

# Geo-economic Challenges Faced by Turkey - Alper H. Yağcı



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At the centennial of the republic, the European Union (EU) remains as Turkey's biggest trade partner and source of investment. The Customs Union (CU) between EU and Turkey requires Turkey to allow most manufactured goods from the EU duty-free, and also adopt EU tariffs vis-à-vis third countries, without being able to take part in the formulation of the tariff decisions. The deal was agreed to by Turkish politicians back in 1995 with the hope that Turkey would sooner or later become a full member of the EU. This move, while facilitating Turkish firms' integration with European value chains, made Turkey's base tariff rate one of the lowest among countries of comparable level of development, at a time when Asian countries like China started pushing exports aggressively. Under these circumstances, the deteriorating relations between the EU and Turkey now make the update of the CU more necessary, yet also more elusive, as common

ground becomes hard to find and the parties make progress conditional on the resolution of other issues. Far from making progress, the EU and Turkey have recently filed complaints about each other's policies (Turkey's pharmaceutical localization practices and EU's steel tariffs) at the World Trade Organization. (I take up these themes more broadly in a book edited by Harun Arıkan and Zeynep Alemdar in 2023, see <https://link.springer.com/book/10.1007/978-3-031-25799-5>).

Another challenge in relation to Turkey's access to European markets is the European Green Deal, a climate policy vision announced by the EU in late 2019. As part of the deal, starting fully from 2026 a carbon border adjustment mechanism (CBAM) will levy a surcharge for the carbon contents of the goods entering the borders of the EU, if they were not taxed or priced earlier at their country of origin. Being part of the CU has already led some of Turkey's economic sectors to adopting European standards in their environmental practices. However, there are still marked discrepancies in carbon intensity between Turkey and the EU, so the CBAM would mean rising carbon costs for the Turkish industries covered by the mechanism and would lead to either market loss or internalization of the cost through surcharges paid. If Turkey adopts its own carbon pricing, the country could capture some of the offsetting revenues that would be otherwise paid to the EU's CBAM and, if it chooses to do so, use these revenues to subsidize a transition to more sustainable energy use.

At the more global level, Turkey's position with regards to trade and investment is likely to be affected by the growing tensions between USA and China. Biden administration has put limits on the export to China of advanced semiconductors, chip-making equipment, and supercomputer components, a policy likely to bring about a degree of disinvestment away from that country. Turkey can potentially take advantage of the situation by capturing parts of the value chain that have been hitherto embedded in China. There may be some reason for optimism: The recent growth of the defense industry, for example, has showcased Turkey's potential for manufacturing innovation. However, defense is a *sui generis* sector whose chief customer is the government, which can directly steer and subsidize it to great effect amidst a heightened need for national self-sufficiency due to political reasons. In general, when it comes to higher-end manufacturing the

industrial ecosystem in Turkey is regarded to lag behind not only Japan, Korea and Taiwan—which together dominate the semiconductor industry—but other competitors like Brazil too. Any opportunities provided by partial Chinese withdrawal from global value chains may remain untapped without reforms to halt the brain drain from Turkey, to upgrade labor skills and to form viable geographical clusters of dynamism.

It should also be noted that growing difficulties faced by China means not only opportunities but also risks for Turkey, by way of global economic slowdown and demand shortage. The silver lining of a slowdown scenario would be the concomitant fall in energy prices. Unfortunately, the situation in Israel/Palestine may give rise to regional conflicts that would push energy prices further up. In case Iran gets dragged into the ongoing Gaza conflict, a large-scale war could not be completely ruled out and the economic repercussions of such an escalation are hard to predict. The current sanctions against Iran put Turkey in the difficult position of trying to keep relations with the USA afloat while not shutting doors to a regional trade partner completely. A war would mean much harder decisions to make.

Another issue that could put Iran and Turkey at loggerheads is the recent developments in Southern Caucasus. Azerbaijan has taken over the Nagorno-Karabagh territory that had remained under Armenian occupation for three decades, and announced intentions to facilitate a corridor for direct transport connection with its Nakhchivan exclave, and therefore with Turkey. Armenia protested against a corridor that would pass through its (Zangezur) territory and, eyeing pan-Turkic cooperation with suspicion, Iran too has signaled its lack of support for the general concept. Considering that most international trade occurs by sea, the importance of occasionally announced land routes to improve connectivity between Asia and the West may be less immediately economic and more indicative of the involved countries' desire to politically commit to each other. Likewise, the net economic impact of a possible Zangezur corridor is hard to estimate and can be easily overstated, but a corridor would be an improvement if it can be realized without provoking conflict with the neighbors.

Looking ahead, Turkey's long-term economic vision has to pay attention to changing demographic realities. The country's substantial economic growth in the twenty first century was facilitated by an ever-rising population ratio of working-age individuals. However, this ratio hit a historical high in 2020, and it is now projected to follow a downward trend. With a low employment rate, a welfare state mostly geared towards pension payments rather than social investment instruments like child support, and affordable housing becoming a serious problem in metropolitan areas, Turkey's native population is increasingly unable or unwilling to reproduce itself. Fertility rate is now around 1.7 per woman, below not only the world average but also the conventional population-replacement rate of 2.1. In other words, even though Turkey has long prided itself on its demographic dynamism, the paradigm now must shift to meet the challenges of an aging native population and a workforce that is increasingly consisted of immigrants. The main source of immigrants is the Near East, the largest demographic probably being the Syrian refugees. Among the latter, who mostly hail from rural areas, only 8% of men aged 18 and over had a high school (or higher) level education in 2018, as reported in a study by Tuğba Adalı et al (see <https://www.routledge.com/Syrian-Refugees-in-Turkey-A-Demographic-Profile-and-Linked-Social-Challenges/Cavlin/p/book/9780367501198>). This low-cost, low-skill workforce has been instrumental in boosting Turkey's industrial production in the post-2018 weak currency era but its contribution to an upgrading of the country's industry towards more price-inelastic, high value-added segments will be limited. The growing immigrant population also raises issues of cultural and political integration in a country that is already deeply divided along rival value orientations. This is an issue that is likely to become more and more important for Turkey's domestic politics and its international position in the future.

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