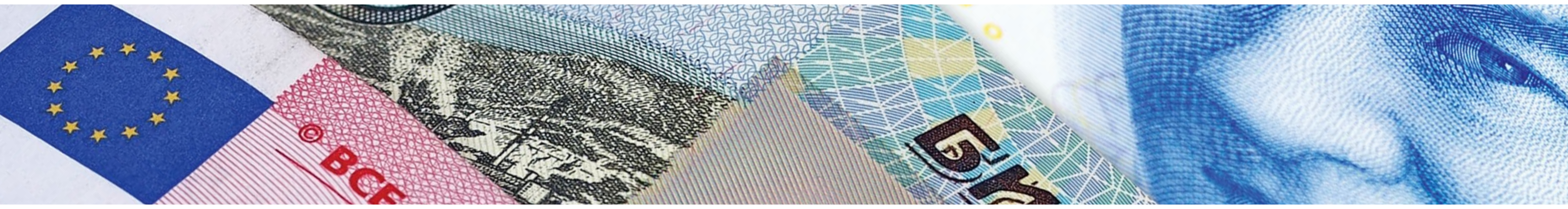
CHATHAM HOUSE

briefing paper



On Europe's Fringes: Russia, Turkey and the European Union

Philip Hanson

Russia and Eurasia Programme/Europe Programme | July 2011 | REP/EP BP 2011/01

Summary points

- Russia and Turkey, significant powers on the fringes of the European Union, both have awkward relations with Brussels.
- As Russia's and Turkey's strength becomes greater and the EU's declines, the relationships between them will increasingly involve political as well as economic factors.
- Turkey is economically and politically closer to Europe than Russia is, while Russia's relationship with Europe mainly consists of a mutual energy dependency.
- Russia's unpredictable business environment remains a key constraint on its deeper integration with the EU. The Turkish economy faces challenges, but Turkey has a much better business environment than Russia.
- The EU's own economic deficiencies suggest that it needs to remain circumspect in dealing with both countries. But Turkey, in particular, should be considered more of a foreign policy partner.

Introduction

The European Union has excellent working relations with Norway and Switzerland. Its dealings with other neighbours are in various degrees awkward and unsettled. Among those other neighbours Russia and Turkey stand out. Both are large, both straddle Europe and Asia, and both are influential emerging (or in Russia's case re-emerging) powers. For both countries the relationship with Brussels has tended to stagnate in recent years.

'Are these two important nations developing successfully as things are, without much to gain from closer links with Europe? Or are there ways in which those links could and should be strengthened?'

In other respects, of course, they are very different. Turkey is a functioning democracy with a diverse and dynamic economy, yet it is in danger of becoming stuck as a permanent candidate for EU membership, with the credibility of eventual accession declining. Russia is a recovering ex-superpower with a distorted industrial sector inherited from Soviet times, a heavy dependence on natural-resource exports and an authoritarian political regime, albeit a soft and flexible one. Its leaders have been unable even to arrive at an understanding with the EU about the terms on which their relationship is to be conducted. Yet at the same time Russia's role as an energy supplier to Europe is of high importance for both sides.

Meanwhile relations between Moscow and Ankara – historical adversaries – have become much closer than ever before. In certain respects, such as visa-free travel, relations are better between them than between either country and Brussels. Are these two important nations developing successfully as things are, without much to gain from closer links with Europe? Or are there ways in which those links could and should be strengthened?

In this paper I compare the economies of Turkey and Russia, and consider what constitutes the major constraint on growth for each of them. In the light of that assessment, and of their current relations with Brussels and with each other, what might the implications be for Europe, whose relative economic power, internal coherence and reputation for economic governance have all been declining? Here political as well as economic considerations have to come into the picture.

I draw two main conclusions in this paper. The first is that Europe should be putting more effort into reviving its engagement with Turkey: European political governance and human-rights practices can still serve as good examples for Turkey even if Europe's economic example has lost some of its allure; and Europe can benefit from Turkey's economic vitality as well as, politically, from its role as a bridge to the Islamic world. The second is that the EU, while not disengaging from Russia (even if that were possible), should not be looking for a breakthrough in its dealings with Moscow as long as the political and economic regime there remains substantially unchanged.

Comparing Russia and Turkey

Both Russia and Turkey are classified by the World Bank as 'upper-middle-income countries', although per capita GDP – measured in dollars at purchasing-power parity (PPP) – is some 15% higher in Russia than in Turkey (see Table 1). Turkey's population is about half the size of Russia's, though the gap is diminishing; and it is also rising while Russia's has been falling. For Russia the ratio of working-age to dependent population is set to fall over the next decade; for Turkey that ratio will rise – a positive sign for its growth prospects, unlike the negative indication for Russia (whose working-age population was still, until very recently, rising). At the same time, Turkey's potential output will probably continue to be limited by a very low female participation rate in the labour force.[1]

1 27.9% in 2010 Q2, against 61.5% for Russia. Whether the Turkish economy could readily generate more jobs for women is another question. http://laborsta.ilo.org.

Table 1: The economies of Turkey and Russia (2009)

	Turkey	Russia
Population (m)	70.5	141.9
GDP at exchange rate ($ bn)	614.5	1,232
GDP at PPP ($ bn)	879.3	2,116
Per capita PPP GDP ($)	12,466	14,913
Inflation (CPI) % year-on-year	6.3	11.7
Unemployment (%)	14	8.4
General govt balance, (% GDP)	-5.6	-6.2
Current a/c balance (% GDP)	-2.3	4

Source: IMF, *World Economic Outlook* Database (October 2010)

Recent growth; medium-term prospects

The rates of real GDP growth of the two countries, so far in the 21st century, have been of a similar order. On a per capita basis Russia's performance would look better, because its population has been falling; its GDP per capita has therefore risen faster than total GDP, which is the reverse of Turkey's situation. The time profiles of their recent development have been different. The global crisis produced a steeper fall in Russia's economic activity in 2009 (the steepest of all G20 countries) and the subsequent recovery there has been more hesitant. Figure 1 shows the similarities and differences in recent real GDP performance and the International Monetary Fund's April 2011 projections for the two countries up to 2016: modest growth at close to 4% a year for both. Some analysts forecast growth rates more in the order of 5%, for both countries, but nobody is predicting rates of economic expansion similar to China's for either.

Figure 1: Developments in aggregate real GDP for Russia and Turkey (annual % changes, 2000–10 actual and 2011–16 projected)

Sources: Rosstat; Turkstat for data to end 2010; IMF *World Economic Outlook*, April 2011 database for projections 2011–16

Political and administrative background

In what is still, just about, a Western-led world, Turkey is more of an insider than Russia. Both countries are members of the G20, but Turkey has been a member of NATO since 1952, is a member of the World Trade Organization (WTO) and of the Organization for Economic Cooperation and Development (OECD), and is a candidate to join the EU – though nobody expects accession any time soon.

The World Bank governance rankings put both Russia and Turkey below a weak, peripheral EU member such as Greece (see Table 2). However, the differences between Greece and Turkey are not large, while Russia, as one might expect, is marked down as significantly less democratic ('voice and accountability') and more corrupt than Turkey, and fares much worse than the other two countries as far as the rule of law is concerned.

Russia and Turkey are both shown as politically less stable than Greece (though in the broader international perspective none of the three looks good). This is probably too harsh. Peaceful political competition is now entrenched in Turkey. The military has been tamed and now reports to a civilian defence minister. The Kurdish problem has not been solved, but a promising way forward based, intriguingly, on a European federal model has entered mainstream political debate.[2] Meanwhile, concerns about the treatment of Kurdish activists and of journalists advocating Kurdish independence are justified, but do not amount to political instability. (Somewhat similar reservations apply to the 'political stability' ranking of Russia. A regime can be unpleasant without being unstable.)

Inflation; macro-balance

Both Turkey and Russia have suffered from high inflation in recent times, and may do so again, but in the past decade both states achieved a fair degree of control over inflation. At the end of 2010 the difference between their annual consumer inflation rates had narrowed from that shown in Table 1 to just over two percentage points: 8.7% in Russia and 6.4% in Turkey.[3]

Some of the more salient macro-economic differences can be seen in Table 1. Russia's current account was in surplus even in the crisis year of 2009 and its government deficit had been preceded by almost a decade of surpluses. In post-communist times, Russia has had a net private inflow of capital only in 2006 and 2007, and in most years of the recent past it has been accumulating foreign exchange reserves (including in its Reserve Fund) and running down public external debt. On the whole, therefore, Russia has been saving more than it has been investing domestically. Turkey's current account and general government deficits, and net capital inflows,

Table 2: World Bank governance rankings (2009)

	Greece	Turkey	Russia
Voice & accountability	139	168	190
Political stability etc.	171	194	191
Govt effectiveness	144	149	142
Regulatory quality	138	154	178
Rule of law	146	155	189
Control of corruption	152	153	202

Source: http://info.worldbank.org/governance/wgi/pdf/wgidataset.xls (3 December 2010)
Note: n = 213, ranking reversed from original so that 1 = best.

2 Yezdanı (2011).
3 December-to-December figures, BOFIT *Russia Statistics* and www.turkstat.gov.tr/SagMenu/gunceleng/guncelEn.xml.

suggest the opposite position. It has a low savings rate, which is hardly surprising in a country where the average age is in the twenties.[4] That points to fundamental differences between the binding constraints on the two countries' growth.

Labour and employment

Unemployment is significantly lower in Russia than in Turkey, where it is a chronic problem and there are difficulties creating jobs for a growing indigenous workforce. Russia, by contrast, has just begun to face the problems of coping with a diminishing indigenous workforce, with the number of immigrants unlikely to be sufficient to offset this.

> 'Unemployment is significantly lower in Russia than in Turkey, where it is a chronic problem and there are difficulties creating jobs for a growing indigenous workforce'

Both countries have relatively high wage-bill taxes in the form of social security contributions by employers. In Russia the social insurance rate rose to 34% of the wage bill at the start of 2011.[5] In addition, Turkey has a relatively high minimum wage and mandatory severance payments (provisions of this kind are weaker in Russia and thus less of a disincentive to employment). Partly because of these direct and indirect employment costs, both countries have significant shadow and semi-shadow economies, in which firms either do not report their existence to the authorities at all or report only part of their employment and wage payments.[6] Turkey's ruling Justice and Development Party (AKP) wants to implement liberal labour-market reforms designed by the World Bank; the difficulty is to create a political consensus behind them.

The informal economy is almost certainly larger in Turkey: according to OECD estimates it accounts for 44% of all employment.[7] This is connected with the fact that Turkey has a larger (and more rapidly shrinking) share of its workforce in agriculture, and with the fiscal disincentives to increase employment in the formal sector. In addition, women who previously worked on family farms tend to drop out of employment as families move to the cities.[8]

Turkey has an acute problem of youth unemployment, worsened by patchy educational provision and by difficulty in competing with Asian suppliers in low-wage lines of production. Russia has an almost opposite suite of problems: falling numbers of young people entering the labour force, lowering both the rate at which skills are upgraded across the labour force as a whole and the occupational and geographical mobility of labour; and an inheritance of minimally restructured former Soviet enterprises. Russia has to cope over the next 20 years or so with a rising ratio of dependents to those of working age in the population, whereas Turkey has a 'demographic window of opportunity' up to 2025, when that ratio is expected to rise.[9] In the area of advanced training, Russia still appears to have an advantage. The World Economic Forum, in its *Global Competitiveness Report 2010–11*, ranks Russia 50th and Turkey 71st out of 139 countries for 'higher education and training'.[10] However, Turkish elite universities are probably more international in the composition of their faculty and student bodies. The gap in educational provision between the two countries may well be narrowing.

4 The median age in 2000 was 25. http://www.turkstat.gov.tr/PreIstatistikTablo.do?istab_id=204.
5 *BOFIT Weekly*, 31 December 2010.
6 OECD (2010), Chapter 3; Gimpel'son and Kapelyushnikov (2007).
7 OECD (2010): 114.
8 Ibid., Chapter 3; economic analyst Bernard Kennedy, in a personal communication of 15 February 2011, suggests that this phenomenon may now be of less importance as the rate of rural–urban migration has peaked.
9 http://www.unicef.org.tr/en/content/detail/53/children-in-the-population.html.
10 WEF 2010, pp. 286, 330.

Institutions; business environment

Some scepticism about the ranking of economies is healthy, but all the same, some are derived from hard evidence that goes beyond 'perceptions'. In particular, the World Bank's Ease of Doing Business surveys, based in substantial part on survey evidence of the costs of carrying out particular business operations, are useful for the present comparison. In the latest rankings based on 2010 data, the business environment was considerably better in Turkey than in Greece, and was even worse in Russia than in Greece. Meanwhile, the OECD's measurement of the extent of product market regulation puts the three economies in the same order, though with Greece and Turkey closer together (see Table 3).[11]

Turkey has strong, established private companies of all sizes. Their independence from the state is clear.[12] That is not the case in Russia. Moreover, Turkish big business is not operated through offshore holding companies, unlike its Russian counterpart. That indicates more trust in domestic institutions. And the Turkish banking sector is strong (see below).

International integration

Considered as participants in the global economy, and given their population size and development level, both Turkey and Russia appear, statistically, to be quite open. In 2009 Russia's exports of goods and services were equivalent to 28% of GDP and its imports to 20%, with somewhat higher figures in the pre-crisis years. The respective figures for Turkey were 23% and 24%. These are healthy measures of openness for two relatively large, middle-income countries.[13]

Both countries have in recent times been strongly oriented towards the EU in their merchandise trade. Europe has been the destination of just over 50% of Russian exports since the mid-1990s and in recent

Table 3: World Bank ease of doing business rankings, 2011

	Greece	Turkey	Russia
Starting a business	149	63	108
Dealing with construction permits	51	137	182
Registering property	153	38	51
Getting credit	89	72	89
Protecting investors	154	59	93
Paying taxes	79	75	105
Trading across borders	84	76	162
Enforcing contracts	88	26	18
Closing a business	49	115	103
OVERALL	109	65	123

Source: www.doingbusiness.org/data/exploreeconomies/ (accessed 3 December 2010)
n = 183

11 In this exercise lower scores indicate less regulation. The OECD average for 2008 is 1.340. Greece scores 2.374, Turkey 2.351 and Russia 3.094 (www.oecd.org/dataoecd/33/12/42136008.xls). The overall scores are derived from measures under 18 separate headings in three groups: state control; barriers to trade and investment; barriers to entrepreneurship. See Wölfl et al. (2010).

12 The AKP may be, according to the *Economist's* regular label, 'mildly Islamist', but it is also more free-market in economic policy than the opposition Republican People's Party (CHP). The latter follows the Kemalist, secular tradition but, as Şener Aktűrk stressed to me, that tradition owes much to the example of inter-war France, *étatisme* and all. The core support of the AKP comes from the export-oriented new bourgeoisie of Anatolia.

13 World Bank data, http://data.worldbank.org/indicator/NE.EXP.GNFS.ZS for export; http://data.worldbank.org/indicator/NE.IMP.GNFS.ZS for import.

years just under 50% of Turkey's.[14] In terms of product composition, Turkey's profile is more sophisticated: goods of high and medium technological levels comprise some 40% of its exports, while oil, gas and metals (mostly not highly fabricated) make up some 80% of Russian exports.[15] Turkey's strength as an exporter of services – construction, in particular, as well as tourism – should be noted.

Table 4 suggests much greater engagement in foreign direct investment (FDI) on the part of Russia than of Turkey. Yet the evidence for Russian barriers to inward FDI is more than anecdotal, and so is the evidence for the use of discriminatory procedures and regulatory barriers against imports. The OECD product market regulation measures[16] show Russia creating barriers to trade and investment much more extensively than Turkey.

Table 4: Stocks of inward and outward foreign direct investment, 2000 and 2009 ($ bn)

		2000	2009
IFDI	Turkey	19.2	77.7
	Russia	32.2	252.5
OFDI	Turkey	3.7	14.8
	Russia	20.1	248.9

Source: UNCTAD, *World Investment Report* database.

Note: FDI stocks are end-year accumulated past FDI flows net of withdrawals and at current prices.

Nonetheless Russia's stocks of inward and outward FDI (IFDI and OFDI) are much larger than Turkey's and grew much faster in the early years of the last decade. This reflects, on the inward side, the attractions both of Russia's large and rapidly growing market and of the country's natural resource endowment. Turkey has a smaller market, less in the way of natural resources and probably, on the whole, stronger domestic companies, all of which reduce the attractiveness to foreign firms of direct investment.

However, the picture for Russia is also reflective of the country's poor rule of law, weak protection of property rights and widespread criminality. Even though Russia has had capital convertibility since mid-2006, there is, in addition to officially recorded OFDI, a continuing stealth outflow of capital. Part of it is estimated by the Central Bank of Russia (CBR) in a line entry in the balance of payments: 'Export revenues not received, imports paid for but not received, and payments for fictitious securities transactions'. Another part is contained in the persistently large and negative net errors and omissions item. The CBR includes both of these items in its calculation of net private capital flows.[17] And it appears that Russia generates an unusually large flow of capital to tax havens, where many Russian tycoons locate their holding companies.[18] Estimates by Global Financial Integrity put Russia second after China among all developing economies in the volume of 'illicit financial flows' in the period 2000–08. Turkey is 18th or 19th, depending on the method of calculation.[19]

From this it is possible to conclude that Russia is quite extensively integrated into the world economy but that this integration would be more extensive still if its economic and civil institutions were stronger and more orderly. Russia has tended to be a net exporter of capital, in a variety of forms, from the build-up of foreign-exchange reserves through officially recorded outward foreign investment to stealth outflows probably used to launder money and escape taxation. Turkey, on the other hand, is a low saver, reliant on net capital inflows and perhaps receiving less than could usefully be absorbed; its credit rating has been kept below investment grade because of its high unemployment rate, low fiscal transparency and allegedly high political risk.[20] This means that expansion, pushing up the current account deficit and depending in part on net capital inflows, is particularly sensitive to shocks; that is because a large part of the

14 www.customs.ru and Peet (2010): 6.
15 Ibid.
16 See footnote 11.
17 http://cbr.ru/statistics/print.aspx?file=credit_statistics/bal_of_payments_est.htm.
18 For details see Hanson (2010).
19 Kar and Circio (2011).
20 OECD (2010): 71–3; see above on political risk.

capital inflow is short-term.[21] Despite reasonable fiscal discipline and sound banks, IFDI seems to be constrained by the perception of Turkey as in some respects fragile.

Key constraints on Russian and Turkish economic development

Russia and Turkey are two potential tiger economies from which few people at the moment expect tigerish behaviour: witness the IMF medium-term forecasts in Figure 1. Russia's performance has come to be seen – including, apparently, by its own leaders – as dangerously dependent on the price of oil; yet its efforts at diversification are regarded with scepticism while the decline in the labour force and (it is argued) excessive social spending dampen future prospects.

> 'Turkey's growth, if allowance is made for the global crisis, is not self-evidently slowing down, while the sources of Russia's projected slowdown seem to lie rather in demographic developments and changing international conditions'

This rather pessimistic view of the two nations' future development amounts to saying that, as upper-middle-income countries, they could and in some sense should be catching up with the developed world more rapidly than is likely to be the case with their present institutions and policies.

It is possible that both are close to a 'middle-income trap' in the order of $15,000 at PPP per capita, a level at which emerging economies bump up against the limits to growth from the production of basic goods but cannot break into high-tech markets or global financial services. It is not obvious, however, that this is necessarily what is happening. Turkey's growth, if allowance is made for the global crisis, is not self-evidently slowing down, while the sources of Russia's projected slowdown seem to lie rather in demographic developments and changing international conditions.[22]

Regardless of their recent trajectories, however, the binding constraints on growth in the two states are not the same.[23] It is true that they are investing on only a modest scale for countries trying to catch up with the developed world (in 2008 gross capital formation was 25% of GDP in Russia and 22% in Turkey),[24] but there the similarities end.

During the 1999–2008 boom Russia reduced public debt, ran budget and current account surpluses, built up foreign exchange reserves and in eight of the ten years placed more private capital abroad than was coming into the country. (The net outflow of private capital continued in 2009, 2010 and the first quarter of 2011.) The country was, in other words, saving more than it was investing domestically. Meanwhile Turkey, which also experienced a boom in that decade, for the most part ran current account and budget deficits and was a net recipient of capital – albeit on only a modest scale in terms of direct investment.

In its 2010 economic survey the OECD argued that Turkey needed a higher domestic savings rate to support a higher investment rate.[25] That is not Russia's problem: it needs more of its savings invested at home rather than abroad. One plausible conjecture about the modest rate of domestic investment in Russia is that it is constrained by the low appropriability of returns to investment because of the predatory nature of the Russian state. In other words, it is the predatory state with its unpredictability and poor rule

21 Rodrik (2009); OECD (2010): 35; Hudson (2011).

22 See Hanson (2011 forthcoming).

23 Dani Rodrik's (2007) approach to 'growth diagnostics' is used only rather loosely in the following discussion. Rodrik himself leans towards the view that Turkey's binding constraint is financial (Rodrik, 2009).

24 http://data.worldbank.org/indicator/NE.GDI.TOTL.ZS. This indicator declined in both countries in 2009. The investment share of GDP (in 2003 prices) had risen steadily but not sharply in Russia since 2000, from around 17%, according to Rosstat (www.gks.ru/free_doc/new_site/wp/tab25.xls, accessed 10 March 2011). The Economy Minister put 2010 fixed investment at only 21% of GDP (*Vedomosti*, 24 January 2011).

25 OECD (2010): 36–7.

of law that constitutes Russia's key development problem.[26] According to this view, much of the capital that leaves Russia is 'escaping the system'. In Turkey it is more likely that the social rate of return on investment is constrained by skill shortages, together with relatively high labour costs and inflexible labour markets in the formal sector.[27]

An alternative interpretation of the Russian case is that potential returns to domestic investment are high and can be appropriated (on the whole) by investors, but that finance is too costly.[28] Certainly the financial services sector is stronger in Turkey.

In the World Economic Forum's *Global Competitiveness Report 2010–11*, there is a wide gap in the rankings (out of 139 countries) between Russia and Turkey with regard to financial services (se Table 5).[29]

Table 5: Global rankings of Russia and Turkey on selected financial-services indicators, 2010

	Russia	Turkey
Soundness of banks	129	36
Fin thro' local equity market	107	46

Note: 'Fin. thro' local equity market' refers to the ease and cost of raising finance through share issues on the local securities markets. For full definitions see the source.
Source: WEF (2010), country tables.

Russian stock-market capitalization is respectable in scale for a middle-income country. It is composed, however, of a relatively small number of very large listed companies, many of which are controlled (but not wholly owned) by the state, and have highly illiquid shares. The ratio of the 2010 share turnover to end-year market capitalization was 43.0% for MICEX (Moscow), against 126.6% for the Istanbul market (which has a smaller market capitalization but one made up of about 50% more companies).[30] This picture of a more active market in Istanbul is in line with a 2010 assessment by the index company FTSE, which has raised Turkey, along with the Czech Republic and Malaysia, from 'Secondary Emerging' to 'Advanced Emerging' market status, with effect from June 2011; Russia remains in the lower category.[31]

Turkey, in other words, has the makings of an effective market for corporate control.[32] Russia does not. Assets can certainly change hands in Russia (see the cases of Yukos, Sakhalin Energy, Russneft and the Kovykta gas field). What Russia does not have is a *competitive and rule-governed* market for corporate control, one that would tend to move assets into the hands of those best able to make a good return on them. Turkey's much more liquid capital market, by contrast, provides at least a basic precondition of a market for corporate control.

The character of corporate control, the net export of private capital and the large role of the state in national saving (until 2009, at any rate) suggest that weaknesses in Russia's financial sector are best seen as symptoms of the defective business environment, rather than as constituting a separate, and binding, constraint. Turkey, on the other hand, has a plain, old-fashioned shortage of savings.

In Russia, an independent judiciary capable of protecting property rights needs to be established to address the problem of a predatory state. Banks must become more strongly capitalized and the securities market must somehow become more extensive and more liquid to address financial-sector weakness.[33] Both lines of reform are fraught with difficulties, but the former probably requires a fundamental change in the political order. Russia's political elite is deeply

26 Can the behaviour of a variable (in this case, GDP) be accounted for by something that is fixed, or at most, only slowly changing – in other words, something that is not itself a variable? I suggest that other variables do indeed account for Russian growth, in a growth accounting sense, but that the difficult business environment acts as a ceiling on the growth rate, chiefly by holding down investment.

27 OECD (2010), Chapter 3.

28 This is argued by Connolly (2011).

29 WEF (2010), country tables.

30 World Federation of Exchanges data from www.world-exchanges.org/statistics/ytd-month. The turnover-to-market-capitalization ratio for Istanbul is not far from the average across all members of the World Federation.

31 www.ftse.com/.

32 A market for corporate control exists when there are no institutional impediments to a controlling stake in a company being bought from its current owners by other persons or companies who judge that they can manage that company more profitably, and can raise the funds for the purchase.

33 The CBR seeks to move to a 300-million-rouble minimum capital for banks by 2015 (the level in 2011 is 90 million roubles or about $3 million). The minister of finance has called for a figure of 1 billion roubles by 2015 (Kudinov 2011).

and opaquely engaged in business and the control of major assets.[34] Pursuing the latter line of reform is perhaps possible without challenging the authorities, but if, as argued above, financial-sector weakness is not in fact an independent constraint for Russia, a radical improvement in economic performance probably requires a change in political regime.

In Turkey it may be that the key requirement is a liberalization of the labour market in the formal sector. That would reduce the supply price of labour in the formal sector, raise employment and also reduce the incentives for business to enter or to remain in the informal sector. Increased investment in education is perhaps a necessary accompanying policy.[35]

The political and social difficulties attached to these reforms, in both countries, are very great. What, if anything, does this tell us about relations with the EU and about desirable EU policies?

Future relations: Europe or some other club?

For both Russia and Turkey, the relationship with the European Union is difficult and not visibly improving. In terms of economic relations, there are two influences operating against improvement. First, the EU exerts a large gravitational pull on both economies, but that pull is tending to weaken. Second, the EU seeks to conduct its dealings with its neighbours on the basis that they can and should adopt European rules and norms. This approach looks increasingly divorced from reality. EU member states have large and visible differences in foreign and security policies, including policies that bear on their dealings with neighbouring countries. And trying to get neighbours to adopt the EU's *acquis communautaire* as a whole or in part seems ever more absurd when member states manifestly do not observe the rules of the economic game uniformly and are at a loss as to how to conduct internal EU affairs.

Influential countries close to the EU therefore have stronger inducements than before to invest in their own alliances and networks. Richard Sakwa, looking at political and social developments in Europe, Turkey and Russia, suggests that a 're-thinking of Europe' is needed.[36] Economic developments across Europe also require everyone concerned to think again.

Europe's weakening gravitational pull

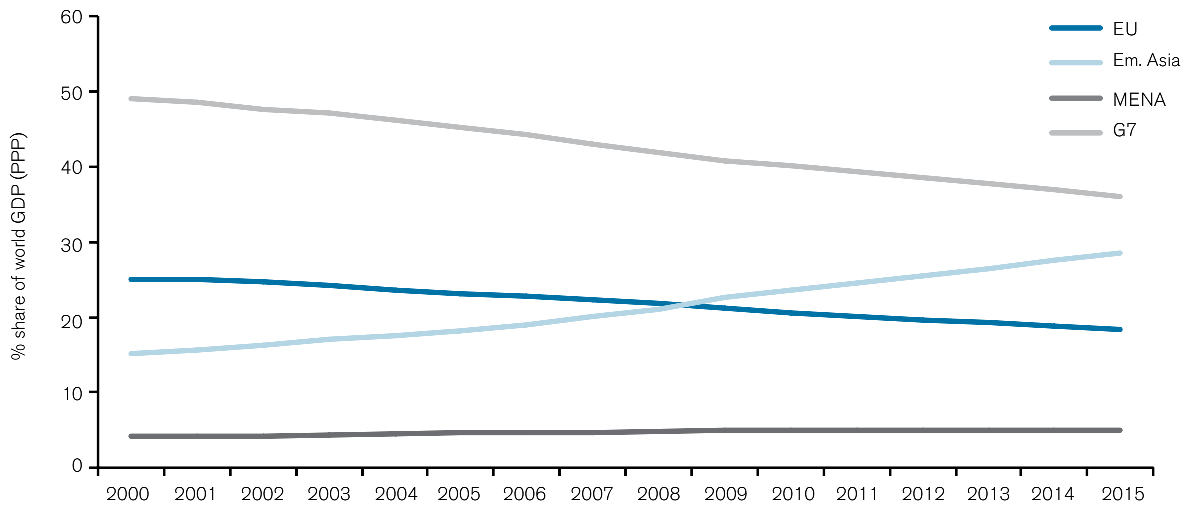
The EU still looms large in the merchandise trade of both Russia and Turkey. Its gravitational pull, determined by economic size and proximity, is necessarily strong for both countries. The EU accounted in 2010 for close to 50% of merchandise trade turnover for Russia and 42% for Turkey.[37]

There is at present no similar competing gravitational pull exerted by a major state or trading bloc on either of the two economies. Russia has been conducting 13–14% of its merchandise trade with other members of the Commonwealth of Independent States (CIS) and more recently an increasing proportion, approaching 10%, with China.[38] About 4% of its trade has been with Turkey, slightly more than with the United States.[39] Turkey's merchandise trade partners outside the EU include the countries of the Middle East and North Africa (about 17% of its 2010 merchandise trade turnover) and Asian countries outside the Middle East (approximately the same share).[40] The CIS countries, a group that overlaps with the Asian category, accounted in 2010 for 14% of Turkish merchandise trade, of which Russia made up 9%.[41] Trade in services probably follows a similar pattern.[42]

For the time being at least, both Russia and Turkey might be said to be stuck with Europe. Turkey of course has closer links: it has had a customs union (excluding agriculture) with the EU since 1996 and is in negotiation over accession. Russia's most immediate ties with the EU

34 Medvedev's March 2011 demand that senior ministers quit the boards of state companies will make no difference to this.
35 OECD (2010), Chapter 3.
36 Sakwa (2010).
37 http://www.turkstat.gov.tr/PrelstatistikTablo.do?istab_id=624.
38 http://www.customs.ru/ru/stats/stats/popup.php?id286=735, accessed 20 April 2011.
39 This is from Russian Customs data. There is a significant 'shuttle' trade, mostly informal imports from Turkey into Russia, which presumably does not show up in the Customs data; but the CBR's estimates for all trade bypassing Customs do not suggest that including the shuttle trade would alter Turkey's share by an order of magnitude.
40 Derived from January–November 2010 data from http://www.turkstat.gov.tr/PrelstatistikTablo.do?istab_id=624.
41 Ibid.
42 Trade in services covers any current (non-capital) international trade that does not involve a tangible object.

Figure 2: Shares of selected groups of countries in world GDP, 2000–09 actual and 2010–15 projected



Notes: PPP denotes valuation at purchasing-power parity; MENA = Middle East and North Africa; Em. Asia = Emerging Asia (includes China and India; excludes Japan, South Korea, Singapore and other 'newly industrialized' Asian countries). G7 and EU overlap.
Source: IMF WEO database, October 2010

are of a more particular sort: oil and gas pipelines that feed its major exports westwards to Europe. It is true that Russia could in the long run diversify its hydrocarbons exports to Asian and Pacific markets. But its ability to do this depends mainly on the development of Eastern Siberia. That will be a very costly, long-term project that is unlikely to redirect a large proportion of Russian oil and gas exports away from Europe in the near future. Russia also has a political and business elite whose foreign portfolio of bank accounts, holding companies, yachts, villas, country houses and town mansions is mostly in Europe, and many of whose children go to school in Europe.

Despite all these connections, the EU's gravitational pull on its neighbours looks likely to weaken for internal reasons. The combined economy of EU member states may be large and, in most years, growing, but it is tending to lose ground to other regions of the world (see Figure 2). The economic pre-eminence of Europe and the G7 countries has been eroded in recent years – a process that is expected to continue at least in the medium term. Europe's mature economies are, almost by definition, growing more slowly than emerging economies, so there is nothing surprising about this. Figure 2 also shows that the Middle East and North Africa, a possible alternative 'neighbourhood' for Turkey, has not been particularly dynamic, with its share of world economic activity increasing only marginally over the period.[43]

The credibility of the EU

Along with some decline in its relative size, and therefore its gravitational pull, as a centre of business activity, Europe has lately been suffering a loss of economic reputation. This might be recovered in the long run, but for the time being at least the EU's performance during the global economic crisis has not strengthened its claim to resilient economic arrangements, macro-economic discipline and growth. Over a somewhat longer period, more authoritarian and interventionist regimes, most notably in China, have gained credibility.

In recent years, the EU's stock has probably fallen in Turkey and Russia; after all, it has declined in Europe itself. The attraction of closer formal relations with the EU looks questionable for both countries as far as economic issues are concerned.

43 *Hürriyet Daily News and Economic Review* groups foreign news according to an ingenious classification based (very loosely, from a British point of view) on river basins. This forms a 'regionscape' of areas particularly pertinent to Turkey: Danube (for Europe), Volga (for Russia, the western CIS and the Baltics), Amur Darya (including Central Asia, Afghanistan, Pakistan and India), Euphrates (for the Middle East, extending west to Egypt) and Kura-Aras (for the South Caucasus).

Turkey, as a candidate for EU membership, is expected to meet the Copenhagen economic and political criteria.[44] The economic requirements include macro-stability, the ability to compete in the EU market and such *acquis* headings as 'competition policy and state aid'. Many boxes remain to be ticked and a number of 'chapters' of the negotiations are, at the time of writing, frozen – the immediate grounds for this being the stalemate over Cyprus. Yet Turkey already has a healthier business environment than Greece or Italy, to judge by the World Bank's Ease of Doing Business rankings, as noted above.[45] Moreover, the budgetary and sovereign debt positions were healthier in Turkey than in several EU member states in 2010–11. Its main difficulties with Brussels – perhaps less readily soluble than the Cyprus issue – have been connected to issues in French and German domestic politics. Among the people I spoke to in Turkey in May 2011, there were disagreements over the role of the Cyprus dispute. For some it was the real stumbling-block. Others reckoned it could be speedily dealt with if there were green lights from Paris and Berlin.

In the 2011 election campaign in Turkey the leading parties routinely asserted that EU accession was important, but they did not waste much time talking about it. Accession is close to being a dead issue in Turkish politics. Commentators note that, after all, Europeans themselves were losing confidence in the EU.[46] Some believe that even changes in France and Germany to governments that are friendlier towards Turkey would leave daunting obstacles to membership.[47] Other experts were more optimistic.

The package Turkey could expect on accession would in any case not contain much in the way of obvious financial inducements. As a large and relatively poor country with a big agricultural sector, it would be unlikely to be offered much in the way of regional funds and farm subsidies – precisely because it would absorb large amounts of both.

The status of Turkey as permanent membership candidate is one that at present suits both Brussels and Ankara. Ahead of the June 2011 election, the AKP government got away with jailing journalists who advocated Kurdish independence (but did not advocate violence). This was good for attracting nationalist voters and could be quietly reversed once the government was returned.[48] Meanwhile the European Commission can talk of the need to revise Turkish media legislation and avoid discussing obstacles on the European side to Turkey's accession.

As things stand, the incentives for Ankara to implement the EU *acquis*, including those political parts of it that could be beneficial, are weak. The incentives to develop links with other countries are strong. Those links may be complementary to, not substitutes for, links with Europe, but they still tilt the balance of Turkish interests a little away from the EU. One example of the consequences of the shifting balance of Turkey's international linkages concerns the customs union with the EU. This has facilitated a strong growth in Turkish exports of manufactures. Yet now it is sometimes criticized because the common external tariff, a necessary part of any customs union, prevents Ankara giving special tariff deals to third parties.

Russia figures prominently in Turkey's new alliances. The growing cooperation between Ankara and Moscow is symbolized by a Commission for High-Level Cooperation and a Joint Strategic Planning Group.[49] Russia provides natural gas to Turkey, in particular, and there are large Russian investments in the steel industry[50] as well as a recent agreement on Russian construction of a nuclear power station at Akkuyu. Turkey sells Russia a range of goods and services including textiles, clothing, tourism and construction services.[51] Visa-free

44 For details see Faucompret and Konings (2008), Chapters 3 and 4.
45 In the World Bank Ease of Doing Business rankings for 2011, Turkey is placed ahead of Poland, Italy and Greece. www.doingbusiness.org/data/rankings.
46 For example, Idiz (2011).
47 Interviews conducted in Istanbul, May 2011.
48 The fact that the opposition CHP did somewhat better than before and the AKP failed to get a super-majority in parliament that might have allowed it unilaterally to amend the constitution suggests a further maturing and stabilization of politics in Turkey, despite the government's shameful treatment of the media.
49 Kardas (2011); Markedonov (2011). On the origins of the developing relationship with Russia, see Aktűrk (2006).
50 Kurtaran (2011).
51 According to one of the people I interviewed in Istanbul, Russian tourism began in the 1990s with rich Russians coming to Turkish resorts whereas 'now the rich Russians go to London and we get the middle class'.

travel between the two countries began in March 2011. This is in awkward contrast to the unequal visa relationship with Europe: quick and easy visa purchase for EU citizens entering Turkey; slow and difficult prior acquisition of visas required of Turks visiting the EU. Relations with Russia are in many ways less irksome.

Conclusions

Let us start with the obvious: Europe's energy ties with Russia are important for both the buyers and the seller. That particular relationship looms very large in dealings between Russia and its European neighbours. However, Russia is not a petro-state. It has a diversified economy, even if much of its non-oil-and-gas business is uncompetitive. The large and growing Russian market attracts European investment in consumer industries: car-making, soft drinks, brewing, confectionery and retailing. The present political order in Russia, however, impedes any improvement in the country's economic and political institutions, at any rate for the time being, regardless of EU policies. Part of its policy-making elite acknowledges a need for greater openness to foreign trade and investment, for the sake of more successful diversification.

In both economic and political institutions Europe shares far more with Turkey. Indeed, the common Turkish view that Europe would benefit economically from closer ties to Turkey is hard to contest. For the medium term at least, the Turkish economy is a good deal healthier than much of Europe's.

What are the possibilities for fruitful cooperation between Europe and these two Eurasian economies? And what might be the risks of not pursuing cooperation?

In the case of Russia, engagement remains a necessity for the EU, but it would be wrong to invest great hopes and resources in attempts to promote major institutional change while the present political regime remains in place. It is hard to believe, for example, that an official partnership for modernization will achieve anything that a wider Russian opening to Western companies will not. And it is questionable whether even the latter will contribute much if the present political leadership maintains its grip on Russian society.

> 'In the case of Russia, engagement remains a necessity for the EU, but it would be wrong to invest great hopes and resources in attempts to promote major institutional change while the present political regime remains in place'

In the case of Turkey it is equally hard to believe that an *acquis* to which, officially, Greece, Italy and Spain are parties can offer a great deal of hope for tackling Turkish economic weaknesses such as the two-tier labour market. In face of the evidence of dangerously defective economic institutions in several member states, the EU would be well advised, on the economic front, to try a new trick: humility. As a candidate for membership, Turkey is committed to adopting the whole *acquis*. But ticking the economic boxes, as Bulgaria and Romania were officially deemed to have done in the recent past before they joined the EU, cannot really be expected to help Turkey or anyone else. As far as Turkish political development is concerned, matters are rather different. The Turkish government's handling of the Kurdish issue, and of the media in connection with that issue, really would benefit from being more 'European'.[52]

Meanwhile the deepening relationship between Ankara and Moscow entails some risks from the point of view of political liberalization, primarily for Turkey. There is a danger that closer and deeper relations between the two

52 In the 2011 election campaign, while the AKP leader was denying that there was a Kurdish problem, the opposition CHP deputy leader, Sezgin Tanrıkulu, argued that removing the reservations that Turkey attached to its signing of the European Local Administrations Autonomy Condition would allow more autonomy for Kurdish regions without a formal departure from Turkey's unitary state (Yezdanı, 2011). This might not appease the more fervent Kurdish nationalists but at least it illustrates the potential usefulness of European models to Turkey's political institutions.

states will help, in the absence of a further deepening of relations with the EU, to entrench an illiberal approach to the Kurdish issue and to media freedom in Turkey.

If major member states that block progress on Turkish accession were to change their position, it might be possible for the EU to offer more encouraging signals: to state, for instance, that Turkey could become a member by (say) 2020 provided it met some specific targets that are part of the standard criteria for membership.

This would make accession a real prospect for Turkey and not just a pious aspiration of dwindling credibility. It would strengthen pressures to improve the treatment of minorities and the media. Insofar as this would improve risk assessments of the country, it would reduce Turkey's vulnerability to sudden reversals of the flows of 'hot money'. It might also help the processes of economic reform, and these could with luck extend to the labour market.

For the time being, at least, that is unlikely to happen. More realistic, perhaps, is the suggestion that the EU should treat Turkey as more of a partner in foreign policy and security matters than it now does.[53] Faced with turmoil in the Middle East and North Africa, Europe needs the help and advice of just such a modernizing, moderately Islamic state as Turkey. There is a chance that closer cooperation on this front would spill over into closer economic relations, to the benefit of both parties. Meanwhile, offering greater freedom of movement for Turkish citizens would help, beginning with easier acquisition of multiple-entry visas to the Schengen area and to non-Schengen EU nations.

For Russia, the key constraint of a defective business environment can probably be removed only in conjunction with a change in political regime. The domestic political and economic liberalization that is needed is unlikely to be more than marginally hastened by external influences. But at any rate two such means of influence are to hand. One is the liberalization of energy markets, particularly for gas, in Europe. The other is active support for Russia's efforts to join to the WTO. Its accession has become a bone of contention between liberals and nationalists in the Russian political elite. Anything that Europe could do to facilitate that accession would help the former against the latter.

If the EU persists in its efforts to insist on open access to gas pipelines and greater unification of pipeline grids, and in general making the gas market more competitive, that will lessen the political and economic attractiveness of the Russian status quo. That status quo is based on resource rents and the notion of Russia as an 'energy superpower'. European energy-market liberalization would hardly be enough by itself to transform the present predatory state into something more benign, but it would work in that direction.

> 'Faced with turmoil in the Middle East and North Africa, Europe needs the help and advice of just such a modernizing, moderately Islamic state as Turkey. There is a chance that closer cooperation on this front would spill over into closer economic relations, to the benefit of both parties'

Nudges in these two parts of Russia's political anatomy cannot transform it, but they could assist an evolution towards a more liberal state. More ambitious policies of engagement with Russia should await a shift in Moscow towards a more liberal and less nationalistic leadership.

Meanwhile the idea that strong neighbouring countries must be persuaded to become more 'European' for the sake of closer economic relations with the EU should be played down. The glaring disparities in both institutions and economic performance among member states, old and new, suggest that, economically at least, the *acquis* is really not all that *communautaire* within the EU in the first place. It therefore makes little sense to insist on it as some sort of gold standard for an accession candidate like Turkey or a neighbour like Russia.

53 See, e.g., Barysch (2011, Hakura (2011), Straw (2011).

References

Aktűrk, Şener (2006), ‘Turkish-Russian Relations after the Cold War’, *Turkish Studies*, 7: 3 (September): 237–64.

Barysch, Katinka (2011), ‘Turkey, the EU and the Mediterranean Uprisings’, Centre for European Reform, CER Insight 03/11.

Connolly, Richard (2011), ‘Financial Constraints on the Modernization of the Russian Economy’, forthcoming in *Eurasian Geography and Economics*, 52: 3.

Faucompret, Eric, and Jozef Konings (2008), *Turkish Accession to the EU: Satisfying the Copenhagen Criteria* (Abingdon: Routledge).

Gimpel’son, V.E., and R.I. Kapelyushnikov (eds) (2007), *Zarabotnaya plata v Rossii*, [*Wages in Russia*] (Moscow: GU-VShE).

Hakura, Fadi (2011), ‘Secularism to the rescue of the Arab Spring’, *Hűrriyet Daily News and Economic Review*, 13 May: 10.

Hanson, Philip (2010), ‘Russia’s Inward and Outward Foreign Direct Investment: Insights into the Economy’, *Eurasian Geography and Economics*, 51: 5: 632–53.

Hanson, Philip (2011), ‘Modernizing Russia: Internal and External Implications and Challenges’, forthcoming from Istituto per gli Studi di Politica Internazionale (ISPI) (Milan).

Hudson, Alexandra (2011), ‘Deficit leaves Turks skating on thin ice’, *International Herald Tribune*, 25 January: 21.

Idiz, Semih (2011), ‘EU, as distant a prospect as ever’, *Hűrriyet Daily News and Economic Review*, 13 May: 10.

Kar, Dev, and Kurly Circio (2011), *Illicit Financial Flows from Developing Countries 2000-2009* (Washington, DC: Global Financial Integrity).

Kardas, Saban (2011), ‘Turkey and Russia Move Closer to Visa-Free Travel’, *Eurasia Daily Monitor*, 25 January.

Kudinov, Vasilii (2011), ‘TsB predlagayet bankam minimal’niy kapital v 300 mln rub’ [‘The Central Bank proposes 300 mn. rouble minimum capital for banks’], *Vedomosti*, 18 January.

Kurtaran, Gőkhan (2011), ‘Steel company eyes new investments in the south’, *Hűrriyet Daily News and Economic Review*, 11 May: 13.

Markedonov, Sergei (2011), ‘<<Sorevnovatel’noye sotrudnichestvo>> i prizrak <<khishchnogo pirshestva>>,’ [“‘Competitive cooperation” or a “predator’s feast”’], *Politcom.ru*, 17 March.

OECD (2010), *OECD Economic Surveys. Turkey*, vol. 2010/3 (Paris: OECD).

Peet, John (2010), ‘Anchors aweigh. A special report on Turkey’, *The Economist*, 23 October.

Rodrik, Dani (2007), *One Economics, Many Recipes. Globalization, Institutions and Economic Growth* (Princeton, NJ: Princeton University Press).

Rodrik, Dani (2009), ‘The Turkish Economy after the Crisis’, Turkish Economic Association Discussion Paper, 2009/9.

Sakwa, Richard (2010), ‘Russia and Turkey: Rethinking Europe to Contest Outsider Status’, *Russie.Nei.Visions* no. 51 (Paris: IFRI).

Straw, Jack (2011), ‘Turkey is a crucial ally. To snub it is sheer folly’, *The Times*, 28 March: 20.

WEF (2010), *Global Competitiveness Report 2010-11*, World Economic Forum, http://www3.weform.org/docs/WEF_GlobalCompetitivenessReport_2010-11.pdf.

Wölfl, Anita, Isabella Wanner, Tomasz Kozlak and Giuseppe Nicoletti (2009), ‘Ten Years of Product Market Reform in OECD Countries. Insights from a Revised PMR Indicator’, OECD Economics Dept, Working Paper no. 695 (Paris: OECD), April.

Yezdanı, Ipek (2011), ‘CHP offers Euro-style solution to Kurdish problem’, *Hűrriyet Daily News and Economic Review*, 14 May: 1, 3.

Philip Hanson is an Associate Fellow of the Chatham House Russia and Eurasia Programme and an Emeritus Professor of Birmingham University, where he also served as Director of the Centre for Russian and East European Studies. He has worked mainly on the Soviet and Russian economies, with some excursions into related fields. He is the author of a number of books, including *Regional Economic Change* in Russia (co-edited with Michael Bradshaw) and *The Rise and Fall of the Soviet Economy*, and of many journal articles. He has worked in the UK Treasury, the UK Foreign and Commonwealth Office, the United Nations Economic Commission for Europe and Radio Liberty, and been a visiting professor at the universities of Michigan, Harvard, Kyoto and Sodertőrns (Stockholm). He was awarded an OBE in 2011 for services to Soviet and Russian studies.

Acknowledgments

I am grateful to Richard Connolly, Julian Cooper, Bernard Kennedy, Andrew Mango, James Nixey and two anonymous referees for helpful comments on earlier drafts, and to Fadi Hakura and Fusun Ozerdem for initial orientation on Turkey. I am also indebted to those experts who kindly spared the time to talk with me in Istanbul in May 2011: at Koç University, Professor William Hale, Professor Suhnaz Yilmaz, Docent Dr Şener Aktűrk; at Fitch Ratings, Istanbul, Dr Botan Berker (General Manager); at IBS Research and Consutancy, Mr David Tonge (Managing Director); and at Kanal D TV Center, Mr Mehmet Ali Birand (political talk-show host and newspaper columnist).

Chatham House is grateful to Akbank for its support and partnership on the Turkey Project. More information about this project is available at http://www.chathamhouse.org/research/europe/current-projects/turkey-project

Chatham House has been the home of the Royal Institute of International Affairs for ninety years. Our mission is to be a world-leading source of independent analysis, informed debate and influential ideas on how to build a prosperous and secure world for all.

Chatham House
10 St James's Square
London SW1Y 4LE
www.chathamhouse.org

Registered charity no: 208223

Cover image ©istockphoto
Designed and typeset by Soapbox, www.soapbox.co.uk