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TRADE POLICY REVIEW

TURKEY

Report by the Secretariat

This report, prepared for the Trade Policy Review of Turkey, has been drawn up by the WTO Secretariat on its own responsibility. The Secretariat has, as required by the Agreement establishing the Trade Policy Review Mechanism (Annex 3 of the Marrakesh Agreement Establishing the World Trade Organization), sought clarification from the Government of Turkey on its trade policies and practices.

Document WT/TPR/G/44 contains the policy statement submitted by the Government of Turkey

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INTRODUCTION

1. Since the previous Trade Policy Review in 1994, Turkey has implemented a wide range of reforms within the framework of the customs union between Turkey and the EU, taking it significantly beyond its Uruguay Round commitments as well as generating improved and more secure trading opportunities for third countries. In addition to halving its manufacturing tariffs to the levels of the EU common external tariff (CET), Turkey has also harmonized much of its legislation with that of the EU in areas such as competition policy, customs provisions, intellectual property rights and standards. While the Customs Union Decision (CUD) has clearly resulted in an overall liberalization, some new trade measures were introduced as a result of the customs union (quantitative restrictions on textiles and clothing, and tariff quotas). Another area of concern is the policy imbalance between manufacturing and agriculture: over the past four years, the manufacturing sector has experienced substantial liberalization while transfers to the already heavily supported agricultural sector have increased. In addition, macroeconomic imbalances (high fiscal deficits and inflation) and slow progress in the implementation of key structural reforms (including in the social security system, the privatization programme and in banking) may threaten the sustainability of Turkey's strong, but variable, growth performance.

(1) ECONOMIC ENVIRONMENT

2. In 1994, the Turkish economy experienced a severe recession, following growth of 8% in 1993. A severe budget deficit and real currency appreciation triggered a financial and foreign exchange crisis at the beginning of 1994, leading to a contraction of 6% in GNP for the year. However, the economy quickly recovered, aided by the customs union between Turkey and the EU and deregulation in general: annual average growth between 1995 and 1997 was 7.7%.

Over the same period, the current account deficit widened somewhat but was generally kept at a manageable level. Gross international reserves accumulated to a record high of nearly five months of merchandise imports and the real exchange rate remained relatively stable.

3. Historically, expenditures on state economic enterprises were a major source of Turkey's fiscal imbalances. These have largely been brought under control; however, social security spending and interest payments have now become major causes of the deficit. In the past, monetization of deficits contributed to high inflation, but the new Banking Act has greatly limited the Central Bank's ability to do so. The Government has, instead, resorted to domestic borrowing on the open market. As a result, the public sector borrowing requirement almost doubled between 1995 and 1997, reaching 8% of GNP. This has driven up real interest rates, threatening to crowd out private investment.

4. Despite the recovery, the overall economic situation remains fragile, particularly in respect of price inflation. Macroeconomic imbalances and slow progress in the implementation of key structural reforms (including in the social security system, the privatization programme, and banking) may threaten the sustainability of the strong growth performance.

(2) DEVELOPMENTS IN TURKEY'S TRADE POLICY REGIME

5. Far-reaching structural and legislative reforms have been undertaken by Turkey in connection with its customs union with the European Union. Exposure to foreign competition has increased as trade barriers have been lowered on an MFN basis, and many trade-related reforms have been implemented while others are in the pipeline. Examples include the adoption of new *legislation protecting intellectual property rights and the establishment of a competition authority. Over the past four years, Turkey has also enacted a comprehensive law on privatization and simplified its already relatively liberal foreign direct investment regime. However, the restructuring of the costly social security system, the implementation of the privatization programme and reform of the banking sector are areas where much remains to be done.*

6. Within the framework of the Customs Union Decision (CUD), which entered into force in January 1996, Turkey has eliminated tariffs on manufactured imports originating in the EU, adopted the EU common external tariff (CET) for manufactures and the industrial component of processed agricultural products, and is progressively aligning itself to the EU's preferential trade regime, as required. The CUD goes well beyond the basic requirements of a customs union; in the context of the Decision, Turkey has enacted a wide range of trade and trade-related legislation, seeking to apply many elements of the "acquis communautaire" in the areas of customs provisions, duty concessions, officially supported export credits, competition policy, state aid, intellectual property rights, standards, and sanitary and phytosanitary measures. Turkey has until 2001 to implement the CUD fully.

7. Generally, the adoption of the CUD has improved market access conditions for third countries to most sectors of the Turkish market, and the implementation of many of the trade-related reforms will improve the business environment for foreign investors and traders. The Decision, however, has also obliged Turkey to introduce some new external trade measures to achieve harmonization with those of the EU. For example, the adoption of the EU textile and clothing regime was designed to close the bridge to the EU market that would otherwise be opened under the CUD; this measure is currently subject to a challenge by India under WTO dispute procedures. Turkey itself is a major exporter and very limited importer of textiles and clothing. Turkey has also introduced tariff quotas on some agricultural and processed agricultural products in the framework of some of its recently signed free-trade agreements; these include agreements with the Baltic States (Estonia, Latvia and Lithuania), several Eastern European countries (Bulgaria, Czech Republic, Hungary, Romania, Slovak Republic and Slovenia) and Israel.

8. As bilateral barriers have been lifted, trade between Turkey and the EU has grown. Imports from the EU increased from US$17 billion in 1995 to US$25 billion in 1997, amounting to about half of Turkey's imports. However, exports to the EU increased only marginally, as most manufactured exports have been traded duty-free since the early 1970s and agriculture is yet to be liberalized. While there may be concern about trade diversion, third countries should generally benefit from the alignment of Turkey's tariffs with the EU CET. Since 1 January 1996, Turkey has been applying the same rules of origin as the EU with respect to imports from third countries, in terms of both preferential and non-preferential rules.

9. In most areas, Turkey's commitments towards the EU involve obligations exceeding those of the WTO Agreements. However, some legislative changes introduced since the previous Review have also been induced by WTO commitments including on trade-related aspects of intellectual property rights (TRIPS) and safeguards. As a result of the Uruguay Round, the share of bound tariff lines increased from 31 to 46%, with all agricultural lines bound. While nominal bindings in industry are generally well above applied rates, the CUD obliges Turkey not to impose higher tariffs than the EU common external tariff (except in areas where the CUD does not apply, mainly in agriculture) with the consequence that Turkey's tariff is, in practical terms, bound at EU rates. Turkey also made extensive commitments under the General Agreement on Trade in Services (GATS); its *schedule covers 72 activities out of a total of 161 in nine sectors. Since then, Turkey has become a party to the 1995 Interim Agreement on Financial Services, the 1997 Agreement on Telecommunications Services, the 1997 Information Technology Agreement (ITA), and the 1997 Agreement on Financial Services. Turkey ceased to apply Article XVIII:B ("balance-of-payments" article) of GATT in 1997.*

(3) SPECIFIC TRADE AND TRADE-RELATED MEASURES

(i) Tariff and non-tariff border measures

10. Since the previous Trade Policy Review in 1994, Turkey has further opened its economy to foreign competition. The Mass Housing Fund (MHF) levy has been virtually eliminated, thus simplifying taxes payable on imports and improving transparency. In 1998 the levy covered 3% of the tariff lines, compared with 87% in 1993. In addition, in January 1996, Turkey adopted the EU common external tariff (CET) on most industrial imports (except for 290 "sensitive" items at the twelve-digit level on which tariffs will remain above the CET until 1 January 2001) and on the industrial component of processed agricultural goods. As a result of these actions, the average level of border taxation (including the MHF) was cut by more than half from 27% in 1993 to 13% in 1998. On the other hand, substantial tariff dispersion continues to exist and there is a large number of tariff rates (242 distinct rates, excluding ad valorem equivalents) with the greatest variations seen in agriculture.

11. Turkey ranks sixth among WTO Members for the number of final anti-dumping measures imposed between 1989 and 1996; however, the number of new cases initiated has declined in recent years and no new final measures have been introduced since 1995. Turkey is not obliged under the CUD to adopt the EU's anti-dumping measures, and the two parties retain their mutual rights in this area. Import certificates were abolished in 1996, but a number of goods remain subject to prior import licensing, partly related to the enforcement of standards. Examples include certain telecommunications equipment, machinery, motor vehicles, transmission apparatus, chemicals and civil aircraft related products.

12. Turkey has eliminated many of its export incentive programmes, including the energy incentive (providing discounted prices on electricity, natural gas and liquified petroleum consumed in the production of exported products); free wheat (supply of wheat without payment to certain companies subject to export performance); and the transportation subsidy (for exports of some agricultural products). Instead, Turkey now relies on a wide range of indirect measures, including duty concessions and preferential credit allocation to exporters. Within the framework of the CUD, the OECD Consensus principles on officially supported export credits with a repayment term of two or more years have been adopted. Nevertheless, the Turk Eximbank incurs substantial negative net operating cash flows associated with its export and credit guarantee programmes. Since Turkey's previous review, the number of items prohibited for exports, by broad categories, has increased from seven to 14, while the items affected by export taxes has fallen from seven to two (hazelnuts and semi-processed leather).

(ii) Internal measures

13. Turkey's state-aid system of tax exemptions and concessional credit is complex, non-transparent and generous, amounting to 7.5% of GDP in agriculture alone. The wide range of factors determining the value of incentives poses difficulties in evaluating the impact of the schemes. Studies have emphasized the distortionary resource allocation effect of these measures.

14. State economic enterprises increased their share of GDP (at constant prices) from

8% in 1991 to 11% in 1994 (latest available data), but evidence suggests that this role may have diminished since then. Moreover, the financial position of the enterprises has improved, largely because of the adoption of more realistic, market-based pricing policies. Nevertheless, the demarcation between the private and the public sector is not always clearly defined. In this regard, the comprehensive privatization law of 1994 provides a framework for progress, but the privatization process has so far been slow and marred by legal disputes.

15. The private sector environment has improved with the enactment of a modern and comprehensive legal framework in the area of intellectual property and the establishment of a competition board. However, enforcement capacity is lagging behind the legislative progress.

(4) SECTORAL POLICIES

16. Since Turkey's previous Review, the already heavily supported agricultural sector has received increased assistance, while the manufacturing sector has opened up to foreign competition through lower border protection.

17. The agriculture sector accounts for 14% of GDP and employs about half of the labour force. The sector, which is largely excluded from the customs union, continues to be subject to extensive and costly government intervention. Support to the sector has increased in recent years. According to OECD estimates, total transfers (expressed in U.S. dollars) almost doubled in the period 1994 to 1997, reaching the equivalent of 7.5% of GDP. Support price interventions and the fertilizer subsidy continue to be serious drains on the budget.

18. Tariff protection in the agriculture sector constitutes a significant barrier to imports, and has increased since the previous review; using the Uruguay Round definition, the average MFN tariff increased from 35% in 1993 to 43% in 1998. The food, beverage and tobacco subsectors are also characterized by strong tariff escalation, thereby maintaining higher levels of effective protection than is evident from the nominal rates. A ban on imports of live animals and meat has been in force since May 1996 to prevent the expansion of epidemic diseases (including bovine spongiform encephalopathy (BSE)).

19. While agriculture (other than the industrial element of processed items) is excluded from the customs union agreement, Turkey undertook important agricultural commitments in the Uruguay Round. All agricultural tariff lines were bound at levels equal to or above the sum of applied MFN rates and MHF levies. Unlike many WTO Members, however, Turkey did not undertake any "tariffication" for agricultural products. Turkey also undertook to reduce its budgetary outlays for export subsidies for 46 products by 24% and the volume of subsidized exports by 14%, in equal instalments over a ten-year period starting in 1995. However, it made no commitment to cutting financial support for agricultural producers, as the level of support computed by the Government was below the de minimis level of 10%.

20. As a result of the customs union and the phasing out of the MHF, Turkey's average MFN tariff on imports of manufactures (ISIC 3) more than halved from 27% in 1993 to 12% in 1998. Excluding food, beverages and tobacco manufacturing (ISIC 31), the average MFN rate for manufactures dropped from 25% to 5.5% over the same period. Trade between the EU and Turkey, with a few exceptions, is duty free. In the automobile sector, foreign investors have accepted as a "gentlemen's agreement", without any legal obligation, to incorporate a certain share of local content.

21. State economic enterprises dominate the energy sector (some 90% of the market is state-owned) and many prices are influenced by Government policies. In order to improve the functioning of the sector and to meet the projected energy demand, the sector is a *primary target for privatization. However, progress has so far been slow, with court rulings overturning many decisions.*

22. Since the previous review, several services areas are beginning to open up. However, investors in certain sectors, particularly finance and banking, require special government approval before setting up business. Privatization of dominant state economic enterprises in areas such as air transport and basic telecommunications was initiated with the enactment of the 1994 law on privatization, but, as with other sectors, progress has been slow. Five ports have so far been transferred to the private sector, while the main ports are owned and operated by state economic enterprises.

23. The banking sector suffers from a number of weaknesses. Preferential lending to favoured sectors, which accounts for about half of the loans to the state banks, not only introduces distortions but also has a high direct financial cost. Supervision and accounting standards need to be strengthened, while cross-ownership between banks and industrial companies may also imply that market principles for extending credits are not fully applied.

(5) OUTLOOK

24. While Turkey's overall economic performance is strong, the budget deficit continues to be a drag on the economy, causing high inflation and elevated real interest rates to the detriment of private investment. Moreover, the slow progress in the implementation of key structural reforms, such as reform of the social security system, may hinder improvement of the fiscal position. The efficiency of the economy would also benefit from moving ahead with the privatization of state economic enterprises and reform of the financial sector.

The reforms induced by the customs union between EU and Turkey are expected to have significant economic benefits, especially in terms of restructuring and modernization of the manufacturing sector; by and large, other countries should also benefit from the market-opening in manufactures and greater security in the trade regime and business environment. However, the agreement with the EU does not cover agricultural products, and the current trend of increasing support in this sector is contrary to the liberalization seen elsewhere in the economy. This sectoral imbalance could be a tax not just on consumer welfare but also implicitly on manufacturing and services that compete with agriculture for production factors.