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**‘Turkey in the Customs Union :
Is it Time to Modify the Agreement?’**

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SYNOPSIS

There are mainly three milestones in the history of Turkey's relations with the EU since 1960s : The signing of Ankara Association Agreement in 1963, Turkey's formal application for full membership in 1987 and the establishment of Customs Union. This thesis aims to elaborate the Customs Union regime between Turkey and the EU, which came into effect on 1 January 1996. Turkey is the only country that established Customs Union with the EU as a non-member state. Therefore, it has been exposed to the EU influence much more than any other candidate country. This study begins with the presentation of the relations until now on a chronological basis. It furthermore analyzes the main motivations and interests of the Turkish policymakers in forming the Customs Union before accession to the EU.

Undoubtedly Customs Union has both had positive and negative effects on Turkey. It is an inseparable part of the EU membership and therefore it creates various problems for Turkey due to its non-membership status. This research examines these problems to present suggestions under the fact that Turkey's accession to the Union is not possible in the foreseeable future.

This thesis argues that Customs Union regime led to high policy-dependency for Turkey and the potential losses of it has outweighed its potential gains. Therefore Customs Union should be modified by converting it either into a Free Trade Area like the EEA or into a Free Trade Agreement depending on the results of the negotiations with the EU.

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TABLE OF CONTENTS

ABSTRACT.....	ii
ACKNOWLEDGEMENTS.....	iii
TABLE OF CONTENTS.....	iv-v
ABBREVIATIONS.....	vi
TABLES.....	vii
CHAPTER 1 : INTRODUCTION.....	1
1.1 General Introduction.....	1
1.2 The Aim of Research.....	2
1.3 Synopsis.....	3
1.4 The Conceptual and Methodological Framework.....	4
CHAPTER 2 : HISTORY OF RELATIONS BETWEEN THE EU &TURKEY.....	6
2.1 From the Signing of the Ankara Association Agreement Until the Establishment of the Customs Union (1963-1996).....	6
2.2 From the Realization of CU Until Today (1996-2008).....	11
2.3 Motivations of Both Parties to Establish the CU : Turkish Perspective & the EU Perspective.....	16
CHAPTER 3 : EFFECTS OF THE CUSTOMS UNION (CU) ON TURKEY.....	20
3.1 General Effects of a Customs Union (CU).....	20
3.2 Positive Effects of the CU on Turkey.....	23
3.3 Negative Effects of the CU on Turkey.....	29

CHAPTER 4 : HOW AND WHY SHOULD THE CU BE MODIFIED?.....	34
4.1 Problems.....	34
4.1.1 Free Trade Agreements (FTAs).....	35
4.1.2.Lack of necessary financial aid.....	37
4.1.3. Inability of Turkey to Join to Decision-making mechanism....	38
4.1.4 Transportation quotas.....	39
4.2 Suggestions.....	40
CHAPTER 5 : CONCLUSION.....	46
BIBLIOGRAPHY.....	51

Abbreviations

ASEAN	Association of South East Nations
CAP	Common Agricultural Policy
CU	Customs Union
CET	Common External Tariff
DTM	Republic of Turkey Prime Ministry Undersecretariat of Foreign Trade
DPT	State Planning Organisation
EC	European Community
EEA	European Economic Area
ECU	European Currency Unit
EU	European Union
FDI	Foreign Direct Investment
FTA	Free Trade Agreement / Free Trade Area
GATT	General Agreements on Trade and Tariffs
GBOK	EU-Turkey Customs Union Joint Committee
GDP	Gross Domestic Product
GSP	Generalised System of Preferences
IPRs	Intellectual Property Rights
MFA	Turkish Ministry of Foreign Affairs
NTBs	Non-Tariff Barriers
TCMB	Central Bank of the Republic of Turkey
VERs	Voluntary Export Restraints
WTO	World Trade Organisation

Tables

Table (3.1) International Direct Investment Inflow to Turkey by Country

Table (3.2) Foreign Trade Statistics of Turkey in Million \$

Table (3.3) Share of Some Important Sectors in Total Export of Turkey to the EU



CHAPTER 1

INTRODUCTION

1.1 General Introduction

Turkey became an associate member of the EU¹ by signing the Ankara Association Agreement in 1963 with the final aim of becoming a full member. Turkey's desire to be a part of the Western civilisation by completing the Westernisation process, which can be traced back to 1920s, is the most important reason for signing this agreement. In addition to this, the Agreement was also important in terms of integrating the Turkish economy into the EU in order to develop the economic relations further with a trade bloc that Turkey has made a significant portion of its trade. The Association Agreement was modified with the Additional Protocol in 1973 with the eventual aim of establishing a Customs Union (CU) by 1995 latest. (Redmond, 1993, p.27-28)

In 1987, Turkish Government applied for full membership to the Union, which constituted a major turning point of the relations since the signing of the Association Agreement in 1963. The European Commission rejected this application in 1989 and based its decision on the wide development gap between Turkey and the Union on the economical, social and political grounds. However, in 1990, the Commission with the request of the Council prepared the Matutes Package, which proposed the completion of the CU by 1995 as it was envisaged in the Additional Protocol.

(Arikan, 2001, p.127)

¹ In order to avoid confusion the term 'European Union' and its abbreviation EU is used throughout this study, which also refers to the terms European Economic Community (EEC) and the European Community (EC).

Eventually, the CU regime between Turkey and the EU was established in 1995 and made Turkey the first and the only country which joined the CU mechanism without becoming a full member of the EU. CU includes free trade of manufactured goods between the EU and Turkey and the Common External Tariff (CET) against the imports from the third countries. In addition to this, Turkey had to adopt all of the preferential trade agreements the EU has concluded with the third countries by 2001. (Togan, 2000, p.6)

Turkey is not a negligible country for the EU with its huge potential as an export market with its big population and high population growth rate. In addition to this, Turkey is perceived as an important country by the EU for its potential in terms of export, investment, finance, tourism and transportation routes and its geographical proximity to the Middle East, Caucasia and Iran. However, the EU neither wants to break relations with Turkey nor wants to accept it as a full member. Consequently, the EU wants to keep Turkey within its sphere of influence like a satellite and it uses the CU mechanism to realize this containment policy. (Arikan, 2001, p.127)

1.2 Summary

The first chapter of this thesis provides some essential information on historical development of the relations beginning with the Ankara Association Agreement in 1963 until today. Turkey's application for full membership in 1987 and the establishment of CU in 1995 are the two major milestones in this long relationship between the EU and Turkey. It is necessary to analyze the main motivations, reasons and interests of both parties to form the CU because there is no other example of such a relationship between the EU and a non-member country.

Chapter 2 focuses on the impacts of the CU on Turkey. These impacts will be categorised as general, positive and negative ones by considering the fact that they may occur in different times. Chapter 3 will provide with some projections to the future of the CU. Non-member status of Turkey creates serious problems in the functioning of the CU mechanism between Turkey and the EU. The main problems between the parties concerning the CU are inability of Turkey to participate into the committees where decisions are taken, problems concerning the free trade agreements, and transportation quotas and the lack of enough financial aid to offset the negative economical impacts of the CU.

After the analysis of these problems suggestions will be presented under the light of the current Turkey-EU relations. The thesis will be concluded with the best alternative(s) regarding the future of the CU regime under the light of the latest developments.

1.3 The aim of research

The author of this thesis argues that CU has become a permanent status rather than a stepping-stone on the way to the full membership contrary to Turkish policy-makers' expectations in 1995. The problem with the CU is that Turkey has to be a liable country as a member state with little gain. This is because as a non-member country, Turkey has to obey all the decisions regarding the foreign trade policy of the EU such as trade agreements, trade embargoes against third countries and export promotion policies. All these policy decisions are determined by the EU member states and Turkey cannot participate into the formation of this process without becoming an EU member.

Free Trade Agreements (FTAs) that the EU has signed with various third countries are also problematic and they bring additional burden to Turkey. Consequently, Turkey has to go on shouldering most of this economic burden with the ultimate aim of accession without benefiting from the advantages of membership, which include guaranteed access to the EU's single market and agricultural trade, access to the EU's structural funds and participation into the EU decision-making mechanism. The purpose of this research is to analyze these problems in order to find the most appropriate alternative to the CU regime under the fact that Turkey's accession to the Union is not possible in the short or medium run.

1.4 The conceptual and methodological framework

The core of this thesis, the CU regime will be analysed within the context of the EU-Turkey relations from a multi-dimensional perspective. Since the formation of it, CU has always been evaluated and criticised merely from the economic point of view. However, it has other dimensions such as trade policy formation, decision making mechanism, attracting Foreign Direct Investment (FDI) and its effects on Cyprus dispute and Turkish transportation sector.

This thesis seeks to construct a more objective framework by analysing the Turkey-EU relations and the CU from both the Turkish and the EU point of views. Turkish view generally criticizes the EU on the grounds that its policy towards Turkey has not been in line with the declared eventual objectives of the Ankara Association Agreement. However, it rarely criticizes Turkey for its slow progress in the harmonisation of its political and economic system with the EU norms.

On the other hand, the EU perspective generally reflects the official position of the EU and claims that Turkey cannot be a member of the EU because of the political, economic and cultural issues. However, Turkey is not a negligible country for the EU with its huge potential as an export market, with its big population and high population growth rate. This research will analyse the arguments of both parties on a chronological basis from an objective perspective.



CHAPTER 2

HISTORY OF RELATIONS BETWEEN THE EU & TURKEY

2.1 From the Signing of the Ankara Association Agreement Until the Establishment of the Customs Union (1963-1996)

Turkey's far more complicated relationship with the EU than any other European State seeking for EU membership began officially on 12 September 1963 when Turkey signed the Ankara Association Agreement² with the EU to become an associate member after Greece (Muftuler-Bac,1999, p. 241). This Agreement was based on the Article 238 of the EU Treaty which states that :

the Community may conclude with one or more States or international organizations agreements establishing an association involving reciprocal rights and obligations, common action and special procedures.

(Macleod et al, 1996, p.367).

However, reciprocal rights and obligations do not necessarily mean equivalent rights and obligations because associates are not full members of the Union and they therefore have to remain out of the EU's policy and decision making process and institutions. Association is such an unbalanced relationship that the associate is always required to adopt the EU norms and procedures. The EU does not have to

² The whole Agreement is available on the following internet address : <http://www.abmankara.gov.tr/english/lib/tr/001b.html>

adapt itself to the associate. Furthermore, associates have no right to join the decision making mechanism within the Union although they usually have to obey the outcomes. (Phinnemore, 1999, p. 118-119).

On the other hand, forming an association provides an important advantage to the EU non-member country : preparation for membership. Kramer argues that association permits a country to adapt to the EU regulations to such a degree that membership would not pose too many problems to the both parties.

(Kramer cited in Phinnemore, 1999, p. 122).

There were a variety of reasons for Turkey to conclude an Association Agreement with the EU. According to Redmond, these reasons were as follows :

- fulfilment of Turkey's orientation to the West,
- not to allow Greece, which had similarly applied for an association agreement, to have an advantage over Turkey with the Western European countries,
- to have a profitable trade agreement with its largest market,
- the intention of attracting more external financial aid more easily to improve the economic conditions,
- to benefit from the potential of the EU as a suitable outlet for the unemployed Turkish workforce. (1993, p. 24-25)

The Ankara Association Agreement, which was signed in 1963 and came into effect in the December of 1964, consisted of three stages. The first one was a preparatory stage of between five to nine years in which tariff quotas would be reduced for Turkey's most important export products of tobacco, raisins, dried figs and hazelnuts and foresaw the provision of ECU 175 million of loans over five years to assist Turkey's economic development efforts. The second stage was the transitional stage of twelve to twenty two years in which Turkey would form the CU

and adopt the Common External Tariff (CET) of the EU. The Article 28 of the Agreement also refers to the possibility of a third final stage which could involve Turkey's full membership to the EU, although it does not give any timetable for this. Full membership is dependent on the achievement of concrete targets.

(Preston, 1997, p. 213-214 ; Redmond, 1993, p. 25-26)

The Ankara Association Agreement is not only about the trade of manufactured goods. In addition to this, as Kramer points out, it also envisaged the alignment of general economic policies and specific sectors like free movement of labour, capital, freedom of trade in services, freedom of trade of agricultural products, transport, rules of competition and all other economic legal regulations. (1996, p. 204) The Agreement was followed by an Additional Protocol³ which was signed in November 1970 and became effective on 1 January 1973. The main provisions of the Protocol were the abolition of all import quotas for Turkey and a series of staged tariff reductions over twelve to twenty years on imports from the Union to Turkey which would eventually lead to the establishment of a CU by 1995 at the latest.

(Hale, 1994, p. 114).

Implementation of the Association Agreement and the Additional Protocol was never realized hundred percent because Turkey's accession process during 1970s and 1980s was full of problems arising from its political and economic situation. Consequently, both sides avoided to put necessary effort for the full functioning of the Agreement. The Europeans abolished all Non-Tariff Barriers (NTBs) and customs

³ The whole Agreement is available on the following internet address :

<http://www.abmankara.gov.tr/english/lib/tr/001c.html>

duties on Turkish export goods but textiles and clothing, Turkey's most competitive sector, was not included into this. (Kramer, 1996, p. 205). Moreover, granting of the same privileges by the EU through the Generalised System of Preferences (GSP) to other countries in 1971, which compete directly with Turkey in the EU market created further disappointment in Turkish public opinion. (Preston, 1997, p. 214)

Another serious debate between the EU and Turkey was about the free movement of labour. According to the Association Agreement, free movement of labour between Turkey and the EU would begin by 1986. However, Germany opposed to the implementation of the related terms of the Agreement and claimed that free movement was not realistic from economic and social perspectives. Moreover, the Court of Justice concluded that Turkish workers would not have the right to demand free movement based on the Ankara Association Agreement and stated that the Association Agreement was not more than the outline of a plan and did not mention about any concrete regulations. Afterwards this issue has never been brought to the agenda of the Union by Turkey. (Sen, 1996, p. 258)

The last dispute between the EU and Turkey is concerned with Financial Protocols. Turkish policy-makers expected to receive significant amount of aid to offset the negative impact of the integration process on Turkish economy. Although, the EU had granted Turkey around US\$ 705 million within the first three financial protocols, it blocked the Fourth Financial Protocol of ECU 600 million for two reasons: The military coup in 1980 in Turkey and the Greek veto after Greek's accession to the EU in 1981. (Yilmaz, 2003, p.4)

It is not only the EU that is to be blamed for the non-performance of the Association Agreement and the Additional Protocol. It cannot be claimed that Turkey was able to prepare itself during the preparatory stage. (Kramer, 1996, p.207) As

Manisali argues, Turkish bureaucracy was divided into two parts. State Planning Organisation (DPT) and Turkish Ministry of Foreign Affairs (MFA) did not share the same point of view about the EU during 1970s. State Planning Institute prepared a report criticising the conditions of the transitory period. According to this report, Turkey's conduct of its relations with the third countries under the umbrella of the EU would cause major drawbacks for Turkey in the future. (2006, p. 61). Consequently, only two reductions of tariff rates, 10 per cent each for imports from the EU countries were made in 1973 and 1976 by Turkey. The adjustment to the CET was not initiated at all. Furthermore, reduction in quantitative restrictions on imports from the EU was over by 1976. Finally, in 1978, Turkish government announced a five-year moratorium on its obligations under the Association Agreement.

(Kramer, 1996, p.207)

Turkish-EU relations were frozen after the Military Coup of 1980 until the establishment of a civilian government in 1983. The new Prime Minister, Turgut Ozal's submission of a formal application for accession to the EU in 1987 was another turning point of the relationship between the parties. In response, the Commission issued an official opinion in 1989 rejecting the application of Turkey and concluding that it would be impossible to enter into any negotiation process with the applicant countries until the completion of the single market in 1993. The Commission also stressed the social and economic gap between Turkey and the EU as an important obstacle in front of a positive reply to this application. Instead of EU membership, the Commission proposed the implementation of the CU regime based on the existing Association Agreement by the original date of 1996.

(Hale, 1994, p. 115)

After the Commission's negative response to Turkey's request for EU membership, a cooperation program called the Matutes Package, which aim to develop relations with Turkey, was presented to the Council by the Commission in June of 1990. Four main parts of this package are as follows :

- Completion of the CU between Turkey and the EU by 1995,
- Intensification of cooperation between the two parties in the fields like industry, technology and science in order to ease the integration of the Turkish economy with the EU economy,
- Release of ECU 600 million of the financial aid,
- Development of political and cultural cooperation between the EU and Turkey. (Manisali, 1996, p. 46)

The Lisbon Summit of 1992 restated the EU's willingness to intensify and develop relations with Turkey in line with the Ankara Association Agreement but without referring to the full membership negotiations. (Spencer, 1993, p. 15)

2.2 From the Realization of CU Until Today (1996-2008)

The association agreements with Turkey, Cyprus and Malta aim to establish a CU between those countries and the EU. (Macleod et al, 1996, p.281) CU is important in terms of proving that Turkey can fulfil the economic conditions of the Copenhagen criteria for full membership because of Turkey's success to cope with the competitive challenges of free trade in manufactured products and its high level of adoption to the competition and the intellectual property rights (IPRs) of the EU's *acquis communautaire*. (Muftuler-Bac, 1999, p. 241)

There was a mass bombardment of propaganda in the Turkish media supporting the establishment of CU with the EU. As Manisali points out, this propaganda had a big influence on the formation of Turkish public opinion's false belief that CU would be the only way on the way to the full membership. Even the Turkish Prime Minister Tansu Ciller had said that Turkey would become a member of the EU in a few years if the CU would be established. (2006, p.18). How could Turkish people say no to the EU membership?

There are contrary views as to whether CU, which was established between Turkey and the EU as a result of the 6th of March 1995 Association Council Decision, is the outcome of the 1963 Ankara Association Agreement or not. According to the major point of view, CU is Turkey's obligation resulting from the Ankara Agreement. (Dogan, 2004 ; Baydarol, 2007). On the other hand, Manisali makes the following points : CU is not the outcome of the Ankara Agreement and the Additional Protocol as opposed to the general argument and therefore should not be considered as the obligation of Turkey. He supports his argument by stating that these agreements envisage free movement of goods, capital, labour and financial aid. However, the EU did not implement the conditions of these agreements except the first one and therefore it would not be right to claim that CU is Turkey's obligation by disregarding the fact that the EU did not fully carry its own obligations. (Manisali, 1996, p.55)

Contrary to the above view, Baydarol claims that CU is the planned outcome of the Ankara Association Agreement. Therefore, he argues that opening of the CU into discussion would not only mean opening of an economic agreement into debate but would also mean opening of Turkey's final aim of EU membership into discussion. (2007)

The CU and the Cyprus issue were intertwined just before the CU was ratified by the EU. In 1990, the Greek Cypriot administration of Southern Cyprus had applied for the EU membership. However, at that time, the EU had neither said yes, nor said no to this application. Actually, the Greek Cypriots had no right to apply for membership as the Republic of Cyprus because according to the international agreements founding the Republic of Cyprus, the Greek Cypriot administration of Southern Cyprus was not able to join an institution in which Turkey and Greece is not a member together. Furthermore, Turkey's approval was needed. The Greeks objected to the formation of CU with Turkey and Turkish policymakers made a historical mistake to overcome this problem : they did not object to the beginning of the negotiations between the EU and the Greek Cypriots in return for the removal of the Greek veto. At least, Turkey should have obtained an official guarantee from the Brussels that the EU would negotiate with the Greek Cypriots as the Greek Cypriot administration of Southern Cyprus not as the Republic of Cyprus, including the Turkish Republic of Northern Cyprus. (Manisali, 1996, p.53) All of these mistakes created further problems for Turkey later when accession negotiations with the EU began in 2005.

The 1990s were important in terms of the transformation of the European Community into the EU and acceleration of the enlargement process. On 12 December 1997, the EU decided to begin accession negotiations with all the applicant countries except Turkey at the Luxembourg Summit. On 16 July 1997, the European Commission President Santer proposed the Agenda 2000, which set the Union's enlargement strategy and suggested that accession negotiations begin with central and the eastern European countries together with Cyprus on 31 March 1998. The Commission stated that even though Turkey would be eligible for the EU membership

due to the 1963 Ankara Agreement, it was not included into the future enlargement plans of the Union. This situation created disappointment and resentment in the Turkish public opinion and the former Turkish Prime Minister Mesut Yılmaz blamed the EU with discrimination against Turkey on religious grounds. (Muftuler-Bac, 1999, p. 242).

In reaction to the Turkish government's breaking of all relations with the EU officially, the European Council changed the status of Turkey from the applicant country to the candidate one at the Helsinki Summit to mend the deteriorating relations. (Aybet and Muftuler-Bac, 2000, p. 578) The Summit's Presidency conclusions stated that : "Turkey is a candidate State destined to join the Union on the basis of the same criteria as applied to the other candidate states". (ibid) On 1 May 2004, the number of the EU States reached to twenty-five with the acceptance of ten candidate countries. Turkey was not one of these countries although it had a much older relationship dating back to 1963. Finally, on 17 December 2004, the European Council decided to start accession negotiations with Turkey on 3 October 2005 on condition that Turkey would accept the enlargement of the CU to include Cyprus (Lehmann et al, 2007, p.720). It was obvious that negotiations would partially be frozen because Turkey would not accept EU's condition. Consequently, in 2006, accession negotiations were frozen on eight chapters because of Turkey's rejection to enlarge the CU to include Cyprus. (Redmond, 2007, p. 305-306)

It did not take long to see that the major EU countries would not accept Turkey as a full member in the short and medium-term when Austria declared its suggestion of 'privileged partnership'. According to the Europeans, full membership for Turkey was a long term objective. As Keyman and Aydin argue, this critical decision of the EU regarding Turkey should have been more objective and based on

the principle of fairness and objectivity rather than a culturalist and essentialist perception. (2004, p.1) The EU's differing attitude towards Turkey and the other applicant countries has undermined the EU's credibility in the eyes of Turkish public opinion. While problems of the Central and Eastern European nations were discussed together with the help of the EU, Turkey has always been told to solve its own problems before being considered as a candidate state. (Muftuler-Bac, 1999, p.257)

Redmond indicates the EU's differing attitude towards Turkey and the other former candidate countries as follows :

The idea of divided Cyprus acceding to the EU was widely considered to be absurd ; but Cyprus did join in 2004, and is still divided. Requiring Turkey to comply with all copious entry criteria and conditions before it can join the EU is both unfair and inconsistent with previous practice ; indeed, there are arguably some longer-standing EU members that still do not comply completely with all the requirements that aspiring members have had to meet. (Redmond, 2007, p. 316)

As a final comment on Turkey's relations with the EU, The Turkish public opinion has eventually realized that Turkey's full membership is an unlikely prospect in the short or medium run because of unending requests of the EU. As Redmond points out, Turkish policy makers are aware that no regional groupings such as the ones in the Middle East, the Black Sea or the Central Asia can offer economical or political alternative to EU membership. This situation works against Turkey and therefore EU believes that it can delay Turkey's accession as much as it likes without any fear of Turkish reaction (1993, p. 52-53)

2.3 Motivations of Both Parties to Establish the CU : Turkish Perspective & the EU Perspective

Another important milestone in the EU's relations with Turkey was the establishment of CU, which entered into force by 31 December 1995. Undoubtedly, CU brought a new dimension to the relations although its full implementation particularly the financial aid package was postponed due to the Greek-Turkish disputes over Cyprus. (Avery and Fraser, 1998, p. 94) What were the expectations, motivations and interests of both parties when they signed the 6th of March 1995 Agreement? Why did Turkey insist on becoming a part of CU when there is so much asymmetry? Could they realize their aims?

Motivations of both parties behind CU are different from each other. Collapse of the Communist regimes diminished Turkey's importance in the eyes of the EU and created new applicant countries waiting for the EU full membership. Turkey found itself at the end of this queue of candidate states and saw CU as a step to eventual accession, although most of the member states of the EU saw it as the highest level of integration available to Turkey in the foreseeable future (Luelno and Williams, 2000, p. 258) Therefore, Turkey's interest in the CU was mainly political rather than the economical one. Turkey strongly lobbied to prevent a decision to veto the CU. To influence the final decision of the EU, even the former Turkish Prime Minister Tansu Ciller promised to pursue a democratic development in Turkey and to prevent Islamic fundamentalism as a major threat. (Krauss, 2000, p. 234) However, if the CU is the obligation of Turkey coming from the Ankara Agreement and the Additional Protocol, why did Turkey need to lobby against the Greek veto and make a concession by not objecting to the acceptance of the Greek Cypriot administration of Southern Cyprus to the EU ?

Eder makes the following arguments relevant to the position of Turkey vis-a-vis the EU : Turkey has faced with the risk of economic isolation as a result of the economic integration among the developed countries. Therefore, it tried to be a part of the EU even though it had to make deep concessions to achieve it. Systemic theories like neo-realism, neo-institutionalism, hegemonic stability and regime theories all offer a variety of explanations for this. While asymmetry of power in the new global order is the main reason for neo-realists, prior economic and political ties together with various regional agreements are the most important reason for neo-institutionalists. Hegemonic stability theory refers to the deepening of integration particularly after the Maastricht Treaty within the EU as the main reason for Turkish fear of exclusion leading to the intensification of Turkish efforts to join.

(Eder, 2000, p. 31)

Regime theories are also beneficial for their contributions in explaining how globalisation and liberalisation pressures in the world economy and finance have played a key role in the insistence of Turkey to join the EU at all costs. However, none of these theories can explain the role the domestic institutions and interest groups play like the Putnam's two-level game theory can. This theory suggests that the domestic opposition groups within dominant member countries of a regional bloc are very effective in increasing the bloc's bargaining power vis-a-vis the applicant country. To be able to use its domestic interest groups effectively is the main reason for the EU to extract concessions from Turkey as compared to the weakening bargaining position of Turkey due to ineffective domestic opposition to Turkey's entry into the CU regime. (ibid)

Turkey's motivation to conclude the CU with the EU was mainly because of the Turkish policy-makers' assumptions that CU would strengthen Turkey's demand

for full membership. Parallel to this view, the former Turkish Foreign Minister Murat Karayalcin stated his belief at the Association Council Meeting in December 1994 that the CU will serve as a stepping-stone to the realization of the final objective of the EU membership which remains Turkey's long standing goal. (Arikan, 2001, p.127)

Economic motivation of Turkey for the CU was to provide closer economic integration with the EU. CU included legislation on a variety of subjects and therefore Turkish policy-makers believed that the CU would assist Turkey's efforts to liberalize and modernize its economy. In that sense, according to them, CU would also prepare Turkey's economy to the full membership. (ibid, p.128-129)

CU negotiations were mainly conducted by the State Planning Organisation (DPT) and the Turkish Ministry of Foreign Affairs (MFA). While the DPT wanted to consider the opinions of the various interest groups, the MFA rushed to conclude the negotiations under the influence of the governing coalition. The industry-government dialogue on the agreement was rather limited and far from making a useful analysis on economical grounds. (Eder, 2001, p. 44) As Eder points out, instead of negotiating the terms of the CU such as the nature of escape clauses (the conditions of suspending the privileges given to Turkey), product exemptions from the CET and rules concerning the IPRs and competition, the Turkish government merely reflected the entire process as Turkey's becoming a part of the Western civilisation. (ibid, p. 49)

The EU did not share the same view with Turkey and considered the CU nothing more than an economic agreement as part of the Ankara Association Agreement rather than a stepping-stone towards Turkey's membership. In fact, as Arikan argues, the CU was an important mechanism for the realization of the EU's containment policy for Turkey and also a good way of strengthening the relations through institutional and financial cooperation. In this perspective, the main

motivations of the EU to conclude CU with Turkey were based on the security and economical factors. (2001, p.131) Parallel to this view, the Lisbon Council in June 1992 noted that :

Events have highlighted Turkey's geopolitical importance and the role which it can play as an ally and as a pole of stability in its region: the Community should take all appropriate steps to anchor it firmly within the future architecture of Europe. (Preston, 1999, p.218)

Given this declared objective of the EU to anchor Turkey into the Union as a stable and a secular country with its large market, (Ugur, 2000, p.147-148) the EU's perception of the CU was mainly influenced by the economic and security considerations. On the economic ground, the EU was very content with the conclusion of such an economic mechanism which would provide the European countries with additional concessions in such a big consumption-oriented market. Besides, Turkey would be very useful for the EU firms as an export base in order to penetrate to the Black Sea, Central Asian and the Middle Eastern markets by means of cooperation with the Turkish firms. (Arikan, 2001, p. 132)

In conclusion, as the above analysis suggests, both Turkey and the EU had different motivations and interests in the completion of the CU. While Turkey interpreted it as an eventual step on the way to full membership, the EU saw it as a very useful mechanism to upgrade relations with Turkey without mentioning the possibility of full membership. CU also constitutes the core of the EU's containment policy which means strengthening Turkey's ties with the EU and postponing the possibility of Turkey's membership as much as possible. (Arikan, 2001, p.132-133)

CHAPTER 3

EFFECTS OF THE CU ON TURKEY

3.1 General Effects of a Customs Union (CU)

According to the classical international trade theory, adoption of perfect free trade is the best way to avoid the negative consequences on prosperity due to better allocation of production factors. Each country specialising in the production of goods which it has a comparative advantage can have a more efficient production process thanks to economies of scale and intense competition. (Molle, 2001, p. 95- 96)

CU is the natural consequence of trade liberalisation efforts of member countries, but it is at the same time protection of the entire Union against the third countries. It has two types of effects : static and dynamic. The static effects are concerned with the impacts of the establishment of the CU on welfare. The dynamic effects focus on the impact of the CU on the rate of output growth of a member country in the medium-term. In general, the benefits of joining the CU would be determined by the height and structure of each member country's external tariff compared to the CET of the CU. (Michalopoulos and Tarr, 2004, p.4-5)

Moussis defines a Customs Union (CU) as :

an economic area whose members agree, by treaty, to not to impose any customs duties, charges having equivalent or quantitative restrictions on each other and to adopt an external common customs tariff in their relations with third countries. (Moussis,1991, p.59)

CU includes both the CET and regulations on the use of NTBs to prevent member countries from obtaining additional advantages for their sectors. (Molle, 2001, p. 430) The theory of CU is mainly concerned with the gains and losses incurred by the establishment of it and focuses on the short-term static effects of trade creation and trade diversion. (Lohrmann, 2001, p. 26) CU is best analysed by making a distinction among its trade creation, trade diversion and trade expansion effects. According to Viner, trade creation occurs when demand for imports exceed demand for home-produced goods as result of reduction in the tariffs. Trade diversion is a shift in imports from an efficient and cheaper non-member country to a more expensive less efficient member country due to preferential tariff treatment. Trade diversion is not a decline in trade but rather a shift in trade away from least-cost suppliers to the more expensive ones. (Viner cited in Vollrath, 1998, p. 29-30) Later, the concepts of trade creation and trade diversion were expanded by Meade to include trade expansion, which is an increase in the total domestic demand in a member country either from a partner country or from the rest of the world.

(Meade cited in Vollrath, 1998, p.29-30)

Joining a CU with a CET can be costly for several reasons. First, it is possible that partner country suppliers might raise prices under the tariff protection they receive. Therefore, consumers in member countries with a previously lower external tariff rate are likely to pay higher prices, excluding the tariff, to member country producers than they were paying before joining the CU for the same amount of goods purchased. Second, because imports from the third countries are subject to higher tariff rates, there will be a diversion of sales away from these third countries' suppliers towards member country suppliers. This trade diversion has two costs: (a) since the importing country cannot collect any tariff revenue on imports from other

member countries, a loss of tariff revenue will occur on these trade-diverting imports; (b) consumers will have to pay higher prices to member countries' suppliers (excluding the tariff) than they were paying to the suppliers of third countries before joining into the CU. (Michalopoulos and Tarr, 2004, p.7-8)

On 1 July 1968, free movement of goods was partially achieved by the EU. At that time, the industry of each member country was protected so well that the companies saw no need to make any efforts to modernise technology or reduce production costs. The European consumers had to pay high prices for low quality goods and CU contributed to correct this situation. (Moussis, 1991, p. 59-60)

In the last 40 years, the economies of the EU member countries have been integrated very well as a consequence of the great increase in the exchange of goods particularly during 1960s and 1970s. The high increases in the trade-GDP ratios of the member countries are the most important indicators of this integration of the goods market as a result of the CU. In the 1970s and 1980s, the new member states of the Union abolished all quotas and tariffs in the internal trade after several years of a transition period. However, removal of the NTBs has always been very difficult because they were closely related with the national regulations to pursue important policy goals. In 1985, the Commission issued a White Paper to complete the internal market and to remove all the remaining barriers by 1992 by abolishing the control mechanisms at the internal frontiers. This 'Single Act' gave great powers to the EU institutions to pass all the required legislation to materialize these aims. As a result of the bold approach of the EU, a great number of regulations has been adopted and the single market for the goods has practically been concluded. (Molle, 2001, p. 103-104)

3.2 Positive Effects of the CU on Turkey

Although being rather complex, CU regime between Turkey and the EU has contributed to the establishment of a successful regional arrangement. CU is not only limited with border controls, but it is a much deeper integration with the adoption of some of the EU legislation. More specifically, CU between the parties requires Turkey to adopt the Union's legislation such as elimination of technical barriers to trade, protection of competition, administration of border procedures, implementation of various regulations for ensuring compatibility with international arrangements for the protection of Intellectual Property Rights (IPRs). Undoubtedly, this alignment process of regulatory regimes not only deepens integration between Turkey and the EU but also provides some important potential gains to Turkey by improving the Turkish business environment. (Ulgen and Zahariadis, 2004)

CU between Turkey and The EU guarantees free circulation of industrial goods including processed agricultural ones. However, it does not include agriculture or service sectors. With the establishment of the CU, quotas were prohibited and voluntary export restraints (VERs) regarding trade in textile goods were abolished. (Lehmann et al, 2007. p.720) The decision to establish a CU in March 1995 required Turkey to adopt the CET against imports coming from third countries by 1 January 1996 and to adopt the preferential trade agreements the EU has concluded with third countries by 2001. (Togan, 2000, p. 6)

In terms of CU's economic impacts on Turkey, there are various views. According to one of these views, the CU is an economic success although it has been more favourable to the EU than Turkey because there has not been a considerable amount of increase in Turkey's exports to the EU while imports have increased significantly. (Luelno and Williams, 2000, p.258) The most important reason of this is

that the establishment of the CU did not lead to substantial reductions in trade barriers for Turkey, because the Union had already abolished the nominal tariff rates on imports of industrial products coming from Turkey in 1971, although it had continued charging import duties on some oil products over a fixed quota and to implementing duties on imports of certain textile products. (Togan, Nebioglu and Dogan, 2005, p.94)

According to the economic theory, the elimination of tariffs between the two parties should lead to trade creation, as a result of additional trade that can be welfare enhancing if high-cost domestic production replaces with low-cost imports. On the other hand, trade diversion can also occur if trade barriers with respect to third countries remain so high that additional trade between partner countries would replace lower-cost imports from third countries. The proportion of these two effects in the economy will determine the overall impact of the CU. According to Ulgen and Zahariadis, bilateral trade between the EU and Turkey has led to significant amount of trade creation as compared to little trade diversion. This significant increase in bilateral trade has not been to the detriment of trade with third countries because the EU's share of Turkish exports has remained constant. Consequently, stronger bilateral trade accompanied by stronger trade growth has provided important welfare gains for Turkey. (2004)

As a developing country with limited capital, Turkey can benefit substantially from foreign direct investment (FDI) that will increase productivity and lead to further job creation. In addition to this, foreign companies can positively affect domestic companies through spillovers. As Lohrmann states, FDI, as a source of technology transfer from developed countries, will have a positive impact on production process by means of external effects via learning-by-doing and spill-over to other sectors. (2001, p. 39). Local companies can improve their conducts of business either by

copying foreign technology and observation or by hiring employees trained by foreign companies.

Although Turkey has a highly skilled labour force, a large market potential and geographic proximity to European, Central Asian and the Middle Eastern markets, it could not attract as much FDI as it expected until 2005. Poland, Hungary and the Czech Republic together attracted US\$ 71 billion of FDI between 1995 and 2000. However, Turkey received only US\$ 5.1 billion of FDI in the same period of time. (Dutz, Us and Yilmaz, 2005, p. 261) This trend has changed in 2005 with the announcement of beginning of accession negotiations with Turkey in the same year. It was expected that the establishment of CU would increase FDI, however, because of lack of long-term political and economic stability, CU did not make the expected positive impact on Turkey until the opening of the EU accession negotiations in October 2005. (Yilmaz, 2003, p.6)

As Table 3.1 indicates, Direct Investment Inflow from the EU-27, reached to almost US\$ 13 billion in 2007, compared to US\$ 1 billion in 2004 and US\$ 5 billion in 2005. As a final point it should be emphasized that although CU had a positive impact on inflow of FDI to Turkey as a result of integration of Turkish economy with the EU, it was the opening of negotiations for eventual accession in 2005 that gave the real momentum to it. Institutional reforms together with stabilisation will contribute to enhanced competition and better application of the rule of law which will eventually, persuade foreign investors to channel more funds for investment in Turkey.

(Dutz, Us and Yilmaz, 2005, p. 289)

Table 3.1 : International Direct Investment Inflow to Turkey by Country

2004	2005	2006	2007	Foreign Direct Investment (FDI)
1,025	5,005	14,489	12,693	EU (27)
73	391	357	1,004	Germany
34	2,107	439	317	France
568	383	5,069	5,682	Netherlands
126	165	628	688	United Kingdom
15	692	189	76	Italy
209	1,267	7,807	4,926	Other European Countries
109	1,650	91	379	Other European Countries (Excl. EU)
--	3	21	5	Africa
36	88	848	4,206	U.S.A.
61	26	121	11	Canada
--	8	32	24	Central America and Caribbean
--	--	1	466	South America
60	1,756	1,927	1,370	Asian
--	1,675	1,783	296	Gulf Arabian Countries
54	3	127	298	Near And Middle Eastern Countries
6	78	17	776	Other Asian Countries
--	1	108	26	Australia
--	1	7	10	Unclassified
1,291	8,538	17,645	19,190	TOTAL (Million Dollars)

Source : Central Bank of the Republic of Turkey (TCMB)

Undoubtedly, CU with the EU has several important economical, trade, institutional, legal and financial benefits for Turkey. According to Turkish people supporting the CU, Turkey's political system has been positively influenced and become more democratic as a result of adoption of social and political regulations of the EU. (Yesilada, 1998, p.181) Turkish consumers can reach to various cheaper and more quality products thanks to the CU. Furthermore, Turkish consumers have been better protected due to adoption of the EU legislation on technical norms. CU has

several positive effects on Turkish producers such as integration to a huge export-market and cheaper and more quality inputs coming from the EU countries to be used in production process. Existence of a big and stable market was vital for the Turkish manufacturers especially during crises in 1998. At that time Turkish exports to third countries dropped significantly. On the contrary, Turkey's export to the EU increased substantially and offset the negative effects of the crises on Turkish economy. (Dogan, 2004)

The data in Table 3.2 reveal that with the formation of the CU, the share of imports from the EU to Turkey did not make a significant increase until 2003. On the contrary, there was a negative growth rate of imports from the EU between 1998 and 2001. The most important reasons for this negative trend until 2002 were the financial crises in Russia and Far East in 1998, the earthquake in Turkey in 1999 and the economical crises in Turkey in 2001, which was one of the worst crises in Turkish economic history. With the recovery and expansion of the Turkish economy, the imports from the EU reached to US\$ 35 billion in 2003, and US\$ 48 billion in 2004 with a 36,8% of growth rate within these two years. The most recent data indicate that import from the EU was almost US\$ 69 billion in 2007.

As compared to increase in imports from the EU, exports to the EU countries did not make a significant increase until 2003. The growth rate of exports to the EU countries reached to 34% in 2003 and 33% respectively in 2004. There is an increasing trend since 2003 until 2007 in the export of Turkey to the EU reaching to US\$ 60 billion in 2007. Table 3.2 additionally indicates two important facts : First, Turkish economy is highly integrated with the EU in terms foreign trade, particularly export because majority of Turkey's export goes to the EU. Second, on the contrary to

the major belief, Turkey's foreign trade deficit does not mainly stem from trade with the EU but it stems from trade with third countries.

Table 3.2 : Foreign Trade Statistics of Turkey in Million \$

	Exports to the EU	% Change	Total Exports	Imports from the EU	% Change	Total Imports	F. Trade Deficit (EU)
1996	12,569	-	23,224	24,321	-	43,627	11.752
1997	13,435	6,9	26,262	26,119	7,4	48,559	12.684
1998	14,813	10,3	26,974	25,282	-3,2	45,921	10.469
1999	15,424	4,1	26,587	22,530	-10,9	40,671	7.106
2000	15,664	1,6	27,775	28,527	26,6	54,503	12.863
2001	17,546	12	31,334	19,823	-30,5	41,399	2.277
2002	20,415	16,4	36,059	25,689	29,6	51,554	5.274
2003	27,394	34,2	47,253	35,140	36,8	69,340	7.746
2004	36,581	33,5	63,167	48,103	36,9	97,540	11.522
2005	41,365	13,1	73,476	52,696	9,5	116,774	11.331
2006	47,935	15,9	85,535	59,401	12,7	139,576	11.466
2007	60,398	26	107,215	68,611	15,5	170,057	8.213

Source : Republic of Turkey Prime Ministry Undersecretariat of Foreign Trade (DTM)

It is natural that there are winner and loser sectors in Turkey because of the CU regime. Proportion of clothing sector in Turkey's export has diminished significantly as compared to the remarkable increase in production of various goods like TVs, some electrical household appliances like fridges, transport equipment and road vehicles like buses. This substantial increase has not only offset the negative effects of decrease in some sectors but has also created a new prospect for future development in higher technology sectors in Turkey. (Lohrmann, 2001, p. 42) This positive change in Turkey's export to the EU can be observed from Table 3.3.

However, this trend has slowed down since 2005 because of China's accession to the World Trade Organisation (WTO) the same year.

Table 3.3 : Share of Some Important Sectors in Total Export of Turkey to the EU

Sectors	Textile & Clothing		Electric & Electronic		Other Industrial Goods		In Million US\$
	To the EU	% Change	To the EU	% Change	To the EU	% Change	
1996	4,914	-	1,503	-	3,707	-	11,549
1997	5,146	4.7	1,548	3.0	3,879	4.6	12,248
1998	5,690	10.6	2,082	34.5	3,975	2.5	13,498
1999	5,619	-1.2	2,704	29.9	4,178	5.1	14,348
2000	5,764	2.6	2,864	5.9	4,106	-1.7	14,510
2001	6,046	4.9	3,753	31.0	4,371	6.5	16,118
2002	6,947	14.9	4,923	31.2	4,623	5.8	18,459
2003	8,750	26.0	7,097	44.2	5,929	28.3	24,484
2004	10,501	20.0	11,593	63.4	8,045	35.7	34,417
2005	11,358	8.2	13,019	12.3	9,581	19.1	38,306
2006	11,913	4.9	15,783	21.2	11,208	17.0	43,924

Source : Republic of Turkey Prime Ministry Undersecretariat of Foreign Trade (DTM)

3.3 Negative Effects of the CU on Turkey

CU has various negative impacts on Turkish economy. These problems mainly stem from free trade between two unequal partners : the EU and Turkey. CU has had more negative impacts on some sectors than others. In this respect, some of the negative impacts of CU on Turkish economy can be listed as follows :

- CU has negatively affected the foreign trade balance of Turkey although this was an expected situation because the EU had already abolished the trade barriers concerning certain industrial goods from Turkey in 1973. As a consequence of the establishment of the CU regime, total foreign trade deficit of Turkey with the EU between 1996 and 2001 reached to US\$56 billion. (Yilmaz, 2003, p.5) CU has certainly improved market access conditions for the EU and non-EU exporters to the Turkish market. As a result of this, both the imports from the EU and from third countries have increased remarkably. (Togan, 2001, p.16) Turkish market has suddenly become the sixth market of the EU. On the contrary, there was no change on Turkey's export to the EU. People who expected a large increase in Turkey's export to the EU market were mistaken because 65% of Turkey's export to the EU was composed of textile and clothing products. It was obvious in 1995 that the EU consumers would purchase textile goods from the Eastern European countries or from India and China. According to the WTO agreements, the EU has gradually abolished textile quotas against the third countries which would mean loss of an important advantage for Turkey stemming from the CU regime.

(Dogan, 2004)

- The second anticipated negative impact of the CU on Turkish economy is concerned with the national budgetary revenues. Turkey lost billions of dollars of tax income from the imports from the EU countries. According to estimates of Turkish Ministry of Finance, total revenue loss of Turkey was about \$US 2,2 billion in 1996 and \$US 2,5 billion per year in the following years. Financial aid is crucial for the healthy functioning of the CU especially at a time when the public and foreign trade deficit of Turkey has grown steadily

and Turkey has been deprived of tax revenue from trade with the EU countries. However, Turkey received only €582 million from Brussels between 1996-2001 as financial aid for the assistance of adjustment and restructuring process, whereas the EU had promised Turkey €2,7 billion in the same period. (Yilmaz,2003, p.5)

- The negative effects of implementation of CET and adoption of common commercial policy of the EU have been as follows :
 - ✓ Turkey had to give privileges to the third countries because of the FTAs that the EU concluded and therefore lost billions of dollars of tax income. Furthermore, these countries are generally developing ones that are good at the same sectors with Turkey that may cause increasing competition and loss of market share for Turkish exports in the EU market.
 - ✓ Turkey had to give up privileges that it had applied to some countries before CU through bilateral trade agreements. Turkey has to apply the same protective policies to the countries like USA or Japan and therefore these countries can abolish the privileges that they have given to Turkey.
 - ✓ Under the CU regime, Turkey can no longer import cheap products from third countries to use as inputs in the production of its export goods without paying any customs duties. This has decreased Turkey's competitiveness as compared to other developing countries in terms of exports. (Dogan, 2004)

- It is argued that formation of CU with the EU will worsen the problem of unemployment in Turkey because of hard competition from the EU. (Yilmaz, 2003, p.6) The Turkish SMEs lacking economies of scale with little technological know-how and expertise have been most adversely affected by increased competition from the European companies. (Eder, 2001, p. 49)

Despite significant liberalisation and harmonisation efforts of the CU regime, it also allows for a number of exemptions and exclusions in the commercial relations of both sides particularly in the area of trade defence measures and safeguards. Under the CU regime, both Turkey and the EU can initiate, investigate and impose antidumping and countervailing duties when trade practices cannot guarantee the correct functioning of the system .(Ulgen and Zahariadis, 2004) The EU's implementation of anti-dumping investigations against the Turkish products creates extra difficulties and gives harm to the Turkish economy. With the establishment of the CU, quotas were abolished but the EU kept the right to impose antidumping duties. (Togan, Nebioglu and Dogan, 2005, p. 103)

Although it is not possible to argue that the number of trade defence measures has increased after the CU, it would be right to state their continuation has constituted an obstacle in front of developing trade relations between Turkey and the EU. Obviously such trade measures have had a negative impact on Turkish exporters although the European exporters have also been adversely affected.

(Ulgen and Zahariadis, 2004)

Agriculture is one of the most important sectors of the Turkish economy with its contribution of about 11,4 per cent to the GDP and 34 per cent to the employment. CU does not include free movement of agricultural goods except the industrial ones

but both parties have agreed to improve their preferential regime in the agricultural sector with the objective of allowing Turkey to adapt its agricultural policy to the Union's CAP, although no specific time frame has been determined for this. The omission of this sector from the CU regime may negatively effect Turkish economy, produce significant distortions in the allocation of resources and undermine the economic benefits of the regime. (Francois, 2005, p. 129) The huge trade deficit between Turkey and the EU is because Turkey imports mainly industrial goods from the EU, whereas it mostly exports agricultural and textile goods. In this respect, it could be assumed that if agricultural products had been included into the CU, the significant trade deficit of Turkey would have been much less.

(Arikan, 2001, p. 138)

Francois states that the omission of agricultural sector from the CU regime is against the Article XXIV of the GATT and this issue was even raised in the WTO review of the report of the Trade Policy Review Board on Turkey. Interestingly, there was no reaction either from Turkey or from any WTO member states who want to challenge the agreement. This was because the adoption of the CAP by Turkey would decrease some of the member states' export potential against Turkish exports.

(2005, p. 129). In this respect, the reason why the EU and Turkey did not make any progress in the adaptation of the CAP by Turkey is that Turkey has to spend billions of Euros to undertake the regulations of the EU concerned with the agricultural sector and in return, the EU has to transfer billions of Euros to assist Turkey, which would create an additional burden for the EU. (Arikan, 2001, p. 147)

CHAPTER 4

HOW AND WHY SHOULD THE CU BE MODIFIED?

4.1 Problems

Turkey is the only country that has established a customs union with the EU before becoming a full member and hence this unique situation has created several crucial problems for Turkey. Inadequacy of financial aid to meet the financial loss arising from increasing European competition and inability to become a part of another free-trade area or to conclude a separate free trade agreement has created strong tension in Turkey. (Luelno and Williams, 2000, p. 258). With respect to these facts, the main problems of Turkey concerned with the CU can be categorised under four subtitles :

- Free Trade Agreements (FTAs)
- Lack of necessary financial aid
- Inability of Turkey to Participate into Decision-making mechanism
- Transportation quotas

All these problems stem from the fact that Turkey accepted to be a part of the CU regime prior to accession when there was not any future prospects for full membership. The beginning of accession negotiations with the EU in 2005 did not also change the fact that it is not possible for Turkey to become a member of the EU in the short or medium run. Consequently, finding solutions to the problems between the parties has become vital for the prosperity of the relations.

4.1.1 Free Trade Agreements (FTAs)

Formation of a CU does not only mean application of CET of the EU. It also means the implementation of all the preferential trade agreements which the EU has signed with the third countries. Otherwise, third country exporters would be able to circumvent CU import regulations to the detriment of either EU or Turkish manufacturers unless technical procedures concerning rules of origin were implemented. (Kramer, 1996, p. 213)

Because of the CU arrangement Turkey has to negotiate and sign separately a similar agreement with the third countries that the EU makes an FTA. However, these countries do not want to negotiate and sign the same agreements for a simple reason : Their FTA with the EU permit them to export tariff-free to the Turkish market indirectly because their goods would enter into free circulation in the EU and in Turkey thanks to CU regime. In return, they do not have to give the same privileges to Turkey because according to the free trade agreements, only goods coming from the EU countries would benefit from the preferential trade arrangements. This asymmetric situation puts Turkey at a disadvantageous position in those third country markets and Turkey has lost millions of dollars of tax revenue because of trade diversion. The goods coming from the third countries are sometimes re-exported from the EU to take the advantage of the lack of import duties.

(Ulgen and Zahariadis, 2004)

Moreover, Turkey's trade ambitions and its capacity to form its own trade policy are constrained by the EU because of its obligation to obey the foreign trade policy of the EU. Turkey cannot even sign FTAs with other countries without permission of the EU. (Luelno and Williams, 2000, p. 258). The EU concludes FTAs by disregarding the economic interests of Turkey. The EU decides with which

countries or regional groupings it wants to conclude FTAs in line with its common trade policy.

While EU is very willing to enlarge its political and economic sphere of influence via trade agreements, it does not make the necessary effort to force the third countries to sign the same FTAs with Turkey. The possibility of future trade agreements with countries like India, Ukraine, South Korea and regional grouping like ASEAN brings additional problems for Turkey. These countries are good at the same sectors with Turkey which would cause increased competition and market share loss in the EU market. (Uyanusta, 2007, p. 37). For example, Korea is a very competitive country in the sectors where Turkey has a high market share in the EU market like electronics and textile. Both the EU and Korea aim to sign the final agreement in 2008 and they have already agreed to accelerate the process. (European Commission, 2008)

Turkey could not even start negotiations with Algeria, Mexico and the members of ASEAN. When Turkey demanded to begin negotiations with the ASEAN parallel to the negotiation process between the EU and ASEAN, it received a negative reply. The ASEAN secretary stated that it would be impossible to begin negotiations with Turkey because the programme of ASEAN for the next two years is full. In such a situation it is very important to be supported by the EU. Otherwise, Turkey cannot sign the FTAs with the third countries at the same time with the EU and trade diversion may occur, which would harm the Turkish industry. This problem can be avoided with the formation of a mechanism that would apply the conditions of the FTA to Turkey so that Turkey would not need to separately negotiate with those countries.

(Republic of Turkey Prime Ministry Undersecretariat of Foreign Trade, 2007, p. 9-11)

4.1.2 Lack of necessary financial aid

Financial aid is very important for the healthy functioning of the CU especially at a time when the foreign trade deficit of Turkey steadily grows. In addition to trade deficit, Turkey has lost billions of dollars of tax income due to the imports from the EU countries. (Manisali,1995, p.49). According to estimates considering that 17% of Turkey's tax income coming from duties placed on industrial goods, establishment of CU has caused the loss of \$US 2,6 billion per year, equivalent to the financial aid promised by the EU. (Arikan, 2001, p.139)

As Redmond states, as an associate country it is not possible for Turkey to benefit from structural funds, which constitutes significant amount of financial assistance for the member countries. (1997, p. 8) It has already been emphasized by the Turkish officials that Turkey has been the only country that joined the CU regime before full membership and therefore it could not benefit from any financial privileges that all new member states enjoyed. (Kramer, 1996, p. 215)

Consequently, the advantages of forming an association agreement with the EU are quite limited for Turkey due to loss of billions of dollars of tax income, limited financial aid to compensate it and the exclusion of crucial sectors like agriculture and service. Moreover, benefits of the CU have been eroded because similar concessions were given to other non-associates under the GSP. (Redmond, 1994, p. 10) Consequently, Turkey needs additional financial assistance from the EU to compensate economic loss caused by the CU regime on the way to full membership.

4.1.3 Inability of Turkey to participate into decision-making mechanism

Turkey as an associate country can neither join the EU decision-making mechanism nor participate into committees even though it has to obey the final decisions of them. However, separate institutions have been established to discuss the problems between the parties. One of the most important committees between Turkey and the EU, the EU-Turkey Customs Union Joint Committee (GBOK) was created in 1996 to monitor the latest developments concerning the implementation of the CU between parties. (Phinnemore, 1999, p. 58) This committee is important for both sides in terms of evaluating the functioning of the CU regime although it has not always been effective in providing solutions to the emergent problems.

When determining the trade policies of the Union, the EU Commission consults regularly with the Committee 133, which is composed of the trade officials of the member states. This consultation process between the Commission and the Committee 133 is crucial because it provides necessary information to the parties on what is being negotiated. (Young, 2004, p. 209) Turkish officials cannot join the Committees of the EU like the Committee 133, where crucial decisions like the signing of the FTAs with third countries are being discussed. The informative meetings that should normally give timely information concerning the latest developments in the foreign trade policy of the EU has not been adequate to meet the needs of Turkey that the Turkish officials have demanded from the EU the right to participate into several important committees to watch the negotiation process in the observer status.

(Republic of Turkey Prime Ministry Undersecretariat of Foreign Trade, 2007, p.10).

4.1.4 Transportation quotas :

The EU does not prefer to make a global quota agreement with Turkey although it does with the other candidate countries. Therefore, each member country applies transportation quotas as they wish and impels the Turkish exporters to use railways, which is an expensive mode of transportation. This is obviously against the principle of free movement of goods of the CU and in reality, these transportation quotas are aimed for quantity restraints of Turkish export goods. This practice of quotas leads to late delivery of goods and what is more, it increases the transportation costs for the Turkish exporters. According to estimates, the loss of Turkish economy because of these quotas amounts to US\$ 5 billion per year. This is an intolerable and unacceptable situation for Turkey, when Turkey is already faced with billions of dollars of trade deficit and loss of tax revenue. (Baydarol, 2008)

The response of the European officials to the complaints of Turkey has demonstrated that the EU-Turkey Customs Union Joint Committee (GBOK) is not effective in providing solutions to the problems of Turkey. Instead of bringing this problem concerning the transportation quotas to the agenda of the Union, the EU recommends Turkey to negotiate it separately with each member country. It is stated by the European Commission that transportation quotas are not determined by the EU and therefore, Turkey should separately negotiate with each member state for demanding additional quotas or for solving this problem.

(Republic of Turkey Prime Ministry Undersecretariat of Foreign Trade, 2007, p. 24)

Turkey is an associate country which participated into the CU regime of the EU. However, the EU considers Turkey as an ordinary third country and claims that problems concerning transportation quotas cannot be discussed before negotiations

about the related chapter would begin. It should be noted that chapter of transportation is among the eight chapters which were suspended due to the dispute over Cyprus.

Contrary to the claims of the EU that transportation quotas should be discussed under the related chapter, transportation sector is considered to be an inseparable part of the CU according to the final decision of the Court of Justice of the European Communities stating that the CU regime cannot function properly without providing solutions to the problems concerning the transportation sector. As Baydarol argues, transportation quotas applied to Turkey are a clear violation of free trade and therefore, it should be brought to the agenda of the WTO if the problem continues to exist. (2008)

4.2 Suggestions

It has been more than 12 years since Turkey established CU regime with the EU. Undoubtedly, in this period of time, the beginning of accession negotiations for full membership in November 2005 was a very important milestone in the history of relations. However, time has shown that succeeding to become a full member is not as easy as what the Turkish policy makers had envisaged in 2005. It has been obvious that Turkey will not be able to join the Union in the short or medium run as a consequence of suspension of negotiations in eight chapters. As Redmond comments :

Any lingering hopes of full membership for the Turks in the short-run were eventually completely dashed when accession negotiation were partially frozen at the end of 2006. (Redmond,2007, p.306)

In addition to this, the Europeans decision-makers began to express what they have in their minds for Turkey is not accepting Turkey as full membership to the Union, but giving Turkey the status of privileged partnership, a newly invented concept for Turkey by the EU.

Under the light of this changing situation, different point of views and scenarios concerning the future of the customs union and relations between the parties can be listed as follows:

- According to a very optimistic point of view, Turkey made the right decision by becoming a part of the CU. According to the supporters of this view, CU is an important and necessary mechanism on the way to full membership. They claim that joining to the CU is the obligation of Turkey arising from the Ankara Agreement and Additional Protocol and they argue that Turkey will eventually succeed to become a full member of the EU in the medium or long-term.
- According to a second point of view, terms of CU between the parties as a result of signing the 6th of March official document in 1995 should be completely changed. This is inevitable because of several reasons :
 - (a) A serious study concerning the impacts of CU on Turkey had not been made prior to CU agreement,
 - (b) The hesitation of the EU policy makers to give a definite timetable for the accession to the EU makes it impossible for Turkey to join the decision-making mechanism that makes the future course of relations ambiguous. Consequently, the EU policy of expanding its economic and political sphere of influence to the third countries by signing FTAs have created negative economical impacts and additional burden on Turkish economy. According to the supporters of this view, Turkey will not

be able to join to the EU in the short or medium run and therefore, it is not possible to pursue relations within the framework of CU. It has become inevitable to abandon the CU regime until the EU gives Turkey a certain final date and more concrete conditions for accession to the Union. It is better to establish either a Free Trade Area like the EEA or sign a Free Trade Agreement instead of CU until Turkey eventually becomes a full member. In both cases, they will better serve the interests of Turkey and be more flexible compared to a rather binding CU regime.

- CU has not had a significant impact on the volume of trade between the parties and created disappointment because the EU had already liberalised its trade with Turkey except textile sector before the CU came into existence. People sharing another view argue that CU should be widened and deepened in order to enhance the trade integration and solve the problems between the parties. Ulgen and Zahariadis with respect to the deepening of the CU state that both the EU and Turkey should concentrate on the elimination of trade defence instruments and should clearly define the terms concerned with the abolition of these instruments. With respect to the widening of the CU, an agreement on the liberalisation of trade and addition of agriculture sector into the CU mechanism would be beneficial. Liberalisation of trade in services would particularly contribute to the integration of Turkish economy and would certainly have a more positive impact on Turkey given the high share of services in the Turkish GDP. Zahariadis and Ulgen further recommend an institutional cooperation between the parties which would allow decision-making in several policy areas just like the EEA and a more flexible visa

regime and rules with regard to the temporary movement of Turkish workers including the key personnel. (Ulgen and Zahariadis, 2004)

Turkey's accession to the EU in the short or medium-term is quite impossible given the problems of Turkey and the Europeans' perception of Turkey as a big, poor and Islamic country. According to most Europeans, Turkey poses a challenge to the EU with a current population of more than 70 million, with its lower per capita income compared to any other member state and with its common border of volatile Middle East and Caucasia. (Barkey and le Gloannec, 2005, p. 130-131) As Redmond underlines, in the case of a referendum on Turkey's accession to the EU, a vote in favour of this accession could not be expected in any member state with any confidence. The most likely outcome of this referendum would be a clear rejection of Turkish membership by the majority of member states. (2007, p. 309-310)

According to Buzan and Diez, the fact that Turkey will not be able to join the EU in the foreseeable future is not an inherently bad thing. They argue that, it is easier for Turkey to develop its relations with its neighbours and other Turkic states in the Central Asia as a closely linked but not a member country. (Buzan and Diez, 1999, p.42) Parallel to this view, Onis asserts that Turkey can obtain several economic and political gains from its multicultural identity by building close relations with all the major blocs that Turkey interacts with, without making binding agreements to make itself part of an economic or political union. He further argues that Islam constitutes an important part of Turkey's cultural heritage and the emergence of the Turkic republics in the Central Asia, which share the same linguistic and cultural heritage is the proof of Turkey's broader identity than a pure European one. This broader identity

should not be seen as a disadvantage but rather be considered as an asset that Turkey can benefit from. (Onis, 1995, p. 48-49)

In 1992, The European Commission suggested that :

the association agreement should be `more actively and effectively applied` and that the EC `should take all appropriate steps to anchor [Turkey] firmly within the future architecture of Europe`. (Phinnemore, 1999, p. 112)

In this perspective, both the Turkish and the European policy-makers considered CU mechanism as a significant development to achieve this aim. However, as Arikan points out, the EU's containment policy towards Turkey has been inadequate to prepare the economic ground for the EU membership because of its inability to provide a similar degree of integration in the other fields of the European single market. The most important reason for this is its establishment of various forms of cooperation and integration with Turkey with a promise for full membership in the long term without appropriate instruments to accomplish it. CU was limited to cover only trade in industrial goods and some of the most important areas of the EU's single market such as agriculture, free movement of labour, services, environment and transport was excluded. Furthermore, the EU's policy towards Turkey has both lacked a clear accession strategy to support Turkey's preparation for the Union's internal market and an adequate technical and financial support to achieve this.

(Arikan, 2001, p. 160-161)

To conclude, Turkey's highly integrated economy with the EU and the reciprocal economic interests between the parties makes further development of relations inevitable. However, relations should be based on a new ground by taking the interests of Turkey into consideration. It is obvious that joining the CU regime has to be simultaneous with the accession to the EU. Otherwise, there may be serious problems between the parties in the foreseeable future which may damage the relations. As Ugur has argued, withdrawal from the CU may become a rational choice for Turkey unless the EU would be ready to offer additional concessions. (Ugur, 2000, p.149) CU regime is sustainable in the long run only if the EU gives a specific date for Turkey's full membership. Otherwise, policy-dependency aspect of the CU will put such a heavy political and economic burden on Turkey that conversion of the CU into a Free Trade Area will be inevitable in the long run. (Ulgen and Zahariadis, 2004)

Signing a Free Trade Agreement or forming a Free Trade Area by taking the EEA as an example instead of CU regime would be the best option for Turkey. Contrary to the argument that it might lead to deterioration in relations, this alternative will ameliorate relations by providing more concrete solutions to the problems. If the EU really wants to see Turkey as a full member then it would not use this as a pretext for the deterioration of relations. Otherwise, it is not worth risking the national interests of Turkey for an open-ended and unrealistic aim. It should never be forgotten that no economic advantage can offset the loss of Turkey arising from implementing decisions which are against its national interests.

CHAPTER 5

CONCLUSION

This thesis has argued that the CU regime between Turkey and the EU which was realised on 31 December 1995, as a result of the Association Council Decision of 6 March 1995, should either be converted into a Free Trade Area or into a Free Trade Agreement because of the major drawbacks it has created for Turkey. It is an undeniable fact that CU regime is a part of the EU full membership and therefore, joining this regime should be simultaneous with the accession to the EU as a full member.

Undoubtedly, CU regime has various benefits on Turkey's institutional, legal and financial system. The EU and Turkey has been trade partners for decades and Turkey has always benefited from such a stable and big export market like the EU. Turkish consumers are also better protected and able to make a selection among more quality products since the establishment of CU. In addition to this, approximation of the laws and the adoption of the Union's *acquis communautaire* have contributed to the effective implementation of rules and therefore increased the quality of life standards in most fields of daily life.

However, CU regime has also created various problems for Turkey arising from its non-membership status. Turkey has never been this much open to the EU influence and consequences of the EU's decisions like any candidate country in the history of the EU. This is mainly due to Turkey's participation into the CU regime before full membership.

The Additional Protocol, which set the details of the Transitory Period of the Ankara Association Agreement, had foreseen the gradual creation of a CU by 1996 after a maximum of 22-year period. However, it had also foreseen free movement of

labour after the same period of time. (Redmond, 1993, p.28) The EU blocked the implementation of this article in order to protect its interests. As a consequence of this situation, it has been argued in this thesis that establishment of CU with the EU is not the obligation of Turkey coming from the Ankara Association Agreement because the EU did not implement its obligations coming from the same agreements.

Turkish policy-makers' motivation to conclude CU before the accession was political rather than economical. Turkey's hopes for accession to the EU after its formal application for full membership to the EU in 1987, was eroded with the end of the Cold War because Turkey's strategic importance compared to the Cold War Period had diminished (Aybet and Muftuler-Bac, 2000, p.580) Therefore Turkey found itself at the end of the queue of candidate countries because priority was given to the Eastern European countries. For this reason, Turkish policymakers rushed to join the CU without even necessarily evaluating potential costs and benefits of this historical decision.

The EU did not agree with Turkey that CU would be a major step on the way to Turkey's full membership as the EU's Ambassador to Turkey, Michael Lake stated in 1997 :

the customs union created misconceptions on both sides. The European side felt that Turkey would be preoccupied with making it work and not press for full membership for the time being, while Turkey had the misconception that the customs union was a stepping stone towards full membership in the next year or two. (Arikan, 2001, p. 133)

Furthermore, CU provides much less rights than what the Ankara Association Agreement had envisaged for Turkey. CU regime does not include free movement of labour and capital as compared to the Ankara Agreement. It only includes free movement of industrial goods and excludes important sectors like services and agriculture. (Manisali, 1996, p.55) Actually, CU has been the most important mechanism for the EU to keep Turkey in its sphere of influence without dealing with the problematic aspects of Turkey's membership (Arikan, 2001, p.328) : free movement of labour, capital, participation into the CAP and into the decision-making mechanism and delivering billions of Euros of financial aid from the Structural Funds.

Yet, CU has created several important drawbacks for Turkey. As indicated in the Chapter 3, two of these most critical drawbacks are problems concerning the FTAs that the EU concludes and inability of Turkey to join to the decision-making mechanism and to the committees to protect its national interests. These drawbacks stem from the fact that CU regime is an inseparable part of full membership and therefore this situation may create further problems for both parties and damage the relations. Turkey, as an associate country, is obliged to obey the final decisions of the EU and has to shoulder the burden of the EU without benefitting from the instruments that full members enjoy such as accession to the structural funds and shaping the agenda of the Union.

It is clear from the above analysis that CU regime is only sustainable if the EU decides to accept Turkish accession in the short or medium run. However, attitudes of and the speeches of several EU leaders concerning Turkey's membership to the Union has clearly revealed that the EU will try to persuade Turkey to accept the status of privileged partnership rather than membership status. The statements made by some EU policy-makers that Turkey is not a European country and the efforts to use this as

a valid reason to support this argument contradicts with the Ankara Association Agreement, the single valid agreement determining the relations between the parties officially. It is obvious that Turkey will not accept anything short of full membership such as privileged partnership. Turkey should no longer pursue being a part of CU without being given a specific date for accession. Otherwise, the compulsory situation of compliance with the *acquis communautaire* without being able to participate into the decision-making mechanism will make the costs of the CU regime greater than its benefits for Turkey.

The beginning of accession negotiations with the EU on 3 October 2005 had refreshed hopes for EU membership among the Turkish people. However, with the freezing of negotiations in eight chapters because Turkey did not accept to enlarge the CU regime to include Cyprus has once more reminded Turkish public opinion that the negotiations are open-ended and the EU may never allow Turkey to join. Under these conditions, it is inevitable for the Turkish decision-making authorities to be realistic and to implement necessary policies to protect the national interests of Turkey.

The policy-dependency aspect of the CU regime has created intolerably high political costs that it is time for Turkey to discuss modification of the CU regime into a Free Trade Area including the free movement of services, capital and other crucial aspects of an economic area or into a Free Trade Agreement depending on the results of negotiations with the EU. In both cases, relations would be based on a better ground because Turkey would not have to make a concession from its national interests.

While there is not a better alternative for Turkey other than the EU membership in the foreseeable future, Turkish people have realised that the EU is not the only alternative for Turkey. Developing stronger economic and political ties with the rest of the world with greater energy will certainly contribute to Turkey's growing importance in international politics. However, this is only possible so long as free and sovereign policies are implemented in line with the necessities of changing world order.



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