China since the mid-2000s and slightly declined in the US over the last decade, it has continued to rise in the EU.

The EU's strategy for now is to remain open while embracing greater strategic autonomy. In several key strategic sectors, such as semiconductors, electric vehicles and batteries, renewable energy technologies, and digital technologies, Europe is at disadvantage in terms of production and price compared to China or the US. Therefore, diversifying Europe's supply chains is necessary and establishing stronger trade links with different countries would make sense.

How the EU and Turkey navigate these changes will determine Turkey's future within the European economic structure. Therefore, a new approach is required, based on the radically different (geo)political, (geo)economic, and environmental parameters emerging. Both sides must adapt to these processes, affecting their bilateral economic relations. Moreover, the basis of their trade relations, namely the Customs Union, is not fully adapted to today's economic and political realities with its limited scope. Given the fading of a membership prospect for Turkey in EU, economic and trade relations will become the most important focus for the foreseeable future between Ankara and Brussels.

Turkey's heavy dependence on foreign trade and investment underscores the importance of global players (the EU, US, and China) in shaping the country's economic development. However, there is no doubt that Turkey will be most affected by the EU's changing economic and trade policies. The strong economic ties between Turkey and the EU, embodied in trade and investment, are evident. The EU is by far Turkey's top trading partner. It is the main destination for Turkish exports, the most important source of imports, and the primary source of investment. Data shows that 41.3 per cent of Turkey's exports are absorbed by the EU. It is also important to note that the EU is more open in terms of inward and outward foreign direct investment (FDI) than other regions and its FDI is significantly higher than that of China and the US. Thus, Turkey's interests as a country benefiting from trade and open economic relations, align with those of the EU.

From an economic perspective, Turkey is also important for the EU as it is a large market and production base with 85 million inhabitants and the EU's 5th largest trading partner (trade in goods). Therefore, it is in the interest of both sides to preserve and further develop these relations. Turkey indeed holds significant potential to contribute to the EU's strategic autonomy, particularly in the context of developing alternative supply chains in neighbouring geographies.

Turkey's geographical proximity and strategic location are significant advantages. The EU's economic and financial decoupling from Russia strengthens Turkey's rising position in the global supply chain as a link between Central and East Asia and Europe. Connectivity is an important factor in global trade and Turkey could play a crucial role. Additionally, thanks to the Customs Union, Turkey's industrial sector is well integrated into EU value chains. Turkey is also in a good position globally in terms of export diversification. While the number of countries Turkey exports extensively to was 69 in 2003, it reached 108 in 2022. Over the same period, the number of products exported competitively increased significantly, from 1,331 products in 2002 to 1,718 in 2022. This shows the potential for Turkey to specialise in genuinely new, sophisticated products. Moreover, the Customs Union has also directly and indirectly increased Turkey's alignment with the EU acquis, rules, production norms, and standards.

Energy interconnections, mature infrastructure, and significant industrial capacity (industry remains a significant part of GDP) are other strengths of Turkey. Discussions and calls for re-industrialisation are multiplying in Europe, but the EU cannot produce everything it needs and will have to source many products from neighbouring countries. Turkey's exports to the EU are already relatively sophisticated, focusing on manufactured goods, machinery, transport equipment, and miscellaneous manufactured items. If Turkey can upgrade and utilise its energy connections and industrial capacity to align with decarbonisation, its attractiveness as an investment destination and market for the EU will increase. However, macroeconomic uncertainties and shortcomings in the rule of law will need to be addressed to fully leverage and strengthen Turkey's strong potential with the EU. These factors play a crucial role in trade-related decisions through supply chains and long-term investments.

Outlook and Recommendations

The reconfiguration of global value chains is increasingly debated as an economic policy tool to secure the supply of critical products and establish strategic autonomy at the EU level. The EU's position within international production networks is likely to undergo restructuring to ensure strategic autonomy. Turkey, as a neighbouring country and part of the Customs Union, is already largely integrated into European industrial supply chains. Strengthening the economic relationship between the EU and Turkey is possible and beneficial for both sides.

In light of the shifting dynamics, new tools are emerging for the EU to reformulate and develop its economic cooperation with Turkey. These include extending the Customs Union, further integrating Turkey into its supply chains shaped by the search for strategic economic autonomy, including Turkey in decarbonisation and energy transformation efforts, and cooperation through investments and other channels. These collaborations will have important economic, strategic, and ecological implications for both, while also significantly affecting their future relations in general. Turkey's untapped renewable energy potential highlights the importance of trade in electricity and future hydrogen production as key opportunities for enhancing cooperation on the energy transition.

However, the question of a trust deficit in their relations needs to be addressed. In this new era, economic relations will be increasingly shaped by geopolitical considerations. According to the IMF, the EU's outward FDI has become more sensitive to geopolitical distance since 2017, with the EU's FDI increasingly driven by geopolitical alignment rather than geographic distance or other economic considerations.

Years of political crises have fuelled mistrust between Turkey and the EU. Therefore, serious mechanisms must be established to encourage dialogue in preparation for the new geopolitical and geo-economic era, which promises to be challenging for both sides. The EU and Turkey will need to find ways to protect themselves from geopolitical economic tensions. They will need each other to navigate these challenges successfully.

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