Fatal Attraction:
Turkey's Troubled Relationship with the European Union*

Hadi Salehi Esfahani
University of Illinois at Urbana-Champaign

May 2003

Abstract

This paper examines the relationship of Turkey with the European Union and its predecessor. It addresses the following questions: Have the requirements of economic integration helped or hindered the process of economic reform in Turkey? Could greater assurance and support from Europe have impeded or enhanced the reform process? Could an alternative sequence of steps towards integration have rendered the process more productive? What role did Turkey's political and economic characteristics play in the process? The paper argues that there may have been a mismatch between the deals offered by the EC/EU and Turkey's needs and capabilities, which ruled out full compliance with those deals. Specifically, the opening of Turkish markets to increased foreign competition in the absence of effective fiscal and monetary institutions may have resulted in loss of macroeconomic discipline. Such difficulties entailed large costs and may have caused delays in Turkey's preparation for EU membership.

JEL Classification: F13, P15, D72

Key words: Turkey, Trade Policy, Economic Integration, Political Economy.

Please address all correspondence concerning this paper to:
Hadi Salehi Esfahani
Department of Economics
University of Illinois
Urbana, IL 61801, USA
Phone: (217) 333-2681; Fax (217) 333-1398; E-mail: Esfahani@uiuc.edu

* I am thankful to Werner Baer, Larry Neal, and other participants at the University of Illinois Conference on the Expansion of the European Union, February 2003, for helpful discussions.

1. Introduction

Integration into Europe has long been a cherished goal of Turkey's ruling elite. Indeed, shifting the population's aspirations "Westward" was an integral part of Turkey's national project from its inception after World War I. But the road towards integration has been a long and difficult one. In their attempts to fulfill the criteria for closer ties, Turkish politicians have had to make compromises that have either absorbed a great deal of political energy and capital or have caused failures in other respects. While in case of most other potential candidates, integration into the European system (European Union, EU, and its predecessor, the European Community, EC) has been viewed as a means of strengthening and consolidating political and economic reforms, Turkey has struggled through a long list of reforms required for candidacy. This slow and awkward process has raised a number of important questions: Have the requirements of economic integration helped or hindered the process of economic reform in Turkey? Could greater assurance and support from Europe have impeded or enhanced the reform process? Could an alternative sequence of steps towards integration have rendered the process more productive? What role did Turkey's political and economic characteristics play in the process?

This paper addresses the above questions. It argues that there may have been a mismatch between the deals offered by the EC/EU and Turkey's needs and capabilities, which ruled out full compliance with those deals. In order not to lose out on the opportunity to join the EC/EU, Turkish politicians seem to have taken steps that strengthened the ties with Europe, but stretched the capabilities of the government and caused failures in other respects. Specifically, the opening of Turkish markets to increased foreign competition in the absence of well developed capital markets may have increased the pressure on the government to offer support to some failing economic operations. Since the institutions needed for maintaining fiscal discipline were weak in

Turkey, the pressure resulted in high volumes of deficit spending. The government tried to keep the large deficits off-budget as much as possible (in the form of contingent or hidden liabilities) hoping that it could ride out the fiscal shock, but eventually the economy succumbed to a series of major financial crises. Such failures have entailed large costs and have caused further delays in later stages of preparation for EU membership.

The difficulties that Turkey has faced in its relations with the EC/EU do not diminish the major gains made in opening and extending markets. Rather they highlight the fact that the conditions and the step taken to realize those potential gains matter. This paper argues that a key reason why the Turkey has had to make difficult compromises has been weaknesses in its political and economic institutions. Given the problems posed by those weaknesses, more supportive offers that allowed Turkey to focus on the more fundamental institutional reforms that addressed the weaknesses may have generated better outcomes. These observations do not necessarily imply that the prospects for future progress in EU-Turkey relations are bleak. Turkey has made substantial progress towards reform in recent years, especially since the end of 1999 when the EU accepted Turkey's candidacy for full membership. In addition, Turkey's domestic politics are undergoing changes that have prepared the ground for further progress in substantial ways.

While the analysis in this paper focuses on the EC/EU-Turkey relations, its implications are obviously broader. The results suggest that the successes and failures of economic integration depend on the institutional capabilities of the partners and the steps taken to build those institutional capabilities. Early integration when the political and economic institutions are not sufficiently developed may have adverse repercussions even when there are large potential gains in unifying the markets. Studies of this kind contribute to a better understanding of the characteristics that make countries good candidates for integration into economic unions and the preparations needed to reach that stage.

The plan of this paper is as follows. Section 2 starts with a discussion of the early phases of Turkey-EC relations in the 1960s and 1970s. Section 3 examines the successes and disappointments of the relationship in the 1980s when Turkey seriously focused on accession to the EC. Section 4 analyzes the institutional weaknesses in Turkey, which seem to be the root causes of failures in its relationship with the EC/EU. Section 5 reviews the developments since the formation of customs union in 1996. Section 5 offers concluding remarks.

2. Turkey and the EC in the Import Substitution Era

Turkey applied for Associate Membership of the European Economic Community in 1959 and signed an agreement in 1963. This agreement, which was put into effect in December 1964, was a stage by stage integration process towards eventual full membership in the EC. The process was to start with preparations for lowering of trade barriers and at later stages allow for free mobility of labor between Turkey and the Community. The timing of this agreement was ironic because in the early 1960s Turkish policymakers were instituting a strong set of import substitution industrialization (ISI) policies. At the time, Turkey was a largely agrarian economy (Figure 1) and its nascent manufacturing was dominated by food and textile industries (Figure 2). There was a widely held view among Turkish politicians and businesses that protection was essential for Turkey's industrial development at least for some time. EC policymakers were also skeptical about the ability of the Turkish industries to withstand competitive pressure from Europe. In addition, they were concerned about disruptions in the European economy if later on large masses of unskilled Turkish workers were given access to the EC labor markets.

The motives for the 1959 application and the 1963 accession agreement seem to have been strategic ideas. The agreement would reaffirm Turkey's commitment to secular and Western-oriented political system and provide a framework for the country to work toward convergence with Western Europe over the long run. It also ensured that the ties with the rest of Europe remained strong, counterbalancing the influence of Turkey's main rival, Greece, inside Europe and its overdependence on the United States outside Europe (Önis, 2001).

Because of concerns from both sides, the 1963 agreement set long term goals and envisaged a 22-year process starting in 1973 and extending to 1995. Meanwhile, Turkey continued with an intensive ISI policy and there was not much change in its economic relations with the EC during the 1960s. Turkey's trade flows with Europe and the rest of the world were largely unchanged. In fact, in the late 1960s its real exports and imports were still below their peaks in the early 1950s (Figure 3). But, the structure of the economy was undergoing a major change, with agriculture giving way to industry and services (Figure 1). In manufacturing, which in the early 1960s was dominated by food and textiles, new lines of production were quickly expanding (Figure 2). This transition was also reflected in the structure of exports, though manufactured products still remained a very small part of the total (Figure 4).

The volume of Turkey's trade experienced rapid expansion and structural change in the early 1970s (Figures 3 and 4) when the Turkish currency was devalued and protection rates were lowered somewhat in 1970 and 1971 (Figure 5).[1] There was also some opening for increased foreign direct investment (FDI), though the amounts hardly exceed three percent of domestic investment. Public investment was capped and private investment resuscitated (Figure 6). There

[1] The average effective tariff rate shown in Figure 5 is meant to serve as an indicator of overall protection rate. Tariff rates varied greatly across products (and sometimes even different shipments of the same product). Also, significant non-tariff mechanisms were used along tariffs to restrict imports.

was also a reduction in political violence, which had been rising in the late 1960s. This was because the military responded to the rising political turmoil by removing the elected prime minister and installing a caretaker government by the military in 1971. The caretaker government was composed mostly of technocrats who made attempts at further reforms, but had limited success. In 1973, new elections were held and the professional politicians returned to power.

A turning point in the EC-Turkey relations came in 1973 when they singed an additional protocol, which significantly lowered EC's trade barriers for most Turkish manufactured exports, without reciprocal liberalization on the part of Turkey. Ironically, Turkey's foreign trade that had experienced rapid growth during in the early 1970s stopped expanding and became more volatile (Figure 3). A host of factors were responsible for Turkey's failure to take advantage of the EC's offer. In particular:

1. The main comparative advantage of the Turkish industry at the time was still in food, apparel, and footwear and the greatest potential for exporting to Europe was in the latter groups. But, those groups were not included among the products liberalized by the EC.

2. EC's liberalization coincided with the first oil shock, which led to slow growth and instability around the world, including Europe. As a result, European markets were not particularly inviting for Turkish producer to invest and develop new export products.

3. The Turkish invasion of part of Cyprus, following the Greek-inspired coup in the island, created unease in Turkey's relations with European countries, especially after democracy returned to Greece in the wake of the fateful Cyprus coup.

4. After 1973, when the old pre-military intervention politics was more or less reinstituted, the country entered a period of increasing economic and political instability. This hampered the government's attention to long-term strategic policies.

5. The successive, short-lived coalition governments that took office until 1980 frequently included the Islamist elements, especially from the National Salvation Party (NSP), who had reservations about integration into Europe.

6. Most Turkish politicians maintained their skepticism about the ability of the country's industry to survive liberalization of imports at the time and were not eager to reciprocate the EC's unilateral trade liberalization.

Under these circumstances, the government returned to the ISI policies. While the terms of trade were turning against Turkey following the oil shock, the government allowed the real exchange rate to appreciate and raise trade barriers (Figure 5). It also used strongly expansionary fiscal and monetary policies to increase public and private investments (Figure 6). Though these policies helped GDP grow for a few years in the mid-1970s (Figure 7), a huge and unsustainable trade gap was created (Figure 3). The process of structural change continued, but at a slow pace and at the cost of supporting increasingly inefficient investments.[2] Signs of major economic failures emerged in 1977 when foreign borrowing costs rose, GDP growth fell, and inflation accelerated. In 1978, Turkey faced a major debt crisis, followed by hyper-inflation and sharp drops in GDP (Figure 6). The crisis added fuel to political turmoil and a vicious circle of deteriorating economic and political conditions was set in motion.

---

[2] Krueger and Tuncer (1982) find that in the mid-1970s total factor productivity (TFP) in Turkish manufacturing was falling at the rate of about 1.2 percent per year. Before 1973 (TFP) had been growing at an average rate of about 2.5 percent per year.

The political and economic conditions in Turkey in the mid-1970s proved fateful for Turkey-EC relations. Soon after returning to democracy, Greece applied for full membership in the EC. Turkey, which had kept up with Greece earlier in applying for association with the EC, failed to match the act this time. The EC was initially reluctant to proceed with Greece's case without giving Turkey a chance, but European governments quickly turned to the view that EC membership was crucial for the revival of democracy and encouragement of economic reform in Greece (Önis, 2001). As a result, the application was treated with urgency and was processed quickly, allowing Greece to become a full member by 1981. Interestingly, in 1978 and 1979 the EC suggested that Turkey should apply for membership along with Greece, but Turkey declined the suggestion.[3] Evidently, the domestic political struggle and opposition from within the coalition governments prevented Turkish politicians from seizing the opportunity. The outcome came to pose a major obstacle for Turkey's long-term aspirations because the continued occupation of northern Cyprus and other disputes ensured that Greece would use its veto power to block Turkey's accession to EC.

By 1980, Turkey was in a deep political and economic crisis. Bad luck had struck Turkey with the second oil shock. But, as discussed in more detail below, the blame should largely go to the country's political institutions that failed to motivate prudent policymaking and lacked the potential for systematic reform when their failures became apparent. There was probably little that the EC or other outsiders could have done to improve conditions in Turkey at the time. Finally, in 1980, a military coup put an end to that situation and prepared the ground for a major shift in trade policies.

[3] "Timeline: Turkey and the EU", Guardian Unlimited, www.guardian.co.uk/turkey/story/0,12700,859599,00.html, Friday December 13, 2002.

3. Turkey and the EC in the 1980s: Reform Successes and Disappointments

In the late 1970s, many policy analysts inside and outside Turkey came to the conclusion that export promotion was the answer to Turkey's economic woes. Europe's doors were open for a wide range of products that Turkey could potentially produce and export. The oil-rich economies of the Middle East had also become attractive markets in which Turkey could gainfully participate. These opportunities could be used for a more efficient strategy of industrialization. There was also a need for a reform in the political institutions to reduce instability. The leaders of the 1980 coup set out to accomplish these tasks. Initially, the junta established martial law, dissolved the legislature, and took control of all government functions. It imposed media censorship and banned the activities of all political parties and many associations, such as labor unions. At the same time, technocrats who had drawn up a plan for policy change were given a chance to proceed with their reforms.

In analyzing the post-1980 developments, the issue that is of most interest for our purposes is whether the political and economic reforms prepared Turkey adequately for taking advantage of the potential gains from integration into Europe. Conversely, one wonders whether the presence of EC/EU membership as a prize accelerated or delayed the process of reform in Turkey. To address these issues, we first review the reforms of the early 1980s and then analyze the subsequent policy changes in light of relations with the EC/EU.

The economic policy reforms of 1980 were implemented with financial and technical assistance from the International Monetary Fund (IMF). The program created a trend of real devaluation for the Turkish currency, instituted export subsidies, and slashed many import tariffs (Figure 5). There were also controls on government expenditure, especially wages and salaries, while income taxes were raised to compensate for the loss of tariffs and other indirect taxes

(Figures 8 and 9). These measures diminished the budget deficit and helped reduce the need for money printing (Figure 10). However, at the same time the government assumed large amounts of debt that were not accounted for in the budget and went well beyond the debt increase implied by the current deficit (Figure 10). These debts were liabilities to which the government had committed itself in the earlier years in explicit or contingent form, but it had never acknowledged them formally in its financial accounts. This was part of a clean up operation that the IMF normally imposes as part of its standby agreements (Esfahani and Kim, 2002). In the subsequent few years, the program more or less continued, though the deficit started rising again because the government allowed tax revenues to decline without matching reduction in expenditure. This problem became more serious after 1983 when the military initiated a process to return the country back to democracy.

The political reforms were mainly aimed at creating conditions for the emergence of majority governments, so that decisions could be made more effectively. This was done by making the legislature unicameral and by imposing a minimum of 10 percent of the popular vote as a requirement for a party to be able to send representatives to the parliament. Also, severe restrictions were imposed on the movements of parliamentary deputies from one party to another and the prime minister was given freer hand in issuing decree-laws and dismissing ministers (Evin, 1994; Heper, 1994). The constitution was further amended to restrict the activities of political parties and other associations (Sakallioglu, 1991; Arat, 1991).[4] These changes helped solve some old problems, but created serious new ones. As we will see below, the prerogative granted to the executive facilitated the creation of significant hidden liabilities, which

[4] Many leftist parties and organizations and Kurdish separatist movements have always been outlawed by a perennial provision of the Turkish constitutions that no party or organization could profess ideologies that would divide the nation; e.g., by encouraging class conflict or separatism.

contributed to economic instability in Turkey. The restrictions on associations and political freedoms became contentious issues in the Turkey-EC/EU relations.

The economy's response to the reforms was quite positive. Inflation declined and GDP growth resumed vigorously (Figure 7). Manufactured exports grew with leaps and bounds, helping total exports go up by 50 percent in 1981 and double by 1985, in real terms (Figures 3 and 4). Imports grew more slowly and allowed the trade deficit to decline. This was partly because of the devaluation and partly because despite the reductions in tariffs, other restrictions and charges were imposed on imports and maintained until the mid-1980s. Interestingly, in the first few years, trade with Europe did not expand as much as with the rest of the world.

As Turkey scored clear successes in its export promotion policy and the economic conditions improved, the issue of joining the EC became more prominent on the government's agenda. There was not much progress in Turkey-EC relations before 1983 because of Europe's objection to the absence of democratic conditions in Turkey. However, with the return of the democracy in 1984, the Council of Europe accepted the participation of Turkish parliamentarians and accession talks were revived, though at a slow pace. Although elections had returned and democratization had started, Europe still considered Turkey's democracy a very limited one. There was no civilian control over the military, major political parties and prominent politicians remained banned, and civil and political rights, especially for the Kurdish minority, were restricted. In addition, the presence of death penalty and persistence of cases of torture, disappearance, and extra-judicial executions, along with the Cyprus question, were major sources of unease in Europe. On the economic front, the old concerns about the capabilities of the Turkish economy remained. The EC was also unsure of the government institutions in Turkey to design and implement effective and fair regulations in various markets.

European objections to the political conditions in Turkey lent support to the popular demands inside the country and mounted pressure on the government to proceed with further democratization. In 1987, the ban on the pre-1980 prominent politicians and political parties was lifted through a referendum and Turkey recognized the right of its citizens to file complaints with the European human rights commission. On the economic front, in the mid-1980s the Turkish government began to increasingly liberalize imports as well as the domestic markets.

These steps along with the strength and confidence that Turkish producers had gained through the experience of export-oriented growth after 1980 encouraged the government to apply for full EC membership in 1987. The European Council responded to the application in 1989. While recognizing Turkey's eligibility for membership, the Council deferred decision on the matter, arguing that the economic and political conditions in Turkey did not meet the necessary criteria (Commission of the European Communities. 1989). Meanwhile, the Council suggested, Turkey and EC could proceed with the formation of a customs union, which was part of their original 1963 agreement. Although this was disappointing for the Turkish politicians, the application intensified the Turkey-EU negotiations and paved the way for further cooperation (Sandalli, 2003).

As the European Council was drafting its response to Turkey's application, the tenuous nature of the country's political and economic institutions began to show its symptoms. In 1988 and 1989, the inflation rate rose sharply and the GDP growth rate became negative (Figure 7). Despite the fact that budget deficits appeared to be relatively small, public debt began to rise with leaps and bounds (Figure 10). In 1988 and 1989, the government's debt jumped by 25 percent and 13 percent of GDP, respectively. At the same time, the real exchange rate was allowed to appreciate and the growth rate of exports, especially the new manufactured products, slowed down sharply (Figures 3, 4, and 5). Although some of these trends were reversed in some subsequent years, massive fluctuations became a hallmark of the Turkish economy in the following years. Turkey's inflation rate and income crash set new records in 1994 (Figure 7). The event was repeated in 2001, though at lower inflation rates. [There was a large negative GDP growth in 1999 as well, but that was due to a major earthquake and brief contagion effect from the Russian crisis.] Growing budget deficits and ever larger jumps in public debt generated outside the official budget became a new pattern (Figure 10). In retrospect, 1988 was a turning point after which the economy began experiencing major instability. It also marked the reversal of the expansionary trend in the share of industry and manufacturing in the Turkish economy, though the growing role manufacturing in exports resumed in later years (Figures 1 and 4).

Why did the Turkish government that aspired membership in the EU allow the economy to deteriorate so badly? Were there shocks beyond the government's control that were driving the crises, or was it the failure of government policies? Did the efforts at reform and increased openness, especially relations with the EC/EU help or hurt? How did the instability in Turkey affect its relations with the EU in the 1990s?

To address these questions, we need to examine the political and economic institutions in Turkey and assess their role in policymaking. This will be done in the next section.

4. Institutional Weaknesses, Trade Liberalization, and Fiscal Crises

An important change in 1988 that may offer a clue about Turkey's troubles over the past 15 years is the political context and the institutions under which the country returned to democracy. The events of 1960s and 1970s had shown that Turkey's polity was highly fragmented and its politics could be quite contentious. Party politics depended substantially on personalities who mostly competed fiercely to promote their own power, even when it came at the cost of collective failures. A system of proportional representation in the pre-1980 period had intensified this problem and had led to the survival of small parties that were constantly engaged in shifting coalitions to position themselves better relative to others. The result was that the politicians who took office had little incentive to implement long-term efficient policies because their coalition had a good chance of falling apart and losing power before anyone could ascertain the benefits those policies and be inclined to support the politicians who had initiated it. This tragedy of commons situation can go a long way in explaining the failure of the Turkish politicians to deal with the economic challenges of the 1970s and take advantage of the opportunities for building closer ties with Europe.

As pointed out above, the reforms in the constitution and other political institutions during the early 1980s were meant to address these problems. However, they did not fully solve the problem and, inadvertently, added new ones. The 10 percent minimum popular vote required for gaining seat in the legislature did ensure that very small parties would not be able to compete. However, it allowed medium sized parties to survive and even gave them a chance to be highly over-represented in case some other party happened to receive 10 percent of the popular vote. The stakes for reaching office were raised further by the freer hand that the executive was given in making policies. This was particularly important because a party that was in power for a while had a greater chance of shifting resources around and ensuring that its own goals are met. These high stakes also meant that the parties in office had little hope of mustering support from those outside, which vied for creating a situation that brought down the incumbent government and gave them another chance at the elections. Of course, it is possible in such situations that the ruling politicians opt for prudent use of resources, improve overall economic conditions, and gain popular support to survive in office over a longer period of time. But, that was not a likely scenario in Turkey because governments came to office saddled with major problems from the past. These took time to resolve and some of them were hidden or contingent liabilities for the government that acted as a time bomb. When such problems came to the fore, managing them took a great deal of energy and pushing the blame for them to the predecessors would not solve them. Caught between the options to address long term problems with uncertain credit and to deal with the immediate problems and receive credit from one's immediate constituency, in most cases the Turkish politicians often opted for the latter. This was particularly natural in coalition governments where sharing the blames and credits suffers from a free rider problem. Empirical analysis of budget deficits in Turkey by Tutar and Tansel (2000) confirms such effects.

An important way that the ruling politicians used their powers was to create extra-budgetary funds (EBFs) and off-budget liabilities. In both cases, vast amounts of resources could be directed towards the politicians' preferred goals without much oversight from the legislature or other sources. In the case of EBFs, the formation of the funds and the sources on which they could set levies had to be legislated, but the amount of levies and expenditures of the funds were decided by the cabinet (Önis, 1991). EBFs had existed before in Turkey, but on a limited scale. In 1981, they accounted for 1.3% of GNP. However, after the elections of 1983 EBFs proliferated quickly and by the early 1990s came to control almost 6% of GNP and well over a third of budgetary revenues (Figure 8; see also Önis and Webb, 1994: 152). The off-budget and contingent liabilities must have been even larger because during the 1990s, the average budget deficit was about 8 percent of GDP, of which about 3 percent of GDP was financed by seigniorage (increase in reserve money as a share of GDP). At the same time, government debt was increasing each year by an average of about 22 percent of GDP. This means that the government must have taken over liabilities in the order of about 17 percent of GDP per year (see Figure 10)! Adding this number to the total budgetary and EBF expenditures make it clear that the government must have been spending close to 50 percent of GDP, with about half of it in the budget and the other half managed more freely by the executive outside the budget.

An important factor that motivated the legislature and other sources of power to tolerate such arrangements was that they or their constituency could also be among beneficiaries of the system. The executive's discretion over large amounts of funds allowed him/her to compensate, directly or indirectly, those who were in positions to challenge the arrangements. Moreover, the uses of the funds targeted large blocks of voters, offering them jobs, financial assistance, and subsidized goods and services (e.g., housing, fuel, education, healthcare, etc.). For example, one of the EBFs provided mass housing, which help low income families as well as the workers and businesses in the construction industry. Some of the benefits were also indirect, e.g., when the funds were allowed to levy taxes on imports, hence generating protection for the import competing industries. In fact, in the late 1980s, this tactic partially reversed the import liberalizations of the first half of 1980s (Celasun, 1994: 468).

A factor that made matters worse in terms of allocation of off-budget resources was the unstable nature of the coalition governments that emerged from the elections. Coalition members gained control over large resources, but had little incentive to allocate them efficiently to long term goals because they understood that their tenure could not last long.

The weak incentives of the politicians in Turkey to improve the performance of fiscal policy are also reflected in the frail nature of the country's budget institutions. The study of those institutions by Atiyas and Sayın (1999) shows that even the part of government expenditures that is formally included in the budget lacks transparency, performance assessment, and audit. In fact, the budget law is hardly binding and there are few checks and balances.

In the context of political institutions described above, the need to maintain liberal trade and show commitment to EU membership posed a particular challenge for Turkey. Once domestic markets were opened, a host of people who faced stiff competition from abroad came to the government demanding support. Given the government's discretion to redistribute resources at large scale, it was difficult not to respond to those demands. This was an important reason why off-budget expenditures started growing in the mid-1980s. In particular, the government used off-budget resources to support public works projects, cheap credit for the private sector, and subsidies to public enterprises to help them maintain their employment and wages (Önis and Webb, 1994: 170).

A more direct piece of evidence that connects trade liberalization with fiscal problems in Turkey comes from Esfahani and Leaphart's (2000) study of trade policy in Turkey. They find that in 1988, following the trade policy reforms of the mid-1980s, protection rates were lower in industries that were dominated by public enterprises. They argue that this was because the government had a more direct way of supporting such enterprises and therefore, had an easier time removing their trade barriers. They show that protection had remained higher for small, labor-intensive, private firms, which the government had greater difficulty offering direct support, protection rates.

The fiscal situation worsened in the late 1980s when the ban on parties and politicians was lifted and political competition increased. As we have seen, on-budget and off-budget government expenditures increased while taxes remained constant relative to GDP. This is also reflected in the huge real wage increases in manufacturing, especially the public sector, during that time (Figure 11). Interestingly, despite doubling of real labor costs during 1988 and 1991 and economic contraction during 1989, the unemployment rate in Turkey remained steady (Figure 12). One may be tempted to see this outcome as a consequence of productivity increases. However, as Figure 13 shows, increases in productivity during those years do not come close to explaining the pattern of wage increases.

The massive increases in public expenditures after the mid-1980s eventually brought about the crises of 1989 and 1994. The latter in particular was associated with sharp declines in real wages and incomes. The government came under increasing pressure from domestic and international sources to curb its use of off-budget mechanisms. The instability was also hurting the cause of joining the EU. This process led to a reduction in the size of EBFs. However, the government ended up resorting to more subtle and less visible mechanisms as we will discuss in the next section.

5. Customs Union and EU Membership Candidacy

The Turkey-EU negotiations after 1989 led to the formation of a customs union on January 1, 1996. Many political issues remained to be resolved, but economic ones had become less of a concern for customs union formation. A major difficulty for Turkey, Greece's opposition, had changed by the mid-1990s because Greece now felt that the Cyprus problem may be solved more easily with Turkey joining Europe than being outside. The formation of the custom union 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 Europe for products originating outside the EU. The benefits to Turkey were mainly the 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.

Finally, after a few years of further negotiation, on December 10, 1999, the EU summit in Helsinki agreed to recognize Turkey as an applicant country. Turkey accepted the conditions after some hesitation and began a process of more intensive political and economic reforms. On the political front, in 2001, Turkey overhauled much of its military-drafted constitution to fulfill EU political criteria. In 2002, the Turkish parliament passed sweeping reforms, including the abolition of the death penalty and the easing of bans on the use of the Kurdish language, to meet some of the EU's human rights criteria. Also, the parliament overwhelmingly approved a package of human rights reforms, including sanctions against torture.

On the economic front, the most important issue on the agenda was stabilization. To this end, in December 1999, as its candidacy for EU membership was confirmed, Turkey signed a standby agreement with the IMF and initiated an exchange rate-based stabilization and later on opened up its capital account. The confidence created by the EU's offer and IMF backing encouraged a sudden surge in foreign lending and foreign direct investment inflow into Turkey (see Figures 6 and 15). The government of Turkey allowed the domestic banks to borrow extensively from abroad and invest in domestic treasury bonds, which had very high yields. This move turned out to be a return to the old strategies for having access to off-budget resources. The massive capital inflow ended up essentially in the government's hand, which ultimately could not be sustained at the high the interest rates being offered. In November 2000, some of the private banks faced difficulties and the problem soon spread to a larger group and ultimately engulfed government banks as well. The government's attempt to devalue the currency further speeded up the process. In 2001, the government had to assume debts equal to about 45 percent of GDP.

Inflation remained high and GDP dropped by 8 percent. The cycle of instability seemed to have returned even with the promise of full membership at hand.

Besides the above reforms, some of which may ultimately bear fruit, the customs union and the EU candidacy have so far had little tangible benefits for Turkey. As pointed out above, foreign direct investment experienced small surges in 1996 and 2000-2001, but both case were short lived (Figure 6). In fact, total private investment in Turkey has declined since 1998. Regarding trade, since Turkey had already liberalized its trade rather broadly and enjoyed a great deal of access to European markets, the customs union did not have much impact on the volume of trade between Turkey and Europe (Figure 3). Neither does it seem to have affected the existing trends in the structures of production and exports. Industry and manufacturing seem to be losing their shares in GDP, with the notable exception of machinery and transport equipment (Figure 2). Sectoral productivities in industry and services are also continuing their steady growth (Figure 13). With regard to the structure of exports, the share of textiles in merchandize exports has started to decline, while the share of manufactured products continues to rise (Figure 4). However, there is some evidence that Turkish exports are becoming less concentrated, although the range of 3-digit items being exported (as reflected in the number of product lines) has remained more or less constant (Figure 14). In other words, diversification in terms of the types of products being exported seems to have reached a plateau in recent years, but the weight of each in total exports has gotten more uniform across products. This is also contributing greater stability in the terms of trade (Figure 5). Finally, the customs union and the EU membership candidacy has been associated with a steady rise in unemployment rate, though real wages also have increased somewhat (Figures 11 and 12).

6. Conclusion

The review of Turkey-EC/EU relation in this paper highlights some of the dilemmas of economic integration between developed and developing countries. It shows that when domestic policymaking institutions are weak, the opportunity for joining a developed economic union could be a mixed blessing. While there is a clear promise of gains from integration and the extension of developed country's support and confidence, an institutionally weak country may end up making costly compromises. It may have to reverse the sequence of reforms that suits it best in order to keep the interests of the stronger partner alive, especially when there are competitors who might jump in and spoil the relationship. These difficulties should not be ignored in evaluating the benefits of proceeding with integration and the way it should be done.

References

Arat, Yesim, 1991, "Politics and Big Business: Janus-Faced Link to the State," in Heper (1991a): 135-147.

Atiyas, İzak, and Şerif Sayın. 1999. "Budgetary Institutions in Turkey," manuscript, the World Bank, Washington, DC.

Celasun, Merih, 1994, "Trade and Liberalization in Turkey," in Gerald K. Helleiner, ed., *Trade Policy and Industrialization in Turbulent Times*, London: Routlegde: 453-484.

Commission of the European Communities. 1989. "Commission Opinion on Turkey's Request for Accession to the Community", Brussels, December 18, 1989.

Esfahani, Hadi Salehi, and HoeJeong Kim. 2002. "Hiding Public Debt," manuscript, University of Illinois.

Esfahani, Hadi Salehi, and Stephanie Leaphart, 2000. "Testing the Political Economy Models of Trade Policy: A Generalized Methodology with an Application to Turkey … and Some New Results," manuscript, University of Illinois.

Evin, Ahmet, 1994, "Demilitarization and Civilianization of the Regime," in Heper and Evin (1994): 23-48.

Heper, Metin, 1994, "Trials and Tribulations of Democracy in the Third Turkish Republic," in Heper and Evin (1994): 231-241.

Krueger, Anne O., and Baran Tuncer. 1982. "Growth of Factor Productivity in Turkish Manufacturing Industries," *Journal of Development Economics*, 11.3: 307-325.

Önis, Ziya, 1991, "The Political Economy of Turkey in the 1980s: Anatomy of Unorthodox Liberalism," in Metin Heper, ed., *Strong State and Economic Interest Groups: The Post-1980 Turkish Experience*, de Gruyter, Berlin: 27-40.

Önis, Ziya. 2001. "An Awkward Partnership: Turkey's Relations with the European Union in Comparative-Historical Perspective," *Journal of European Integration History*, 7.1: 105-119.

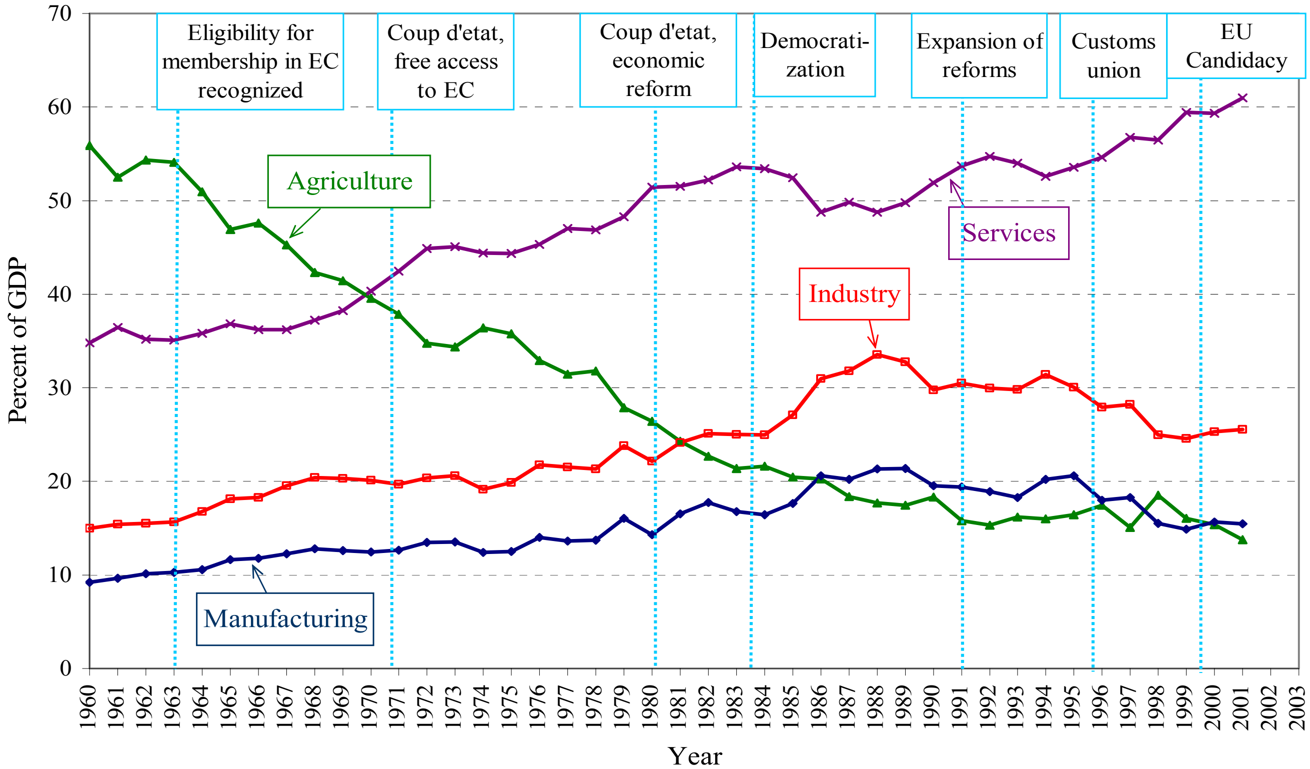
Önis, Ziya, and Steven B. Webb, 1994, "Turkey: Democratization and Adjustment from above," in Stephan Haggard and Steven B. Webb, *Voting for Reform*, A World Bank Book, Oxford University Press, Oxford: 128-184.

Sandalli, Nilufer. 2003. "Turkey-EU Relations," manuscript, the University of Illinois at Urbana-Champaign.

Sakallioglu, Ümit Cizre, 1991, "Labor: The Battered Community," in Metin Heper, ed., *Strong State and Economic Interest Groups: The Post-1980 Turkish Experience*, de Gruyter, Berlin: 57-69.

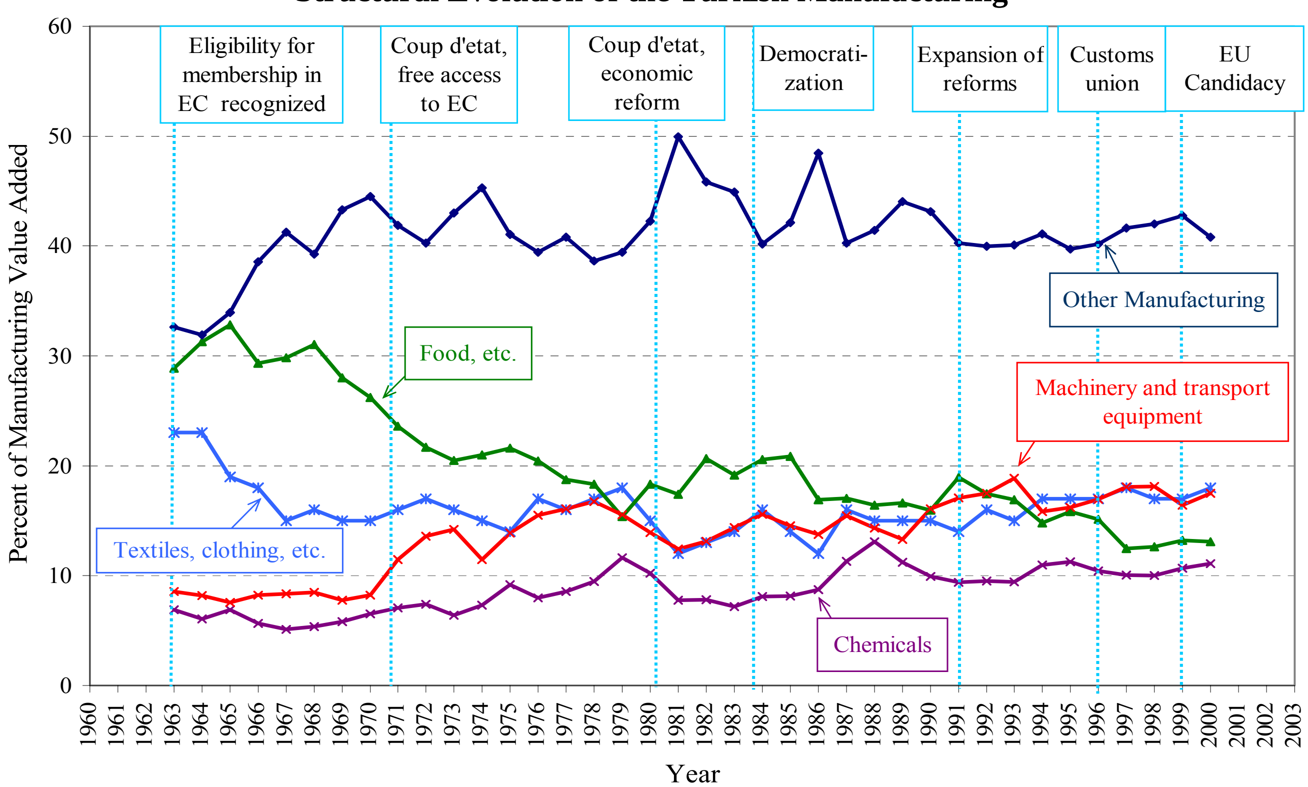
Tutar, Ibrahim, and Aysit Tansel. 2000. "Political Business Cycles, Institutional Structure And Budget Deficits In Turkey," Economic Research Forum for the Arab Countries, Iran, and Turkey, Working Paper 2019.

Figure 1
Structural Evolution of the Turkish Economy



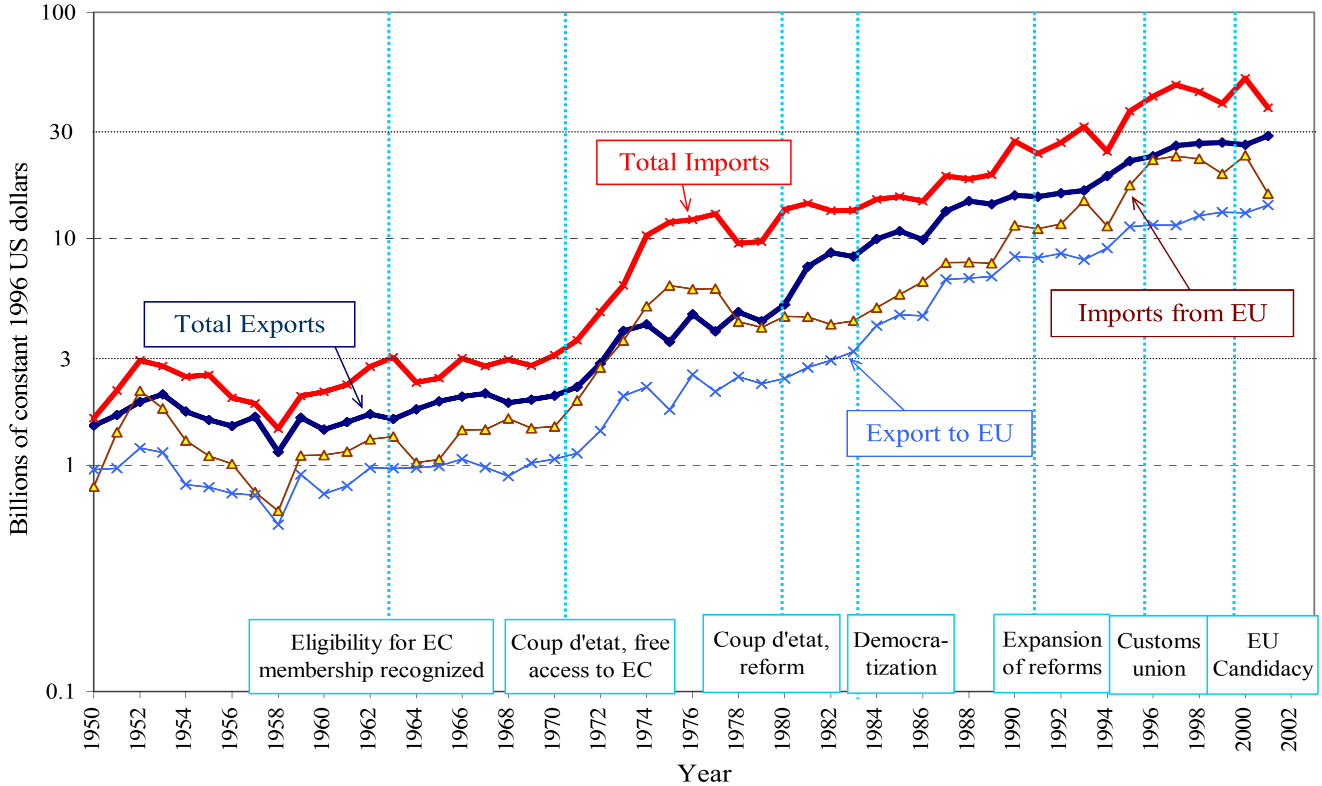
Source: The World Bank, *World Development Indicators*.

Figure 2
Structural Evolution of the Turkish Manufacturing



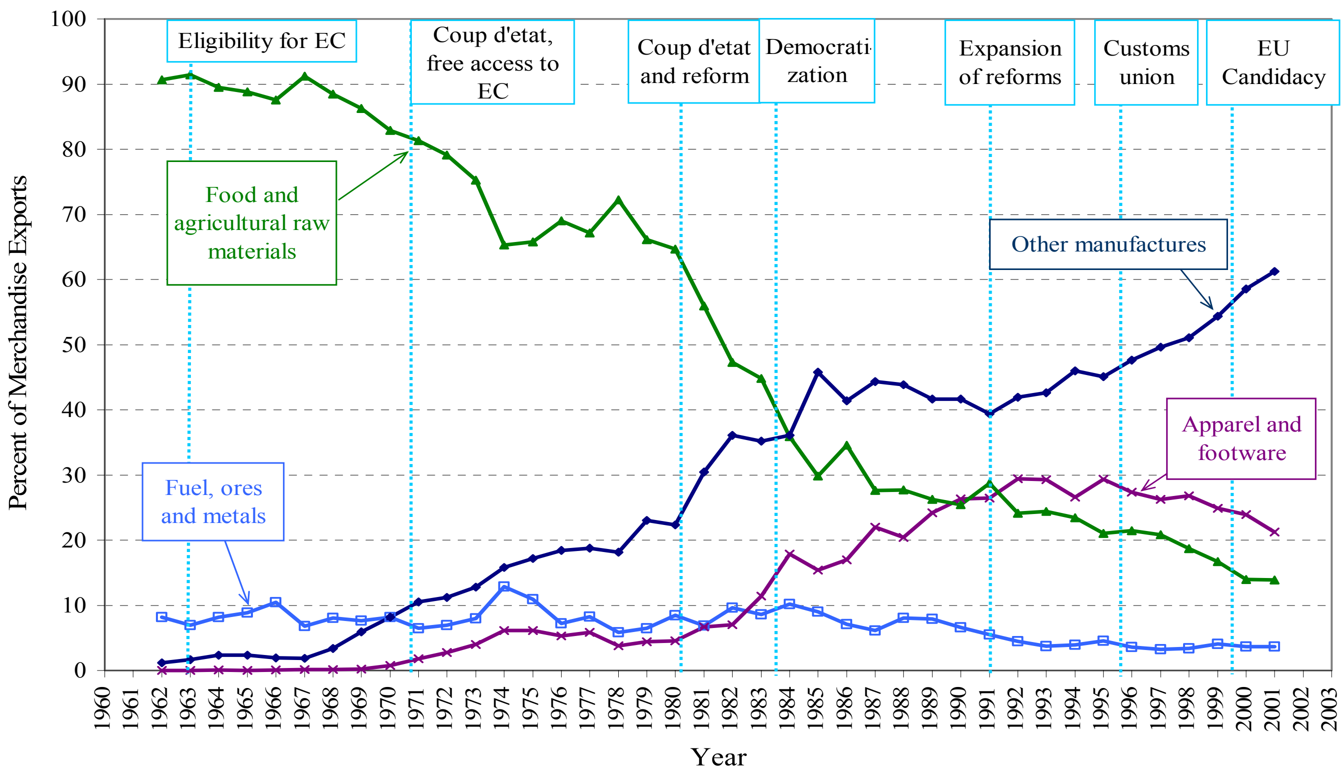
Source: The World Bank, *World Development Indicators*.

Figure 3
Turkey's Trade with the European Union and the World



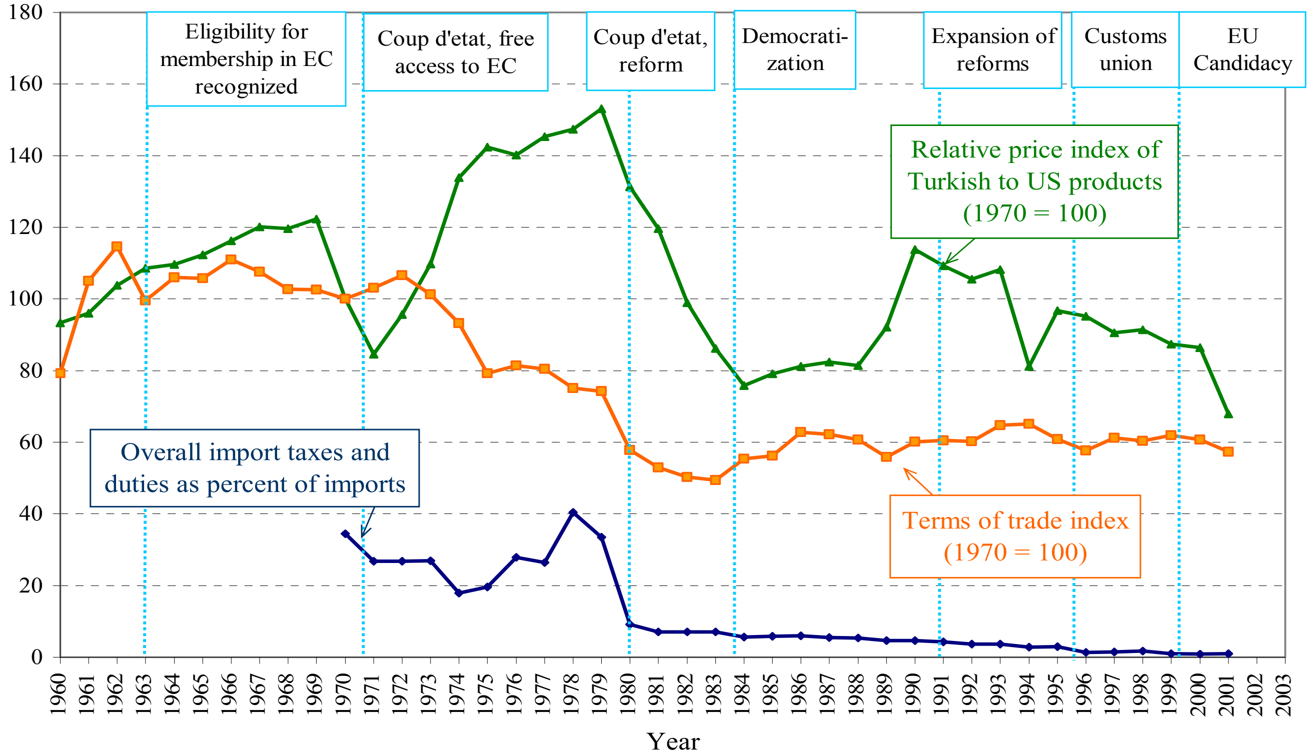
Source: UNCTAD, *Handbook of Statistics*.

Figure 4
The Structure of Merchandise Exports of the Turkish Economy



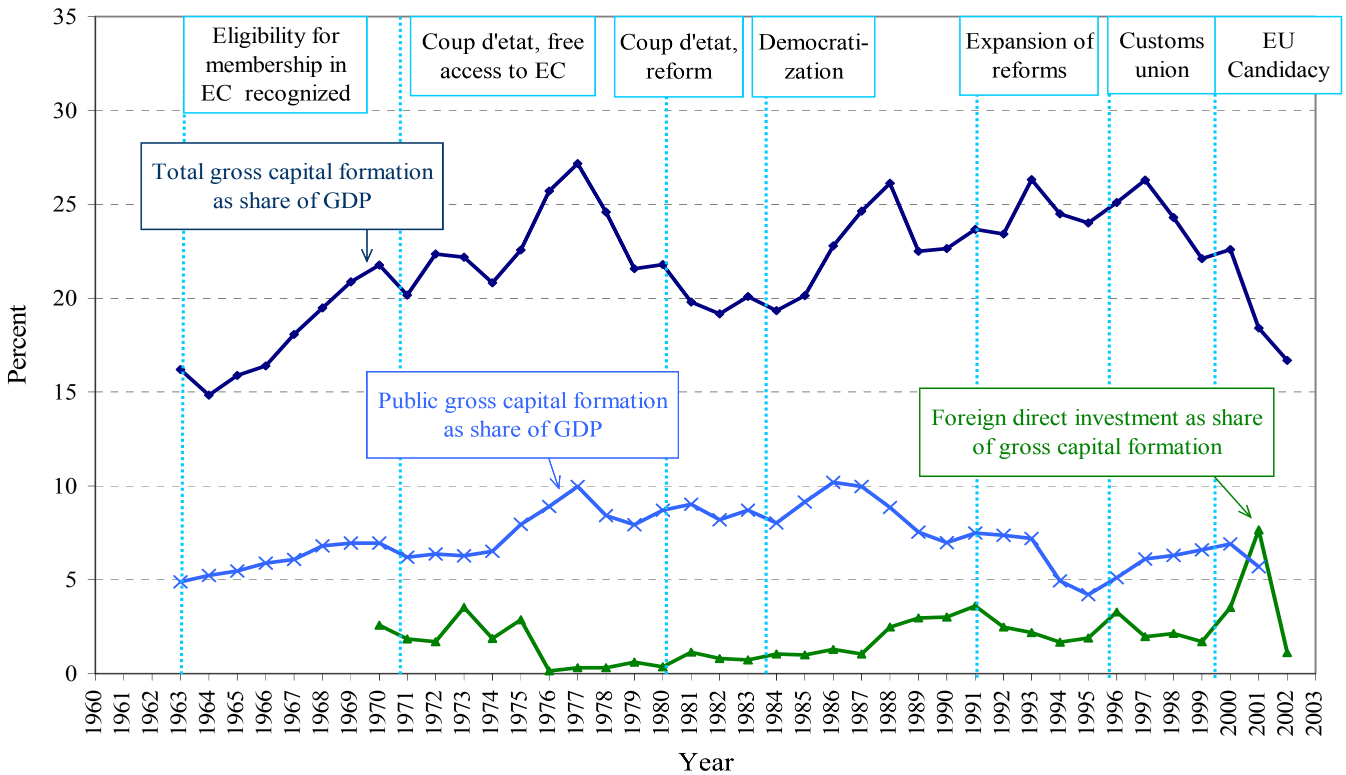
Source: The World Bank, *World Development Indicators*; UNCTAD, *Handbook of Statistics*.

Figure 5
Real Exchange Rate, Tariff Rate, and Terms of Trade



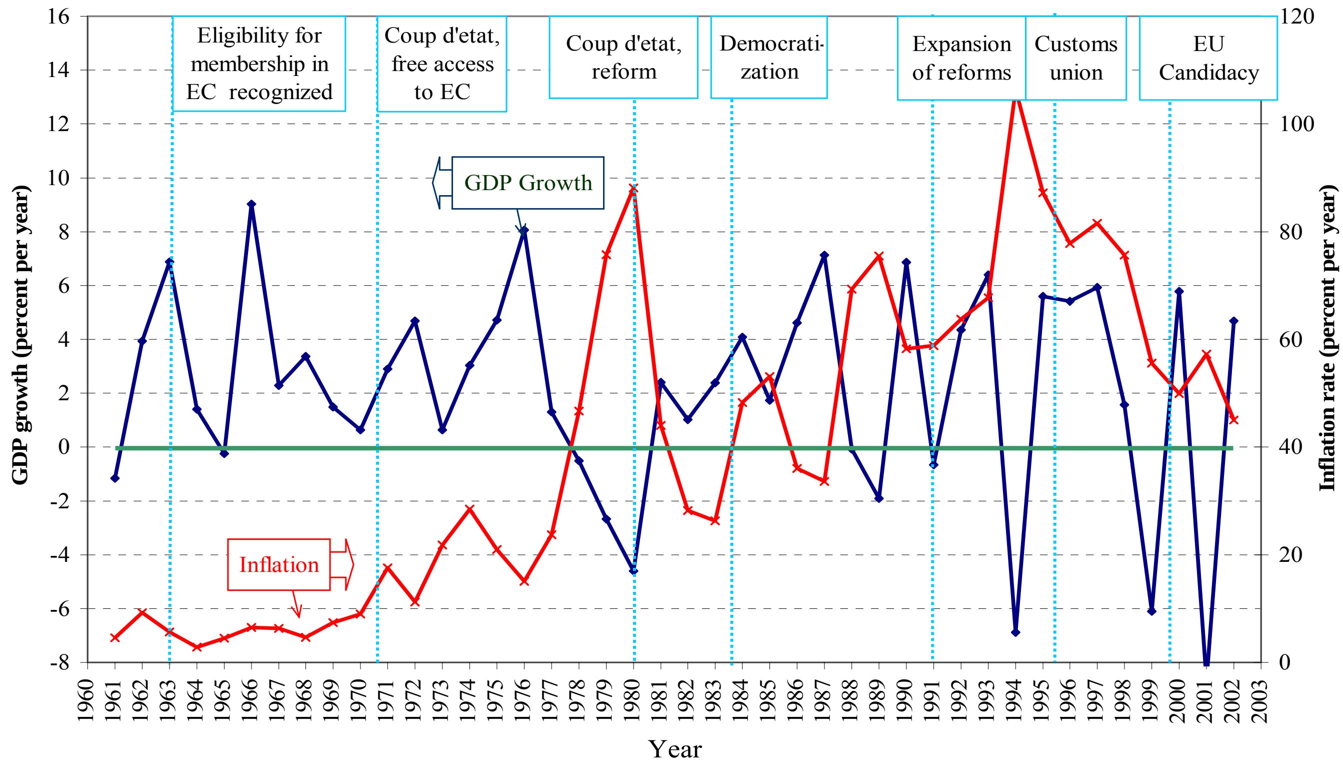
Source: The World Bank, *World Development Indicators*.

Figure 6
Capital Formation and Foreign Direct Investment in the Turkish Economy



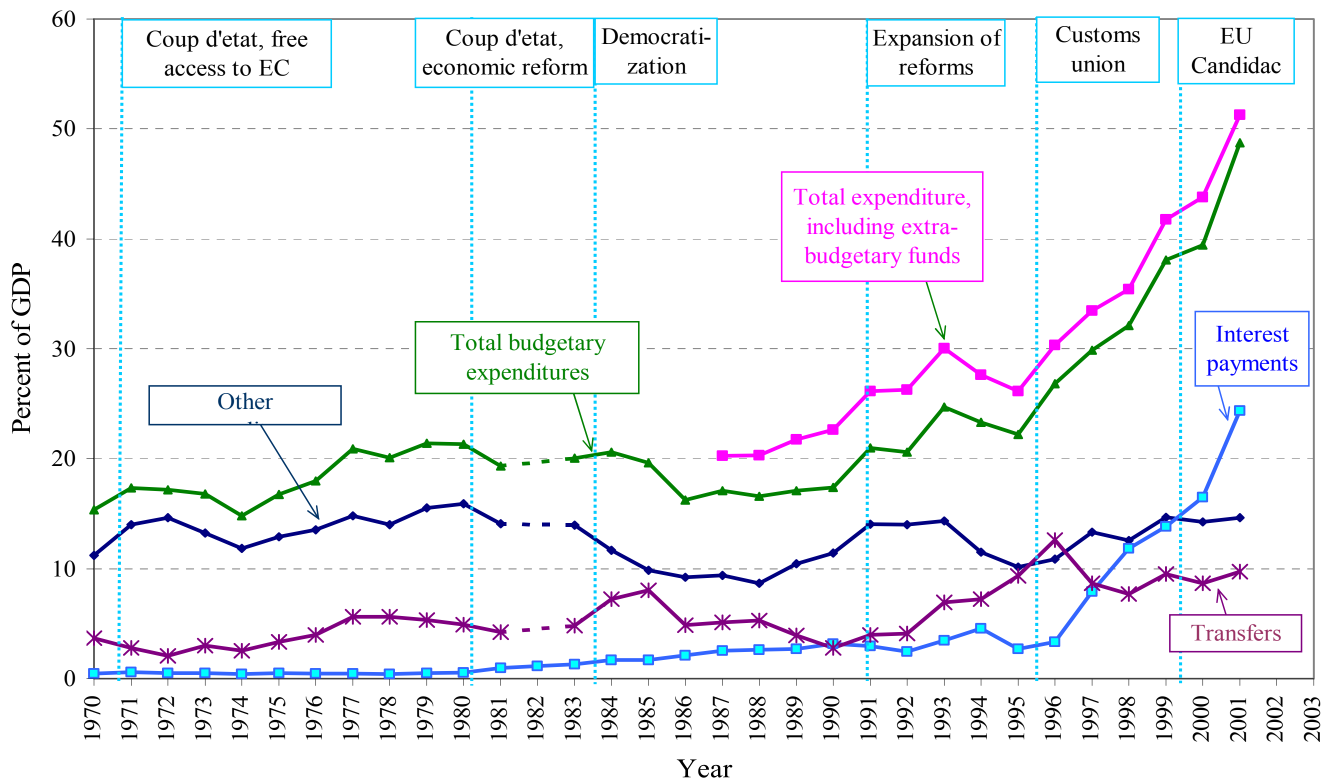
Source: State Planning Organization of Turkey, *Economic and Social Indicators*.

Figure 7
Inflation and Growth Rate of GDP per Capita in Turkey



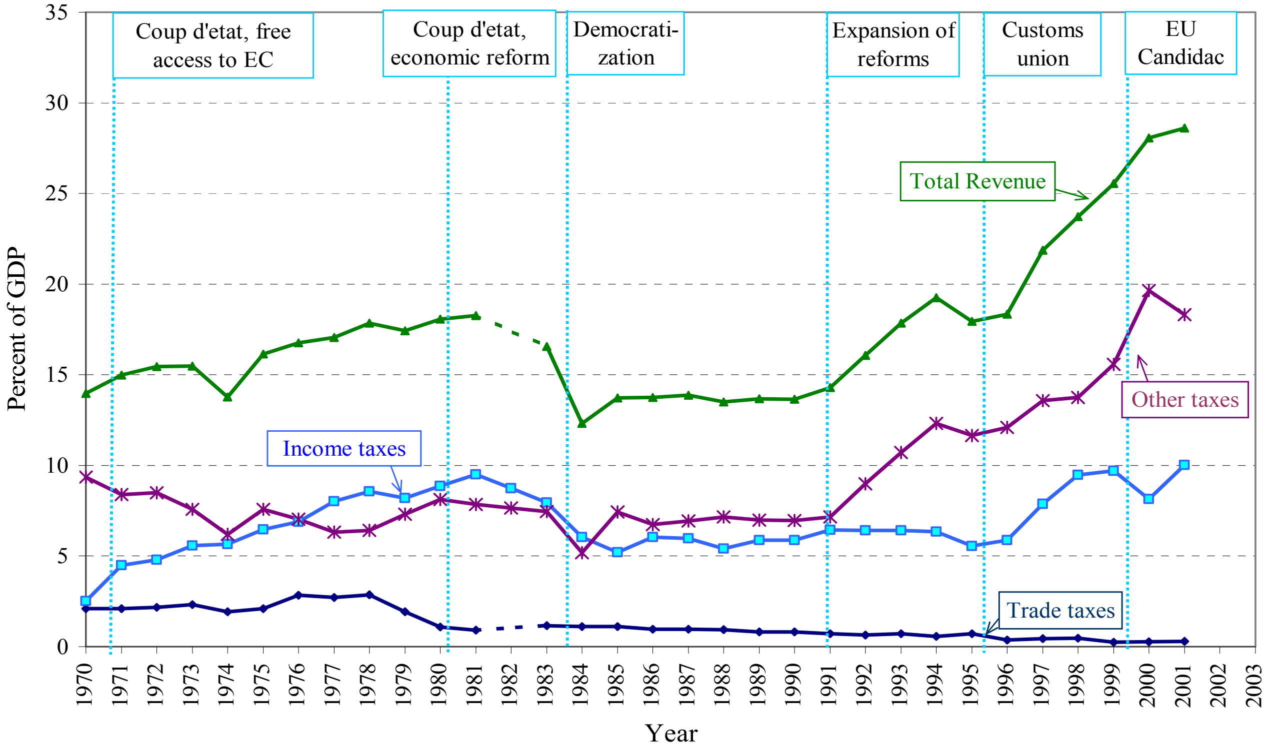
Source: The World Bank, *World Development Indicators*.

Figure 8
Government Expenditures by Cateogry as Share of GDP



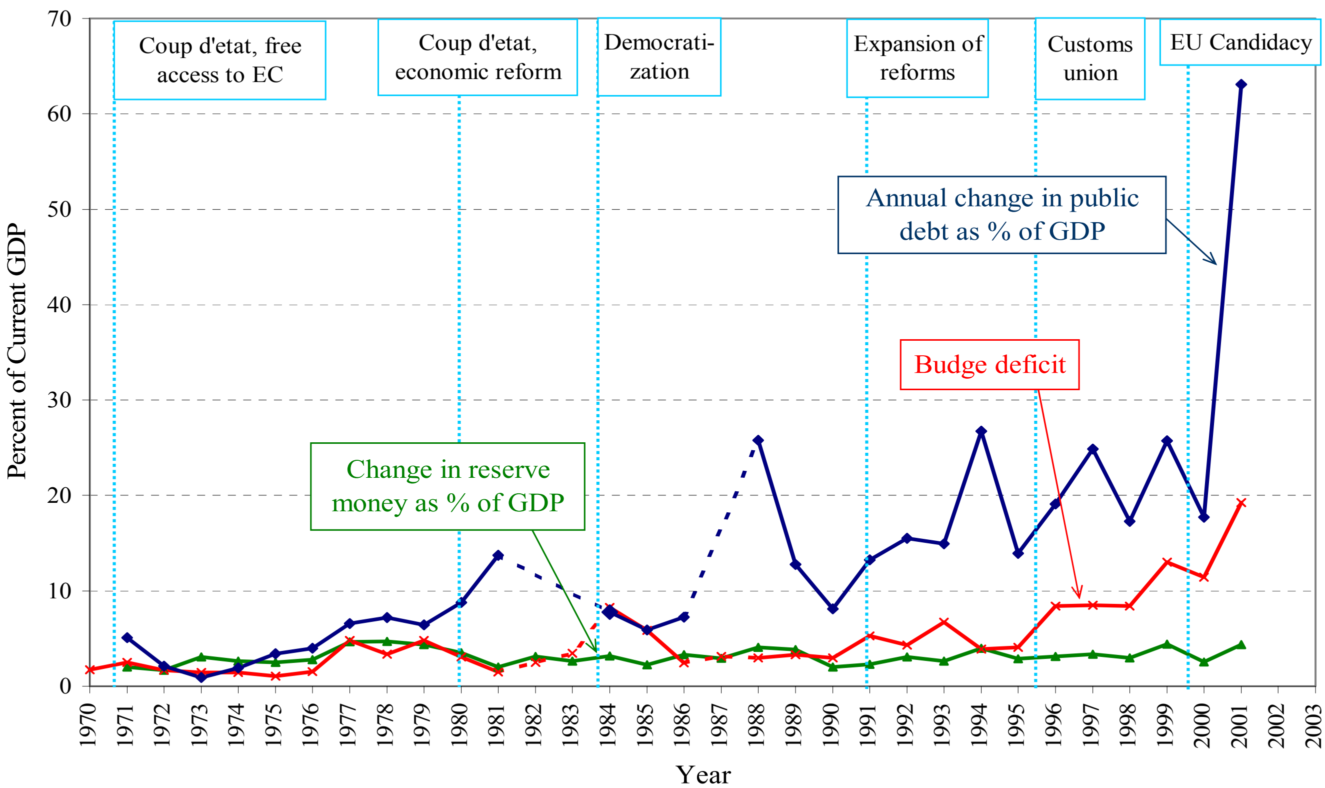
Source: The World Bank, *World Development Indicators*.

Figure 9
Government Revenues by Source as Share of GDP



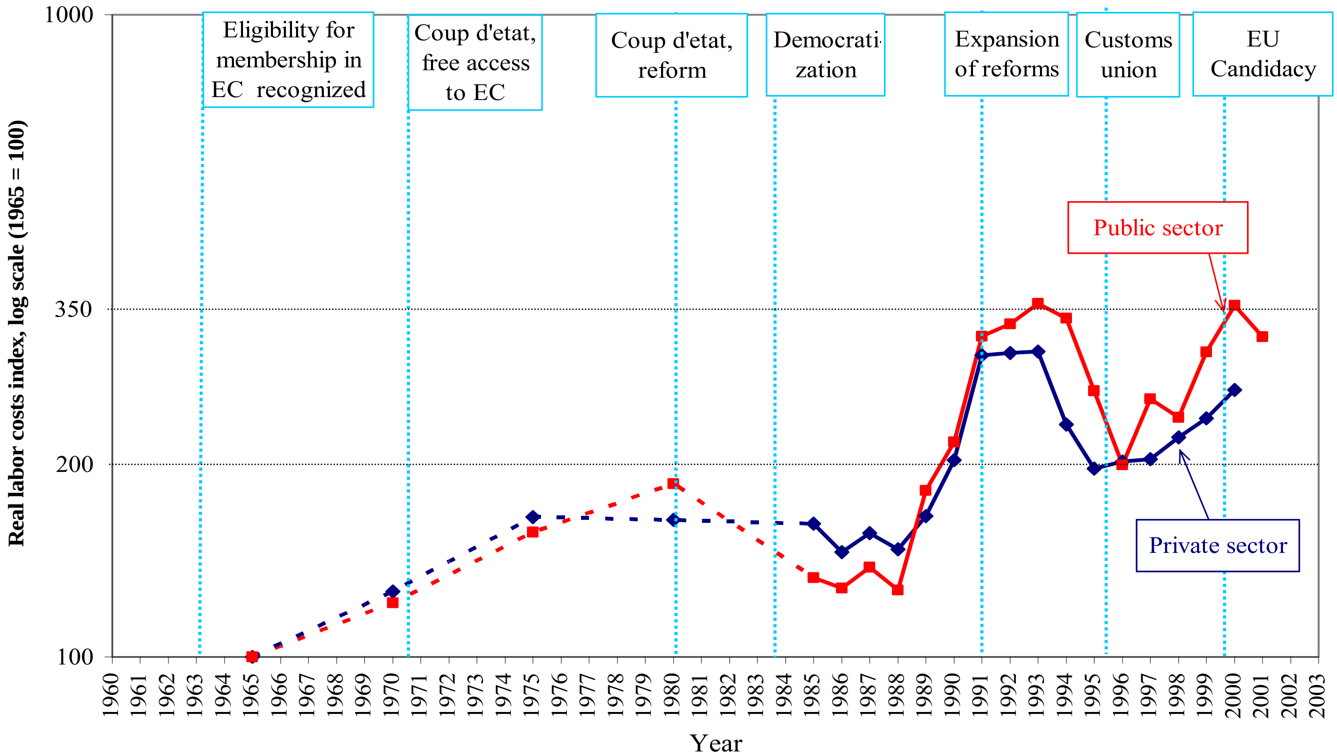
Source: The World Bank, *World Development Indicators*.

Figure 10
Deficit, Debt Change, and Monetary Expansion in Turkey



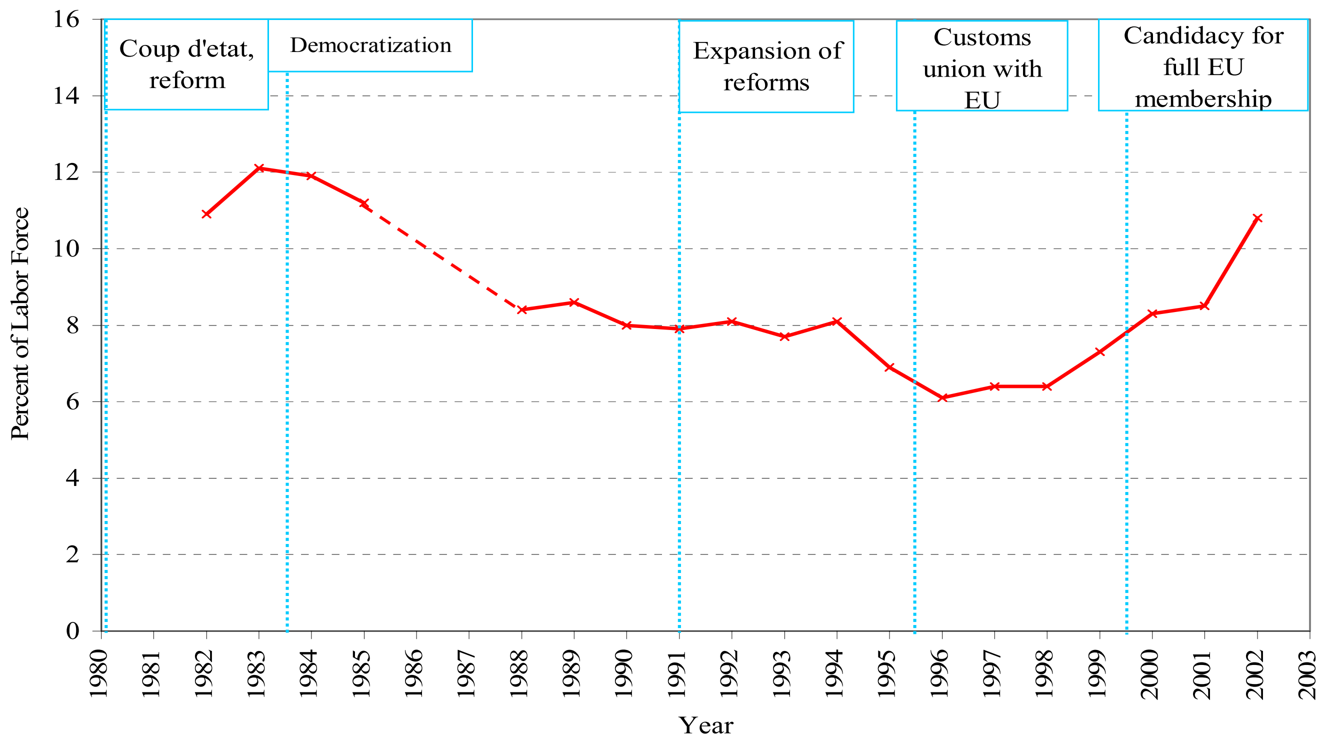
Source: The World Bank, *World Development Indicators*; IMF, *International Financial Statistics*.

Figure 11
Real Labor Cost Indices in Turkish Manufacturing



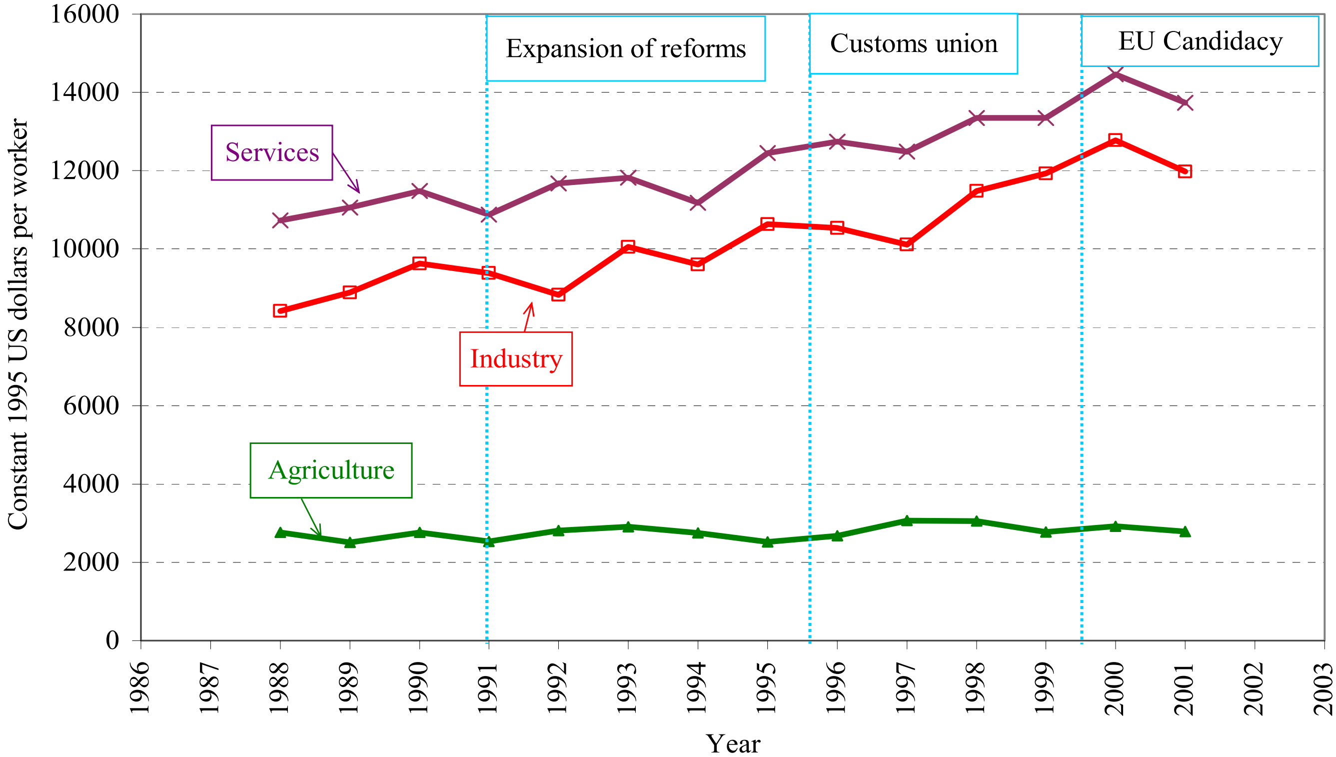
Source: State Planning Organization of Turkey, *Economic and Social Indicators*.

Figure 12
Unemployment Rate in Turkey



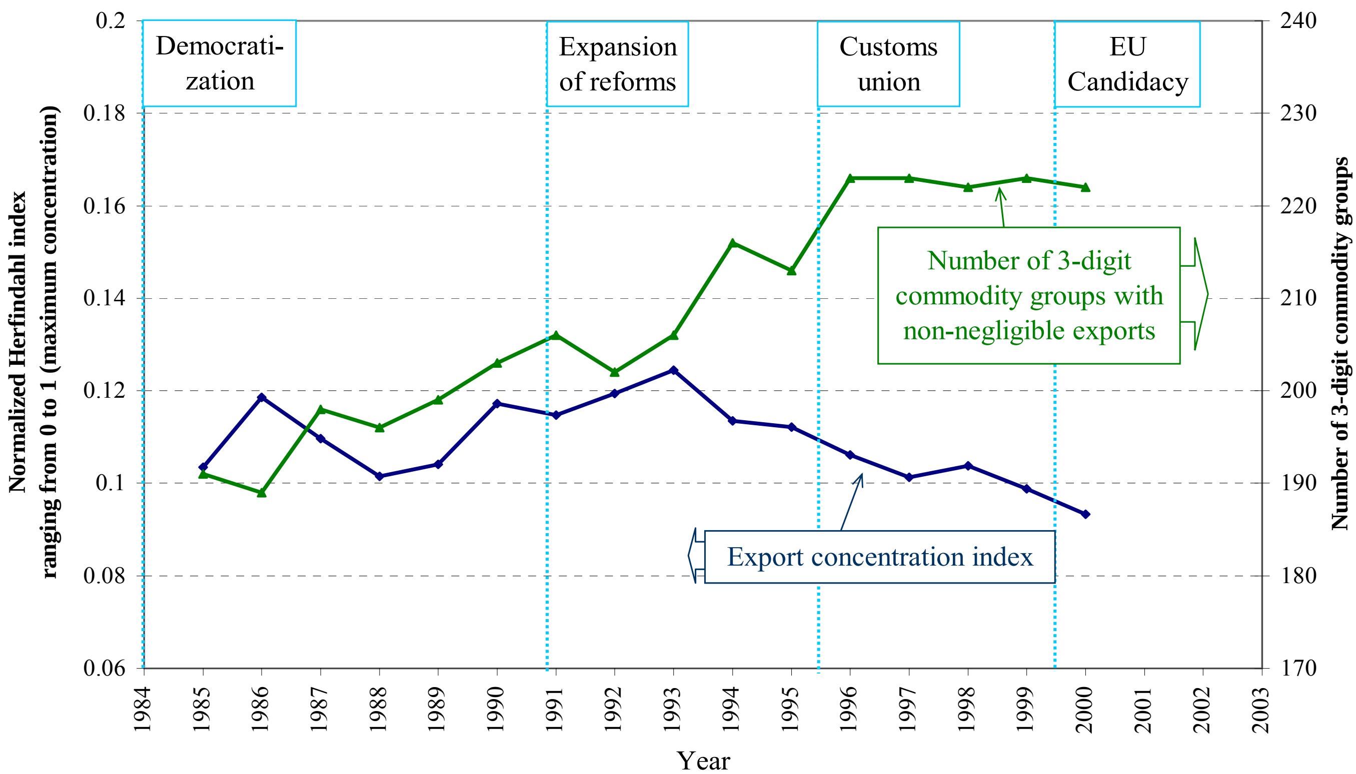
Source: The World Bank, *World Development Indicators*.

Figure 13
Worker Productivity by Main Sector in Turkey



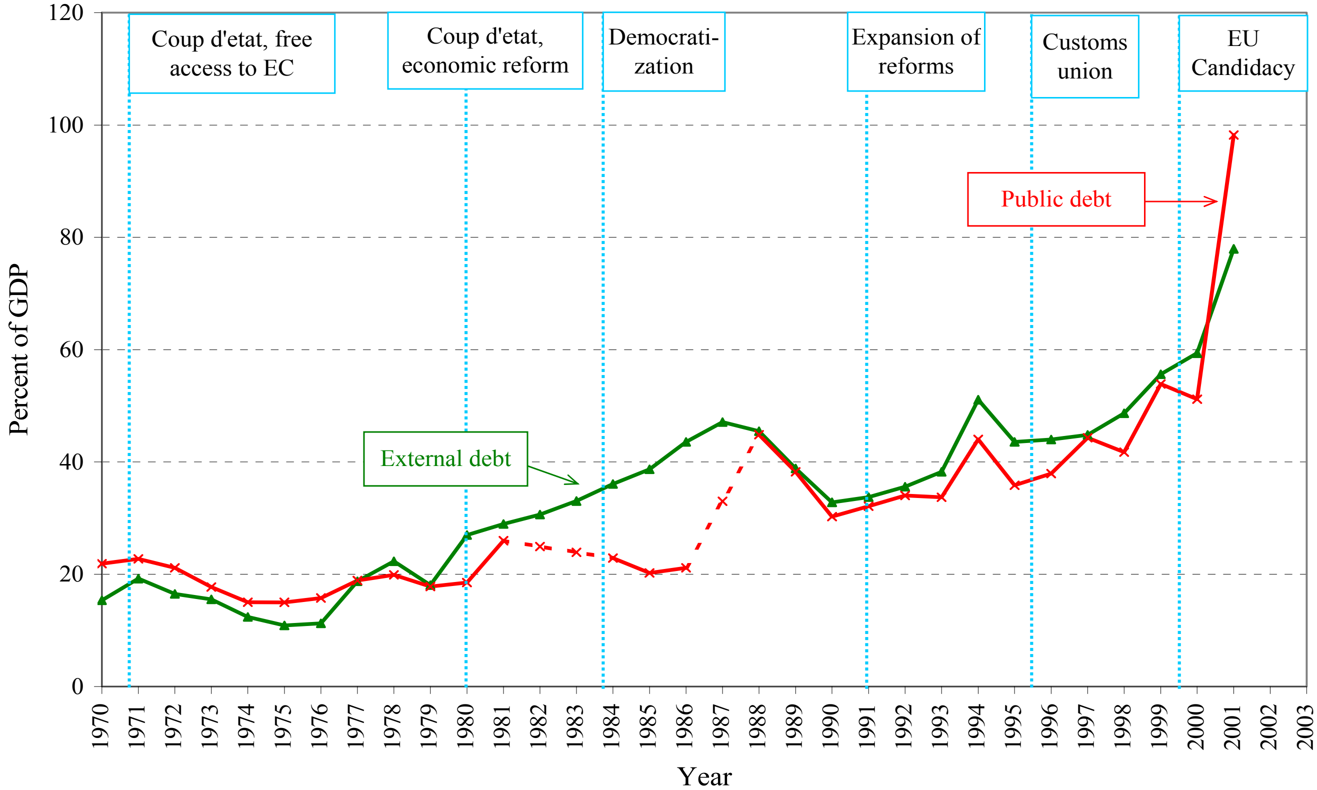
Source: State Planning Organization of Turkey, *Economic and Social Indicators*.

Figure 14
Diversification Indices of Turkey's Exports



Source: UNCTAD, *Handbook of Statistics*.

Figure 15
Government Debt and Total External Debt as Shares of GDP in Turkey



Source: The World Bank, *World Development Indicators*.