

# TURKEY AND IRAN: AN ANALYSIS BASED ON MUTUAL TRADE AND DEFENSE SPENDING



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**ABSTRACT** | Turkey and Iran are two neighbors who are competing for being a regional power in the Middle East. Defense spending has an important status for both countries, in terms of both the state of continuous turmoil in the countries of the region and as an indicator of national power. On the other hand, there is an increasing volume of trade between two countries as well, in parallel to the trend of improvement in diplomatic relations within the last decade.

In this study, mutual trade relations between Turkey and Iran and effects of defense spending on the economies of both countries are discussed theoretically. Improvement of economic relations between both countries in 2000s resulted in a situation of mutual existence rather than regional competition. Further improvement and diversification of economic relations may have positive outcomes for both countries. The strengthening economic relations may change the perception of threat by two countries against each other and may allow utilization of some resources reserved for defense spending in more productive areas.

**Keywords:** Iran, Turkey, Trade, Defense spending

**JEL Classification:** F13, F52, H56, O53, P52.

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# TÜRKİYE VE İRAN: İKİLİ TİCARET VE SAVUNMA HARCAMALARI TEMELİNDE BİR ANALİZ



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**ÖZ** Türkiye ve İran Ortadoğu'da bölgesel bir güç olabilmek amacıyla olan iki komşudur. Gerek bölge ülkelerinin sürekli kargaşa halinde olması, gerek milli güçlerin önemli bir göstergesi olması açısından savunma harcamaları her iki ülkede de önemli bir yer tutmaktadır. verdikleri önemi artırmaktadırlar. Diğer yandan, son on yıldır iki ülke arasındaki diplomatik ilişkilerin gelişen seyrine paralel olarak artan bir dış ticaret hacmi de söz konusudur.

Bu çalışmada Türkiye ve İran arasındaki ikili ticaret ilişkileri ve her iki ülkede savunma harcamalarının ülke ekonomilerine etkileri teorik olarak irdelenmiştir. 2000'li yıllarda her iki ülke arasındaki ekonomik ilişkilerin gelişmesi bölgesel rekabetten ziyade bir ortak varoluş durumunun gelişmesine neden olmuştur. Türkiye ve İran arasındaki ekonomik ilişkilerin daha da gelişmesi ve çeşitlenmesi her iki ülke için olumlu etkiler yapabilir. Ekonomik ilişkilerin güçlenmesi her iki ülkenin birbirine karşı olan tehdit algısını değiştirerek savunma harcamalarına ayrılan bazı kaynakların daha üretken alanlarda kullanılmasına olanak sağlayabilir.

**Anahtar Kelimeler:** İran, Türkiye, Ticaret, Savunma harcamaları

**JEL Kodu:** F13, F52, H56, O53, P52.

**Türü:** Derleme

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## **1. INTRODUCTION**

Throughout 2000s, Turkey and Iran are thriving to be regional powers in the Middle East in where political and economic conflict has been a constant fact. Both countries employ regional policies in order to exert their positions as regional powers. In this respect, the degree of normality of relations between these two neighbors may have important consequences for their regional aims.

In both countries, economic policies in support of regional objectives are executed in two dimensions alongside diplomacy. First, Turkey has been seeking to improve trade relations with its neighbors since 2002 within the framework of its “zero problems” policy. Moreover, energy and border trade with Turkey has become an important outlet for Iran who has been experiencing difficulties due to international sanctions imposed upon itself in relation to its nuclear program. Another dimension in support of efforts for regional supremacy is the increasing defense spending in both countries.

Relations between Turkey and Iran can be roughly characterized as “a period of good relations” until the beginning of 1980s (Sarıaslan, 2013: 71). After the changes of political regimes in the both countries at the beginning of 1980s, economic relations between Turkey and Iran has been following a fluctuating course in parallel to diplomatic relations. In this study, an overview of economic relations between Turkey and Iran is provided, with an emphasis on mutual trade, and effects of defense spending on the economies of the both countries are analyzed. In authors’ opinion, maintaining mutually beneficial economic relations between both countries free from political tensions is important in order for Turkey and Iran to fully utilize their potential for further development. The paper is organized as follows: The second section consists of an analysis of trade relations between Turkey and Iran. Effects of defense spending on both economies are studied in the third section. Some recommendations for further improvement of economic relations between both countries are provided in the fourth and final section.

## **2. TURKEY- IRAN TRADE RELATIONS**

The beginning of the 1980s is an important turning point for the analysis of economic relations between Turkey and Iran since both countries have gone through regime changes during these years. After the Islamic Revolution in Iran in 1979 and the 1980 military coup in Turkey good relations between two neighbors, which were shaped by conditions brought about by being US allies against the Soviet Union, have started to fluctuate in parallel to ideological differences and political conflicts stemming from the competition between both countries for regional supremacy (Hentov, 2011, Ünal and Ersoy, 2014: 144-145).

Turkey's exports to the Middle East have increased with the abandonment of import-substitution policies in favor of an export-oriented growth policy after 1980. Neutrality policy of Turkey during the Iran-Iraq War in 1980s has resulted in a rise of Turkey's bilateral trade with both Iran and Iraq. It was reported that the volume of bilateral trade with Iran has increased to 2,3 Billion US Dollars in 1983-1984 period. This situation has resulted in the development of solid mutual dependency relationships between Turkey and its two important southern neighbors (Aydın and Aras, 2005: 24). In the following years, the volume of trade between Turkey and Iran has fluctuated according to the status of political relations between two countries and to domestic economic conditions in both.

Several empirical studies have been conducted for testing various factors affecting trade relations between Turkey and Iran. Karabulut and Shahinpour (2013) studied the effects of such factors as population, urbanization, education, political system, religion and cultural individualism using 1959-2010 data. Although the model is found to be insignificant, Karabulut and Shahinpour (2013: 357) observed that interest rate and exchange rate have a negative effect while level of industrial development, inflation rate and education have a positive effect on the bilateral trade between Turkey and Iran. Heidari and Hamidi (2012) have reached the conclusion that for the 1965-2009 period, real per capita GDPs in Turkey and Iran are converging due to bilateral trade and economic cooperation. Heidari and Hamidi (2012) have recommended expansion of the volume of bilateral trade and the extent of regional trade agreements within the Organization of Islamic Cooperation necessary for sustainable growth in the both countries. According to Heidari and Hamidi (2012: 151), a trade volume of 30 Billion US Dollars or more would result in creation of more employment opportunities in both Turkey and Iran.

Since 2002, relations between both countries have been continuing in a phase of "mutual pragmatism", rather than competition, in which both countries put getting the best benefit possible out of this situation in the first place. There are same factors in the background of this positive development:

- Election of governments with a conservative tendency in Turkey which resulted in a change of Iran's perception as the major external threat to Turkey's secularity, in contrast to the rhetoric of previous Turkish governments, and the positive environment in diplomatic relations established by the "zero problems" approach of Turkish governments in 2000s (Karacasulu and Aşkar Karakır, 2011:113, Habibi, 2012: 2-3, Sarıaslan, 2013: 72, Ünal and Ersoy, 2014: 146),

- Turkey's recognition of trade and economic relations with neighbors as the most important tools in active implementation of the "zero problems" policy,
- Emerging of Turkey as an important strategic outlet for Iran to bypass international sanctions imposed upon itself,
- Complementarity of economic relations between the two countries, for example, Turkey's being a net energy importer and Iran's being an energy exporter (Habibi, 2012: 3-4).

In sum, it is too early to say that all the factors (for example, installment of NATO's missile shield, difference of opinions about the conflict in Syria, Iran's natural gas exports to Turkey which do not comply with the quality and quantity stated in the bilateral agreement between the two countries) creating political and diplomatic tensions between Turkey and Iran have been overcome with, however, it may be said that both countries have adopted a mutual existence approach through bilateral trade for their practical interests.

The Preferential Trade Agreement signed between the both countries in 2014 which will be effective as of the beginning of 2015 aims to further expand the volume of trade by doubling the trade flows.

**Table 1. An Overview of Turkey-Iran Bilateral Trade, 2002-2014, (thousand US Dollars)**

Yaer	Exports	Imports	Volume	Balance of Trade	Proportion (Exports/Imports)
2002	333.962	920.971,69	1.254.933,69	-587.009,69	0,36
2003	533.786,23	1.860.682,80	2.394.469,03	-1.326.896,57	0,29
2004	813.031,28	1.962.058,69	2.775.089,97	-1.149.027,41	0,41
2005	912.940,05	3.469.705,75	4.382.645,80	-2.556.765,70	0,26
2006	1.066.901,63	5.626.610,15	6.693.511,78	-4.559.708,52	0,19
2007	1.441.190,09	6.615.393,84	8.056.583,93	-5.174.203,75	0,22
2008	2.029.759,63	8.199.688,99	10.229.448,62	-6.169.929,36	0,25
2009	2.024.546,25	3.405.985,56	5.430.531,81	-1.381.439,31	0,59
2010	3.044.177,15	7.645.007,86	10.689.185,01	-4.600.830,71	0,40
2011	3.589.634,59	12.461.532,35	16.051.166,94	-8.871.897,76	0,29
2012	9.921.602,40	11.964.778,63	21.886.381,03	-2.043.176,23	0,83
2013	4.192.511,35	10.383.216,70	14.575.728,05	-6.190.705,35	0,40
2014	3.412.065,41	9.126.132,69	12.538.198,10	-5.714.067,28	0,37

**Source:** Compiled from Turkish Statistical Institute (TURKSTAT) Foreign Trade Statistics Database (Access Date: 01.19.2015) by authors.

Balance of trade between the two countries is developing against Turkey in recent years as a result of increasing energy imports from Iran. Oil exports are reported to have positive effects on the real GDP of Iran, where the financial markets are not matured, in the long-run (Esfahani et.al., 2013). In comparison, Turkey's economy is more diversified. Sustaining economic growth is vital for Turkey who has a vision of being among the ten largest economies of the World by 2023 with a target of 500 Billion US Dollars of annual exports. In this respect, it is very important for Turkey to provide its industries with a continuous energy supply without any problems in order to develop a productive economy and create an environment of confidence that would have a positive psychological boost for the realization of 2023 targets. Turkey is a net energy importer. Besides being an important trade partner, Iran is Turkey's primary source of oil imports (51% of total oil imports in 2011) and the secondary source of natural gas imports (Babali, 2012: 6) (Table 2). This situation makes Iran a strategic country for Turkish economic policy. Moreover, Iran may sometimes use this dependency as a foreign policy tool, thereby executing a defense policy without guns. The flow of natural gas is also a source of tension, with Iran clearly violating the conditions agreed upon bilaterally by supplying lower quality natural gas in lower amounts (Babali, 2012:7).

**Table 2. Turkey's Natural Gas Imports, 2005-2013, (million Sm<sup>3</sup>)**

	Russia	Iran	Azerbaijan	Algeria (LNG)	Nigeria (LNG)	Others*	Total
2005	17.524	4.248 (15,98)	0	3.786	1.013	0	26.571
2006	19.316	5.594 (18,51)	0	4.132	1.100	79	30.221
2007	22.762	6.054 (17,06)	1.258	4.205	1.396	167	35.482
2008	23.159	4.113 (11,01)	4.580	4.148	1.017	333	37.350
2009	19.743	5.252 (14,65)	4.960	4.487	903	781	35.856
2010	17.576	7.765 (20,41)	4.521	3.906	1.189	3.079	38.036
2011	25.406	8.190 (18,66)	3.806	4.156	1.248	1.069	43.874
2012	26.491	8.215 (17,89)	3.354	4.076	1.322	2.464	45.922
2013	26.212	8.730 (19,28)	4.245	3.917	1.274	862	45.269

**Source:** Republic of Turkey Energy Market Regulatory Authority (EMRA) Natural Gas Market 2013 Annual Sectoral Report, p.20. \* denotes countries from which spot LNG (Liquid Natural Gas) was imported. Numbers within parentheses show the percentage of natural gas imports from Iran within the total natural gas imports in the related year.

Complementarity is an important feature of bilateral trade between Turkey and Iran, with the complementarity in energy trade being the most apparent relationship. It is also reported that Turkey's imports and exports with its neighbors show dependency in the long-run (Akbaş and Şentürk, 2013), as Iran's imports dependent on its energy imports. On the other hand, transfer of technology and know-how from Turkey is needed for developing the unproductive sectors of Iran (Foreign Economic Relations Board, 2011: 13).

Important export items are precious metals, food and beverages, intermediate industrial goods and spare parts for Turkey while it is by far energy for Iran (TURKSTAT). It is obvious that the increasing volume of trade has positive consequences in both countries; however, diversification of trade items and developing trade relations in different sectors would be beneficial for Turkey and Iran. Although nontariff barriers, such as gasoline tax imposed on cross-border truck transportation, were removed by Iran in 2014, there are still some structural obstacles. Iran's trade regime requires the investigation of whether goods and services to-be-entered into country "inconvenient" and the condition that only one financial intermediary institution from Turkey is authorized to issue letters of credit for imports creates further obstacles and delays and makes entry to Iranian market very difficult for Turkish exporters (Ergönül, 2014).

Another intensifying trade activity between the both countries in the last couple of years is tourism. Increase of Iranian tourists who cross the border for daily and weekend trips is observed to bring vitality into commercial activity in such border provinces as Iğdır. On the other hand, there is an increasing amount of Iranian students who are preferring universities in the eastern and northeastern provinces of Turkey, which is also increasing short-term trips by Iranians to Turkey.

All these developments are fueled by the developments in diplomacy rather than by economic reasoning. This positive political environment has positively affected investment flows between both countries (Habibi, 2012: 4), however, the level of bilateral investments is not satisfactory (Ünal and Ersoy, 2014: 147), in particular for Turkey, considering the economic capacities of the both countries. Total amount of Turkish investments in Iran between January 1996 and September 2014 is 1.292 Million US Dollars while the total amount of

Iranian investments in Turkey within the same period is a mere 101 Million US Dollars (Çakıroğlu, 2014).

Iran provides Turkish investors with a market full of opportunities that is not fully-opened yet. However, factors like uncertainty, lack of trust emanating from the seizure or interruption of previous large-scale Turkish investments, high taxes on such items as advertising for foreign firms investing in Iran are deterring Turkish investors (Foreign Economic Relations Board, 2011: 7). Development of spontaneous investment flow between two countries is important for preventing conflict. When the perception of conflict towards each other is minimized, Turkey and Iran can use some of their defense budgets for more productive purposes or for different political purposes.

### **3. DEFENSE SPENDING IN TURKEY AND IRAN**

The perception of threat from neighboring countries is an important aspect which determines the volume of defense spending in any country. Defense spending is a sub-category of public spending which is important for protection of a nation's own land and sphere of influence and in creation of a suitable psychological environment in which the society fulfills its functions by feeling safe from any threats. Therefore, defense spending is crucial in politically- divided and conflict-ridden regions such as the Middle East. A cut in defense spending in any country may have positive trade creation effects elsewhere in the world (Seitz et.al., 2015) and decreased defense budgets due to decreased conflicts between neighbors may increase welfare in both countries through positive effects of increasing international trade and bilateral economic relations (Shin and Ward, 1999). In this respect, a decreased perception of trade between such neighbors with a long history of political division as Turkey and Iran may have positive growth repercussions in the economies of both countries, as well as in the whole of the Middle East, through intensified trade and other economic transactions.

Defense spending may also affect economic growth through three different mechanisms (Yakovlev, 2006: 29-33). First, by providing the security of the country and the society, and thereby the markets, defense spending indirectly impacts growth by creating an environment of stability and trust for economic growth. Second, defense spending may have a negative influence on growth due to high opportunity costs incurred in case where increasing defense spending may result in a competition between defense sector and civil sectors. Third, increase in defense spending may decrease unemployment and optimize capital utilization when the economy is not working efficiently. In such a case, growth-inducing effects of defense spending may occur through positive externalities particularly in infrastructure, technological development and



accumulation of human capital (Giray, 2004: 188).

There is a rich empirical literature on the relationship between defense spending and economic growth. Empirical research on defense spending-growth nexus has been producing different results so far. While some studies found that defense spending positively affect economic growth (for example, Benoit, 1978, Sezgin, 2001, Dunne, et.al., 2001, Gökbunar and Yanıkkaya, 2004), some other studies found a negative effect (for example Değer, 1986, Landau, 1993, Mintz and Stevenson, 1995) and some others reached that there is no relationship between defense spending and growth (for example, Faini, et.al., 1984, Biswas and Ram, 1986, Kollias, 1997, Görkem and Işık, 2008).

Because of their geopolitical positions, defense spending is an important item within the public spending of both Turkey and Iran. On the other hand, some researchers report that defense spending are tend to be higher in resource-rich countries due to the higher demand for protection against internal and external risks (Musayev, 2014: 2). In a study conducted by Musayev (2014) for 89 countries using data from the 1970-2010 period, defense spending is found to increase growth in the existence of high risk of internal threat, however, the effect of defense spending is reversed when it is made with rent-seeking or corruption motives and no negative effects are found when corruption is low and natural resource stock is high. In parallel, it may be said that defense spending for internal threats in Turkey may have positive effects on growth while revenues from natural resource exports have a neutralizing impact on the negative growth effects caused by high defense spending.

**Table 3. Defense Spending in Turkey and Iran, 2000-2013**

Year	% of Public Spending		% of GNP	
	Iran	Turkey	Iran	Turkey
2000	23,3	-	3,8	3,7
2001	22,1	-	4	3,7
2002	10,5	9,0	2,5	3,9
2003	13,9	8,2	2,8	3,4
2004	16,7	7,8	3,1	2,8
2005	15,5	7,5	3,5	2,5
2006	14,4	7,4	3,5	2,5
2007	12,1	6,9	2,7	2,3
2008	8,5	6,7	2,1	2,3
2009	10,0	6,8	2,2	2,6
2010	11,2	6,7	2,2	2,4
2011	10,0	6,3	2,1	2,2
2012	10,3	6,3	1,9	2,3
2013	-	6,1	-	2,3

**Source:** Compiled from [www.sipri.org](http://www.sipri.org) by authors.

It can be seen from the table that the shares of defense spending in public spending in both countries show a tendency to decrease since 2000 while the shares of defense spending in GNP demonstrate a similar tendency from 2006 onwards, with the average shares of defense spending in Iran and Turkey are approximately 2,1% and 2,3%, respectively.

Positive effects of defense spending on economic growth may particularly be seen in countries which have advanced defense industries. Besides contributions to employment, export of defense products manufactured as a result of intense research and development activities in such countries makes significant contributions to the economies of these countries. It may be said that production of defense goods and services has a rather positive effect in the economies of such countries with advanced defense industries as Russia, China, Israel and the US, where the ratio of defense spending in GNPs does not demonstrate sudden increases over the years (Table 4).

**Table 4. Share of Defense Spending in GNPs of Some Countries, 2000-2013**

Year	% of GNP			
	Russia	China	Israel	USA
2000	3,6	1,9	8	3
2001	3,8	2,1	8,4	3
2002	4,1	2,2	9,6	3,4
2003	3,9	2,1	9,6	3,7
2004	3,5	2,1	8,7	3,9
2005	3,6	2,1	8	4
2006	3,5	2,1	7,8	3,9
2007	3,4	2,1	7,2	4
2008	3,3	2	6,9	4,3
2009	4,1	2,2	6,9	4,8
2010	3,8	2,1	6,4	4,8
2011	3,7	2	6	4,7
2012	3,9	2	5,8	4,4
2013	4,1	2	5,6	3,8

**Source:** *Compiled from [www.sipri.org](http://www.sipri.org) by authors.*

Increasing acts of terror in the Middle East and negative outcomes of political changes caused by “the Arab Spring” necessitates an increase in defense spending in Turkey as well as in other parts of the Middle East. Looking at the share of defense spending in some European and Middle Eastern countries, it may be said that both domestic political situation and pursued stability policies have a direct influence on the share of defense spending (Table 5).

**Table 5. Share of Defense Spending in Total Public Spending (%)**

Year	% Public Spending													
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Austria	1,9	1,8	1,8	1,8	1,7	1,8	1,7	1,9	1,8	1,7	1,6	1,6	1,6	1,5
Belgium	2,8	2,7	2,5	2,4	2,4	2,2	2,2	2,3	2,5	2,2	2,1	2,0	1,9	1,9
Denmark	2,8	2,9	2,8	2,7	2,7	2,5	2,7	2,6	2,7	2,4	2,5	2,4	2,4	2,4
France	4,9	4,8	4,7	4,8	4,8	4,6	4,6	4,5	4,4	4,5	4,3	4,2	4,1	3,9
Germany	3,3	3,1	3,0	3,0	3,0	2,9	2,9	2,9	3,0	3,0	2,9	2,9	3,0	3,0
Italy	4,4	4,1	4,2	4,2	4,1	3,9	3,7	3,5	3,7	3,5	3,5	3,5	3,3	3,1
The Netherlands	3,5	3,4	3,3	3,3	3,3	3,3	3,3	3,2	3,1	3,0	2,8	2,8	2,7	2,6
Portugal	4,5	4,5	4,6	4,3	4,4	4,5	4,5	4,2	4,3	4,2	4,0	4,2	4,1	4,5
Spain	3,1	3,0	3,0	2,9	2,8	2,7	3,0	3,0	2,8	2,5	2,3	2,1	2,2	2,1
<b>Bahrain</b>	<b>16,1</b>	<b>13,2</b>	<b>13,0</b>	<b>14,4</b>	<b>14,0</b>	<b>12,2</b>	<b>12,1</b>	<b>11,6</b>	<b>10,8</b>	<b>13,0</b>	<b>10,6</b>	<b>11,0</b>	<b>10,8</b>	<b>12,2</b>
<b>Egypt</b>	<b>..</b>	<b>..</b>	<b>9,6</b>	<b>9,9</b>	<b>9,0</b>	<b>8,9</b>	<b>7,7</b>	<b>7,4</b>	<b>6,7</b>	<b>6,3</b>	<b>6,3</b>	<b>5,8</b>	<b>5,4</b>	<b>4,7</b>
<b>Saudi Arabia</b>	<b>29,8</b>	<b>29,0</b>	<b>25,2</b>	<b>24,3</b>	<b>23,1</b>	<b>25,3</b>	<b>26,8</b>	<b>27,0</b>	<b>25,3</b>	<b>24,1</b>	<b>21,8</b>	<b>20,4</b>	<b>21,</b>	<b>25,2</b>
<b>Qatar</b>	<b>..</b>	<b>..</b>	<b>12,1</b>	<b>11,3</b>	<b>7,8</b>	<b>6,4</b>	<b>5,8</b>	<b>6,6</b>	<b>8,4</b>	<b>5,8</b>	<b>4,8</b>	<b>..</b>	<b>..</b>	<b>..</b>
<b>Lebanon</b>	<b>12,8</b>	<b>14,2</b>	<b>13,1</b>	<b>13,0</b>	<b>13,5</b>	<b>14,2</b>	<b>12,7</b>	<b>13,2</b>	<b>11,7</b>	<b>12,6</b>	<b>14,0</b>	<b>14,1</b>	<b>13,2</b>	<b>13,4</b>
<b>Syria</b>	<b>19</b>	<b>18,9</b>	<b>17,4</b>	<b>19,1</b>	<b>17,7</b>	<b>17,8</b>	<b>16,5</b>	<b>15,9</b>	<b>15,5</b>	<b>15,0</b>	<b>13,6</b>	<b>..</b>	<b>..</b>	<b>..</b>
<b>Jordan</b>	<b>18</b>	<b>17,4</b>	<b>17,0</b>	<b>17,4</b>	<b>13,4</b>	<b>12,5</b>	<b>13,0</b>	<b>15,9</b>	<b>17,1</b>	<b>16,7</b>	<b>17,0</b>	<b>14,5</b>	<b>12,6</b>	<b>10,0</b>

Source: Compiled from [www.sipri.org](http://www.sipri.org) by authors.

Besides bypassing international sanctions, Iran's policy of establishing tight economic and energy links with its close neighbors is related to providing national security through formation of strategic ties. In this context, Turkey is important for Iran as a neighboring Muslim country and Turkish private sector is as particularly important as a source for much needed technological and financial resources (The Economic Policy Research Foundation of Turkey, 2012). On the other hand, Iran is a strategic neighbor for Turkey as an important source for its increasing energy demand and access to Iranian market is a strategic priority for Turkey due to its growing trade deficit (Stein: 2012, 3). In such a state of mutual dependence conflicts arising from political and diplomatic differences are rather detrimental to the economic benefits of both countries.

Some empirical studies show that in case where perception of threat from neighbors are high, increasing defense spending in one neighbor result in an increase of defense spending in the other neighbor, thereby causing the first neighbor to increase defense spending again and so on (Shin and Ward, 1999, Islam, 2015). Hence, Akal, et.al. (2011) have reached the conclusion that there is a bilateral causality between defense spending in Turkey and Iran that Iran's

participation in Shanghai Cooperation Organization as an observer has resulted in an increase of Turkish defense spending. In this respect, heightened perceptions of threat may have negative consequences on growth through both increasing defense spending and decreasing trade and financial flows. Empirical studies show that expansion of volume of bilateral trade between countries would decrease the probability of conflict between trading countries and consequently defense spending in these countries, creating welfare increasing effects not only in the trading countries but also in the rest of the world (Seitz, et.al., 2015). Therefore, a lowered perception of mutual threat between Turkey and Iran is important as this condition will likely to lead an expansion of trade volume between both countries and a possible increase in welfares of other Middle Eastern countries.

It has been reported that there is causality between Iran's defense spending and economic growth (Farzanegan, 2014) and that openness and defense spending have positive effects on growth effects while embargo and sanctions between 1980 and 2008 have a negative impact on growth (Yurttañıkmaç, et.al., 2012). Iran's defense spending has been significantly dependent on its energy revenues. Defense spending fluctuates as to fluctuations in energy exports. Decrease of energy revenues due to international sanctions against Iran and embargo on its oil revenues significantly decrease Iran's defense and security spending, however, this situation also creates an incentive for Iranian administration to invest in non-oil productive sectors, with the investments focusing on research and development and human capital (Farzanegan, 2011: 1067). Under sanctions Iran intensifies investments on the development of its own domestic technologies in defense industry and in other industries. By creating its unique system of research and development Iran is pursuing a self-sufficiency policy for its security needs. In other words, under embargo and sanctions, externalities created by investment in science and technology may have important growth consequences for Iran. In this sense, Iran compensates its lack in technology by investing in forming the quality human capital that creates technology. In a study on the relationship between oil revenues and long-run growth in Iran, Esfahani et. al. (2013: 222) concludes that despite Iran's level of technological development lagging behind its major trade partners, technological development has realized in a pace close to that of its trading partners.

#### **4. DISCUSSION AND RECOMMENDATIONS**

After regime changes in both countries in 1980s, economic relations between Turkey and Iran has been demonstrating changes in parallel to the fluctuations in their political relations. Volume of trade between two countries has been expanding in the last decade though the pace of this expansion is

slowing down as to the state of political affairs. At this point, both countries have become strategic partners for each other; Turkey needs to have an uninterrupted flow of energy for its growing economy and national vision of 2023 while Iran needs its neighbor to bypass sanctions and provide its markets with necessary technologies and intermediate goods. Under these conditions both countries are, although not officially declared by the both, in a state of “mutual existence”. Nevertheless, economic relations between two countries are still prone to possible tensions created by difference of opinion in various political and economic issues. This situation constitutes the major impediment to private capital flows between two countries as uncertainty deters private investors from both countries to invest in the economies of each other.

Because of their geopolitical positions in the Middle East, defense spending is an important item for both countries, although the shares of defense spending in GNPs are showing a tendency to decrease in recent years. Economic policy based on dependencies formed by the energy trade is a tool of “defense without guns” for Iran whose defense spending depends largely on its energy revenues. Embargo and sanctions imposed upon Iran has resulted in an inward-looking investment approach in Iran, with an emphasis on creating national defense technologies through research and development and formation of human capital. Such an emphasis brings about positive externalities for other domestic industries as well, however, the level of technological development of Iran is still lagging behind. Although Turkish defense industry is developing in recent years, its defense spending is still relatively outward-oriented. Unlike Iran, Turkey can export defense goods and services. It can be inferred from the empirical literature that the decrease in Iran’s defense spending due to embargos is positively affecting Iran’s growth while investments in defense spending have growth-inducing effects for Turkey.

Improvement of relations between Turkey and Iran depends on improvement of economic relations. First of all, bilateral foreign direct investments (by private sectors of both countries in each other’s economy) should increase in order to create an intermediary that would soften the effects of possible future tensions resulting from political differences. Such flow of direct investments across borders has also been one of the basic ideas that brought European Union forth as an example of a successful regional integration. However, lowering of the level of perception of threat of each other still is important for the improvement of economic relations and the best possible way to achieve this is the expansion and diversification of bilateral trade between these two neighbors by transforming current trade structure dominated by energy and precious metals to one in which a diversified portfolio of goods and services are exchanged. Being a regional power requires a strong

economy and forming mutual dependencies through establishing economic ties with neighbors. In this context, it would be beneficial for both Turkey and Iran to work for diminishing political tensions between themselves and pursue pragmatic bilateral trade policies that will increase the welfare of the both countries.

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