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YEDİTEPE UNIVERSITY
GRADUATE INSTITUTE OF SOCIAL SCIENCES

IMPACTS OF CUSTOMS UNION MEMBERSHIP OVER EU ORIGINATED CAPITAL INFLOWS TO TURKEY

by

Erhan Abdullah KANAT

Submitted to the Graduate Institute of Social Sciences
In partial fulfillment of the requirements for the degree of
Master of
Business Administration

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LIST OF ABBREVIATIONS

CAP	Common Agricultural Policy
CCP	Common Commercial Policy
CCT	Common Customs Tariff
CGE	Computable General Equilibrium
CEEC	Central and Eastern European Countries
CU	Customs Union
EC	European Commission
EEA	European Economic Area
EEC	European Economic Community
EFTA	European Free Trade Association
EMU	Economic and Monetary Union
EU	European Union
FCA (YASED)	Foreign Capital Association
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GNP	Gross national Product
ICC	International Chamber of Commerce
ICI (ISO)	Istanbul Chamber of Industry
IFC	International Finance Corporation
MFA	Ministry of Foreign Affairs
NAFTA	North American Free Trade Agreement
OECD	Organization for Economic Co-operation and Development
SAD	Single Administrative Document
UNCTAD	United Nations Conference on Trade and Development
UN	United Nations
VAT	Value Added Tax
WSSD	World Summit on Social Development
WTO	World Trade Organization

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PREFACE

The entry of Turkey into force of Customs Union with the European Union on January 1, 1996 is seen by many people as a further important step in the process of strengthening the ties between Turkey and the European Union.

Customs Union is a major challenge for Turkish businesses. New opportunities open up for some in the short-term but for many the immediate challenge is to adjust to competition.
The Turkish private sector has shown in the past that it can core with competition in external markets. It now will have to adjust to more in its home market. The important state sector, however, will clearly encounter more difficulty in face of increased competition.

Customs Union Decision includes provisions, which go far beyond a mere trade agreement. But it is difficult to say that the potentiality of these provisions is used in full with a mutual understanding of solidarity to reap the whole expected benefits.
I hope that this study, which evaluates the topic in detail by empirical methods, shall constitute a reference document.

Finally i would like to take this opportunity to thank my advisor Prof.Dr. Ahmet Serpil.

ABSTRACT

There had been various discussions over both the advantages and disadvantages of becoming a member of the Customs Union for Turkey. While these discussions mostly focus on the changes in the volume of foreign capital inflows, omitting conjectural changes, possible consequences of such integration had not been thoroughly analyzed and expressed. This study attempts to shed light on this issue by investigating Turkey's capital inflows before and after the Customs Union Agreement. Meanwhile, this paper takes also explicitly into considerations concurrent changes in the macroeconomic environment that could have affected Turkey's capital inflows as well as other countries'.

Capital inflows plays a crucial role in economic development of nations, ranked at any level, (either the developed, or the developing or the under-developed) through transfers of technology, improvements of efficiency and increases in foreign trade volume. Nowadays in the world, where globalization is a very important determinant, FDI is especially important for emerging economies like Turkey.

Turkey has a number of strengths that separate it from its neighboring countries such as a strategically advantageous location, a large and growing domestic market, and a strong potential for economic growth. However, chronic high inflation, unstable politic and social environment and a weak-banking system have inhibited Turkey's ability to attract substantial levels of investment. Considering the recent trend of economic and political instability, Turkey could not offer demanded adequate market conditions to foreign investors and the exaggerated optimistic expectations of related government agencies over the so-called ''boom'' of foreign capital inflows did not realize.

Finally, even though Turkey has integrated with the most powerful economic union (partly in its Customs Union Organization) in the world starting from 1996, our statistical datas and findings indicate that Customs Union Agreement did not have remarkable impacts on Turkey's capital inflows from the EU countries and the forecast foreign investment amount did not occur.

Key Words:
Customs Union
Foreign Capital
Capital Inflow
European Union
Turkey

ÖZET

Türkiye'nin Gümrük Birliği'ne girmesinin getirdiği avantaj ve dezavantajlarla ilgili birçok tartışma yaşandı. Bu tartışmalar konjonkturel değişimleri hesaba katmadan yabancı sermaye akışı hacmindeki değişiklikler konusunda yoğunlaşmışken, bunun olası sonuçları o zamanlar ne yazık ki layıkıyla analiz edilip, ifade edilmemişti. Bu çalışma bu konuya ışık tutmak amacıyla Gümrük Birliği'ne üyelikten önceki ve sonraki, Türkiye'ye giren yabancı sermaye akışını incelemektedir. Bu inceleme esnasında özellikle bu dönemde, Türkiye'de olduğu gibi dünyanın diğer ülkelerine giren sermaye akışını da etkileyen makroekonomik çevredeki, aynı zamanda oluşan, değişimleri de dikkate alır.

Gelişmişlik düzeyi ne olursa olsun (gelişmiş, gelişmekte olan veya az gelişmiş) , yabancı sermaye akışı; teknoloji transferi, verimlilik iyileştirme yöntemleri ve dış ticaret hacim artışları yoluyla ülkelerin ekonomik gelişmelerinde hayati bir rol oynar. Bugünlerde globalleşmenin çok önemli olduğu dünyamızda, yabancı yatırım Türkiye gibi gelişen ekonomilerde özellikle önemlidir.

Türkiye'nin komşularına kıyasla avantajlı stratejik konumu, gelişmekte olan büyük bir iç pazarı ve kuvvetli bir ekonomik potansiyeli gibi kuvvetli yönleri vardır. Ama kronik yüksek enflasyon, politik ve sosyal istikrarsızlık ve zayıf bankacılık sistemi, Türkiye'nin yabancı sermaye çekmesini engellemiştir. Süregelen ekonomik ve politik istikrarsızlık da göz önüne alındığında Türkiye yabancılara, yatırım için istenen cazip koşulları sunamamıştır ve ilgili devlet kurumlarının iyimserce beklediği dış sermaye akışında "patlama" gerçekleşmemiştir.

Sonuç olarak Türkiye 1996'dan itibaren dünyanın en güçlü ekonomik birliğinin gümrük bölümüne üye olmuş olmasına karşın, istatistik veriler ve bulgular Gümrük Birliği'nin Türkiye'ye, Avrupa Birliği üyeleri kökenli belirgin bir sermaye akışını getirmediğini ve beklenen miktarda yabancı yatırımların gerçekleşmediğini göstermektedir.

Anahtar Kelimeler:
Gümrük Birliği
Yabancı Sermaye
Sermaye Akışı
Avrupa Birliği
Türkiye

1. INTRODUCTION

On January 1st 1996 the Customs Union between the European Union and Turkey came into effect, thereby the closest economic relationship between the EU and any non-member country created. The Customs Union implies fundamental changes in the Turkish trade and competition legislation and policies, and creates new opportunities and challenges for the Turkish economy. The decision of Turkey-EU Association Council to establish a Customs Union between Turkey and the EU was the most important development affecting Turkish economy as a whole, since the liberalization measures in the 1980s. Our study, primarily dwells on the effects of Customs Union on the Turkish economy concerning the capital inflows into Turkey by main economic indicators.

The Customs Union between the European Union and Turkey marks a significant turning point in the history of the relationship. From the point of view of commercial relations within this new Customs Union and with the rest of the world, Turkey is no longer an outsider but an insider. This means we must take not only a mechanical adjustment to the new arrangements but a political and psychological adjustment. The Customs Union is not merely a trade arrangement, it has bedrock political and strategic implications for the region and for Europe as a whole. With the entry into force of the Customs Union, Turkey has eliminated all customs duties and charges having equivalent effect, as well as quantitative restrictions applied on imports of industrial products from the Community. For products imported into Turkey from third countries, Turkey started to apply the rates of protection specified in the common external tariffs. In the field of the adaptation of Turkish legislation to the competition policy of the EC, a great degree of progress has been achieved.

The Customs Union which was achieved between Turkey and the European Union at the beginning of 1996 is the fulfillment of a long process, and a decisive step in fully integrating Turkey with the European Union. The process started out in 1959 when Turkey asked to negotiate an association agreement with the European Economic Community (EEC). Turkey has always been a part of all the European institutions and particularly since the post Second World War era. Therefore, this decision is simply reflecting Turkey's long standing vocation for integrating itself further with Europe.

Actually, the Association Agreement signed in Ankara in 1963 between Turkey and the EEC is the oldest existing in the external relations of the European Union. This Agreement envisaged three progressive stages for the integration of Turkey to the Community. The first one was the preparatory stage. The transitory period governed by the Additional Protocol, based on a Customs Union which ended up in 1995 through a balanced scheme of reciprocal obligations, is the second stage. It is followed by the final stage. According to the Agreement, the Community undertook to assist in improving the economic conditions in Turkey. This was to be done in order to reduce the disparity between the Turkish economy and the economies of the member states of the EC, thus facilitating the accession of Turkey to the Community. During these stages the EC was to also provide financial assistance necessary for Turkey to fulfill its obligations. Moreover, the Community assumed counterbalancing duties in the social and agricultural fields with a view to compensate the opening of the comparatively weaker Turkish market.

The close relations between Turkey and the EU continued to progress throughout the years despite international and local economic and political challenges. Due to these challenges, both sides were sometimes forced to postpone some of their respective obligations. These delays and the changing conditions brought Turkey to accelerate the implementation of Article 28. Indeed, in April 1987, in an effort to deepen relations, Turkey applied for full membership. In December 1989, the European Commission issued an Avis which stated that, although Turkey was eligible for full membership, the conditions were not yet ripe. Subsequently, both parties agreed to first complete the Customs Union on time as provided for in the Association Agreement, and to anticipate the implementation of the third stage during which full integration of the two economies would be carried on, by broadening its content and scope in line with the recent achievements inside the EU. Negotiations to this end which began in 1993 ended with the decision concerning the Customs Union on March 6, 1995. In this context, the Association Council also adopted a resolution for further developing relations with Turkey in various fields through the establishment of a political and institutional dialogue. In accordance with its declaration made at the Association Council, the European Union also undertook to put in force a financial co-operation in order to allow Turkey face with the increased competition and to adapt her industrial sector to the new situation. Turkey for her part adapted its legislation to Community standards in all areas relevant to the functioning of the Customs Union. Subsequently, the European Parliament gave its assent in December 1995 and for all practical purposes the Customs Union came into effect on January 1, 1996.

Although it is much too early to make a through assessment, the Customs Union currently seems to function in the economic field without major difficulties. The Customs Union Joint Committee set up under the Customs Union decision held its first meeting on February 19, 1996, and took up a number of relatively minor issues related to the operation of the Customs Union. However, financial cooperation has yet to begin, being held off for alien political reasons to the association brought up by one member country. This is a legal obligation of the European Union and should be solved accordingly to permit the Customs Union to function smoothly. On the other hand, the broadening of political and institutional dialogue is yet to materialize.

The Customs Union is a reciprocally profitable development which is expected to have an important economic and political impact in and around Turkey and for the EU. It constitutes an additional step for the integration of Turkey with Europe after decades of her participation in political, military, defense and economic organizations. In short, it is not an end in itself but a significant prelude towards the basic aim of the Association Agreement. The smooth functioning of the Customs Union will surely pave the way to the full integration of Turkey to the European Union.

In terms of trade in industrial goods and processed foods, Turkey is a full partner of the European Union. Services are not included, nor is agricu1ture. These gaps should be resolved over time. But the trading relationship alone, even before the Customs Union was completed, put Turkey at 10th position among the European Union's worldwide trading partners, and far ahead of any other Mediterranean country. Moreover, Turkey has for years received two thirds of its foreign private capital investment from the European Union - some of it non-European capital based in Europe. Both trade and investment should increase substantially. Mergers and acquisitions, joint ventures, business cooperation of all forms - including services - should flourish. Turkey is increasingly known as one of the Big Emerging Markets and there are huge gaps - or rather huge opportunities - for enterprising business, industry and services to fill. Energy experts expect demand, and therefore the economy as a whole, to double over the next

20 years. Moreover, Turkey is a resilient environment in which to operate. With macro-economic difficulties which await structural reforms to bring down domestic debt, interest rates and inflation, Turkish business and industry nevertheless persistently demonstrate dynamism and an increasingly wide-ranging and export-oriented innovation. This also means that much opportunity for industrial skills not yet fully developed in Turkey; in financial engineering, especially for small and medium sized enterprises, the technological base, packaging, marketing, remains to be seized.

The Customs Union confronts both the European and the Turkish business community with a variety of new legislation, particularly in the fields of standards, protection of intellectual and industrial property including patents, design and copyright and European competition law. There is almost a complete lack of the legal expertise and much room for consulting services in Turkey, and for the Turkish market in Europe. Although the European market has been open to Turkish businessmen for the past 22 years, the recent rash of complaints about visas for Turkish businessmen, a problem which the Member States are addressing, indicates that the opportunities are not perceived one way. The Customs Union will build up new networks, new business, new familiarity in trade, investment, personally and psychologically both ways.

2. HISTORICAL BACKGROUND

2.1 History of the negotiations

The Association Agreement between Turkey and the European Union (EU) was signed on September 12, 1963 and it came into effect on December 1, 1964. This agreement, which has the final objective of full membership of Turkey to the EU, aims at promoting the continuous and full strengthening of trade and economic relations between Turkey and the EU.

According to this agreement the association would comprise:

- preparatory stage
- a transitionary stage
- a final stage

An Additional Protocol was signed on November 28, 1970 and came into effect on January 1, 1973. It describes the steps and technical requirements to achieve the Customs Union between Turkey and the EU.

According to the Additional Protocol, the EU abolished all tariffs imposed on Turkish exports of industrial goods in 1973. On the other hand, Turkey was to reduce the tariffs imposed on the industrial goods originating in the EU to zero over a 12 year period for some products and a 22 year period for others. Turkey was also to align its customs tariffs towards third countries to the Common Custom s Tariff (CCT)[*] of the EU. As a result of political instability in Turkey, there have been several cutbacks in the relations and Turkey could not fulfill its obligations as to the tariff reductions. The essential part of the reductions were achieved during the mid-1980s. The Customs Union between Turkey and the European Union gained momentum with the Association Council[**] meeting on 9 November 1993. With this meeting, the work program on the Customs Union was ratified.

According to this work program, the main targets to achieve were:

- Free circulation of goods between the EU and Turkey also including the provisions applying to processed agricultural products,
- Cooperation in regard to adaptation to the Common Agricultural Policy and provisions for reciprocal preferential market access,
- Application of common trade policy meaning Common Commercial Policy (CCP), preferential policies and agreements and sectoral policies,
- Customs cooperation,
- Trade related service s and others (telecommunications, financial services, transport, tourism),
- Approximation of trade related legislation,
- Institutional provisions,
- Financial issues and investment promotion

[*] CCT: the common customs tariff imposed by European Union member states on imports coming from third countries

[**] Main decision making body established with the aim of dispute settlement and decision making on the Customs Union issues -composed of European Commission and Turkish government representatives - meets at least twice a year

It was also decided that the Steering Committee* meetings would be held once a month, a final draft would be prepared and submitted to the Association Council which would meet at the end of 1994. The Customs Union would be decided based on this draft.

The Association Council meeting in December 1994 ended with no decision on the commencement of the Customs Union between Turkey and the European Union. The reason was not due to disagreement over details of the Customs Union itself but rather to a political manoeuvre by Greece having as excuse its concerns over human rights in Turkey and asking or a definite schedule for full membership for Cyprus. Both sides, the European Union and Turkey, agreed upon most of the technical issues concerning the Customs Union.

Finally, the agreement was ratified at the Association Council meeting held on 6-7 March 1995 and approved by the European Parliament on 13 December 1995. The agreement came into force on 1 January 1996. (Kabaalioğlu, 1996)

2.2 Content of the Agreement

Turkey is the only country which enters into full Customs Union with the EU without being a full member. As it is a unique case for the EU, there are several issues other than the tariff reductions where Turkey and the EU agree to cooperate.

The agreement covers the achievement of a full Customs Union between the EU and Turkey for industrial and processed goods. This indicates elimination of customs duties for goods originating in the EU and alignment of Turkish custom s duties towards third countries to the CCT of the EU.

There are minor derogations from the original agreement. For example, with the Association Council decision on 6-7 March 1995, Turkey has been granted a five year transition in adoption to CCT for the products identified as sensitive. Some of these products are gasoline, fuel oil, some types of heavy goods and vehicles. This list has recently been modified. Accordingly goods such as steel rope, motorcycle, bicycle and furniture are included in the list of sensitive goods and craft paper whereas goods such as petroleum products were excluded. There is also a transitional period of one to three years in reduction of the industrial protection

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* The mixed committee composed of technocrats from both Turkey and the EU with the aim of designing the technical aspects of the Customs Union.

on processed food and exemption of used cars from the Customs Union, The agreement leaves the opportunity of imposing anti-dumping duties with the procedure of early warning.
For electronic goods such as TVs, tape recorders, refrigerators etc. manufactured in Turkey, in case that there are third country originated components used, the CCT will be determined and a compensating duty will be imposed on the exports into the EU.
Agriculture is not included in the Customs Union process. According to Art. 32-35 of the Additional Protocol, adaptation to the Common Agricultural Policy (CAP) of the EU is scheduled only after the Customs Union came into effect on 1 January 1996. According to the decision of 6-7 March 1995, an additional period is necessary for the free circulation of agricultural goods between the signatories. In the meantime, Turkey will adjust its policy in order to adopt the common agricultural policy measures for the free movement of agricultural products. This will take at least ten years for the full customs union on agricultural products.
The most striking aspect of the Customs Union between Turkey and the EU is the fact that Turkey will be considered on the same ground as the Union members especially on economic and commercial issues and will act like a full member. That will bring many obligations to be fulfilled by Turkey. It will also have to adopt its trade policy towards third countries in line with the EU's foreign trade policy.
Another important aspect is that Turkey has to adopt its internal policies like competition policy, intellectual and industrial property rights, patent and trade mark legislation, harmonization of standards, non-discrimination in taxation and in export and in investment incentives to that of the EU policies.(Erzan and Filiztekin, 1998)
The legislation on intellectual and industrial property rights has already been adopted in June 1995. According to this, any artistic production, including software, are totally protected under this law. Several decrees have been issued related to the Turkish Commercial Law, patent rights, protection of commercial brands, industrial design and geographical indications. Although the necessary legislation has been adopted, Turkey could not achieve any progress yet on the implementation of these legislation because of problems in establishing the necessary executive committees.
In terms of harmonization of technical standards, Turkey has a transitional period of five years until 31 December 2000 to apply EU standards. Accordingly, Turkey will have to allow EU

products that conform to EU technical standards to enter the Turkish market*. Turkish products will have to prove conformity to EU legislation in one of the EU Member States.

In terms of aligning its commercial policy to that of the Common Commercial Policy of the EU, Turkey has a transitional period of five years until 31 December 2000. Within this period Turkey is to conclude preferential trade agreements such as Generalized Preferential Agreements with third countries which have preferential access to the EU market. (Somsag,1996)

2.3 A Customs Union Or A Free Trade Area?

There are several different degrees of customs integration and of organizing economic cooperation. Two common ones are Customs Unions and free trade areas. How do they differ? Why one and not the other?

A free trade area is used when countries wish to bring together their economies but not to integrate them or turn them into a single economy. Some free trade areas include the European Economic Area (EEA) and European Free Trade Association (EFTA), and the North American Free Trade Agreement (NAFTA) between the USA, Canada and Mexico, Mercosur in Latin America and Caricom in the Caribbean.

The aim is to partly, or in the end, to totally, eliminate customs duties and restrictions to trade between them. But, as each member of a free trade area keeps its own customs tariff and commercial policy in force towards outsiders, rules are needed to determine which goods inside the area can move freely from one member country to another: basically, origin rules.

Customs procedures have to be kept for consignments crossing the internal borders to see if the rules are met. (Smith, 2000)

A Customs Union goes further, and aims at economic integration with no internal border restrictions (but different internal sales taxes hinder this);

all members of a Customs Union apply a common customs tariff and commercial policy towards third country goods so no rules are needed to determine which goods inside the union can move freely and no origin rules are needed; thus no internal frontiers are needed for customs or external trade purposes. A common customs tariff enables the application of

* However, as the institutional framework in Turkey is not ready yet to apply the EU standards.

common policies vis-à-vis non-members. The economic integration within the Customs Union can be far-reaching.

The single market entered into force in 1993, really ensuring the four basic freedoms: free circulation of goods, persons, services and capital in a frontier-free internal market. This single market abolished the role of customs collecting excises/VAT between the Member States and allowed the real Customs Union underlying the Community to become apparent to all.

In 1994 the customs code consolidated all of the Community customs legislation into a single text and set up a framework for the Community's import and export procedures. The underlying principle was that the procedures should avoid the interruption of trade flows by establishing the right balance between the freedom of trade and the responsibility of traders on the one side and the necessity of control on the other. (El-Agraa, 2000)

The single internal market serves as an engine for greater harmonization in a variety of customs and non-customs areas. As a consequence of this economic integration, not only has the Community become the world's most important trading partner with third countries, intra-Community trade has also grown considerably.

The single market, securely based on the Customs Union, is the foundation on which EU initiatives on policies for growth, competitiveness and employment can be based.

The single market serves as a catalyst in the strategy for economic expansion of the EU. This would not be possible without the existence of the Customs Union and its principle of free circulation of goods. (Stan, 1999)

Upon entry into force of the Customs Union Decision, Turkey cut all duties and equivalent charges on imports of industrial goods from members of the EU to zero. Furthermore, Turkey harmonized its tariffs and equivalent charges on the import of industrial goods from "third countries"* with the Common External Tariff of the EU, and will progressively adopt EU commercial policy and preferential tariff policies within 5 years. For certain specifically identified sensitive products Turkey will maintain rates of protection above those specified in the Common Customs Tariff for imports originating in third countries for up to five years. These products include mainly ceramic products, motor vehicles and footwear.

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* The countries which don't have membership in EU.

As a result of these measures Turkey's weighted rates of protection for imports of industrial products have fallen from 5.9% to 0% for products originating in the EU and EFTA and from 10.8% to 6% for products originating in third countries. These rates will drop further to 3.5% after the fulfillment by the EU of its commitment under the Uruguay Round of GATT. Although agricultural products are excluded from the treaty, Turkey is progressively adopting many aspects of the Common Agricultural Policy. The EU will take as much account as possible of Turkish agricultural interests when developing its agricultural policy. Progressive improvement, on a mutually advantageous basis, of the preferential arrangements for the trade in agricultural products is also envisaged. (Hallet, 1996)

Harmonization work so far with the EU's commercial policy includes monitoring and safeguarding measures on imports both from the EU and third countries, the management of quantitative restrictions and tariff quotas and the prevention of dumped and subsidized imports.

Turkey has adopted EU rules and legislation on competition. Subsidies through State resources in any form whatsoever which distort or threaten to distort competition are banned. However assistance to promote economic development in Turkey's less developed regions and assistance intended to promote cultural and heritage conservation and which does not adversely affect competition will be allowed. On the other hand Turkey will progressively adjust any state monopoly of a commercial character so as to ensure that no discrimination exists in the conditions under which goods are produced or marketed between nationals of EU member countries and Turkey.

Turkey has harmonized its laws with EU legislation eliminating technical barriers to trade. There is now effective co-operation between Turkey and the EU in the fields of standardization, calibration, quality, accreditation, testing and certification.

Turkey has harmonized its legislation on intellectual, industrial and commercial property to EU standards and has implemented laws covering consumer protection, and the protection of competition. Both sides are banned from using internal taxes as indirect protection mechanisms and from using tax rebates as export subsidies. (Bac,1996)

3. THE TURKISH ECONOMY IN GENERAL

3.1 Developments in the Turkish economy concerning the macroeconomic development

After the collapse of the Ottoman Empire in the early 1920's, a new leadership tried to rebuild the Turkish economy. Much was borrowed from the Soviet model, right down to production plans and an emphasis on the development of heavy industry by state enterprises. During the 1960's and 1970's, state policy was still inward-looking, excessively protective for the own industries and based on state-run companies. This led in the late 1970's to a cease in economic growth, a contraction of industrial production and an inflation rate to over 100%. In response to this in the early 1980's, the first serious efforts were made to move the country towards a market economy with an international exposure. An ambitious program was launched to reduce subsidies and price controls, deregulate interest rates, privatize state enterprises, and liberalize trade.

We observe a steady growth during the first halve of the 1980's, with annual growth rates that run up to 10%. Since then, there is greater volatility in the economic development. Years of high growth are followed by years of stagnation. In 1994, Turkey ran into serious problems with its public finances, causing a contraction in production. In 1999, a new deterioration of public finances emerged, accompanied by another decline in GDP. This was followed by the banking crisis of 2000-2001, causing a collapse of the exchange rate. From 2000 to 2001, the level of GDP measured in US$ dropped from 201 to 147 billion US$, a decline of 27%.

The unstable development in GDP during the last two decades has been accompanied by high rates of inflation. Between 1988 and 1993, inflation was never below 60% and peaked at 106.3% in 1995. In recent years, inflation slightly declined. In 2002, a rate of 29.7% was the lowest of the last two decades. (OECD, Economic Surveys, 1999)

Poor public finance management has played an important role in the crises of Turkey. In fact, various semi-autonomous budgetary funds are responsible for public expenditure programs. These funds have a high degree of autonomy but face soft budget constraints. This has led to large problems in public finances on several occasions. For instance, the IMF reports a public sector deficit in 1999 up to 24% of GDP, partly because the government took over a number of bankrupt commercial banks. As a result, the crisis was accompanied by an increase in the debt/GNP ratio from 51% in 1999 to 96.7% in 2001. Except for the debt increase, the contraction in GDP also contributed to this increase of nearly 50%-points.In response to these problems with its public finances, Turkey, in cooperation with the IMF, has launched a reform program to close down various funds, privatise state enterprises and reform the financial sector. Outside pressure, i.e. induced by the prospect to become EU member, may help to obtain these objectives. (Bekmez, 2002)

3.2 Current situation in Turkey

3.2.1 Key economic indicators

Table 1.1 shows some key economic indicators of the Turkish economy in 2003. The table compares these indicators with the EU-15, the countries that will accede to the EU in 2004 (Accession-10), and Bulgaria and Romania. We see that Turkey is a relatively large accession country. Its size in terms of population (more than 68 million people) approaches that of the Accession-10 and exceeds the size of each current EU Member State, except for Germany. The Turkish accession would imply that the EU population would increase by more than 17%.

Table 1.1 Key economic indicators for Turkey in 2000, compared with other regions

	Population (millions)	GDP (current bln. US$)	Per capita GNI (PPP in % EU-15)
EU-15	376.3	8325	100
Accession-10	75.1	330	44
Bulgaria	7.9	12	23
Romania	22.4	33	27
Turkey	68.6	199	30

Source: World Bank (2003a).

In terms of GDP, the accession of Turkey would imply a more modest expansion of the EU. Indeed, GDP would rise by 2.2% of today's level of GDP in the EU-15. The Turks thus earn a much lower income per capita than the average EU citizen. Expressed in terms of purchasing power parities, gross national income per capita in Turkey is only 30% of that in the EU-15. This income is of a similar level as in Romania and somewhat higher than in Bulgaria. It is, however, below the average level in the Accession-10, which is 44% of the EU-15 average in 2000. The unemployment rate in Turkey was 8.5% in 2000*.

3.2.2 Trade Relations

Trade liberalization has been an important aspect of Turkey's economic policy since the early 1980's. It led to the formation of the Customs Union between Turkey and the EU in 1995, which covers trade in industrial goods and processed agricultural products. The agreement with Turkey goes beyond a normal Customs Union, though. It also covers the harmonization of technical legislation, the abolishment of monopolies and the protection of intellectual property. Moreover, negotiations have been started on the mutual opening of the public procurement markets, liberalization of trade in services, and the abolition of restrictions on the freedom of establishment. These latter policies would prepare Turkey for membership of the EU. Trade liberalization has intensified economic integration of Turkey and the rest of the world. To illustrate, whereas the sum of imports and exports as a share of GDP was still only 18% in 1980, this share has increased to almost 50% in 1999.

Table 1.2 shows the openness of Turkey and other accession countries in terms of their export/gdp ratio. Openness depends not only on trade policies, but also on other factors like the sectoral structure and the size of the economy. In particular, large countries are generally less open to trade than small countries. Table 1.2 shows that Turkey, being the largest country in the table, is least open. It exports slightly more than 21% of its GDP. For an average country in the EU-15, this share is almost 28% and in the Accession-10 almost 38%. Bulgaria features a high share of more than 60%. A relatively low degree of openness implies that a trade increase due to the internal market has less effect on the total economy than for countries with a higher degree of openness.

Most European countries export only a small part of all their goods and services to Turkey. Indeed, the average export share of the EU-15 to Turkey is 1.2%. This share is four times smaller than for the other accession countries, which feature an average export share of around 5%. An average Accession-10 country has Turkey as a destination for only 0.5% of all exports.

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* Note that 2001 crises reduced the welfare level in Turkey measured in US $.

Being neighboring countries, Bulgaria and Romania bring 10.3% and 6.1% of their exports to Turkey, respectively. The final column of table 1.2 shows the export shares with a destination in the EU-15. We see that, similar to Accession-10 and Bulgaria and Romania, the majority of all exports from Turkey are transported to the EU-15. This reflects the agreement on the customs union between Turkey and the EU, which has intensified economic integration between these regions since 1995. Irrespective of the degree of openness, the integration of Turkey with the EU is somewhat less advanced compared to the EU-15 and the Accession-10. The reason is that various trade between Turkey and the EU-15 have maintained, despite the

Table 1.2 Trade relations, 2003

	Export in % of GDP	Export share to Turkey	Export share to EU-15
EU-15	27.9	1.2	62.1
Accession-10	37.8	0.5	59.1
Bulgaria	60.2	10.3	51.7
Romania	26.9	6.1	64.0
Turkey	21.4	-	52.3

Source: IMF, Directorate of Trade Statistics 2002.

Customs Union. In particular, Turkey still has to take and implement measures concerning the removal of technical barriers to trade, harmonize commercial policy, align to the preferential customs regime, and abolish state monopolies and state aid*. A part of these measures is related to the institutions in Turkey. Hence, there is room for further integration if Turkey would indeed conform to all the rules of the internal European market and is able to reform its institutions. (OECD, International Direct Investment Statistics Yearbook,2003)

3.2.3 Sectoral Structure

Table 1.3 reveals how total value added in Turkey is divided between fifteen different sectors. It shows value-added shares in percent of total value-added for Turkey, the Accession-10, Bulgaria, Romania and the EU-15. We see that the Turkish economy features a relatively large share of value added in Agriculture of 14.2%. This share is smaller than that for Bulgaria and Romania, where the Agricultural sector comprises 28.2% and 19.3% of total value added,

* At the end of 2000, the EU Embassies' Commercial Counselors in Ankara reported to Brussels several problem areas, varying from excessive bureaucracy to difficulties in applying the requirements of the Customs Union.

respectively. It is much larger, however, than in the Accession-10, where the Agricultural sector is responsible for 6.9% of value added, and the EU-15 where it is only 2.5%.7 One reason for the large agricultural sector in Turkey is the substantial amount of agricultural support by the Turkish government. In particular, transfers to farmers run up to 5% of GDP. In addition, there are guaranteed output prices, import protection, export subsidies, subsidized services to farmers and sometimes state involvement in supply. Under pressure of the WTO and with the prospect of future accession to the EU, Turkish agricultural policy is now being gradually reformed. The aim is to bring it more in line with the CAP and reduce the amount of public support.

Apart from Agriculture, Turkey also features relatively large Textiles, Trade Services and Transport Services sectors. These sectors are labor-intensive and feature relatively low productivity levels. The tourism sector is part of Trade Services and Transport Services and is important for the Turkish economy. Compared to the Accession-10, Turkey features a low share in Machinery and Equipment, Transport Equipment and Business Services. (Dimaranan and Mc Dougall, 2003)

Table 1.3 Value-added for sectors in % of total value added, 2003

	Turkey	Accession-10	Bulgaria	Romania	EU-15
Agriculture	14.2	6.7	28.2	19.3	2.5
Energy	3.6	3.2	4.5	5.3	1.8
Food processing	6.2	5.6	9.9	13.8	3.1
Textiles	2.3	1.0	3.6	1.5	0.6
Wearing apparel	1.3	1.3	0.8	4.2	0.5
Chem. and minrs.	3.8	5.6	8.0	4.6	4.7
Metals	1.3	1.8	2.5	1.1	0.9
Machinery and equipment	3.2	8.2	4.4	5.0	7.7
Transport equipment	1.4	2.4	0.5	2.4	2.6
Transport services	11.6	5.7	5.8	6.8	4.7
Trade services	20.6	12.7	4.0	6.2	12.8
Business services	7.1	16.7	19.7	15.9	18.2

Other services	16.9	18.0	3.4	3.9	30.6
Construction	4.5	6.2	2.1	5.7	5.7

Source: Dimaranan and McDougall (2003) and own calculations

3.2.4 Export Specialization

Table 1.4 shows the so-called revealed comparative advantages of Turkey. In particular, the first column presents the share of exports of a particular sector in Turkey, relative to the average share of that sector in other countries' export (and multiplied by 100). If a sector features an index larger than 100, then it is said that Turkey specializes its exports in that sector, i.e. it has a revealed comparative advantage in that sector relative to other countries. Table 1.4 reveals that Turkey specializes in Agriculture, Textiles, Wearing Apparel, and most Services sectors (excluding Trade Services). The exports of Textiles, Wearing Apparel, Transport and Business Services are also important in absolute terms: they make up more than 50% of all exports of Turkey, since these sectors are relatively open*. The comparative advantages of Turkey to some extent mimic those from the other accession countries. In particular, both specialize in Agriculture, Textiles and Wearing Apparel. Accordingly, the accession of Turkey to the EU could affect the competitiveness of the Central and Eastern European Countries in these sectors. Yet, there are also some important differences. Most of the Accession-10 countries export more machinery products and more products from the Food Processing industry, while Turkey exports relatively more Business and Other Services. (Dutz and Yılmaz, 2003)

Table 1.4 Export specialization, export shares and openness of sectors in Turkey, 2001

	Revealed Comparative Advantage	Export in % total exports	Exports in % of production
Agriculture	225	4.5	7.9
Energy	18	1.0	4.0
Food processing	82	2.9	7.3
Textiles	534	13.4	63.5

* Not every sector in which Turkey has a comparative advantage is important for trade. For example Turkey has a comparative advantage in this sector, but since trade in Construction is fairly low, it does not contribute much to the openness of the Turkish economy.

Wearing apparel	403	9.6	72.9
Chem. and minrs.	63	7.3	24.9
Other Manufacturing	52	3.0	15.8
Metals	144	5.9	34.7
Machinery and equipment	38	10.9	42.6
Transport equipment	71	6.8	54.9
Transport services	129	10.3	21.5
Trade services	81	2.5	3.7
Business services	151	11.3	40.9
Other services	125	5.9	11.3
Construction	696	4.6	16.2

Source: Dimaranan and McDougall (2004) and own calculations.

4. IMPLEMENTATION OF THE CUSTOMS UNION SINCE 1996

The content and the provisions of the Association Council Decision No: 1/95, in a number of areas, goes beyond the minimum requirements of a Customs Union. Turkey is also having to implement a number of measures which are part of the acquis communataire similar to those applicable within the EU.

As far as the implementation procedures are concerned, the Customs Union Decision supplements the partnership's existing "legal framework". In addition to the classical components of a customs union, i.e. tariff reductions and harmonization with the Common Customs Tariff, the Decision also contains other principles and arrangements, which aim at developing the partnership beyond the envisaged fields, parallel to the broad and dynamic evolution of the European Union itself. In this framework, the obligations of the parties arising from the Customs Union Decision mainly cover the following areas.

4.1 Abolition Of Customs Duties, Quantitative Restrictions And Measures Having Equivalent Effect

In principle, mutual obligations arising from this essential component of the Customs Union were fulfilled as of 1.1.1996. However, reductions concerning sensitive products stipulated by the Association Council Decision No: 2/95 are still being enacted. Within this scope, in the last three years certain problems were faced as regards automotive products, because of incentives given to some Far East-based investments. (Harris, 1996)

4.2Abolition of technical barriers to trade:

4.2.1 Primary Obligations

Customs Union was established as the primary step towards the "free movement of goods" among the EU member states. However, it was soon realized that the measures adopted under the classical definition of the customs union fell short of securing free movement of goods at a desired level. Hence the Member States decided to follow a more liberal approach and sought to abolish the other barriers in front of the free movement of goods as well. In this respect, the technical barriers, which are commonly referred to as procedures related to standards were the main targets to be eliminated.

The Decision embodies two essential elements:

a) Firstly, it is agreed that Turkey would adopt the Community mechanisms, more specifically the acquis communautaire, related to standardization, measuring, calibration, quality, accreditation, testing and certification within five years from the Decision's entry into force. The list of the legislation that has to be adopted was specified by the Association Council Decision No: 2/95.

b) The second important element is that, during this process, if Turkey fulfils the required harmonization measures with respect to a certain good or group of goods, the technical barriers to that particular good(s) have to be abolished without having to wait for the end of this transition period. (Harrison, Rutherford, 1998)

4.2.2Achievement

With respect to harmonization with the European Union legislation, the Decision on Standardization Regime in External Trade published in the Official Gazette no: 22222 of 9 March 1996, entered into force on 8 April 1996. In line with the existing international standards, the new regime envisages quality controls to be carried out only on grounds of personal security, environmental protection, national security requirements and consumer protection. Other aspects of quality are to be determined by market conditions. The aim is to meet WTO Agreement commitments and to fill the gap that may arise from the five-year transition period and to prevent technical legislation and standards applied in foreign trade from constituting an obstacle to international trade.

In 1993, the Turkish Standards Institute (TSE), which has the sol e authority and responsibility for preparing and publishing Turkish standards for all types of materials, products and services in Turkey, started to adopt and harmonize its standards with those of the EU. The aim is to harmonize Turkey's legislation on a wide range of technical regulations under 32 main topics with those of the EU by the end of year 2000. Since 1993 more than 90 percent of EU standards have been adopted as Turkish standards. Turkey has also harmonized its sanitary and phytosanitary regulations with EU norms, in areas such as food norms. (Harrison and Tarr, 2000)

To bring standardization procedures inconformity with the EU norms and to prevent Turkish imports from possible technical barriers, the Law no. 4457 on Establishment of Turkish Accreditation Council, which was prepared with the participation and cooperation of all the parties concerned, has been adopted on 27 October 1999 and published in the Official Gazette no. 23866 on 4 November 1999. To acquire the maximum benefit for Turkey's imports, it is of utmost importance to eliminate disputes among institutions and start to bring the new system into action as soon as possible. if the system is not changed, problems in imports will be inevitable. Moreover, it should be born in mind that such a change would especially enable imports to be monitored in accordance with the internationally accepted standards.

In the field of abolition of technical barriers, apart from these limited initiatives no progress was achieved, that can be considered crucial for Turkish companies. For instance, the minimum standards even for a single product group has not been met yet. One of the reasons for this delay is the problems faced in the application of the Association Council Decision No: 2/97. In relation to this matter, there are three different fields in the Turkish legislation;

- Fields similar to the EU legislation.
- Fields having no similarities with the EU
- legislation. However, the institutions responsible for harmonization in these fields could be specified.
- Fields having no similarities with the EU legislation and which do not fall under the
- responsibility of any specific institution.

In order to overcome the difficulties that can arise under the second and the third fields, a Framework Decision was prepared, which divides the areas to be harmonized, as well as the required legislation among the related institutions. However, since the Decision has not been legalized, the problem still prevails. The Framework Decision has to be implemented immediately, so that the institutions that are currently deprived of the power to prepare legislation can be given the necessary authority. (Harrison and Rutherford, 2000)

4.3 Harmonisation with the EU's External Trade Policy

4.3.1 Basic Obligations

Upon the entry into force of the Decision, Turkey has agreed to apply;

a) Measures that are compatible with the import, export and textiles legislation of the EU.

b) The Common Customs Tariff (CCT).

c) Turkey has also agreed to adopt the

preferential trade regime applicable to third countries within a period of five years from the entry into force of the Decision. (Turkey has declared the countries that will be given priority in this field).

4.3.2 Achievement

In the field of import and export legislation and CCT, the legislative harmonization has been achieved to a large extent. (See the list in Article 12 of the Decision No: 1/95)

In order to materialize certain amendments envisaged by the Decision, negotiations have already been initiated with the third countries. The first leg of this process is swiftly being carried out with the third countries that the EU has preferential agreements with Turkey.

Although there should be a certain similarity, the purpose is not to have exactly the same agreements with the EU. As provided by the Decision, these agreements are negotiated on the basis of mutual interests. Naturally, the main purpose is to increase the trade volume between the countries concerned and to widen the range of products that are subject to the trade. Turkey will also benefit from the tariffs offered to the EU by these countries in the context of the association agreements, free trade agreements and co-operation agreements (however, Turkey has to grant parallel concessions with the EU). As a result of these parallel agreements, trade diversions shall be prevented; the local producers shall be able to obtain raw materials with privileged conditions and without being exposed to tax differentiation. More importantly, as a result of the signing of these agreements, Turkey is included to the Pan European Cumulation System for industrial goods as of 1 January 1999. Turkey's demand for taking part in the EU Mediterranean Cumulation System and European System for Agricultural Products is still under consideration,

The second leg of the negotiations with the third countries concerns the limiting of imports and/or rearrangement of the import rules, In this context, as of 1.1. 1996, parallel measures have been unilaterally put into force for the 52 countries to which the EU apply quotas and surveillance measures in the textiles and clothing sectors.

All the agreements need to be completed in the near future bearing in mind the priorities of Turkey stated in Annex no 10 to the Decision.

As far as the agreements are concerned, Turkey has fulfilled her commitments in relation to harmonization with the EU's external trade policy under Article 16 of Decision No: 1/95. However, the other aspects of the issue that are equally important, have not even been brought into discussion yet. For instance, questions like how the obligations under the EU's autonomous regime (the concessions that are given unilaterally) are to be fulfilled will come in the agenda in the very near future. (Harrison and Tarr, 1999)

4.4 Agricultural and Processed Agricultural Goods Trade

The Customs Union does not cover agricultural goods and the free circulation of agricultural products will only be implemented upon Turkey's alignment of its policies to the EU's Common Agricultural Policy. However, in the period between the signing of the Ankara Agreement and the adoption of the Customs Union Decision, the EU granted certain concessions to Turkey. As a result, a large extent of Turkey's agricultural exports to the EU benefits from tariff exemptions or tariff reductions. (For instance, prior to the Protocol dated 25 April 1997, 71 % of the agricultural exports benefited from the exemptions and 5% benefited from the reductions. Hence in total. 76% of Turkey's exports benefited from the concessions. (IKV, In The Frame Of CU The Processes Agriculture Products in EU And In Turkey, 1998)

4.4.1 Basic Obligations

The Customs Union Decision stipulates that the EU and Turkey shall progressively improve, on a mutually advantageous basis, the preferential arrangements in agricultural products.

The industrial components of the processed agricultural goods are already covered by the Customs Union. Elimination of tariffs on the industrial components of processed agricultural goods was carried out gradually (Between 1.1.996 - 1.1.1999).

4.4.2 Obligations that have been fulfilled

The negotiations on agricultural concessions that had been initiated in 1993 were concluded İn 1997. The Protocol and Annexes embodying the bilateral concessions on agricultural goods were initiated on 20 April 1997 in the 38th EU-Turkey Association Council meeting.

As a result of these new bilateral concessions, the volume of Turkish exports benefiting from concessions increased from 70% to 93%, whereas for the EU it resulted in an increase from 7% to 33%. (Hartler and Laird, 1999)

4.4.3 Issues that have not been addressed

In agriculture, Turkey gave its first real concessions to the EU by the Decision No: 1/98. However, this Agreement did not function properly due to Turkey's ban on beef imports. As a response to this ban, the EU suspended some of its concessions on Turkey's exports.

Another important impediment to Turkey's agricultural exports stems from hygiene concerns, In this field, legislative and procedural harmonization will not only facilitate our exports, but also may be used as a means of control on imports.

4.5 Harmonization of Legislation on Competition Rules:

4.5.1 Basic Obligations

The Decision obliges Turkey to harmonize its legislation on competition rules with that of the EU. Moreover, within one year from the Customs Union's entry into force, all of the EU's block exemption directives and the related principles in case law shall also be adopted.

Apart from these, all agreements, decisions and concerted practices between undertakings that may distort or limit competition, as well as any abuse of dominant position shall be prohibited, in so far as they affect trade between the parties.

4.5.2 Achievement

The first step in this field was the adoption of the Act on the Protection of Competition on 13,12.1994 prior to the Customs Union Decision. The key provisions of Turkey's competition law are based on EU competition law. The Law on the Protection of the Consumer was put into force in 1995. However there were serious delays in implementation. The Independent Com petition Board members were selected and appointed in 1995 on the basis of the Council of Ministers decision 97/9090. However for a number of reasons, the Competition Board, which is the major executive authority under the Act, became functioning after three years, only on 3.11.1997. Efforts to harmonize and implement legislation on black exemptions are still being carried out. (Hertel, 1997)

4.6 State Aids

4.6.1 Basic Obligations

In principle, all state aids that distort or threaten to distort competition by favoring certain undertakings or the production of certain goods are considered incompatible with the proper functioning of the Customs Union. In accordance with this basic principle, Turkey has undertaken to carry out the necessary legislative amendments.

On the other hand, for a period of five years from the entry into force of the Decision, aids to promote development of Turkey's less developed regions and aids aiming at accomplishing structural adjustment necessitated by the establishment of the Customs Union, sh all be considered compatible with the Customs Union.

In accordance with the Decision, in the textiles and clothing sector Turkey will align its state aids to those of the EU before the entry into force of the Decision. On the other hand, harmonization of state aids in other sectors shall be completed within two years from the Decision's entry into force. (IKV Journal, The Monetary Aids of EU to Turkey, 1996)

4.6.2 Obligations that have been fulfilled

Turkey's declaration of September 1995 asserting that "there are no specific state aids in Turkey and due to their general or regional character, the current incentive measures do not conflict with the provisions of the Customs Union Decision and World Trade Organization's (WTO) Agreement on Subsidies and Rebalancing Measures" has been accepted by the EU. In textiles and clothing sector, Turkey has aligned its state aid system with that of the EU as of 1.1.1996.

Within the framework of legislative harmonization in sectors other than textiles and clothing, "Decision 94/640 concerning State Aids on Exports" was published in the Official Gazette no: 22168 of 11.1.1995". The aim of the Decision is to support Turkey's exports, without conflicting her commitments to the EU and the WTO. Implementation procedures of this particular Decision were specified by the Money Credit Coordination Board Decisions that were published in the Official Gazette on 1.6.1995.

Turkey progressively revamped its incentives to exporters, shifting from direct payments to general exemptions. In this regard Turkey has adopted the OECD's consensus principles on officially supported export credits with a repayment period of two or more years. (Frankel, 1998)

4.7 Monopolies and Public Procurement

4.7.1 Basic Obligations

In the field of monopolies, within one year of the entry into force of the Customs Union, Turkey was to ensure to uphold the principles embodied in the EU legislation and case laws concerning public undertakings or undertakings to which special or exclusive rights have been granted. On the other hand, within two years from the entry into force of the Decision, state monopolies of a commercial character had progressively to be adjusted, so as to ensure that no discrimination exists between nationals of the member states and of Turkey.

As regards government procurement, no specific arrangements are determined. The Association Council is given the mandate to set a date for the initiation of negotiations aiming at the mutual opening of the government procurement markers. (Bayar, 2000)

4.7.2 Obligations that have been fulfilled

Negotiations are being carried out with the Commission representatives, on the draft law amending the Act on Monopolies. However on public procurement, a dare to initiate negotiations for the mutual opening of the government procurement markets has still not been set. (Bayar, 2000)

4.8 EVALUATION

A comparison between the obligations and opportunities embodied in the Customs Union Decision No: 1/95 of 6 March 1995, with what actually has been accomplished, reveals the following conclusions:

a) As far as the scope and the mechanisms are concerned, the Customs Union Decision and Resolution on Broadening the Association (together with the Association Agreement, its annexes and other Association Council Decisions) embody the necessary elements for further integration and means to prepare Turkey for full membership.

b)The essential Customs Union provisions, providing for the "free movement of industrial goods" have been fulfilled to a large extent. In this sense, the Customs Union functions.

c) However, it is not possible to argue that all the Customs Union provisions are property applied either by the EU or Turkey. Although a completely liberal regime is being carried out in bilateral trade, real integration has still not been achieved in the preparation and application of a common external trade policy (i.e. sensitive products, preferential trade policies, and dumping and institutional provisions).

d) Although the Customs Union functions in a positive way for the "free movement of goods", it falls short of acting as a "tool for further integration". Mutual steps to broaden the partnership and to integrate Turkey into the Single Market are not being taken. The main reason for this is the lack of political dialogue between the parties.

e) There is no sufficient progress not only on bilateral matters, but also on issues that require merely unilateral efforts, some of which would have real positive implications for Turkey (Fuller and Henze, 1999)

The experience of the Customs Union that has been in force for a period exceeding four years shows that the lack of political stability, which also causes an apathy on the public administration and the civil society, is the underlying reason for not being able to fulfill the obligations under the Customs Union or to use its opportunities.

Within this framework, the Economic Development Foundation has described the reasons creating this problem as shown below, and tried to bring its views to the attention of the decisions makers of both Turkey and the EU:

"On Turkey's part, the lack of political will is mostly a result of the absence of a membership perspective, whose timing and procedures are well defined. This argument is supported by the fact that, as soon as the Customs Union goal became tangible, it received tremendous support from the political and economic circles, resulting in a number of important legislative amendments. So evidently, a clear membership perspective will elevate Turkey's harmonization efforts.

The precondition for any development in this field is that, the EU should extend Turkey the same unifying and constructive co-operation model offered to the other candidate countries. Likewise, it is essential for Turkey to fulfill her obligations under the terms of the Copenhagen criteria as soon as possible.

Turkey's primary expectation is a clear membership perspective, which in effect would break the vicious circle that leads to tension between the parties. A clear membership perspective, with its momentum, will not only facilitate the elimination of obstacles to political integration, but also it will further the economic integration, by attracting foreign investment."

Finally, by virtue of officially approving Turkey's candidacy status, the initial steps have been taken at the Helsinki European Council in December 1999 towards eliminating the lack of political will between the parties that has been perceived as the primary problem for many years. From now on, the ambiguities that have been created by "definition" that Turkey is "eligible" for EU membership has been removed and the legal process whereby Turkey is an "official candidate" is launched. (ISO, Avrupa Yolunda Türkiye'nin Dış Ekonomik İlişkileri ve Bölgesel İşbirliği Stratejileri, 2000)

Now both parties have the task of taking swift and decisive steps in an attempt to prove that this is not merely a temporary decision but a determination that reflects their genuine wishes.

Whilst the official candidacy status has brought about new obligations. it has also provided new instruments for the utility of the parties. The EU should secure the usage of these instruments by Turkey swiftly and on the basic of equal conditions as the other applicant countries.

On the other hand, the existence of these new instruments has not reduced the importance of the Customs Union. The Customs Union will remain as the main integration instrument at hand for a considerable time. The Customs Union will play a central role in the integration of Turkey-EU as was the case in the internal integration of the EU. The spill over of the current integration level to other areas will easily be built on the core that has been created by the Customs Union. (Karluk, 1998)

5. AN OVERVIEW OF TRADE AND FINANCE SINCE 1996, BASICLY CONCERNING THE CAPITAL INFLOWS TO TURKEY

Trade flows between the EU and Turkey is significant, but capital inflows to Turkey have been very low, even after the entry into force of the Customs Union. The financial assistance provided by the EU to Turkey has also been negligible in the recent years*.

* There has been a significant change in this field since the tragic earthquake in Turkey.

Turkey's population is around 68.6 million and the population growth rate is around 1.5%. The local civilian work force is about 22 million. The population is much younger compared to European countries (approximately 70% of the population is below the age of 35). Turkey shall continue to constitute one of the largest populations in the Middle East and Eastern Europe. The official language is Turkish. However, many Turkish businessmen speak and conduct transactions in English. French, German and Russian are also widely used for business. Islam is the dominant religion, but Turkey is a secular state. Turkey, situated at the crossroads where two continents meet, is an ideal center for investors looking for a location at the heart of Euro-Asia. With its dynamic and growing economy, huge market, competitive & skilled labor force, Turkey offers numerous opportunities to international investors. The liberal foreign investment legislation and the experience of more than 6311 foreign capital firms ensures a stable and reliable investment environment. At the request of our government, the Foreign Investment Advisory Service (FIAS), a joint facility of the International Finance Corporation (IFC) and the World Bank, completed a study of the Administrative Barriers to Investment to enhance the foreign direct investment environment in Turkey and the necessary changes are underway. The involvement of foreign capital is highly encouraged in Turkey's privatization program, South-East Anatolian Project (GAP) and major infrastructure projects. Petroleum and natural gas pipelines from the Russian Federation and CIS countries places Turkey at the crossroads of world's future energy resources. Turkey invites international investors from all countries and business sectors to take place in such a promising investment environment. (Francois, 1998)

5.1 Turkey's Trade With The Eu

The EU is Turkey's largest trade partner both for exports and imports. Trade flows have significantly increased since the entry into force of the Customs Union, but the dynamics of imports from the EU have been much stronger than the increase in the Turkish exports to the EU. From 1995 to 1997, imports from the EU increased by 70%, exports to the EU increased by 28% leading to a rise in the foreign trade deficit by 177%. The EU is one of the largest markets for Turkish textile and clothing products. The other main important export items are animal and vegetable products and vehicles with 10% share in total exports of Turkey;

machinery and mechanical appliances together with optical photographic items have 6% share in total exports.

The EU is also the main import partner of Turkey. In 1997, the EU had a share of 51.2% in Turkey's total imports and Turkey's share in the EU exports was 3%. Machinery and mechanical appliances have a share of 34% in Turkey's total imports from the EU. The other

Table 2: Turkey's Foreign Trade and EU's Share

	General *Million$*			**European Union Million$**				**The Share of EU (%)**		
	Export	Import	Volume	Export	Import	Volume	Deficit	Export	Import	Volume
1968	496	764	1,260	226	393	619	167	45,4	51,4	49,1
1971	676	1,171	1,847	329	582	911	253	48,7	49,7	49,3
1972	885	1,563	2,448	428	851	1279	423	48,4	54,5	52,2
1974	1,532	3,778	5,310	761	1748	2509	987	49,7	46,3	47,2
1980	2,910	7,909	10,819	1300	2360	3660	1060	44,7	29,8	33,8
1985	7,958	11,343	19,301	3204	3895	7099	691	40,3	34,3	36,7
1993	15,348	29,429	44,777	7,289	10,950	18,239	3,661	47,5	37,2	40,7
1994	18,105	23,270	41,375	8,269	10,279	18,548	2,010	45,6	44,2	44,8
1995	21,636	35,707	57,343	11,078	16,760	27,938	5,782	51,2	47,2	48,7
1996	23,224	43,626	66,850	11,548	23,138	34,686	11,590	49,7	53,0	51,9
1997	26,261	48,559	74,820	12,248	24,870	37,118	12,622	46,6	51,2	49,6
1998	26,974	45,921	72,895	13,498	24,075	37,573	10,577	50,0	52,4	51,5
1999	26,588	40,692	67,280	14,333	21,419	35,752	7,086	53,9	52,6	53,1
2000	27,485	54,149	81,634	14,352	26,388	40,740	12,036	52,2	48,7	49,9
2001	31,342	41,399	72,741	16,118	18,280	34,398	2.162	51,4	44,2	47,3
2002	18,912	26,054	44,966	9,673	11,752	21,425	2.079	51,1	45,1	47,6

Reference: State Institute of Statistics; January-June

articles and their share in total imports are as follows: Vehicles aircraft (17%). products of chemicals (i 0%). textile and textile articles (7%) and plastics and rubber (9%).

The Russian crisis affected adversely the EU imports in 1998. While the import growth rate of the EU was 9.1 % in 1997 with respect to the previous year, it dedined to 7.4% in 1998 and a further dedine is expected in 1999. Since the export performance of Turkey is highly correlated with the import volume of the EU, Turkish exports to the EU have been seriously affected by the Russian crisis. (Karluk, 2000)

Turkey's foreign trade gained momentum especially in 1990s. This period was affected by changes and developments in the world economy and political structure.

Exports which were $ 13 billion in 1990, rose to $ 21.6 billion in 1995 and $ 27.8 billion in 2000. During 1990-1995, the average annual growth rate of exports was 10.8 percent, while it was 5.1 percent between 1995 and 2000. The primary reason of high growth rate of exports during the period of 1990-1995 was a considerable increase in the import demand of European Union. Also, in 1994 economic stabilization measures had an important impact on this development. Moreover, the devaluation of TL in 1994 in the framework of April 5 decisions gave a substantial competitiveness to Turkish exporters. However, as a result of economic crises in Newly Industrialized Asian Countries and in Russian Federation, increase in the world trade and world demand shrank. This had a significant impact on Turkey's export performance in 1999, which was only 2.7 percent. On the other hand, after 2000, Turkey's exports growth rate is accelerating at an important pace. Turkey showed a great performance in exports in 2001, 2002 and 2003. Turkey's exports grew by 12.8, 15.1 and 30.5 percent respectively. (Tezel, 2003)

Imports, which were $ 22.3 billion in 1990, grew by 9.9 percent annually, between 1990 and 1995, and reached $ 35.7 billion in 1995. The average annual growth rate between 1995 and 2000 was 8,8 percent. Turkey's membership to the World Trade Organization in 1995 and the entrance to the final stage of Customs Union with the European Union in 1996 and the growing economy were reasons of rapid growth rate of Turkey's imports during the last 8 years. In 2000, a 6.1 percent GNP growth, a sharp fall in interest rates, appreciation of TL in real terms, depreciation of EURO against US Dollar, and a sharp increase in crude oil prices brought about a 34 percent rise in imports. After such a steep increase, imports decreased by 24 percent in the following year when economy shrank, too. 2002 and 2003 was the years of recovery after the crisis in 2001, where imports and economy grew together. The increase in imports was 24.5 percent in 2002 and 33.5 percent in 2003. The export/import ratio declined from 58.1 percent in 1990 to 51.0 percent in 2000 as a result of the spiky increase in imports. But then, this ratio rose to 68.4 by the year of 2003. The average annual increase in volume of trade decreased from 10.2 percent in 1990-1995 to 7.5 percent in 1995-2000. Between 1995 and 2000, especially, because of unstable growth of economy and so imports, the volume of foreign trade rose to $ 82.3 billion at the end of 2000. This share continued to increase until 2003, but related to important appreciation of TL in 2003 GNP growth in US Dollar was considerably high that lowered the share of foreign trade in GNP. Trade deficit (CIF imports – FOB exports) showed an 8 percent annual growth rate between 1990 and 1995 and rose from $

9 billion to $ 14 billion. Between 1995 and 2000 trade deficit grew approximately by 14 percent at an annual rate. Again as a consequence of 2001 crisis, the share of foreign trade deficit shrank to 5.3 percent and as a result of huge appreciation of TL against US Dollar, fell to 3.9 percent in 2003. (ITO, Turkey's Foreign Economic Relations in the path of Europe, 2003)

Table 3: The Sectoral Distribution of Turkey's Trade With EU (million $)

	Agriculture		Textile		Iron Steel		84th, 85th and 87th*. Sections		Industry Products		Total	
	Exp.	Imp.	Exp.	Imp.	Exp.	Imp.	Exp.	Imp.	Exp.	Imp.	Exp.	Imp.
1994	1,647	185	4,150	501	293	1679	782	4,375	1,762	3,865	8,634	10,279
1995	1,965	790	5,353	828	505	1,353	1,239	6,617	2,017	6,773	11,078	16,860
1996	1,854	675	5,660	1,379	421	1,852	1,505	10,155	2,109	8,848	11,548	23,138
1997	2,037	512	5,930	1,611	622	2,081	1,550	11,751	2,109	9,123	12,248	24,870
1998	1,941	477	6,464	1,425	703	1,873	2,083	11,696	2,307	9,011	13,498	24,075
1999	1,900	489	6,363	1,318	818	1,466	2,705	10,428	2,562	8,238	14,348	21,416
2000	1,483	474	6,433	1,400	888	943	2,803	13,612	2,745	9,599	14,352	26,388
2001	1,674	304	6,699	1280	997	1004	3,754	7,736	2,993	7,957	16,118	18,280
2002**	719	255	4,285	912	490	700	2,508	4,711	1,671	5,174	9,673	11,752

Reference: SIS
*84th sectional: Nuclear Reactors, Cauldron, Engined Tools, Tools, Spare Parts; 85th section: Electrical Tools and Tools, Parts and Spare Parts; 8th. sectional: Vehicles, Tractor, Bicycle, Motorcycles, etc...
**January June

When exports by main sectors are examined there seems to be a steady decrease in the exports of agricultural products until 2002. Exports of the agricultural products decreased on average by 3.3 percent annually between 1995 and 2000. Exports of agricultural products showed a good performance especially in 2003. As a result of that development, the share of export of agricultural products in total exports also decreased in the last decade and as compared to 1990, its share fell down from 25.5 percent to 11.2 percent in 2003. The export of mining products showed a slight improvement in the last decade. The value of exports of mining products has reached to 2 billion dollars in 2003. The share of these products in total exports did not reveal any increase. It increased lower than general exports did and so its share in total exports declined compared to 1990. On the contrary of other main sectors' exports, export of manufactured products increased its share in total exports from 1990 to 2003. This share rose from 67.7 percent in 1990 to 83.8 percent in 2003. The export of manufactured products increased by 12,8 percent annually between 1990 and 1995. This increase in exports of manufactured goods decelerated in the following five years period, realizing 7.2 percent annual increase. But after that, the increase in the exports of manufactured goods accelerated and reached to 30.3 percent annual growth rate.

Table 4: Turkey's Place in EU's Import and Export (million Euro)

	EU Total Export	EU Total Import	EU's Export to Turkey	Turkey's share in EU's Total Export %	EU'S Import from Turkey	Turkey's share in EU's Total Import %
1980	211,1	280,6	2,0	1,0	1,1	0,4
1993	390,6	470,2	12,4	2,6	6,8	1,5
1994	471,4	518,5	9,3	1,8	7,9	1,5
1995	573,3	545,3	13,4	2,34	9,2	1,69
1996	627	581,1	18,3	2,92	10,2	1,76
1997	721,1	672,4	22,4	3,11	11,9	1,77
1998	730,8	709,8	22,1	3,03	13,6	1,92
1999	758,3	772,1	20,5	2,71	15,5	1,95
2000*	937,9	1026,8		3,2		1,7

Reference: Eurostat
*Eurostat states Turkey's share in EU's Import and Export, but export and import figures (million €) are not stated.

There was a significant development in exports of Turkish manufactures, especially in the last 6 years. The machinery and transport equipment sector had the most significant share in exports in 2003 and its share in total exports increased in the last 5 years. The export of clothing made up 28.3 percent of total exports in 1995 and the share decreased to 21,2 % in 2003.

5.2 Capital Inflows To Turkey

Capital Flows is the movement of foreign exchange from one country to another. The types of transactions used to move money internationally include: foreign direct investment and capital repatriation, and portfolio investment such as stocks, bonds and derivatives, loans and loan repayments, bond issues and payments. Turkey's capital inflows are based only on foreign direct investments.

Because of the economic and political uncertainties in the country, Turkey has been unable to attract much foreign investment even after the entry into force of the Customs Union. Foreign direct investment was 663 million dollars in 1989 and since then there has not been any significant rise. It was only 554 million dollars in 1997 and 573 million dollars in 1998. The share of the foreign direct investment in GDP was only 0.3% The EU is the main provider of FDI with a share of 62% in total inflow of foreign investment in Turkey.

With the liberalization of the capital movements in 1989, the portfolio investment became one of the main foreign assets of the country. The inflow of security transactions of non-residents was 2.5 billion dollars of which 1.1 billion dollars came from the EU countries. Total portfolio investment (mainly short term) has been one of the main sources, with almost 4 billion dollar yearly due to high interest rates and stable exchange rate system. However, depending on the macro-economic and political environment, capital inflows fluctuate significantly. (Soğuk,2000)

5.2.1 FDI in Turkey

Turkey, situated at the crossroads where two continents meet, is an ideal center for investors looking for a location at the heart of Euro-Asia. With its dynamic and growing economy, huge market, competitive and skilled labor force, Turkey offers numerous opportunities to international investors. The liberal foreign investment legislation and the experience of more than 6.000 foreign capital firms ensure a stable and reliable investment environment.

In Turkey, developments in foreign investments accelerated along with the changes in the economic and social structure. The deregulation of interest rates, establishment of organized financial markets for money, foreign exchange stocks and securities, liberalization of capital movements and reforms in the banking sector are just same of the major economic policy changes while one of the major policy decisions was the adoption of liberal and flexible foreign investment practices. As a result of the changes in the foreign investment legislation, the investment climate was made more efficient and suitable for potential investors, starting with the 1980s. (Uyar,2002)

In 2003, the Government has initiated a comprehensive reform program to streamline all investment-related procedures and to attract more private direct domestic and foreign investment. The Government has established a Coordination Board for Improving the Investment Climate. The Board assigned specialized technical committees to work on developing concrete proposals and strategies in order to overcome all main obstacles. As productive collaboration between the public and the private sector is key in this process, each technical committee consists of private sector and government agencies representatives. The key reform areas have been determined as company establishment, employment, licenses, location of investment, taxes and incentives, customs and standards, intellectual property rights, small and medium sized enterprises, promotion of investment, foreign direct investment regulation.

On the other hand, the law that redesigns company registration process which diminishes the prior 19 required steps to 3 steps and reducing turnaround from two and a half months to one day is enacted. Thus, the company registration procedures which previously were taking almost two and a half months and requiring excessive documentation and approvals from several authorities have been simplified and streamlined. Now the registration can be done in only one day and all that is required is to fill out a standard form at one point without applying to several different authorities for approvals.

Taking into consideration the importance of a strong legal framework for foreign direct investment, the existing relevant legislation was reviewed to assess the needs for as well as the content of new foreign direct investment law has been drafted taking into consideration international best practices and the new FDI law has been enacted and published an June 17, 2003. (Commission of the European Communities, 1996)

With the new FDI legislation notification based system instead of screening and approval system will be in effect. Also this law defines investment and investor in line with the international standards and abolishes minimum capital requirement of US$ 50,000 per real or legal person for foreign investors.

Some of the important features of the new law are a broader definition of investors to include foreign nationals, Turkish nationals resident abroad, foreign legal entities and international organizations; freedom to invest; internationally accepted FDI definition; national treatment; guarantee to transfer proceeds; key expatriate personnel; protection against expropriation; access to real estate and international dispute settlement. (Marcenier and Yeldan, 2000)

5.2.2 FDI Figures of Turkey

As of the end of 2002, accumulated foreign direct investment in Turkey amounted to US$ 33,9 billion in terms of the value of foreign capital approvals and US$ 15,7 billion in terms of actual capital inflow.

The total of last year's foreign direct investment approvals stand at US$ 2,2 billion, whereas actual inflows remained at US$ 590 million. In terms of approvals, the leading investors are France, the Netherlands, Germany, USA, United Kingdom, Switzerland, Italy and Japan.

Among the country groups, EU has a share of 68 % in the total foreign investment stock. The total share of OECD countries accounts for 88 % of the total foreign investment stock. The remaining 12 % go for the Islamic countries with 2 %, East European countries with 1 % and other countries with 9 %.

Sector based composition of FDI inflows to Turkey shows a similar trend with that of FDI flows in the world economy. While services represent around 50-55 % of the total stock of FDI, manufacturing sector investments account for some 35 to 40 % of annual flows. Share of agriculture and mining sector investments is around 5 % of the total stock.

Within the manufacturing industries, the leading sectors are;

- Automotive and transportation equipment
- Food, beverage and tobacco industries
- Chemical and petroleum products
- Electrical machinery and electronics

Within services sector, the leading sectors are;

- Banking
- Trade & retail chain stores
- Telecommunications
- Tourism

As of the end of 2002, 6,311 foreign capital companies operate in Turkey. The foreign partners of these companies include 108 of the 500 companies, which are listed in the Top 500 companies list of the Fortune Magazine.

From January to March 2003, 121 new foreign capital companies have been established in Turkey. This figure presents a 58,7 % decline compared to the same period of the previous year. On the other hand, total authorized FDI reached US$ 503 million, whereas it was US$ 523 million the previous year, showing a decline of 3,82 %.

Table 5 FDI Inflows to Turkey

YEARS	AUTHORIZED FDI (MILLION $)	NO.OF FOREIGN CAPITAL COMPANIES (**)	REALIZATIONS (MILLION $) (***)
1980	97	78	35
1981	338	109	141
1982	167	147	103
1983	103	166	87
1984	271	235	113
1985	234	408	99
1986	364	619	125
1987	655	836	115
1988	821	1.172	354
1989	1.512	1.525	663
1990	1.861	1.856	684
1991	1.967	2.123	907
1992	1.820	2.330	911
1993	2.063	2.554	746
1994	1.478	2.830	636
1995	2.938	3.161	934
1996	3.836	3.582	914
1997	1.678	4.068	852
1998	1.646	4.533	953
1999	1.700	4.950	813
2000	3.477	5.328	1.707
2001	2.725	5.841	1.288
2002	2.243	6.280	1.042
2003(*)	1.208	6.511	150
TOTAL	35.203	---	14.372

http://www.hazine.gov.tr/stat/yabser/ti17.htm
*As of June 2003
** Cumulative
***Data for 2003 is between Jan-May
Important: All types of permits issued by General Directorate of Foreign Investment are abolished by Foreign Direct Investment Law No. 4875

enacted on June 17, 2003. Therefore any statistics on base of permits will not be published from this date on.

US$ 303 million of the total US$ 503 million authorized FDI inflow in the first quarter of 2003 is for manufacturing sector (60 %), while US$ 1 million is for agriculture (0,15 %), US$ 3 million for mining (0,62 %) and US$ 196 million (39,0 %) for services sector.

On the other hand, 29 % of the total investments were from Germany in the first three months of the year, followed by the USA and the Netherlands with shares of 17% and 15 % respectively. (Kowalczyk, 2000)

Foreign Direct Investment in Turkey has been relatively modest, given the size and dynamism of the Turkish economy. Although it increased from 18 million $ US in 1980 to 612 million $ US in 1996, it represented only 2.33 per cent of GDP in 1996. Meanwhile there have been almost always substantial differences between Foreign Direct Investments permits and realizations (cumulatively almost $ 19 billion of foreign investment permits and $ 6 billion net inflows during the last ten years).

Portfolio investments have been much higher than Foreign Direct Investments: between 1987-1996 with $ 14 billion net inflows. Indeed capital markets in Turkey have recorded considerable progress. One of their main instruments was the establishment of the Istanbul Stock Exchange (ISE) which today is one of the most rapidly growing emerging markets in the world (with its 292 million $ US of average daily value of stock trading in February 1998, ISE is among the best four emerging markets and ahead of many developed markets in Europe).

Turkey is not only a capital-importing country, but also a capital-exporting one. During the 1987-1996 period, the yearly average of interest received was almost 940 million $ US, as opposed to yearly outgoings of 2.470 million $ US. Most of the interest payment received consist of Foreign Direct Investments by Turkish firms and private holdings of government bonds and foreign equities. International debt markets have contributed significantly to finance the current account deficit and to repay debt obligations. Consequently, Turkey's foreign debt has steadily increased from 16.2 billion $ US in 1980 to 79.8 billion $ US in 1996, representing almost 44 per cent of the GNP. Of the total, 25.7 per cent was accounted for short-term debt and the remaining 74.3 per cent for medium and long term. The OECD countries which provide the vast majority of private; investment, have also been the main bilateral lenders. (OECD, Economic Surveys, 1999)

Foreign direct investment (FDI) is now the most significant type of capital flow to developing countries. While FDI can bring key economic benefits such as employment generation and export-led growth, concerns are often raised about its social and environmental impact. The challenge for both investors and host countries is to secure the mutual economic benefits of FDI without widening the gap between rich and poor or damaging the environment.

The International Chamber of Commerce (ICC) and UNCTAD both regard FDI as a major contributor to economic growth and development. However, while FDI flows have increased enormously in recent years, reaching US$ 1 trillion in 2000, distribution has been uneven, and the LDC group received very little. But this is also true for a number of emerging economies whose potential is not reflected in the level of FDI they receive. Turkey is among them.

While the promotion of FDI for LDC countries is at the heart of the global fight to reduce and eventually eradicate poverty, there is also need to ensure that far larger levels of FDI are directed to these already well-equipped economies. Turkey's level of economic growth and its sustainable human development process should be dramatically stimulated if FDI would reach US$ 7 billion a year. A figure mentioned by Kemal Derviş in the understanding that relevant governmental bodies should ensure the development of the legislative and regulatory environment required. (Soğuk, 2000)

However, investors should also keep in mind the geo-political and economic importance of Turkey and help national actors such as YASED, TUSIAD or ISO, who strive to improve the prevailing conditions for foreign investment. But we should also stress the need for both national and international investors to also look at the investment needs in the less developed regions of Turkey.

A source of unskilled labor that migrates to the already over crowded urban centers of central and western Turkey or abroad, these eastern regions could eventually offer ground for challenging development opportunities. Comprehensive capacity building efforts, together with national and foreign investment could be harmoniously combined with the wealth of human resources that they can offer. Again, the role of national authorities is at the center of this possible evolution of the future economic and social landscape of Turkey.

Access to FDI for poorer communities and small and medium size businesses can be promoted by fostering credit/loans and capacity building programs to improve their bargaining power, as strongly stressed in 1995 during *both the World* Conference on Women (WCW) and the World Summit on Social Development (WSSD).

The increase in foreign trade deficit would result in diminishing foreign exchange reserves and therefore increased need for foreign borrowing. Instability of the trade balances would also effect the domestic balances as a result of decreasing foreign exchange reserves and upward pressure on prices.

There will be pressure on exchange rates in the direction of devaluation of Turkish Lira which will encourage exports and discourage imports. To prevent a chronic unbalance there will be a need for policies to create export revenues like increasing incentives for exports in the framework of the Customs Union. To increase the foreign exchange reserves, another approach would be encouraging foreign investments in Turkey.

With Customs Union foreign capital investment in Turkey will increase as a result of increased opportunities of trade and production. The Turkish market will become more attractive as a result of structural changes such as adoption of competition law, legislation on intellectual and property rights and patent law. Certainly, macroeconomic stability is the key factor in ensuring the increase in foreign investment after the Customs Union. However, it might also be the case that a foreign investor already established in Turkey might close down its factory and merely export to Turkey from the EU. (Taşhan, 1996)

The EU has an important share in foreign capital investment in Turkey. The share of five EU countries were around 60% of total foreign investments in Turkey at the end of 1995. According to the Foreign Capital Association (YASED), the foreign direct investment for 1996 is expected to be around $2-3 billion. The increase in foreign capital investment will help increase employment and invest in technology which will be essential in adaptation of Turkish economy to increase in competition due to Customs Union.

Foreign investments in Turkey have started to follow a trend of increase by the latter half of the 1985. It is very well known that the foreign investments in the country had not reached sizeable volumes prior to 1980. The total volume of foreign investments on the automotive, pharmaceutical, food and petroleum industries reached only US$228 million during the 25 years between 1954 in which the Foreign Investment Encouragement Law was enacted and 1980. Approximately all of those investments were made by three petroleum companies, two automobile manufacturers, five commercial vehicle manufacturers, eight pharmaceutical companies, three tyre manufacturers and some fifteen food, chemicals, electrical devices and machines manufacturers. (Tezel, 1996)

Along with the decisions taken on January 24, 1980 and the liberalization policies pursued during early 19805, Turkey gradually started attracting foreign investments. The volume of investments exceeded US$200 million on an annual basis for the first time in 1987 and reached US$1 billion in 1990, having doubled in 1988 and 1989. However, annual foreign investments in Turkey have not exceeded this figure seriously since then.

Almost half of the US$1 billion-worth annual foreign investments were constituted by newcomers up to 1993. However, the rate of these new investments fell rapidly in the aftermath of the 1994 crisis and the share of new foreign investments in the total volume of foreign investments fared between 5% to 10% since 1995. Among these investments amounting to roughly US$50100 million on an annual basis, there have been a few relatively large-scale investments such as those by Honda, Hyundai, Akçansa and Ford since 1994. The fact that the remaining US$15-20 million was being invested by 300 to 400 newcomers since then has further diminished the importance of these figures. Almost all of these are family business, belonging to neighboring countries and carry the commercial office characteristics. However, this picture changed slightly in 2000 as the volume of new foreign investments reached US$1.3 billion during the first ten months of the year thanks to the newly launched GSM and energy projects. (MFA, Relations between Turkey and the European Union, 2001)

It is customary to make certain speculations on the total volume of investments that Turkey should attract on an annual basis. Regarding the latest developments in the world economy, this figure should not fall below US$2530 billion. Turkey was placed second to China in the US government's "10 Big Emerging Markets" strategy for the 20005. Considering that the annual foreign investments to China add up to LJS$63.5 billion -including Hong Kong, those to Brazil and Argentina add up to US$31.4 billion and US$23.5 billion respectively, we could make a better appraisal related to. the potential annual foreign investments to Turkey.

The developments in the world economy since 1994, when this strategy was initially engineered, have shown clearly that the foresight of this strategy could also be exceeded. While Turkey had attracted a total volume of US$1 billion in 1990, China had attracted US$3.5 billion and Brazil, Mexico and Indonesia had each attracted US$1 billion. The fact that Turkey had attracted the highest per capita foreign investment in the world in 1990 is the best proof to the assertion that these levels can be captured again.

Similarly, the United Kingdom included Turkey within the ten most important developing countries and took steps to improve its economic relations with the country since then. Though not being clearly devised strategies, similar attitudes in other countries are also apparent. It is common knowledge by now that the reason underlying Turkey's failure to fulfill its potential in drawing foreign investment is related to its political and economic instability. Breaking inflation records for years and years, Turkey lost much of its appeal to the foreign investors due to factors. like the economic instability, sizeable budget deficits, high interest rates as a result of high public sector borrowing requirement ratios, failure in making headway in privatization, failure in the protection of intellectual property rights -especially the copyrights and trademarks, non-tariff barriers, price controls, discrepancies in the judicial system leading to delays in the decision making etc. (MFA, A Strategy for Developing relations Between Turkey and the European Union, 2000)

Political stability is higher above economic stability in the priority lists of foreign investors. Turkish politics has been unable to achieve this stability since the 1994 economic crisis. After a five to six month turmoil leading to Prime Minister Tansu Çiller's resignation, Turkey experienced a 10-month interim with no government and then came the unfortunate Refahyol (Welfare Party and True Path Party) coalition. As soon as the ANAP-DSP (Motherland Party and Democratic Left Party) coalition was established in 1997, rumors were spread about the possibility of an early election. This process continued until the 57th government without a break. Even the investors, who had made up their minds about investing in Turkey, kept suspending their investment decisions during this unstable period.

Turkey used to be one of the top 10-15 markets of the world prior to the last crisis. Recent research tends to conclude that the total size of the Turkish economy stands somewhere around- US$500 billion. The official size of the Turkish economy had been announced to be US$210 billion prior to the crisis. This figure should have fallen to US$150-160 billion by now. Despite a fall in purchasing power to some US$350-400 billion, Turkey still owns one of the largest economies of the world. The basic factor underlying the importance of the Turkish market is this dual structure. (DPT, Avrupa Birliği'nin Genişleme Süreçlerinde Yaşanan Ticari Gelişmeler, 1999)

Besides the research carried out in Turkey and the announcements of Turkish officials, this assertion was also supported by the OECD predictions based on the purchasing power parity criterion. The OECD used to predict the Turkey's per capita purchasing power parity at US$6,500 based on official figures. According to a more specialized research, the per capita purchasing power parity in the Western region of Turkey, populated by some 25-30 million people, used to stand at US $15,000. All these figures illustrate the appeal of the Turkish market. The above mentioned figures do not include the ever growing market opportunities around the Black Sea and among the Turkic Republics, created by investing in Turkey. The fact that most of the foreign investors in Turkey manage their operations in the above mentioned areas from their bases in Turkey displays Turkey's importance in the eyes of these investors.

Besides its market opportunities, Turkey's human resources, comparable to those of the industrialized countries, its well laid-out infrastructure, Turkey's presence in certain multi-lateral agreements, such as the agreement on preserving foreign investments and preventing double taxation with around 60 countries, shows us the other side of the coin about Turkey. The above mentioned factors justify foreign investors decisions to expand their investments in Turkey and to use Turkey as an operational base for the penetrating the neighboring markets including the Eastern Europe, the Black Sea region, the Central Asia and the Middle East. Profit transfers from Turkey stand at negligible volumes US$1.5 billion since 1954. Companies choose to re-invest their profits in the majority of the cases.

Unfortunately, as see n clearly from the total investment figures, Turkey's reality and its potential do not match. It should be emphasized once again that Turkey's failure to fulfill its potential is only due to the political and economic instability. Turkey is unable to restore investor's confidence in spite of its huge potential. The already pessimistic picture of some four and a half months age has gone worse by now. However, changing all these is within Turkey's capabilities. It is anything but impossible that Turkey should reverse this trend and attract an annual foreign investment volume of US$25-30 billion. Numerous developing countries have managed increasing their annual foreign investment volume by eight to ten folds, in a short period of two or three years. Regarding this picture, the conclusion follows almost automatically that it is easier for a country like Turkey to reach similar performance.

Investors are well aware that a chronic problem of instability can not "be cured overnight. However, what they want to see is so me permanent steps being taken on the path towards stability. It has been noted that some serious steps were taken recently. The Constitution was amended to allow for concession and international arbitration, the retirement age -an important component of the social security reform- was redefined and the banking legislation was amended besides the special attention paid to the budgetary discipline, a feature long forgotten in the Turkish economy management.

The Letter of Intent to the IMF and the resulting deflationary stabilization program, where the government had announced an annual exchange rate program, were the crucial steps that foreign investors had been expecting *for* years. All these measures had cultivated a positive outlook on the part of international finance and rating institutions and eased Turkey's international borrowing. (Uyar, 2001)

Turkey's prestige had reached a peak as its accession to full membership candidacy status to the European Union at the December 1999 Helsinki Summit. Right afterwards, Prime Minister Bülent Ecevit had attended the World Economic Forum in Davos and voiced a call for foreigners to invest in Turkey was taken as concrete improvements among foreign investors.

Nevertheless, Turkey's failure in enacting its deflationary program and the appearance of certain attitudes and regulations disturbing the foreign investors in country have east some shadows on these significant improvements. So me restraints placed on certain regulations by certain ministries have raised doubts about whether the government would re-adopt the restrictive measures of the pre-1980s. Among these bleak applications are seeking of a majority of domestic shares in the project controlling enterprises to be established after the August 17 earthquake, attempts to prohibit the operations of foreign security companies, postponing of some privatization projects, unjust practices of the legislation faced by some foreign investors, obstacles related to the employment of foreign personnel, and spreading of the non-tariff barriers just to name a few. The inflation rate, which is expected to exceed at least 50% in the aftermath of the recent failure of the deflationary program, has made the use of inflationary accounting concepts obligatory once again. The failure to initiate this system will but add to the bleak aspects of the investment atmosphere in Turkey. (Ekin, 1999)

Considering that Turkey has no option of rejecting foreign investments, what is to be done and what is not to be avoided becomes obvious. Owing to the abovementioned issues, Turkey holds a second chance nowadays. The measures to be taken and the legislation to be passed in order to recover from the crisis will set the basis for Turkey to re-attract foreign investment. Special attention should be pa id to prevent the negative attitudes of some ministries and the adverse effects of sc5me practices due to lack policy co-ordination a,nd to put an end to blaming foreign investors at every opportunity will help restore Turkey's credibility in international circles.

Immediate success is not a crucial issue as long as the government carries on its attempts to institute stability. As mentioned earlier, foreign investors are not expecting a miraculous recovery. What matters for them are the goodwill and the attempts of the government. In short, the government is obliged to carry on its deflationary policies and to fulfill its commitments. Thus, the launching of the Build-Operate projects as rapidly as possible and the smooth continuation of the privatization program are crucial in that respect. The foreign investment to be drawn to the Build-Operate projects and privatization (transfer of administrative rights) projects will supply the initial momentum. Similarly, the restructuring of the state owned banks and the overall reforms in the banking sector are crucial issues on the agenda. The rapid legislation of the laws appearing on the emergency package launched by the State Minister for the economy and the swift action in carrying out the infrastructure reforms will lead to a reconstitution of Turkey's credibility in the eyes of the international finance and rating institutions. (De Santis, 1998)

Consequently, Turkey used to be taken as one of the most promising investment spots of the world and what happened recently has not reversed this presumption. Turkey fails to fulfill its potential due to the ongoing instability and attracts only one thirtieth of the potential investment projects. However, Turkey will reach the desired levels in this respect provided that the initiation of some recently taken beneficial steps are ensured, the anti-inflationary struggle is won, the deficiencies of the investment environment are cured and the legislation is harmonised with that of the EU. The total capital invested in the world is US$1.1 trillion during 2000. Turkey's carrying out the reforms on its agenda and its recovery from the crisis will suffice to claim a 3-4% share from this pie, as do Turkey's major competitors. (Luiz ,2000)

5.2.3 FDI in the World

FDI is the purchase of land, equipment or buildings or the construction of new equipment or buildings by a foreign company. FDI also refers to the purchase of a controlling interest in existing operations and businesses (known as mergers and acquisitions). Multinational firms seeking to tap natural resources, access lucrative or emerging markets, and keep production costs down by accessing low-wage labor pools in developing countries are FDI investors.

Globalization of the world economy is gathering pace, with international investment as the prime driver. Since the early 1980s, world foreign direct investment (FDI) flows have grown rapidly faster than both world trade and world output. Estimations indicate a continuation of this trend for the following years.

Today, every country is aware of the fundamental role which international investment has, it is through the channels of investment that technological interchange and free circulation of capital, people and ideas take place.

The global economic conditions are getting more and more challenging. FDI has declined in 2002, as cross-border mergers and acquisitions wane and the economies of the major industrial countries show signs of economic slowdown and international political tensions, FDI are expected to recover strongly over the next five years, starting from the second half of 2003. Over the longer term, international production seems set to raise its share of global economic activity. The trend towards better business environments; regional integration; technological change; industrial consolidation; sharper global competition; and opportunities in emerging markets will all underpin renewed strong expansion in FDI.

In respect of global investment flows, a significant slowdown can be observed. Global foreign direct investment flows declined sharply in 2001. Inflows fell by 45 percent and outflows by 50 percent. This reversal -after a steady growth since 1991 and large rises in 1999 and 2000- reflects two factors: the slowing of economic activity in major industrial economies and the sharp decrease in their stock market activity. These combined to slow down new international investments, particularly new cross-border mergers and acquisitions.

FDI inflows fell by 45% in 2001, and by a further 22% in 2002 to an estimated US$ 580bn. The global slowdown, political risks, stock market collapse and corporate scandal have all taken their all on global foreign direct investment. The run up to the war in Iraq, and the ensuing uncertainty, contributed to the overall decline in FDI in 2002. The high oil risk premium and the impact on overall confidence shaved about half a percentage point off world growth over the past year. It also reinforced the already existing investor caution around the globe. The impact of recent geopolitical uncertainty on FDI is in strong contrast to the negligible economic impact of the September 11th 2001 attacks on the US and subsequent fears of terrorism. The steep decline in global FOI in 2001 and the sharp global slowdown predated the events of September 11th. However, despite the likelihood of continuing international political tensions, FDI will recover strongly over the next five years, according to World Investment Prospects, annual analysis of global investment trends, published by the Economist Intelligence Unit. Over the longer term, international production seems set to raise its share of global economic activity. The trend towards better business environments; regional integration; technological change; industrial consolidation; sharper global competition; and opportunities in emerging markets will all underpin renewed strong expansion in FDI. A recovery will begin during 2003, and accelerate from 2004. The growth in global FOI in 2003-07 will be much stronger than the growth in world trade or GDP. (Hertel, 1997)

Recent years have witnessed fundamental changes in global realities and in our perception and interpretation of these realities. This applies particularly well to the concepts of development, finance and investment. In the case of development, in the 1960s (coinciding with the independence of the former European colonies) development was primarily seen as a stated process of catching-up that focused on accelerating economic progress in the poorer, the so called 'developing' nations so as to close the gap between them and 'developed' countries. It was expected that economic growth would trickle down and lead to a better life for all.

Today, the notion of development has changed significantly. It has been expanded to take into account the lessons learned from past experience and experiences elsewhere. However, the challenge of catching up remains, and given the growing inequity in income distribution globally and, in most emerging and transition economies, nationally, it has even become more urgent than before. But development is no longer seen as a straight line leading from lower to higher levels of growth and automatically on to enhanced well-being.

Development today is increasingly perceived as a challenge of combining the three concerns of growth, human development and environmental sustainability into an integrated policy of Sustainable Human Development (SHD). This challenge exists in 'developed' as well as 'developing' countries. This has been demonstrated in the Human Development Reports (HDR) that UNDP publishes annually on selected development topics. These publications, supported by the outcome of research undertaken all over the planet, make this distinction less relevant.

In addition, development is no longer viewed as a state-led process. Economic and political liberalization have ushered in a multi-actor world in which policymaking, and hence development, have become tripartite processes, involving people and civil society organizations, business and the state.

Moreover, there is growing recognition that, as a result of increased openness and globalization, many policy outcomes can no longer be achieved through domestic action alone but require international cross-border cooperation. The concert of finance has undergone a no less dramatic reorientation. Just like development, finance has been a highly state owned process until recent years. With a gradual shift to the market-oriented financing system, and the rapid pace of expansion of the financial markets, some analysts are now worried that these financial markets, affecting investment promotion actions, have also become too powerful, binding the hands of policymakers and leading the real economy. This needs to be carefully assessed and evaluated in order to maximize the positive benefits derived from such developments. (Luiz, 2000)

5.2.4 Portfolio Investment

Portfolio Investment refers to the purchase of foreign stocks, bonds or other securities. In contrast to FDI, foreign portfolio investors have no controlling interest in the investment, which is typically a short-term one. The relative ease with which portfolio investment can enter and exit countries has been a major contributing factor to the increasing volatility and instability of the global financial system.

Portfolio investment, which had resulted in a net inflow of USD 33,65 million in January-December 1996, showed a net inflow of USD 60,82 million in January-July 2003

As for the developments in portfolio investments' assets side, it is observed that residents' security transactions abroad recorded net purchases of USD 383 million, and net sales of USD 117 million in January-July 2003 and 2004, respectively.

As for the developments in portfolio investments' liabilities side, in July 2004, general government realized a repayment of 509 million to nonresidents for the bond issue in 2000. As a result, a net borrowing figure of USD 230 million was observed in January-July 2004.

Non-residents' security transactions associated with equity securities and the government debt securities issued in the domestic capital markets, which realized net purchases of USD 90 million and USD 616 million in July 2004 respectively, indicated net purchases of USD 568 million and USD 2.140 million in January-July 2004.

Turkey has one of the most liberal foreign exchange regimes in the world, with a fully convertible currency as well as a policy that allows foreign institutional and individual investments in securities listed on the ISE since 1989. There are no restrictions on foreign portfolio investors trading in the Turkish securities markets. Decree No. 32 passed in August 1989, removes all restrictions on overseas institutional and individual investment in securities listed on the Istanbul Stock Exchange. Hence, the Turkish stock and bond markets are open to foreign investors, without any restrictions on the repatriation of capital and profits. Decree No. 32 also allows Turkish citizens to buy foreign securities.

Monthly equity investments owned by foreign investors in the Stock Market are as follows:

Table 6 Portfolio Investments By Foreign Investors (Million USD)

	Jan.	Feb.	Mar.	April	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.
1995	---	---	---	---	---	---	---	---	---	---	---	1,936
1996	2,457	2,849	3,029	2,736	2,489	2,965	2,617	2,551	2,79	2,926	3,165	3,085
1997	4,655	4,564	3,997	3,577	3,793	4,456	4,728	4,938	5,97	5,881	5,465	6,018
1998	5,718	5,296	5,373	6,864	5,765	6,095	6,589	3,845	3,2	3,068	3,668	3,7
1999	3,429	5,196	5,554	6,741	5,853	5,555	6,603	5,555	7,001	7,362	8,92	15,36
2000	14,597	13,362	12,734	15,046	11,39	11,34	11,999	11,188	9,503	10,645	8,079	7,404
2001	8,636	5,331	4,009	5,725	4,863	4,796	3,938	3,949	2,988	3,742	4,58	5,635
2002	5,812	4,719	5,43	5,37	4,313	3,716	3,643	3,413	3,124	3,657	4,533	3,45
2003	3,769	4,108	3,033	3,914	4,27	4,323	4,237	4,945	5,77	6,81	6,693	8,954
2004	8,683	9,645	10,813	8,836	8,192	9,074	9,189	9,943				

http://www.ise.org/members/portfolio.htm, Istanbul Stock Exchange

5.2.5 Other Investments

The other investment account, which is composed of trade credits, loans and foreign exchange deposit accounts, recorded a net inflow of USD 3.047 million in January-July 2003 and of USD 3.837 million in January-July 2004.

a. Assets

As regards the trade credits, USD 578 million and USD 963 million were extended in return for exports during January-July of 2003 and 2004, respectively. With regard to the loans sub-item, a credit extension of USD 406 million and a net repayment of USD 531 million were realized in January-July 2003 and 2004.

Banks' foreign exchange holdings with foreign correspondents, which decreased by USD 2.382 million in January-July 2003, increased by USD 1.665 million in the same period of 2004.

b. Liabilities

The liabilities side of other investment indicates that trade credits, which are provided for imports, realized a net disbursement of USD 408 million in long-term loans and of USD 2.305 million in short-term loans, adding up to net disbursement of USD 2.713 million in January-July 2004 due to increasing import expenditures. During the same period of 2003, a net disbursement of USD 936 million had been observed.

With regard to the sub-categories of the loans, due to the International Monetary Fund loans, while a net repayment of USD 2.350 million was realized by the Central Bank, the General Government realized a net disbursement of USD 301 million in January-July 2004. For the long-term loans received from international capital markets and other international organizations, the General Government materialized a disbursement of USD 1.419 million and a repayment of USD 1.685 million during the same period in 2004. In July 2004, of that USD 704 million disbursement, USD 629 million belongs to Undersecretariat of Treasury, which was provided by World Bank for financing some restructuring projects. Finally, a net total disbursement of USD 272 million and of 2.208 million were realized by the banks; a net total disbursement of USD 91 million and of USD 3.370 million were also realized in the other sectors, in January-July of 2003 and 2004, respectively.

Foreign exchange deposit accounts, which had increased by USD 1.474 million in January-July 2003, also recorded an increase by USD 89 million in January-July 2004. This mainly stemmed from the increase in deposit accounts opened with the resident banks by USD 122 million despite the decrease in the deposit accounts opened with the Central Bank by USD 33 million.

Reserve Assets, Official reserves, a sub-item under reserve assets, recorded an increase by USD 1.016 million in January-July of 2003, despite a decrease by USD 460 million during the same period of 2004. (Dönmez,2003)

5.3 EU-Turkey Financial Co-Operation

Financial co-operation with the European Union starred with the first protocol aiming at the improvement of the productivity of Turkish economy as envisaged in the Ankara Agreement. From 1970 to 1977, two more Financial Protocols and one additional protocol were signed in 1981; the fourth protocol was initiated but never entered into force because of the Greek veto. At the Association Council Meeting in 1980 a special co-operation fund was devoted to Turkey, amounting to 3 million Euros.

Throughout three financial protocols, one additional protocol. and a special co-operation fund, the EU has provided only 827 million Euros of financial assistance to Turkey between 1964 and 1980. On March 6, 1995 the Community declared that, with the establishment of the Customs Union, it would resume its financial co-operation with Turkey by supplying 375 million Euros in the form of grants over a five year period starting 1996, and by providing access to the EIB funds amounting to 300 to 400 million Euros available under the 1992-1996 new Mediterranean policy for the financing of infrastructure projects. The EU would also make available additional EIB loans amounting to approximately 750 million Euros for improving the competitiveness of the Turkish economy over a five year period starting in 1996, provide access to funding facilities which the Community will make available as from 1996 in favor of all Mediterranean countries, and supply 200 million Euros in cases of special need of macro-economic assistance linked to the execution of IMF-improved programs.

However, this financial co-operation package has largely failed to materialize. Only 339.5 million Euros was made available in the period 1992-1996 and projects worth about 100 million Euros have been approved since then as part of the MEDA program. No other progress had been made in relation to the other elements of the financial co-operation package. However, there has been a significant change in the field of financial co-operation after the tragic earthquake of 17 August in Turkey. The Community Humanitarian Office, ECHO, released 4 million Euros right after the earthquake. it has later released a further aid of II million Euros. The total emergency assistance provided by the Union should reach 30 mi/lion Euros. As the Ecofin Council of 8 October had requested, the European Commission submitted a proposal to the Council and to the European Parliament, which, once approved, will allow the Community to guarantee loans from the European Investment Bank for reconstruction in Turkey. This series of EIB loans will be limited to 600 million Euros and will be used in investments for infrastructure (transport, energy, etc), industrial installations, SMEs and housing. 200 million Euros should also be provided to help Turkey continue its reforms. (Bayar,2000)

5.4 Financial Co-operation With In the EU-Mediterranean Partnership

Within its MEDA program, the EU promised to provide a financial assistance of 3.4 billion Euros to the Mediterranean Countries between 1995 and 1999. The European Investment Bank also allocated 2.3 billion Euros to the Mediterranean Countries. 375 millian Euros from the budgetary sources and 215 million Euros from the EIB sources were committed to Turkey. However, up to now, only 12 million Euros could be utilized from the budgetary sources.

Following the financial aid after the earthquake in Turkey, the Commissioner responsible for enlargement, Mr. Günter Verheugen informed the European Parliament that Turkey would receive 375 million Euros under MEDA by the en d of this year. A substantial part of the resources of the MEDA 2 program would also be allocated to Turkey in the year 2000. (Hoekman, 2000)

5.5 Special Action Program

As the only financial instrument specific to Turkey and devoted to the implementation of the Customs Union, the special action program was approved by the European Parliament in 1995 but did not enter into force because of the Greek veto. Consequently, 375 million Euros grants managed by the Commission and 750 million Euros long-term loans from the European Investment Bank could not be utilized.

5.6 Macro-Economic Assistance

As an element of the European Strategy for Turkey*, the European Commission proposed a grant of 150 million Euros from the budgetary sources to support the deepening process of the Customs Union between the EU and Turkey**. According to article 130 w of the EC Treaty, financial assistance can be provided by qualified majority voting if the country is a developing one. The Council approved the proposition of the Commission; however, the European Parliament did not adopt this proposal. After the earthquake in August a large share of this amount is allocated to cushion the negative effects on industry. European Parliament has approved this proposal. However, it is obvious that without appropriate funding, it is not feasible to implement all aspects of neither the European Strategy for Turkey nor of any possible accession partnership after Helsinki Summit. (Brown, 2000)

The existing grants, which were also open to the Mediterranean countries, were provided under various conditions. Total commitments Turkey received from the MEDA program in the last three years have been only 10% of the total funds, whereas Egypt received 29%, Morocco 20% and Tunisia 12% of the budget.

Consequent to the Helsinki European Council, it is envisaged to grant to Turkey an amount of 177 million Euros for a period of three years with the aim of carrying out the accession partnership. The said amount will be supplied from two different sources. Accordingly, the sum of 127 million Euros will be acquired from the MEDA program and the remaining amount of 50 million Euros be obtained from the macroeconomic aid schemes envisaged under the Customs Union. (Kuvenhoven and Memedovic, 2001)

6. BALANCE OF PAYMENTS DEVELOPMENTS AFTER CUSTOMS UNION IN JANUARY-JULY 2004

6.1 Current Account

Current Account is the section of a country's balance of payments statement which totals international transactions for import and export payments, interest on debts, profits from

* European Commission (1998) Communication from the Commission to Ihe Council, European Strategy lar Turkey The Commissions' initial operational proposals, Com (1998), 124 final

** European Commission (1998) "The Proposal for a Council Decision Regarding the Implementation of Measures to Intensify the EC-Turkey Customs Union" COM (1998) 600 final.

foreign direct investment and aid grants. The current account is a broad measure of a country's trade balance.(a negative current account balance = a trade deficit)

The current account deficit realized as USD 703 million in July 2004, while it is observed as USD 10.025 million during the overall period of January-July 2004. As compared to July 2003, the foreign trade deficit figure increased by 73,3 percent to USD 2.405, while net tourism revenues are estimated to grow by 22,4 percent to USD 1.826 million in July 2004.

6.1.1 Foreign Trade

The foreign trade deficit increased by 100 percent pulling the cumulative deficit to USD 14.037 million during January-July 2004. The key factors underlying this development are:

-the increase of export (FOB) revenues by 32,7 percent, realizing as USD 34.406 million,

-the increase of shuttle trade by 9,6 percent, realizing as USD 2.176 million,

-the increase of import (CIF) expenditures including gold imports by 45,1 percent, realizing as USD 53.825 million.

Table 7 Foreign Trade Figures

Selected Items (Million USD)	Jan. - July 2003	Jan. - July 2004	Change (%)
Export FOB	25.920	34.406	32,7
Shuttle trade	1.985	2.176	9,6
Import CIF	-37.105	-53.825	45,1
(Gold imports)	-1.550	-2.095	35,2
Foreign trade deficit	-7.016	-14.037	100,1

6.1.2 Services

In comparison with January-July 2003, services surplus increased by 38,5 percent to 5.240 million in the same period of 2004. Based on the estimates for July 2004 (since the related 3rd period surveys have not been completed yet), the tourism revenues recorded an inflow of USD 7.157 million in January-July 2004, which reflects a 35,8 percent increase over the same period of 2003. As a result, the net tourism revenues amounted to USD 5.634 million increasing by 40,4 percent. In January-July 2004, 40,7 percent increase in the number of foreign visitors over the same period of 2003 is the leading reason for the increase in the tourism revenues.

As for the transportation, the other important item of this category, revenues increased by 26,6 percent in comparison with the same period of 2003, whereas expenditures increased by 44,8 percent because of a 51 percent increase in the freight expenditures, a sub-item under transportation, in line with the growing imports. Thus, net transportation expenditures recorded an increase of USD 330 million compared to the same period of 2003, amounting to USD 581 million in January-July 2004.

6.1.3 Income

Investment income, which had shown a net outflow of USD 3.272 million in January-July 2003, also recorded a net outflow of USD 3.222 million during the same period of 2004. The main components of investment income, direct investment income, portfolio investment income, and other investment income showed a net outflow of US dollars 40, 179 and 217 million in July 2004, respectively.

In comparison with the first seven months of 2003, the interest expenditures of long and short-term loans decreased by 13,5 percent in 2004, realizing as USD 2.196 million.

6.1.4 Current Transfers

In comparison with January-July 2003, current transfers increased by 68,8 percent, realizing as USD 1.994 million over the same period of 2004. Regarding the sub-items of current transfers, workers' remittances and imports with waiver recorded a net inflow of 16,6 percent and 120,3 percent amounting to USD 421 million and USD 1.368 million, respectively.

6.2 Capital And Financial Accounts

Capital and Financial Accounts is the section of a country's balance of payments statement which totals all international purchases and sales of assets including foreign direct investment, portfolio investment, bank loans, other securities and foreign currency holdings.

In January-July 2004, the financial account recorded a net capital inflow of USD 8.695 million with a 190,6 percent increase in comparison with the same period of the previous year. The main developments under financial account during this period are summarized as follows:

6.2.1 Direct Investment

As regards the non-residents' net direct investment in Turkey, which includes the loans received from foreign direct investors abroad and real estate purchases of non-residents in Turkey, an inflow of USD 582 million was recorded in January-July 2003 and also an inflow of USD 1.800 million was observed during the same period of 2004. USD 918 million of this amount, including the July 2004 estimate figure of USD 250 million, belonged to the net real estate purchases of non-residents in Turkey. The USD 184 million of the net direct investment in Turkey belonged to the net loans received from foreign direct investors abroad.

Residents' net direct investment abroad, which had shown an increase of USD 238 million in January-July 2003, also resulted in an increase of USD 457 million over the same period of 2004. As a result, direct investments recorded an inflow of USD 1.343 million in net terms in January-July 2004.

6.2.2 Portfolio Investment

Portfolio investment, which had resulted in a net inflow of USD 60,82 million in January-December 2003, also showed a net inflow of USD 74,37 million in January-August 2004.

As for the developments in portfolio investments' assets side, it is observed that residents' security transactions abroad recorded net purchases of USD 383 million, and net sales of USD 117 million in January-July 2003 and 2004, respectively.

7. IMPLICATIONS OF THE CUSTOMS UNION

7.1 Macroeconomic Implications

With the Customs Union and the complete tariff reduction for EU products coming into Turkey, the protection rate imposed on imports of industrial goods will be decreased from on average 10.97% to zero. This will cause an initial tax revenue lass for the government budget. Abolition of the "Mass Housing Fund (MHF)" both for the goods originating in the EU and in third countries is also another reason for a significant initial tax revenue lass.

Adoption to the CCT of the EU will also result in reduction of duties imposed on industrial products produced in third countries from 18.4% to 5.8% on average. The tax income loss as a result of this reduction depends on the difference between Turkish and EU's tariff rates and the amount of imports per product. The overall impact is likely to be a budget deficit.

The total amount of tax revenue loss arising from adoption of CCT, the abolition of the Mass Housing Fund and the customs tariff reductions is estimated to be around $3.5 billion.

Harmonization of the policies and the establishment of executive committees for the functioning of the Customs Union will also cause an increase in public expenditure. Extra incentives that will have to be granted to industry after the Customs Union will be another item in public expenditure.

The tax revenue lost by tariff reductions will have to be compensated by revenue earnings by importers and consumers through cheaper imports of raw materials and end products. The efficient taxation of this additional revenue would increase the public revenue in real terms compensating the revenue loss. The short run revenue loss could be compensated with the efficient medium and long term policy measures. (Jones, 2000)

7.2 Trade balance

According to the Customs Union theory creation of a customs union results in an increase in trade between the parties and improve the distribution of resources (depending on the economies being competitive or complementary before the customs union) and trade diversion towards third countries which sometimes could be the lowest cost producers of certain products.

A customs union is mare likely to be advantageous on balance if the economies of the partners are actually very competitive but are potentially complementary. if they produce similar products but efficiencies differ, they will each contract their relatively inefficient industries and expand their efficient ones. There will be a beneficial increase in mutual trade without much diversion of imports or exports from other markets. If, on the other hand, their economies are already complementary, the prospects of gains on the production side would be correspondingly small. A customs union is more likely to increase economic welfare the higher the initial duties on imports from the partners, High duties imply high levels of inefficiency being protected", Thus, the higher the inefficiencies, the greater the gains from trade after such protection is removed. (Bergstrand, 1999)

Accordingly, Turkey's trade volume after the Customs Union is expected to increase but the direction of it will most probably be towards the increase in imports from the EU and less increase in exports to the EU. The reason for this is that the EU has abolished the protection of its market by reducing the customs tariff imposed on industrial products coming from Turkey in 1971 after the signature of the Additional Protocol whereas Turkish market remaiiled highly protected until very recently for most of the products coming from the EU. Abolition of Turkish customs tariffs for the EU's industrial products will result in increased volume of EU products entering into the Turkish market. According to the European Commission, the EU's exports to Turkey are expected to double within five years following the entry into force of the agreement.

The short term effect of the Customs Union on trade balances would be negative as the increase in imports would be higher than the increase in the exports ending with a bigger deficit in the foreign trade balances. However, considering that most of the Turkish imports have been conducted under the incentives regime -that means free of duties- the increase in imports might not be that high after the Customs Union. (Krueger and Aktan, 2001)

7.3 Industrial implications

With the achievement of the Customs Union and especially the elimination of customs duties, Turkish industries will have to face increased competition from their European counterparts. The legislative changes such as competition law, industrial and intellectual property rights, patent law, consumer rights and geographical indications will oblige Turkish entrepreneurs to work to international and European standards which will bring extra costs to their business processes.

As a result of alignment to the CCT of the EU, some third country products such as textile, consumer goods, pharmaceutical, Iran & steel will enter the Turkish market cheaper than before. Therefore, in addition to competition from the EU, Turkish products will have to face the competition from third country products. This will force the change on the sectors that have been heavily protected for many years and therefore producing under very inefficient conditions. There will be concentration on more competitive sectors rather than uncompetitive ones. This will result in the closing down of uncompetitive firms which will raise the problem of unemployment and some decrease in the GNP for a short period.

There is a need for restructuring in Turkish industrial policy with more rational strategies. R & D investment, technology and know how transfer, structural support for sectors as in the EU are essential measures to be taken.

In general, the imports of raw materials will be cheaper because of the tariff reductions for the imports from the EU and application of CCT for imports from third countries. Most of the imports of raw materials in production are coming from the EU. However, the incentive regime allowing free of duty importation of raw materials for re-exportation purposes will be compensated by a duty imposed in re-exportation to the EU. Around 55% of imports of raw materials originate in the ED. This indicates that 45% of this type of imports originate in third countries such as US 22%, Japan 18% and Central and Eastern countries 11.5% (1994) and Turkish government will impose the compensating duty on this type of imports when re-exported to the EU. This will increase the cost of production of some sectors which once benefited from the duty-free imports and now subject to duty payments. As a result Turkish end-products in some sectors will be more expensive.

Small and Medium Size Industries will be more vulnerable to competition from the EU industries. According to the research conducted by the Istanbul Chamber of Industry by interviewing companies (mostly SMEs) in the manufacturing sector, Turkish companies believe that they are not competitive in both local and foreign markets related to the factors such as product standards, economies of scales, sub-industries, qualified labor force, cost of raw materials, financial and bureaucratic structure, infrastructure, international relations, efficiency of labor and cost of finance.

There are some issues to be considered in evaluating the competitiveness of industries:

- Labor is cheap in Turkey in absolute terms. However, in terms of efficiency, labor is more expensive in Turkey than in the ED. Salary increases should be granted against efficiency increases.
- Energy is also more expensive than in the EU which effects the competitiveness of the industries negatively. For the survival of most of the sectors after the Customs Union industries should be supported by more rational industrial policies as in the EU. Scale of the industries will be another important factor for defining the survival of them after the Customs Union. Those industries that have not reached the optimum scale will hardly survive the competition after the Customs Union.
- Technical Standards is another area that Turkish industry will have to adapt itself to that of the EU. Most of the sectors such as automotive components and pharmaceutical

and those who are falling under the definition of SMEs do not have enough resources and knowledge to apply the same standards as in the EU.

(Lister, 2000)

7.4 The leap into the single market

Before the single market, free circulation of goods within the Community was not a reality. Numerous customs border formalities were still in existence, for example because of the way of collecting VAT and excise duties and for statistical purposes. Before 1993, all hauliers were stopped at the internal Community borders for 'customs' and tax clearance and even inspection.

Chronic queues of trucks at the customs posts hindered intra-Community trade and cost EU trading companies large amounts of time and money.

Customs legislation, though already harmonized, was not applied in a uniform way. Despite the absence of customs duties in trade between the Member States, in fact there was little difference in administrative burden or appearance between intra-Community trade and trade with non-member countries - the same was essentially true for travelers. 'Customs' clearance at the Community's internal frontiers was elaborate and time-consuming. The constant flow of new Community and national laws, regulations and standards for health and consumer protection etc. was formerly enforced by the customs services at the internal borders, because those were there anyway. The first step in achieving a real internal single market was the replacement of 'customs' formalities at internal frontiers by new fiscal, statistical and other control systems that required no control or documentation at the moment that the goods crossed the internal borders.

On 1 January 1993, all 'customs' checks at the internal borders, including the use of the single administrative document, were abolished for the movement of goods. Spot checks still occur for drugs and immigration, but routine internal border checks have disappeared. (Swaminathan and Hertel, 1999)

7.5 The tariff gives the customs duties

While the free circulation of goods within the European Union is the internal aspect of the Customs Union, the Common Customs Tariff is the external aspect. It applies to imports of goods across the external borders of the Customs Union.

The common commercial policy fixes the tariff rates for customs charges due on goods imported into the Community and the exceptions to this, as well as prohibitions and restrictions. All this is monitored and controlled by customs staff.

The Common Customs Tariff, or CCT, is common to all members of the Union, but the rates of duty differ from one kind of import to another depending on what they are and where they come from.

Rates depend on the economic sensitivity of products and are a means of protecting the Community's economic interests.

By means of its Common Customs Tariff, the Community applies the principle that home or domestic producers should be able to compete fairly and equally on the Community market with manufacturers exporting from other countries.

Raw materials and semi-manufactured goods, which the Community often does not produce anyway and which it needs to produce goods, usually benefit from low duty rates. There are also temporary or permanent duty suspensions available if Community manufacturers have to use materials or components from outside to manufacture Community exports. This makes cheap raw materials and semi-finished goods available to EU manufacturers on the same competitive footing as they are to foreign processing companies. The duty relief systems are called 'inward processing' or 'duty suspension' depending on the one used.

In some economic sectors it is necessary to stimulate competition by low tariffs, as we find in the pharmaceutical and information technology sectors.

The Community is constantly adapting the Common Customs Tariff as a steering instrument for world trade. It has participated in eight tariff rounds, cutting tariffs considerably[*] .

The last multilateral agreement, 'the Uruguay Round', focused on the abolition/reduction of duties for information technology products, one of the strategic sectors in world trade; the next, or 'Millennium Round', is being prepared at present. Increases in duties are only possible in accordance with the rules of the WTO, which normally require compensation by reducing other rates. This can be needed when countries join Customs Unions, as sometimes, for some products, the Customs Union may have higher duties.

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[*] Under the General Agreement on Tariffs and Trade of the World Trade Organization.

By shaping its Common Customs Tariff in compliance with the World Trade Organization rules the European Union has demonstrated that it takes its responsibilities within a free world trading system very seriously.

The Community nomenclature is based on an international classification tool, the Harmonized System, administered by the World Customs Organization (WCO), an intergovernmental organization also based in Brussels. The systematic list of commodities serves many uses and is applied by most trading nations. It forms the basis for international trade negotiations and the settlement of tariff disputes and trade statistics.

Imported and exported goods have to be declared stating under which subheading of the nomenclature they fall. This determines what rate of customs duty applies and how the goods are treated for statistical purposes. Effectively everything depends on this classification, as all trade measures use the nomenclature to describe which treatment is to be given to what goods. This instrument is crucial when the precise description of goods and classification has to be used for trade legislation. It is used, for example, in the identification of goods covered by non-tariff measures, import quotas, surveillance and prevention of the importation of certain goods.

It is also used in formulating and applying origin rules, as they are based, to a large extent, on the end product being in a different tariff heading than the imported products used in manufacture.

7.6 Mutual 'preferential' trade

The European Union does not, however, promote trade only within the multilateral context of the World Trade Organisation (WTO).

It has also concluded 'preferential' agreements with individual countries or groups of countries by means of free trade agreements and customs.

There are free trade agreements, such as the European Economic Area (EEA) - the EU, Iceland, Norway and Liechtenstein - which promote and maintain trade links between the European Union and its neighboring countries and include most of the former EFTA countries. There is also a free trade agreement with Switzerland, which is the member of EFTA that did not join the EEA. Lastly, there are free trade agreements with the central and east European countries - Poland, Hungary, the Czech and Slovak Republics, Slovenia, Estonia, Latvia, Lithuania, Bulgaria and Romania. Customs are playing an important role in this context, since these agreements aim at achieving trade promotion by mutual tariff concessions and help to prepare for accession.

All these agreements are linked, as the origin rules allow the use of each other's products in further manufacture.

Additionally, the European Union has concluded Customs Union agreements with Turkey, San Marino and Andorra.

7.7 Development and preferential trade

By using its commercial policy to encourage development, the European Union has become the world leader in helping the developing world to trade by providing 'preferential' access to Community markets. This means access at reduced rates of customs duty. Up to now these have been mostly one-way arrangements where our partners do not give any preferential treatment to Community exports. This falls into three main groups, the Convention, the set of agreements with our Mediterranean partners and the Generalized System of Preferences

The GSP

The general system of preferences for developing countries is an internationally accepted way of developing trade based on trade concessions granted autonomously by the industrialized countries.

For the Community most of the developing countries covered by the GSP worldwide are also covered by the ACP or Mediterranean agreements. For the Community the GSP allows Asian and Latin American countries to export to the European Union at lower than normal duty rates for manufactured goods and processed agricultural products. Access to this program can be granted as a means of promoting the ideals of the European Union in the developing world.

For example, additional GSP tariff cuts were offered to developing countries conforming to international agreements on environmental protection and forbidding child or forced labor.

In all these preferential systems the respect of customs provisions (origin rules) is the key to enjoying the benefits of such tariff preferences. In controlling the correct application of these provisions, customs officials are the guardians of the Community's external policy.

8. CUSTOMS COOPERATION AGREEMENTS

Apart from the abolition of tariffs between partners, it is a priority for the European Union to create other cooperative links, bringing in the world's other large trading nations. For the benefit of world trade and international assistance to fight against customs fraud, the European Union has signed customs cooperation and mutual administrative assistance agreements with the United States, Canada and Korea and others are in the making.

In addition, the European Union has committed itself to training and information programs with other countries, in particular helping to modernize the customs administrations in third countries and their working methods, thus improving the flow of trade.

As tariffs are reduced and the product range of goods being imported evolves, the protection of the Union's economic interests is shifting more and more towards the use of other instruments. These 'non-tariff' measures are varied and include actions against:

Unfair competition

Unfair trade practices usually consist of dumping or paying illegal subsidies. Dumping exists when an exporter in a third country sells particular goods on the Community market more cheaply than on its domestic market. Sanctions can be introduced against subsidies when specific goods exported to the Community benefit from subsidies considered illegal under the terms of the WTO agreement.

In both cases the Commission can conduct detailed investigations in the suspect countries.

Trade sanctions in the form of extra, targeted, duties (anti-dumping duties) or insistence upon importers agreeing a certain level of prices (price undertakings) can be applied to imports which cause significant economic difficulties to producers in the European Union, because of unfair trade practices.

Sanctions are usually introduced after considering the request made by Community producers of a particular product about unfair competition. The measures we are allowed to take have to be in accordance with the criteria stipulated in the World Trade Organization agreement and those laid down by Community legislation.

The nomenclature of the common customs tariff is used to define the products in question, and the terms used are quite specific and provide for closely targeted protection. The scope of the measures that can be taken by the Union is limited to the level of dumping or subsidy, or to what is necessary to eliminate negative economic effects suffered by Community industry, if such a level is lower than the dumping or subsidy.

However, measures are only imposed when the investigation shows that they are in the interest of the European Union.

The effects of such measures on the interests of users and consumers are thereby taken into account.

Anti-dumping and countervailing duties are charged in addition to the rates of the Common Customs Tariff. The customs rules of origin determine whether the imported goods are considered to be from the suspect country. (Krueger, 2000)

8.1 External Relations Policy Measures

The Customs Union acts as an enforcement mechanism for the common external and security policies where measures such as sanctions and embargoes are used. It is increasingly used to put pressure on countries acting in a way that the global community finds unacceptable.

Customs play a major role in implementing the economic sanctions in relation to imports and also intervene in respect of exports to countries under sanction.

An example of an external relations measure is the control of arms exports and the control of the export of dual-use goods.

Dual-use goods are those goods produced for civilian purposes that could also have a military use. Some chemicals, for example, can be used to make both fertilizers and explosives. We do not want these goods to fall into the wrong hands.

User-friendly procedures and modern customs law can be factors when it comes to determining the location of business and industry. Time and cost saving are an element of competition for the EU economy. Not only is the simplification of trade procedures vital, but so is the efficiency of the methods used for the protection of our citizens.

The Commission and national administrations have a joint responsibility in fulfilling the legitimate expectations for all of this.

The Commission, through DG XXI - Directorate General for Taxation and Customs Union, is responsible for initiatives for the development of customs policy, for proposals for customs legislation, for aiding coordination between the Member States' administrations, and for seeking advice and feedback from business and industry at Union level. The national customs administrations are responsible for the day-to-day application of EU law: collecting customs duties, excise duties and VAT on imported goods and applying all the other policies we have mentioned here. They also maintain contact with the national local business communities.

The basic customs legislation itself is contained in the Community customs code and in the nomenclature. The other policies, which customs apply at the borders, are enshrined in other laws.

All these are, in general, adopted by the Council of Ministers and ap-proved by the European Parliament on the basis of proposals made by the Commission. Subsidiary law, often called implementation provisions, is adopted by the Commission in strictly delimited circumstances and then, usually, only after approval by the Member States' authorities expressed in the customs code committee for customs law or another committee where other legislation is concerned. (MFA, The New Enlargement of the EU: Turkey and Other Applicants, 1999)

8.2 New Member States

The candidate countries are preparing for accession to the European Union. Customs is an area of particular importance as we are all mutually dependant on one another in the Union. The chain is as strong as its weakest link.

The very role of customs makes the creation of an efficient, effective modern customs administration an indispensable element of the accession package. The control of the external frontier on behalf of an enlarged EU will be in itself a major task, whilst the very role of customs in a single market requires specific expertise. This has been recognized by the inclusion of customs as a priority sector in the accession partnerships set up to guide the enlargement process.

Consequently, funding under the program for technical assistance to candidate countries has been made available.

Close cooperation between the Commission, the partner countries' and the Member States' customs administrations has already produced considerable progress.

This has been particularly noticeable in the adoption of new customs legislation by our partners.

Nevertheless, a significant amount of work remains to be done, especially when it comes to achieving an operational capacity equivalent to that found in the EU. This is especially the case in areas of work that are new to them i.e., the application of the common agricultural policy.

The enforcement of EU customs and trade-related laws will be in itself a major task for the candidate customs administrations; to do this, whilst allowing an increasing amount of traffic to flow without undue hindrance, will be extremely difficult.

This is why a specific strategy to assist in preparation has been adopted jointly by the Commission, the Member States and candidate countries. We have produced 'road maps' to chart the route to be taken; operational capacity will be tackled using 'blueprints' setting out operational standards or guidelines for the different sectors of customs operations.

A check on the progress made is carried out in the sub-committees on customs and taxation created under the various Europe agreements. Here we also regularly exchange information on enlargement developments. (Molle, 1994)

8.3 Consolidation program: Customs 2002

The interoperability of the customs administrations of the European Union and cooperation between them are rendered more difficult by their different structures, responsibilities, cultures and traditions.

This, however, provides a fertile breeding ground for new ideas and synergies. The harmonization of customs legislation is now virtually complete. However, differences in the detailed application of the common rules among and between the Member States can mean that the effects are slightly different.

The effect of the single market is then not exactly the same everywhere. A more homogeneous application of the harmonized customs law by administrations had to receive a higher profile.

This implied a framework for discussion and decision making on non-legal questions and issues.

This is why the Community set up the 'Customs 2000' program.

In December 1996, the Parliament and the Council adopted the Commission proposal for an action program for customs in the Community.

This was to agree explicit guidelines so that customs services could have a clear idea of the role they were expected to play within the Community dimension.

However, this was to be without encroaching upon national competences. This program has been a success, but it can be improved upon. It will now be prolonged and updated as 'Customs 2002' through the inclusion in this program of the existing and future information technology program. It will also be opened to all countries that are candidates for accession.

What can we conclude from the history of European customs and the future tasks which they will face? We have come a long way, but we have not yet arrived. In fact, we will never arrive, at least for as long as trade into and out of the European Union cannot be left free from any kind of limitations or control. Will this ever happen? Perhaps, but not in the foreseeable future. Customs must adapt and change to meet new roles, new challenges, and to harmonize, possibly even, to have unified procedures and practices everywhere. The first steps have been taken: 15 customs services are now acting as one.

Customs has a future. It has a vital role in carrying out your wishes: to collect your taxes, to protect your industries, your employment, your health, your environment.

9. TURKEY'S ACCESSION TO THE EU

9.1 Turkey's development without accession

How would the Turkish economy develop over the next twenty years if the country would not accede to the EU? One can imagine different scenarios. Turkey could integrate economically with the EU, without becoming a full member. In that case, the Customs Union may be further deepened, without Turkey becoming part of the internal market. Alternatively, Turkey could become disappointed about its cooperation with the EU and decide to focus more on its relationship with its eastern neighbours in Asia. In that case, a process of disintegration with the EU may become real.

Uncertainty about the future development in the absence of accession to the EU renders it difficult to assess the economic implications of the accession itself. Against what scenario should we compare the accession? In model simulations, the usual approach is to develop a so-alled baseline scenario in which the current situation is extrapolated into the future. Thus, the baseline neither assumes a tendency towards disintegration, nor a tendency towards more integration. The impact of the accession to the EU is then determined by comparing the economic outcomes of a scenario with accession to the baseline.

In the next section, we follow this approach by simulating the economic implications of the Turkish accession with our CGE model. Thus, we develop a baseline until 2025 in which the relationship between Turkey and the EU remains as it is today, i.e. a customs union in industrial products, a limited degree of integration with respect to the internal market, but neither full membership of the EU nor further integration in other respects. In the baseline, we include a number of developments inside and outside Turkey which can be foreseen with certainty. For instance, we assume that ten candidate countries from Central and Eastern Europe become member of the EU in 2004. Moreover, Bulgaria and Romania are assumed to accede in 2007. (Commission of the European Communities, Report from the Commission on Developments in relations with Turkey since the Entry into Force of the Customs Union, 2001)

We also assume that the international agreement of textiles and clothing (ATC) vanishes in 2005 such that the Turkish textile sector will face more competition from Asian countries. With regard to Turkey, we include demographic projections based on the UN, which suggests that population grows from 68 million in 2001 to around 86 million in 2025. We do not include substantial reforms in Turkish policy as compared to today's situation. Economic growth in Turkey in the baseline scenario exceeds that in the EU due to a catching up. In particular, the baseline assumes a real growth rate of GDP of 5.6% per year in Turkey, which is partly due to a relatively fast growing population. GDP per capita grows annually by 4.5%.11 In the Accession-10, growth is lower at 2.9% per year, in part because of a gradual shrinking population (0.3% annually). GDP in the EU is assumed to grow at 2% per year during the coming decades. Relative to the baseline scenario, we explore the economic implications of the Turkish accession. In particular, we determine first the long-term economic outcomes in the baseline scenario and then compare them with the outcomes in a scenario with accession of Turkey. Thereby, we assume that Turkey becomes a member of the EU in 2010. The exact date, however, has no significant impact on the long-term simulation outcomes. An important question is: what effects do we attribute to the accession of Turkey. In the next four subsections, we discuss four changes that are induced by Turkey's accession to the EU. These are, respectively, accession to the internal European market, an improvement of Turkish institutions in response to EU-membership, free movement of labor, and access of Turkey to EU funds. The last effect is not simulated in our CGE model, for reasons explained below.

9.2 Accession to the internal market

A major economic aspect of the accession of Turkey to the EU involves the accession to the internal market. This will affect the economies of Turkey and EU members via trade, FDI, domestic investment, and so on. The focus here is on the trade effect of the internal market.12 Accession to the internal market may increase trade for at least three reasons. First, administrative barriers to trade will be eliminated or at least reduced to levels comparable to those between current EU members. Here, one can think of reduced costs of passing customs at the frontier: less time delays, less formalities etc. Anecdotic evidence suggests that there is a lot to be gained here in the case of Turkey. Secondly, accession to the internal market implies a reduction in technical barriers to trade. The Single Market reduces these technical barriers by means of mutual recognition of different technical regulations, minimum requirements and harmonization of rules and regulations. Although the customs union between Turkey and the EU has already eliminated some of these technical barriers, it appears that substantial further advances have to be made. Finally, risk and uncertainty will be mitigated by the Turkish accession to the EU. Especially political risks and macroeconomic instability may reduce substantially. In measuring the economic implications of accession to the internal market, we follow the approach of Lejour et al. (2004). That study shows for the countries from Central and Eastern Europe that the accession to the internal market is much more important than the elimination of bilateral trade tariffs and common external tariffs as in a customs union. That conclusion and the existing customs union between Turkey and the EU in manufacturing suggest that the accession to the internal market is the relevant issue, and not the elimination of remaining tariffs and harmonization of external tariffs.13 Lejour et al. (2004) measure the economic consequences of accession in two steps. First, they follow Bergstrand (1989) in estimating gravity equations on the industry level. (Commission of the European Communities, The Proposal for a Council Decision Regarding the Implementation of Measures to Intensify the EU-Turkey Customs Union, 1998)

9.3 Improving Turkish institutions

It is sometimes argued that EU-membership may work as a catalyst for Turkish institutional reforms. For instance, by becoming EU-member, Turkey has to conform to all EU legislation and enforcement by the European Court of Justice. Moreover, via the method of open coordination, Turkey will regularly be assessed by the European Commission and other Member countries on its economic policies. EU-membership can thus trigger institutional reform in Turkey and reduce the widespread corruption. Today, the high level of corruption hinders economic transactions substantially.

Improvements in institutions and transparency may benefit the economic development of Turkey by improving its competitive position.

Better quality institutions and less corruption would increase trade by 17% to 27%. Although we cannot explicitly attribute the extent to what EU-membership will actually improve institutions in Turkey, it is clear that these have to be reformed in order conform to the internal EU market and the acquis communautaire. It can not be excluded that Turkey also reforms its institutions without becoming EU member, but the possible EU membership can be an extra stimulus to carry out these reforms. By way of illustrating the importance of national institutional reform in Turkey, we have assessed the importance of corruption for trade relations. In particular, we have re-estimated our gravity equation on aggregate trade of the previous section, by including a multiplicative construct of the Transparency International Corruption Perceptions Index for the exporting and importing country in the equation. The coefficient for this index in the gravity equation measures the systematic impact of corruption on the intensity of bilateral trade between countries. The results suggest a significant impact of corruption on trade (see appendix A).16 To get a feeling for the quantitative importance of corruption for trade, we did the following experiment. Suppose that, by improving institutions and obtaining more discipline within bureaucracies, EU-membership of Turkey would raise the Corruption Perceptions Index of Turkey to a level comparable with Portugal, i.e. Turkey would rise from place 64 with an index of 3.2 to place 25 with a value of 6.3. By doing so, we find that aggregate trade of Turkey would rise by 57%. Compared to the EU-dummy for the internal market (which induces a rise in bilateral trade between Turkey and the EU of 34%, suggesting an increase in aggregate trade of around 17%), the impact of less corruption would be much bigger. If EU membership would indeed work as a catalyst for institutional reform, this therefore has potentially important economic implications for Turkey. It is also possible that EU membership is less successful as a catalyst for institutional reform. There is for example much resistance against the reforms so that they are difficult to implement. Assume that Turkey only rises to place 33 with an index of 4.9, a level comparable to that of Hungary. In that case, aggregate trade of Turkey would still rise by 28%. (MFA, The Enlargement of the European Union: Turkey and Other Applicants, 1999)

9.4 Level Playing Fields' Are Being Established With Europe

The Decision taken by the Association Council on 6 March 1995 which constitutes the legal basis for the Customs Union consists of 66 articles, 16 statements and 10 annexes. A Customs Union Joint Committee is the main body responsible for ensuring that trade operates smoothly, dealing with technical issues and any disputes. The Committee meets on a regular basis.

The chief characteristic of the Customs Union is that goods will move freely between the EU and Turkey without being subject to customs duties or quantitative restrictions; it covers all aspects of trade and commercial policy to ensure there is a "level playing field" for Turkish and European firms. The main features of this Decision are:

- The elimination of customs duties, quantitative restrictions and measures of equivalent effect on trade in industrial goods, including processed agricultural products, between Turkey and the EU.
- The adoption by Turkey of the EU's Common External Tariff in its trade with third countries.
- The adoption by Turkey of measures equivalent to the EU's common commercial policy.
- Progressive alignment of tariffs by Turkey in line with the EU's preferential trading arrangements with certain third countries.
- The adoption by Turkey of customs provisions in line with those of the EC.
- Agreed competition rules and the alignment by Turkey of its legislation in this area with that of the EC.
- The adoption by Turkey of legislation in the field of intellectual property protection to secure a level of protection equivalent to that in the EC.

- The abolition by the EC of Voluntary Restraint Arrangements in trade in textiles with Turkey.
- The formation of an EC/Turkey Customs Union Joint Committee and the adoption of other institutional arrangements to enable Turkey to be properly informed of, and formally consulted about, policy formulation in the EC on matters which affect the Customs Union.

During the Association Council meeting of 6 March 1995, a Resolution was also adopted in accompanying areas which provides for the intensification of cooperation between the European Union and Turkey in the fields which are not covered by the Customs Union i.e. industrial cooperation, Trans-European networks, cooperation on energy, transport, telecommunications, agriculture, environment, science, statistics, matters relating to justice and home affairs, consumer protection, cultural cooperation, information and communication.

During the same meeting of the Association Council, the European Union made a statement about financial cooperation with Turkey, in order to help it to restructure its industrial sector to the new competitive situation created by the Customs Union and improve its infrastructure linkages with the European Union as well as to reduce the difference between its economy and that of the Community. This financial cooperation amounts to some 2.2 billion ECU's for a 5 year period. (IKV, Avrupa Ülkeleri ile Türkiye'nin Avrupa Birliğ'ne Tam Üyeliğinin Avrupa Birliği'nin Bütünleşme ve Genişleme Dinamikleri Yönüyle Değerlendirilmesi, 1999)

10. CONCLUSIONS AND SUGGESTIONS:

As well as it's young and unsaturated domestic market, also with closeness to Middle East, Black sea and Asia, Turkey is an attractive country for European Union companies.

Moreover Turkey, with a membership of CU, could provide access into EU markets to Far East, Japan and US companies due to its geographic situation.

When foreign investment figures are evaluated, although these qualifications, it is obviously observed that the expectation that the investments will increase after the membership to EU did not materialize.

Afterwards the membership to CU, the share of EU did not increase in permitted foreign investment. The %65 share of EU, seems to increased to %85 in 1996 with an investment project of France. But when actual accesses are considered, it is seen that the share is same.

Total foreign investment permissions and actual access figures indicate that, rather than EU countries, the foreign investments from third countries also did not change.

Consequently although Turkey integrated with the most powerful economic union in the world, the expected foreign investment inflow did not materialize, all these indicators shouldn't be evaluated as CU will not bring any utilities either in the future.

With the absence of economic and political stability, Turkey could not provide safe market conditions and these factors caused these negative results in foreign investment. According to the political instability, sudden political changes and macro economic imbalance terrifies foreign investors. With chronic inflation problem and high interest rates, the foreign investments in Turkey loses value, besides high taxes decreases profit rates. In this environment, foreign investors can not make long term business plans.

Besides the cancellation of adjudications, untransparency of state adjudications law, the problems with Turkish judgments system, and the complication of subjects under discussion, causes lack of confidence against Turkey.

For EU companies Turkey is still an attractive country with it's unsaturated market and with low labor costs, but when it is compared to other candidate countries, it is seen that the labor costs in Turkey is high. Energy costs, especially electric prices that are used in industry sector are high, and this causes a disadvantage to Turkey in production costs when compared to other member countries. On the other hand, when it is compared to EU candidate countries in Central and East European Countries, the investment supports are insufficient and the problems faced with the existent investment support appliances are negative factors in competition with other member countries.

When subjects under discussion about the foreign investment permit are examined, with the regulations made in 1980's, it formed into a liberal structure. And the current elastic subjects under discussion are now stronger with new regulations. The authority of Customs Law's 4458th article, which is about information acquisition and which came into force in the early 2000, provides the foreign investor free information about subjects under discussion, statistical data, origin and price list information. The effect of these regulations, which are made in the last two years, should be evaluated in the following next term. The International Strengthening Law that is accepted in 1999 and came into force in June 2001, that is the solution of international commercial disagreements by referee or referee's committee, is immensely important to create a safe environment for foreign investment in Turkey.

With these developments, Turkey has to improve a comprehensive strategy to increase the entrance of foreign investments. In this frame, the political and economic stability and the subsidies of foreign investment as a state policy should be provided. The tax subject under discussion and other laws should be fair, easily understood and applicable. Besides the tax and the subsidies system should be regulated to prevent unfair competence for foreign investors. Another important point is, in subject to attract foreign investment, Turkey has a geographical advantage when compared to other candidate countries, Turkey has to focus on it and determine a strategy to improve logistic services that will facilitate transit trade. On the other hand Turkey has to explain its membership perspective to international markets to remove the confidence problems of foreign companies against Turkish market, and to attract the investment that will come from the third countries.

To emphasize the positive features, that are existent in investment environment in Turkey, promotion efforts will be very effective.

The long-term impact of the Union on Turkey will be to strengthen Turkey's competitiveness internationally. Facing competition from abroad, Turkish companies have had to increase both the quality of their products and the efficiency of the processes in which they are made. With these pressures of competition both from abroad and from consumers domestically, Turkish companies are becoming more competitive compared to the rest of the world. Reforms are still needed. Domestic and foreign exporters in Turkey are expected to increase capacity in order to achieve economies serving a much wider market.

Turkey is one of the most open countries to attract capital inflows. But unfortunately Turkey has not been able to realize large amounts of capital inflows. Besides the economic and political instability that has already been mentioned, the weak Turkish Banking system is another problem that has negatively affected the inflow of capitals to Turkey. It has been forecasted that the number of banks in the system could consolidate down to 15 or 20 larger banks in the future. The privatization program will also have a large impact on the sector as the state banks will eventually be privatized. The relatively high costs in Turkey also discourage capital inflows.

As to the external reasons increased competition for capital inflows and global events in the 1990s negatively affected the flow of capital to Turkey.

With globalization, as countries are moving towards openness, the number of nations competing for capital inflows is increasing. This is pressurizing governments to find ways of differentiating themselves from other markets by creating a favorable environment to invest.

There have also been a number of major global events that had a negative impact on capital inflows into Turkey. The Tequila crisis in Mexico in 1994, the Asian crisis in 1997-1998 and the Russian crisis in 1998 are among the most deteriorating global events. From 1996 to 2002 the average growth in realized capital inflows was 1% for Turkey. There is a connection between these economic downturns and the poor performance of capital inflows into Turkey. Not only these global events, but also the financial crises of 2000-2001 in Turkey brought into question the stability and the level of risk associate investing in emerging market economies.

We assess the economic effects of three shocks induced by the accession of Turkey to the EU: Accession to the internal market; an improvement in national institutions in Turkey; and free movement of labor. We thus ignore the potential membership of EMU or the implications of transfers from the EU budget. Moreover, we concentrate on the long-term implications of the Turkish accession to the EU, not to short-term issues, and focus on trade relations, not to foreign direct investment.

In analyzing these aspects of the Turkish accession, we first derive a quantitative measure for the potential size of the shocks of the enlargement. Then, these shocks are simulated by means of a CGE model for the world economy. The simulations yield the following results. The accession to the internal market yields positive effects for Turkey: private income (a measure for welfare) increases by 4.4 billion US$ (approximately € 3.5 billion, assuming 1€ = 1.25US$), while GDP expands by about 0.8% in the long term. Also the current EU-15 and the countries of Central and Eastern Europe benefit from the accession of Turkey to the EU, albeit only marginally. The largest impact in Turkey is apparent in the sectors Textiles and Wearing Apparel, which expand by respectively 18% and 15%. This comes at the expense of production of these sectors in Southern Europe and Central and Eastern Europe.

The effects of accession to the internal market are small compared to the potential gains of improvements in national institutions in Turkey. Indeed, if EU membership would be able to

trigger reforms in Turkey such that the country would climb on the so-called Transparency.
The suggestions to improve the level of FDI in Turkey:

Turkey should create a better environment for investment to increase the level of capital inflows it attracts.

a) Existence of a stable political environment and strong and consistent macro-economic policy:

A strong government that can provide political stability and *strong* and stable macro-economic policy is necessary for the increase of capital inflows in Turkey. This includes reducing the level of inflation, maintaining a stable currency, and improving the level of the fiscal budget.

b) Modernization of created assets in Turkey:

Turkey must continue to develop the level of its infrastructure regarding transportation, telecommunication, and utilities. Turkey must improve the infrastructure such as the expansion of the network of roads and highways; the establishment of a reliable supply of energy and water; and the development of an extensive telecommunications network that provides cheap and reliable service. Modernization of created assets also includes a need to upgrade the level of quality of education, training, and intellectual property right. Over the past two decades, Turkey has changed its economic structure that was based on agriculture and textiles to manufacturing and service-based industries. Turkey should invest in high-tech industries in order to further diversify and in order to increase its competitiveness to attract capital inflows.

c) Effective Investment Incentives with clearly defined objectives:

Investment incentives, is an important factor in the attractiveness of a host country to potential investors. There are some problems inherent in the current system for investment incentives. Turkey needs to communicate more effectively these incentives to current investors and potential investors abroad. Along with this, government bureaucracy is the primary issue to be struggled.

d) Improvement of the image of Turkey:

Turkey needs to undertake a massive promotional effort for the improvement of its image internationally. Through organizations such as the chambers of industry and commerce, the government should be increasing its effort to promote Turkish industry and business around the world. This needs to be a "team" effort and requires the cooperation of government agencies, private industrialists, the media, and NGOs.

e) Effective implementation of privatization schemes:

Privatization has been a policy of the Turkish government for the past two decades, with not much of a success mainly due to political instability. Privatizations will provide the government with some directly needed funds and will give foreign investors the opportunities to invest in Turkey.

f) Existence of a sound financial sector:

A strong, trusted and efficient banking and financial sector is necessary for economic efficiency. An accountable and credible financial sector will be a motivating factor for the foreign investors.

Turkey has a number of strengths such as a favorable location, a large domestic market, and a strong level of economic growth. However, high inflation, an unstable government and a weak banking system have largely decreased the country's ability to attract substantial levels of investment. In 1999 the level of capital inflows to developing countries has been around 183 billion dollars. The destination of 117 billion dollars of the total has been the 5 newly industrializing countries in the Far East. Turkey attracted only 813 million dollars in the same year. This figure increased to 1.3 billion dollars in 2000. It would be instructive to compare this figure with the corresponding capital inflows to some other countries in the same year: 24 billion dollars to Argentina, 39 billion to China, 7.3 billion dollars to Poland, 32.7 billion dollars to Brazil, 12 billion dollars to Mexico, 5.1 billion dollars to the Czech Republic.

Turkey can only increase the level of FDI over the next decade by establishing economic and political stability, developing its created assets, using strong investment incentives, promoting itself and its industry abroad, increasing the pace of privatization and improving the financial sector.

We have translated the potential trade increase in corresponding non-tariff barriers, which thus reflect the costs of non-membership of internal market. We then simulated the removal of these non-tariff barriers with a macroeconomic model for the world economy. We start with a scenario in which the current situation is simply extrapolated into the future, the so-called baseline scenario. In this scenario, Turkey's GDP per capita grows faster than that of the EU by about 2.5% per annum due to catching up. Subsequently, we simulate a scenario in which trade barriers between the EU and Turkey are removed. The effects of this accession to the internal market are evaluated after 20 years. The results suggest that that Turkey will experience an additional annual welfare gain (measured by private income) of 4.4 billion US$ (approximately € 3.5 billion at US$1.25 per €). GDP increases by an additional 0.8%. This reflects the gains from integration, specialization and trade creation. The effect for Turkey is larger than that for the current EU member states. For them, the macroeconomic impact is positive, but negligible in quantitative terms. The reason is that only a small fraction of European capital flow to Turkey, while a major part of Turkey's capital flow to the EU.

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