

T.C.
BAHÇEŞEHİR ÜNİVERSİTESİ

**TRADE RELATIONS BETWEEN THE EUROPEAN
UNION AND TURKEY: EVOLUTION AND FUTURE
PROSPECTS**

Master Thesis

SERPİL POLAT

İSTANBUL, 2008

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**SOCIAL SCIENCES INSTITUTE
MASTER IN EUROPEAN UNION RELATIONS**

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BA, Bilkent University

Supervisor: YRD. DOÇ. DR. CENGİZ AKTAR

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INSTITUTE OF SOCIAL SCIENCES
MASTER IN EUROPEAN AND INTERNATIONAL STUDIES

Name of the thesis: Trade relations between the European Union and Turkey:
evolution and future prospects.

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Date of Thesis Defense:

The thesis has been approved by the Institute of Social Sciences.

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ABSTRACT

TRADE RELATIONS BETWEEN THE EUROPEAN UNION AND TURKEY: EVOLUTION AND FUTURE PROSPECTS

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Master in European Union Relations
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April, 2008, 76 pages

This thesis examines the evolution of trade between the European Union and Turkey and discusses what prospects are envisaged for future. European Union, with its share of about 50 percent on both exports and imports, is Turkey's biggest trade partner. After came into effect of Customs Union on January 1, 1996, trade relations between the EU and Turkey have further intensified. During the years following the Customs Union, while Turkish imports from the EU has followed an unstable pattern; from sharp increases to rapid decreases in years of economic crisis, Turkish exports destined to the EU has increased steadily. During this period, Turkish export and import baskets changed considerably. The share of agricultural products on total imports decreased while that of automotive and parts and electrical-electronical goods increased significantly. As for exports, the share of low technology intensive sectors such as textile, agriculture and iron and steel decreased whereas the share of high technology intensive sectors like automotive and parts and electrical-electronical goods rose considerably.

This thesis consists of introduction, three consecutive parts and conclusion. The first part starts with the historical development of Turkish economy and continues by analyzing the current macroeconomic situation and demographic patterns of Turkey and the EU.

In the second part, evolution of trade between the EU and Turkey is examined in detail. Firstly, the harmonization efforts of Turkey following the customs union and the effects of customs union on volume and structure of Turkish foreign trade are examined. An empirical analysis also conducted to find out the effect of customs union on welfare and growth. Secondly, specialization of Turkish foreign trade is studied by examining the level of processing, technology and factor intensities embodied. Lastly, Turkey's participation into producer and buyer driven value chains and networks is examined.

In the third part, the possible scenarios concerning future trade relations of Turkey and the EU are assessed. The possible effects of Turkish accession to the single market following full membership are examined. Lastly the effect of Turkey's full membership to the EU on foreign direct investment is examined. In conclusion an overall evaluation is made.

Keywords: Turkish Foreign Trade, European Union, Customs Union

ÖZET

AVRUPA BİRLİĞİ VE TÜRKİYE ARASINDAKİ TİCARİ İLİŞKİLERİN GELİŞİMİ VE GELECEK İÇİN BEKLENTİLER

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Avrupa Birliği İlişkileri Yüksek Lisans Programı
Tez Danışmanı: Yrd. Doç. Dr. Cengiz Aktar

Nisan, 2008, 76 sayfa

Bu tez çalışmasının amacı Avrupa Birliği ve Türkiye arasındaki ticari ilişkilerin gelişiminin incelenmesi ve gelecekle ilgili beklentilerin tartışılmasıdır. Avrupa Birliği, ihracat ve ithalatında sahip olduğu yaklaşık yüzde 50'lik pay ile Türkiye'nin en önemli ticari ortağıdır. Türkiye ve Avrupa Birliği arasında 1 Ocak 1996 tarihi itibarıyla yürürlüğe giren Gümrük Birliği ile ticari ilişkiler daha da yoğunluk kazanmıştır. Gümrük Birliğini takip eden yıllarda Türkiye'nin AB'den ithalatında genel olarak önemli bir artış ve kriz yıllarında sert düşüşler gözlenirken, ihracatında düşük fakat istikrarlı bir artış seyri görülmüştür. Bu dönem içerisinde Türkiye'nin hem ithalat hem de ihracat sepetinde önemli değişiklikler olmuştur. İthalat da tarım ürünlerinin payı azalırken, motorlu taşıtlar ve parçaları ve elektrikli ve elektronik ürünlerin payı çok önemli ölçüde artmıştır. İhracat da ise tekstil, tarım ürünleri, demir ve çelik gibi düşük teknoloji sektörlerin payı azalırken, yüksek teknoloji gerektiren motorlu taşıtlar ve parçaları ve elektrikli ve elektronik ürünlerin payında önemli ölçüde artış gözlenmiştir.

Bu çalışma giriş ve üç bölümden oluşmaktadır. Birinci bölümde, Türkiye ekonomisinin tarihsel gelişimi özetlenmiş ve bugünkü makroekonomik durum hakkında bilgi verilmiştir. Ayrıca Türkiye ve Avrupa Birliğinin demografik yapıları incelenmiştir.

İkinci bölümde, Türkiye ve AB arasındaki ticari ilişkilerin gelişimi ayrıntılı olarak ele alınmıştır. İlk olarak Gümrük Birliği sonrasında Türkiye tarafından gerçekleştirilen uyum çalışmaları ve Gümrük Birliği'nin Türk dış ticaretinin yapısı ve hacmi üzerindeki etkileri incelenmiştir. Ayrıca, Gümrük Birliği'nin refah ve büyüme üzerindeki etkisinin tespiti için ampirik bir analiz yapılmıştır. İkinci olarak, Türk dış ticaretinin uzmanlaşması ürünlerin işleme derecesi, içerdikleri teknoloji ve faktör yoğunluğu açısından incelenmiştir. Son olarak, Türkiye'nin üretici ve alıcı güdümlü ağlara katılımı ele alınmıştır.

Üçüncü bölümde, Türkiye ve Avrupa Birliği ticari ilişkilerinin geleceğine yönelik muhtemel senaryolar değerlendirilmiş ve Türkiye'nin tam üyelik ile birlikte tek pazara girmesinin Türk ekonomisi üzerindeki muhtemel etkileri üzerinde durulmuştur. Son olarak, AB'ye tam üyeliğin doğrudan yabancı yatırım üzerindeki muhtemel etkileri incelenmiştir. Sonuç bölümünde genel bir değerlendirme yapılmıştır.

Anahtar Kelimeler: Türk Dış Ticareti, Avrupa Birliği, Gümrük Birliği

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ABBREVIATIONS

Central and East European Countries	:	CEEC
Consumer Price Index	:	CPI
Customs Union	:	CU
Customs Union Decision	:	CUD
European Economic Area	:	EEA
European Economic Community	:	EEC
European Free Trade Association	:	EFTA
European Telecommunications Standards Institute	:	ETSI
European Union	:	EU
Foreign Direct Investment	:	FDI
Free Trade Agreement	:	FTA
General Agreement on Trade in Services	:	GATS
Gross Domestic Product	:	GDP
Gross National Product	:	GNP
Generalized System of Preferences	:	GSP
International Bank for Reconstruction and Development	:	IBRD
Information Communication and Technology	:	ICT
International Monetary Fund	:	IMF
Intellectual Property Rights	:	IPR
Least Developed Countries	:	LDC
Multilateral Agreements	:	MLA
Non-Tariff Barrier	:	NTB
North Atlantic Free Trade Area	:	NAFTA
North Atlantic Treaty Organization	:	NATO
Organization for Economic Cooperation	:	OECC
Organization for Economic Cooperation and Development	:	OECD
Quality Conformance Certificate	:	TSEK
Standard International Trade Classification	:	SITC
Technical Barriers to Trade	:	TBT
The European Committee for Electro technical Standardization	:	CENELEC
The European Committee for Standardization	:	CEN
The Southern Common Market	:	MERCOSUR
Turkish Patent Institute	:	TPI
Trade Related Intellectual Property Rights	:	TRIPR
Turkish Standards Institute	:	TSE
Turkish Accreditation Authority	:	TURKAK
United Nations	:	UN
World Intellectual Property Organization	:	WIPO
World Trade Organization	:	WTO
Exchange Rate	:	XR

1. INTRODUCTION

Ever since the foundation of modern Turkey in 1923, the country is closely aligned with the West. Turkey was a founding member of the United Nations, and a member of NATO (since 1952), the Council of Europe (1949), OECD (since 1961) and an associate member of the Western European Union (1992).

In addition to political and military cooperation and integration with Western Europe, Turkey has aimed at completing the integration with the Western Europe in the economic area, as well. Accordingly, Turkey applied the European Economic Community (EEC) for membership in July 1959, just 3 years after the creation of the ECC. After completing the negotiations, the Ankara Agreement (Agreement Creating An Association Between The Republic of Turkey and the European Economic Community) was signed on 12 September 1963.

Until the end of the 1970s, Turkey pursued an inward-oriented, or import-substituting, industrialization strategy. In early 1980, in response to a balance of payments crisis accompanied by a deep recession and accelerated inflation, Turkey abandoned its inward-oriented development strategy and started to introduce free market-based economy. After import-substitution policies were abandoned in favour of trade integration measures its trade openness has been on the rise. The sum of export and import as a share of Gross Domestic Product (GDP) moved from 18 percent in 1980 to 48 percent in 2001.

The European Union (EU) is by far Turkey's main trading partner, accounting for slightly more than half of its exports and slightly less than half of its imports. Since 1963, Turkey has been given a preferential trade status by the EU, with the leading to a progressive reduction in import tariffs (especially on the EU side), the adoption of

pieces of the EU regulatory body (the so-called *acquis communautaire*) by Turkey, and the provision for a gradual creation of a customs union. In 1970, an addition protocol to the Ankara Agreement was signed, that fixed the transitional period before the establishment of the customs union in 22 years. Finally, and after several delays, the customs union (CU) was launched at the end of 1995 and came into force in 1996.

Trade figures after the completion of the customs union shows that a high degree of trade integration has been achieved. In 1996, Turkey's imports from the European Union (EU) rose by 34.7 percent compared to 1995 and reached 22.7 billion dollars, while its exports, amounting to 11.4 billion dollars, rose by 3.6 percent. The EU preserved its place as Turkey's biggest trading partner with a 52.9 percent share in its imports and 49.5 percent in its exports. This trend continued in following years and in last year Turkey's exports to the EU amounted to \$60 billion and imports from the EU reached \$68 billion.

During last decade, Turkey's trade patterns and export basket, although still dominated by unskilled labor intensive products, has been moving quickly towards products characterized by a higher level of processing, medium to high technology content and the use of skilled labor. The major force behind this shift has been the entry of Turkish firms into producer-driven networks (automotive and information communication technology networks), which are capital and skilled-labor intensive industries.

This thesis examines the evolution of trade between the EU and Turkey. Every step in process of Turkey-EU trade integration evaluated in detail to answer what are the effects of the customs union on Turkish economy; if it was welfare enhancing or not; how the patterns and content of Turkish exports changed over the long trade partnership with the EU; what are the problem areas of this partnership; what prospects are envisaged for future, and what are the possible effects of Turkey's entrance into internal market following full membership to the EU.

The remainder of the thesis is organized as follows. The first chapter deals with the Turkish economy. It starts with the historical developments and continues by analyzing the current macroeconomic situation and demographic patterns of Turkey. Second chapter examines evolution of trade between the EU and Turkey. Effects of CU on volume and structure of Turkish foreign trade as well as welfare and growth are examined. Specialization of Turkish foreign trade and its participation into producer and buyer driven value chains and networks are also is examined in this chapter. Third chapter deals with the problem areas of Turkey-EU trade relations and tries to find out to which directions Turkish-EU trade relations may move in the future. The possible effects of Turkish accession to the single market on welfare, growth and foreign direct investment are examined as well. In conclusion an overall evaluation is made.

2. TURKISH ECONOMY

2.1 HISTORICAL DEVELOPMENTS

At the time of the collapse of the Ottoman Empire during World War I, the Turkish economy was underdeveloped. Agriculture depended on outmoded techniques and poor-quality livestock, and the few factories producing basic products such as sugar and flour were under foreign control. 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, which protected from foreign competition.¹

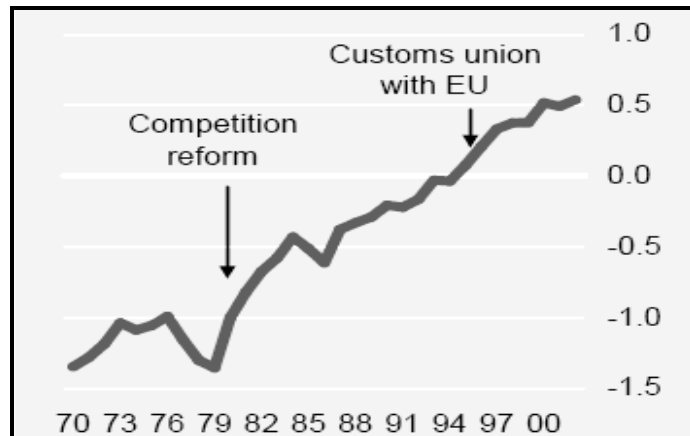
From 1923 to 1926, agricultural output rose by 87 percent, as agricultural production returned to prewar levels. Industry and services grew at more than 9 percent per year from 1923 to 1929; however, their share of the economy remained quite low at the end of the decade. By 1930, as a result of the world depression, external markets for Turkish agricultural exports had collapsed, causing a sharp decline in national income. Growth slowed during the worst years of the depression but between 1935 and 1939 reached 6 percent per year. During the 1940s, the economy stagnated; in large part because maintaining armed neutrality during World War II increased the country's military expenditures while almost entirely curtailing foreign trade.²

After World War II Turkey began to pursue an outward-oriented development scheme and joined international associations like IMF, International Bank for Reconstruction and Development (IBRD), Organization for Economic Cooperation (OECC) and North Atlantic Treaty Organization (NATO). One of the very important steps in this process was Turkey's application for full membership to the EEC in 1959. The Ankara Association Agreement, between Turkey and the EEC, came into force in December 1, 1964, constituting the legal basis of the relations after this date.

¹ A.M. Lejour, R.A. Mooij, C.H. Capel, 2004. *Assessing the Economic Implications of Turkish Accession to the EU*. CPB Netherlands Bureau for Economic Policy Analysis, p. 17.

² Library of Congress (USA), Federal Research Division. *Country Studies, Turkey*, 2006. Washington.

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. Oil price shocks in the 1970s and related balance of payments problems contributed to a deep economic recession and a political and social crisis in the country leading a cease in economic growth, a contraction of industrial production and an inflation rate to over 100 percent. In response to this in the early 1980's, the first serious efforts were made, by Özal government under the January 24th decisions, 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. In this context quantitative restrictions on import were eliminated and consequently import tariff rates were reduced in various steps. As a result of trade liberalization, the economy wide nominal protection rate declined from 70.19 percent in 1984 to 28.25 percent in 1991 and since then trade openness of Turkey increased rapidly(Figure 2.1).

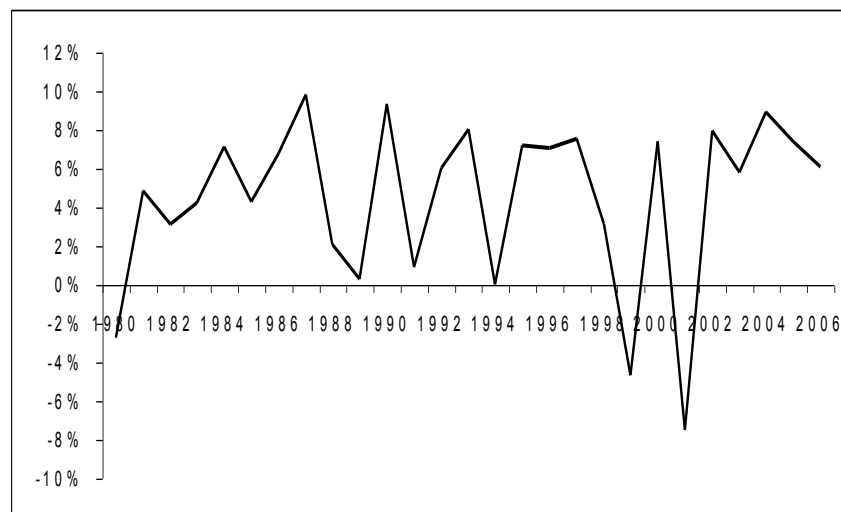


Source: Neuhaus (2005)

Figure 2.1 : Trade openness of Turkey (1970-2000)

Deutsche Bank Research³ reports that Turkey is among the top 5 emerging growth centers, and also ranks third among the five countries that will open most in the next 15 years. The study measures the changes in trade openness of countries between 1980 and 2005; results suggest that it is Turkey which opened most during this period and it is the sixth most open emerging market. The two most important reasons are specified as the major reform initiative in 1980 especially with the goal of fostering competition and the customs union with the EU in 1996.

After the trade liberalization efforts of 1980, growth rate increased considerably. Figure 2.2 shows the development of the Turkish economy since 1980 by means of the volume of the GDP.



Source: Turkish Statistical Institute

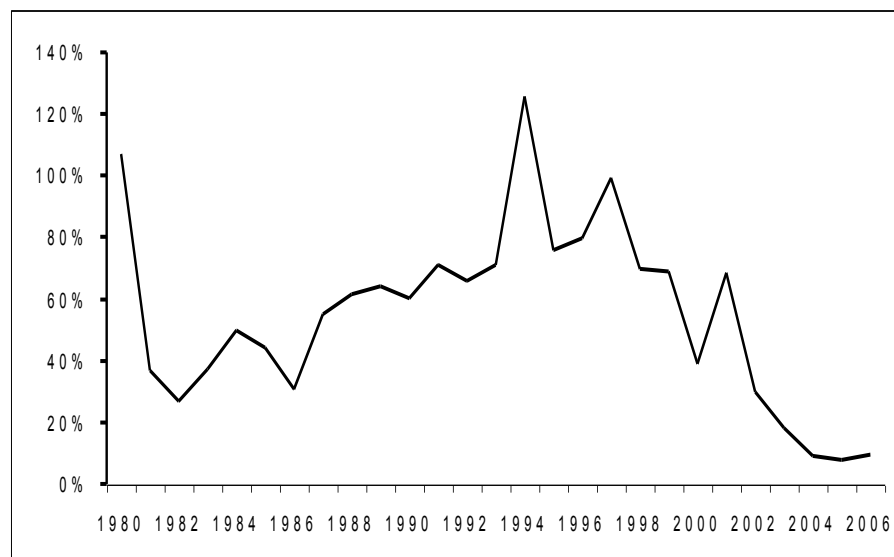
Figure 2.2 : GDP growth in Turkey (1980-2006)

There is a steady growth during the first half of the 1980's, with annual growth rates that run up to 10 percent. Since then, there is greater volatility in the economic development from years of high growth to years of stagnation. In 1994, the country ran into serious problems with its public finances, causing a contraction in production. In

³ M. Neuhaus, 2005. *Opening Economies Succeed*. Frankfurt: Deutsche Bank Research. Available from: http://www.dbresearch.com/PROD/DBR_INTERNET_EN-PROD/PROD000000000189232.pdf (cited 10 March 1997), p.2.

1999, a new deterioration of public finances caused 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\$ declined by 27 percent, from 201 to 147 billion US\$.

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 percent and peaked at 106.3 percent in 1995. In recent years, inflation slightly declined. In 2002, a rate of 29.7 percent was the lowest of the last two decades.⁴



Source: Turkish Statistical Institute

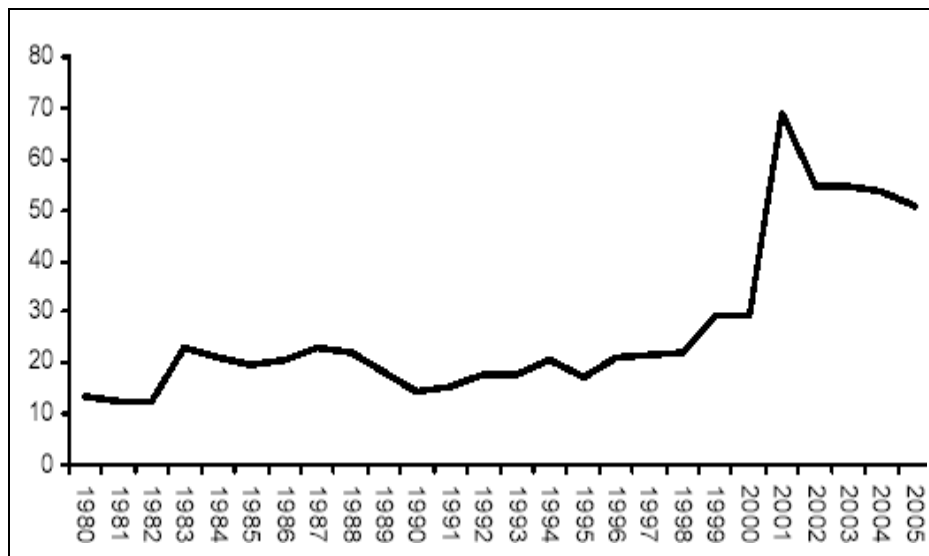
Figure 2.3 : Rate of inflation in Turkey (1980-2006)

Poor public finance management has played an important role in the crisis 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.⁵ This has led to large problems in public finances on several occasions. The

⁴ Lejour, Mooij, & Capel, p. 19.

⁵ G. Sak, 2000. *Characteristics of the Fund Experience in Turkey: Budgetary Funds, Extra Budgetary Funds and Other Fund Like Arrangements*. Ankara: Ankara University, mimeo, p.15.

IMF reports a public sector deficit in 1999 up to 24 percent of GDP, partly because the government took over a number of bankrupt commercial banks. As a result, the debt/ GNP ratio increased from 29 percent in 2001 to 69.2 percent in 2001(Figure 2.4).



Source: Ulusoy, & Cural (2006)

Figure 2.4 : Public debt/GNP ratios Turkey

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, privatize state enterprises and reform the financial sector. Prospect of becoming a member of the EU may be very helpful to obtain these objectives.

2.2 CURRENT MACROECONOMIC SITUATION

Turkey's ambitious fiscal adjustment has facilitated a substantial decline in the public debt ratio and underpinned the strong economic performance since 2001 but existing

vulnerabilities underscore the need for continuous fiscal discipline.⁶ Table 2.1 shows some key economic indicators of the Turkish economy from 2001 to 2006. Growth rate bounced back from a GDP fall of -7.4 percent in 2001 to 7.9 percent in 2002. After nearly 9 percent growth in 2004, it slowed down to 7.4 percent in 2005, and to 6.1 percent in 2006.

Table 2.1 : Main macroeconomic indicators of Turkey

<u>Key Economic Indicators</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>
CPI Inflation, year (%)	68.5	29.7	18.4	9.32	7.72	9.65
GNP Growth (%)	-9.5	7.9	5.9	9.9	7.6	6.0
GDP Growth (%)	-7.4	7.9	5.8	8.9	7.4	6.1
Capacity Utilization Rate (%)	71.7	76.2	78.5	81.5	80.3	81.0
Real XR (1995=100)	112.5	125.3	136.5	143.5	160.0	160.6
T-Bill rate (%)	82.3	62.7	46.0	39.2	39.1	18.0
<u>Public sector</u>						
Budget Balance (% of GNP)	-16.5	-14.6	-11.3	-7.1	-2.0	-0.8
Primary Balance (% of GNP)	6.8	4.3	5.2	6.1	7.4	8.6
<u>External indicators</u>						
Current Account Balance(million \$)	3,392	-1,524	-8,036	-15,601	-22,603	-31,679
Current Account Balance/GNP	2.4	-0.8	-3.4	-5.2	-6.4	-7.9
Foreign Trade Balance	-3,733	-7,283	-14,010	-23,878	-33,530	-40,128
Export (million \$)	31,334	36,059	47,253	63,167	73,122	85,142
Import (million \$)	41,399	51,554	69,340	97,540	116,048	137,032
<u>Employment Indicators (%)</u>						
Labor market participation rate	49.8	49.6	48.3	48.7	48.3	48.0
Unemployment rate	8.4	10.3	10.5	10.3	10.3	10.1

Source: Turkstat; Turkish Treasury; OECD Economic Survey of Turkey; Worldbank2007stats

After decades of high inflation (exceeding 100 % in some years), Turkey has succeeded over the past few years in bringing the annual inflation rate into single digits, with consumer prices rising 9.32 percent in 2004 and 7.72 percent 2005. This process was driven by a tight fiscal policy, major improvements in productivity, and the strength of

⁶ A. Varuudakis et al., 2006. *Public Expenditure Review Turkey*. Washington DC: Worldbank Poverty Reduction and Economic Management Unit, p.48.

the lira. However, a weaker lira, globally worsening perception of emerging markets and higher energy prices have reversed this process. In spite of the inflation targeting regime of Central Bank, with the initial objective of bringing the inflation rate down to 5 percent (plus or minus 2 percent) by the end of 2006, the realized rate was 9.6 percent.

Meanwhile, the budget remains in good shape. Aided by falling interest costs, budget deficit has fallen to 0.8 percent of GNP, and in spite of the significant rise in interest rates the primary budget remains in substantial surplus. Overall, fiscal consolidation has been strong.

Nevertheless, the Turkish economy is still vulnerable. Driven by strong domestic demand growth, higher oil prices and lower tourism earnings, the trade and current account balances have deteriorated significantly over the past couple of years, with the current account deficit reaching 7.9 percent of GDP in 2006, after sharp increase of 6.4 percent in 2005. Thanks to increased foreign currency reserves, as a result of very high privatization revenues, the country can still easily finance its current account deficit. Another reason of high current account deficit was higher investment, which should enhance the export capacity of the economy over the medium term, and help reducing the external vulnerability.

As a result of interest rate increase in United States in May 2006 the lira has depreciated by more than 18 percent. As a response to this global financial market volatility Central Bank increased interest rate 4,25 points and domestic government bond yields have significantly increased. After the interference of the Central Bank US Dollar dropped back to 1,46 YTL in August from 1,59 YTL in June and stabilized afterwards. The Central Bank continued increasing foreign currency reserves reaching US\$ 60.8 billions.⁷

Gross fixed capital formation growth increased to 27 percent in 2006, from 19 percent in 2005 . The external sector contributed negatively to GDP, as import growth was

⁷ Türk Sanayicileri ve İşadamları Derneği, 2006. *2007 Yılına Girerken Türkiye Ekonomisi*. İstanbul, p.18.

much higher compared to that of export. Being a rapidly growing economy Turkey ran into fast growing external imbalances. The reasons were too slow structural reforms and a sizeable increase in investment spending in 2005. The authorities reacted promptly by fiscal and monetary tightening which proved out effective. Besides, the restrictive effect on growth may be alleviated by strengthening external demand.

In spite of the high growth, the unemployment rate is around 10 percent with a young unemployment rate of 18 percent. The skill mismatch between labour demand and supply and some labour market rigidities continue to hamper job creation. The lower unemployment rate in the agricultural sector, which includes unpaid family workers, suggests large pockets of underemployment in the economy. In addition, the employment rate fell slightly to 48 percent in 2006 from 48.3 in previous year.

Overall, if growth remains robust and the impressive progress in reducing inflation is sustained, Turkey is an unlikely near-term candidate for a crisis.⁸

2.3 DEMOGRAPHIC INDICATORS

Being a small country in economic terms, Turkey is a large country in terms of population. Table 2.2 sets out UN population forecasts for Turkey, the EU 25-27 and the EU27+Turkey from 2005 to 2050. Turkey today has a population of 70 million. By 2015, the possible accession date, it will have a population of 82 million, almost as large as Germany. Ten years later in 2025, Turkey at 87 million would be the largest member of the Union. Population is predicted to stabilize at around 97 million in 2050. Turkey in 2025 would constitute 15.5 percent of the EU's population, while Germany would account for 14.3 percent. In today's EU of 25 members, Germany accounts for

⁸ M. Mussa, 2006. *Global Economic Prospects 2006/2007: Continued Solid Growth in 2006, Rising Risks for Inflation, Financial Markets, and Growth for 2007*. Washington DC: Institut for International Economics, p. 17.

18.1 percent of the total population. Even in 2050, Turkey has a population share below this at 17.7 percent.⁹

**Table 2.2 : Total Population: Turkey, Germany, EU 25, EU 27, EU 27+Turkey
UN estimates 2005-2050**

	<u>2005</u>	<u>2015</u>	<u>2025</u>	<u>2050</u>
Turkey	71,970	82,150	88,995	97,759
Germany	82,652	82,497	81,959	79,145
Total EU 25	461,479	456,876	454,422	431,241
Total EU27	490,898	485,692	481,837	454,559
Total EU27+Turkey	562,508	567,842	570,832	552,318
Turkey as % of EU28 (incl. Turkey)	12.8%	14.4%	15.5%	17.7%

Source: UN World Population Division, World Population Prospects: the 2006 Revision; Eurostat2006

Table 2.3 sets out data for GDP at market prices and purchasing power parity (pps) for Turkey and a selection of the EU member states.

Table 2.3 : Gross Domestic Product: Turkey and the EU (2006)

Country	GDP at Current prices \$ millions	GDP per head (PPS) \$ thousands	% of average EU (PPS)
Turkey	401,763	9,240	32.7
Romania	121,901	10,124	35.8
Bulgaria	31,516	10,021	35.5
New EU 10	710,885	19,956	70.7
EU25	14,456.419	28,213	100.0
EU 27	14,609.836	27,915	98.9

Source: International Monetary Fund

Although Turkey and ten new member states are alike in terms of population, 70 million and 75 million respectively, Turkey is much poorer. The new ten member states account

⁹ K. Hughes, 2004. *Turkey and the European Union: Just Another Enlargement? Exploring the Implications of Turkish Accession*. Friends of Europe Working Paper, p.

for 16 percent of EU25 population and 4.9 percent of EU GDP, while Turkey's GDP in 2006 is only 2.8 percent of that of the EU25. Turkey's GDP per head (in pps terms) is slightly below that of Romania, and is only 32.7 percent of the EU average. Consequently, it will take long time to approach the EU average.

Turkey also has very strong regional inequalities. Income per head in the poorest regions (in eastern Anatolia) is around one fifth that of its richest regions (in the Marmara – Istanbul region). Tackling widespread poverty and regional inequality is probably Turkey's largest economic challenge. Considering its growth potential it is considered that Turkey's economic impact on the Union and the internal market is likely to be marginal for the Union, though it could be highly positive for Turkey itself.

Turkey has a young population with 30 percent of the total population under the age of 15 and 20 percent in the 15-24 age groups. Turkey's growth potential lies in particular in this growing population of working age.

As Table 2.4 shows, Turkish unemployment at 8.4 percent is only a little above the EU25 average and below that in many of the new member states such as Poland. However, Turkey has a very low overall employment rate (the proportion of the 15-64 age group actually in work) – 45.9 percent compared to EU25 average of 64.8 percent. It is lower than that of any of the EU25 member states. This is because of the very low female employment rate of 23.9 percent compared to an EU average of 57.6 percent. The only EU member state which is close to this figure is Malta with 34.9 percent.

Around one third of the total labour force employed in agriculture. This rate is higher compared to major emerging economies. There has been substantial migration from poor rural to wealthier urban areas into the largest cities – Ankara and Istanbul. But a continued large shift from low productivity agriculture to services is still needed.

Table 2.4 : Employment rates and unemployment – Turkey and the EU (2006)

Country	Total employment rate	Males	Females	Unemployment
Turkey	45.9	68.1	23.9	8.4
Poland	54.5	60.9	48.2	13.8
France	63.8	68.5	58.8	9.2
Malta	54.8	74.5	34.9	7.3
EU15	66.2	73.5	58.7	7.7
EU25	64.8	72.0	57.6	8.2

Source: Eurostat 2007

Apparently, in 2020s Turkish workers joining the labour market will be three times more than German workers. It seems that these demographic considerations will constitute the basis of the relations between Turkey and the European Union.¹⁰

¹⁰ J. C. Vérez, J. Bourrinet, J. R. Chaponnière & T. Chopin, 2005. *D'un Élargissement À L'autre : La Turquie Et Les Autres Candidats*. Lyon: L'harmattan, p.16.

3. TURKEY-EUROPEAN UNION TRADE RELATIONS

3.1 CUSTOMS UNION

The lead up to the customs union decision began with the association agreement in 1963, which entered into force on 1 December 1964.¹¹ The Ankara Agreement, which would prepare Turkey for full membership to the Community, specified that the process of economic integration between Turkey and the European Economic Community (EEC) should involve three stages: the preliminary stage, the transition stage and the final stage. During the preliminary stage, from 1964 to 1973, the EEC would give some direct financial aid to Turkey and establish preferential trade conditions. The transition stage was supposed to last for 22 years, during which the Community and Turkey would eliminate all tariffs and trade barriers in order to establish a customs union between Turkey and the Community.

The preliminary stage was completed in five years without any problems and Turkey took the necessary steps to initiate the second stage of the Association Agreement. During, the transitional stage, which was aimed at setting the timetable towards the establishment of a CU between the parties by 1995, the Additional Protocol , was signed in 1970, and came into effect in January 1973. The Additional Protocol covered Turkey's and the EEC's trade and financial commitments to each other. After the additional protocol was signed, the EEC abolished tariffs and equivalent taxes (as of September 1971) on industrial imports from Turkey, with the exception of certain sensitive products such as machine woven carpets, cotton yarn and cotton textiles. The EEC also removed all quantitative restrictions on industrial imports from Turkey with the exception of restriction on imports of cocoons and raw silk. However, it did continue to apply quotas and minimum import prices which were within the framework

¹¹ *Agreement Establishing an Association between the European Economic Community and Turkey*. 12 September 1963, Ankara. Available from: <http://www.deltur.cec.eu.int/kitap/e-ankara.rtf> (cited 02 May 2007)

of the Common Agricultural Policy. With these actions, the EEC had fulfilled most of its obligations during the transition period.

During the first four years of the transitional period (1973-1976), the implementation of the Additional Protocol went ahead as planned. However, after 1976, the process of implementing the Additional Protocol came to a virtual standstill since Turkey was unable to reduce the tariffs as planned. In January 1977, Turkey postponed the first step of her scheduled tariff alignment with the Common Customs Tariff. One year later she also postponed the third round of tariff reductions.¹²

During the period 1976-1987 the Turkey-EEC relations became tense because of the extension of concessions by the EEC to many LDC's under the General System of Preferences, which eroded the preferences granted to Turkish agriculture and industry.

On 9 November 1992 at a meeting of the Association Council both sides agreed to restart the implementation of the provision laid down in the Association Agreement. Until the end of the 1995, Turkey fulfilled all her tariff reductions which were mentioned in 20 and 22 years lists in the Additional Protocol. On March 1995, it was agreed at the Association Council meeting in Brussels, that Turkey would join the European Customs Union.

The CU came into force in January 1996. Turkey eliminated all custom duties, quantitative restrictions, and all charges which have equivalent effect to qualitative restrictions for industrial products and processed components of agricultural products in its trade with the EU and adopted the common external tariff against third country imports. Weighted tariff rates that Turkey implies on imports of industrial products originating from the EU15 and EFTA countries have fallen from 5.9 percent to 0 percent and from 10.8 percent to 6 percent for similar goods originating from third countries.

¹² A. Adam, T. Moutos, 2005. *Turkish Delight for Some, Cold Turkey for Others?: The Effects of the EU-Turkey Customs Union*. Munich: CEifo Working Paper No.1550, p. 6.

The CU between Turkey and the EU goes far beyond a basic customs union with free international trade and common external tariffs and has given new impetus to the liberalization process in Turkey.¹³ Apart from the liberalization of tariffs and adoption by Turkey of the EU's common external tariff for industrial products and the industrial components of processed agricultural products, the agreement also embraces a number of integration elements; the adoption of the Community's commercial policy towards third countries including textile quotas, the adoption of the free trade agreements with all the EU's preferential partners including EFTA, Central and Eastern European and Mediterranean countries; cooperation on the harmonization of agricultural policy, mutual minimization of restriction on trade in services, harmonization of Turkey's legislation to that of the EU in the area of competition policy, state aids, anti-dumping, intellectual and industrial property rights, public procurement and technical barriers to trade.¹⁴

However, CU excludes Turkey from the common agricultural policy, including the freedom of movement of agricultural product, free movement of labour and capital and services. Furthermore, it allows for the continuation of contingent protection and safeguards measures by the EU unlike in the Europe Agreements.

In order to advance the CU, negotiations have been started in 2000 on the mutual opening of the public procurement markets, liberalization of trade in services, and the abolition of restrictions on the freedom of establishment. The negotiations are conducted in parallel sessions with the understanding that nothing is agreed until everything is agreed.

¹³ U. Utkulu, & D. Seymen, 2003. *Trade and Competitiveness between Turkey and the EU: Time series evidence*. Open Minds Conference. University of Lodz, p.3.

¹⁴ Adam, Moutos, p. 8.

3.1.1 Harmonization Efforts Following the Customs Union

3.1.1.1 Common commercial policy

Turkey started the process of adoption of a wide range of the EU trade and trade related legislation, covering the external trade regime, competition policy, intellectual property, and consumer protection with the entry into force of the CU.

All customs duties and charges having equivalent effect applied to imports of industrial products from the EU are eliminated and the Community's Common Customs Tariff for imports from the third countries with the exception of a limited number of sensitive products such as automobiles, footwear, leather products and furniture started to apply. As a result, average protection rate regarding industrial goods which was 16 percent prior to the CU was reduced to 4.2 percent for the countries except the EU, EFTA and the countries with which Turkey concluded FTAs.

In the framework of the Agreement, common rules for imports and exports, administration of quotas, protection against dumped or subsidized imports, autonomous arrangements on textile imports, legislation regarding inward and outward processing regimes are aligned with the EU's application for the proper functioning of the CU and adoption of the common commercial policy.

In accordance with Article 16 of the CU, Turkey has aligned herself with the EC Generalized System of Preferences (GSP)¹⁵ as of August 25th 2004.¹⁶ Within this context, for the products under the CU, all preferences involved in the EC GSP have been incorporated into the framework of the Turkish Import Regime, vis-à-vis developing countries.

¹⁵ In 1968, the United Nations Conference on Trade and Development (UNCTAD) recommended the creation of a "Generalized System of Tariff Preferences" under which industrialized countries would grant trade preferences to all developing countries. The EC was the first to implement a GSP scheme in 1971. This authorises developed countries to establish individual GSP schemes. the EU's GSP grants products imported from GSP beneficiary countries either duty free access or a tariff reduction, depending on which of the GSP arrangements a country enjoys.

http://ec.europa.eu/trade/issues/global/gsp/index_en.htm (cited 15 February 2007)

¹⁶ Decision No: 2004/7731 that was published in Official Journal of 25564, dated 25 August 2004.

In order to align with the common competition policy the Competition Board established. The alignment of the state aid legislation with the global and EU norms, the participation of Turkey to international agreements regarding intellectual, industrial and trade related property rights and the effective functioning of Patent Institute are among the arrangements made.

3.1.1.2 Free trade agreements

Turkey has signed bilateral trade agreements with 14 countries in the framework of aligning its trade regime on the EU's in the context of the CU. In addition to the free trade agreement (FTA) signed with EFTA in 1991, FTAs are concluded with Israel, Hungary, Romania, Lithuania, Czech Republic, Slovak Republic, Estonia, Latvia, Slovenia, Bulgaria, Macedonia, Poland, Croatia and Bosnia-Herzegovina, Morocco, Palestine, Tunisia, and Syria. FTAs with Lithuania, Hungary, Estonia, Czech Republic, Slovak Republic, Poland, Slovenia, and Latvia are expired when these countries become EU members on 1 May 2004. As of that date, these countries are included in the CU.¹⁷

Today, FTAs with Israel, Romania, Bulgaria, Macedonia, Croatia, Bosnia-Herzegovina, Palestine, Morocco, Syria, Egypt and Tunisia are in force. Negotiations with Albania, Jordan, Lebanon, Chile, Mexico and Faroe Islands are ongoing. Moreover, a framework agreement to initiate free trade agreement negotiations was signed with Gulf Cooperation Council on 30 May 2005.¹⁸

In the near future, it is expected to initiate negotiations with Algeria, Serbia-Montenegro, South African Customs Union and The Southern Common Market (MERCOSUR).

¹⁷ Undersecretariat of the Prime Ministry for Foreign State. Available from: <http://www.dtm.gov.tr/dtmweb/index.cfm?action=detayrk&yayinID=383&icerikID=483&dil=EN> (cited 1 May 2007)

¹⁸ Commission of the European Communities, 2006. *Turkey 2006 Progress Report*. Brussels, p.71.

3.1.1.3 Participation into Pan-European Cumulation system

The Pan-European Cumulation System is based on harmonization of rules of origin applied in preferential trade between the EC, the EFTA countries, the CEEC countries and the Baltic States. It was created in 1997 on the basis of the European Economic Area (EEA) Agreement (1994) to strengthen the effectiveness of the Europe Agreements and to benefit the economic operators by changing rules of origin within Europe which created costly barriers to trade.

The system enables manufacturers to use any originating input from the area in the manufacture of finished products, without running the risk of losing free trade status if it is exported within the area. Therefore the system encourages intra-industry trade, exports and Foreign Direct Investment (FDI) inflows.¹⁹

Turkey joined the system as of January 1, 1999, after signing the agreements with the CEEC and the EFTA countries. Between Turkey and the EC system works in a different way. The difference is that the products are in free circulation between the EC and Turkey regardless of the fact that they are or not originating.

Thanks to the system Turkish products can be used within the system as originating products without losing free trade status. At the same time Turkish producers may use inputs originating in Europe without affecting the tariff preference of finished products. Therefore the system enlarges the sourcing area for all the countries in the system.

¹⁹ B. Kaminski, N.G. Francis, 2006. *Turkey's Evolving Trade Integration into Pan-European Markets*. Washington DC: World Bank Policy Research Working Paper 3908, p.4.

3.1.2 Effects of the Customs Union on Turkish Foreign Trade

3.1.2.1 Changes in volume and structure of foreign trade

The European Union has always been the most important trade partner of Turkey. There are three main reasons; the first one is that most of the Turkish industrial goods have been exported to the EU with zero tariff rates since 1971, the second is that geographically, the EU countries are the closest developed markets to Turkey which creates a cost advantage in transportation for Turkish exporters. Finally, Turkish population living in the EU countries that reached almost 5 millions has been always a natural buyer for Turkish products exported to the EU countries.²⁰

Table 3.1 shows Turkey's foreign trade and the share of the EU. As table shows during 1990's almost 50 percent of the total foreign trade of Turkey has been realized with the EU countries. In 1995, just before the entry into force of the CU, the share of the EU in total Turkish exports was 51.2 percent, while the share of imports from the EU in total Turkish imports was 47.2 percent.

In the first year of the CU Turkish exports to the EU increased only 4.3 percent, while the total exports rose to 7.3 percent and the imports from the EU reached \$23 billion with an increase of 37.2 percent. This asymmetry can be explained by the fact that the EU has abolished the tariffs on most Turkish export in 1971, while the tariffs on industrial goods imports from the EU countries decreased to zero only after the entry into force of the CU by 1996. Consequently, after this sharp increase in the first year, the rate of increase in imports from the EU decreased to 7.5 percent in 1997 whereas the increase of exports to the EU was 6.1 percent.

²⁰ S. Malkoç, 2002. *The Effects Of The Customs Union On Turkish Foreign Trade And Industry*. Thesis for the M.A. Degree. Illinois: University of Illinois, p. 18.

Even though exports did not increase as much as imports during the first years after the entry into force of the CU, they followed a much steady pattern. Except 1993 exports grew every year including years of economic crisis.

Table 3.1 : Turkey's foreign trade and the share of the EU

Year	Total Exports (\$mil)	Chg (%)	Total Imports (\$mil.)	Chg (%)	Exports to the EU(\$mil)	Chg (%)	Share (%)	Imports from the EU (\$mil.)	Chg (%)	Share (%)
1990	12,959	11.5	22,302	41.2	7,177	26.9	55.4	9,897	53.1	44.4
1991	13,593	4.9	21,047	-5.6	7,347	2.4	54.0	9,896	0.0	47.0
1992	14,719	8.2	22,871	8.7	7,936	8.0	53.9	10,656	7.7	46.6
1993	15,348	4.3	29,429	28.7	7,599	-7.1	49.5	13,875	30.2	47.1
1994	18,105	18.0	23,270	-20.9	8,635	13.6	47.7	10,915	-21.3	46.9
1995	21,636	19.5	35,707	53.4	11,078	28.3	51.2	16,861	54.5	47.2
1996	23,224	7.3	43,627	22.2	11,549	4.3	49.7	23,138	37.2	53.0
1997	26,261	13.1	48,559	11.3	12,248	6.1	46.6	24,870	7.5	51.2
1998	26,974	2.7	45,921	-5.4	13,498	10.2	50.0	24,075	-3.2	52.4
1999	26,587	-1.4	40,671	-11.4	14,348	6.3	54.0	21,401	-11.1	52.6
2000	27,775	4.5	54,503	34.0	14,510	1.1	52.2	26,610	24.3	48.8
2001	31,342	12.8	41,399	-24.0	16,118	11.1	51.4	18,280	-31.3	44.2
2002	36,059	15.1	51,553	24.5	18,459	14.5	51.2	23,321	27.6	45.2
2003	47,252	31.0	69,339	34.5	24,484	32.6	51.8	31,695	35.9	45.7
2004*	63,120	33.6	97,539	40.7	34,417	40.6	54.5	45,434	43.3	46.6
2005	73,476	16.4	116,774	19.7	38,394	11.6	52.3	49,220	8.3	42.1
2006	85,141	15.9	137,032	17.3	43,924	14.4	51.6	53,849	9.4	39.3
2007**	107,154	25.3	169,987	21.8	60,405	37.5	56.4	68,590	27.4	40.4

Source: The Undersecretariat of Foreign Trade

*As of May 1, 2004 EU-25

**As of January 1, 2007 EU-27

Three factors may account for change in exports: import demand, competitiveness and diversification. When a country merely maintains its share in imports, the increase in exports is because of the growth in import demand. When it increases more than import demand, then these extra exports can be attributable to increased competitiveness. When the increase comes from new exports, it stems from the diversification effect. In the case of Turkey, the growth in import demand was accountable for 52 percent of the increase

in Turkish exports between 2000 and 2004, the growth in competitiveness for 48 percent of the increase, and the growth in diversification for 1 percent of the increase in exports.²¹

In 1999 and 2001 Turkey had serious economic crisis. In these years, imports from the EU decreased 11.1 percent and 31.3 percent respectively. While exports have steadily expanded demonstrating relative insensitiveness to balance of payments crises, imports have been volatile, with their annual changes highly correlated with GDP growth rates. However, with the exception of the periods of economic crisis, imports increased more than the exports. Consequently trade deficit is almost doubled between 1995 and 2007, reaching \$9.9 billion from \$5.7 billion.

After the entry into force of the CU, there have also been serious structural changes in the Turkish trade with the EU. Table 3.2 gives the sectoral breakdown of Turkish exports to the EU, for the years 1996 and 2006. As seen from the figures structure of the exports has changes considerably during the first ten years of the CU.

Table 3.2 : Sectoral breakdown of Turkish exports to the EU (\$million)

	Value(1996)	Share %	Value(2006)	Share %	Change %
Agricultural Products	1,005	8.2	1,831	4.2	82.1
Manufactures	6,837	59.7	30,885	70.3	451.7
Iron and steel	420	3.6	3,189	7.3	759.2
Electrical and electronic products	1,503	13.0	15,783	35.9	1050.1
Machinery	414	3.6	3,308	7.5	799.0
Automotive products & parts	376	3.3	8,441	75.3	2244.9
Electrical and electronic equipment	713	6.2	4,034	9.2	565.7
Textile and Clothing	4,914	40.1	11,913	27.1	242.4
Textile	1,319	10.7	3,441	7.8	260.9
Clothing	3,598	29.4	8,472	19.3	235.4
Other industrial products	3,707	32.1	11,208	25.5	302.3
TOTAL	11,549		43,924		

Source: The Undersecretariat of Foreign Trade

²¹ Kaminski, & Francis, p. 8.

In 1996 more than half of the exports consist of low technology products such as textile and clothing, agricultural products and iron and steel. In 2006, the share of the agriculture and textile and clothing has decreased while the share of technology-intensive electrical and electronic products increased enormously. This shows gradual change of the Turkish exports to the EU towards higher value-added products. Nevertheless, textile and clothing still compose around one third of total exports.

As seen from Table 3.3, after the CU, imports followed a trend similar to exports. Manufactures imports rose, while the share of agricultural products imports decreased from 2,6 percent in 1996 to 1,3 in 2006. Automotive products and parts imports more than tripled while electrical and electronic equipments more than doubled.

Table 3.3 : Sectoral breakdown of Turkish imports from the EU (million\$)

	<u>1996</u>		<u>2006</u>		Chg%
	Value	Share%	Value	Share%	
Agricultural Products	639	2.6	709	1.3	110.9
Manufactures	13,491	58.5	31,618	58.7	234.3
Iron and steel	2,080	9.0	4,149	7.7	99.4
Electrical and electronic products	10,153	43.9	25,499	47.4	151.1
Machinery	6,137	26.5	11,578	21.5	88.6
Automotive products & parts	2,043	8.8	8,794	16.3	330.4
Electrical and electronic equipment	1,973	8.5	5,127	9.5	159.8
Textile and Clothing	1,258	5.1	1,970	3.7	56.6
Textile	1,139	4.6	1,715	3.2	50.5
Clothing	119	0.5	255	0.5	114.3
Other industrial products	9,008	38.9	21,522	40.0	138.9
TOTAL	23,138		53,849		

Source: The Under secretariat of Foreign Trade 2006

3.1.2.2 Increasing intra industry trade between the EU and Turkey

According to the Factor Endowment Theory international trade patterns of countries are determined by relative supplies of factors of production. Every country exports goods which are produced by their abundant factors, therefore international trade is expected to take place among countries with different factor endowments. But over the last two decades, it has been seen that countries with similar factor endowments do more trade than countries with different factor endowments. This caused a new concept, namely intra-industry trade (IIT), to emerge which tries to explain the current trends in international trade. It is defined as the simultaneous export and import of commodities which are grouped in the same industry. It is first discussed by Balassa (1966), and after by Grubel and Lloyd (1975) who developed a multipurpose index to measure the level of intra-industry trade between countries.²²

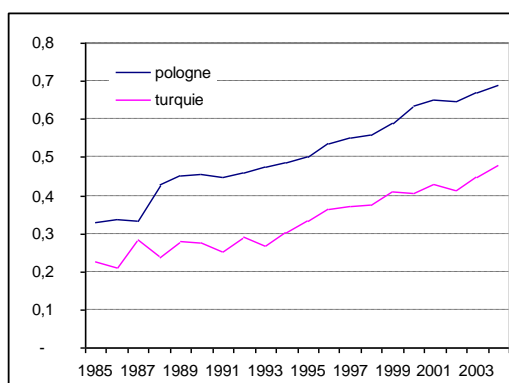
The determinants of intra-industry trade are classified as industry specific variables and country specific variables. The former consist of product differentiation, scale economies and market structure while the latter comprise level of development and GDP, market size, transportation cost, economic cooperation between countries and foreign direct investment. Havrylyshyn and Civan (1985) calculated that level of average intra-industry trade between industrialized countries is 58.9 percent while between developing countries it is only 22.6 percent. Therefore the level of intra industry trade between the EU and Turkey is not expected to be high.²³

In the literature it is assumed that economic integration leads to a large increase in intra-industry trade. So it is expected intra-industry trade between Turkey and EU countries to increase after the Custom Union. An empirical study proves this assumption by stating that intra-industry trade between EU and Turkey increased to 36.7 percent in

²² P.N. Emirhan, 2002. *Intra Industry Trade Dynamics of Turkey*. European Trade Study Group Fourth Annual Conference, p. 2.

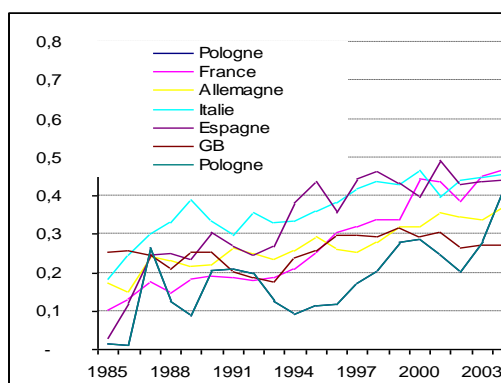
²³ İ. Karakoyun, 2004. *Endüstri-içi Ticaret Kavramı ve Türkiye ile Avrupa Birliği Ülkeleri Arasındaki Endüstri-içi Ticaretin Düzeyi*. Türk İdare Dergisi, 76 (442), pp. 209-227.

2000 from 21.3 percent in 1993.²⁴ Another study shows that the rate of Turkey increased constantly from 0,38 to 0,48 between 1995 and 2005 and reached the rate between Poland and EU in 1995(Figure 3.1and 3.2).²⁵



Source : Chaponnière, Verez (2006)

Figure 3.1 : GL Index of Turkey and Poland



Source : Chaponnière, Verez (2006)

Figure 3.2 : GL Index of Turkey and the EU

Emirhan (2002) has also analyzed the IIT dynamics of Turkey for various country and industry groups and found that the share of IIT in Turkey's bilateral trade is highest for European Union member countries and these countries are followed by EU candidates.²⁶ This is explained by the existence of Customs Union and geographical closeness. She concluded that higher IIT levels for EU members stem from the Customs Union Agreement with these countries and that these countries are geographically close to Turkey.

3.1.2.3 Top twenty export performer sectors

Shift towards trade in more technologically advanced products has affected Turkey's competitiveness in EU markets, and have played a critical role in transformation of

²⁴ H. Gabrisch, M.L. Segnana, 2003. *Vertical and Horizontal Patterns of Intra-industry Trade Between EU and Candidate Countries*. Halle: Institut Für Wirtschaftsforschung Halle, p.16.

²⁵ J.C. Veréz, & , J.R. Chaponnière, 2005. *L'évolution des Échanges Commerciaux Entre L'UE et La Turquie Depuis L'Union Douanière de 1995*. Varsovie, p.15.

²⁶ Emirhan, p. 13.

Turkish export basket. As can be seen from Table 3.4 listing top 20 sectors, identified in terms of four-digit Standard International Trade Classification (SITC) products, ranked according to the value of exports to the EU, some products have emerged as top performers in Turkey's EU-oriented exports in last years.

Table 3.4 : Top 20 (four-digit SITC) exporters to the EU in 2004

SITC4	Product	Exports (\$million)		2004 Index 2000=100	Export Share		Ranking		Share of EU in Exports	
		2000	2004		2000	2004	2000	2004	2000	2004
7810	Passenger motor cars, for transport	491	2,838	578	2.9	8.0	6	1	84	76
8462	Under garments, knitted of cotton	1,046	2,351	225	6.2	6.6	1	2	72	82
7611	Television receivers	768	1,971	256	4.6	5.6	3	3	90	91
7821	Motor vehicles for transport of goods	37	1,484	4,022	0.2	4.2	84	4	78	89
8439	Other outer garments	729	1,399	192	4.3	4.0	4	5	64	73
8451	Jerseys, pull-overs, Twinsets, cardigans	870	1,155	133	5.2	3.3	2	6	83	79
8459	Other outer garments & Clothing	593	1,111	187	3.5	3.1	5	7	73	75
7849	Other parts & accessories of motor vehicles	379	1,044	276	2.3	3.0	9	8	62	64
6584	Bed linen, table linen, toilet & kitchen	461	888	193	2.7	2.5	7	9	74	66
8423	Trousers, breeches etc. Of textile fabrics	431	747	173	2.6	2.1	8	10	71	66
8472	Clothing accessories	257	603	235	1.5	1.7	13	11	92	83
0589	Fruit otherwise prepared or preserved	203	561	276	1.2	1.6	19	12	83	83
7139	Parts of internal combustible piston engines	189	554	293	1.1	1.6	20	13	76	77
8463	Under garments, knitted, of synthetic	311	538	173	1.9	1.5	11	14	91	87
6732	Bars & rods, of iron/steel	159	429	270	0.9	1.2	22	15	20	25
0577	Edible nuts	375	421	112	2.2	1.2	10	16	81	78
7731	Insulated elect.wire, cable, bars, strings	278	396	142	1.7	1.1	12	17	61	49
7752	Household typerefrigerators	157	395	251	0.9	1.1	24	18	81	70
7831	Public-service type passenger motor	206	389	189	1.2	1.1	18	19	21	42
6783	Other tubes and pipes, of iron or steel	158	351	223	0.9	1.0	23	20	63	56
	All above products	8,097	19,626	242	48.2	55.5			69	71
0 to 9	All goods	16,803	35,378	211	100	100			55	55

Source: Kaminski, & Francis (2006)

The share of exports to the EU of Turkey's top 20 exporters increased from 69 percent in 2000 to 71 percent in 2004. This is much higher than the average share of the EU in total exports (60 percent). Except clothing the levers of export growth have been

medium to high technology products; 91 percent of motor vehicles for transport of goods, 90 percent of television receivers and 80 percent of parts of piston engines produced in Turkey are exported to the EU market. Decrease in the share of the EU destined exports of some products like household refrigerators and passenger motor cars, stemmed from their extension in global markets following their success in EU markets.

There has also been a significant change in terms of technology content and natural resource intensity of top twenty performers. The share of medium to high technology products in top-twenty rose from 25 percent in 2000 to 39 percent in 2004 and clearly at the expense of the fall in the share of low technology products from 59 percent to 47 percent. Especially increase in exports of passenger cars and trucks and exports of boats and other vessels were spectacular.

3.1.2.4 Geographical reorientation of Turkish foreign trade

Reorientation of Turkish foreign trade towards the EU occurred in 1980's, i.e. much earlier than the entry into force of the CU in 1996. As seen from Table 3.5, which shows the Turkish foreign trade by country groups, Turkish exports to the EU25 has increased from 44.1 percent in 1985 to 55.2 percent in 1995 while the share of imports from the EU25 has increased from 38.3 percent in 1985 to 48.4 percent in 1995. After the entry into force of the CU, share of the EU25 in Turkish foreign trade ranged between 47 percent and 50 percent.

However, increase in the share of the EU realized at the expense of trade with the Middle East and the North African countries. The share of Middle East and North African Countries (MENA) decreased dramatically between 1985 and 1990, from 36 percent to 17 percent. Its share remained about 11-12 percent henceforward. In other words, it is not the CU which raised the share of the EU in Turkey's total trade; it is caused by the reorientation of trade from MENA to European countries in 1980s.

Table 3.5 : Turkish foreign trade by country groups

	<u>EXPORTS (\$ million)</u>					<u>EXPORT SHARE (%)</u>				
	1985	1995	2002	2003	2004	1985	1995	2002	2003	2004
EU (25)	3506	11,917	19,541	26,222	34,907	44.1	55.2	54.6	55.5	55.3
<i>EU15</i>	3398	11,077	18,331	24,488	32,575	42.7	51.3	51.3	51.8	51.6
<i>EU10</i>	107	840	1,210	1,734	2,332	1.4	3.9	3.4	3.7	3.7
EFTA	133	293	406	538	658	1.7	1.4	1.1	1.1	1.0
MENA	3,315	3,019	4,298	6,567	9,512	41.7	14.0	12.0	13.9	15.1
East Asia	44	340	541	955	758	0.5	1.6	1.5	2.0	1.2
NAFTA	527	1,616	3,654	4,016	5,343	6.6	7.5	10.2	8.5	8.5
Russia	0	1,232	1,168	1,368	1,859	--	5.7	3.3	2.9	2.9
Rest of the World	433	3,182	6,154	7,587	10,084	5.4	14.6	17.3	16.1	16.0
TOTAL	7,958	21,599	35,762	47,253	63,121	100	100	100	100	100
	<u>IMPORTS (\$ million)</u>					<u>IMPORT SHARE (%)</u>				
	1985	1995	2002	2003	2004	1985	1995	2002	2003	2004
EU (25)	4,339	17,269	24,502	33,529	45,475	38.3	48.4	47.9	48.4	46.6
<i>EU15</i>	4,228	16,862	22,289	31,696	42,359	37.3	47.2	45.4	45.7	43.4
<i>EU10</i>	111	407	1,214	1,833	3,116	1.0	1.1	2.4	2.6	3.2
EFTA	205	892	2,483	3,396	3,911	1.8	2.5	4.8	4.9	4.0
MENA	3,669	3,830	5,065	6,577	8,373	32.4	10.7	9.9	9.5	8.6
East Asia	160	1,023	2,218	3,865	6,451	1.4	2.9	4.3	5.6	6.6
NAFTA	1,322	4,101	3,434	3,841	5,234	11.7	11.5	6.7	5.5	5.4
Russia	0	2,082	3,863	5,451	9,033	--	5.8	7.5	7.9	9.3
Rest of the World	1,646	6,510	9,705	12,681	19,063	14.4	18.2	18.9	18.3	19.5
TOTAL	11,341	35,707	51,270	69,340	97,540	100	100	100	100	100

Source: Based on State Institute of Statistics data

Notes: EU-10 includes new members of the EU as of May 1, 2004 (Cyprus, Czech Republic, Estonia, Hungary, Malta, Latvia, Lithuania, Poland, Slovakia and Slovenia); NAFTA includes Canada, Mexico and the U.S.; MENA refers to Middle-East and North Africa and EFTA include Iceland, Norway and Switzerland.

3.1.3 Effects of Customs Union on Welfare and Growth

The literature on economic integration defines two different effects, namely static and dynamic effects. Static effects represent changes in the allocative efficiency of member states, without taking into consideration economic structure or technology changes, taking their productive capacity as given. By contrast, dynamic effects measure the impact of integration on the productive capacity of member states.²⁷

²⁷ A. Sapir, 1992. *Regional Integration in Europe*. The Economic Journal, **102** (415), pp. 1491-1506.

3.1.3.1 Static effects of customs union

According to conventional economic theory preferential regional agreements are necessarily welfare improving. However, Viner (1950) proved that this is not always the case. He claims that regional trade agreements not only lead to trade creation but also may lead to significant trade diversion. Consequently, welfare would be reduced by diverting imports from the least cost source to a higher cost source.²⁸

Viner (1950) distinguishes between two welfare effects: trade creation and trade diversion. Trade creation involves a shift in domestic consumption from a high-cost domestic source to a lower-cost partner source due to the abolishment of trade barriers; this is because for most countries, trade is dominated by manufactures which have relatively high import demand elasticities, boosting trade creation. Whereas trade diversion involves a shift in domestic consumption from a low-cost world source to a higher-cost partner source as a result of the elimination of tariffs on imports from the partner. Trade creation is always welfare enhancing, while trade diversion is considered as negative.²⁹

According to Viner (1950) the closure of high-cost domestic industry would be beneficial for the home country because it would free resources for use in areas that home country had a comparative advantage. This would increase welfare in customs union area. On the other hand, the trade diversion effect would be harmful to the home country because of the shift to a higher-cost source of imports, which means that the union as a whole would be worse off. If a customs union is welfare-improving for participating countries and world as a whole or not depends on the magnitude of these two effects. A predominantly trade-creating union would be advantageous, while a predominantly trade-diverting union would be harmful for the participating countries.³⁰

²⁸ J. Viner, 1950. *The Customs Union Issue*. New York: Carnegie Endowment for International Peace.

²⁹ D. Greenaway & L.A. Winters, 1994. *Surveys in International Trade*. Boston: Blackwell, p. 48.

³⁰ Malkoç, p. 8.

The degree of welfare enhancing effects of a customs union depend on some criterias; it is proportional to the size of the pre-existing trade between customs union members, the depth of the cut of trade barriers between members and import demand elasticities for goods on which barriers are being reduced. According to Corden(1976), if the initial non-uniformity of the tariffs of the members are high, gains will be higher. Also Lipsey(1958) argued that the countries would have higher levels of trade if they have a common border or geographically close to each other, therefore a customs union between neighbors will be more trade creating.³¹

It is obvious that Turkey and the EU satisfies many of these criterias. Even before the CU, the EU was Turkey's main trade partner; in 1995 the share of EU15 in total Turkish exports was 51.3 percent while that of imports was 47.2 percent. It is geographically close to Europe and it had substantial trade barriers prior to the CU.

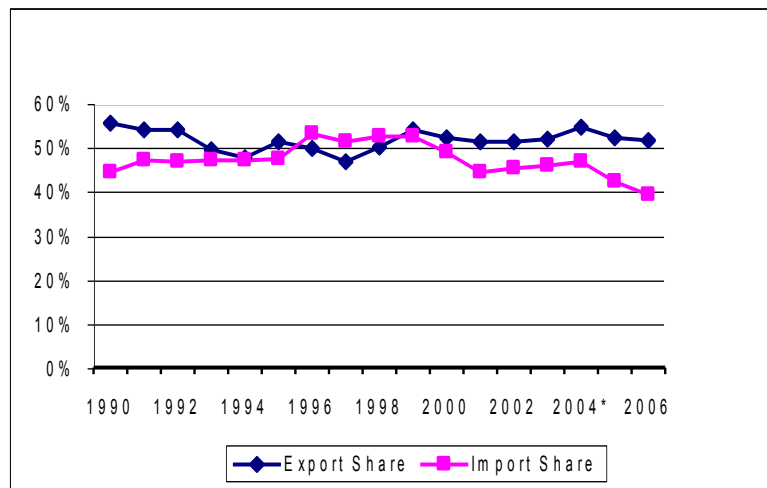
Figure 3.3 gives the share of EU in Turkey's exports and imports. The data suggests that the CU caused more trade creation, than trade diversion. While the share of the EU in Turkey's imports was 47.2 percent in 1995, in 1996 it increased to 53 percent. Its share in exports decreased to 49.7 percent in 1996 from 51.2 percent in 1995. This shows that the trade creation effect of customs union occurred in favor of the EU.

The share of the EU on Turkey's foreign trade, however, started to get back to the pre-customs union level beginning from 2000. In 2006 it was 44 percent, even lower than the level before customs union. As stated before, the reason of high increase in few subsequent years after entry into force of the CU was due to the fact that the EU had already abolished tariffs on industrial goods of Turkey before 1996. In other words, it was Turkey who abolished the tariffs on 1996 not the EU.³²

³¹ C. Hartler, S. Laird, 1999. *The EU Model and Turkey-A Case for Thanksgiving*. Ceneva: World Trade Organization Staff Working Paper TPRD99-01, p. 3.

Available from: http://www.wto.org/english/res_e/reser_e/tp9901_e.htm (cited 10 January 2007)

³² A. Şahinöz, 2004. *AB-Türkiye: Ticari İlişkiler Ve Gümrük Birliği*. İşletme ve Finans Dergisi, 219, pp. 28-45.



Source: The Undersecretariat of Foreign Trade
 * As of May 1 2004 EU25

Figure 3.3 : Share of the EU in Turkey’s exports and imports

Even though the trade creation effect of customs union occurred mostly in favor of the EU, Turkey also had significant gains. It is estimated that the bilateral liberalization of industrial tariffs alone has benefited Turkey at around 1 percent of GDP.³³ Further liberalization towards third countries and adoption of free trade areas has also led to important gains. It is suggested that harmonization with the EU’s common external tariff has led to an additional 0.5-1 percent of GDP. Most importantly, deep integration measures such as harmonization with EU technical regulations have further enhanced market access. It is estimated that Turkey has gained around 0.5 percent of GDP from harmonization with EU technical regulations.³⁴

Stronger bilateral trade relations with the EU countries did not damage the trade with the rest of the world. Its share in Turkish exports has remained roughly constant after the CU.

³³ Harrison, G.W., Rutherford, T., & Tarr, D.G., 1996. *The Economic Implications for Turkey of a Customs Union with the European Union*. World Bank Policy Research Working Paper No. 1599, Washington, D.C., p.11.

³⁴ Ibid, p. 13.

3.1.3.2 Dynamic effects of customs union

According to many analysts the static welfare effects of customs unions and other regional preferential arrangements are typically small and possibly negative. That's why, they, then focus on the potential dynamic benefits, which however, are difficult to define and even more difficult to measure.³⁵ Baldwin (1992) states that dynamic gains from trade liberalization are several times the static gains. It has presumed that customs unions and free trade agreements produce substantial growth effects through better exploitation of scale economies, technology spillovers and greater competition resulting in higher productivity. However measurement difficulties make it hard to evaluate their importance.³⁶

Competitiveness of firms and industries of a country depends on several variables and also highly correlated with the level of development. Table 3.6 shows the effect of the CU on the competitiveness of Turkish industries. In order to understand if the CU caused any changes in the competitiveness of Turkish economy as a whole and by sectors, Balassa Index is used. The index measures the competitiveness gains or losses in Turkish industry as a result of the CU. The Balassa Index is defined as follows:

$$B = (X_{kt} - M_{kt}) / (X_{kt} + M_{kt}), \quad (3.1)$$

Where X_{kt} is exports of commodity k in time t and M_{kt} represents imports of commodity k in time t. Results range between -1 and 1. A high value of B indicates the existence of a comparative advantage while an increase in B indicates that the country under consideration has improved its competitive position against its competitors.

³⁵ C. Michalopoulos, D. Tarr, 1997. *The Economics Of Customs Unions In The Commonwealth Of Independent States*. Geneva: Worldbank Working Papers 1786, p. 4.

³⁶ R.E. Balwin, 1992. *Measurable Dynamic Gains from Trade*. The Journal of Political Economy, **100** (1) pp. 162-174.

As seen from Table 3.6 there has been different courses in different product groups. In Turkey's traditional export products like agriculture and textile and clothing competitiveness decreased but it was a rather smooth downturn. Even they had a negative index, a considerable improvement of competitiveness has seen in iron and steel, machinery, automotive and parts and electrical and electronic goods. A possible explanation of this could be technology import brought by foreign direct investment attracted by the country especially in automotive and white goods sectors.

Table 3.6 : Changes in competitiveness of sectors according to Balassa Index

	Agriculture	Textile & Clothing	Iron & Steel	84.,85., 87. Chapters*	Other Industrial goods	Total
1994	0.77	0.78	-0.64	-0.69	-0.43	-0.12
1995	0.43	0.73	-0.57	-0.67	-0.54	-0.21
1996	0.47	0.60	-0.66	-0.74	-0.61	-0.33
1997	0.60	0.58	-0.50	-0.77	-0.62	-0.34
1998	0.60	0.65	-0.35	-0.69	-0.59	-0.28
1999	0.59	0.69	-0.07	-0.59	-0.52	-0.20
2000	0.53	0.64	-0.18	-0.65	-0.56	-0.29
2001	0.67	0.67	-0.22	-0.35	-0.45	-0.06
2002	0.58	0.64	-0.20	-0.33	-0.49	-0.12
2003	0.56	0.68	-0.25	-0.32	-0.49	-0.13
2004	0.58	0.67	-0.08	-0.31	-0.42	-0.14
2005	0.51	0.70	-0.23	-0.29	-0.33	-0.12
2006	0.44	0.72	-0.13	-0.24	-0.31	-0.10

Source: Calculations based on The Undersecretariat of Foreign Trade statistics

*84:machinery, 85: automotive and parts, 87: electrical and electronic goods

However, because of the economic and political instability it is hard to say that dynamic effects of the CU were felt significantly. Until 2005 the level of foreign direct investment was much lesser than expected. Nevertheless, since the dynamic effects occur in long term it is necessary to avoid rash conclusions.³⁷

Overall it is possible to say that the CU has helped the transformation of Turkish industry by introducing stronger competition. Furthermore by accentuating the need for

³⁷ M. Ede, 2006. *Gümrük Birliğinin Türkiye Ekonomisine Etkileri*. Available from: <http://forum.ekibi.net/gumruk-birliginin-turkiye-ekonomisine-etkileri-t-160.html> (cited 22 March 2007)

gaining a competitive edge, it contributed to improvements in productivity.³⁸ In the long term it is expected that thanks to increasing competitiveness Turkey will better profit from the scale economies.

3.2 SPECIALIZATION OF TURKISH TRADE

Industrial products have driven export expansion between 1996-2006. Their share in total exports rose from 80 percent in 1996 to 86.2 percent in 2006. Industrial products are a highly heterogeneous group, which means that they have different levels of contribution to the expansion. The degree of processing and the technology content of the exported products reveal Turkey's industrial capacities.

3.2.1 Degree of Processing Embodied in EU-Oriented Exports

The composition of trade in terms of end-use product categories enlightens changes in the domestic demand for various goods depending on the extent of their processing as well as a country's capacity to produce more complex products. Industrial development is related to increase in net exports of products representing higher level of processing. The increase in the weight of the processed manufactures (machinery together with automobiles and parts) in total imports and exports indicate that the level of industrial processing carried out in the country is growing.³⁹

As seen from the Table 3.7, which demonstrates the level of processing embodied in exports, there has been a considerable change over the years. Share of traditional sectors, i.e. textile and clothing and agriculture, in Turkey's exports fell from 69 percent in 1995 to 43 percent in 2005.

³⁸ S. Ülgen, Y. Zahariadis, 2004. *The Future of Turkish-EU Trade Relations*. Brussels: Centre for European Policy Studies, EU-Turkey Working Papers, p. 8.

³⁹ Kaminski, & Francis, p. 17.

Exports of automobiles and parts have remarkably expanded. Their share in total exports increased from 3.38 percent in 1995 to 17.3 percent in 2005. The large share of automobiles and parts indicates Turkey's participation in EU automotive networks. This spectacular increase was due to the big automotive industries investing Turkey after the CU.

Table 3.7 : Exports of end-use product categories to the European Union in 1995,2000-05

	Export (\$ million)							Export Share (%)						
	1995	2000	2001	2002	2003	2004	2005	1995	2000	2001	2002	2003	2004	2005
Agricultural foods and feeds	2,106	1,751	1,923	1,947	2,435	3,122	4,045	18.0	11.6	11.4	10.0	9.42	9.0	10.53
Industrial raw materials	331	412	390	402	515	705	859	2.83	2.7	2.3	2.0	1.99	2.0	2.24
Machinery, excl. Auto	952	2,320	2,553	3,281	4,534	6,136	7,270	8.1	15.39	15.16	16.85	17.54	17.83	18.93
Automobiles and parts	395	942	1,641	2,176	3,460	6,032	6,643	3.38	6.2	9.74	11.17	13.4	17.52	17.3
Textile and clothing	6,051	6,792	7,085	8,055	10,06	11,51	12,37	51.7	45.0	42.0	41.38	38.97	33.45	32.23
Other consumer goods	1,662	2,703	3,038	3,330	4,585	6,561	6,650	14.2	17.93	18.0	17.11	17.74	19.06	17.32
Fuels	201	157	208	274	240	349	556	1.71	1.0	1.2	1.4	0.93	1.0	1.45
All Goods	11,69	15,07	16,83	19,46	25,83	34,42	38,39	100	100	100	100	100	100	100

Source: Based on Turkstat Statistics.

Note: End-Use categories are defined as Agricultural Food & Feeds (SITC 0+1+2+4-27-28), Industrial Raw Materials (SITC 27+28+68), Machinery, excluding auto (SITC 7-78), Automobiles & Parts (SITC 78), Textiles & Clothing (SITC 65+84), other Consumer Goods (SITC 5+6+8+9-65-68-84), Fuels (SITC 3) and All Goods (SITC 0 to 9).

Overall, the expansion in exports of more processed goods took place in highly demanding and competitive European markets indicate Turkey's integration into these markets.

3.2.2 Level of Technology Embodied in the EU-Oriented Exports

A taxonomy developed by Landesman and Stehrer (2003) is used in order to assess the technology content of Turkey's trade with the EU. It distinguishes among three categories of activities and assign to each of them products identified in trade statistics in terms of two-digit SITC. Rev.3. They are classified as low technology and unskilled labor intensive activities, medium to high technology activities and resource intensive activities. They involve following sectors;

- Low and labor intensive group: textiles and clothing, wood products, most chemicals, tires, etc.
- The medium to high technology group: machinery and equipment, transport equipment, electrical and optical equipment, pharmaceuticals, etc.
- Resource intensive activities: extraction of mineral resources or unprocessed agricultural products.

Table 3.8 demonstrates Turkey's exports and imports in terms of technological and resource intensity. Turkey has a very strong revealed export specialization in EU markets for low technology and unskilled labor intensive products. However, figures show that the most important change in Turkey's EU-oriented exports has seen in the share of medium and high technology products. The value of their exports increased eight-fold between 1995 and 2004 growing at an average rate of 21.5 percent over 1995-2003. The average rate of growth for low tech and unskilled labor intensive products however was only 5.4 percent and that for resource intensive products amounted to 9.9 percent. The share of medium to high tech products rose from 13.3 percent in 1995 to 24.5 percent in 2000 and 37.3 percent in 2004. Stronger competitiveness of Turkish suppliers and increasing import demand of the EU for these products were the major causes of this growth in exports. Their share in the EU external imports of these products increased from 0.5 percent in 1995 to 0.9 percent in 2000, 2.1 percent in 2003 and to 2.5 percent in 2004.

Table 3.8 : Technology content of Turkey's trade with the EU-25

Factor Input							Index 2004	
	1995	2000	2001	2002	2003	2004	1995 =100	2000 =100
	Turkey's Exports to EU25 (\$ million)							
Low tech products & labor intensive	8,459	9,552	10,361	11,630	14,805	16,422	194	172
Medium to high tech products	1,623	4,112	5,325	7,041	10,297	13,157	810	320
Resource intensive products	2,078	3,087	3,398	3,579	4,729	5,708	275	185
	Turkey's Export Share (%)							
Low tech products & labor intensive	69.6	57.0	54.3	52.3	49.6	46.5	67	82
Medium to high tech products	13.3	24.5	27.9	31.6	34.5	37.3	279	152
Resource intensive products	17.1	18.4	17.8	16.1	15.9	16.2	95	88
	Exports in % of Imports (%)							
Low tech products & labor intensive	402	430	546	479	510	507	126	118
Medium to high tech products	20	26	59	62	60	56	280	217
Resource intensive products	36	38	53	43	41	40	111	105
	Share in EU25 External Imports (%)							
Low tech products & labor intensive	5.9	6.5	6.8	7.3	7.8	8.3	142	129
Medium to high tech products	0.5	0.9	1.3	1.7	2.1	2.5	453	262
Resource intensive products	0.8	0.9	1.0	1.1	1.2	1.2	151	132
	Export Specialization Index							
Low tech products & labor intensive	3.4	3.5	3.2	2.9	2.8	2.8	84	80
Medium to high tech products	0.3	0.5	0.6	0.7	0.8	0.8	268	162
Resource intensive products	0.5	0.5	0.5	0.4	0.4	0.4	89	82

Source: Kaminski, & Francis (2006)

The value of Export Specialization Index is defined as follows;

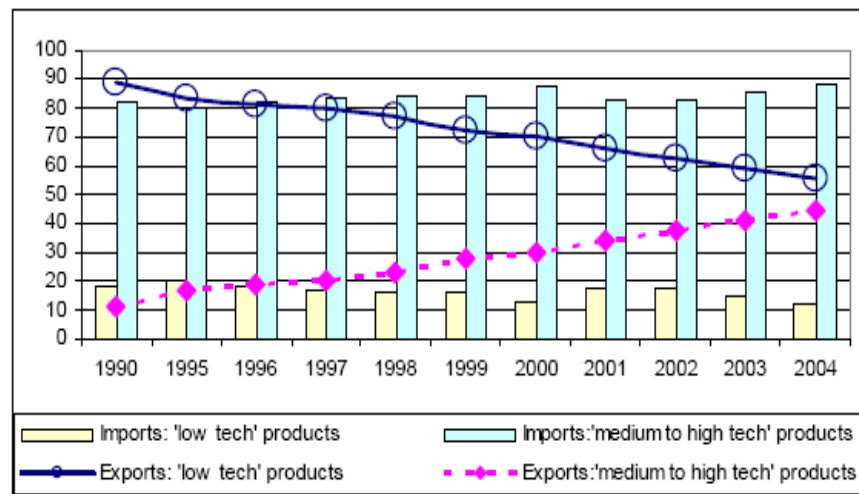
$$ES_{ij} = (x_{ij}/X_i) / (m_j/M) \quad (3.2)$$

Where: x_{ij} is country i 's exports of product j to the EU; $X_i = \sum_j x_{ij}$ is country i 's total exports to the EU; $m_j = \sum_i x_{ij}$ is EU's total 'external' imports of a product j ; $M = \sum_i \sum_j x_{ij}$ is EU's total external imports.

A value for this index below unity indicates a comparative disadvantage while a value greater than unity, means that the country has a revealed comparative advantage in the product. In other words, Turkey has a revealed comparative advantage in a product if its export of that item as a share of its total exports exceeds the EU imports of the item as a share of EU total imports.

ESI index of low technology and unskilled labor intensive products of Turkey shows that Turkish suppliers have a significant presence in these markets. Turkish exports accounted for 8.3 percent of EU total imports of low tech and unskilled labor intensive products in 2004.

Exports of low technology and unskilled labor intensive products have been around five times higher in terms of value than their imports from the EU. This means that these products are Turkey's major source of net foreign currency earnings. Regarding medium to high value products Turkey is a large net importer. Exports of medium to high technology products in terms of their imports remarkably increased from 20 percent in 1995 to 56 percent in 2004.



Source: Kaminski, & Francis (2006)

Figure 3.4 : Technology content of Turkey's exports to the EU

As seen from Figure 3.4 the level of technology content of Turkish imports from the EU was relatively stable, while that of exports changed sharply over time. The share of low tech and unskilled labor intensive products fell down steadily from 90 percent in 1990 to 70 percent in 2000 and 56 percent in 2004.

Since 1990 exports of medium to high technology products raised steadily whereas that of low technology products followed a decreasing trend. Regarding imports, medium to high technology products have always accounted for about 80percent of imports from the EU.

3.2.3 Factor Intensities of Turkey's EU-Oriented Exports

Ever since Eli Hecksher's 1919 pioneering contribution to international trade theory, and especially since Paul Samuelson's early papers in the 1940's (Stolper and Samuelson, 1941, Samuelson, 1948, 1949), the concept of factor intensity has played a key role in explanations of trade patterns.⁴⁰

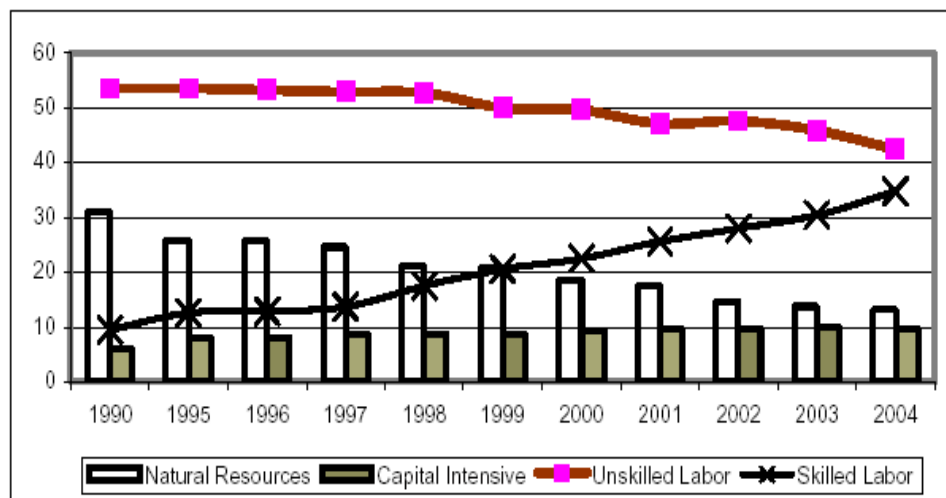
According to the Heckscher-Ohlin theorem a given country's comparative advantage (or disadvantage) is determined by its factor endowments. A country has a comparative advantage in those sectors that use intensively the productive factors that are abundant in the country. Cross-country trade patterns are determined by differences in comparative advantage: a country will export goods whose production uses intensively the factors that are relatively abundant (and thus comparatively cheap) in that country before trade and import those goods whose production would require the use of relatively scarce (expensive) factors.⁴¹

Considering, respective endowments in factors of production; temperate climate, available land for agricultural production and relatively uneducated labor force Turkey is expected to export products with significant content of natural resource and unskilled labor intensive products and import capital and skilled labor intensive products. However, according to empirical data this expectation realized only on the import side.

⁴⁰ R.W. Jones, 2002. *Trade Theory and Factor Intensities: An Interpretative Essay*. New York: University of Rochester, p. 2.

⁴¹ M. Widgrén, 2006. *Challenges created by the new EU Member States and third countries*. Helsinki: Economic Council of Finland, p. 9.

Turkey's imports from the EU followed a very stable path over time, the share of capital and skilled labor intensive goods accounting for around 80 percent. There has been a significant restructuring in factor intensities of its exports indicating rapid movement towards higher value-added products (Figure 3.5) Since 2000 the share of natural resource-based and unskilled labor intensive products has been falling, while that of capital- and skilled labor-intensive products has been rapidly expanding. The major drivers of change were skilled labor intensive products. Their share in total EU-oriented exports amounted to 10 percent in 1990, increased to 22 percent in 2000 and 30 percent in 2004. Whereas the share of unskilled labor-intensive products decreased to 49 percent in 2000 from 54 percent in 1990 and further decreased to 46 percent in 2004.⁴²



Source: Kaminski, & Francis (2006)

Figure 3.5 : Factor intensities of Turkey's exports to the EU (%)

This transformation in factor intensities of Turkish foreign trade is the reflection of the capacity of the country to develop more and more sophisticated and competitive industrial products in global markets. The simple average of the aggregate share of skilled labor and capital intensive products in total EU directed exports from Turkey rose from 21 percent in 1996 to 44 percent in 2004.⁴³

⁴² Kaminski, & Francis, pp.23-24.

⁴³ Ibid, p. 23.

Exports of skilled labor intensive products grew on average over 1990-2004 at 21 percent per year. From 1990 to 1993 the share of skilled labor intensive products imported from Turkey in the EU-15 was stable at around 1 percent; in 1994 it increased to 1.2 percent and kept growing every year in 1995-2004.⁴⁴

In conclusion, the outlook of Turkey's industrial development that arises from the analysis of the level of technology and factor content of foreign trade proves the emergence of modern and competitive industrial structures in European markets. Especially following the years of the entry into force of the CU, there has been a strong shift towards production of skilled labor and technology intensive goods. Although low technology and unskilled labor intensive and resource based products together still account for more than half of Turkish exports to European markets, exports of medium to high technology products with high content of capital and skilled labor were the levers of the export expansion. Considering the growing competition from low-wage countries in Asia, shift away from products embodying natural resources and unskilled labor is important for future sustainability of exports.

3.3 TURKEY'S PARTICIPATION IN PRODUCER AND BUYER DRIVEN VALUE CHAINS AND NETWORKS

Industrial and commercial capital have promoted globalization by establishing two distinct types of international economic networks; "producer-driven" and "buyer-driven" global commodity chains. A commodity chain refers to the whole range of activities involved in the design, production, and marketing of a product.⁴⁵

Integration into the EU-25 production and distribution value chains and networks has been the driver of Turkey's increasing participation in division of labor based on

⁴⁴ Ibid, p. 25.

⁴⁵ G. Gereffi, 1999. *A Commodity Chains Framework for Analyzing Global Industries*. Durham: Duke University, <http://www.ids.ac.uk/ids/global/pdfs/gereffi.pdf> (cited 20 March 2007), p.1

outsourcing and production fragmentation.⁴⁶ EU-25 absorbed 68 percent of all Turkish network exports as compared to 56 percent of Turkish total exports. Network exports to the EU have expanded rapidly, with their share in total EU-25 destined exports rising from 58 percent on average in 1995-99 to 62 percent in 2004 (Table 3.9).

Table 3.9 : Significance of European markets in Turkish all network trade

Market	Average share in Turkey's total networks' exports			Average share in Turkey's all goods exports			Share of total network exports in all goods exports		
	1995-99	2000-04	2004	1995-99	2000-04	2004	1995-99	2000-04	2004
EU25	66.2	68.0	69.5	53.7	55.1	55.3	57.9	61.6	61.8
Other Europe	3.2	3.2	3.9	3.6	3.8	4.4	41.8	42.1	43.7
Rest of the World	30.6	28.8	26.6	42.7	41.1	40.3	33.7	35.0	32.5

Source: Kaminski, & Francis (2006)

3.3.1 Participation in Buyer-Driven Value Chains and Networks

Buyer-driven commodity chains refer to those industries in which large retailers, marketers, and branded manufacturers play the pivotal roles in setting up decentralized production networks in a variety of exporting countries, typically located in developing or transition economies. This pattern of trade-led industrialization has become common in labor-intensive, consumer goods industries such as textile and clothing, footwear, furniture, toys, house wares, etc.. Production is generally carried out by tiered networks of contractors that produce finished goods for foreign buyers. The specifications are supplied by the large retailers or marketers that order the goods.⁴⁷

⁴⁶ Kaminski, & Francis, p.28.

⁴⁷ Gereffi, p.1.

Table 3.10 : Trade with the EU-25 in buyer-driven chains

Product (SITC Rev. 2)	1996	2000	2001	2002	2003	2004	Index 2004 2000=
<u>Textile & Clothing (SITC 65+8998+84)</u>							100
Exports of T&C (\$ mill.)	6,144	6,807	7,098	8,036	10,090	11,542	170
Imports of textiles (\$ mill.)	1,012	1,182	1,093	1,402	1,612	1806	153
Memo Items:							
Share of T&C in Turkey's all exports (%)	50.3	44.7	41.6	41.1	38.5	33.1	74
Share of EU25 in Turkey's total T&C exports (%)	69.8	66.6	66.8	65.2	66.1	65.4	98
Share in EU25 external imports of T&C (%)	11.1	11.7	12.4	13.6	14.6	14.8	127
<u>Footwear and Parts (SITC 85+6123)</u>							
Total exports of footwear & parts (\$ mill.)	39	36	42	52	83	106	298
Imports of footwear & parts (\$ mill.)	61	63	44	53	64	74	118
Memo Items:							
Share of footwear & parts in Turkey's all exports	0.3	0.2	0.2	0.3	0.3	0.3	130
Share of EU25 in Turkey's total footwear exports	26.1	31.3	33.0	39.5	45.2	51.7	165
Share in EU25 external imports of footwear & parts (%)	0.26	0.27	0.36	0.53	0.70	0.71	259
<u>Furniture and Parts Network</u>							
Total exports of furniture & parts (\$ mill.)	33	103	119	162	257	343	334
Imports of furniture & parts (\$ mill.)	114	159	103	112	142	213	138
Memo Items:							
Share of furniture & parts in Turkey's all exports	0.3	0.7	0.7	0.8	1.0	1.0	146
Share of EU25 in Turkey's total furniture exports	41.1	57.0	59.5	55.9	56.2	56.1	98
Share in EU25 external imports of furniture & parts (%)	2.10	2.60	3.17	3.86	4.25	4.4	162
<u>Total Buyer-Driven Chains</u>							
Share of total above chains in Turkey's all exports (%)	50.9	45.6	42.6	42.2	39.8	34.4	75
Share of EU25 in Turkey's total above chain exports (%)	68.8	66.0	66.3	64.7	65.6	64.9	98

Source: : Kaminski, & Francis (2006)

Turkey's major network industry is textile and clothing and followed by footwear and furniture. Even though the share of textile and clothing products in Turkish exports follow a declining trend it still accounts for majority of network exports. According to Eurostat statistics in 2005 the share of Turkey in the EU's total textile and clothing imports was about 15 percent being second supplier of the EU after China. Share of the EU25 in Turkey's total textile and clothing exports accounts for about 65 percent, in other words the EU is the most important market for textile and clothing producers.

Furniture sector was the most rapidly expanding network sector after the entry into force of the CU. The contraction in the share of textile and clothing products in total exports of buyer-driven chains was due to the emergence of the furniture network as a significant exporter. Its share in total exports rose steadily from 0.3 percent in 1996 to 1.0 percent in 2004 (Table 3.10).

Export of footwear also increased rapidly in 2002-2004 from \$52 million to \$106 million. Nevertheless it still account for only a small part of total network exports.

Turkish buyer-driven network industries increased their share in EU external imports through the combination of exports of both parts and final products. Export share of textile and clothing increased 25 percent in 2000-2003 and in 2004 it was six times higher than their imports. As seen from table 3.10 all three sectors have positive trade balances in 2004. In other words they are net exporters and their share in the EU imports is increasing consistently.

3.3.2 Participation in Producer-Driven Value Chains and Networks

Producer-driven commodity chains are those in which large, usually transnational, manufacturers play the central roles in coordinating production networks. This is characteristic of capital and technology-intensive industries such as automobiles, aircraft, computers, semiconductors, and heavy machinery.

Producer-driven chains are characterized by high barriers to the entry of new firms because in these chains, manufacturers making advanced products like aircraft, automobiles, and computers are the key economic agents in terms not only of their earnings, but also in their ability to exert control over backward linkages with raw material and component suppliers, and forward linkages into distribution and retailing.⁴⁸

⁴⁸ Ibid , p.2.

On contrary to buyer-driven commodity chains which are lead by highly competitive globally decentralized factory systems, producer-driven commodity chains are characterized by global oligopolies. These oligopolies develop and sell brand-named products exert substantial control over how, when, and where manufacturing will take place, and how much profit accrues at each stage of the chain. Consequently, the main leverage in buyer-driven industries is exercised by retailers and marketers at the distribution and retail end of the chain.⁴⁹

Producer-driven network trade of Turkey accounts for a larger share of network trade compared to buyer-driven trade. Automotive industry is more EU concentrated than the information, communication and technology (ICT) industries. The EU markets take a larger share of total ICT network's exports than automotive network's exports.

Both automotive and ICT network exports increased significantly after the CU. Automotive network exports was only \$ 577 million in 1996, with a spectacular increase in 2004 it amounted to \$ 7.019 million. Consequently, its share in Turkey's total exports rose to 20.1 percent in 2004, from 4.7 percent in 1996 (Table 3.11).

ICT exports followed the same path with their value amounting \$ 2.556 million in 2004 from \$ 228 million in 1996. Consequently their share in EU imports of these products increased from 0.3 percent in 1996 to 1.2 percent in 2004.

⁴⁹ Ibid, p.2.

Table 3.11 : Trade with the EU-25 in producer-driven networks

	1996	2000	2001	2002	2003	2004	Index 2004 2000=100
Producer-driven Network							
Automobile Network							
Exports of auto & parts (\$ mill.)	577	1,357	2,225	2,783	4,355	7,019	517
Imports of auto & parts (\$ mill.)	2,582	5,391	2,255	2,953	6,011	10,529	195
Memo Items:							
Share of auto & parts in Turkey's all exports (%)	4.7	8.9	13.0	14.2	16.6	20.1	226
Share of EU25 in Turkey's total auto & parts exports	53.1	63.8	70.5	68.4	70.2	72.8	114
Share in EU25 external imports of auto & parts (%)	1.6	2.9	4.6	5.5	7.0	8.8	303
Information, Communication and Technology Network (ICT)							
Exports of ICT network (\$ mill.)	228	819	811	1,333	1,692	2,556	312
Imports of ICT network (\$ mill.)	1,212	3,780	1,822	2,032	2,298	2,979	79
Memo Items:							
Share of ICT network in Turkey's all exports (%)	1.9	5.4	4.8	6.8	6.5	7.3	136
Share of EU25 in Turkey's total ICT network exports (%)	69.8	81.3	77.4	83.5	85.5	87.2	107
Share in EU25 external imports of ICT network (%)	0.3	0.6	0.7	1.1	1.1	1.2	206
Total Producer-Driven Chains							
Share of total above network in Turkey's all exports	6.6	14.3	17.8	21.1	23.1	27.4	192
Share of EU25 in Turkey's total above network exports	57.0	69.5	72.2	72.6	73.9	76.2	110
Share in EU25 external imports of total above chains	0.6	1.2	1.8	2.5	2.9	3.4	289

Source: Kaminski, & Francis (2006)

The share of exports of producer-driven networks in exports of manufactures reached 22.5 percent signaling a shift towards specialization in higher valued added networks. In 2006 export of automotive sector passed the share of agriculture for the first time.

4. FUTURE PROSPECTS FOR THE EU-TURKEY TRADE RELATIONS

There exist two possible scenarios for the EU-Turkey future trade relations. First is that the existing CU may be enhanced by solving problems which prevent it from functioning perfectly today and by including the sectors that are not covered by the CU. The second scenario is Turkey's accession to the internal market after successfully completing the accession negotiations and becoming a full member.

4.1 DEEPENING AND WIDENING THE CUSTOMS UNION

As previous sections suggest, the CU has been an important step forward in Turkey's integration with the EU and the global economy. Since the dynamic effects of the CU have proven to be more important than the purely static effects, it is believed to have been a welfare-enhancing form of trade integration. In other words, the CU has accelerated the transformation of Turkish industry by introducing stronger competition and emphasizing the importance of competitiveness, which led to improvements in productivity. It has also changed the industrial structure, by helping domestic industries to integrate with global webs of production and distribution. It has further contributed to the modernization of Turkey's economic legislation and therefore to its business environment. These are all factors that reveal the beneficial effects of the CU.

However the CU also has some drawbacks. First of all it requires a common commercial policy. However changes in commercial policies are carried out without cooperation or consultation between the parties, meaning that Turkey has to implement EU's commercial policies without being able to participate into policy-making process. The second is that because of the continuation of contingent protection, safeguards and technical barriers to trade, customs union is not functioning as good as it should. The other problem areas are insufficient policy harmonization or implementation problems of Turkey in the intellectual property rights, competition law and state aids policies.

4.1.1 Common Commercial Policy

After the creation of the CU Turkey was required to harmonize its commercial policy with that of the EU. This included signing of a series of free trade agreements with the countries which had a similar agreement with the EU. Table 4.1 presents Turkey's trade with these countries.

Table 4.1 : Impact of free trade agreements on Turkey's foreign trade (\$thousand)

Country		1996	1999	2000	2001	2002	2003	2004
Lithuania	export	15,094	25,764	23,953	32,586	53,723	84,972	122,531
	import	30,795	61,070	71,499	77,796	110,457	135,980	173,930
	volume	45,889	86,834	95,452	110,382	164,180	220,952	296,461
	balance	-15,700	-35,306	-47,546	-45,210	-56,734	-51,009	-51,400
Hungary	export	102,808	121,919	109,994	170,230	200,934	282,196	349,938
	import	94,420	95,000	216,262	186,673	325,902	409,426	705,407
	volume	197,228	216,919	326,256	356,903	526,836	691,622	1,055,345
	balance	8,389	26,919	-106,268	-16,443	-124,967	-127,229	-355,469
Estonia	export	4,595	9,046	9,439	13,169	18,105	23,183	35,521
	import	14,544	4,748	7,091	1,336	1,177	13,871	44,257
	volume	19,138	13,794	16,530	14,505	19,282	37,054	79,778
	balance	-9,949	4,298	2,348	11,833	16,927	9,313	-8,736
Czech Rep.	export	93,461	67,257	101,571	109,399	130,235	188,313	222,264
	import	108,442	82,018	158,740	126,873	316,959	443,623	654,592
	volume	201,903	149,275	260,311	236,272	447,195	631,935	876,857
	balance	-14,982	-14,761	-57,169	-17,474	-186,724	-255,310	-432,328
Slovakia	export	20,149	16,986	20,199	27,565	33,198	59,707	108,605
	import	23,697	45,675	51,533	49,418	112,341	203,023	232,714
	volume	43,846	62,661	71,732	76,983	145,539	262,730	341,319
	balance	-3,547	-28,689	-31,334	-21,853	-79,143	-143,315	-124,109
Poland	export	253,248	219,624	174,596	241,233	342,647	482,736	697,677
	import	79,311	81,245	164,681	168,070	245,134	410,765	996,105
	volume	332,559	300,869	339,277	409,303	587,780	893,501	1,693,782
	balance	173,937	138,379	9,915	73,163	97,513	71,971	-298,428
Slovenia	export	24,534	38,681	47,581	62,667	68,981	102,476	188,559
	import	16,793	48,005	55,652	48,948	57,115	85,222	203,222
	volume	41,327	86,686	103,233	111,615	126,097	187,698	391,781
	balance	7,741	-9,324	-8,071	13,719	11,866	17,254	-14,663
Letonia	export	1,970	9,841	16,086	16,108	20,343	26,682	38,366
	import	3,426	1,659	11,949	153	220	1,249	1,151
	volume	5,396	11,500	28,035	16,261	20,563	27,930	39,517
	balance	-1,456	8,182	4,137	15,955	20,123	25,433	37,214
EFTA countries	export	335,937	361,613	324,252	316,114	409,043	538,086	657,981
	import	1,112,068	926,070	1,155,270	1,480,929	2,511,999	3,395,678	3,911,430
	volume	1,448,005	1,287,682	1,479,522	1,797,043	2,921,042	3,933,764	4,569,411
	balance	-776,131	-564,457	-831,018	-1,164,815	-2,102,956	-2,857,592	-3,253,450

**Table 4.1 : Impact of free trade agreements on Turkey's foreign trade
(\$ thousands) (Cont.)**

Country		1996	1999	2000	2001	2002	2003	2004
Israel	export	254,853	585,239	650,142	805,218	861,434	1,082,998	1,313,890
	import	192,627	298,257	505,482	529,489	544,467	459,488	714,143
	volume	447,481	883,496	1,155,624	1,334,707	1,405,900	1,542,486	2,028,033
	balance	62,226	286,982	144,660	275,728	316,967	623,510	599,747
Romania	export	314,045	268,185	325,818	392,028	566,497	873,347	1,235,485
	import	441,290	401,156	673,928	481,140	661,765	955,971	1,699,553
	volume	755,335	669,341	999,746	873,168	1,228,262	1,829,318	2,935,039
	balance	-127,244	-132,971	-348,109	-89,112	-95,267	-82,625	-464,068
Bulgaria	export	156,906	233,595	252,934	299,415	380,332	621,685	894,326
	import	362,771	295,573	465,408	393,516	508,449	689,462	959,471
	volume	519,677	529,168	718,342	692,931	888,781	1,311,147	1,853,797
	balance	-205,865	-61,978	-212,474	-94,101	-128,116	-67,778	-65,145
Croatia	export	27,116	29,897	23,589	30,112	42,873	85,598	118,060
	import	28,542	7,893	25,375	17,330	9,388	16,697	35,229
	volume	55,658	37,790	48,963	47,442	52,260	102,295	153,290
	balance	-1,426	22,004	-1,786	12,781	33,485	68,901	82,831
Bosna-Herz.	export	22,474	39,892	26,871	27,586	43,264	63,227	99,938
	import	2,485	16,222	7,497	4,926	6,317	8,343	11,476
	volume	24,958	56,114	34,368	32,512	49,581	71,570	111,414
	balance	19,989	23,670	19,374	22,659	36,946	54,885	88,463
Macedonia	export	74,251	93,670	107,765	89,816	101,316	122,715	149,330
	import	31,714	7,878	10,470	9,115	14,914	27,342	51,935
	volume	105,964	101,547	118,235	98,930	116,230	150,057	201,266
	balance	42,537	85,792	97,295	80,701	86,403	95,373	97,395
Palestine	export	360	1,822	5,622	5,999	4,729	6,489	9,025
	import	1	1	153	98	13	454	545
	volume	361	1,823	5,774	6,097	4,742	6,943	9,570
	balance	359	1,821	5,469	5,901	4,716	6,035	8,480
Tunisia	export	94,547	238,434	162,272	140,593	121,142	220,015	255,637
	import	49,968	66,574	64,843	72,936	71,801	98,140	100,410
	volume	144,515	305,008	227,115	213,528	192,942	318,155	356,047
	balance	44,579	171,861	97,429	67,657	49,341	121,875	155,228

Source: The Undersecretariat of Foreign Trade

Even though these agreements have contributed to a growth in Turkey's trade volume, trade deficit with these countries has also increased. Nevertheless, even after the completion of the CU, changes in commercial policies were conducted without consultation to Turkey. While signing free trade agreements after 1996 the EU did not take into consideration the existence of a customs union agreement with Turkey. At the same time because of the CU arrangement, Turkey was forced to conclude a similar agreement with those countries after the EU did. The problem was that most of the time, those countries did not want to negotiate with Turkey because their agreement with the EU allowed them to export tariff-free (although indirectly) to the Turkish market, as

their goods would enter into free circulation within the Community and therefore within the Turkish-EU CU. In return, Turkey was unable to export these countries under the preferential conditions since it was not an EU member. This means that, they could export to Turkey on a preferential basis but did not have to extend this preferential arrangement to Turkey. This structure also put Turkish exporters at a disadvantageous position with regard to the Community exporters in those third countries. Furthermore, Turkey loses tariff revenues since goods originating from these third countries are not exported to Turkey directly but re-exported from the Community so as to take advantage of the lack of import duties.⁵⁰

However, since Turkey can not automatically be made a party to the free trade agreements that the EC concludes there is no simple solution to this problem. To overcome this problem EU started to introduce a “Turkish clause” in its new bilateral trade agreements in which it asks its trading partner to negotiate a similar agreement with Turkey.⁵¹

4.1.2 Contingent Protection and Safeguards

As stated earlier, EU-Turkey CU differs from the Europe Agreements meaning that it allows for the continuation of contingent protection and safeguard measures in cases of unfair practices in their bilateral trade.⁵²

Contingent protection measures include anti-dumping and countervailing duties. Anti-dumping measures consist of special import duties imposed on products when the price of imports is alleged to be below the price (or normal value) charged by the foreign firm in its domestic market. Countervailing measures involve special import duties imposed when subsidized exports in foreign countries result in a costly reallocation of resources

⁵⁰ Ülgen, Zahariadis, p. 8.

⁵¹ Ibid, p.20.

⁵² Decision No 1/95 Of The EC-Turkey Association Council of 22 December 1995 on implementing the final phase of the Customs Union (96/142/EC) Section III Trade defense instruments Article 11-12.

in the importing country or when subsidized exporters are able to preempt competitors in the home market and enjoy monopoly power.

During the ten years following the entry into force of the CU the EU has used many times these trade defense measures against Turkey. Since 1996 the Community has initiated several anti-dumping cases against Turkey. As seen in Table 4.2, cases appear to be concentrated in low-skill manufacturing, like metals, textile and apparel industries.

Table 4.2 : Anti-dumping measures taken by the EU against Turkey

Product	Initiation date	Result
Pentaerythri-tol	2006	Terminated/No duty
Steel ropes and cables	2005	Duties
Hollow sections	2002	Provisional measures rejected
PVC	2001	Duties
Flat-rolled products of iron	2001	No duty
Welded tubes of iron & non-alloy steel	2001	Duties
Paracetamol	2000	No duty
Steel-stranded ropes and cables	2000	Undertaking: No duty
Televisions (color)	2000	No duty
Steel wire rod	1999	No duty
Cotton fabric (unbleached)	1997	Expired/No definite measure
Unbleached cotton fabrics	1996	No duty
Polyester yarn (PTY)	1995	Expired
Polyester yarn (POY)	1995	Expired
Cotton fabric	1994	No duty
Cotton yarn	1994	Expired
Bed linen	1994	No duty
Portland cement	1992	No duty
Semi-finished rod of alloy steel	1992	Expired
Polyester yarn (manmade fibres)	1991	Expired
Asbestos cement pipes	1990	Undertaking

Sources: The anti-dumping semi-annual reports by Members for the period 1 January -30 June 2006; WTO; European Commission Directorate General for Trade database http://ec.europa.eu/trade/issues/respectrules/anti_dumping/stats.htm

It is stated by the EU that such measures will only be allowed to lapse if Turkey can convincingly demonstrate to the Community that all competition and anti-subsidy disciplines as well as other areas of the *acquis communautaire* have been adopted and enforced in the Turkish economy. However, no explicit guarantee or a specific timetable is given for their abolishment in future.

Turkey also uses anti-dumping measures extensively. As of 2006 Turkey uses anti-dumping measures against eight EU countries (Table 4.3). Sectors that are more often subject to anti-dumping measures include textiles, chemicals and some light manufacturing.

Table 4.3 : Anti-dumping measures taken by Turkey against the EU countries

Country	Product	Date of Imposition	Measure
Belgium	Polyvinyl Chloride	06/02/2003	AD Duty
Finland	Polyvinyl Chloride	06/02/2003	AD Duty
Germany	Polyvinyl Chloride	06/02/2003	AD Duty
Greece	Polyvinyl Chloride	06/02/2003	AD Duty
Hungary	Polyvinyl Chloride	06/02/2003	AD Duty
Italy	Polyvinyl Chloride	06/02/2003	AD Duty
Netherlands	Polyvinyl Chloride	06/02/2003	AD Duty
Romania	Polyvinyl Chloride	06/02/2003	AD Duty

Source: WTO Committee on Anti-Dumping Practices -Semi-Annual Report Under Article 16.4 of the Agreement Turkey

The second trade defense measure in the context of the CU is safeguards. Concerning safeguards the modalities of the 1970 Additional Protocol are valid. Article 60 of the Additional Protocol states that *“if serious disturbances occur in a sector of any of the parties [Turkey, the Community or individual member states], or prejudice its external financial stability, or if difficulties arise which adversely affect the economic situation in a region of any party, then that party may take the necessary protective measures”*. Consequently these measures may have serious consequences on the depth of integration between the two parties. Nevertheless, so far, neither party in the EU-Turkish CU has invoked the safeguard provision.

As a result it is possible to say that contingent protection measures, which are defined by Nelson⁵³ being “worse” than statutory protection⁵⁴, continue to play an important role

⁵³ D.R. Nelson, 2006. *Proliferation of Contingent Protection among Developing Countries: Causes and Consequences*. New Orleans: Murphy Institute, Tulane University, p.2.

in the EU-Turkey trade relations. Since the establishment of the CU, both parties have used trade defense measures extensively even though it was Turkish exporters which have been affected more. Continuation of these measures seems to be an important problem that makes market access difficult for both sides. Turkey's further alignment with the community's competition and state aids policies may be helpful to solve this problem.

4.1.3 Technical Barriers to Trade

According to The Agreement on Technical Barriers to Trade of WTO definition "Technical Barriers to Trade" (TBTs) means any restrictions arising from different standards⁵⁵, technical regulations⁵⁶ and conformity assessment⁵⁷ procedures across countries regarding products.

The legal character of technical regulations distinguishes them from non-regulatory barriers or standards which are voluntary, not legally binding and arises from the self-interest of producers or consumers involved. Technical regulations mainly relates to either technical specifications or testing and certification requirements.

⁵⁴ Contingent protections are dependent on a quasi-judicial/bureaucratic finding prior to application of the protection. By contrast, traditional protection is "statutory", i.e. it is applied in every case, without any such finding.

⁵⁵ According to this Agreement, a standard is a "Document approved by a recognized body that provides, for common and repeated use, rules, guidelines or characteristics for products or related processes and production methods, with which compliance is not mandatory. It may also include or deal exclusively with terminology, symbols, packaging, marking or labeling requirements as they apply to a product, process or production method."

⁵⁶ A technical regulation is a "Document which lays down product characteristics or their related processes and production methods, including the applicable administrative provisions, with which compliance is mandatory. It may also include or deal exclusively with terminology, symbols, packaging, marking or labeling requirements as they apply to a product, process or production method."

⁵⁷ Conformity assessment procedures, defined as "any procedure used, directly or indirectly, to determine that relevant requirements in technical regulations or standards are fulfilled" are essential to demonstrate compliance with such regulations. "These procedures include, inter alia, procedures for sampling, testing and inspection; evaluation, verification and assurance of conformity; registration, accreditation and approval as well as their combinations."

Technical barriers therefore affect business pre-production, production, sales and marketing policies. The need to adapt product design, re-organize production systems, multiple testing and certification costs can entail a significant cost (or technical trade barrier) for suppliers of exported goods. Therefore the removal of such barriers promotes trade and efficiency.⁵⁸

Technical barriers to trade played a central role in the CU, as they represent an important step forward in Turkey's integration with the EU Single Market. According to Article 8 of CUD, Turkey was obliged to incorporate all Community legislation on the removal of TBTs into its national law. Provisions of the CUD related to elimination of the TBTs cover most of industrial products such as textiles, motor vehicles, machineries, household appliances, pressure vessels, medicinal products, cosmetics, medical devices which constitute most of trade between the EU and Turkey.

However, the agreement focuses primarily on standardization and adopts a relatively minimalist position in the area of conformity assessment. This means that even the goods produced under the correct EU specifications can still face barriers upon export to the EU as well as to Turkey.

The current system of standardization and conformity assessment in Turkey includes several governmental and semi-governmental bodies with direct control over the creation and enforcement of standards. The main institution is the Turkish Standards Institute (TSE) with primary authority and responsibility for preparing and publishing Turkish standards for all types of materials, products and services. Although it is a non-governmental organization, the TSE remains a public institution under the heavy influence of the state. Around 10 percent of its revenue comes from the government, and the highest decision making authority, the General Assembly includes various ministry representatives.

⁵⁸ P. Brenton, J. Sheehy, M. Vancauteren, 2000. *Technical Barriers to Trade in the European Union: Importance for Accession Countries*. Brussels: CEPS Working Document No. 144, p. 3.

In the area of conformity assessment, the Turkish system is characterized by various levels of authority. Testing and certification procedures on imported products are performed by different national bodies, including the TSE and relevant ministries. In terms of enforcement, all imported products that are subject to mandatory standards must hold a Certificate of Conformity (TSE mark) and a Quality Conformance Certificate (TSEK), produced by the TSE prior to importation. In obtaining the TSE and TSEK marks, exporters to Turkey have to go through a lengthy and costly procedure, which involves the adoption of an inspection or control certificate by the TSE. The authorities stress that although the procedure is obligatory only for mandatory standards, it is also highly recommended for the marketing of products subject to voluntary standards.⁵⁹

In the area of accreditation, Turkey has established an independent audit. Turkish Accreditation Authority (TURKAK) is argued to be an independent legal entity with administrative and financial autonomy. However, the law still allows for substantial interference from the state.⁶⁰ In the last Progress Report of Turkey, European Commission states that “*regarding accreditation, some progress can be noted. TURKAK, the national accreditation agency, signed the Multilateral Agreements (MLA) of the European Accreditation Cooperation (EA) on calibration laboratories, testing laboratories, quality systems certification bodies and inspection bodies*”⁶¹.

Thus because of the relatively low levels of transparency and openness of the system it is possible to say that the current institutional environment in Turkey allows for considerable room for the continuation of technical barriers. According to European officials the number and nature of products subject to mandatory standards are above and beyond international standards. Also, delays and unnecessary documentation place European producers in a disadvantageous position in the Turkish market.

⁵⁹ Ülgen, & Zahariadis, p.14.

⁶⁰ Ibid, p. 22.

⁶¹ Commission Of The European Communities, 2006. *Turkey 2006 Progress Report*. Brussels, p. 32.

Regarding standardization, Turkey's process of harmonization with the EU system has two principal domains namely horizontal and vertical legislation. European Commission reports that good progress was made on horizontal measures: *“In the area of standardization, the number of mandatory standards declined significantly, they decreased from 300 in 2005 to 29 in 2006. The remaining mandatory standards are mainly in the area of construction products. Turkish Standards Institute (TSE) further adopted EN standards of the European Committee for Standardization (CEN), the European Committee for Electro technical Standardization (CENELEC) and the European Telecommunications Standards Institute (ETSI). About 90 percent of CEN and 88 percent of CENELEC standards are now adopted.”*⁶²

Market surveillance is done by the local authorities in accordance with the related Community Directives. If any party finds that a product, the conformity of which with those Directives has been attested to, fails to satisfy essential health and safety requirements, it may take all appropriate measures, including partially or completely restriction of marketing of this product.⁶³ In market surveillance, it is reported by European Commission that although administrative capacity of the Ministries is sufficient, their organization and coordination is lagging behind to perform effective market surveillance duties.

Concerning vertical legislation, the CUD requires Turkey to adopt all 319 EU Directives. As seen in Table 4.4 until today 214 of them are harmonized. This means that there are still 85 directives to be adopted.

⁶² Ibid., p. 32.

⁶³ Ç. Yılmaz, 2002. *The Elimination of the Technical Barriers to Trade between Turkey and the European Union and its Trade Effects on Turkey*. Ankara: The Undersecretariat of Foreign Trade, p.13.

Table 4.4 : Progress of Turkey on harmonization of TBTs

Product Groups	The Number of Transposed EU Legislation	Total Number of EU Legislation to be Harmonized
Motor vehicles Ministry	63	65
Agricultural & forestry tractors	23	23
Lifting & mechanical appliances	4	5
Household appliances	3	6
Gas appliances	3	3
Construction plant & equipment	0	9
Other machines	1	1
Pressure vessels	6	6
Measuring instruments	25	27
Electrical material	4	8
Textiles	3	4
Foodstuffs	47	65
Medicinal products	6	18
Fertilizers	3	7
Dangerous substances	2	19
Cosmetics	3	8
Environment protection	2	7
Info. tech. telecoms & data	1	14
General Provisions in TBTs	3	9
Construction products	1	3
Personal protective equipment	1	1
Toys	1	1
Machinery	1	1
Tobacco	1	2
Energy	0	0
Spirit drinks	1	1
Cultural goods	1	1
Explosives for civil use	1	1
Medical devices	1	1
Recreational craft	1	1
Miscellaneous	2	2
TOTAL	214	319

Source: The Undersecretariat of Foreign Trade

In the area of conformity assessment, European Commission reports that substantial progress was achieved, albeit for a limited number of activities and sectors. Turkey can now notify conformity assessment bodies to the European Commission.

Overall much remains to be done to reduce technical barriers to achieve a better market access for both sides. Removal of technical barriers will reduce transaction costs of

exporters of both parties and facilitate market access. If Turkey establishes an adequate infrastructure relating to standardization, accreditation, conformity assessment and market surveillance appropriate to the Community requirements, Turkish exporters would not have demand required certification from the European authorities. Consequently, duplicative certification costs for the Turkish exporters will be eliminated. In sum, Turkey's export to the EU will significantly rise thanks to elimination of technical barriers combined with tariffs and quotas.

4.1.4 State Aids and Competition Law

The evolution of Turkey's economy from a government-controlled regime to market-based competition brought in 1994 the Act on the Protection of Competition (Competition Act) and the creation of the Turkish Competition Authority (TCA). The CU with the EU has further accelerated this process. The CU obliged Turkey to enact the EU's standard competition provisions as its own law and to establish an agency to enforce them.

The Competition Act establishes the TCA as an autonomous enforcement agency. Decision-making authority of the TCA is Competition Board with its seven members. Law enforcement procedures can be triggered by a complaint or at the Board's own initiative. It has broad investigative powers, including authority to obtain a court order permitting the search of corporate premises. The objective of the TCA is promoting efficient markets and consumer welfare, prevent monopolies and protect consumers.

Both OECD and European Commission report that the Authority has continued to make excellent progress, developing a reputation as one of Turkey's most effective autonomous agencies. It is highly supported by business leaders because of its efforts to move the Turkish economy to a competition-based and consumer welfare-oriented market mechanism.

However the TCA still has some drawbacks; disorganization in its approach to harmonization with the EU competition law, little public understanding of competition policy, inexperienced and slow judicial review organs, and inadequate commitment to competition by other parts of the government.⁶⁴

In order to make the TCA more effective OECD report⁶⁵ recommends following measures:

- Promptly establish a mechanism for controlling anticompetitive state aid.
- Eliminate or control state-created enterprises and associations vested with monopoly concessions or with powers and privileges enabling them to undertake anticompetitive conduct.
- Restore competition policy oversight of banking sector mergers.
- Mandate an explicit role for the TCA in regulatory analysis.
- Improve the TCA's law enforcement capacity.
- Adopt an organized approach to harmonization with EU competition law.
- Expand consultation with sectoral regulators.

Furthermore the TCA should work harder to promote a competition culture in Turkey. However, taking into consideration the fact that competition rules are in force in the EU for forty years, and in Turkey only for a decade there are still a lot to do for spreading the competition culture in Turkey. Therefore, for Turkey's adoption of the new rules introduced by the EU, a longer transition period than the foreseen in CUD should be given to Turkey.

The Article 34 of the CUD which deals with state aids states that: *“Any aid granted by Member States of the Community or by Turkey through State resources in any form whatsoever which distorts or threatens to distort competition by favoring certain undertakings or the production of certain goods shall, in so far as it affects trade*

⁶⁴ Organization for Economic Cooperation and Development, 2005. *Competition Law and Policy in Turkey*. Paris, p. 1.

⁶⁵ Ibid, p.15.

between the Community and Turkey, be incompatible with the proper functioning of the Customs Union.”

Also establishment of “Turkish State Aid Monitoring and Supervisory Authority” is envisaged by the CUD. However, although the EU’s progress reports on Turkey routinely decry the failure to resolve this question it remains unsolved.

The independent enforcement of state-aid control is important not only fulfilling Turkey’s obligations stemming from the CU but also in successfully liberalizing and de-regulating state-owned or dominated domains of activity such as telecommunications, energy, postal services or even banking.

Considering the fact that the state’s potential for unfair competition is a significant impediment to foreign investment the application of state-aid rules will contribute positively to Turkey’s image vis-à-vis international investors.

4.1.5 Intellectual Property Rights

Intellectual property rights (IPRs) is also one of the important area of deep integration in the context of the EU-Turkey CU. Annex 8 Article 1 of the CUD states that “*The Parties confirm the importance they attach to the obligations arising from the Agreement on Trade-related aspects of intellectual property rights concluded in the Uruguay Round of Multilateral Trade Negotiations.*” This means that the parties focus on mutual compatibility with international regulations. According to the Annex 8 Article 3 of the CUD before entry into force of the CUD Turkey had to accede to the following multilateral conventions on intellectual, industrial and commercial property rights:

- Paris Act (1971) of the Bern Convention for the protection of literary and artistic works,
- Rome Convention (1961) for the protection of performers, producers of phonograms and broadcasting organizations,
- Stockholm Act (1967) of the Paris Convention for the protection of industrial property (as amended in 1979),
- Nice Agreement concerning the international classification of goods and services for the purposes of the registration of marks (Geneva Act, 1977, as amended in 1979),
- Patent Cooperation Treaty (PCT, 1970, as amended in 1979 and modified in 1984).

Turkey has made considerable progress in the area of IPRs. The Turkish Patent Institute has administrative and financial autonomy and has full responsibility for the registration and administration of patents and IPRs (trademarks, industrial designs and designation of origin).

On the legislative side, a first important step has been the adoption of detailed legislation aiming at strengthening alignment with the EU directives on rental rights and lending, copyrights and the provisions of the Rome and Bern Conventions, TRIPs and the World Intellectual Property Organization (WIPO) 'Internet' Treaties. Furthermore, in November 2000 Turkey ratified and acceded to the European Patent Convention. In the area of protection and supervision, in 2001, Turkey adopted new legislation identifying the division of legislative powers between the general civil and penal courts and new specialized courts that are handling cases related to IPRs. In 2006 a regulation on Record and Registration of Intellectual and Artistic Works was published. The Turkish Patent Institute (TPI) improved its IT structure and online services. The databases of registered industrial designs, trade marks and patents have been opened to the public for preliminary search of earlier rights and the state of play of the rights. This facility reduces the costs of the applicants remarkably and shortens the application process.

Given all these developments in recent years Turkey is described as an attractive investment environment, which is in compliance with the TRIPs and the WTO. This qualification is an important step forward for Turkey that should be emphasized. IPRs essentially set a rules-based system for the marketing and trade of innovative new ideas and thus act as a powerful signaling mechanism for potential foreign investors. By acquiring a sound set of IPR rules and a transparent and reliable monitoring system, Turkey creates better opportunities for strengthening foreign investment flows and in particular foreign direct investment.⁶⁶

However, despite these developments, as seen in Table 4.5, much remains to be done to promote compatibility and integration with the EU system. Piracy and counterfeit remain serious problems in the country. According to The International Intellectual Property Alliance, trade loss due to piracy is increasing substantially every year. It is estimated that in 2006, the total trade loss due to piracy reached \$243 million with counterfeit levels as high as 80 percent in the music and 66 percent in the business software industries.

Table 4.5 : Estimated trade losses due to copyright piracy (\$ million) and levels of piracy: 2002-2007

Industry	2007		2006		2005		2004		2003		2002	
	Loss	Level	Loss	Level	Loss	Level	Loss	Level	Loss	Level	Loss	Level
Books	23.0	NA	20.0	Na	23.0	Na	23.0	Na	25.0	Na	25.0	Na
Records and Music	22.0	80%	20.0	80%	18.0	80%	15.0	70%	15.0	75%	18.0	75%
Business Software	193.0	64%	203.0	66%	157.0	65%	107.0	66%	81.0	66%	38.5	58%
Entertainment software	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Motion pictures	NA	NA	NA	NA	29.0	NA	50.0	45%	50.0	45%	50.0	45%
Total	238.0		243.0		227.0		195.0		171.0		131.5	

Source: International Intellectual Property Alliance 2008 Special 301 Report, Turkey

⁶⁶ Ülgen, & Zahariadis, p. 21.

In order to fight against piracy provincial anti-piracy commissions are founded in 2002. However European Commission reports that, provincial anti-piracy commissions are not functioning effectively. Similarly it is reported that the number of the IPRs civil courts and their logistical infrastructures is insufficient and training of judges needs to be strengthened.

The European Commission provides funding to Turkey to enable institution building (legislation, administration, and implementation). However, although a number of positive steps have been taken on the legislative, institutional and monitoring fronts, Turkey should further strengthen its efforts in the fight against piracy, administrative capacity of provincial enforcement committees should be strengthened and efforts should be made to achieve full alignment with the EU directives.

4.1.6 Liberalization of Trade-in Services

Service sector is the most dynamic sector of the economy. It is important for the developed as well as for developing country economies. The rapidly expanding services sector is contributing more to economic growth and job creation worldwide than any other sector. The services sector is accounting for some three-quarters of the GDP for the EU and around 60 percent for Turkey. Additionally, over three-quarters of EU jobs are in the services sector.⁶⁷ In Turkey it amounts to 50 percent.⁶⁸ Although, because of the rapid expansion of goods exports the share of services exports in total exports decreased in recent years it still accounts for about one fifth of total exports. Table 4.6 demonstrates the importance of services sector in Turkish exports.

⁶⁷ Eurostat

⁶⁸ Turkstat

Table 4.6 : Export composition of Turkey 1996-2006

Year	Goods Exports (\$ million)	Services Exports (\$ million)	Share of services exports in total exports(%)
1996	32,067	13,057	28.9
1997	32,110	19,248	37.5
1998	30,662	23,171	43.0
1999	28,842	16,359	36.2
2000	30,721	19,454	38.8
2001	34,373	15,199	30.7
2002	40,124	14,031	25.9
2003	51,206	17,952	25.9
2004	67,047	22,941	25.5
2005	76,949	26,640	25.7
2006	91,889	24,414	21.0

Source: The Undersecretariat of Treasury

Services sector in Turkey is dominated by state owned enterprises and under heavy state influence. This prevents the sector from competition and this low level of competition negatively affects productivity in the services sector. As a result liberalization of services trade and consequent increasing competitiveness in the sector may boost growth and value added in the sector. At the same time the competitiveness of the manufacturing industry would increase due to reduced costs. Privatization of business services such as financial services, telecommunications and energy would further increase these productivity and competitiveness gains.

In 2000, the EU and Turkey began negotiations with the aim of reaching agreements on trade in services and government procurement. The negotiations on services and government procurement are conducted in parallel sessions with the understanding that nothing is agreed until everything is agreed on both issues.

Actually liberalization of trade in services as well as free circulation of capital and labor in parallel with the liberalization of trade in goods was envisaged in the Ankara Association Agreement of 1963. In fact, Articles 13 and 14 of the Ankara Agreement, as well as Article 41(2) of the Additional Protocol foresaw, by decision of the

Association Council, the progressive abolition of restrictions on the freedom to provide services and the freedom of establishment, using the relevant provisions of the EC Treaty as guidelines. Yet the efforts for economic integration were suspended in 1974. They were resumed in 1987 but focused on the liberalization of trade in goods meaning the completion of the CU. Member states did not want to include liberalization of trade in services to the CUD. The reason was that liberalization of trade in services between Turkey and the EU would necessarily entail some degree of liberalization as regards the right of establishment of service providers and this could provide the opportunity for many Turkish service providers to immigrate to the EU countries.

After December 1999 Helsinki EU Summit, where Turkey was granted candidate status, the negotiations on trade in services restarted and they still continue. It is expected to be completed before Turkey's full membership.

Integration with the EU in trade in services requires policy convergence by adopting *acquis communautaire* in the services area. The requirement of policy harmonization makes liberalization of services trade a difficult issue for Turkey which is not a full member of the EU. Furthermore, once the free trade agreement is in place, Turkey has to follow the changes made in the EU legislation and incorporate these in its national legislation. This means that Turkey will have to adopt legislation created by the EU and it will lose its ability to follow an independent policy. Considering that the services sector represents almost 60 percent of the Turkish economy the loss of independence in policy-making seems significant.

A possible solution to this problem could be a similar arrangement made between the EU and EFTA countries while establishing the EEA. In the EEA agreement EFTA countries were allowed to join the work of technical committees where new legislation was being discussed. Otherwise liberalization of trade-in services seems politically unattractive.

Another important problem area in liberalization of trade in services is the temporary movement of service providers. The services deal would need to address this question appropriately, given that in some service activities, movement of service providers is indispensable for the supply of the service. Also, the Community's visa regime with regard to Turkish service providers is needed to be amended so as to give essence to these freedoms.⁶⁹

Lastly, the institutional capacity of regulatory institutions would be instrumental in ensuring the proper functioning of the services agreement by providing effective regulatory oversight of the whole service sector. Thus, it would be of interest to launch specific programs to strengthen the institutional capacity of these institutions and to enhance their knowledge of the related EU acquis and practice.⁷⁰

4.2 ACCESSION TO THE INTERNAL MARKET

Although many steps towards preferential integration have been made, some authors place the emphasis on the trade potential that could emerge from full EU membership. They state three main reasons; administrative barriers will be progressively reduced to levels consistent with the Internal Market; technical barriers to trade are likely to decrease considerably through harmonization or mutual recognition of standards and regulations; and uncertainty related to political risk and macroeconomic instability should decrease, thus fostering a more favourable environment for trade and (foreign) investment.⁷¹

⁶⁹ Ülgen, & Zahariadis, p. 20.

⁷⁰ Ibid, p. 21.

⁷¹ D. Antonucci, & S. Manzocchi, 2006. *Does Turkey Have a Special Trade Relation With the EU? A Gravity Model Approach*. Rome: Confederation of Italian Industries, p.3.

4.2.1 Macroeconomic and Sectoral Effects

As stated in previous sections because of the existence of the EU-Turkey CU, in the framework of the Association Agreement of 1963, Turkey is already a part of the internal market, although it is limited to industrial products excluding agriculture, free movement of people, public procurement, establishment and services. Thus, Turkey has already harmonized part of the internal market acquis, including free circulation of goods, intellectual and industrial property rights, competition policy, and adopted the common external tariff.

Lejour, Mooij, and Capel (2004) estimated for Turkey and the EU of the macroeconomic effects of Turkey's accession to the internal market in 2025. As seen in Table 4.7 GDP and consumption in Turkey increase by 0.8 percent and 1.4 percent, respectively. Welfare increases by 4.4 billion US\$ in constant prices. For the EU-15, the economic effects seem quite small. Welfare raises by 3.8 billion US\$; expressed in percentage changes of GDP and consumption, this increase is not visible. Aggregate trade increase is only 0.2 percent. The CEEC-10 countries also experience no significant impact on GDP, but an increase in consumption of 0.2 percent.

Table 4.7 : Macroeconomic effects of Turkey's accession to the internal market in 2025

Countries	Volume of GDP (%)	Volume of consumption (%)	Equivalent Variation (billion\$)	Export volume (%)	Terms of trade (%)
Turkey	0.8	1.4	4.4	8.1	3.5
CEEC-10	0.0	0.2	0.1	0.3	0.2
Bulgaria	-0.0	0.1	0.3	1.3	0.1
Romania	0.0	0.2	0.0	0.8	0.2
EU-15	0.0	0.0	3.8	0.2	0.1
Germany	0.0	0.0	1.2	0.3	0.1
The Netherlands	-0.0	0.0	0.2	0.2	0.1

Source: Lejour, Mooij, & Capel (2004)

These effects are said to have two main reasons. First, thanks to changes in the relative prices countries can better exploit their comparative advantages causing. Consequently, this causes trade creation, increases production efficiency and raises welfare.

A second effect is a terms-of-trade⁷² effect. Turkey experiences a terms-of-trade gain of 3.5 percent without causing any terms-of-trade loss in other European countries; the EU-15 experience a terms-of-trade gain of 0.1 percent and the CEEC-10 of 0.2 percent. The reason for the presence of terms-of-trade gains on both sides is that the abolishment of NTBs causes a reduction in real trade costs.

At the same time, however, integration with Turkey expected to cause trade diversion. The rising imports from Turkey expected to come at the expense of imports from other countries. Especially the countries which specialize in the same industries will be affected most. These effects can be better seen in Table 4.8 which presents sectoral effects of Turkey's accession to the internal market in 2025.

**Table 4.8 : Sectoral effects of Turkey's accession to the internal market in 2025
(Numbers are relative changes in production)**

Sector	Turkey	Bulgaria	Romania	CEEC-10	EU15
Agriculture	4.9	-1.0	-0.3	-1.1	-1.0
Energy	-0.1	0	-0.0	0.1	0.0
Food processing	-0.2	0.1	0.6	0.0	0.1
Textile	17.8	-1.0	-0.3	-0.2	-0.4
Wearing apparel	14.6	-0.8	-0.2	-0.2	-0.3
Chemicals and minerals	-3.9	0.1	0.2	1.4	0.2
Other manufacturing	0.4	0.2	0.2	0.6	0.0
Metals	-0.8	0.2	0.6	2.1	0.2
Machinery and equipment	2.1	0.1	-0.1	0.4	0.0
Transport equipment	-0.9	0.1	0.2	0.5	0.1
Transport services	-0.6	0.1	0.2	0.5	0.0
Trade services	1.0	-0.0	0.2	-0.0	-0.0
Business services	-0.3	0.0	0.2	0.0	-0.0
Other services	-0.7	0.0	0.2	0.2	0.0
Construction	1.2	-0.0	0.2	0.0	0.0

Source: Lejour, Mooij, & Capel (2004)

⁷² The terms of trade is measured as the price of exports relative to imports that holds just outside the domestic border.

According to figures it is the Textiles and Wearing Apparel which expand most. This is because of their strong export orientation and the relatively large NTB in the sector. Also some other sectors like Trade Services and Construction in Turkey affected positively. However production in 8 sectors decreases, most substantially in Chemicals, Metals and Transport Equipment, because accession to the internal market does not affect trade costs much in these sectors.

Overall an aggregate trade increase for bilateral trade with Turkey of 34 percent is estimated. However, considering the fact that the potential impact of economies of scale and technology spillovers, FDI or the effects of the EU budget transfers are not included in the study the real effects could be higher than expected.

4.2.2 Effects of Institutional Reform

The potential improvement in national Turkish institutions is the second effect of Turkey's accession into the single market. Reforms resulted from the EU membership may have important implications for the Turkish economy. Lejour, Mooij and Capel (2004) simulate institutional reforms by an improvement in the Turkish position on the TI Corruption Perceptions Index from place 64 to 25. According to their gravity equation estimations, an improvement in the competitive position of Turkey results aggregate trade increase by 57 percent, an improvement in institutions raises GDP in Turkey by 5.6 percent, while consumption rises by 8.9 percent. Welfare increases by 28.2 billion US\$ in constant prices.

These macroeconomic effects are substantially larger than the impact of the accession to the internal market. Researchers state two main reasons for this; first, the estimated trade impact of the improvement in the Corruption Index is bigger than that of the accession to the internal market; second, the improvement in institutions affects all sectors alike.

It should be also noted that these gains will only materialize if the accession of Turkey to the EU results the expected institutional improvement.

4.3 FOREIGN DIRECT INVESTMENT

Foreign Direct Investment (FDI) has been increasingly seen as an important source of industrial growth and development for developing countries. FDI causes technology spillovers, assists human capital formation, contributes to international trade integration, helps create a more competitive business environment and enhances enterprise development.⁷³ Because of these benefits, developing countries are competing to attract FDI and to be more competitive in this race they started to re-structure their political and economic policies.

On the other side, investors prefer countries that have well-functioning market economy and demand minimum bureaucratic requirements. They compare countries on the basis of what they offer to foreign investors, including various information from political and economic stability to taxes, incentives, investment location, logistic costs, personnel costs, presence of skilled labor, costs and condition of infrastructure for transportation, telecommunication, and energy.⁷⁴

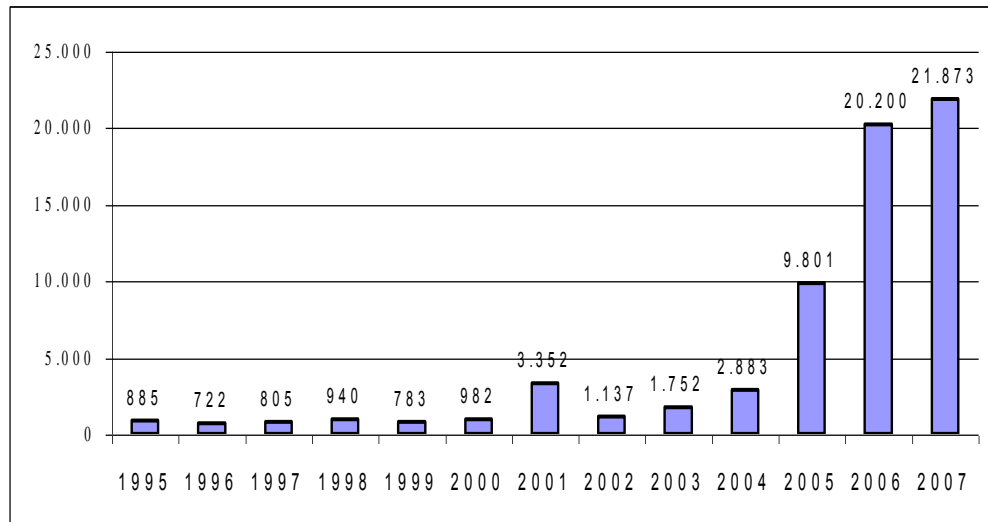
Turkey has always attracted very low inflows of FDI relative to other comparable countries. The reasons of Turkey's poor FDI attractiveness can be; structural barriers, heavy bureaucratic requirements, macroeconomic and political instability, corruption, and so on.

According to World Investment Report of the United Nations, in 2000 Turkey had minimum annual FDI attraction potential of \$ 35 billion. However, for Turkey the real

⁷³ OECD, 2002. *Foreign Direct Investment for Development; Maximizing Benefits, Minimizing Costs*. Paris, p. 11.

⁷⁴ Turkish Industrialist's And Businessmen's Association, 2006. *Investment Environment and Foreign Direct Investments in Turkey*. Istanbul, p. 12.

amount was less than \$1 billion, meaning \$34 billion loss as a result of FDI attraction issue not being adopted as a policy.



Source: The Undersecretariat of Treasury

Figure 4.1 : Foreign direct investment (inflows) to Turkey (\$ million)

The EU membership is expected to increase FDI inflows because of increasing confidence due to the removed uncertainty in political and economic stability. Previous experiences prove that the EU membership and even the membership process itself produce substantial increase of FDI inflows. In fact Eurostat states that “*European companies have a tendency to respond to globalization pressure by enhancing the division of labor through FDI within the EU rather than to third countries.*” In other words the EU membership makes a country more attractive for FDI from other EU countries. Furthermore with the EU membership a country also attains the opportunity to get a share from the FDI inflows to the EU from third countries. In Spain and Portugal, after full membership foreign investment increased 10 times in five years. For CEEC-10 FDI inflows since 1993 amounted to about \$170 billion.⁷⁵

⁷⁵ Turkish Industrialists And Businessmen Association, 2004. *FDI Attractiveness Of Turkey; A Comparative Analysis*. Istanbul, p. 5.

The decision of starting the accession negotiations with Turkey in 2005 and economic and political stability in last years boosted FDI inflows to Turkey. In the last two years FDI inflows exceeded \$40 billion. According to World Investment Report 2007 of the United Nations Turkey was the largest recipient of FDI in West Asia in 2006. Considering the fact that during last decade Turkey received an average FDI inflow of less than \$1billion the trend in last years is spectacular.

Table 4.9 demonstrates that much of the FDI inflows to Turkey originated from the EU countries.

Table 4.9 : Breakdown of the number of FDI companies by countries

Countries	2.007	Share (%)
European Union 27	2404	65.0
Other European Countries	220	5.9
African Countries	49	1.3
North America	169	4.6
Central And South America		0.6
Caribbean	21	
Near And Middle Eastern Countries	527	14.2
Other Asian Countries	277	7.5
Other Countries	35	0.9
Total	3702	100

Source: The Undersecretariat of Treasury

Since 2002 Turkey has made various legal changes in order to attract more foreign investment. Most important step was the establishment of the Improvement of the Investment Environment. It represents a significant change in mentality towards foreign investment on the part of bureaucrats and politicians. New FDI law, approved in June 2003, adopted equal treatment principle meaning that foreign investors acquire same rights and obligations with that of domestic investors. These new arrangements in investment environment together with above mentioned reasons accounted for the substantial FDI inflows to Turkey in last years. These investments are expected to continue as Turkey progress in accession negotiations and align its legislation with the *acquis communautaire*.

5. CONCLUSION

In 1980s Turkey shifted away from an import substitution policy to export led growth. Customs union agreement with the EU was the most important step forward in this opening process. Since its establishment, the customs union has been able to function on a sound basis. It may appear at first sight disappointing that the customs union has not had a major impact on the direction of trade. However this is understandable given that the EU had already liberalized its trade with Turkey well before the customs union entered into force and thus the EU had already become the most important trading partner of Turkey. After the customs union this did not change, yet it was instrumental in the growth of the volume of trade between the EU and Turkey and the growth of overall trade of Turkey. In light of the growth in trade volume and a lack of significant change in trade direction, it can be concluded that the Turkish-EU customs union has been a welfare creating one, leading to more trade creation than trade diversion.⁷⁶

Improved policy environment and domestic liberalization contributed rapid expansion of exports. The Pan European Cumulation of Origin Agreement together with the implementation of customs union provisions has set the groundwork for the growth of intra-industry and network trade. Since the entry into force of the customs union Turkey's trade patterns are changed considerably. It is driven by skilled labor-intensive, higher value added products with medium to high technology content; based on the entry of Turkish firms into supply chains of automotive and ICT networks; and supported by fast growth of unskilled labor and low technology intensive products. The shift towards higher value added exports has been taking place because differentials in fast growth rates have been in their favor. This has not been due to either slow down or collapse of unskilled labor-intensive exports but to a stronger push in other exports.

⁷⁶ Ülgen, & Zahariadis, p. 21.

The shift towards products requiring more capital, a better-trained labor force and high technologie and participation in international producer-driven networks has three important consequences. First, industries intensive in skilled labor and capital usually pay higher wages. The growth of exports in these sectors boost output growth and help improve living standards. Second, the shift away from products embodying natural resources and unskilled labor competitive in global markets are important for future sustainability of exports. Considering the growing competition from low-wage countries in Asia and elsewhere, it is obvious that these exports may not be sustainable over a longer term. On the contrary capital and skilled labor intensive products are less sensitive to changes in labor cost. Third, network members guaranteed membership are less vulnerable to local shifts in demand as they operate in multiple foreign markets.⁷⁷

There are, however, a number of issues that remain regarding the future of trade integration between the EU and Turkey. For a better functioning customs union the EU must undertake an effort to alleviate the concerns of the Turkish side in terms of the policy dependency framework and Turkey should eliminate the hidden forms of protectionism, especially in the area of technical barriers to trade. Finally, both parties should focus on the elimination of trade defense instruments vis-à-vis each other and should define the conditions related to the abolition of these instruments in clearer terms. An agreement on the liberalization of trade in services should be the next step in the Turkish-EU trade integration path.⁷⁸

In case of Turkey's enter into single market following completing negotiation process the macroeconomic implications for EU countries are small but positive. European exports increase by around 20%. Turkey experiences larger economic gains than the EU; welfare increases by 4.4 billion US\$ while GDP expands by about 0.8 percent in the long term. If Turkey would succeed in reforming its domestic institutions in response to the EU-membership, consumption per capita in Turkey could raise by an additional 9 percent. These benefits would spill over to the EU.

⁷⁷ Kaminski, & Francis, p. 37.

⁷⁸ Ülgen, & Zahariadis, p. 21.

To conclude it is possible to say that the available evidence looks like the long partnership between the EU and Turkey has been a success story, and it seems that the story has not finished yet.

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