EFFECTS OF JOINING THE EUROPEAN UNION ON TURKEY'S ECONOMY

by

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TABLE OF CONTENTS

List of tables

Table

List of Figures

Figure

ABSTRACT

Turkey has been longing for European Union membership for decades. On December 31 1995, the Customs Union between Turkey and the European Union came into effect. Turkey was declared a candidate country for EU membership in December 1999. The Customs Union negotiations and membership in the EU paved the way for Turkey to improve its economic structure immensely. This work focuses on the effects of the Customs Union and European Union membership preparations on Turkey's economy as well as a brief overview of Turkey's economic structure. Customs Union started showing its effects on Turkey's economy after the reforms undertaken since the declaration of Turkey's candidacy to EU membership in 1999. However, improvements in the economy are still low compared to other members of the Union due to lack of technological developments, infrastructure and institutionalism in Turkey. The analysis shows that in order to experience the full benefits of entry into the Customs Union and European Union, Turkey's economy will have to undergo a continuous restructuring and reformation.

INTRODUCTION

Turkey has been striving for full membership of the European Union since 1963 when it became an associate member of the European Community (EC), now known as the European Union (EU) since the acceptance of Maastricht Treaty in 1992. After implementing economic reforms in accordance with the goal of meeting certain EC objectives, the Turkish government applied for full membership to the EC in 1987. However, the EC deferred any decisions on Turkey's membership at least until 1993 when the EU declared the opening of negotiations with Austria, Finland, and Norway in 1992; it was obvious that the EU was reluctant to accept Turkey as a member. However, with the hopes of further integration, new efforts were made to create a customs union between the EU and Turkey in 1995. The main goal of the Customs Union was to eliminate all barriers to trade between the EU and Turkey and therefore help Turkey achieve growth through more trade. With respect to the Customs Union, Turkey introduced many reforms in its trade policy aimed at adopting the technical and administrative aspects of the EU trade policy. The Customs Union is only the first step towards becoming a member of the European Union, therefore Turkey will have to undertake more reforms and create more institutions before the necessary conditions can be created for full membership that would allow free movement of services, agricultural products, capital, and labor.

Finally, at the Helsinki meeting of the European Council in 1999, the EU declared Turkey's candidacy for membership. Since then, Turkey and the EU went into a phase of Accession Partnership in which the EU and Turkey negotiate issues that are of concern to the EU, mainly about adopting acquis communitaire, the legal framework of the EU. However, unlike what it had done with other previously candidate countries, the EU has not yet set out a timetable for Turkey's accession. Therefore, it is likely that Turkey's accession to the EU will not happen in the near future.

Many EU members are against admitting Turkey into the union due to several economic and political reasons. The biggest economic obstacle for Turkey is the low level of development of its economy. Turkey lags behind EU member countries in almost all economic categories: inflation, budget deficit, GDP per capita, etc. However, many reforms undertaken since 1999 show some improvements in these areas. The political obstacle to Turkey's membership is Turkey's inability to fulfill the political criteria for membership, particularly the democratic, and human rights criteria. Some of the political and human criteria of membership are "...stability of institutions guaranteeing democracy, the rule of law, human rights and respect for and protection of minorities." (European Commission, 2004). The European Commission states that the major obstacle to Turkey's membership is its failure to satisfy the political and human criteria rather than economic criteria. However, accession is not possible without the fulfillment of all criteria.

Membership to the EU is crucial for Turkey if it does not want to lag behind in the political and economic developments of the world. The European Union (EU) is one of the largest economies in the world with a population of more than 455 million people. Having the European Union's support in world politics and trade can help Turkey achieve its long sought after dream of a stable economic and political structure.

As a native of Turkey, I have a special interest in this topic. Relations of Turkey with the EU have become the most commonly argued topic in Turkey. Since 1990 interestingly, the Turkish people are frustrated about the ongoing delays and vague promises of the European Union concerning Turkey's membership. Negative results from the two referendums that took place in France and Holland on the acceptance of the new constitution of the European Union, indirectly imply the rejection of Turkey's membership by the citizens of the EU. They are not fully convinced of the benefits of a possible accession of Turkey into the EU. Even though the negative results from the referendums made have discouraged the Turkish people, the central government is in full force completing the necessary reforms for accession.

This thesis is designed to analyze the economic effects of a possible EU accession by Turkey. It is structured into five chapters. The first chapter gives an overview of the Turkish economy. It describes the macroeconomic background of Turkey as well as its current industrial structure, capital flows, inflation, debt burden and growth. Chapter II gives a brief explanation of the Customs Union and its relation with Turkey. In addition, this chapter explores the structure of Turkey's exports plus an overview of the benefits and costs of the Customs Union membership are discussed. Chapter III outlines the economic characteristics of the European Union and the Monetary Union. This chapter will also emphasize the requirements of full membership in the European Union, the degree of Turkey's fulfillment of the requirements and the EU assisted reforms undertaken by Turkey. In Chapter IV, the overall effects of the Customs Union, and possible accession to the EU and further concerns of Europe with regard to Turkey's accession are analyzed using relevant empirical data. Finally, Chapter V summarizes the findings of the thesis, and derives conclusion on the overall effects of Turkey's efforts to meet the membership criteria set by the EU.

Chapter I – An Overview of the Turkish Economy

This chapter provides a historical overview of the Turkish economy. It describes its industrial structure and current major economic problems facing Turkish economy.

1.1. A Brief Historical Overview

Since the 1950s, Turkey has suffered an economic crisis in almost every decade; the most significant occurred in the 1970s. In each case, there was a rapid expansion followed by a sharp increase in imports that resulted in a balance of payments crisis. In most cases, the government's reaction was to devalue the national currency (lira) and with the help of the International Monetary Fund (IMF), implement an austerity program designed to reduce domestic demand. Military interventions in 1960 and 1971 had significant negative effects on the economy as well. After each intervention, the government would increase its spending and overheat the economy.

Because of the absence of structural reforms, Turkey continued running chronic current account deficits, which were usually financed by external borrowing. Turkey's external debt increased to US$16.2 billion by 1980. Debt servicing costs that same year represented 33% of exports (U.S. Library of Congress, 2003).

Turkey experienced one of its worst crises following the sharp rise in world oil prices in 1973-74. Turkey had to borrow from foreign lenders once again in order to finance the increase in its current account deficit. In 1979, when the inflation rate had risen to three digit levels and unemployment rose to 15%, the government realized that it could not pay even the interest due on its foreign debt. It was at this point that the government officials realized that Turkey was in need of serious economic reforms.

In 1980, Prime Minister Suleyman Demirel, with the help of President Turgut Őzal, started a reform program to shift the Turkish economy towards an exports led growth strategy. The reform program included a devaluation of the Turkish lira, the institution of a flexible exchange rate, maintenance of positive real interest rates, tight control of the money supply and credit, elimination of most subsidies, reform of the tax system and encouragement of foreign investment (U.S. Library of Congress, 2003). The program succeeded in overcoming the balance of payments crisis, it also improved Turkey's position in international capital markets as a reliable borrower and revived economic growth. However, the program was not able to solve two major problems of the economy: unemployment and inflation. (Turkish Statistical Institute, 2004) The chronic high level of unemployment caused a substantial increase in emigration of Turkish workers to foreign countries.

The Iran-Iraq war between 1980 and 1988 benefited Turkey. Both countries became important trading partners of Turkey. Iraq also became dependant on Turkey for export routes for its crude oil. The embargo on Iraq ended Iraq's oil exports through the pipeline in Turkey. Since then, Turkey lost around US$3 billion in trade with Iraq following the Persian Gulf War in 1991 (U.S. Library of Congress, 2003). In spite of all these disruptions, the Turkish economy started to grow once again. In 1994, the country experienced another crisis after the government granted large salary increases to civil servants and subsidies to state enterprises. Public borrowing amounted to 17% of Gross Domestic Product (GDP) at that time. The inflation rate increased and reached 73% in mid 1993. The rise in the exchange rate increased imports, slowed down exports and the trade deficit rose to US$ 14 billion in 1993 (Ismihan, Tansel& Kivilcim, 2002).

Concerns over the economic policy created a situation of "dollarization" of the economy when residents of Turkey switched their domestic assets into foreign currency deposits in order to protect their investments. By the end of 1995, about 50% of the total deposit base was in foreign currency deposits up from 1% in 1993. Lack of confidence in the government and the economy triggered large-scale capital flight and the collapse of the exchange rate. By mid 1994, the lira plummeted by 76% relative to its value at the end of 1993 (Kafaoglu, 2004). Once again, the government was forced to announce an austerity program. Under this program, the government decided to undertake a set of reforms to achieve certain goals with the help of US$740 million standby loan from the IMF. Even though these reforms were successful at generating a small surplus in the budget, the fiscal crises resulted in a 5% decline of real GDP (Kafaoglu, 2004).

The Ecevit government (1999-2002) restarted structural reforms along with a new IMF agreement. The reforms included a social security reform, a public finance reform, a reform of state banks, a banking sector reform, increased transparency in public sector, and the introduction of related legislation to liberalize telecom, and energy markets. Under the IMF program, the government also sought to use exchange rate policies to curb inflation (Reynolds, 2003).

In late 2000, because of the growing account deficit, weak banking system and the failure to implement the structural reforms needed, the economy experienced a liquidity problem, which forced the government to sign a new agreement with the IMF. In 2001, a dispute between political leaders triggered a run on the Turkish Lira that caused an increase in interest rates. The inflation rate rose, domestic public debt increased, and the economy suffered a deep economic downturn (Gross National Product, GNP fell by 9.5%

in 2001). The government was forced to let the lira float and adopt a more ambitious economic reform program, including a very tight fiscal policy and enhanced structural reforms with the help of loans from the IMF.

IMF loans enabled Turkey to stabilize the interest rates and the domestic currency and meet its foreign debt obligations. Since then, the inflation and the interest rates fell significantly, the currency stabilized, and confidence in the economy grew. Nonetheless, the economy remained fragile and continued implementation of reforms is essential to sustain growth and stability. On July 29, 2004, the IMF cleared the way for a further disbursement of loans totaling US$661 million, as part of an economic aid package approved two years earlier (Reynolds, 2003).

Turkey has been an associate member of the European Community since 1963 and has become an official candidate in 1999. Turkey also agreed to the Customs Union with EU in 1996 removing tariffs on some products with the exception of agricultural and fishery products. Negotiations with the EU officially opened on October 2005. Since 1999, Turkey has been undertaking important reforms to satisfy the EU candidacy requirements.

1.2. Industrial and Trade Structure of the Turkish Economy

Both state and private enterprises have contributed to economic development in Turkey. From being an economy mostly dependent on agriculture, Turkey transformed itself into an economy where industry and services are more productive and rapidly expanding. Before 1950, the government played a major role in the economy, protected major industries by erecting tariff walls and quotas, and discouraged foreign investment. International trade played a minuscule role.

The Turkish economy is now a combination of modern commercial and industrial sectors and a traditional agricultural sector. The latter includes a large poor rural sector, which employs approximately half of the total labor force. In 2001, agriculture accounted for 40% of employment. According to 2004 estimates, agriculture accounted for 11.7% of GDP and employed 35.9% of the total labor force, industry accounted for 29.8% of GDP and employed 22.8% of labor force, and services accounted for 58.5% of GDP and employed 41.2% of labor force (Turkish Statistical Institute, 2004). We note that although agriculture accounts for the lowest percentage of GDP, it employs almost as many workers as the service sector, which also accounts for the highest percentage of GDP.

The industrial sector, which has always been considered the key sector of the economy, took the lead in the development process. It showed significant growth especially after the liberalization measures taken in 1980. The most important and the largest exporter are the textile and clothing industries. This industry is almost entirely operated by companies in private hands. The automotive industry (seventh largest in Europe) is also one of the growing sectors of the Turkish economy.

Turkey is self sufficient in nurturing food. Blessed with a suitable land and climate, it has a capacity to grow many kinds of crops. As noted above, the agricultural sector has been Turkey's largest employer and a significant contributor to GDP. However, as the country developed, the importance of the services and industry sectors in Turkey's international trade increased continuously at the expense of agriculture. From 1980 to 1999, the share of exported agricultural products in exports declined from 57% to 10% while exported manufactured products rose from 36 to 88% (Socio-Economic Statistics and Analysis Service, 2005). One reason for the decrease in agricultural exports is the acceptance of the Customs Union with the EU, which excludes trading of agricultural products, with Turkey's largest exporter, the EU. Even though agriculture accounted for only 11.7% of GDP, it actually plays a significant role in the Turkish economy, employing, as mentioned above, one third of the Turkish labor force.

Other major sectors include services, fishing, forestry, and tourism. The telecommunication industry was liberalized in 2004 after the creation of the Telecommunications Authority. In recent years, Turkey has become a major tourist destination for Europeans. By the end of 2005, according to recent estimations, 22 million tourists will visit Turkey, an increase of 25% from the previous year (Undersecretariat of Foreign Trade, 2005).

1.2.1. Trade Indicators

Turkey entered into a Customs Union with the EU in 1995. This led to the elimination of custom duties on industrial products imported from the EU and the European Free Trade Association (EFTA) in 1996. Under the agreement, Turkey reduced its high tariffs, and experienced a relative increase in capital inflows. However, domestic producers suffered intense competition from the EU producers for a share of the Turkish consumer market. After and before the Customs Union, the EU has been Turkey's largest trading partner. In 1997, 47% of Turkish exports and 51% of Turkish imports were to and from the EU countries (Ertugrul & Selcuk, 2001). Effects of the Customs Union on Turkey's economy are discussed in chapter 3 of the paper.

The trend in exports shifted significantly in 2003. Besides textiles, the automobile sector strengthened its position. In 2004, total exports added up to US$ 69.47 billion.

Turkey mostly exports products such as apparel, foodstuffs, textiles, metals, and transport equipment. Germany, United Kingdom, United States, France, and Italy account for 13.9%, 8.8%, 7.7%, 7.4%, and 5.8% of Turkish exports respectively.

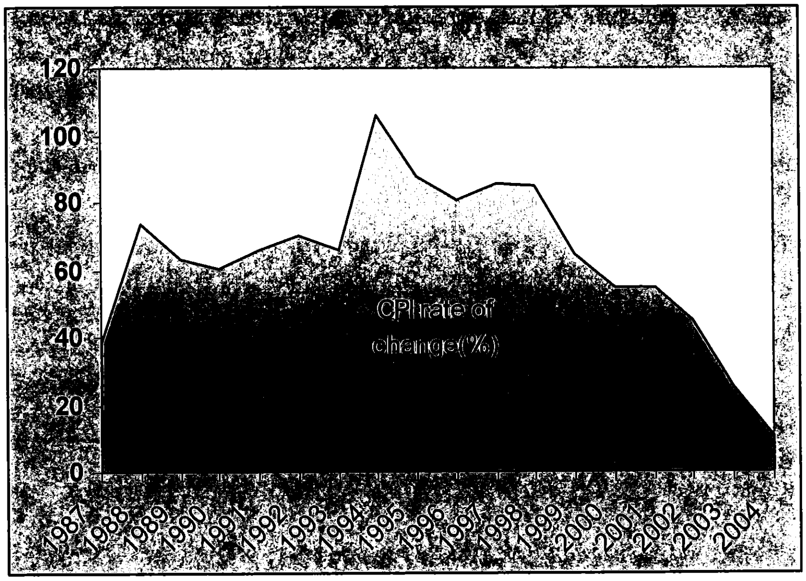
Principal imports of Turkey include machinery, fuels, coal, chemical products, iron, and steel products, motor vehicles and processed petroleum products. Major import partners of Turkey are Germany (13%), Italy (8.1%), Russia (7.3%), France (5.8%), UK (5.5%), and US (5.2%). In 2004, total imports were worth US$ 94.5 billion. The current account balance of Turkey shows a deficit of US$15.3 billion (Undersecretariat of Foreign Trade, 2005).

1.3. Major Economic Issues in Turkey

1.3.1. Inflation

Turkey's major problems continue to be high inflation and public sector indebtness. Turkey has suffered from chronic high inflation for many years and only recently has the inflation rate dropped to a single digit number.

Figure-1: Rate of change in CPI between 1987-2004



Source: Turkish Statistical Institute, 2004

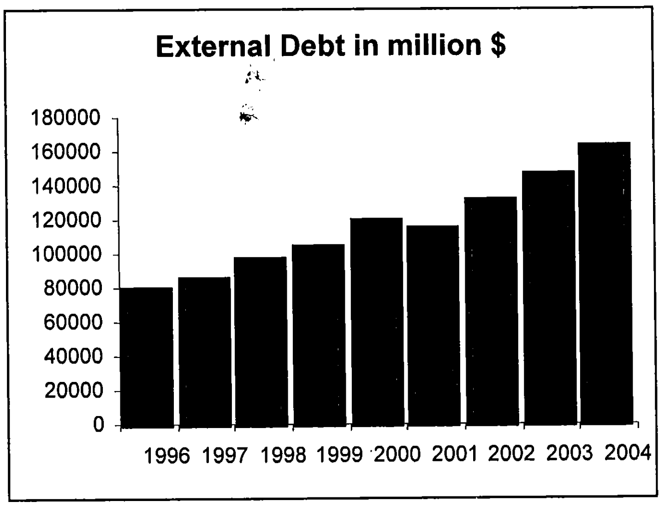
Figure-1 above demonstrates the rate of change in the consumer price index (CPI) from 1987 until 2004. The inflation rate followed an unstable rate of change pattern between 1987 and 2002. The inflation rate (CPI) has been above 40% until 2003, it dropped to 25% in 2003 and to 10.6 % in 2004. According to OECD (2005) statistics, the current inflation rate in Turkey is 9.3%.

1.3.2. Capital Flows

Turkey can be classified as a typical transition country that is moving away from a boom-bust economy to a stable market economy. Turkey still depends on international financial markets, however, and there is definitely room for more growth.

External debt and capital flight are the key challenges that the Turkish economy is facing. Turkey's foreign debt as a percentage of GDP is higher than most other new EU entrants or EU candidates. Half of Turkey's external debt appears to be the result of a significant capital flight. Turkey's government debt, most of it short-term and in foreign currency, amounts to 74% of GDP and makes the Turkish economy highly vulnerable to interest rate changes (Belke, 2004). A budget surplus of 6.5% of GDP and low interest rates are making it easier to service the debt. Turkey's debt more than doubled between 1995 and 2001. The fiscal costs of cleaning up the banking sector after the 2001 crisis have increased significantly the public debt burden. By the end of 2001, the net public debt amounted to 95% of GNP (Ertugrul & Selcuk, 2001).

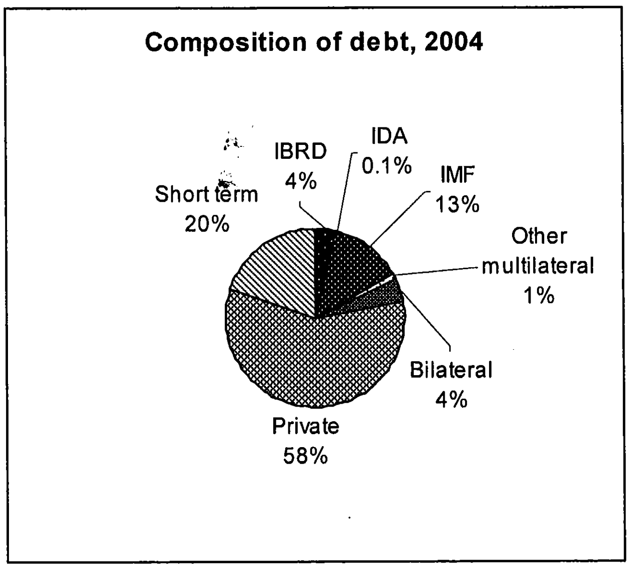
Figure-2: External Debt in million $



Source: Turkish Statistical Institute,2004

Figure-2 above shows the growing external debt from which Turkey has been suffering throughout the years. Turkey's external debt has been increasing rapidly since 1996 and it amounted to US$ 161 billion in 2004. High debt is associated with low growth since a higher distortionary tax burden on capital is required to service the debt, leading to a lower rate of return on capital, lower investment and growth. Therefore, external debt is one of the key issues that Turkey will need to deal with before investment and therefore growth can recover. The net public debt to Gross National Income (GNI) ratio fell from 70 percent in 2003 to 64 percent in 2004, thanks to declining real interest rates, strong fiscal performance, the recovery of economic growth, and the continued appreciation of the real exchange rate. With increasing capital inflows and growing demand for Turkish government bonds, the Turkish Treasury had no problem servicing the debt. The average maturity of new debt in 2004 increased to 12 months from under 10 in 2003 (Ertugrul & Selcuk, 2001).

Figure-3: Composition of debt



IBRD: International bank for reconstruction and development
IDA: International Development Association
IMF: International Monetary Fund

Source: The World Bank Group, 2005

Figure-3 shows the distribution of the stock from outstanding government bonds among major groups of bondholders. The private sector long-term bond holdings account for the highest percentage, followed by private sector short-term debt holdings. Financial institutions such as the IBRD (International Bank for Reconstruction and Development), the IDA (International Development Association), and the IMF (International Monetary Fund) hold almost US$ 100 million or 17% of the total debt. Government revenues in 2004 amounted to $66.79 billion and expenditures were $93.31 billion, including capital expenditures. In 2004, 3 percent of government expenditures were allocated to health, 10 percent to education, and 8 percent to defense (The World Bank Group, 2005). The total debt GNP ratio decreased from 78 percent in 2001 to 54 percent in 2004. (Turkish Statistical Institute, 2004) The ratio of total debt to GNP has fallen almost by 30 percent of GNP since its 2001 peak. For three consecutive years now, the Central Bank has done better reducing the inflation rate than the end-year target it had set for itself. In addition, the fall in the inflation rate has strengthened the credibility of monetary policy. However, total debt still accounts for 54 percent of GNP, which is higher than the debt GNP ratio of any EU member.

1.3.3. Foreign Direct Investment

According to the central bank of Turkey, US$ 546 million, and US$ 1.06 billion worth of Foreign Direct Investment (FDI) projects have been realized in 2001 and 2004 respectively. (Turkish Statistical Institute, 2004) Foreign Direct Investment has totaled only $16.4 billion between June 30, 2003 and the end of 2004. Total investment between 1980 and 2002 was US$ 16.2 billion. FDI in Turkey was US$ 1 billion annually during the 1990s. In 2001, there was an increase of US$3.3 billion, (Turkish Statistical Institute, 2004). This limited amount reflects the concerns of foreign investors regarding political and macroeconomic instability, burdensome regulations, and the significant role that government plays in the economy. Over the last five years, 70 percent of direct foreign investment came from Europe. Turkey has been taking significant steps towards attracting foreign investment. However, the government still needs to clear up some of the important hurdles. In order to attract more investment, Turkey stopped foreign investment screening and strengthened intellectual property legislation. However, high indirect taxes and continuing gaps in the intellectual property regime inhibit investment

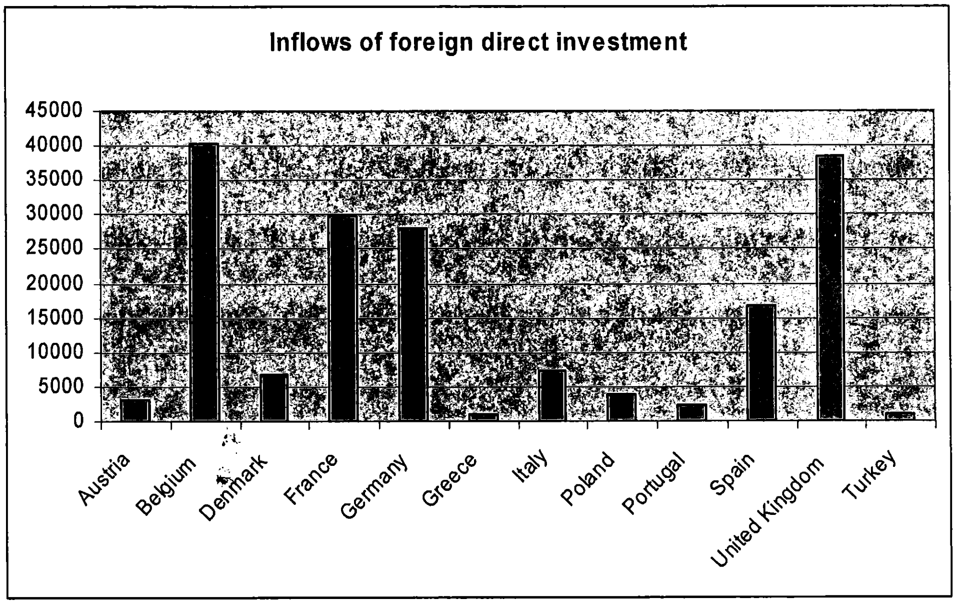
(Kamu Yatirimlari, 2004). The Turkish privatization board has also taken steps toward privatizing more state owned companies. In 2005, the government privatized both the state tobacco company and the telephone company. Currently, it is in the process of privatizing a series of other state owned companies.

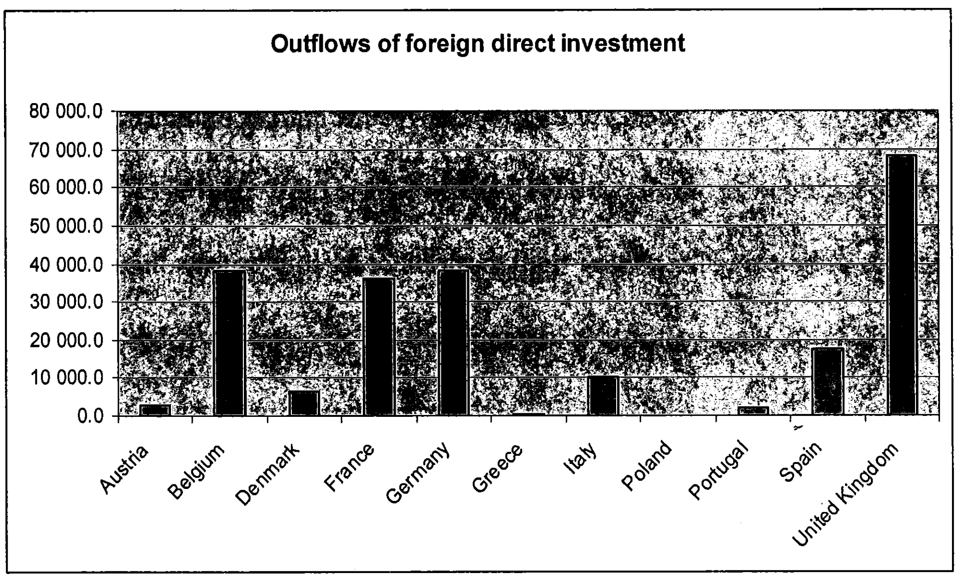
Turkey's investment framework is a combination of a law enacted in 1954, the liberal and the flexible foreign investment policies in 1980 and other upgrades in the 1990s. Turkey adopted an international arbitration system in 1999. In June 2003, a new law on FDI, modifying a number of other laws related to the rights of foreign investors had been passed (Undersecretariat of the Ministry of Foreign Trade, 2004).

Foreign direct investment has been one of the weakest areas in Turkey's economy. Despite the liberalization reforms from the 1980s and the accession to the European Customs Union, foreign direct investment has continued to increase at a sluggish pace. FDI in Turkey has not yet reached its potential level. However, a more stable and a faster growing economy, will boost confidence in the Turkish economy, and enable Turkey to enjoy a higher rate of FDI inflows and outflows.

Figure-4 contains a chart showing the foreign direct investment inflow and outflow data of several EU countries and Turkey. Clearly, in this group of countries, Turkey is one of the worst performer, both in FDI inflow and outflow.

Figure-4: Inflow and outflow of foreign direct investment, in European countries and Turkey, million US$





Source: OECD, 2004

1.3.4. Financial Sector

Banking sector difficulties were partly responsible for Turkey's financial crisis in 2001. They led the government to reduce the number of state banks from four to three after Emlak Bank merged with TC Ziraat Bankasi. In October 2001, three private sector banks that belong to the Dogus Group merged into Garanti (Ottomanbank and Korfezbank) while HSBC purchased Demirbank in November 2001. In June 2002, Pamukbank, the smaller of the two banks in the Cukurova group announced its merger with Turkey's largest bank, Yapi Kredi and it has been operating successfully since then.

The rescue of the banking sector cost the state (which guaranteed all deposits and previously failed to compensate state banks for issuing subsidized loans at its request) the equivalent of 30 percent of GDP in 2001/02. The cost of the rescue was financed partly out of the US$ 15.7 billion loan made to Turkey in 2001 by the IMF and the World Bank (Banking Regulation and Supervision Agency, 2005).

The November 2000 and February 2001 economic crises most severely hit the banking sector forcing them to contract their balance sheets and to reorganize. The year 2003 was the recovery year for the financial sector. By June 2003, Turkey's banking sector total assets were approximately US$ 150.4 billion nearly the same as of the end of year 2002 (U.S. Library of Congress, 2003). In 2002, the ratio of total assets to GNP was 78 percent and dropped to 68 percent in the first half of 2003. Regardless of the reforms, financial sector remains fragile.

Conclusion

Despite major efforts to modernize it, the Turkish economy remains a dual economy with a fragile and underdeveloped financial sector.

Chapter II – The Customs Union between Turkey and the EU

2.1. The Concept of a Customs Union

A group of countries form a Customs Union that remove all tariffs and other barriers to all trade between the member states plus there is a common external trade policy adopted by the group vis-à-vis non-member countries. Customs Unions improve economic efficiency and establish closer political and cultural ties between member countries. A Customs Union is the third stage in Balassa's theory of economic integration that he proposed in the 1960s to describe how parts of different economies are integrated (European Community Studies Association, 2002). According to his theory, as economic integration increases, the barriers of trade between markets diminish. The European Union holds one of the largest and most integrated economies in the world with a single market for every product.

2.2. The EU and the Customs Union

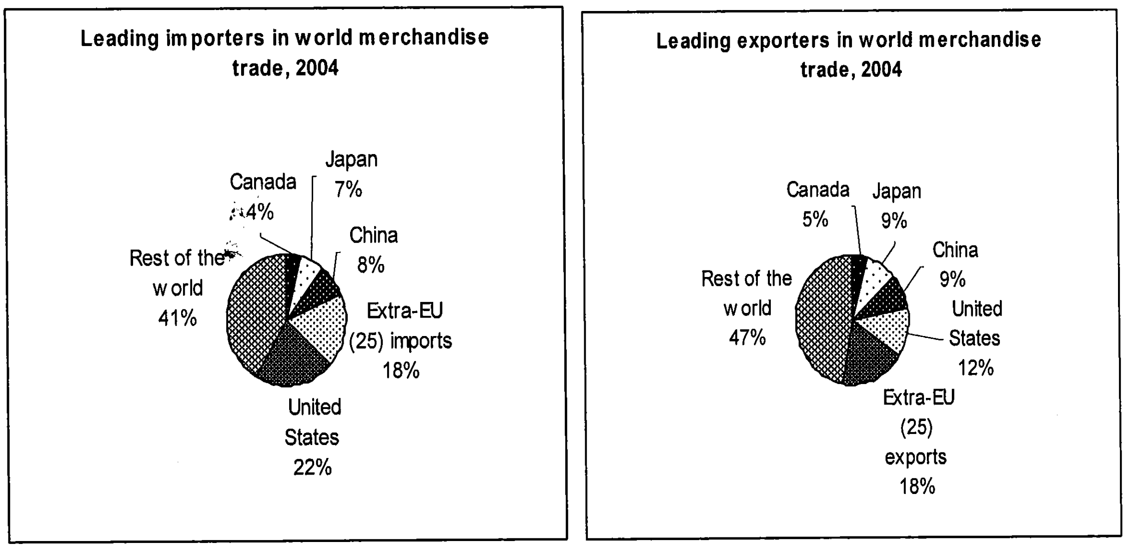
The Treaty of Rome, signed by six major Western Europe countries in 1957 was the first attempt to form a customs union in Europe. Thus, it created the European Economic Community (EEC). In 1967, institutions created by the same six countries merged with the EEC to form the European Community (EC), creating a single Commission, a single Council of Ministers, and the European Parliament. The admittance of new members to the community, and the acceptance of the European Monetary Union by the majority of EC members in 1992 resulted in the creation of the European Union (EU). Therefore, in the remainder of this thesis, the community will be referred to as the EU, the European Union.

The Customs Union is an essential part of the European Union. Creating a Customs Union in order to eliminate all customs duties on trade between members was one of the first steps that the European Community took after its establishment in 1958. The actual Customs Union was completed in 1968 when all custom duties and restrictions were removed among the six founding members of the European Union. This structural change opened new trade opportunities and boosted the economy of all members. Consumers were also enjoyed a wider range of products with cheaper prices and trade grew threefold between 1958 and 1972 (OECD, 2004).

The Customs Union does not only involve the elimination of all trade barriers but also involves providing assistance for the implementation of the legislation will help improve the structure of the member state economies. The goal is to make sure that the goods being exported are not only subject to the same tariff rules but also to the same customs provisions. The Common Customs Policy, which is the core segment of the Customs Union, fixes the tariff rates or charges due on goods and services imported into the Union. Common Customs Tariff (CCT) means common for all members, but the rates may be different depending on the kind of imported products, and the country of origin (European Commission, 1999).

The European Union also participated in eight worldwide tariff reduction rounds. In compliance with the recommendations of the General Agreement on Tariff and Trade and its successor, the World Trade Organization (WTO), the EU reduced tariffs on the imports of all goods and services to a minimum level except for agricultural and fishery products. The main reason for this exception is a significant difference between the world prices and European prices for these products, the latter being higher than the former. In order to protect such sectors from cheap imports, the European Union agreed in the Uruguay Round to remove the quantitative restrictions on imports and to replace them by the more generally accepted instruments of customs duties.

Figure-5: Leading exporters and importers in world merchandise trade (excluding intra-EU (25) trade), 2004

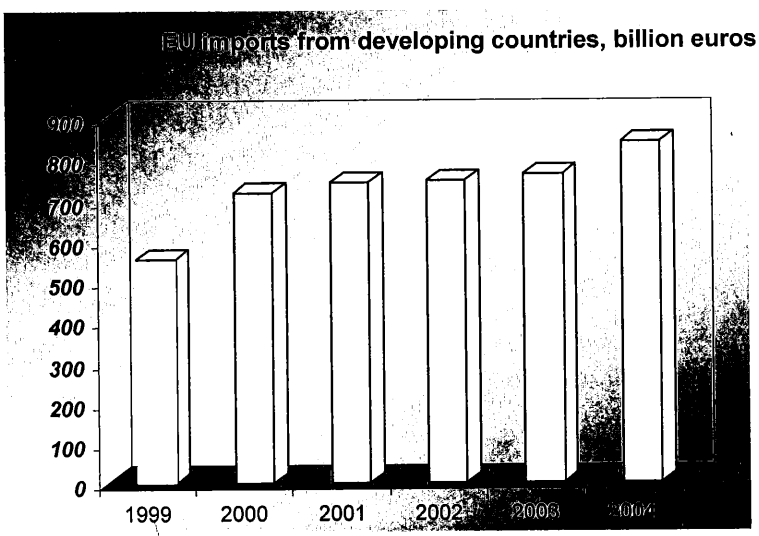


Source: WTO, 2004

Since the European Union formed a single market, it accounts for more than one sixth of global trade in goods and services. This is higher than the percentage of global trade accounted for by its nearest competitors United States and Japan (European Commission, 1999). As Figure-5 shows, the European Union accounts for 18% of world exports and 18% of world imports in 2004. Although members of the European Union produce raw materials and semi manufactured goods, they import the bulk from other non-member countries with low duty rates. In contrast, they export manufactured and industrial goods.

The European Union promotes trade between its members in agreement with the multilateral context promoted by the World Trade Organization (WTO). An example of the Union's efforts to encourage worldwide development is its commercial policy. The European Union has become one of the world's leaders in helping developing nations through trade by giving them preferential access to its community markets. Under the policy, a customs union has been established between the EU members with certain non-EU members. In addition, the policy promotes trade between EU members and non-members of the Union by establishing agreements with other countries or groups of countries based on customs agreements. These agreements are called "preferential" agreements. One example of a preferential agreement is the European Economic Area (EEA) between the European Union, Iceland, Norway, and Liechtenstein (Undersecretariat of Foreign Trade, 2005).

Figure-6: EU (E25) imports from developing countries



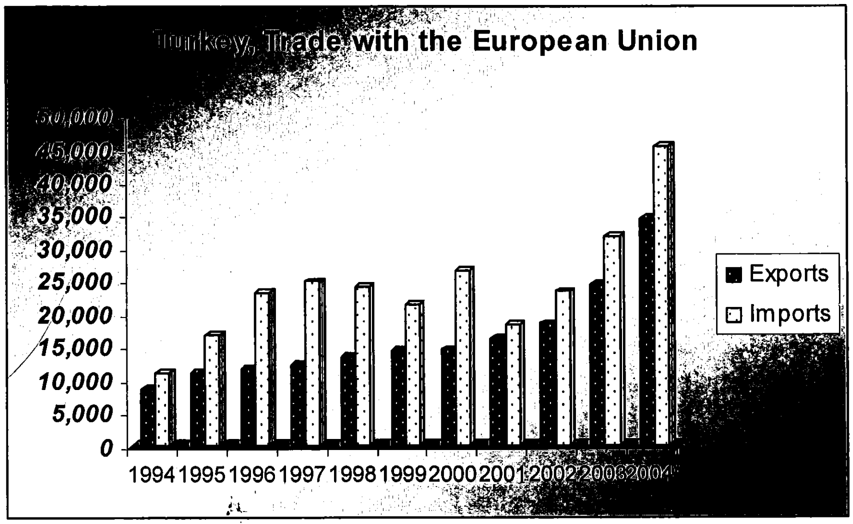
Source: Eurostat, 2004

Figure-6 shows the total value of EU imports from developing countries. The graph suggests an increasing trend in imports from developing countries between 1999 and

2004. The EU imports from developing countries increased by 70 percent during this period. Article III-314 of the Constitution of Europe states "By establishing a customs union, the Union shall contribute, in the common interest, to the harmonious development of world trade, the progressive abolition of restrictions on international trade and on foreign direct investment, and the lowering of customs and other barriers" (European Commission, 2005).

Turkey is one of the developing countries that has benefited from the EU policy of easier access for developing countries to its large markets. Thanks to the application of Article III-314, the European Union market now plays a major role in Turkey's international trade. The EU shares in total Turkish imports and exports amount to 47.25% and 54.73% respectively. In contrast, Turkey's share in total EU imports and exports amount to 3 % and 3.66% respectively. Turkey has been able to increase its exports to the EU rapidly after the crises in 2001 as shown in figure-7 below. These facts indicate how dependent Turkish trade is on unhindered access to EU markets. By establishing a strong trade relation with the EU over the years, Turkey hopes to maintain growth rate of its income per capita (European Commission, 2005).

Figure-7: Turkey's trade with the European Union in million US$



Source: EuroStat, 2004

2.3. Turkey and the Customs Union with the EU

The Customs Union first appeared in Turkish politics as one of the stages that Turkey had to go through in order to become a full member of the European Union. When the government of Turkey applied for associate status to the European Community (EC) in 1959, the understanding was that the Customs Union was the next step after Turkey became a member of NATO. However, the EC governing council thought otherwise. After World War II, Europe became much more conservative and skeptical about admitting new members. Concerns over the compatibility of Turkey and Europe emerged among members of the EC. At the same time, Turkey was already preoccupied with internal political difficulties that ended up with a military intervention in 1960 and the delay of further negotiations with the European Union.

2.3.1. The Bumpy Road

The actual association agreement took place in 1964 under the name EC-Turkey Association Agreement. The agreement consisted of three stages with no definite time frame. The first stage is the *preparatory* stage. During this stage, Turkey would develop its economy in preparation for accession to the EU with the help of the unilateral financial concession and aid provided by the European Union. The second stage is the *transitional* stage during which the EU and Turkey enter into a customs union. In the third and final stage, Turkey becomes a full member of the EU. The second step, towards a customs union between Turkey and the EU, started with the approval of the Additional Protocol of November 13, 1970 (Republic of Turkey Prime Ministry Undersecretariat of Customs, 2003). This agreement briefly explained how to establish a customs union between the EU and Turkey. The agreement required the EU to abolish its tariffs and barriers to imports from Turkey with some exceptions. In exchange, Turkey would do the same over a period that varies between twelve to twenty years, depending on the product imported. However, during the transition stage, the pace of progress was slower than expected. The main reason for this slow pace was the EU restrictions on the access to the EU markets for goods such as textiles, in which Turkey had a comparative advantage. The relations between Turkey and the EU during this stage were sometimes strained as the EU members realized the full consequences of the Customs Union with Turkey, and the rising world economic and political problems. Germany was concerned over the free mobility of labor from Turkey since there was already a significant Turkish community established in Germany. Another irritant was the 1974 Cyprus crisis between Turkey and Greece that hurt Turkish relations with Europe. As more complications arose, the Additional Protocol Agreement ended with the military coup in 1980. With the economic reforms of 1980 such as the liberalization of the economy and the new export-oriented development policy adopted by the Turkish government, EU's confidence level in Turkey was on the rise once again. Prime Minister, Turgut Ozal, found this suitable for a full EC membership application and applied on April 14, 1987. However, the EC, which became the European Union (EU) later on, was not at all prepared for such an application and it took almost three years for the European Commission to prepare its "Opinion" (Undersecretariat of Foreign Trade, 2005). In its Opinion, the Commission reminded the Turkish government that the implementation of the Single European Act and completion of reforms in the internal market by the end of 1992 were the two main priorities for Turkey before any new enlargement negotiations could take place. In its "Opinion", the EC also included a list of obstacles to Turkish membership. These included economic stability, problems with the EC member Greece, and inadequate human right provisions among others. Also by that time, the Soviet Union had collapsed and Turkey, which had established its relations with Europe based on its strategic position with respect to the Soviet Union, had to refigure its position in world politics. In conclusion, the Commission proposed to delay full membership indefinitely and focus on short term goals like completion of the Customs Union by 1995.

2.3.2. The Establishment of the Customs Union

It was not until March 6, 1995 that the Turkey-EU Association Council agreed that a customs union would be set up between Turkey and the EU. Turkish exports rose from US$ 1.377 billion in 1980 to US$ 11.083 billion in 1995 and the share of the European imports increased from 33% to 47% in the same period. (Seki, 2005)

One of the unique features of the Turkey-EU Customs Union is that Turkey is the first and only country to have customs union with EU without becoming a full member.

Therefore, Turkey not only had to cooperate on issues like tariff reductions but also on other issues over which it does not have a voice in the European Council.

By joining the Customs Union, Turkey agreed to remove its tariff and non-tariff protection against imports from the EU for all goods covered by the Customs Union. Articles 10 and 11 of the Additional Protocol of the Customs Union provided two lists of goods. For industrial goods in which Turkey was more competitive, tariffs were to be eliminated over 12 years. For other goods, the tariff reductions were to be spread over 22 years. Moreover, the Customs Union covered only industrial and processed agricultural products. Traditional agricultural products are to be included in the Customs Union only when Turkey completes its adaptation to the Community's Common Agricultural Policy.

As mentioned before, the Union requires each member country to remove its tariffs on imports from any member of the Customs Union and to adopt a common tariff on imports from third countries outside the Union. Turkey would impose the "Common External Tariff" (CET) of the EU on imports from third countries. Accepting EU's Common External tariff means that Turkey will have to provide preferential access to its domestic markets for all countries to which the EU had or will grant preferential access. Now, Turkey has free trade agreements with EFTA, Israel and Central and Eastern European Countries (CEECs) for which the Community grants preferential market access, while additional agreements are still being negotiated with Croatia, Tunisia, Egypt, Morocco, and Palestine (Republic of Turkey Prime Ministry Undersecretariat of Customs, 2003).

Agricultural products are a special case within the EU. The European Union spends about €100 billion, annually. Almost half of this expenditure is undertaken to implement the Common Agricultural Policy (CAP), and one third is spent to strengthen the social and economic unity. The European Union spends about €50 billion to subsidize farmers. It spends €35 billion under the "structural funds program" to close the economic gap between rich and poor regions within the EU (Cowles & Dinan, 2004). The main concern over this budgeting is the fact that the new Central and Eastern European countries and Eastern European member states have relatively large agricultural sectors and they are considered as relatively poor regions.

Apart from these difficulties of adapting its agricultural policy to that of the EU, Turkey also accepted the Customs Union Decision (CUD), which covers the implementation of several pieces of trade based legislation and adjustment to the technical standards of the EU. The CUD also required Turkey to accept all preferential trade agreements that the EU has concluded by 2001. However, agricultural products remained outside of the agreement.

2.3.3. Tariffs

Turkey's average tariff on imports of industrial goods from other third countries outside the Union dropped to 4.4% in 2003 in accordance with the Customs Union's trade and tariff regulations. However, Turkey still maintains high tariffs on food and agricultural products to protect its domestic producers. The highest tariff rates are imposed on imports of animal products. The government increases tariff rates during the harvest season or when it predictably accumulates high stocks of agricultural products. Duties on fruit products range from 61% to 149%. There are also high duties and excise taxes of more than 200% on imported alcoholic beverages (Harrison, Rutherford & Tarr, 1997). Furthermore, the process of importing alcoholic beverages is complicated; it requires state approved control certificates and permits. The state owned TEKEL, which used to market all alcoholic beverages, has been recently privatized. Now private companies have control over imports and distribution of alcoholic beverages. There are also plans to liberalize the tobacco market over a five-year period to create a more competitive environment. Turkey also allows higher prices for domestically produced generic drugs.

The Customs Union has also knocked down most of its investment barriers. Currently it has a liberal investment regime. Once approved, foreign investors are treated as local companies.

With the exception of the financial and petroleum sectors, which require a special permission from the government, all sectors open to Turkish investors are also open to foreign investors. However, investing in the private sector is challenging because of excessive bureaucracy, a weak judicial system, high tax rates, etc. Corruption remains a major issue in Turkish government; there have been many allegations that the contracts are awarded according to personal and political relations between the parties (Seki, 2005).

2.4. Structure of Turkish Exports

For a long time, the protection of the domestic market created a bias against exports of agricultural products. The government subsidized the export of these products at various rates. Historically, wheat and sugar have been the main subsidized commodities. Export subsidies are (10%-20%) granted to 16 agricultural and processed agricultural products. Thus, before Turkey decided to apply for membership in the EU, the exports of agricultural products and raw material dominated the structure of its exports.

2.4.1. Exports to Europe

A customs union is bound to induce deep change in the export structure of a country. After Turkey started its negotiations in the latter, the export structure started to change. The long suppressed competitive costs emerged as the main determinants of Turkey's exports. Although comparative costs are powerful engines, they can also condemn a country to stagnation if unchecked (Harrison, Rutherford & Tarr, 1997).

Eighty percent of Turkey's comparative advantage in the European market derives from industrial products like textiles and weaving products, followed by vegetable and fruit products and agricultural products. In general, products in which Turkey has a comparative advantage form only 10.7% of EU's total imports but 68% of Turkish exports to EU. The reason behind the low share of products in which Turkey has a comparative advantage in EU's total imports is the fact that there are structural problems with Turkish exports. For example, the trade pattern with Germany shows that 75.6% of Turkish exports in 1999 were in products that accounted for only 11.4% of German total imports in the same year (Undersecretariat of Foreign Trade, 2005). For Turkey to increase its exports to Germany, it should change its export structure to target the other products that account for 89% of total German imports.

Turkey has comparative advantage in products like vegetables, spices, tobacco leaves, all types of cotton products, woven products, rugs, construction products, and textiles. Even though Turkey's exports of these products to EU members increased, EU's total imports of these products have not changed much since 1990. In other words, Turkey gained share in products with relatively income inelastic demand.

To take advantage of the Customs Union with the EU, Turkey needs to change its comparative advantage in order to specialize in products with high-income elasticity of demand such as electronic machinery, plastics, and information technology products. The EU imports of these products are growing fast while its imports of products in which Turkey has currently a comparative advantage are stagnant.

2.4.2. Exports to the NAFTA Region

The products in which Turkey has comparative advantage in the NAFTA market account for 9.8% of NAFTA's total imports. These products account for 73.3% of total Turkish exports. Most Turkish exports of the products in which Turkey has a comparative advantage go to the United States. Therefore, Turkey does not hold much competitive power with Canada and Mexico. Turkey has a comparative advantage relative to Mexico in tobacco leaves only and relative to Canada in cotton products, synthetic fiber textiles, construction material from stone and soil, iron and steel wire rod and female wear. However, the share of iron-steel wire rod in total Canadian imports has been decreasing for the past ten years. Products in which Turkey has a comparative advantage relative to US are mostly concentrated in the ready-to-wear products, textiles and tobacco leaves. These products account for half of its exports to the US. Even though Turkey is one of the major exporters of tobacco leaves to the US, the share of tobacco leaves in US total imports is decreasing due to a dwindling market for tobacco products because of health hazards. The Customs Union with the EU allows Turkey easier access to these markets but it again faces the same conundrum.

2.4.3. Exports to the Middle East

Exports to Middle East countries vary from country to country. Turkey has comparative advantage relative to the countries of the Middle East mostly in non-cocoa sugar products, and chocolate food products. Turkey has less of a comparative advantage in the Gulf countries like Saudi Arabia and Bahrain relative to Jordan and Israel. The competitive power of Turkish products in Saudi Arabia is high in men's wear, soap, and detergents, and in Bahrain, Oman and Kuwait, it is high in iron and steel wire rod. Turkey's exports to Israel are similar to its exports to western countries; they include construction materials of stone and oil, fresh and dried fruits, weaving threads, and synthetic and artificial fiber textiles. It is possible to see the same problematic pattern with Turkey's imports to the Middle East and another reason for a shift in comparative advantage to products with higher income elasticity.

2.4.4. Exports to North Africa:

Turkey's major exports to North Africa include ready-to-wear clothes, motorcycles, and bicycles. Half of its exports to Tunisia ($350 million) are ready to wear products. Turkey's pattern of exports to Tunisia is the same as the pattern of its exports to western countries; products in which Turkey has a comparative advantage account for 74% of total exports to Tunisia. However, Tunisia's imports of these products account for only 15% of Tunisia's total imports. Turkey exports iron and steel to Algeria and vegetables, fruits, threads, construction materials, and male/female wear to Egypt (Undersecretariat of Foreign Trade, 2005).

In conclusion, Turkey's structure of exports and its economy are in great need of reform with a view of shifting the emphasis to products with higher income elasticity of demand. Unless Turkey acquires a comparative advantage in products that have a growing demand by its trading partners, it will fail to take advantage of the great opportunities offered by a customs union with the EU.

2.5. An Overview of the Benefits and Costs of the Customs Union between Turkey and the EU

The general theory of the second best states that have given a certain number of distortions, the removal of some distortion does not necessarily increase welfare. Without the removal of all distortions, it may not be possible to increase welfare completely (Seki, 2005). The implications of this theory to customs unions are clear. A customs union removes some distortions (tariffs) but not all of them. Therefore, there is no guarantee that customs union will increase economic welfare completely.

Seki (2005) argues that one of the most argued negative effects of forming a customs union is that it can lead to the substitution of imports from a high cost member country for low-cost imports from a non-member country; this is the phenomenon of trade diversion. The trade creation taking place, thanks to the removal of tariffs and trade barriers among members, would have, of course, a positive impact on welfare. However, the trade diversion would not only hurt the economy of the non-member country but also, by transferring production from a more efficient source to a less efficient source; it will reduce the gain in efficiency for a member country.

It can be argued that the prevalence of the preferential trade agreements between the EU and the new member countries should reduce the concern for trade diversion from European integration, since almost all outsiders have been able to negotiate free access to the market of the European Union in most sectors. This means that reductions in internal tariffs will not lead to lost trade opportunities for those efficient outside producers that now have free access to the EU domestic markets.

The European Union has many preferential trade agreements with different countries. Some of them are preferential trade agreements with the EFTA (European Free Trade Association), the EEA (European Economic Area) agreement, and the Association Agreement with Central and Eastern European countries, the Western Balkans (stabilization and association agreements, with extensive free trade), Russia and Ukraine, Mediterranean countries (free trade area to be completed by 2010), Chile and Mexico (free trade agreements). There are also negotiations underway to establish a free trade area with the MERCOSUR (European Commission, 1999).

In order to prevent trade diversion, the government of Turkey continues its efforts towards the alignment of its tariff rates and trade barriers with third parties in accordance with the requirement of the preferential and autonomous regimes granted by the EU. Currently, in addition to the free trade agreement signed with the EFTA in 1991, Turkey concluded free trade agreements with Israel, Hungary, Romania, Lithuania, Czech Republic, Slovak Republic, Estonia, Latvia, Slovenia, Bulgaria, Macedonia, Poland, Croatia and Bosnia Herzegovina. Of course, the preferential agreement with the previously candidate countries were abolished on May 1, 2004 following their accession to the EU. Today, free trade agreements with Israel, Romania, Bulgaria, Macedonia, Croatia, Bosnia-Herzegovina, Palestine, and Tunisia are in force. In addition, negotiations with Albania, Egypt, Jordan, and Lebanon are continuing. Moreover, a framework agreement to initiate free trade agreement negotiations was signed with the Gulf Cooperation Council on May 30, 2005 (Undersecretariat of Foreign Trade, 2005).

In Turkey, joining the Customs Union in 1996 was considered the last step towards becoming a full member to the EU. It was also expected to increase the level of wealth in Turkey, reduce the risk premium of investing, and encourage capital inflows. Like in the case of every other positive signal received from the EU, this decision overwhelmed the Turkish people, thinking that they were very close to the finishing line. However, Kafaoglu (2004) argues that the Custom Union was just one of the other obstacles that the EU forced Turkey to overcome so that it can postpone the actual membership negotiations for many more years. Several years after joining the Custom Union, the consequences of the Custom Union became apparent and unexpectedly, they were not all in favor for Turkey (Kafaoglu, 2004).

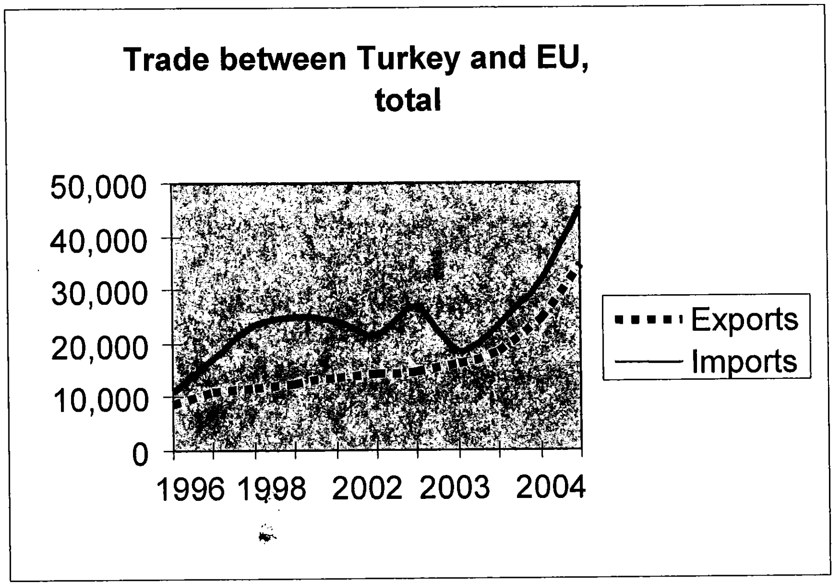
For consumers, the Customs Union has brought better quality, cheaper products and more variety, because of increased competition in the Turkish market. Consumer protection increased as the European technical norms were progressively applied. Producers also benefited from cheaper and higher quality inputs, as well as access to stable and larger export markets. The existence of a large and stable export market proved its importance during the economic crisis of 1998. Turkey's exports to major destinations other than the EU declined whereas the exports to the EU remained unimpaired. This helped offset some of the negative effects of the crisis. EU's share of Turkish export increased from 46.6% in 1997 to 50% in 1998 and 53.9% in 1999 whereas EU imports stayed stable at 51% over the same period (EuroStat, 2004).

Without the Customs Union, there is more red tape and delays with negative effects on growth and trade. Under the Customs Union, Turkey is part of a larger trading bloc, a fact that has given it more weight in international trade negotiations and disputes, as with the World Trade Organization (WTO). Acting alone, Turkey would have much more difficulty in making its voice heard in world politics. Turkey would benefit more, should the Customs Union be enlarged to services and the liberalization of public procurement. This would bring Turkey ever closer to Europe and promote competition, transparency, and good governance (Kafaoglu, 2004).

The Customs Union between Turkey and the EU does not involve only the abolition of all customs duties and charges, prohibition of all quantitative restrictions between the parties and implementation of a common customs tariff to the outside world. It also requires Turkey to harmonize its commercial and competition policies, including intellectual property laws with those of the Union, and extend most of EU's trade and competition rules to the Turkish economy. The Customs Union has strengthened Turkey's capacity to cope with tremendous competitive pressures, not only from the EU but also from third countries.

Some of the expected benefits of the Customs Union for Turkey were the transition that took place in the Turkish economy, the greater integration with the world economy, the modernization, and liberalization of the Turkish economy, and the increased competition that will improve the efficiency of Turkish producers. Membership to the Customs Union was also expected to give a substantial increase in the inflow of foreign direct investment. Overall, the long-term effect of these changes would translate into lower rates of unemployment and improve Turkey's income per capita.

Figure-8: Trade between Turkey and EU, total in million $US



Source: Turkish Statistical Institute, 2004

Figure-8 shows the export and import pattern between Turkey and Europe. Since the establishment of the Customs Union, the volume of trade between the EU and Turkey increased significantly. However, its benefits to the Turkish economy were modest. When the EU abolished its tariffs on industrial products in 1995, it had excluded textiles and clothing products. Thus, it is not surprising that the Customs Union did not bring significant enhancements to Turkey's exports to the EU as can be seen from figure-8. Turkey's exports did not increase significantly immediately after the establishment of the Customs Union, but there is a relatively significant increase after the economy started recovering in 2002. In contrast, the effects were quite opposite for the EU. The removal of tariff barriers to Turkish imports from the EU led to a large increase in imports from Europe, causing a steep rise in Turkey's trade deficit. After completion of the Customs Union in 1996, Turkey's imports from the EU increased by 37.2% compared to 1995 and reached \$23.1 billion while its exports increased by only 4.2 percent and amounted to \$11.5 billion (Undersecretariat of Foreign Trade, 2005). Another concern during the transition period was whether Turkish domestic producers would be able to handle the intense competition coming from overseas because of the new Customs Union. Even though the Customs Union created a great challenge to the Turkish industrial sector, it is evident that Turkish producers were successful in overcoming the difficulties of transition and were able to compete with their respective EU rivals.

There remains a lot of division among people's opinions about the Customs Union. Those critical of the Customs Union argue that one country cannot be in a Customs Union with the EU without becoming a full member of the European Union. It is rational to assume that the Customs Union with the EU serves the interest of the fifteen EU members and during the bargaining process, the decisions concerning the Customs Union are made within the EU. Therefore, it is not to Turkey's advantage not to be able to voice concerns about the decisions made within the EU while it must implement the corresponding changes regardless. This is another reason why many think that from the point of view of Turkish national interests, the establishment of Customs Union with the EU was nothing more than the incorporation of Turkey within the union without granting it membership and a voice in the decision making process (Kafaoglu, 2004). To prove their claims, critics point out the strategy used by newly admitted members of the EU before becoming full members. For instance, Greece, Spain, and Portugal, realizing the possible negative outcomes it might bring, did not accept Customs Union alone without membership (Togan, 2004).

The advocates of the Customs Union viewed this integration a step toward full membership. However, EU officials viewed it solely as a mechanism to improve cooperation and did not link it to full membership. Supporters of the Customs Union have claimed that it made Turkey the nonmember country with the strongest integration to the EU, which will lead to the consolidation and quicker absorption of Western values in Turkey (Togan, 2004).

The supporters of the Customs Union have exaggerated the economic benefits; they claimed that the Customs Union will improve Turkey's process of integration into the world economy but it does so only in those areas where Turkey has a poor comparative advantage. Agricultural commodities, for instance, were left outside the scope of the March 6 decision in 1995. Supporters of Customs Union claim that there is still no free trade in agricultural products because the Turkish government has yet to take steps to make the basic regulation of the EU's CAP (Common Agricultural Policy) applicable to Turkey's national agricultural policy. However, these steps cannot be taken without Turkey's full membership in the EU. Such a move without membership may result in a financial burden, which Turkey alone cannot carry.

The initial excitement over Turkey's Customs Union with the EU in 1995 was followed by a serious disappointment at the EU's 1997 Luxembourg summit, when Turkey was not given candidate status. In reaction to this disappointment, Turkey cut all of its political dialogue with EU. However, with the help of the United States, the European Union could not deny the improvements achieved by the Turkish economy since the establishment of the Customs Union in 1995. Turkey was finally given candidate status in 1999 at the Helsinki summit. Turkey was also promised that the only obstacle left for full membership was the satisfaction of the Copenhagen criteria, criteria that not all current members of the EU have satisfied.

Conclusion

Since the creation of the Customs Union with the EU in 1996, Turkey has been able to export to the EU as if it were a member with the exception of agricultural and fishery products. Abolishing or limiting the Customs Union is still a favorite topic of discussion for Turkey's nationalists and industrialists. They are among the most ardent critics of the Customs Union. They include company owners who are hurt by intense competition of higher quality and cheaper imports from the EU and other third world countries made possible by the enlargement of the Turkish market.

The detailed quantitative effects of the Customs Union on the Turkish economy will be analyzed empirically in Chapter IV. In this chapter, we analyzed the qualitative effects of a Customs Union between two unequal partners on the junior partner's economy. When the two partners are significantly unequal in size and degree of economic development, the Customs Union automatically slows down the economic growth in the junior partner temporarily and can lead to stagnation and wretchedness (European Community, 2002). Theoretically, one would expect the Customs Union to freeze the Turkish economy in its tracks due to the intense competition that it creates in domestic markets, destroying some or most infant industries that the Turkish government had spent a considerable time and effort to develop. Some critics view the Customs Union between Turkey and the EU as a union similar to the ones created when governments of a powerful advanced economy colonized an underdeveloped economy as it happened in the seventeenth, eighteenth, and nineteenth centuries. The discussion suggests that if Turkey is to avoid a colonization type of Customs Union, its government and people must rise to the challenge and take the opportunity to operate a deep structural change of its comparative advantage and method of governance. Without such a change, the Turkish economy may stagnate and all benefits would accrue to current members of the European Union. Fortunately, the Customs Union and the hope of Turkey becoming someday a member of the Union have already started to induce significant changes in the method of governance of business and government thanks to the requirement that Turkey must satisfy the Copenhagen criteria in order to become a member of the Union. Still, as it will appear in Chapter IV, these changes are not enough.

Chapter III – Benefits from the Prospect of Turkey's Admission into the EU

3.1. European Union

3.1.1. History of the Union

Throughout history, there have been many conflicts and wars among the nations of Europe. In reference, France and Germany fought against each other three times between the years 1875 and 1945 (EUROPA, 2005). The severity of these conflicts, especially the Second World War, indeed prepared the background for the creation of the European Union. After the end of the Second World War in 1945, governments were fed up with the bloody wars, and loss of economic and political power. To eradicate future conflicts, many European governments concluded that forming a union among European states would bring peace to the region. The first attempt of unification resulted in the formation of the European Coal and Steel Community (ECSC) among only six European countries: Belgium, West Germany, Luxembourg, France, Italy, and Netherlands (EUROPA, 2005). The main purpose of ECSC was to pool the steel and coal resources and therefore reduce the likelihood of any wars. After the success of ECSC, the same six countries also created the European Atomic Energy Community (EURATOM) in 1957 by signing the Treaties of Rome, and thus formed the European Economic Community (EEC) in the same year. The goal of the EEC was to form a customs union among these six member states with freedom of movement of goods, services, capital, and people. EURATOM, on the other hand, was formed to gather the non-military nuclear resources of the states (Cowles & Dinan, 2004). The EEC was the most significant community institution among the three; it was later renamed the European Community (EC), which was the combination of all three communities: EURATOM, ECSC, and EEC.

Some other European states that were not members of the newly formed community formed separately the European Free Trade Association. These countries were Great Britain and member countries of another organization called the Organization for European Economic Co-operation (OEEC) now known as Organization for Economic Co-operation and Development (OECD). However, recognizing the success of EEC, Britain was the first nation, apart from the founding members of EEC that applied for membership. Following Britain's application, Ireland, Denmark, and Norway applied for membership. After two unsuccessful attempts to join EC, Britain, Ireland, and Denmark were accepted in the community. Because of the negative referendum results on whether Norway should join the community or not, its application was rejected. Enlargement of the community continued with the acceptance of Greece in 1981, Spain, and Portugal in 1986 (Cowles & Dinan, 2004).

3.1.2. Concerns of the EU

This initial increase in the number of members was one of the signs that the EC was becoming the strongest economic power in Europe. However, the founding members of the community were highly concerned over the possible problems that might be created with the enlargement. Political leaders feared that new members would flood the labor market, lower wages and cause racial problems. Similar reactions were seen in 2004 when a large number of new members were admitted to the European Union. In order to voice these concerns and to take preventive action, the Single European Act was signed in Luxembourg, and implemented in 1987. The main purpose of the Single European Act was to harmonize laws between countries and resolve policy differences. The Single European Act required the removal of the remaining barriers between member countries and increased competition among European countries; it also set 1992 a target year for the creation of a single market (European Commission, 2005). The integration of European countries meant that they had to make certain policy and economic decisions jointly. Therefore, they had to adopt several common policies like in agriculture, transportation, trade, consumer affairs, etc. Their old policies had to be changed and some new ones had to be created in the course of time, depending on the needs of member states. For example, agricultural policy no longer requires products to be produced in the cheapest way; it is more focused on the needs of farmers and preservation of the environment (Cowles & Dinan, 2004).

One of the significant goals of the EC (EU) is to develop trade among members and with other countries. With respect to developing trade with other countries, the EC signed several customs agreements with third countries. These agreements are referred to as "preferential agreements" as mentioned in the previous chapter. With respect to developing trade between member states, EC required all member states to adjust their economies and policies in accordance with the requirements of achieving a single market in which goods, services, people, and capital could move freely across member countries. Even though it took some time for member countries to adjust their economies, by the end of 1992, the Single Market was created and covered all member countries. The Treaty of Maastricht, signed in 1992, introduced the economic and monetary union (EMU) and a single European currency managed by a European Central Bank. The Treaty of Maastricht gave the European Community (EC) its new name, European Union (EU), in 1992.

More enlargements followed in 1995: Austria, Finland, and Sweden joined the EU, raising the number of total members to 15. A new currency, the Euro, was introduced in world markets on January 1, 1999. All member states with the exception of the United Kingdom, Sweden and Denmark, are now using the Euro as their currency. In 2004, ten more countries; Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, Slovenia joined the European Union. Today, the EU has 25 members and a population of 450 million people. The addition of ten new members required the Union to change its old constitution and form a new one that will enable the union to run as efficiently as before. The Constitutional Treaty signed in 2004 was rejected in the referendums that took place in France in May 2005 and Netherlands in June 2005. Just as it happened during the accession of new members in 1995, Europeans are once again worried in 2006 whether the new 10 members will be able to meet the EU economic standards. The additional spending that will have to be made in order to bring the standard of living in the new members to the EU average is another concern for the EU. There is also an anxiety over losing the European identity since most of the new members and applicants are from eastern Europe instead of western Europe, where the most powerful and core member countries of the EU are located and that share a common history. Two more countries are expected to join the EU, Bulgaria, and Romania in 2007, and membership negotiations have already started with Turkey and Croatia in 2005.

3.1.3. Accession Requirements

In order to apply for full membership to the European Union, candidate states have to respect the principles stated in Article 6 of the Treaty of European Union. The article states, "The Union is founded on the principles of liberty, democracy, respect for human rights, and fundamental freedoms, and the rule of law, principles which are common to the member states." (European Commission, 2005). In 1993, anticipating the admission of new members in 1995, the European Union formulated and adopted the Copenhagen Criteria, which an applicant for membership in the EU must satisfy in order to become a full member of the Union. There are three criteria: political, economic and acquis (total body of EU law). Political criteria state the applicant country must have achieved stability of its institutions guaranteeing democracy, the rule of law, human rights, and respect for and protection of minorities. Economic criteria require applicant countries to have a functioning market economy, as well as the capacity to cope with competitive pressures and market forces within EU. In addition, the last criterion, adoption of the acquis communautaire, states that applicant countries must have the ability to take on the obligations related to membership, including adherence to the aims of political, economic, and monetary union. The "acquis communautaire" is the body of existing and new EU law, including labor market laws, regulations concerned with the Single European Market including competition policy, and many other EU social regulations. Candidate countries for accession have to convince existing member nations of the EU that they are able to meet the demands of EU competition policy and have a sound structure for the operation of monetary policy.

3.1.4. The European Monetary Union

The European Monetary Union (EMU) was an objective of European integration for almost four decades, based on the idea that integrated macroeconomic and monetary policies would make Europe politically and economically stronger as well as more competitive globally. The Single European Act of 1986, which paved the way for completion of the single market, included a reference to the EMU. The single market programme included liberalization of capital movements, one of the preconditions of the establishment of the EMU. Member countries negotiated the terms of reference of the EMU in the intergovernmental conference of 1991, which resulted in the Maastricht Treaty.

3.1.4.1. The Maastricht Treaty

The Maastricht Treaty, also known as the Treaty of the European Union requires candidate countries to satisfy the Maastricht criteria included in the treaty, in order to become a member of the EMU (Not so unthinkable, 2005). Candidate countries must satisfy the following criteria:

1. It should have an inflation rate no more than 1.5% above the average inflation rate of the lowest inflation rate countries in the EU;
2. Its long-term interest rates should be no more than 2% above the average interest rate of the three countries with the lowest interest rates;
3. Its government budget deficit should be no more than 3% of its GDP;
4. Its national debt should be no more than 60% of its GDP;
5. It should not have operated exchange rate realignment for at least two years prior to its admission;

Inflation rate, interest rates, and exchange rate criteria are designed to make sure the candidate country enjoys enough monetary stability to be able to maintain a fixed exchange rate regime with existing members of the EMU. The criteria of national debt and government budget deficit are meant to support the stability of the new Euro currency (€). These criteria protect the EU from threats of inflation caused by government budget deficits.

The Delors report of 1989 set out a plan to introduce the EMU in three stages. It starts with coordination of economic policy and culminates with the adoption of the Euro, the EU's single currency. It includes a blueprint for the creation of institutions like the European System of Central Banks (ESCB), which would eventually become responsible for formulating and implementing monetary policy (World Bank, 2002). There is a fixed timetable leading to the adoption of the single currency by member countries that were able to meet the convergence criteria. To enter the final stage, members must meet four convergence criteria. A member country should achieve a high degree of price stability, have a sustainable government financial position, have at least two years without devaluation, and observe the normal fluctuation margins for the exchange rate of its currency provided by the exchange rate mechanism of the European Monetary System (EMS). Moreover, it should achieve a long-term interest rate indicative of durable convergence and participate successfully in the EMS (World Bank, 2002). Other features of the Maastricht Treaty include the expansion of structural funds to cover the poorer regions of the EU and to cover new areas such as education, culture, public health, consumer protection, trans-European networks, industry and the environment. Fiscal and budgetary policies remain the responsibility of national governments.

Twelve member countries of the European Union have entered the third stage and have adopted the Euro as their currency. The United Kingdom and Denmark have opted out, exempting themselves from the transition to the third stage of the EMU.

On January 1, 1999, the individual currencies of participating member countries were converted into the Euro at fixed rates. Control of the Euro was given to a newly created body, the European System of Central Banks (ESCB), which consists of the central banks of participating member countries and the European Central Bank (ECB). The ESCB has the power to conduct the Euro zone's monetary policy with a responsibility for the maintenance of price stability. It is also responsible for holding and management of the official reserves of the participating member. On January 1, 1999, the national central banks transferred a total of €50, 000 million in foreign reserve assets to the ECB and further reserves have been transferred since that date (Not so unthinkable, 2005).

3.2. Reforms Undertaken by Turkey to Fulfill the Copenhagen Criteria

The Copenhagen criteria state the requirements that define whether a country is eligible for membership or not. Although the Maastricht criteria had been formulated for EU member states to qualify for membership in the EMU, they are also relevant for new candidate countries that aspire to membership in the EU. Those candidate countries are required to satisfy the Copenhagen criteria; furthermore, fulfilling the Maastricht convergence criteria is important to prove the existence of a functioning market economy and the capacity to cope with competition, a major component of the Copenhagen criteria. Each country, during the negotiations, is monitored and necessary adjustments are made towards the completion of the criteria.

The Copenhagen criteria consist of three basic requirements; a functioning market economy, capacity to cope with competition and the ability to implement the other obligations of membership including the Maastricht criteria. A functioning market requires liberalized prices and trade, and a powerful legal system that protects property rights. Macroeconomic stability and strong economic policies also help develop a market economy. Furthermore, a sound financial sector and free entry and exit are essential for market efficiency. Some of the main areas in which Turkey needs to undertake major reforms in order to qualify for membership are analyzed in the remainder of this section.

3.2.1. Market Efficiency

Aspiration to membership in the EU spurred the government of Turkey to undertake a series of reforms starting in the 1980s. These reforms removed price control and subsidies, weakened the role of the public sector, provided incentives to private investment and saving, liberalized foreign trade, reduced tariffs, eased the restrictions on capital flows and foreign exchange controls, privatized the central bank, and reformed the taxation system. Recent related developments in Turkey's economy have been reported in the Union's regular Report of the Commission in 2004. The Commission's reports (2004) state:

> The last 5 years saw a market improvement in banking sector regulation and supervision. Transparency of public sector accounting and the efficiency of tax administration have improved. Current account adjusted rapidly after the 2001 crisis. Inflation has declined significantly. (p. 78)

Although the reforms are helpful, they are not sufficient. Market capacity to cope with competition depends on the existence of a market economy and a stable macroeconomic framework that would allow investors to make sound decisions. This criterion also requires a minimum amount of human and physical capital, including infrastructure that Turkey lacks. Restructuring of government enterprises and reducing their unit costs are two important areas that government enterprises need to work on. Fulfilling the Copenhagen Criteria requires strong economic and political institutions in Turkey. Thus, Turkey's challenge is to develop stronger institutions, while achieving the requirements that are also essential for its economic development. For instance, the legislative institutions of Turkey are inferior to the average of Black Sea countries.

3.2.2. Competitiveness

The competitive structure of the Turkish economy is still weak. Even though exports increased after the liberalization reforms in 1980, the economy still depends highly on the following sectors: textiles, food and beverages, materials and metal goods and housing and household goods. Turkey is especially less competitive in semiconductors/computers, health care, office and defense sectors. Research shows that the technological structure of Turkish exports is weak and dependent on resource-based exports, (Schweickert, 2004). The importance of technology intensive products is inarguable in world markets, and this is a glaring structural weakness of the Turkish economy. Traditionally, Turkish companies have not spent money on research and development, and have relied on imported technologies. However, with the current regulations and further integration with Europe, Turkish companies are open to world competition and are forced to spend on research and development in order to survive. For Turkey to improve its competitive position, the Turkish economy needs to shift to more technology intensive activities.

3.2.3. Macroeconomic Instability

Until recently, Turkish industries suffered from macroeconomic and political instabilities, difficulties of access to finance, insufficient infrastructure investments, insufficient support for innovation and inadequate quality certification services with support. However, Turkey showed its ability to take on the obligations of membership in terms of political and economic reforms. Since Turkey became an official candidate of the EU in 1999, the government has implemented more reforms. In 2002, a newly elected government introduced new laws concerning rights abuses, weak democratic institutions, and economic uncertainty. Many political reforms have been implemented that enabled Turkey to start the accession negotiations. There have also been improvements in economic indicators with the help of IMF supported stabilization programs. IMF programs aim to help Turkey fill the gaps between EU's and Turkey's institutions and laws, and improve its macroeconomic position to adjust its economy to the Maastricht criteria. IMF stand-by agreements are mainly about fiscal and monetary discipline. According to a new IMF supported program, there will be three new significant structural reforms: social security reform, tax reform and financial services reforms. The aim of reforms is to help Turkey become a member of the EU by removing structural barriers and achieve lower real interest rates through tightening of fiscal discipline and creating a better financial sector. The targets for the inflation rate (Consumer Price Index) are 8, 5, and 4 percent respectively for 2005, 2006 and 2007. The ratio of public sector net debt to GNP is expected to decline to 58 percent by the end of 2007 from 68 percent in 2004. It is assumed that growth will be led by increased investment and exports that shall lower the current account deficit to 4.3 percent of GNP in 2005 (Hefeker, 2004). Even so, Turkey has a long way to go before it can fulfill the Maastricht and Copenhagen criteria. Turkey still lags behind almost all EU countries on basic economic indicators; inflation, debt GDP ratio, exchange rate, etc.

Turkey's chances of successful accession to EU are highly dependent on the implementation of economic and political reforms. Financial reforms are essential for membership; especially reforms in the banking sector since banks account for more than 90 percent of the total assets of the Turkish financial system. Restructuring Turkey's banking sector has been very costly so far. In implementing structural reforms, Turkey has met nearly all of the conditions set for the banking sector so that it complies with EU norms. The banking sector has made the necessary adjustments as mentioned by the Turkish "National Program" that aim to help Turkey fulfill the criteria for accession to the EU (U.S. Library of Congress, 2003). Some of the reforms include setting capital adequacy standards, redefining "own funds" and subsidiaries, setting related lending limits, regulating accounting practices, and ensuring transparency of financial reporting. Entry of foreign banks to Turkey is expected to increase competition in the financial sector and therefore improve the quality of banking services and financial products as well.

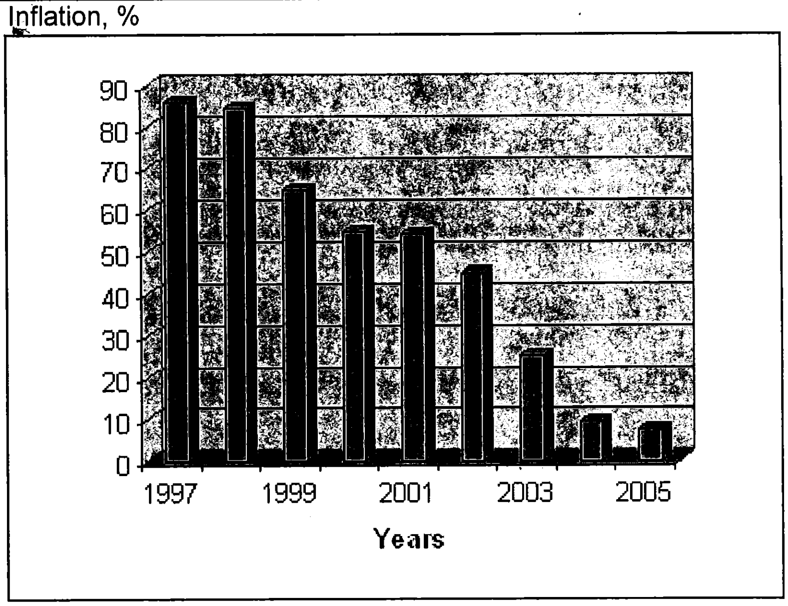
3.2.4. Inflation

Having a high inflation can be detrimental for the economy of any country. A high inflation rate not only affects investment but it also affects the central government budget, since most government revenues lag behind inflation, while government expenditures on goods and debt service, wages and transfer payments are indexed. Therefore, the budget balance deteriorates and creates an incentive to switch from domestic to foreign currencies as a store of value, a phenomenon called currency substitution.

Having experienced chronic inflation throughout the years the Turkish economy suffered from all the negative effects of high inflation stated above. Since the announcement of Turkey's candidacy to EU in 1999, a substantial decline in the inflation rate has been observed. As Table-1 indicates, the annual inflation rate in 1997 topped 85.7% and decreased to 25.3% in 2003 and to 7.7% in 2005. This significant decrease in the inflation rate is one of the benefits that Turkey has earned from its commitment to gain membership in the EU.

Table-1: Annual inflation of Turkey between 1997 and 2003

Years	Annual Inflation, %
1997	85.7
1998	84.6
1999	64.9
2000	54.9
2001	54.4
2002	45
2003	25.3
2004	9.3
2005	7.7



Source: Turkish Statistical Institute, 2004

3.2.5. Government Budget Deficit and Inflation

Encouraging short-term and speculative foreign capital inflows may help to finance public sector deficits with foreign savings and increase imports and consumption. High interest rates seduce speculative capital into the country and contribute to a temporary appreciation of the Turkish Lira. The productive side of the economy would experience a contraction while a period of artificial growth is experienced (Ertugrul & Selcuk, 2001). During the 1990s, the inflation rate was around 70-80% and transfer of seignorage revenues to the public sector increased (Ertugrul & Selcuk, 2001). To bring the inflation rate down, the IMF sponsored reforms in the late 1990s requiring the government to stop forcing the central bank of Turkey to finance its growing deficits. The government, in turn, started borrowing heavily from the Turkish banks. Interest rates increased quickly, which encouraged banks to borrow from abroad.

Domestic and foreign borrowing possibilities of the public sector are expanded through high interest rate policies causing a crowding out of investment. Domestic debt increased significantly and led to a public sector structure that was not functional. The ratio of domestic debt to GNP was 15.4% in 1991, increased to 29% in 2002 and to 69% in 2004, recent estimations indicate that domestic debt ratio is 54%, reaching US$ 167,262 million for 2004 (Turkish Statistical Institute, 2004).

The situation became intolerable resulting in a run on the Turkish Lira in 2001, leading to the financial crisis of 2001 aggravated by the weakness of Turkish banks. After the crisis, the rate of inflation has fallen quickly together with the transfer rate of seignorage revenues to the public sector.

The Customs Union with the EU enabled Turkey to compete with some of the strongest economies in the world. Since then, Turkey has been forced to develop its own competitive power. As government borrowing decreased, an increase of liquidity in the financial sector and a decrease of interest rates helped Turkey achieve higher level of trustworthiness, and attract more foreign investors. These developments are a major benefit for Turkey's journey to gain membership in the EU.

3.2.6. Banking and Financial Sector;

Traditionally, the Turkish banking system has been the core of the financial system. The financial sector works under a universal banking framework that allows commercial banks to engage in different financial activities. Apart from its regular activities, Turkish banks are not allowed to trade goods and real estate for commercial purposes. Investment banking in Turkey started in mid-1980s, and consists mostly of corporate finance, foreign exchange, underwriting of securities, engaging in mergers and initial public offerings. Development banks became an important part of the financial system by providing medium term finance to industry and channeling government funds to the sectors that have priority for the government (Banking Regulation and Supervision Agency, 2005). Newly established foreign banks are a sign of internationalization of the Turkish financial system. Even though the market shares of foreign banks are small compared to domestic banks, by introducing new concepts and practices, they help the development of Turkey's financial system. Turkey's main goal is to develop its regulations in line with EU standards. Accordingly, the government is emphasizing the development and implementation of new regulations that are in harmony with EU's finance and trade regulations.

The central bank of Turkey set up a system of quarterly reports in the mid-1980s that enable timely warnings for banks in difficulty. Even though it is difficult to assess the situation of Turkey's banks, this reform was a step to increase the transparency of banks. There have been several other reform attempts, although, which unfortunately not all of them had been smoothly implemented. A legislation introduced in 1993 aimed at improving the capital adequacy in accordance with EU's was blocked by the Constitutional Court (Banking Regulation and Supervision Agency, 2005).

The Turkish banking sector has undergone substantial reform over the past four years. The establishment of the Banking Regulation and Supervision Agency (BRSA) in 2001 enabled easier monitoring and auditing procedures for Turkish banks. The weak banks are being removed from the financial system by the encouragement of authorities for consolidation and by nationalization of banks that do not meet the requirements of capital-reserve thresholds. The BRSA removed 21 insolvent banks since 2001, and public banks started to offer market interest rates (Banking Regulation and Supervision Agency, 2005).

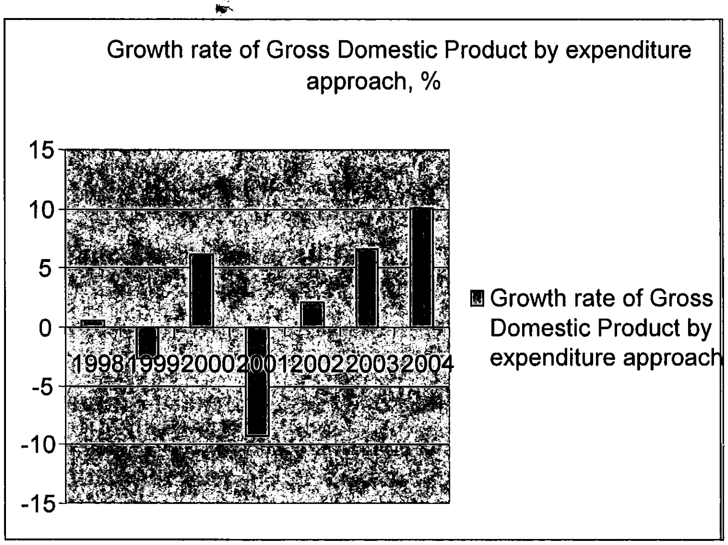
In order to achieve financial stability and long-term economic growth, it is crucial for Turkey to develop its banking sector. In the end, financial stability will prevent repetition of the 2001 financial crisis. With more integration to the EU market, more European firms will gain interest in the Turkish banking sector and it may lead to create major mergers and acquisitions. As Turkey stabilizes its economy with the help of the EU, the asset structure of Turkish banks will change substantially. The political stability that Turkey enjoyed with the help of the reforms has helped build confidence in the market. Therefore, it led to a decrease in interest rates and strengthened the domestic currency (Turkish Statistical Institute, 2004).

The banks in Turkey are still vulnerable to a potential crisis from domestic or outside markets. The main problem for long-term profitability is the lack of sufficient liquidity and equity in Turkish banks. An analysis of Turkish banking assets suggests that the actual amount of banking assets is more than US$ 195 billion. However, almost 49 percent of these assets are locked up in real estate investments and shares within other companies (Nazli, 2004). However, the beginning of membership talks with the EU produced significant improvements in Turkey's financial system.

3.2.7. Growth

So far, Turkey has recovered relatively well from the 2001 crisis. Figure-9 indicates the real GDP bouncing back after falling -9.2% in 2001. The growth rate was 6.6% in 2003 and 5.6% in 2005 (Undersecretariat of Foreign Trade, 2005).

Figure-9: Growth rate of Gross Domestic Product, %



Source: Turkish Statistics Institute, 2004

For many years, the growth rate of real GDP in Turkey has been fluctuating sharply. With membership talks with the EU on the way, Turkey began to experience a steady growth rate of its GDP. With a 5.6% GDP growth rate in 2005, Turkey has been placed as the 22nd largest economy in the world. Even though the growth rate of real GDP did not match the expected rate of 8.9%, its current range looks sustainable (Ertugrul & Selcuk, 2001).

3.2.8. The EU and Turkey Financial Relations

Turkey and the EU financial relations can be analyzed within a framework of three periods namely "Pre-Customs Union Period", "Customs Union Period", and "Candidacy Period." During the pre-Customs Union period (1963-1995), Turkey and EU's financial relations were based on the framework of Financial Protocols. In this period, financial assistance from the EU mainly included grants and credit. The credits were mostly from Community resources and the European Bank of Investment. During the Customs Union period, the assistance was given to eliminate the negative effects of the Customs Union, but the quality and amount fell short of the promised targets (Undersecretariat of Foreign Trade, 2005).

The "Single Framework", adopted at the Fisheries Council on December 17, 2001, was aimed at bringing all of EU's grants under a single framework. The single framework allowed Turkey to make use of the assistance to fulfill the accession partnership priorities and established new structures. Turkey's section in the Presidency Conclusion report of the Copenhagen Summit recommended an increase in financial assistance to Turkey. Additionally, the accession Partnership signed on May 19 2003 sets out a schedule of financial assistance to Turkey starting with €250 million in 2001, followed by €300 million in 2005 and €500 million in 2006 (Undersecretariat of Foreign Trade, 2005). Thus, the announcement of Turkey's candidacy to European Union at the Helsinki Summit held on December 1999 was the beginning of the candidacy period (1999-2006). Recognition of Turkey as a candidate country drove Turkey and the EU financial relations to a new phase. Since then financial assistance from the EU has improved significantly.

3.3. Agriculture

One area that may cause trouble in the current negotiations between Turkey and the EU concerning the admission of Turkey into the EU is the agricultural sector.

3.3.1 EU's Common Agricultural Policy

The 2003 CAP reform involved a major strengthening of rural development policy by reducing direct payments for bigger farms and transferring the funds into rural development measures. However, the CAP program is not seen as a lifesaver for either the EU or Turkey. In 2005, the European Union Committee criticized the CAP for being "unaffordable" and "anachronistic" (European Commission, 1999). The largest EU expenditure goes to CAP and it absorbs 40% of its budget but only 4% of Europe's GDP comes from agriculture. Another major criticism is CAP money is distributed unevenly between members. In addition, there are many criticisms regarding the issue of direct subsidies from the EU to farmers, complaining that perennial subsidies breed inefficiency and chronic dependency (European Commission, 1999).

Table-2: EU expenditure on CAP, in billion of $

	1996	1997	1998	1999	2000	2001
Total EU Budget	102	90	88	73	70	89
Total Agricultural Expenditures	54	50	48	47	38	40
Share of Agricultural expenditures on EU budget	53.60%	55%	54.60%	64.40%	53.80%	45.10%

Source: OECD's Producer Support Estimates, 2003

Table-2 above demonstrates how much EU has spent on the CAP program from 1996 to 2001. The table suggests that even though the absolute amount of expenditures on agriculture seems to be decreasing, it still accounts on average for almost 50% of EU's budget.

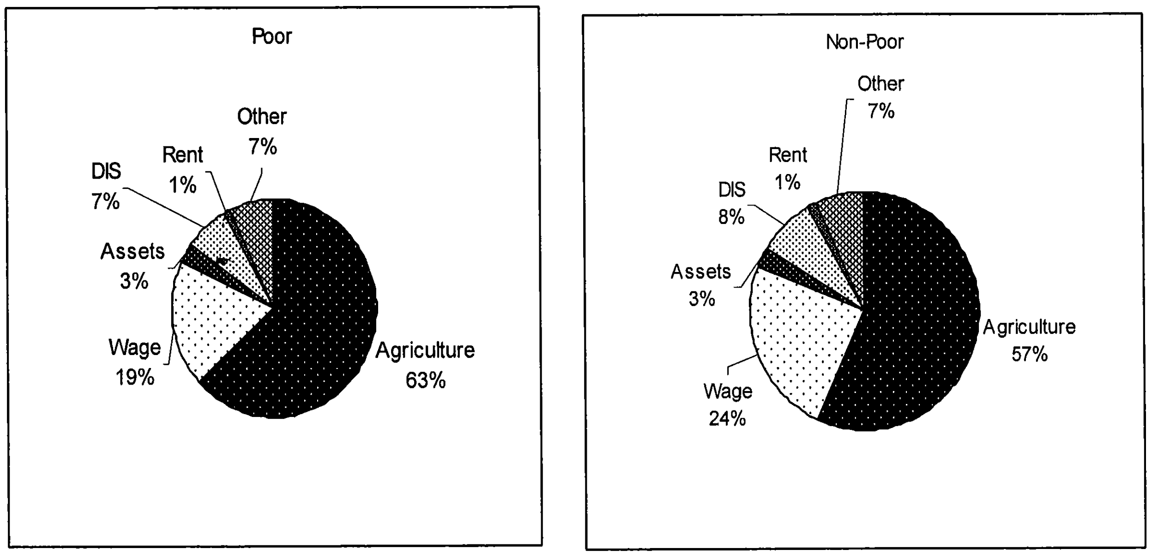
3.3.2. The Problem with the Turkish Agricultural Sector

The newest members of the EU consist of poorer countries of Europe and there are only two other richer countries left in Europe that could apply for membership. These two countries, Norway and Switzerland, are not too interested on becoming members (Delegation of the European Commission, 2004). Therefore, as further enlargements take place, it could increase the operating costs of the Union to intolerable levels before Turkey could become a member. Poorer regions within the union are eligible for Structural and Cohesion Funds. According to Objective 1 classification of the EU constitution, a region with per capita income of less than 75 per cent of the EU average is entitled to receive Structural Funds (Delegation of the European Commission, 2004). Turkey's per capita income is only 30 per cent of the EU-25 average and Turkey can easily qualify for this fund after accession. As stated above, Turkey will also qualify for EU agricultural funds under the Common Agricultural Policy (CAP). Under current rules and regulations, Turkey would receive approximately 14 billion Euros in terms of CAP and structural funds, and become the largest net receiver of EU funds. This represents a heavy burden on the EU budget.

Improvement in the Turkish agriculture sector is one of the accession requirements of the EU membership. The main issues are; the share of agriculture in GDP, employment in agriculture and the extent of government transfers to farmers. Turkey has already switched to a direct payment system from a price support system in order to catch up with EU regulations and laws. Membership to the EU will mean extending EU's agricultural subsidies under the rules of the EU's Common Agricultural Policy (CAP) to

Turkey. Thus, the large number of Turkish farmers is worrisome for the EU. It would be highly costly for EU taxpayers if Turkish farmers have the same benefits as EU farmers.

Figure-10: Income sources of an average Turkish household in rural areas (poor/non-poor)



Source: World Bank, 2004

According to the World Bank in 2004, an average household in Turkey drew its income from six major sources: wages, assets, Direct Income Support (DIS), rent, agriculture, and others. According to Figure-10, agriculture accounts for 57% and 63% respectively of the total income of non-poor and poor households in rural areas. Wages for work outside of agriculture account for 24% and 19% respectively of the total income of non-poor and poor households. Agriculture is a more important source of income for poor households than for non-poor households and wages from work in other sectors of the economy are less important. However, agriculture is still an important source of income for rural households.

3.3.3. Reforms of the Turkish Agricultural Sector

Previously, the Turkish agriculture policy consisted mostly of guaranteed output prices, input subsidies, limited control of supply, and the provision of low cost services to farmers. State and private enterprises and agricultural sales cooperatives bought cereals, tobacco, tea, and sugar from farmers at prices supported by the government. These relatively high prices are also protected by tariffs.

After years of economic downturn, high budget deficits, and debt levels, the government initiated a politically demanding realignment of agricultural support policies in 2000. The Turkish government recognized the need for a reduction in government expenditures in all of its departments. Reforms of agricultural subsidies figured prominently in this program. Accordingly, the government launched a program aimed at improving the efficiency of their support to the sector. In three years, agricultural subsidy reforms reduced fiscal transfers to farmers by US$ 4.3 billion (Ertugrul & Selcuk, 2001).

The overall reform of agriculture is taking place to comply especially with the European Community's agricultural regulations and laws, various agreements with IMF and Uruguay Round Agreement on agricultural trade. Under the program, output price supports, and input price subsidies are being phased out. They will be replaced by a new program called DIS (Direct Income Support). Under DIS, farmers receive direct payment from the government. Apart from harmonizing the Turkish agriculture sector with the EU's, this was done to partially compensate for the removal of the old subsidy system and to continue to provide sufficient income support to people living in the rural areas.

Table-3: Government Support and Investment in Agricultural Sector, US$ million

	1999	2000	2001	2002	2003
Government support and investment	580	636	410	547	761
Share of total investment in government's budget	6.80%	6.70%	7.30%	8.40%	9.20%
Share of GNP	0.31%	0.32%	0.28%	0.29%	0.40%

Source: Kamu Yatirimlari Anasayfasi, 2004

Table-3 shows the government support and investment in the agricultural sector. The decrease in 2001 is a result of the economic crisis that Turkey suffered in that year. That is why the share of government's total investment in agriculture in the government's budget did not fall. Apart from 2001, the rapid increase of government investment continues on, reaching US$ 761 million in 2003.

Before the reforms, Turkey's agricultural policy placed a heavy burden on the Turkish taxpayer. Transfers to farmers amounted to 5% of GDP. With the addition of price supports paid to farmers by the government, it was estimated that total government support to farmers was around 8% of GDP (World Bank, 2004). The decrease in agricultural subsidies was almost US$5.5 billion by 2002 with the implementation of DIS diminishing the cost of agricultural subsides including subsidies and DIS by 2.3 percentage points of GDP. It also helped the government to reach its target of a 6.5% primary budget surplus (World Bank, 2004).

We have seen in the previous chapters that the Turkish economy is highly dependant on agriculture and yet the Customs Union strictly excluded agricultural products from the agreement in order to protect the EU agricultural sector. Turkey has not yet completely adopted an agricultural policy similar to the CAP, the agricultural policy of EU that enables a direct transfer fund to farmers of member countries. During its adjustment phase, Turkey gave up its long time price support system to farmers in 1999 and adopted a direct payment system instead, as in the EU. Currently, Turkey is still in the process of abandoning the leftovers from its previous policy including input subsidies and output price supports in favor of a policy similar to CAP. The CAP is moving towards world market prices while maintaining farmers' income through direct payment tied to livestock holdings (instead of guaranteeing high prices for agricultural products).

Many governments support their farmers by increasing domestic prices, behind tariff barriers and through export subsidies, plus via public expenditure going directly to farmers (Delegation of the European Commission, 2004). Direct payment mechanisms encourage farmers to produce, more than what the market demands with no improvement in environment and food safety. Direct payment can be a more satisfactory type of subsidy than price support since price support can be "decoupled" from production, and therefore reduce farmer's incentive to overproduce. It is also argued that price supports distort production. Direct payments increase farmer incomes reflecting that increased income would eventually affect households' decisions of how much to spend, save, and work plus it could further affect capital and labor in agriculture. The advantage of direct payments is that they do not distort market price signals so that farmers are not encouraged to overproduce leading to lower prices and inefficiency (Delegation of the European Commission, 2004).

In the case that Turkey gains admission to the EU, Turkish farmers would be eligible for CAP benefits and prices of agricultural products in Turkey would drop, increasing consumer's disposable income. However, this change will adversely affect the farmers' incomes since their products will be sold at cheaper prices. In order to prevent a decrease in the income of farmers, direct payments will be made by the European Union to the Turkish farmers. Given the large number of Turkish farmers this implies that the costs for European Union of the accession of Turkey to EU membership will be large, and hence the strong resistance inside the EU to the admission of Turkey in the union.

Conclusion

The mere hope and aspiration that Turkey could become one day a member of EU has prompted the Turkish government and people to undertake important and long overdue political and economic reforms. The goal of many of the reforms is to enable the Turkish economy to fulfill the Copenhagen criteria, in particular the Maastricht Treaty criteria. This chapter discussed some of the benefits that the Turkish economy has already started to enjoy. The most important benefits are the tremendous reduction of the inflation rate, the reduction of the government budget deficits, the reduction in nominal interest rates, the clean up, and strengthening of the banking sector and the gradual removal of price distortions of agricultural products.

The replacement of price distortions by subsidies created another hurdle that Turkey must overcome and will most likely produce more effect but also benefits to the Turkish economy. The large number of people employed in the Turkish agricultural sector blocks the accession of Turkey to membership in the EU. Membership would require the extension of EU's CAP to Turkish agriculture. However, the Turkish contribution to the EU would be proportional to its GDP and it clearly cannot pay for the large additional cost of subsidies to Turkish farmers required under CAP.

One way for Turkey to remove the hurdle is to propose a lump sum subsidy under EU's CAP to its farmers that is feasible and unrelated to the number of people employed in its agricultural sector. This solution would also hasten the reforms of the Turkish agricultural sector and prepare it for the forthcoming onslaught that will result from the eventual demise of the CAP. The commitment of the Turkish government to gain membership in the EU induced it to undertake major reforms of its agricultural policy. Clearly, these reforms have produced a major benefit in terms of reducing the deficit of the government's primary balance. Another additional potential benefit would materialize if the Turkish government would introduce reforms to obviate the need for subsidizing the agricultural sector. This would remove the need for the EU to pay subsidies to Turkish farmers and it would remove a major hurdle to Turkey's membership in the EU.

Chapter IV – Empirical Analysis of the Effects of the Customs Union and the EU Membership

4.1. Introduction

Economic development is spreading all around the world including Turkey. Its rate exceeds 5% per annum in some countries thanks to a combination of technological progress, trade, and better governance. Many countries are trying to increase their market share in international trade in order to be able to compete with the rest of the world. Thus, forming unions among countries geographically close to each other has become an essential tool of trade, and economic development. The European Union is the most significant example of this strategy.

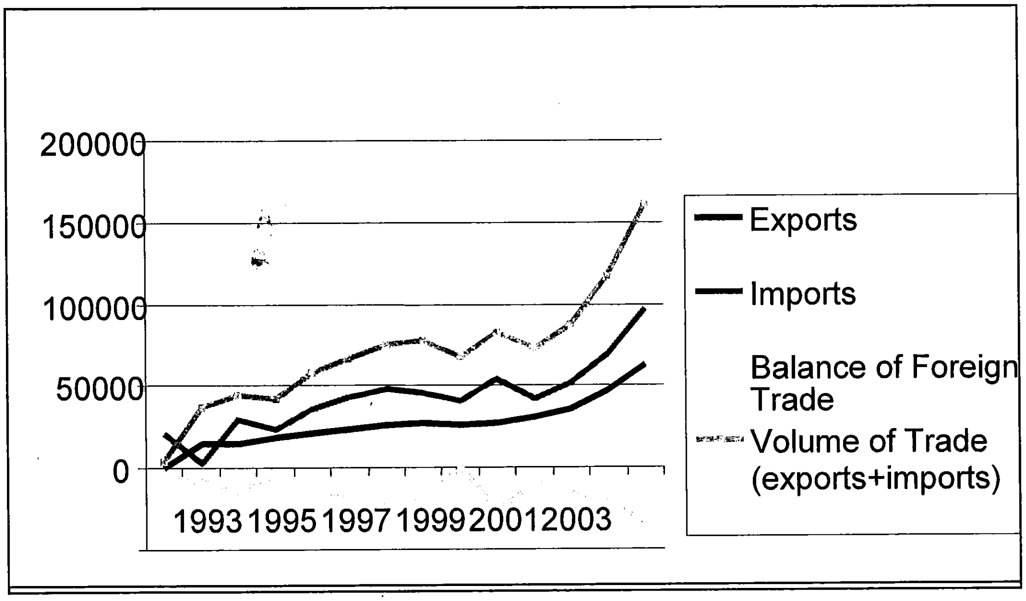
Having a customs union with the EU is one of the preparatory stages that Turkey is required to implement in order to become a full member. The Customs Union with the EU produced direct and indirect effects on Turkey's economy. The prospects of accession to membership in the Union produced further indirect effects. The effects of the Customs Union on Turkey's economy can be divided into static and dynamic effects. The first section is an analysis of the empirical evidence about the static effects of the Customs Union such as trade creation effect, trade diversion effect and income distribution effect on Turkey's economy.

4.2. Static Effects of Customs Union

4.2.1. Trade Creation Effect

As mentioned in chapter II, trade creation effects of the CU take place when production shifts away from less efficient producers to producers that are more efficient within the Union. When the tariffs among the members of the union are eliminated, products produced inside the union become cheaper for EU consumers. Therefore, citizens of the union are able to consume more from a cheaper source, and increase trade volume among members. Figure-11 illustrates the trade creation effects in Turkey due to the Customs Union with the EU during the, seven year period following its implementation.

Figure-11: Turkey's trade indicators, in billion $



Source: Turkish Statistical Institute, 2004

According to Figure-11, exports were US$ 21,635 billion in 1995; they increased further by 20 percent in 1999 to US$ 26,587 billion and to US$ 63,120 billion in 2004. Imports increased 13 % from US$36 billion in 1995 to US$40 billion in 1999; they increased further to US$97 billion in 2004. The volume of trade, defined as exports plus imports, also increased significantly from US$57 billion in 1995 to $67 billion in 1999 and US$160 billion in 2004. However, the larger trade deficit following the formation of the CU is a clear indicator of the difference between the competitiveness of EU and Turkey. Clearly, European Union producers are more competitive than their counterparts in Turkey. Without a doubt, it will take Turkey several years to adjust to the changes in this new competitive environment. At this point, trade creation is benefiting EU more than Turkey. However, this situation could change if more knowledge and better technology is transferred to Turkey.

4.2.2. Trade Diversion Effect

Because of the CU's implementation of tariff reduction between the EU and Turkey, products of third countries become more expensive and trade shifts away from these countries to the members of the Union. Trade diversion decreases the volume of trade for certain third countries. According to statistics from the Turkish Undersecretariat of Foreign Trade, the volume of trade between Turkey and the EU increased immensely. We note especially that the fast increase in EU imports to Turkey that continued until 1997. EU imports to Turkey grew 45% from US$16,861 million in 1995 to US$24,090 million in 1998. However, there has not been a significant change in the pattern of Turkey's trade with the EU as Turkey did most of its trade with the EU before the Customs Union. Statistics after the first four years following the establishment of the Customs Union do not show any trade diversion effects. In addition, since Turkey had preferential agreements with almost all of EU trade partners, trade with third countries were not affected significantly (Undersecretariat of Foreign Trade, 2001).

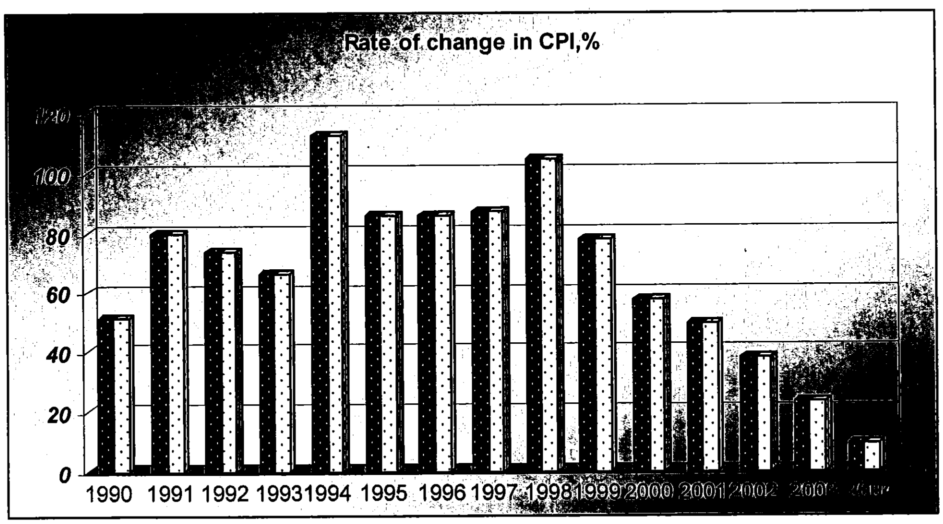
4.2.3. Consumption Effect:

Customs Union causes a decrease in the trade volume of less efficient member countries and that of certain third countries whose products are now more expensive products. If the prices of the Customs Union producers are lower than the prices of outside the union countries' producers, consumption and exports of the Custom Union country will increase. This effect is called the consumption effect of Customs Union.

Thus due to the lowering of tariffs after the formation of the Customs Union, foreign products should become cheaper. Thus, the establishment of Customs Union may lower the inflation rate immediately but temporarily.

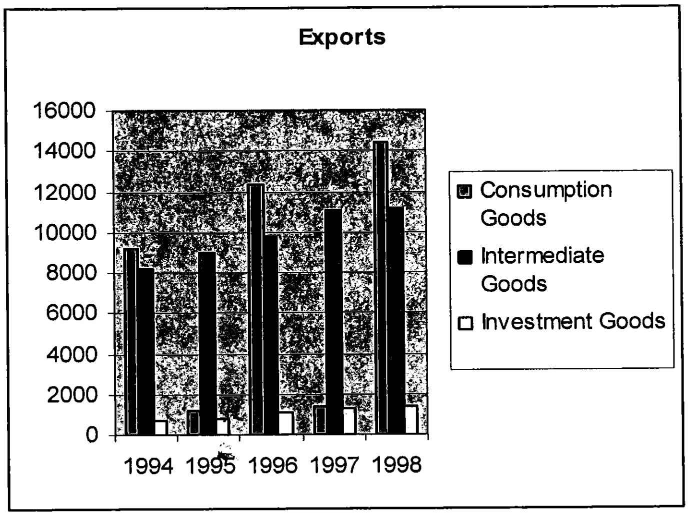
Figure 12 suggests a drop of the inflation rate from 110% in 1994 to 82% in 1995. The inflation rate remained at 82% from1995 until the end of 1997. Then it increased to 100% in 1998. That is, there was a temporary drop of the inflation rate that could be attributed to the establishment of the Customs Union. The continuous decrease of the inflation after 1998 was probably due to the announcements of the candidacy of Turkey to a possible membership of the Union and to the implementation of the financial reforms required by the Copenhagen Criteria.

Figure-12: Rate of change in consumer price index numbers for Istanbul



Source: Turkish Statistical Institute, 2004

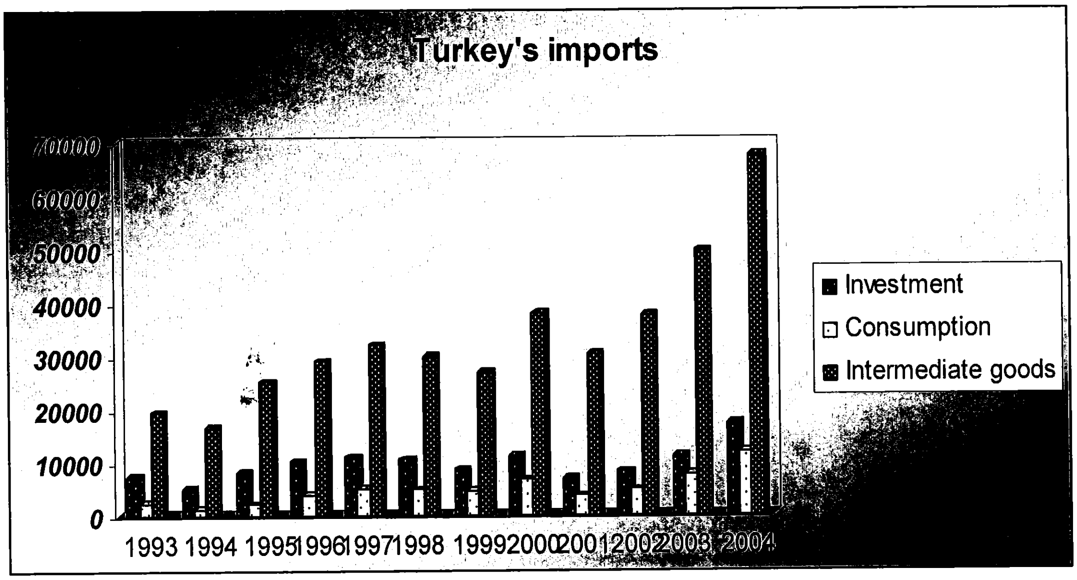
Figure-13: Exports of Turkey by classification of broad economic categories, in million of US$



Source: OECD, 2004

Figure-13 suggests that Turkish exports of consumption goods grew significantly with a 63% increase from US$9 billion in 1994 to US$14 billion in 1998. During the same period, exports of intermediate goods grew by 35%, from US$8 billion in 1994 to US$11 billion in 1998. Investment goods exports increased 89% from US$721 million in 1995 to US$1363 million in 1998.

Figure-14: Imports of Turkey by classification of broad economic categories, in million of US$



Source: Turkish Statistical Institute, 2004

Figure-14 display changes in the pattern of imports to Turkey by broad economic categories. Figure-14 indicate that imports of all three categories of goods; intermediate goods, consumption goods and investment goods have followed an unstable pattern, but that they have grown significantly since 1995. Imports of consumption and investment goods continued to increase at low levels in the following years. Import of intermediate goods grew until 1997 and fell by seven percent to US$29 billion in the following year. The increase in the import of consumption and intermediate goods between 1995 and 1997 suggest the consumption effect of CU. However, the fluctuations with imports of both types of goods after 1995 indicate that Turkey's import based industries are not stable enough and they are easily affected by daily politics.

The import of intermediate goods have accounted for the largest portion of total imports. They include partly finished goods or raw materials. The share of imported intermediate goods amounted to 66.1% in 1993, it increased to 70% in 1995. After stabilizing at 66.7% until 2000, the share of imported intermediate goods increased to 69.3% in 2004. The share of investment goods in the total of Turkish imports amounted only to 24.9% in 1993; and did not change much throughout the years. It decreased to 20.3% in 2002 and increased to 27.4% in 2003. The share of consumption goods increased between 1993 and 2003. The share of consumption goods of total imports to Turkey was 8.5% in 1993, reached 10.4% in 1997, and it increased to 12.4% of 2004's total imports (Undersecretariat of Foreign Trade, 2001).

The fact that most of Turkey's imports are composed of intermediate goods indicate that Turkey was not able to benefit from foreign technology by importing less raw materials, partly finished manufactured products and more investment goods (stocks, bonds, etc) , including machinery, auto parts, etc. Although intermediate goods continue to account for the majority of imports, there is an increasing trend in imports of all three categories since 2001. However, Turkey continues to import more of intermediate goods and therefore its market lacks products that would bring technological improvement. The total share of investment products doubled between 2003 and 2004 while the share of intermediate goods imports decreased slightly. As long as Turkey continues with the reforms in accordance with the harmonization program of EU, it should gain more technological capacity to produce better products, more efficiently and improve the competitiveness of its products (Belke, 2004).

4.3. Dynamic Effects of Custom Union

Dynamic effects are considered more important than static effects because they eventually generate important changes in the structure of the economy for the long term. The dynamic effects that we will analyze in this section are competition effect, technological development effect, and foreign investment effect.

4.3.1. Competition Effect

The Customs Union eliminates all tariffs and quotas among its members and therefore increases competition. Competition forces inefficient firms that produce low quality products with high unit of cost to either change their product lines, production or close business. Every member country eventually specializes in the products in which it has a comparative advantage (European Commission, 1999).

Turkey has a comparative advantage relative to the EU countries mainly in agricultural products. However, the Customs Union between Turkey and the EU excludes these products. After the formation of the Customs Union, productivity and production increased in non-agricultural products in which Turkey has a comparative advantage. However, firms in the industries where EU members have a comparative advantage lost their market share, decreased production and some had to shut down.

The Customs Union requires Turkey to adjust its competitive advantage in accordance with that of the European Union. It is hoped that with appropriate adjustments that would create comparative advantage, new products will develop the Turkish economy further.

4.3.2. Technological Growth Effect

Research and development (R&D) investment is expensive and developing countries like Turkey do not give enough importance to R&D (Torlak, 2004). According to Torlak (2004), research and development investments absorb 2 percent of GDP in the European Union countries, 2.8 percent in the United States, 3 percent in Japan, and only 0.5 percent in Turkey. For countries like Turkey that are not able to produce technological knowledge, the best way to survive in the market is to import and imitate the technology of other, more developed countries.

Turkey continues to import a high share of intermediate goods. In 1980, Turkey's imports consisted mostly of raw materials. However, today, 80 percent of imported intermediate goods are partially finished manufactured goods. Turkey has not been able to switch out from its labor intensive and elementary imported products; as witnessed by the fact that textiles account for 40 percent of its exports. According to OECD statistics, in high technology products, the ratio of the export-import balance is 10 percent, for medium technology products it is 23 percent, for medium-basic technology products it is 77 percent, and finally for basic technology products it is 225 percent (OECD, 2004). The labor working in the textiles industry consists mostly of women working "under the table" for producers who do not pay taxes. This is the only way for the Turkish textile producers to compete with foreign products coming from cheap labor countries.

Enlargement of the market increases competition, which forces companies to concentrate more on research and development in order to differentiate their products from others or to reduce unit costs. Countries who undertake significant research and development will eventually produce high quality products and sell them for a cheaper price. In order to compete in the European market Turkish firms need to do research on new techniques to lower the cost of production, increase productivity, and improve quality.

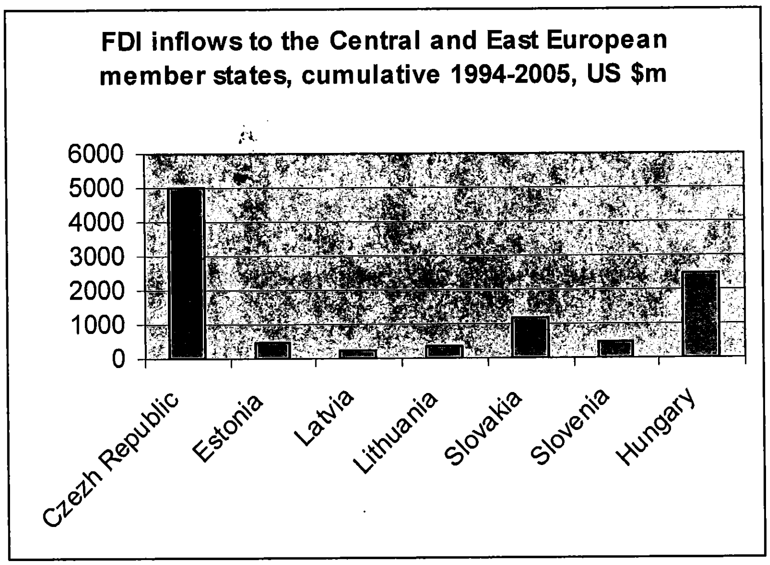
4.3.3. Foreign Investment Effect

As more trade takes place between members, investments will be channeled to more productive and profitable countries. Furthermore, investments, production, and revenue of the union will increase within the union. Turkey attracts foreign direct investment because of its cheaper labor, relations with the Middle East, the Black Sea, and Asia.

Turkey's levels of foreign direct investment (FDI) have been very low. On average annual foreign direct investment is hardly above €1 billion and it dropped down to it is lowest level in 2002 of only €0.3 billion. However, it is not quite possible to compare Turkey's inflows to the previous candidate countries from central and Eastern Europe. Those countries experienced large privatization programmes while transferring their economies from command economies to free market economies. Foreign investors who correctly predicted their accession to the EU enabled these countries to benefit from larger capital inflows. Potential investors are attracted to Turkish market because of its large workforce and large numbers of potential consumers. Turkey's location also enables investors to have easy access to the Middle East and Caucasus markets.

The EU's concern is whether Turkey would be able to attract FDI levels that are comparable to those of the new member countries. Figure-15 below shows the FDI inflows of the eight new members between 1990 and 2003. The table shows that the level of FDI inflows does not depend on the size of a country. For instance, Poland, which is four times larger in population than Hungary and the Czech Republic, acquire much less FDI than those countries.

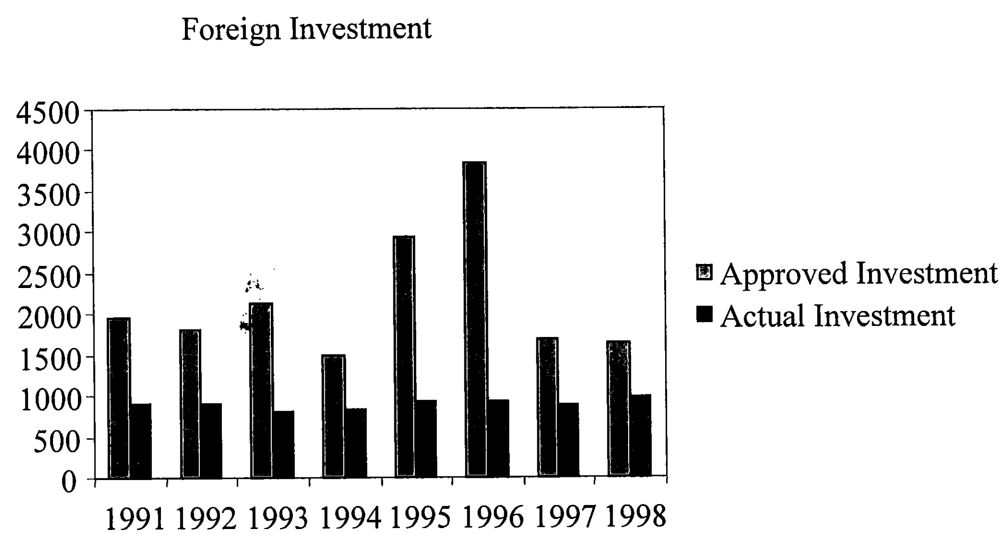
Figure-15: FDI inflows to the eight Central and East European members states, cumulative 1990-2003



Source: OECD,2004

Low levels of FDI in Turkey have been attributed to political and economic instability of the country. The instability causes the risk level for FDI to increase and discourages it. Apart from this, there are also several micro-level obstacles such as bureaucratic barriers, high corporate tax rates, and corruption. In addition, the judicial and court systems are not reliable in making fair decisions, and there are problems in land acquisition, education issues, especially the death of English speaking native people, domestic monopoly power in a number of sectors and the relatively high price of utilities (Hughes, 2004). Even though wages in general are lower in Turkey than in Poland, foreign investors may choose to employ better skilled workers for reasonably higher wages. The lower skill of Turkish workers reduces productivity, which more than offsetting the advantage of lower wages.

Figure-16: Foreign Investment, in million $



Source: Turkish Statistics Institute

Immediately after the establishment of the Customs Union in 1995, approved FDI in Turkey more than doubled between 1994 and 1996. Thereafter, it decreased and returned to levels similar to those before 1995. Actual or realized FDI showed little relation to the establishment of the Customs Union. The expected boom in foreign direct investment after the formation of the CU did not materialize. Furthermore, between 1991 and 1998, actual investments were much lower than approved investments. Some of the causes of the low levels of FDI are the higher wage and/or lower skills of Turkish workers relative to workers in China and other South East Asia developing countries and lower skills relative to the new members of the EU. Another major reason is the lack of

Turkey's access to the EU social funds, European agricultural and insurance funds, as it is not yet a member of the Union.

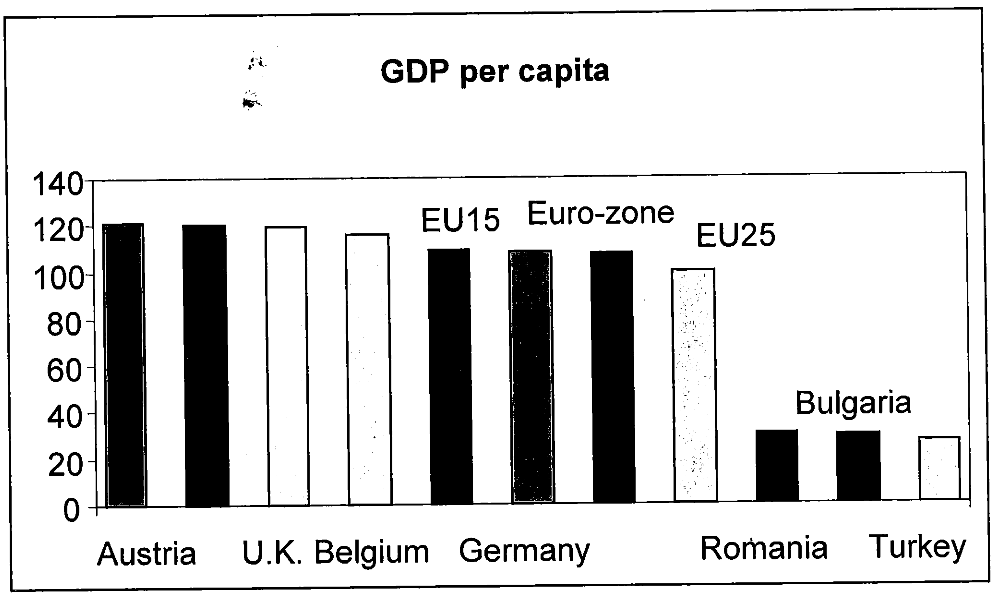
The government has taken significant steps to encourage foreign direct investment in Turkey. In order to reduce bureaucratic barriers, the government introduced new laws aimed to simplify the bureaucratic maze of establishing and registering new companies. It also created a new agency that focuses on improving and analyzing Turkey's FDI levels. However, there is still more to be done in terms of micro-level barriers. Negotiations with the EU are expected to bring back political and economic stability to Turkey but a significant increase in FDI levels cannot be expected unless necessary reforms are implemented. Additionally, developments in privatization and improvement in infrastructure across Turkey will help FDI level to increase as well. Overall, Turkey did not benefit much from the dynamic effects of the Customs Union with the EU in terms of FDI.

4.4. Immigration Effect

Turkey employs almost one third of its total labor force in agriculture. This ratio is higher than in other emerging economies. Migration from rural areas to more rich urban areas has increased in the last ten years. Clear evidence of this immigration is the increase in the number of houses built in one day in large cities without the permission of the municipality. The large urban cities can no longer maintain their growing population. Therefore, Turkey should emphasize more on the development of regional urban centers and services. Meanwhile, the required transformation of the agricultural sector will exacerbate the pressures of Turkish workers emigration towards the EU.

Immigration is one of the most argued issues among Europeans. They fear millions of Turkish laborers will migrate to Europe once free movement of capital and labor is allowed between Turkey and Europe. Immigrants will take away jobs, decrease wages, increase unemployment. Clearly, Turkey will not be allowed free movement of labor by the EU before its income per capita has risen to a level equal or higher than that of the average income in the EU.

Figure-17: GDP per capita expressed in terms of the EU25 average



Source: Turkish Statistics Institute

Figure-17 above shows the difference between income per capita for Turkey and some European Union members. Turkey has the lowest GDP per capita compared to all other European countries. The average GDP per capita of EU25 is almost three times higher that that of Turkey's. On the other hand, a significant increase in Turkey's GDP per capita without full accession of Turkey to membership in the EU is not possible.

Migration from Turkey to Europe will at first affect adversely the welfare of European countries. According to a research done by Togan employment will not be affected much; wages of unskilled workers will decrease, but skilled labor will earn more. The estimated cost to the EU of Turkey's full accession to EU is € 7.8-9.6 billion annually, (Togan, 2004).

Turkey is not expected to experience a significant decrease in its unemployment rate even though economic growth will continue. This is due to the delay in the restructuring of the economy since the 2001 crisis. Skills and education levels of workers are increasing in Turkey. There is a significant increase in the number of graduates from institutions of high-level education. However, the primary and secondary education systems are in need of serious reforms. In rural areas, female participation in education is especially low with rates below 50% as reported in 1999 (Togan, 2004). International organizations like the World Bank helped by introducing programmes aimed at attracting girls to schools. Compulsory education was increased to 8 years in 1997 and many business leaders demand it to be extended to 12 years (Hughes, 2004).

4.5. Invisible Barriers to the Full Realization of Benefits from the CU and to Accession to the EU

Even though Customs Union abolished tariffs and quotas, there remain some barriers to trade. Under Article 44 of the Customs Union agreement, the EU is able to impose anti-dumping measures if Turkey fails to implement the EU type of competition rules and other rules on intellectual, industrial, and commercial property rights (European Commission, 2005). Turkey will also need to develop its infrastructure in order to implement the reforms successfully. A demonstration of conformity requirements has to be established before full accession can be approved. Turkey has been taking major steps toward adjusting its legislation to that of the EU. Nevertheless, it still lags in issues such as standardization, testing, certification, inspection, compliance with rules and EU legislation.

The Customs Union has not been able to affect Turkey's economy significantly because of Turkey's own problems. These problems are macroeconomic and microeconomic problems. The macroeconomic problems of Turkey have been analyzed in the previous section. The most important microeconomic problem of Turkey is the management problems of Turkish companies. It is not reasonable to expect the Customs Union to change everything for the better without Turkish companies adjusting to the competitive market and new CU regulations. Furthermore, the implementation of Turkey's privatization programme has taken a slow pace. Most government enterprises are in need of restructuring and there is room for improvements in private sector governance. Finally, it is hard for Turkey to bear the costs of implementing health, safety and other consumer standards as well as costs from adopting the environmental acquis as integration with the EU progresses. However, one can hope that the Customs Union will benefit Turkey in the end along with the increasing harmonization of its regulations and laws to those of the EU as negotiations progress. With the help of its young labor, geographical situation, and natural resources, Turkey may eventually succeed.

4.6. Rough Estimates of Benefits and Costs of Accession to EU Membership

As part of Turkey's efforts to join the European Union (EU), some of Turkey's companies are investing abroad – both west into Romania and Bulgaria, and East into the Caucasus and Central Asia, benefiting in both directions from lower wages. According to one analyst, 'Azerbaijan is our East Germany' (Hughes, 2004). This outward FDI is taking place in a range of sectors including energy, textiles, glass, automotive parts, chemicals, and construction. Some earlier studies have estimated the benefit to the EU of the membership of each of the ten new member states joining the EU as being between 0.1-0.5 percent of GDP. By 2015, Turkey's membership will likely contribute about 3% of EU's GDP compared to the current figure for the new ten member states of 4.6% (Belke, 2004).

The Netherland Bureau for Economic Policy Analysis estimated the economic impacts of Turkey's accession to the EU. Accordingly, Turkey's accession will result in a 0.8% increase in its GDP, 1.4% increase in consumption and 8.1% increase in exports (Netherlands Bureau for Economic Policy Analysis, 2004). The report predicts a large effect on the textile and clothing sectors. The effects on the European Union of Turkey's membership are much less because of the small size of the Turkish economy compared to that of the EU. There will be a €3.8 billion increase in welfare for the EU, an increase of 0.2% in exports and a 0.1% increase in consumption. The ten new members are expected to experience an increase of 0.3% in exports and 0.2% increase in consumption resulting from Turkey's accession. The Netherlands study also predicts a significant improvement in transparency and a reduction of corruption in Turkey due to the implementation of reforms. With the implementation of reforms, estimates for Turkey show improvements as well. This time Turkey's GDP increases by 5.6% and consumption by 8.9%. Overall, these estimates are small and larger EU benefits would be observed, and if a significant increase in FDI and dynamic scale economy effects were to take place.

4.7. Concerns of Europe

One of the biggest ongoing concerns is the inequality among different regions of Turkey. EU has a number of regional policy instruments, like the Regional Development

Fund, the Social Fund and the Agricultural Guidance and Guarantee Fund. There is a sharp imbalance between the highly active west parts of Turkey and the complacent east and southeast parts of Turkey. The difference in the level of income, education, and infrastructure has led to the migration of many from rural to urban areas.

An important concern of Europe related to the possible membership of Turkey in the EU is that it has a large population and a small economy, which translates as a poor and big country. Accession of Turkey to the EU will be costly. Nevertheless, since Turkey consists of a small sized economy, the accession is not expected to affect the large European market. Turkey's population today is approximately 70 million, by 2015, its population is expected to increase to 82 million, becoming the country with the largest population in Europe. Turkey suffers also from regional inequalities. The poorest regions are located in eastern Turkey where income per head is around one fifth of that in the richest regions of Marmara and Istanbul. Poverty and regional inequalities are the two most important economic challenges to Turkey (Turkey's quest for membership, 2005).

The growing population of the working age is the biggest asset of Turkey. Compared to that of EU members, Turkey's population is younger with 30% of Turkey's population under the age of 15 and 24% between the ages of 15 and 24. Some economists predict that Turkey will experience a "golden age" in five years, with a high ratio of working population, as was previously seen in East Asian countries. Table-4 shows the Turkish unemployment rate (10.6%) is a little above the EU25 average and below that in many of the new member countries like Poland. However, these numbers are only an indication of a more complex labor market. As Table-4 also suggests, the overall employment rate of Turkey, 45.6%, is very low when compared to the 62.8% average of

EU25 countries. The reason behind this fact lies in the low 25.5% employment rates of females compared to the 54.7% average of the EU25 countries. Malta is the only EU member country that has female employment rates closer to Turkey, 33.6%. Most women in Turkey work in the agriculture and textile sectors for businesses that do not pay taxes. Turkey needs to concentrate its efforts on attracting more female workers in order to reach its growth potential. Another problematic area is the high youth unemployment rate, which is higher than the average unemployment rate. The youth unemployment rate was estimated as 16.7% in 2001. The unemployment rate of the urban educated youth is estimated to be still higher. These numbers reflect an economic loss and a social risk created by the unavailability of employment opportunities (Quaisser, 2004).

Table-4: Employment and unemployment rates - EU and Turkey 2002

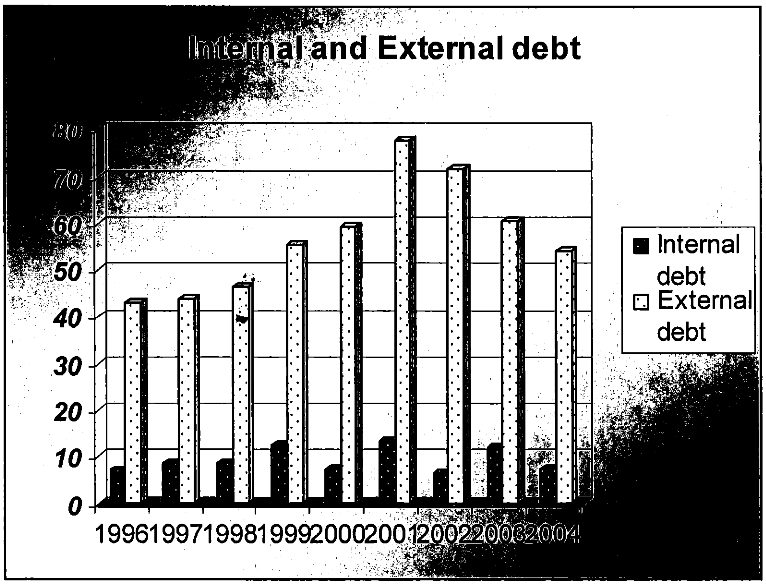
	Total employment rate	Males	Females	Unemployment
Turkey	45.6	65.5	25.5	10.6
Poland	51.5	56.9	46.2	19.9
France	62.8	69.2	56.5	8.7
Greece	56.7	71.4	42.5	10
Malta	54.5	75.3	33.6	
EU15	64.2	72.8	55.6	7.7
EU25	62.8	71	54.7	8.9

Source: EuroStat, 2004

The instability of Turkey's economy after its most recent crisis in 2001 is another concern for European Union. The Copenhagen criteria state that candidates must have established a competitive market. A vulnerable economy prone to financial crises would definitely not be able to meet this criterion. Although Turkey has been able to recover from the 2001 crisis successfully, it has yet to convince the EU that it has implemented the appropriate reforms to strengthen its financial sector ensuring that it is no longer prone to financial crisis.

Another challenge to Turkey's accession to EU membership and to its economic development is Turkey's national debt. Figure-18 shows Turkey's debt figures as a percentage of GDP.

Figure-18: Internal and external debt as a percentage of GDP



Source: Turkish Statistics Institute

Debt figures accounted for 79% of GDP in 2001, which is too high by EU standards. Most of its short-run debt is denominated in foreign currency making its economy highly vulnerable to outside shocks. A sharp decrease in debt figures since 2002 was achieved through the economic reforms supported by IMF loans.

Turkey continues to face several economic problems such as income inequalities, inefficient state sector, and complicated legal and administrative procedures that make it harder for foreign investment to enter the country. The IMF has been assisting Turkey in decreasing budgetary expenditures and undertaking structural reforms, especially in the banking sector.

Conclusion

The establishment of the Customs Union between Turkey and the EU has brought some benefits to Turkey. The evidence analyzed in this chapter suggests that quantitively, the benefits were modest due to the fact that the dynamic effects were weak. Prior to the establishment of the Union, Turkey did not and was not able to change its comparative advantage. Its institutions, legal framework, and most of its infrastructure were inadequate. Its technology lagged behind and suffered from macroeconomic instability and high inflation. Customs Unions are not enough to spur economic development unless the economic and political institutions and infrastructure supported by the movement of labor and capital are all appropriate. In order for the Turkish economy to benefit fully from the Customs Union with the EU, Turkey will need to create appropriate institutions, legal framework, and infrastructure to benefit from the dynamic effects and change its comparative advantage in the appropriate direction.

Fortunately, the Turkish government and public are positive on the idea of Turkey's membership with the EU, the government has been implementing the necessary reforms successfully. Moreover, the EU has agreed to grant Turkey to status of a candidate for membership in the Union. To become a member, Turkey has to satisfy the Copenhagen criteria and the Maastricht criteria. The endeavor to satisfy the criteria will probably help Turkey create the appropriate economic, legal, and political framework to permit the dynamic effects of the Customs Union to work. Turkey does not need to become a member of the EU, but it need to keep aspiring to become one.

Chapter V – Conclusions

Turkey has faced serious financial crises in its recent past, the most recent in 2001. Such instability is inevitably a concern for the European Union; even if Turkey's small size would lessen any future impacts on the internal market or the Euro. Indeed entry into the Euro zone would only be likely some years after EU accession and with many years of financial stability as well as meeting other EMU criteria. However, it is not in the EU's interest to have as a member a country that might exhibit serious financial and economic instability, even outside the Euro. The economic part of the Copenhagen criteria demand that candidates must have functioning market economies and can cope with competing in the internal EU market. An economy prone to regular major financial crises could not be said to meet these criteria.

In general terms, Turkey exports and imports are about 30% of its GDP and the EU is its major trading partner with whom it had a trade deficit in 2003 of €5 billion. Foreign direct investment (FDI) is very low in relation to Turkey's size. Turkey also has a large informal economy; estimates of its size put it between 25-50% of formal GDP. The unemployment rate of around 10% is lower than in many of the 10 new member states. Inflation has come down since 2001 but it remained high until 2004. Turkey is one of the few emerging economies to have experienced very high inflation rates but was able to avoid a hyperinflation. The Turkish inflation fell to single digits, 7.9%, in 2005 for the first time in 30 years. The challenge for Turkey is to maintain a low, sustainable inflation. Turkey's overall sustainability challenge, however, depends on its debt burden of almost

89% of GDP in 2002. Much of this is short-run debt and denominated in foreign currency, making the Turkish economy highly vulnerable to market sentiment and exchange rate fluctuations. IMF loans have supported Turkish reforms since the 2001 crisis and there have been several debates on whether to adopt a new three-year IMF programme in 2005. In spite of existing opposition, a three-year agreement was signed with IMF in 2005. The IMF has been pushing the Turkish government for budget deficit reductions and structural reforms, with reforms in the banking sector seen as particularly important to reduce risks of further problems. Both state and non-state banks are still considered in need of further reform. Meanwhile strict budgetary policies conflict with the need to develop stronger social protection systems and to tackle poverty.

The seeking of membership and opening of the negotiations with the EU would be interpreted by investors as substantially reducing economic and political risk, which would make a significant difference to the sustainability of Turkey's public debt, and allow lower interest rates thus encouraging more investment and growth.

Membership of Turkey in the EU would procure the EU some benefits as well. Turkey has a large market located at the crossroads of the Middle East, the Balkans, and the Caucasus regions, with the potential of linking markets from Asia, the Middle East, and Europe, admitting Turkey into the union is a smart choice for the EU. The EU companies will be able to use Turkey as a joint investment and export base for the Middle East and Eurasia with the adjustment of commercial legislation.

Turkey will also need to participate in the Economic and Monetary Union in order to fulfill the requirements of the Maastricht criteria. Turkey will not be allowed to adopt the Euro without completing the convergence criteria of the Monetary Union, which requires price stability, interest-rate convergence, budget deficit, government debt and exchange-rate stability.

All evidence suggests that Turkey is certainly in need of restructuring its economy. An analysis of Turkey's trade balance in Chapter II showed the unbalanced and unsatisfactory state of Turkey's export structure. The European Union is Turkey's largest export partner however Turkey does not have a comparative advantage in most of the goods with high-income elasticity that the EU imports. Therefore, Turkey's perspective of its exports to the EU is large, where as from the EU's perspective of Turkey's imports, it is very small. The Customs Union between Turkey and the EU is designed to integrate the Turkish economy with the world, however the improvements in world trade take place with products that Turkey does not have a comparative advantage. In order to improve its trade pattern and take advantage of potential membership in the EU, Turkey will have to change its areas of specialization to products with high-income elasticity of demand that make up the bulk of EU imports. The European Union imports mostly electronic machinery, furniture, plastics, information technology, and machines that require more advanced production techniques that are developed through more technology. Since Turkey lags behind in technology among all members of the EU, it will be difficult for Turkey to operate the necessary switch in its export structure in the near future. Additionally, Customs Union is not beneficial if Turkey is unable to voice its concerns in joint meetings with other EU members. Initially Turkey signed the Customs Union agreement willingly; however, adjustments made in the agreement over time have been imposed on Turkey.

High levels of FDI are generally translated into a transfer of technology from a multinational corporation to domestic firms. Multinational corporations are more skilled in areas that enable them to compete with domestic firms. As more foreign firms enter the market, domestic firms are forced to compete and improve efficiency. Moreover, domestic firms can learn about new products, new production processes, new marketing techniques, and organizational skills. If all technology transfer takes place successfully, then domestic firms will improve their efficiency and productivity.

Turkey's foreign direct investment figures have been much lower even after the declaration of its candidacy to the EU. Low levels of FDI have been linked with Turkey's unstable economy and the unwillingness of foreign investors to invest in Turkey. The implications of this fact to Turkey are low levels of technology transfer and no improvement in market competition. Since fewer multinational firms enter the market, the benefits from belonging to the CU are much less than expected; additionally, domestic firms are unable to improve their technological expertise, their efficiency, and therefore their overall productivity.

A major reason for Turkey's unstable economy is its troublesome banking sector. Recent reforms undertaken by the current government have helped Turkey's banks recover from the 2001 crisis. However further improvement is still required in this area. A healthy capital formation is an indicator of a stable financial sector, which is essential for more growth. One of the requirements for EU membership for Turkey is to stabilize its financial sector and strengthen it to a level similar to that enjoyed by EU members. A strong financial sector would also attract more investment from foreign countries. Turkey's financial sector is in the process of stabilization and implementation of more EU laws and regulations that will strengthen it.

Evidence of lack of technological improvement in Turkey is derived from the analysis of Turkey's imports in chapter IV. The analysis suggests that Turkey continues to import high levels of intermediate products. Imports of intermediate products consist mostly of partially finished goods; they are mostly labor intensive, primitive, and non-technology based. Therefore, it is not surprising that Turkey cannot benefit much from a potential technology transfer by liberalizing its imports.

Appreciation of economic growth and change in economic policy should not be limited to the estimation of their effects on consumer welfare. The Customs Union with the EU is not enough to speed up economic development in Turkey because of the limited technological improvement in several economic areas. The main reason behind the slow improvement in Turkey's economy is linked directly to the absence of significant technological improvement.

In order for Turkey to benefit fully from the Customs Union and possibly membership in the European Union, it has to concentrate more on research and development, information technology, information transfer, education and joint ventures with foreign firms that are willing to transfer high technology. Privatization should continue to free industries from political interference, productivity of the private sector should increase, and necessary infrastructure should be built.

However, before any of these can bear fruit, Turkey has to stabilize its economic and political situation. A stable economy will encourage domestic producers and attract foreign direct investment that would produce more capital-intensive products and therefore bring in significant technological improvement. Since it accepted Turkey's candidacy in 1999, the EU has been assisting it achieve a stable economy. Turkey's economy may finally prosper and possibly achieve membership in the EU with the implementation of more EU regulations and fulfillment of the remainder of the membership criteria.

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