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Challenges and Opportunities**

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1. Introduction

The ruling elite have long seen the economic and political integration into Europe a cherished goal for Turkey. Turkey has been a member in many organizations in the Western Europe since the post war period. However, Turkey was officially recognized as a candidate for the European Union in Helsinki in 1999, given a date for the beginning of the accession negotiations in December 2004 and, in this meeting, decided to start the negotiations in October 2005, four decades after the Ankara Agreement signed between Turkey and the EEC in 1963. In addition, Turkey signed a Customs Union Agreement with the EU¹ in 1995.

Integration process reveals unprecedented challenges and opportunities for both sides in terms of economic and political gains. In particular, Turkey would differentiate from the previous enlargements in the context of its population, size, geographical location, economic, security and military potential, as well as cultural and religious characteristics and, in turn, these factors give Turkey the capacity to contribute to regional and international stability (Lejour and de Mooij, 2004). Furthermore, as Turkey starts its journey to the EU, these above factors play an important role in the negotiation processes and might have substantial consequences which might be resulted in the changes in the structure of the common EU policies and in institutional organizations. In most cases integration into the EU has been widely viewed as a means of strengthening and consolidating political and economic reforms. On the Turkish side, she has to raise its political and economic standards up to the EU level and to accept *acquis communautaire* during the negotiation period. These developments and adjustments towards the EU not only in economic but also in political terms would be more clear for Turkey and mutually beneficial for both.

In this context, the aim of this paper is to examine the dynamics of the accession process in terms of the opportunities and challenges for Turkey. In particular, the impacts of the negotiation processes on the potential economic outcomes will be analyzed in detail. In order to fulfill these objectives, the paper will examine the relationship between Turkey and the EU under the sub period which might be clearly distinguished from the economic policies carried out and macroeconomic environments.

2. Developments and Characteristics of Turkish Economy and the EU in Import Substitution Era

¹ The EU is preferred throughout the paper, as integration in Europe passed through many phases, namely the EEC in the 1960s, the EC in the 1980s and the EU in the 1990s.

2.1. A Brief Review of Turkish Economy: 1923-1960

The economic policy implemented immediately after the independence of the Republic of Turkey was based on a liberal economic policy which emphasized the role of private sector (Okyar, 1965). During the early periods, main emphasis was given to the establishment of an economic base on the grounds of self-sufficiency. In 1922, the Turkish Commercial Union was established to constitute a “national economy” with the opportunities created by the state and to mainly fill the vacuum provided by the non-Muslim minorities who abandoned their businesses. In order to determine the economic policies of the Republic, the first Turkish Economic Conference which was held in 1923 in Izmir where mixed economic policies were accepted, but the following decade a liberal economic policy was implemented (Aktan, 1997:167-168). In addition, the government even enacted the Law for Encouragement of Industry to initiate and foster private sector in 1927 (Aktan; 1997:168). Turkey, however, did not have the proper environment to succeed with such a development policy based on private enterprises in the 1920s. The reason was that there were a lot of problems such as shortage of national capital, underdeveloped financial institutions, inadequate policies for introducing foreign capital as well as a shortage of entrepreneurs and an underdeveloped infrastructure (Öniş, 1999a:457, Tezel, 1994). In addition to these disadvantages, the economic liberalism of the new state did not last long as the deteriorating world economic conditions at the end of the 1920s pushed the regime to revise the economic policy and to adopt rigid state-led industrialization, namely *etatism*, where the state takes an active role in economic activities. By adopting *etatism*, the government established State Economic Enterprises (SEEs) for the industries which needed a long time and enormous amounts of capital and planned industrialization centered on the SEEs, while it worked for an accumulation of capital for private sectors and industrial development.

Moreover, with the establishment of the Republic, the founders of the State clearly stated that their objectives were to catch up with and become part of “contemporary civilization” which constituted the fundamentals of the Turkish modernization. The Turkish modernization effort in nature was elite and state driven and these bureaucratic elite controlled the course for the development (Mehmet, 1983:57; Öniş, 1999c; Barkey, 2000:88-90). The main characteristic of the Turkish modernization as argued by Black (1967) is that socio-economic developments were formed by this political elite who played a central role in almost all affairs in a manner of traditional strong state (Heper, 1985). In other words, Turkey turned her face

to the west as an integral part of a national project after World War I. In fact, for major periods of European history, Turkey has been an important factor of European politics. Moreover, Turkey closely aligned itself with the West and has become a founding member of all important other European organizations and since the Second World War has played an important role in contributing to the shaping of European policies. In particular, Turkey began to enter into traditional western institutions in the late 1940's and thus become an important strategic partner of the West. It was admitted to the OECD in 1948, the Council of Europe in 1949 and, most importantly for Turkey, NATO in 1952. Therefore, it can be clearly seen that Turkey has been closely watching economic and political developments in the Western Europe and, to this end, applied for the European Economic Community (EEC) in 1959.

2.2. A Brief Review of Turkish Economy after the Association Agreement: 1963-1980

Following this application for Associate Membership of the EEC in 1959, Turkey signed an agreement, namely Ankara Agreement, in 1963. It is generally argued that political factors rather than economic reasons played an important role in this process. In particular, Turkey's application was not a coincidence following Greece's application for becoming an associate member of the EEC in 1959, since Turkey did not want Greece to have an advantage in international arena over the disputes between both countries. In addition, the agreement would show Turkey's commitment to secular and Western-oriented political system and provide a framework for the country to work toward convergence with the Western Europe over the long run.

Ankara Agreement was put into effect in December 1964 which foresaw a stage by stage integration process towards eventual full membership in the EEC. This agreement aimed at securing Turkey's full membership in the EEC through the establishment in three phases of a customs union, which would serve as an instrument to bring about integration between the EEC and Turkey. Moreover, the agreement proposed to start preparations for lowering of trade barriers and, at later stages, to allow for free mobility of labor between Turkey and the EEC. As far as the economic policies started to be implemented in the early 1960s are concerned, the timing of this agreement can be seen as an irony, since Turkish policy-makers were initiating an industrialization strategy based upon a strong set of import substitution policy under the Five-Year Development Plans. At that time, Turkey was a largely agrarian economy and its manufacturing was dominated by food and textile industries.

From the early 1960s to 1980, Turkey followed a strategy of industrialization through inward-oriented import substitution policies coupled with intensive government intervention under the Development Plans (Aktan, 1997; Okyar, 1965, 1979; Hershlag, 1968; Keyder, 1987). However, the sub-period of 1960-1980 distinguishes from the beginning of the etatism to the end of the import substitution policies in 1980 in the sense that etatism were carried out by the Five-Year Development Plans. Main features of this period are that the economic policies were characterized as interventionist and protectionist and were carried out within the Developments Plans after 1963. Accordingly, the economic policies were mainly designed to protect the domestic industry from the foreign competition and to increase the government's controls over the allocation of resources and production of goods. This economic framework supports the view among Turkish politicians and businesses that protection was essential for Turkey's industrial development at least for some time as put forward in the "infant industry hypothesis". On the other hand, the policy-makers from the EEC side were quite skeptical about the ability of the Turkish industries to withstand competitive pressure from Europe. The agrarian characteristics of the Turkish economy were main reasons behind this skepticism. Following concerns from both sides over the competitive pressure coming from the EEC, Ankara Agreement set long-term goals and envisaged 12-year and 22-year processes starting in 1973. Meanwhile Turkey continued with an intensive import substitution industrialization policy and there was not much change in its economic relations with the EEC during the 1960s.

However, it is widely accepted that Turkish economy was undergoing a major change in the 1960s (Esfahani, 2003). While the share of the agriculture steadily decreased, the share of industry and services had gained importance in the national economy in this period. There had been a similar change in the structure of exports where manufactured products still remained a very small part of the total. In particular, the volume of Turkey's trade witnessed a rapid expansion and structural change in the early 1970s, following the devaluations and lowering protection rates in 1970 and 1971. With the Additional Protocol signed in 1973, the relationship between the EEC and Turkey entered a new phase. The EU accepted to lift or lower the trade barriers for most manufactured goods imported from Turkey in 1972. And this let Turkey export manufacturing goods to the EU markets freely. However, there was not a reciprocal liberalization on the part of Turkey. Instead, it was proposed that the trade barriers for the goods that Turkey had comparative advantages would be lifted in a 12-year period. The trade barriers for the goods that Turkey did not have comparative advantages would be

lowered in a 22-year period. Although there had been these developments, Turkey did not take advantage of the EC's offer for a number of reasons (Esfahani, 2003:811-813). First of all, the main manufactured goods allowed freely to enter the European markets were not those in which Turkey had comparative advantage. Second, the first oil shock, which led to slow growth and instability around the world including Europe, coincided with the EEC's liberalization attempts. Third, the Turkish intervention into Cyprus created unease in Turkey's relations with the European countries. Fourth, during the 1970s, there were several short-lived coalition governments which included in anti-European elements and, as a result, developing close relationship with the EEC was not on the agenda as it was previously. Finally, most Turkish politicians maintained their skepticism about the ability of the country's industry to survive liberalization of imports.

In contrast to the proposition of the Additional Protocol, the governments in the 1970s maintained the import-substitution industrialization policies. However, it is generally argued that the import-substitution strategy of the 1960s and 1970s generated an economy highly dependent on imports and foreign borrowing but with limited capacity to export (Öniş and Webb, 1999:325). Consequently, the Turkish economy experienced severe disequilibria towards the end of the 1970s, following a period of rapid economic growth and structural transformation during the 1960s and the early 1970s. Accelerating inflation combined with huge balance of payments deficits and declining growth rates resulted in successive attempts at economic stabilization from 1978 onwards, culminating in a major adjustment program in January 1980 (Öniş, 1986:7). In addition to deteriorating economic conditions, there was a rapid increase in political violence in the late 1970s and this, finally, led the military to intervene into the politics in September 1980 and the military took power. These developments deeply influenced the long established relationship, which came to a point of virtual freeze, between the EEC and Turkey.

3. Developments and Characteristics of Turkish Economy and the EU in Export Promotion Era

3.1. From Economic Liberalization to Macroeconomic (In)stability in Turkey: 1980-2005

Turkey entered 1980 with a stabilization program with the IMF after one of the worst balance of payment crisis in her history. The crisis, according to the consensus view, reflects

the limits of development policies based on import substitution and some strategic policy errors. The package consisted of not only internal but also external liberalization recommendations on the overall economy. In other words, the policy package put into effect in 1980 and reinforced in the following years was more than just a stabilization and adjustment package; it also marked a shift in development strategy from inward orientation to outward orientation (Senses, 1984; Yildizoglu and Marguies, 1988; Öniş, 1991; Ertuğrul and Selçuk, 2001). To this end, in 1980, the Turkish government embarked upon a series of reforms designed to accomplish the following: remove price controls and subsidies, lessen the role of the public sector in commerce, emphasize growth in the private sector, stimulate private investments and savings, liberalize foreign trade, reduce tariffs, ease capital transfer exchange controls, privatize the Central Bank and reform the taxation system (Etkin *et.al.*, 2000; Dervis and Petri, 1987; Öniş, 1986:9, 1991:27; Ertuğrul and Selçuk, 2001).

In order to achieve these objectives, especially during the 1980s, there was an accelerated reform and adjustment process in almost all sectors of the economic system. The reform process started with liberalization of the foreign trade regime and the financial sector and culminated in the liberalization of capital accounts during late 1989, the latter changing the whole pattern of policy-making environment radically (Aktan, 1997). In other words, Turkey successfully liberalized its foreign trade regime, removed price ceilings on goods and services and other distortions in product markets, and deregulated its financial sector following the structural adjustment policies launched in 1980. The initial outcome of the reform process was promising and was accepted as an impressive development by the domestic authorities and international financial institutions (Ekinci, 1990; Akyüz and Boratav, 2003). In spite of the fact that the general thrust of the strategy had been in the direction of placing greater reliance on market forces and reducing the scale of the state intervention, the degree of privatization had been very restricted. Seven years after the structural adjustment program began, the first major divestiture seen in the late 1980s. In particular, while the current account registered either a surplus or a small deficit, the public sector borrowing requirement (PSBR) reached almost 10 per cent of GNP at the end of the 1980s. Again, inflation accelerated rapidly from 1987 onwards, exceeding on average, 60 per cent during the last three years of the decade (Akyüz and Boratav, 2003).

On the political side, one of the main political characteristic of the post-1980 period is that, with the general elections in November 1983 following the military interlude 1980-1983,

democracy was reestablished and from then on the process of economic liberalization and democratic consolidation proceeded simultaneously (Özbudun, 1988). The newly elected right-of-center Motherland Party (ANAP), under the leadership of Turgut Özal who were also deputy prime-minister during the military intervention in 1980, displayed a strong commitment toward accelerating the pattern of the reform process initiated in 1980.

Main characteristic of the period 1980-1987 in political sense is that there had been a controlled transition to democracy, whereby key elements of the potential opposition were effectively dismantled and relegated to representation (Öniş, 1999b:500; Öniş and Webb, 1999:327). Following the referendum of September 1987, whereby the leaders of the pre-1980 era allowed back to politics, and full party competition effectively restarted in the post-1987 period. In addition, the restrictions on union activities were also relaxed and labor unions once again emerged as an important actor on the political scene.

After 1987, growing macroeconomic instability undermined the some of the major gains established during the first half of the 1980s (Ekinci, 1990; Ergun, 2000; Işık ve Hassan, 2003). Akyüz and Boratav (2003) argue that there are two factors which appear to have played a significant role in the re-emergence fiscal imbalances and the acceleration of inflation. First, macroeconomic adjustment and increase in export were achieved by cutting real wages and reducing support to agricultural producers throughout the period 1980-1987 where the voices of the civil society were almost repressed by all means. Second, contrary to orthodox rhetoric on sequencing, domestic financial markets was liberalized before fiscal discipline had been secured and inflation brought under control (Akyüz and Boratav, 2003). As a result of these policies, public domestic debt and interest payments as a proportion of GDP started to rise from mid-1980s. Thus, towards the end of the decade the economy had run out of steam and public sector deficits and inflation had come back with full force. The policy response was to liberalize fully the capital account in 1989.

It is generally emphasized by many academics (Rodrik, 1990; Cizre and Yeldan, 2002; Alper and Öniş, 2002) that while macroeconomic instability and political uncertainty prevailed, the decision of liberalization of capital account was not timely and premature. Alper and Öniş (2002) argue the government tried to restore its popularity by trying to attract more foreign resources to activate once again the domestic consumption economy.

After the capital account liberalization in 1989, the new disinflationary efforts, based on monetary tightening and real appreciation, pronounced itself much more strongly. However, the government did not take the necessary measures on the fiscal side. As a result of the unsustainable nature of the fiscal policy and the external deficit, the economy witnessed a major crisis in early 1994 (Öniş, 1999a; Yeldan, 1998; Özatay, 1999; Ertuğrul and Selçuk, 2001). In response, the government launched a broad stabilization and reform program focusing on fiscal adjustments. It also provided for a range of public sector reforms, notably divestiture of the state-owned enterprises. During 1994, the program had some important successes, with large corrections in the fiscal and current account deficits in 1994-95 and a sharp rebound in economic activity in 1995. However, it is argued that the program approved by the IMF was not supported strongly by the government and the stand-by agreement came to an end in 1995 (Ertuğrul and Selçuk, 2001). There was no considerable attempt to stabilize the economy and to reduce inflation in the following two years. In July 1998, under the guidance of the IMF, the Turkish government started to implement another disinflation program, which achieved some improvements regarding inflation rate and fiscal imbalances. However, the program could not relieve the pressures on the interest rates. The fiscal balance of public sector was deteriorated by the Russian crisis in 1998, the general election in April 1999 and two devastating earthquake in August and October in 1999 (Ertuğrul and Selçuk, 2001).

In particular, the area affected by the earthquakes was the country's industrial heartland and the immediate and adjacent provinces (including Istanbul) accounting for around one-third of Turkey's overall output. It is assessed that their initial effects would be severely negative on GDP during short term, but that recovery and reconstruction would probably resulted in stronger growth in 2000. An important economic policy concern was that the earthquakes struck an economy already facing severe macroeconomic and structural policy challenges and therefore policy responses have had to be shaped accordingly (Bibee et.al., 2000). In order to fulfill its growth potential, it was quite urgent for Turkey to develop a program which not only proposes fiscal consolidation and disinflation efforts but also meets the financial and economic costs of the earthquakes.

In December 1999, the government started to implement an ambitious stabilization program, aimed at achieving single digit inflation by 2002, after extensive consultations with the Bretton Woods Institutions, supported by an IMF stand-by agreement. Central to the

program have been firm monetary and exchange rate policies, set so as to provide a nominal anchor for reducing inflation expectations; sounder public finance aimed at eliminating the principal source of inflation pressures, and wide-ranging structural reforms designed to liberalize and modernize the economy (OECD, 2001). The program produced significant progress in 2000. But a severe banking crisis blew up in late November, accompanied by massive capital outflows. Furthermore, in early 2001, the second wave of the banking crisis deepened and caused the collapse of the three-year exchange-rate based stabilization program only 14 months after its launch (Akyüz and Boratav, 2003; Cizre and Yeldan, 2002).

A new programme was presented in May 2001 and was further elaborated and redefined during the course of the year and into 2002. This is also supported by the IMF with a commitment of a new funding in Autumn 2001, followed by a substantial disbursement in February 2002. The new program represents a deeper attempt than previous ones to address the fundamental weaknesses in the economy. In particular, the program encompasses key structural reforms which aim at including a strong focus on public sector reform, building a sound banking system and liberalizing markets for private sector –led growth (OECD, 2003).

The newly elected single party government, after the election in November 2002, had maintained the same programme. Although the economic program seems to have made some progress in recent years in strengthening public finance, lowering inflation, and reviving growth, it has also been severely criticized on the several grounds (Yeldan, 2004).

3.2. The EU-Turkey Relations in the Post-1980

Following the positive economic development in the early 1980s and returning normality in 1983 in terms of political developments, Turkey applied for a full membership in 1987 to utilize and to maximize the possible benefits of the membership. The Commission responded to the application in 1989, two years after the application. While recognizing Turkey's eligibility for membership, the commission deferred decision on the matter and argued that the economic and political conditions in Turkey did not meet the necessary criteria. In addition, the commission also stated that the community was not ready to accept any new member until fulfilling the single market in 1992. Moreover, the positive economic aspects of Turkey were pointed out in the commission's report. In particular, high growth rates, privatization attempts, share of young generations in total population, important impacts of the Turkish workers in various member countries on Turkey's current account balance,

huge potential of tourism sector, measures taken to liberalize the trade and promoting fully functioning of free market economy were emphasized in the report. On the other hand, the report also highlighted some of the negative aspects of Turkish economy which were the high rate of inflation, high growth rate of population, low level of national income and per capita income, share of agriculture within economic activities and share of agricultural employment within the total working force.

Meanwhile, the commission suggested that Turkey and the EC could deepen their economic relations and proceed with the formation of a customs union which was part of their original 1963 agreement. This might imply that Turkey's application for full membership gave a positive momentum for the formation of customs union between Turkey and the EC.

On 6th March in 1995, the Association Council adopted its decision numbered 1/95 degree on the completion of the customs union between Turkey and the EU in industrial and processed agricultural goods. On January 1st in 1996, the customs union between the European Union and Turkey came into effect and Turkey abolished all duties and equivalent charges on imports of industrial goods from the EU. Furthermore, Turkey started to harmonize its tariffs and equivalent charges on the imports from third countries with the EU's Common External Tariff (CET).

The Luxembourg EU summit in 1997 was a critical event in EU-Turkish relations in that it showed a lack of balance on the part of the EU in how it dealt with Turkey and other potential EU candidates. At the summit, the EU refused to officially accept Turkey as a candidate for membership citing its lack of adherence to the Copenhagen Criteria as was required before talks could begin. As a result, relations with the EU soured considerably for Turkey for the next two years until December 1999 when it was finally accepted as a candidate in Helsinki, more than 12 years after it had first applied for membership. This did not effectively change Turkey's status though, as the EU decision only confirmed Turkey's candidacy, with no date given as to when official negotiations would begin. Moreover, at the Copenhagen summit in 2002, the EU issued a recommendation stating that if Turkey had fulfilled the Copenhagen criteria by December 2004, and if the European Commission so recommended, negotiations would then immediately start "without delay". At the summit in December 2004, the EU finally decided to start the negotiations in October 2005, four decades after the Ankara Agreement signed between Turkey and the EEC in 1963

4. Turkey's Economic Integration into the EU: Opportunities and Challenges

Turkey was officially recognized as a candidate for the European Union in Helsinki in 1999 and given a date for the beginning of the accession negotiations in December 2004, four

decades after the Ankara Agreement signed between Turkey and the EEC in 1963. In addition, Turkey signed a Customs Union Agreement with the EU in 1995. Integration process reveals unprecedented challenges and opportunities for both sides in terms of economic and political gains. In particular, Turkey would differentiate from the previous enlargements in the context of its population, size, geographical location, economic, security and military potential, as well as cultural and religious characteristics and, in turn, these factors give Turkey the capacity to contribute to regional and international stability (Lejour and de Mooij, 2004). As far as the literature is concerned, economic integration in essence is a dynamic process and, therefore, might have considerable impacts on both economies which might be considered in terms of membership requirements.

The basic requirement of full membership for the EU stipulated by the European Council in 1993 is the fulfilling of the "Copenhagen criteria" which encapsulate the importance of the accession process by requiring that new members must have:

- A functioning market economy,
- The capacity to cope with competitive pressure and market forces within the EU,
- The ability to take on all the obligations of membership.

The fulfillment of the above three conditions create opportunities and challenges for Turkey's economic integration into the EU. First of all, the existence of a functioning market economy requires both prices, and trade, to be liberalized and an enforceable legal system, including property rights, to be in place. Macroeconomic stability and consensus about economic policy enhance the performance of a market economy. A well-developed financial sector and the absence of any significant barriers to market entry and exit improve the efficiency of the economy. To this end, after implementing import-substitution industrialization policies for a long time, Turkey started to constitute the foundation of a market economy with the export-promotion policies in 1980. In order to fulfill this objective, the Turkish government embarked upon a series of reforms designed to accomplish the following: remove price controls and subsidies, lessen the role of the public sector in commerce, emphasize growth in the private sector, stimulate private investment and savings, liberalize foreign trade, reduce tariffs, ease capital transfer exchange controls, privatize the Central Bank and reform the taxation system (Etkin *et.al.*, 2000; Dervis and Petri, 1987; Öniş, 1986:9, 1991:27; Ertuğrul and Selçuk, 2001). In this context, in its 1989 Opinion on Turkey's application for EU membership, the Commission concluded: *"Turkey's economic and political situation, ... , does not convince it that the adjustment problems which would*

confront Turkey if it were to accede to the Community could be overcome in the medium term". However, in its 2003 Regular Report, the Commission found that: "Turkey has significantly improved the functioning of its market economy, while macroeconomic imbalances remain".

Recent developments in the Turkish economy in terms of the existence of a functioning market economy also highlighted in the 2004 Regular Report of the Commission under the following sub-headings (European Commission, 2004):

- The broad consensus about the essentials of economic policy has improved
- Economic stability has significantly improved in the second half of the reporting period
- The current account adjusted rapidly after the 2001 crisis
- The labor market situation has deteriorated during the last 5 years
- Inflation has declined significantly
- Monetary and exchange rate policy was in recent years geared to disinflation
- More recently there has been significant progress in reducing fiscal imbalances
- The transparency of public sector accounting and the efficiency of tax administration have improved
- The macroeconomic policy mix has been adjusted towards a broader reform approach
- The free interplay of market forces has been extended
- Price distortions have been reduced
- The private sector accounts for some 80% of Turkey's economy
- Progress in privatization has remained rather limited
- Barriers to market entry and exit have come down but still impede domestic competition.
- The financial sector has become sounder but is still underdeveloped
- The role of the non-banking financial sector is relatively limited
- The last 5 years saw a marked improvement in banking sector regulation and supervision.

The ability to fulfill the second criterion depends on the existence of a market economy and a stable macroeconomic framework, allowing economic agents to make decisions in a climate of predictability. It also requires a sufficient amount of human and

physical capital, including infrastructure. State enterprises need to be restructured and enterprises need to invest to improve their efficiency. Furthermore, the more access enterprises have to outside finance and the more successful they are at restructuring and innovating, the greater will be their capacity to adapt. Overall, an economy will be better able to take on the obligations of membership the higher the degree of economic integration it achieves with the Union before accession. Both the volume and the range of products traded with EU Member States provide evidence of such integration. In this context, the formation of the customs union in 1995 entailed some costs for Turkey because it had to abolish duties on imports of industrial goods from the EU, as other EU members had already done. It was also obliged to adjust its tariffs and restrictions towards those imposed by the EU for products originating outside the EU. In other words, the CET implies that Turkey is obligated to provide preferential access to its markets for all countries to whom the EU grants preferential access. This process means that Turkey will become a relatively open economy. On the other hand, the benefits to Turkey were mainly promise of European financial support, broader access to the EU markets, and the confidence of world markets that was expected to come with the status (Esfahani, 2003).

Trade with the EU accounts for about 50 per cent of overall Turkish exports. In general, full EU membership for Turkey would ensure this market and also lead to a further opening of the European market to Turkey. As far as the empirical literature on the impacts of customs unions is concerned, Harrison et al. (1996), suggest that improved access to third country markets would be the biggest gain from the customs union arrangement. Using a comparative static computable general equilibrium model for Turkey, they estimate that Turkey stands to gain between 1 and 1.5 per cent of GDP annually from customs union. By contrast, Mercenier and Yeldan (1997), in a general equilibrium exercise, characterize the net impact of the customs union agreement as undesirable for Turkey. Also in a general equilibrium framework, Bekmez (2002) suggest that customs union would lead to revenue losses for the government sector and reduction in GDP, though it would benefit the private sector. Moreover, Neyapti, Taskin and Ungor (manuscript) concluded that customs union agreement has contributed to the increasing volume of trade between Turkey and the EU. Yilmaz (2003) empirically finds that Turkey has a strong comparative advantage in raw and labor intensive goods and so far has comparative disadvantages in the difficultly imitable research oriented goods and in easily imitable research- oriented goods.

The share of EU countries in Turkish export revenues was almost 52 per cent in 2001. The regional distribution of imports reveals the similar picture and the share of EU countries in total imports of Turkey was almost 45 per cent in the same year. Not only has the volume of trade between Turkey and the EU increased very rapidly over the years, but also the export structure has changed radically. Whereas Turkey was mainly an exporter of raw materials and agricultural products in the 1960s and 1970s, today manufactured production covers almost 80 per cent of Turkish exports. Contrary, the share of Turkey in total export (imports) of the EU towards to all candidate countries is 19% (16%), and she takes the second place after Poland (export 24% and import 16%). Foreign Direct Investments (FDI) to Turkey mainly originates from the EU countries. The EU share is about 65% with respect to total foreign direct investments in year 2002. Most foreign firms operating in Turkey come from the EU states. At present, the main channel for the transfer of technology has been foreign direct investments. Turkish firms signed 707 patent licenses and know-how agreements between 1980 and 1992, 88 per cent of which were related to manufacturing. In this regard, Germany and Britain have been playing a very important role in the transfer of technology by foreign direct investments. Turkish workers established their own enterprises in the EU and have been intensifying trade and investment activities between Turkey and the EU. Almost 3 million Turkish workers are employed in the EU countries. Remittances have reached the level of 3 billion US-\$ annually. Additionally tourists to Turkey come mainly from European countries and make an essential contribution to the Turkish balance of payments (Yılmaz, 2003).

As far as the capacity to cope with competitive pressure and market forces within the EU is concerned, the behavior of the small and medium sized enterprises (SMEs) under the customs union might reveal important information whether they might survive in a more competitive environment. Oz (2002) tries to shed some light on the competitive structure of the Turkish industry and on the main sources of competitive advantage of a number of key sectors, namely, glass, construction, leather clothes, automobiles and the flat steel industries, of the Turkish economy by applying Porter's (1990) framework for national advantage. An analysis of the evolution in the competitive structure of the Turkish industry reveals that although Turkey increased its overall exports after the 1980 liberalization, the economy still continues to be dependent on relatively few sectors, the most noteworthy being textiles/apparel, food/beverages, materials/metal and housing/household. She argues that Turkish advantage seems to be concentrated in the 'primary goods' category and to a lesser degree in specialized inputs. The results show that Turkey's position is particularly weak in the semiconductors/computers, health care, office, and defense sectors.

In the same line, Lall (2000) compared Turkey with 13 leading developing countries in terms of exporting manufactures. He showed that the technological structure of the exports is not only weak and mainly depends upon resource-based exports but also stagnant. In view of the rapid changes in the structure of world trade and the growing importance of technology-intensive products, this structural stagnation is a major weakness. Turkey performs relatively well in human capital formation by developing world standards. He argues that Turkish industry had practically no tradition of conducting R&D, preferring to rely passively on imported technologies. Only 13 per cent of national R&D is financed by the private sector. Kırım (1990) assessed by covering 659 largest firms in 1987-88 in Turkey that there was no significant difference in the rate of R&D of exporting and domestic market oriented companies. Under the present liberal regime which is open to competition in a global world, all firms seemed to have been forced to increase their spending on R&D. In a recent study on 87 SMEs of Gebze region, which is the most industrialized part of the country, Alpkan et. al (2002) find that 40 per cent of the respondents continuously performs R&D activities. Lall (2000) argues that government realizes the need for a new strategy to stimulate and support technology development in private enterprises. The government recently launched policies to improve tax incentives for industrial R&D, direct procurement to encourage technological effort, and improve links between industry and the science community. Although Turkey has greatly liberalized its foreign direct investment regime, it has not enjoyed very large inflows in relation to gross domestic capital formation (Kara and Kar, 2003).

Furthermore, Lall (2000) concluded that the structure of export is extremely weak, and has barely upgraded over time. Much of the recent export growth has come from low technology products, spurred by privileged access to the European market rather than global competitiveness. In order to improve its competitive position, Turkey needs a clear strategy shift to more technology-intensive activities which is very imperative. In other words, Turkish industries continue to suffer from macroeconomic and political instabilities, difficulties in access to finance, insufficient infrastructure investments, insufficient support of innovation, and inadequate quality and certification services and support (Commission of the European Communities, 2002).

The performance of the Turkish SMEs in a global world has not been studied in detail. However, studies on the future of the SMEs in the CU with the EU shed some light on the issue. Erzan and Filiztekin (1997) found that the CU had a depressing effect on small firms' employment and value added growth. They show that the SMEs managed to maintain their productivity by labor reduction. Erzan and Filiztekin (1997) emphasize that public policy

should give a high priority to macroeconomic stability in support of the SMEs. It is argued that unlike large firms, which could insulate themselves from adverse macroeconomic conditions and fluctuations, the SMEs suffered from macroeconomic instability. According to Karluk (1996), most of the SMEs owners do not have any proper information about the regulations and standards of the EU. In the same study, it is expected that sectors, which are not competitive, would be negatively affected from the agreement in terms of loss of employees caused by the increase in imports. Although there have been a limited number studies on this issue (Erzan and Filiztekin, 1997; Togan, 1997; Karabıyık, 1997; Bayar, 2000), it is quite early to draw a firm conclusion on the dynamic impacts of the customs union on Turkey.

Recent developments in the Turkish economy in terms of the capacity to cope with competitive pressure and market forces within the EU also highlighted in the 2004 Regular Report of the Commission under the following sub-headings (European Commission, 2004):

- Macroeconomic stability has strengthened and economic reforms are slowly gaining ground
- Education levels have been improving from a low level
- The growth of the capital stock started to accelerate, but FDI has remained limited
- Infrastructure is fairly developed but investment has been limited and uneven
- Enterprise restructuring accelerated in the aftermath of the financial crisis but has slowed somewhat in 2003-2004
- The transition from an agricultural to a service-oriented economy has continued
- Small and very small enterprises are the stabilizing core of the Turkish economy
- State interference in the economy has declined
- Trade and investment integration with the EU has remained at a high level
- The commodity composition of exports has continued to shift towards higher value added
- Price competitiveness of Turkish exports has been maintained despite a volatile exchange rate

As far as the third criterion is concerned, Turkey has recently shown her ability to take on the obligations of membership in terms of the political and economic reforms. With the political reforms, Turkey received a date to start the accession negotiations. On the economic side, there have been improvements in main economic indicators with the implementation of

the last IMF-supported stabilization program. To this end, Turkey showed an intention to sign a new stabilization agreement with the IMF covering next 3 years which is also crucial in terms of the EU accession. The aim of this new program is to fill the gap between the EU and Turkey in the context of macroeconomic development which should reach “the Maastricht criteria” requiring certain convergence in inflation, interest rate, budget deficit and public debt for the sustainability in the euro zone.

On the other hand, there are a few subjects which might constitute either benefits or costs to Turkey. First of all, the significant variation in levels of development across the different regions of Turkey is particularly relevant as regards the question of EU accession (Schultz, 2003). There are also sizeable regional disparities in the current territory of the EU, and the EU has a number of regional policy instruments, such the Regional Development Fund, the Social Fund and the Agricultural Guidance and Guarantee Fund, aimed at aligning the level of performance. However, the regional imbalance is much greater by comparison in Turkey, where there is a sharp contrast between economically highly active regions and other regions characterized by extreme under-development. The regional divide between the developed, largely industrialized western territory of the country and large parts of the considerably backward, largely agricultural and also politically sensitive east and south-east is extremely stark. The considerable differences in the levels of income and education and in the available infrastructure have led to substantial migration from the rural to the urban areas and thus from east to west, with the migrants not always stopping at Turkey's borders. This situation has persisted at length, and the government's efforts to combat the growing regional disparity have shown little success. The European Commission has repeatedly expressed its concern about the continuing large discrepancies in its annual progress reports since 2000. Support from the European Regional Fund is estimated at around \$10 bn (Moustakis, 1998). Virtually the whole country is on the same level of infrastructure as poor regions of Greece, Italy and Portugal. The regional benefits would be immense and would trigger foreign and domestic investment and attract capital.

Second, agriculture remains one of the most important sectors in the Turkish economy (European Commission, 2004). In 2003, its contribution to the total GDP accounted for 12.2%. Since 1983, the share of agriculture has declined from 21.4% to 12.2% in 2003. In terms of employment, the agriculture sector represented about 33% of the whole labor force in 2003 (including forestry, hunting and fisheries), equivalent to some 7 million workers as

compared to 35% in 2001 and 34% in 2002. The number of agricultural holdings decreased by 25% over the last ten years; from 4 million in 1991 to 3 million in 2001. The 2001 census also recorded an average farm size of around 6 ha and indicated that about 65% of farmers have less than 5 ha of land. Only 6% of holdings are larger than 20 ha. In 2003, overall agricultural trade between Turkey and the EU saw a small increase. Turkey's exports to the EU-15 grew from €1,995 million in 2002 to €2,036 million, while its imports from the Community increased from €965 million in 2002 to €1,027 million. EU-15 imports were again dominated by fruit and nuts (though these were down again on the previous year), followed by vegetable and fruit preparations. Key areas of EU-15 exports were tobacco, cereals and animal and vegetable fats. The limited levels of agricultural trade between Turkey and the 10 new Members States fell somewhat, with Turkey maintaining its relatively large surplus (exports €126 million; imports €29 million). As far as the customs union is concerned, it includes the processed agricultural products and does not contain the agricultural products. With the full membership, Turkey takes the comparative advantages in this sector and gains from not only agricultural trade to the EU but also the EU funds in this sector. Moreover, the share and contribution of agriculture to the economy shows that this subject would constitute one of the hotly debated issues in the accession negotiations.

Turkey is currently implementing a program to restructure the farm sector and public support (European Commission, 2004). The government developed the Agricultural Reform Implementation Project (ARIP) with support from the World Bank; it was originally designed for the period 2001-2004, but is planned to be continued also in 2005. The main purpose of the Project is to phase out production and input-based support and to replace it by an area-based income support scheme. It has the following objectives:

(a) to phase out the unsustainable and distorted system of subsidies for fertilizers, credit and price supports, which disproportionately benefited large farmers and cost about US\$5 billion a year;

(b) to privatize most state-owned cooperatives in order to reduce government involvement in the marketing and processing of agricultural products;

(c) to introduce a unified national program of direct income support (DIS) and

(d) to encourage farmers to change from hazelnut and tobacco production to alternative crops in certain regions of Turkey (crop substitution program).

The reform process is still far from complete, but it has had some positive impact, for example on the level of the most trade distorting types of support.

Finally, Turkey's population is quite high compared to the existing and new members of the Union. With the membership, Turkey would be the second largest country in the EU in terms of population after Germany. Free movement of labor is one of the main principles embodied in the rules of the Single European Market. Following the membership, if there is huge labor mobility from Turkey to the EU, this would have deep impacts on the labor markets of the member countries. However, this creates a challenge as well as an opportunity for Turkey. For the EU, it is true that it is quite difficult to absorb such a population which will also be the poorest one in the Union. On the other hand, it is also an opportunity for the EU which has an ageing society and might need new and young labor force in the coming in the future. Moreover, the three factors of low labor costs, closeness to a huge potential Eastern European market and unrestricted access to the European market would trigger massive domestic and foreign investments into Turkey's manufacturing industry. Backed up by the import of technology, this would lead to an economic upswing in this sector of the Turkish industry. Therefore the relatively low cost of Turkey's labor force compared to other EU members will lead to an export of Turkey's labor and to an import of foreign capital. This does further support the growth of Turkey's economy as a result of its accession to the EU.

5. Conclusion

Economic integration with other countries has direct impacts on macroeconomic structures of both sides. If there are big differences in terms of living and political standards, the integration requires a preparation process for both parts. However the preparation process may not be the extent for those which are involved in integration. As is the case for most developing countries, Turkey is facing difficulties in maintaining these problems for several years, but the challenge became even more severe by joining the European customs union in 1996 and by receiving a date to start accession negotiations in October, 2005.

Economic integration may create new opportunities and challenges for both economies. Turkey has long trying to be an essential part of the EU single market by being a member of it. The EU is the biggest economic block in the world and consists of the developed countries. As a developing country, it is generally believed that Turkey may encounter in economic terms many difficulties in this process. In particular, establish a free market economy and coping with the competitive pressure within the EU constituted main subjects for discussion. However, although there have been some macroeconomic imbalances in the economy, Turkey has been trying to establish a free market economy with the reforms

and policies since 1980. In addition, with the customs union in 1995, Turkey also showed that the economy might handle with the competitive pressure coming from the EU since there have not been any significant negative outcomes from the customs union. On the other hand, the macroeconomic instability resulting from high inflation, budget deficit, current account deficits and institutional weaknesses constitute an obstacle to utilize the EU markets for Turkey. As a result, this instability also impedes foreign capital to operate in Turkey.

Turkey has made further considerable progress towards being a functioning market economy, in particular by reducing its macroeconomic imbalances. Turkey should also be able to cope with competitive pressure and market forces within the Union, provided that it firmly maintains its stabilization policy and takes further decisive steps towards structural reforms.

Economic stability and predictability have been substantially improved since the 2001 economic crisis. Previously high inflation has come down to historic lows, political interference has been reduced and the institutional and regulatory framework has been brought closer to international standards. Thus, an important change towards a stable and rule-based economy has taken place. Key economic vulnerabilities, such as financial sector imbalances, have been tackled. Financial sector supervision has been strengthened. As a result, the shock resilience of the Turkish economy has significantly increased. Important progress has been achieved in increasing the transparency and efficiency of public administration, including public finances. Furthermore, important steps have been taken in facilitating the inflow of FDI and in improving the legal framework for privatization.

Economic integration in essence is a dynamic process. In order to get the highest benefit government should keep on macroeconomic and political stability, provide firms with easy access to finance and sufficient support of innovation, and should make sufficient infrastructure investments. Especially, a new strategy to stimulate and support technological efforts seems so crucial in order for SMEs to survive under fierce competition after integration with Europe.

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