



It's a long way to Copenhagen Turkey's Membership of and Convergence with the European Union

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On October 3, 2005, Turkey officially started negotiations for membership in the European Union. Whether Turkey becomes a full member of the EU is likely to be a defining decision, both for the existing EU members and for Turkey. The regional- and geo-political consequences of success or failure of the negotiations, and its cultural and ideological impact, are likely to be even more significant than its economic consequences, although even from an economic perspective the stakes are very high. Turkey's population of over 70 million is larger than that of the ten countries that joined the EU on 1 May 2004 combined. Unlike the EU-25 (and in particular the ten new member states), the Turkish population is young and growing. Its present per capita income is lower than that of any of the EU-25 countries – about at the level of Romania and Macedonia, using Purchasing Power Parity (PPP) estimates of per capita Gross Domestic Product (GDP). However, with the right institutions and policies, Turkey could become a true tiger economy. But this is not guaranteed. With the institutions and policies of the second half of the 20th century, it could end up a mangy cat instead of a tiger.

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This note is motivated by some rather optimistic official reports¹ and especially by the World Bank's recent Country Economic Memorandum for Turkey *Promoting Sustained Growth and Convergence with the European Union*. On balance, I strike a somewhat more downbeat chord, although I believe that even my extended list of obstacles and problems can be handled by Turkey given sufficient ambition, determination and political courage.

Normalisation brings with it recovery-easy growth

Recent events encourage a tendency to describe Turkey as a country that, following truly spectacular macroeconomic mismanagement through most of the 1990s (culminating in a complete loss of fiscal control at the end of that decade, accompanied by rampant inflation and, during 2000-2001, a collapse of the peculiar managed exchange rate regime of the time – a 'crawling peg pseudo-currency board' – and a banking crisis) has cleaned up its act as regards macroeconomic management and has also begun to address some of the overdue reforms in the banking sector and the social security system in a determined manner.

And indeed, credit where credit is due. The government budget is under control. The Total Public Sector (International Monetary Fund definition) had a primary surplus of 7.1% of GDP in 2004 and of 6.5% in 2005. The gross public debt to GDP ratio has come down from a peak of 107.5% in 2001 (following the collapse of the real exchange rate) to 77.4 percent in 2004 and 68.6% in 2005. The corresponding net government debt ratios are 63.5% in 2004 and 56.0% in 2005. Total (private plus public) external debt was 53.5% of GDP in 2004 and 45.9% in 2005.² The

¹ See in particular the (World Bank (2006a, 2006b)), which is a good description of the recent economic performance of Turkey, its prospects and the challenges it faces. See also IMF (2005) and OECD (2005).

² Net external liabilities, which includes portfolio equity and FDI are considerably higher than net external debt. While the payment stream on equity-type external

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central bank has been granted a significant degree of operational independence. Inflation is down to single digits and falling further. The country has adopted the only sensible exchange rate regime available to it: a managed float with no explicit or implicit target or band for the exchange rate, with intervention used only to dampen or lean against fluctuations that are deemed to be excessive. Growth has picked up: after a 7.5% fall in real GDP during 2001, annual real GDP growth has been 7.8% in 2002, 5.8% in 2003, 8.9% in 2004 and 5.8% in 2005. Serious efforts have been undertaken to clean up both balance sheets and governance in the banking sector.

Even more important, the commitment to sustainable fiscal-financial-monetary plans, the pursuit of low inflation and the creation of an operationally independent central bank have survived a change in government. These are no longer partisan issues. This therefore augurs well for their permanence.

Finally, Turkey launched its EU accession negotiations on 3 October 2005. EU membership is a widely shared ambition throughout the Turkish polity. Since continued macroeconomic stability and further, deep structural reform are part of the conditionality for EU accession, this provides, for as long as eventual full EU membership is perceived as a realistic prospect, an important external incentive for persisting with both.

So much for the good news. Let us now consider the complete picture. Normalisation and continued macroeconomic stability are necessary but not sufficient conditions for sustainable growth and eventual convergence with the productivity levels and standards of living of the rich West European nations. The almost eight per cent per annum average growth rate of GDP achieved during four years of recovery from a deep slump should not be confused with the sustainable growth of actual and potential output once the output gap has been closed. The closing of the output gap has now been achieved. It is therefore no surprise that the growth in output is slowing down, probably to no more than five per cent during 2006. Even that five per cent per annum growth rate is likely to be higher than what can be sustained by the Turkish economy without fundamental structural reform.

Macroeconomic stability can never be taken for granted

Like every other virtue, macroeconomic stability has to be fought for and defended every day. At just

liabilities is not contractually fixed – an important advantage to the issuer of such claims in an uncertain environment – they do represent a claim on Turkish resources during good times.

under 70 percent of GDP, the gross public debt to GDP ratio is still high. In addition, it is still of short (albeit lengthening) maturity and about a third of it is denominated in foreign currencies or linked to the exchange rate. Roll-over risk therefore continues to exist and the public finances remain vulnerable to a sudden sharp depreciation of the real exchange rate. There also continues to be significant direct and indirect unhedged exchange rate exposure in the banking system. When banks hedge the currency risk associated with their hard-currency borrowing by lending in hard currency to domestic households or enterprises that do not hold natural or synthetic foreign currency hedges, the banks just exchange currency risk for credit risk. Despite the arm's length relationship now supposed to exist between the government and the banks, there remains a possible implicit contingent exposure of the state to the banking sector. Taking all these facts into consideration, it is no accident that Turkey's sovereign spread over US Treasuries Libor is 165 basis points (bps – 7 March 2006), at about the same level as Brazil (168 bps) and Ukraine (164 bps). Turkey's euro spread over bunds is 155 bps, compared to 23 bps for Poland.

The budget deficit-reducing measures that restored macroeconomic stability mainly took the form of revenue increases. Public spending still amounts to 40% of GDP, a very high level for a country at Turkey's level of economic development and per capita income. What spending cuts there were fell disproportionately on the short-run easy option items of cuts in public sector capital formation and capital maintenance expenditures. The revenue increases were narrowly based: 75% of tax revenue now comes from indirect taxes; personal and corporate income tax revenues are low. Widespread informality (i.e. black market activity) narrows the tax base further. Effective policies for shifting employment and production into the formal sector require the carrot of increased perceived benefits to formalisation rather than enhanced harassment of informal sector activity. Among the benefits of operating in the formal sector are access to the court system and arbitration system, the protection of the law and access to formal sector finance. The value of these benefits depends on the quality of the judiciary and the depth and scope of the formal financial sector. Both still leave much to be desired.

An increase in the relative size of the formal sector would also permit a lower tax and social security contributions 'wedge' between the marginal cost of labour to the employer and the net take-home pay of the worker.

Of considerable concern in the longer term is the fact that the social security budget manages to run a deficit of 5% of GDP despite a young and growing

labour force and generally favourable demographics. Reform of the social security system, probably beyond what the government is currently trying to legislate, is required, including a higher retirement age/pension benefit eligibility age and a clear formula for longevity risk sharing between current and future contributors and beneficiaries. Introducing such reforms now, before population ageing turns the age pyramid into an upside-down pyramid would be a major contribution to long-run fiscal sustainability.

Sustainable growth is hard growth

With the scope for easy growth that comes with economic recovery exhausted, the hard growth phase, that is the phase characterised by the balanced growth of actual and potential output, begins. The growth of potential output is driven by the growth of physical labour inputs, by broadly defined capital formation and by the growth of total factor productivity.

What is the record of growth of productive potential and what are the prospects? Consider the following, sobering fact. In 1955 Turkey's per capita income is estimated to have been roughly double that of South Korea. In 2003, Turkey's per capita GDP (\$6,772 at PPP exchange rates) was just over a third of that of South Korea (\$17,971). Over 50 years South Korean GDP per capita thus increased six time more than that of Turkey. What went wrong in Turkey these past 50 years? What can Turkey do to ensure that 50 years from now we do not look at a similar picture of long-term economic underachievement?

The problems (and the solutions they imply) can be summarised in two simple propositions. (1) Turkey invests too little. (2) The returns on investment are lower than they should be and could be because of the poor functioning of key markets (especially the formal labour markets and financial markets), and because of ineffective economic institutions and governance at all levels. Both propositions are exhaustively demonstrated and supported in the CEM.

Investment

As regards investment in physical capital by the private and public sectors, the picture is one of a very modest share of investment in GDP given the country's stage of development³ As noted above, much of the (limited) spending cuts implemented by the government following the 2000-2001 crisis took the form of cuts in public sector capital formation

(including key infrastructure projects) and cuts in infrastructure maintenance spending.

Table 1. Saving, Investment and Current Account (% of GDP)

	Gross saving rate	Gross investment rate	Current account deficit
1998	22.7	23.6	-1.2
1999	21.2	21.8	1.0
2000	18.2	23.9	4.9
2001	17.5	15.9	-2.4
2002	19.2	21.3	0.9
2003	19.3	22.8	3.4
2004	20.2	25.9	5.1

Source: GSI and Eurostat

It is doubtful that a continuation of the average investment rate of the past seven years, documented in Table 1, will support a growth rate of potential output at the six to seven per cent annual rate required to achieve rapid convergence of per capita real GDP with that of the EU-25 let alone that of the EU-15. China, by comparison, invests more than 40% of GDP. Raising Turkey's investment rate to the 30% to 35% rate likely to be required to achieve its growth ambitions will require a significant increase in the national saving rate, as it is unlikely that current account deficits of 10% to 15% of GDP are likely to be forthcoming in any sustainable manner. Current account deficits of the magnitude seen in the past couple of years (including the six per cent of GDP current account deficit likely to have been run during 2006) are in principle perfectly sustainable in an economy growing at a rate of five or six per cent per annum. The increase in the current account deficit since 2001 represents, statistically, increased investment rather than increased consumption. Indeed the national saving rate has risen slightly during the past four years. While investment is not guaranteed to generate returns at least equal, in present discounted value, to the cost of financing it, the fact that the recent increase in the current account deficit is the counterpart of increased private investment must be viewed as a positive.

If Turkey's investment rate is nothing to write home about, its saving rate is very low indeed for a country with Turkey's demographic composition: Turkey is still a very young nation with a large share of its population of working (and saving) age and a small share of retirees. The government is running only a small financial deficit (similar in magnitude to its investment programme), so it is the private sector saving rate that is startlingly low – at a level characteristic of the old and ageing populations of western Europe, rather than of an emerging market with a still youthful population.

³ The data are of questionable accuracy; the saving should equal investment minus the current account deficit, but there are statistical discrepancies.

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What can be done to raise the domestic saving rate? Apart from continued fiscal restraint, improvements in the financial asset menu available to private savers may help somewhat. The introduction of a mandatory retirement saving plan (defined contribution, individual accounts) for all employees, as a second pillar of the social security system, could also be helpful. It is unlikely that discretionary private saving would be reduced to offset the increase in mandatory retirement saving. There is little discretionary saving by workers, and negative discretionary saving (borrowing) is not an option available to most workers since unsecured borrowing by workers runs into the problem that future labour income cannot be hypothecated (banks cannot secure their lending with a legal claim on future wage income).

Just as important as physical capital formation (if not more so) is human capital formation. Here the bad news is that Turkey underinvests in human capital (especially as regards the education and training of females) and underutilises what human capital it has (again especially the existing potential female labour supply). Turkey's official unemployment rate (around 10% of the labour force), while too high, is not unusual by EU standards. What is unusual is the very low employment rate. Employment as a percentage of the population of working age – those of 15-64 years of age – is 46.1 percent. The female employment rate is extraordinarily low, at 24.3 percent. Older workers too (those aged 55-64 years) have a very low employment rate of 33.1 percent, reflecting the high level of inactivity of this age group in the agricultural sector and widespread early retirement in the formal sector.

Admittedly, these very low employment rates refer to formal sector employment rates. No doubt many of those classified as unemployed or inactive are engaged in some kind of productive activity. But such employment is not the stuff of which skill and knowledge-driven productivity growth is made.

Turkey makes especially poor use of its female labour force potential. Women are more likely to be illiterate than men (81.1% of women were literate in 2003, compared to 95.7% of men). The combined primary, secondary and tertiary school enrolment rates were 62% for girls and 74% for boys in 2002-2003. The average combined enrolment rate was 68% in 2002/2003, about the same level as China (69%) and Iran (69%) (UNDP (2005)). Further evidence of systematic discrimination against women and girls is found in the UNDP's Gender Empowerment Measure. The 2005 measure puts Turkey in 76th place (out of 177), well below any other EU candidate country, including Bulgaria, Romania, Croatia and Macedonia. The UNDP's Gender-Related Development Index for 2005 puts Turkey in 70th place.

It appears that, as regards the position of women and the role of women in economic life, Turkey is effectively a dual society and economy, with a traditional rural/agricultural society and economy and a modern, urban industrial and service-based society and economy. As shown in Dervis et. al. (2004), value added per person employed in agriculture is just one third of that in industry and an even smaller fraction of that in services. One contributor to this poor productivity performance of the agricultural sector is that those employed in the agricultural sector (about a third of the economy-wide work force) are significantly less educated than those in the industrial and urban service sectors. The gap is massive in the case of women: 28.5% of females employed in agriculture in 2003 were illiterate, against 8.5% of males employed in agriculture. The aggregate illiteracy rates in manufacturing employment was 1.2%, in construction 2.6% and in trade and services 1.4%. Women do much better in tertiary education, with female students making up 44% of the total student population.

While education and training achievements are worse for women/girls than for men/boys, the problem of insufficient human capital formation affects men/boys also. In the enlarged EU, only Portugal has a worse educational performance record than Turkey. The inadequacies of primary and secondary education provision are also reflected in the poor PISA scores achieved by Turkish pupils, which were below the average OECD scores for mathematics, reading literacy, science and problem solving.⁴ The overall educational achievements of the People's Republic of China, for instance, are significantly better than that of Turkey, especially as regards primary and secondary education. Turkey cannot compete with China on wages. To compete effectively, it will have to compete through skills, education, innovation, technology transfer, infrastructure and economic governance and institutions, including the quality of the rule of law in economic affairs.

Innovation and technology transfer can be speeded up greatly by attracting FDI. This has been happening for many years now (and 2005 saw net FDI inflows of 2.6% of GDP), but on too limited a scale. It would help to end FDI restrictions in civil aviation, maritime transport, mining and energy.

What are the factors holding back investment, whether domestically financed or foreign? A key factor is the business climate, as is evident from the Business Environment and Enterprise Performance Surveys (BEEPS) conducted by the World Bank in Turkey (World Bank (2006d)), and from the World

⁴ PISA refers to the OECD Programme for International Student Assessment.

Bank's Doing Business database (World Bank (2006c)). Much of the evidence is surveyed in the CEM.

Other sources of information confirm the picture of serious pathologies in the business and enterprise environment. The 2005 Corruption Perceptions Index ranks Turkey joint 65th (out of 158) with Ghana, Mexico, Panama and Peru. On this index, Turkey does score better, however, than Croatia, Poland, Romania and Macedonia.

The Heritage Foundation's Index of Economic Freedom for 2006 puts Turkey in 88th position. Of the EU members and candidates, only Romania ranks lower (in 93rd position). In the 2005 Growth Competitiveness Index of the World Economic Forum, Turkey comes in 66th position, one place ahead of Romania and well ahead of Macedonia (85th).

All these complementary measures of the quality of the institutions governing economic life tell a consistent story – a story that is reinforced by the message conveyed by *prima facie* more 'political' criteria. For instance, the 2005 Annual Worldwide Press Freedom Index put together by Reporters sans frontières, puts Turkey in 98th place out of 167 countries. This is a significant improvement over 2004, when Turkey came 113th out of 167, but still a long way from meeting the standards set by the political Copenhagen criteria.

There is of course, a direct economic dimension to the lack of media freedom in Turkey. The two most effective weapons against corruption are (1) taking away the sources of the rents that public officials control (that is the opaque use of discretionary power to allocate rents) through de-regulation, liberalisation, uniform tariffs etc and (2) the existence of free media and a vocal civil society.

Conclusion: Prioritising and sequencing reforms – The role of the EU accession process

Turkey's negotiations for EU membership will be long and their ultimate successful conclusion is by no means assured. Even if in due course all political, economic and administrative (acquis-related) Copenhagen conditionalities are met, purely political obstacles remain. The commitment by the French President to have a referendum on Turkish EU membership is a serious obstacle to Turkish membership – a 'Doomsday machine' unleashed to stop Turkish accession.

As Turkey's EU membership is not a 'done deal', Turkey must have/prepare a 'Plan B' for the eventuality that full EU membership is never achieved. For domestic political reasons in Turkey

and so as not to weaken Turkey's negotiating position, the existence of a Plan B may never be publicly acknowledged.

The political and administrative capacity to introduce and implement structural reform is limited, so reforms would have to be sequenced rather than implemented comprehensively in one fell swoop. Because the eventual success of the accession negotiations is by no means assured, it makes sense not to put all structural reform eggs in the EU basket, but instead to concentrate on those reforms that make sense regardless of whether and when the EU accession negotiations are successful. With both administrative implementation capital and political capital in short supply, the timing and sequencing of reforms is a crucial issue.

Much of the body of reforms required to qualify for EU membership makes good development sense, but not all of it does. The unqualified pursuit and implementation of EU accession priorities would, from the perspective of successful economic development, be subject to both type I errors (errors of commission) and type II errors (errors of omission).

The *acquis* indeed contains much that is desirable from the point of view of economic development and the creation of a better functioning market economy. For instance, Turkey should enthusiastically pursue any approach that enhances competition for markets and within the market place, by lowering barriers to entry and exit. It should aggressively implement services liberalisation. It should end state aid to the vast majority of enterprises that currently benefit from it – all those for which no convincing decreasing cost or public good argument for the subsidies can be made. It should privatise the remaining profitable SOEs, including the state-owned banks) and close the rest. It should open all its markets to imports from abroad (here the Common External Tariff of the EU is a development negative). It should aggressively liberalise its formal sector labour markets. Meeting the political Copenhagen criteria would have important economic benefits, in addition to the intrinsic benefits of becoming a more open, free and democratic society which respects civil liberties and human rights.

In order to avoid Type I errors, Turkey should not spend a lot of time and resources on adopting or preparing for the Common Agricultural Policy (CAP), not just because the CAP (even in its latest incarnation) is both inefficient and inequitable, but because the post-2013 CAP is bound to be very different from the current CAP. Turkey should not introduce labour cost increasing measures like the EU's Working Time Directive, and other features of

the Social Chapter⁵, some of which would be premature and some of which would be undesirable over any time horizon. It should also not invest vast amounts on environmental projects that are premature from an economic development point of view. For Turkey, the best environmental policy is pricing energy and water at long-run incremental cost to all users, households, industry and agriculture. This will also help the budget by eliminating sources of quasi-fiscal deficits.

As regards avoiding Type II errors, the logic of economic development also requires urgent action in a number of key fields (financing of infrastructure investment, pricing of utilities and of infrastructure services, social security, education and training to name but a few) beyond what is required for EU membership. Turkey should not avoid prioritising these key areas simply because they do not figure prominently in the *acquis*.

Turkey's future is almost entirely in its own hands. Financial aid, whether from the World Bank or from the EU is not essential. Aid, including EU pre-accession funds, can be helpful, but in practice, in Turkey and elsewhere, misdirected, poorly administered aid has often done more harm than good – encouraging waste and corruption.

The main way in which the EU could help Turkey is to grant unconditional market access *now* to the EU for all Turkish goods and services, including agricultural products. Anything less would mean that the EU's professed support for Turkey is cheap talk.

Turkey itself is the only party that can create the conditions for increased and increasingly efficient domestic capital formation and for attracting more FDI.

Whether market access to the EU together with free financial capital mobility and unrestricted FDI are complete substitutes for labour mobility remains an open question. Other than granting immediate and unconditional market access, the only significant contribution the EU can make to Turkish economic wellbeing is to open the door to a much greater extent to both short-term and long-term migration from Turkey.

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⁵ Chapter 13, Employment and Social Policy.

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