November 2007
IMF Country Report No. 07/362

Turkey: 2007 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Turkey

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2007 Article IV consultation with Turkey, the following documents have been released and are included in this package:

- the staff report for the 2007 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on March 7, 2007, with the officials of Turkey on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on May 4, 2007. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its May 18, 2007 discussion of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for Turkey.

The document(s) listed below have been or will be separately released.

Selected Issues Paper
Financial System Stability Assessment

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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TURKEY

Staff Report for the 2007 Article IV Consultation

Prepared by the Staff Representatives for the 2007 Consultation with Turkey

Approved by Susan Schadler and Matthew Fisher

May 4, 2007

Executive Summary

Achievements and challenges: Considerable progress has been made in shaking off the legacy of the 2001 crisis, with the large output gap closed, public debt ratios sharply down, economic institutions strengthened, and the financial system normalized. This revival stems from disciplined financial policies, advances in structural reform, political stability, and favorable global economic conditions. Inflation, however, is still high and new vulnerabilities associated with strong economic performance (large current account deficit and rapid credit growth) have emerged, exposing Turkey to shifts in investor sentiment. Political uncertainty from upcoming elections amplifies near-term risks. Turkey also faces structural challenges (including low employment, widespread informality, and low financial intermediation) that need to be tackled to raise growth durably and catch up to EU income levels.

Outlook and risks: Economic activity is moderating but becoming less reliant on domestic demand. Growth is projected at 5 percent this year but should pick up next year as real interest rates decline and election uncertainties dissipate. The current account deficit should narrow, owing to softer domestic demand and robust external growth, but will likely stay high in the near term. Risks to this outlook are balanced. Long-term growth is expected to range between 5−7 percent, depending on the quality of macroeconomic policies and the pace and breadth of structural reforms.

Discussions: The authorities and staff agreed that the strategy for recovering from the 2001 crisis had been appropriate and successful. Looking ahead, entrenching stability and rejuvenating structural reform would be key pillars of economic policy. On the former, discussions focused on when the primary fiscal surplus target could be eased, how the inflation target could be achieved, and how to protect the economy from vulnerabilities stemming from large capital inflows. Discussions also explored goals of a pro-growth reform agenda. There was broad consensus on the requirements. Staff, however, cautioned against labor market reform proposals that impose upfront fiscal costs without substantially reducing labor market rigidities. The authorities viewed favorably staff's proposal to adopt a fiscal rule to anchor medium-term fiscal objectives, but were not yet ready to commit to it.

Policy priorities: To preserve market confidence and facilitate disinflation, spending should be contained to achieve the primary surplus target of at least 6½ percent of GNP. Monetary policy should remain tight until inflation is firmly on a declining path. To enhance the resilience of the economy to shocks, buffers in public and private balance sheets should be increased and financing structures improved. In the medium run, fiscal policy needs to balance continued debt reduction with the need to make room for growth-enhancing tax cuts on labor and financial transactions. This puts a premium on measures to contain spending, such as social security and civil service reform. Reducing rigidities in labor and product markets, furthering privatization in electricity and banking, and strengthening financial market institutions and supervision are other key reform goals.

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I. Introduction

1. **Having secured a strong recovery from the 2001 crisis, Turkey now faces a new set of challenges**. In recent years, growth has been brisk, inflation has been reduced, and balance sheets have strengthened. Markets have rewarded this stabilization with lower—though still substantial—risk premiums and large capital inflows. Recently, however, the pace of economic activity has moderated, while disinflation has halted. Moreover, a wide current account deficit, largely reflecting surging inflows, exposes the economy to sudden shifts in investor sentiment. Risks are amplified by the upcoming elections and geopolitical factors.

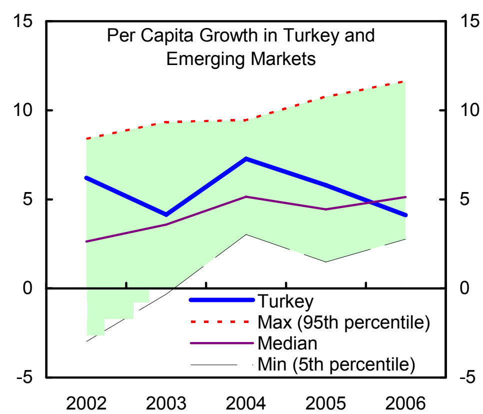
2. **The Article IV consultation provides an opportunity to take a fresh look at the economy from a medium-term perspective**.[1] Discussions covered measures to preserve investor confidence in the run-up to the elections and ensure a credible policy framework in the period following expiration of the current Fund arrangement. With the upcoming post-election period opening a window of opportunity for a new reform agenda, discussions focused on how to prioritize structural reforms to raise potential growth and increase resilience to external shocks.

II. Achievements and Challenges

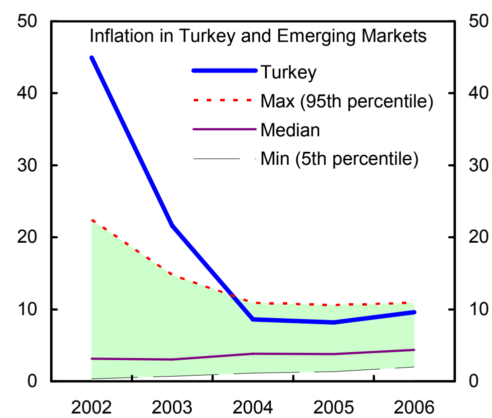
3. **Turkey has experienced an economic revival in recent years thanks to sound macroeconomic policies, a conducive global environment, and political stability.** However, the task of shifting the economy to safe ground is incomplete, and Turkey's success is now bringing new vulnerabilities. Moreover, growth is being held back by continuing structural impediments.

A. Economic Revival

4. **Turkey's vigorous economic recovery from the 2001 crisis has surpassed expectations** (Figures 1−3). The economy has grown briskly, driven by private consumption



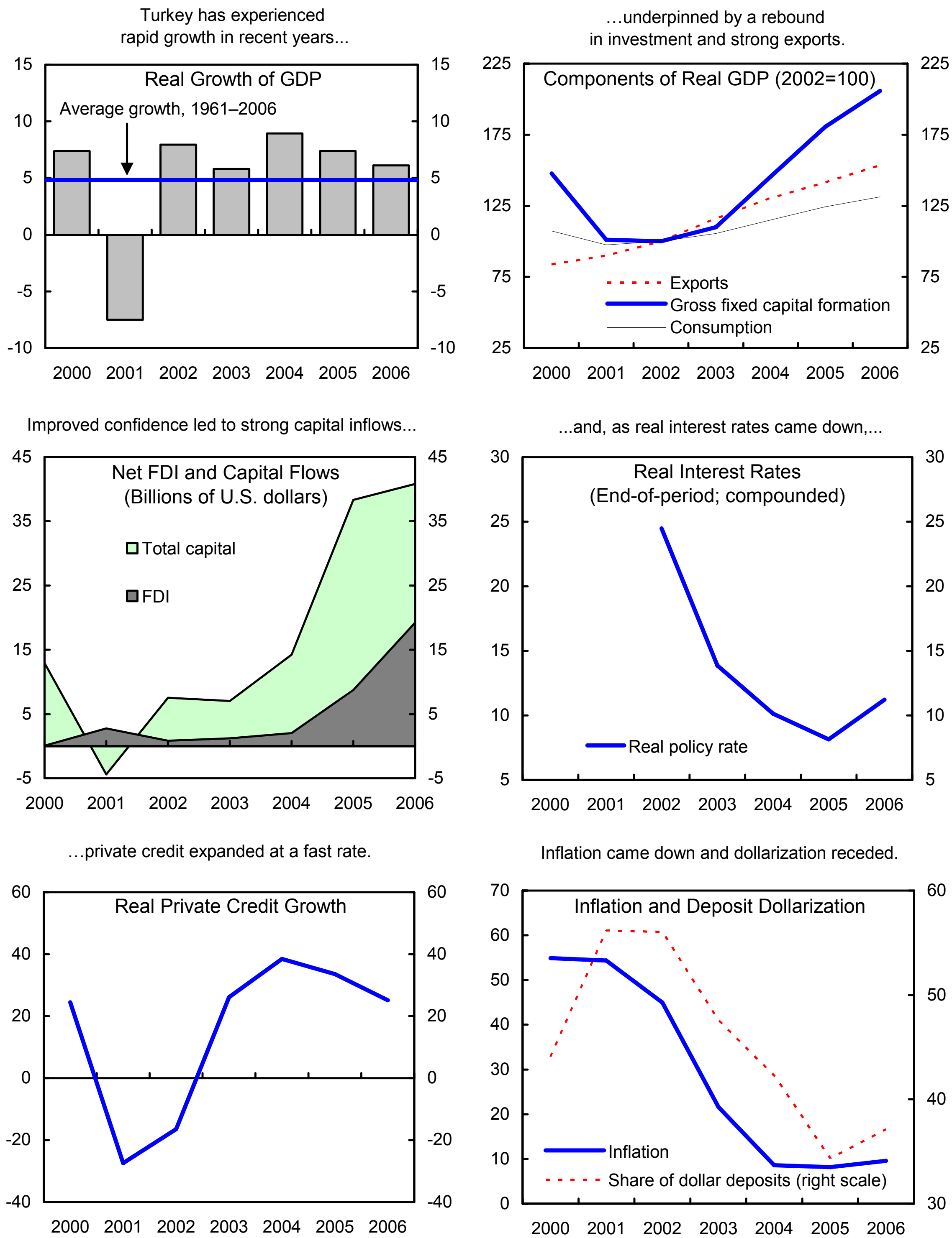
Source: IMF, *World Economic Outlook*.



Source: IMF, *World Economic Outlook*.

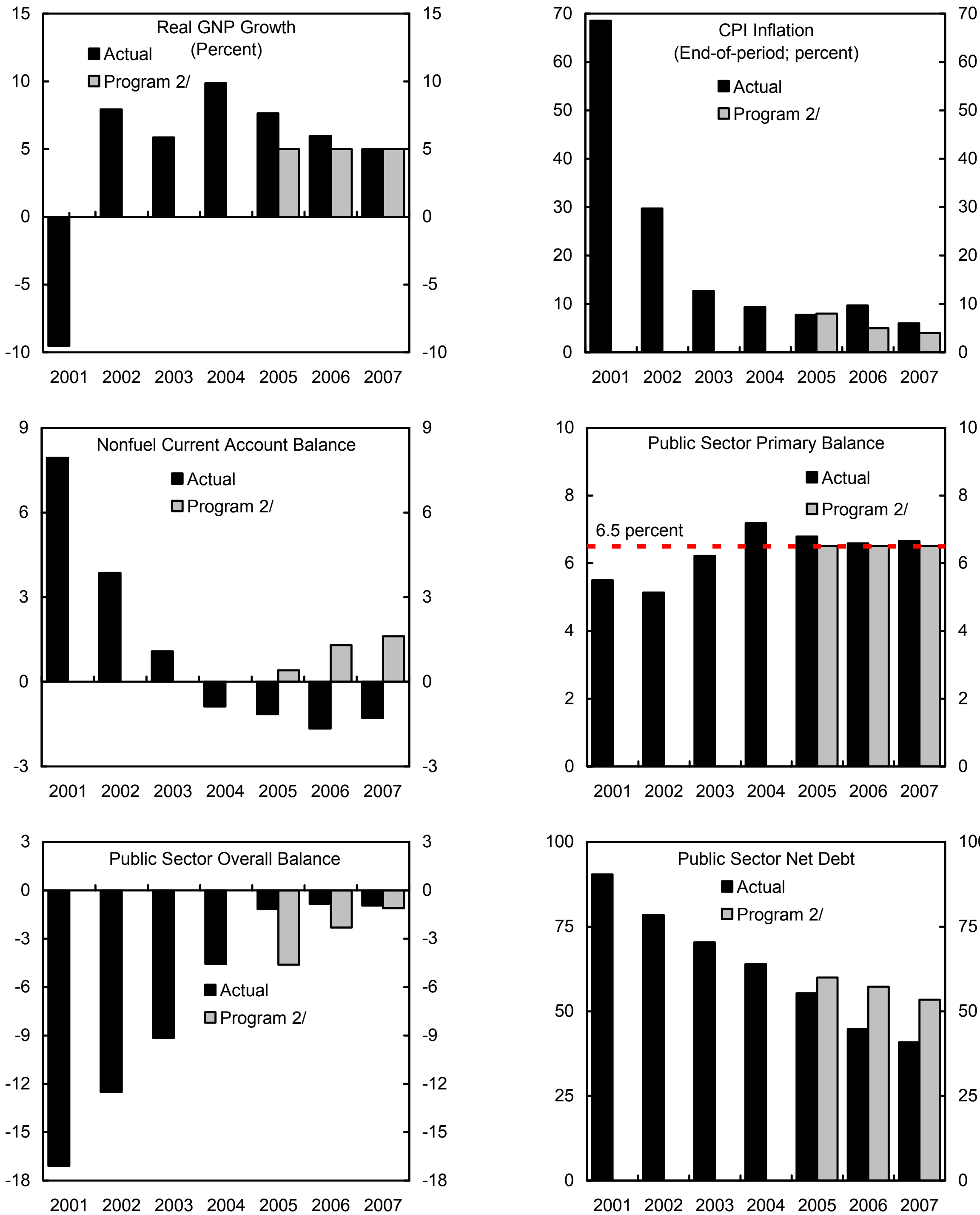
[1] The Article IV discussions were held in Istanbul and Ankara during March 1−7. The staff team comprised Messrs. Giorgianni (head), Fletcher, Lombardo, Meier and Ms. Koeva (all EUR), Messrs. Barnett (FAD), Mathai (WHD), Josefsson (MCM), McGrew (PDR), Bredenkamp (senior resident representative), and Keller (resident representative). Ms. Schadler (EUR) and Messrs. Kiekens and Veziroglu (OED) joined the discussions.

Figure 1. Turkey: Economic Revival, 2000−06
(Percent, unless otherwise indicated)



Sources: Turkstat; Central Bank of Turkey; IMF, *Direction of Trade Statistics;* and IMF staff estimates.

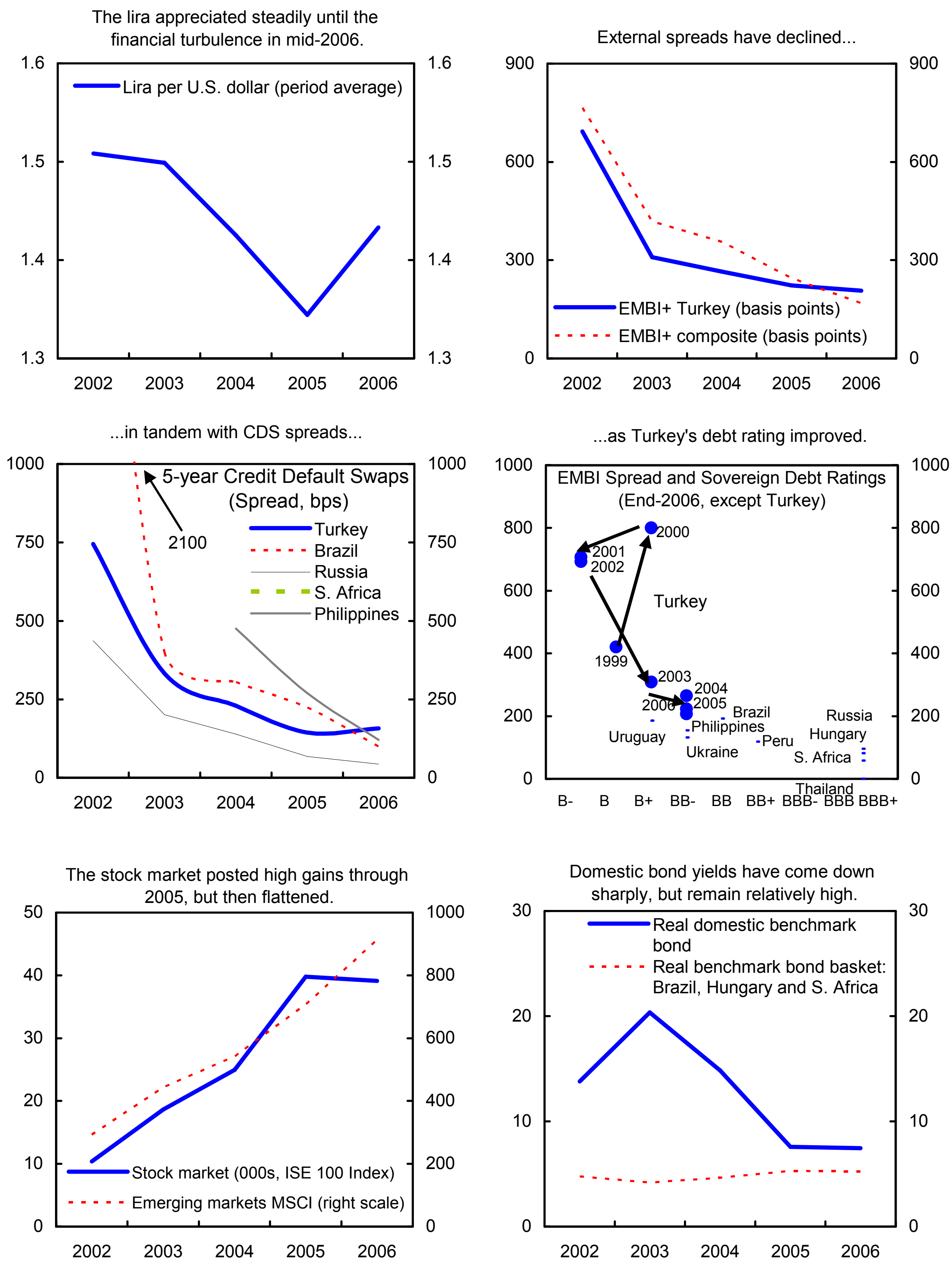
Figure 2. Turkey: SBA's Economic Objectives and Outcomes, 2001–07 1/
(Percent of GNP, unless otherwise indicated)



Sources: Turkstat; and IMF staff estimates and projections.

1/ Data for 2007 are IMF staff projections.
2/ Original program objectives as in IMF Country Report No. 05/412, November, 2005.

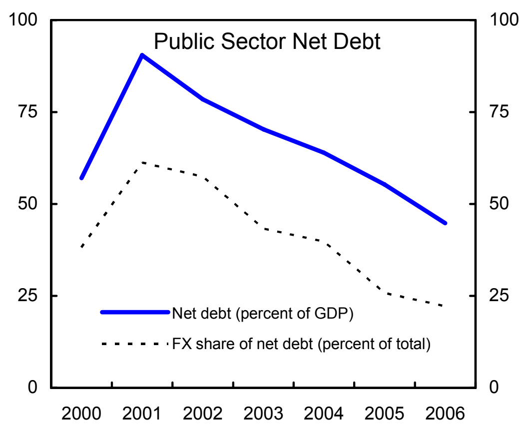
Figure 3. Turkey: Financial Market Performance, 2002–06
(Percent, unless otherwise indicated)



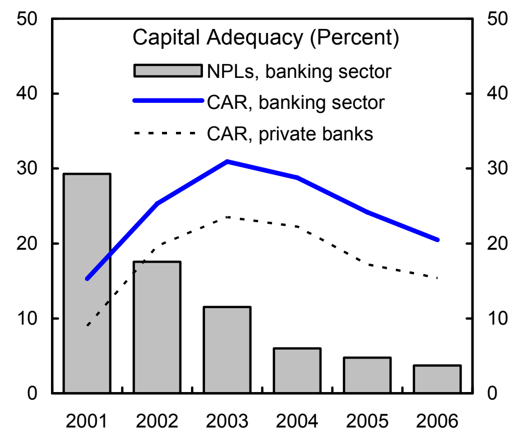
Source: Bloomberg.

and investment and fueled by declining real interest rates, surging capital inflows, rapid credit growth, and rising productivity. Inflation, meanwhile, dropped to its lowest level in 34 years, helping to reverse dollarization. At the same time, financial markets posted significant gains.

5. **In a mutually reinforcing process, strong economic performance has been accompanied by improved balance sheets**. The *public debt* ratio has come down sharply, and its composition has improved. Central bank *reserves* have risen. *Bank balance sheets* have strengthened (low NPLs and capital levels above regulatory minima). And while *corporates and households* have increased their leverage, this process started from very low levels.

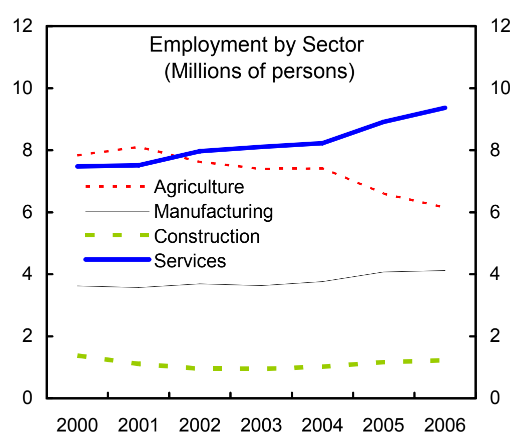


Source: Turkish Treasury.

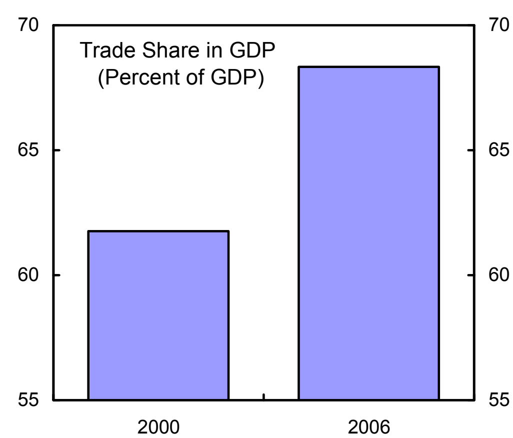


Source: BRSA.

6. **The real economy has modernized, becoming less reliant on traditional sectors and more open to trade**. Moreover, foreign ownership has increased significantly, particularly in the banking sector, on the back of a surge in private mergers and acquisitions and an ambitious privatization drive.



Source: Turkstat.

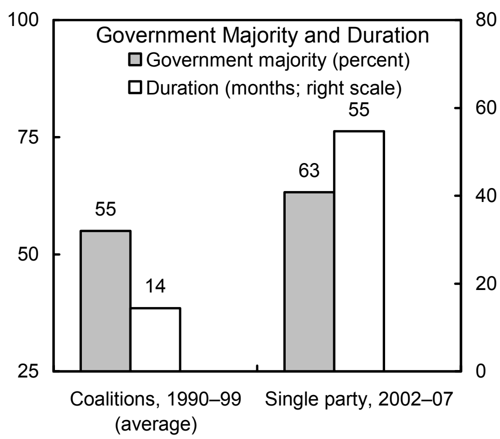


Source: Turkstat.

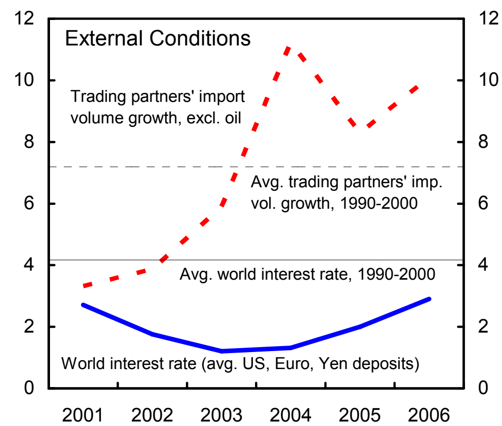
7. **Sound economic policies, political stability, and generally favorable external conditions have underpinned these positive outcomes**.

- **Policies**. On the *macroeconomic side*, fiscal discipline (centered on the 6.5 percent of GNP primary surplus target) and monetary policy restraint by an independent central bank have set off a virtuous cycle of disinflation, declining interest rates, and high, private sector-led growth. The floating lira has served as a shock absorber and improved incentives for managing currency risks. On the *structural side*, bank recapitalization and enhanced supervision, tax reforms, and privatization have restarted private credit, promoted FDI, and spurred competitiveness. The ongoing SBA has helped anchor these policies, despite encountering delays in structural reforms (Box 1).

- **Politics**. After a decade of coalition governments, Turkey has been ruled since November 2002 by a single party with a dominant parliamentary majority. This has facilitated policymaking, as the government has embraced financial discipline and market-friendly policies anchored to Fund arrangements and EU accession.



Source: IMF staff calculations.



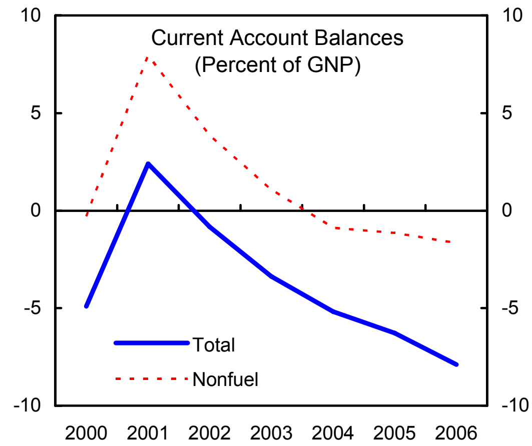
Source: IMF, World Economic Outlook.

- **External environment**. Low global interest rates, combined with Turkey's relatively high returns and improved investment climate, have produced a surge in capital inflows, with a significant portion financing private sector activity. FDI has taken off, covering more than half the current account deficit. Meanwhile, sustained growth among Turkey's main trading partners has helped exports.

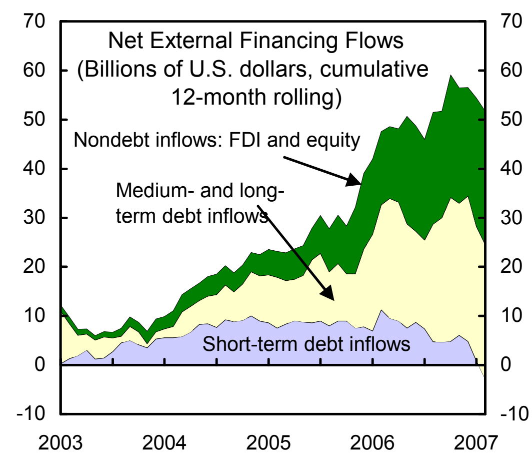
B. Economic and Financial Challenges

8. **Turkey faces several vulnerabilities that need to be carefully managed to avoid the boom-bust cycles of the past**. Some vulnerabilities (relating to debt levels, inflation, and dollarization) reflect the remnants of the large imbalances inherited from the 2001 crisis. Others (large current account deficit, appreciating currency, rapid credit growth) have emerged as byproducts of strong growth and prospects for EU accession. These are unlikely to abate in the near-term.

9. **Large capital inflows have brought benefits, but also vulnerability to reversals in investor sentiment**. Surging capital inflows have appreciated the lira (up over 30 percent since end-2002 in real terms) and, with higher oil prices, have widened the current account deficit. As a result, the downward trend in external debt has reversed and gross financing requirements have risen (Appendix I). And, while the composition of external financing flows has improved sharply, short-term debt rollover requirements remain high, and the stock of nonresidents' portfolio investment has reached record levels reflecting strong international investor appetite for lira assets and carry trades. These developments, combined with still-low reserve coverage, expose Turkey more than most other emerging market countries to changes in investor sentiment, as seen during last year's financial market turmoil (Table 1; Figures 4–5). Moreover, shocks to emerging markets have non-negligible spillovers onto lira assets and vice versa (Box 2).

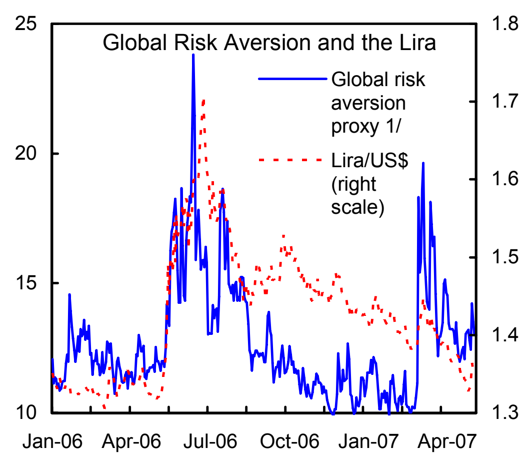


Sources: Turkstat; and IMF staff estimates.



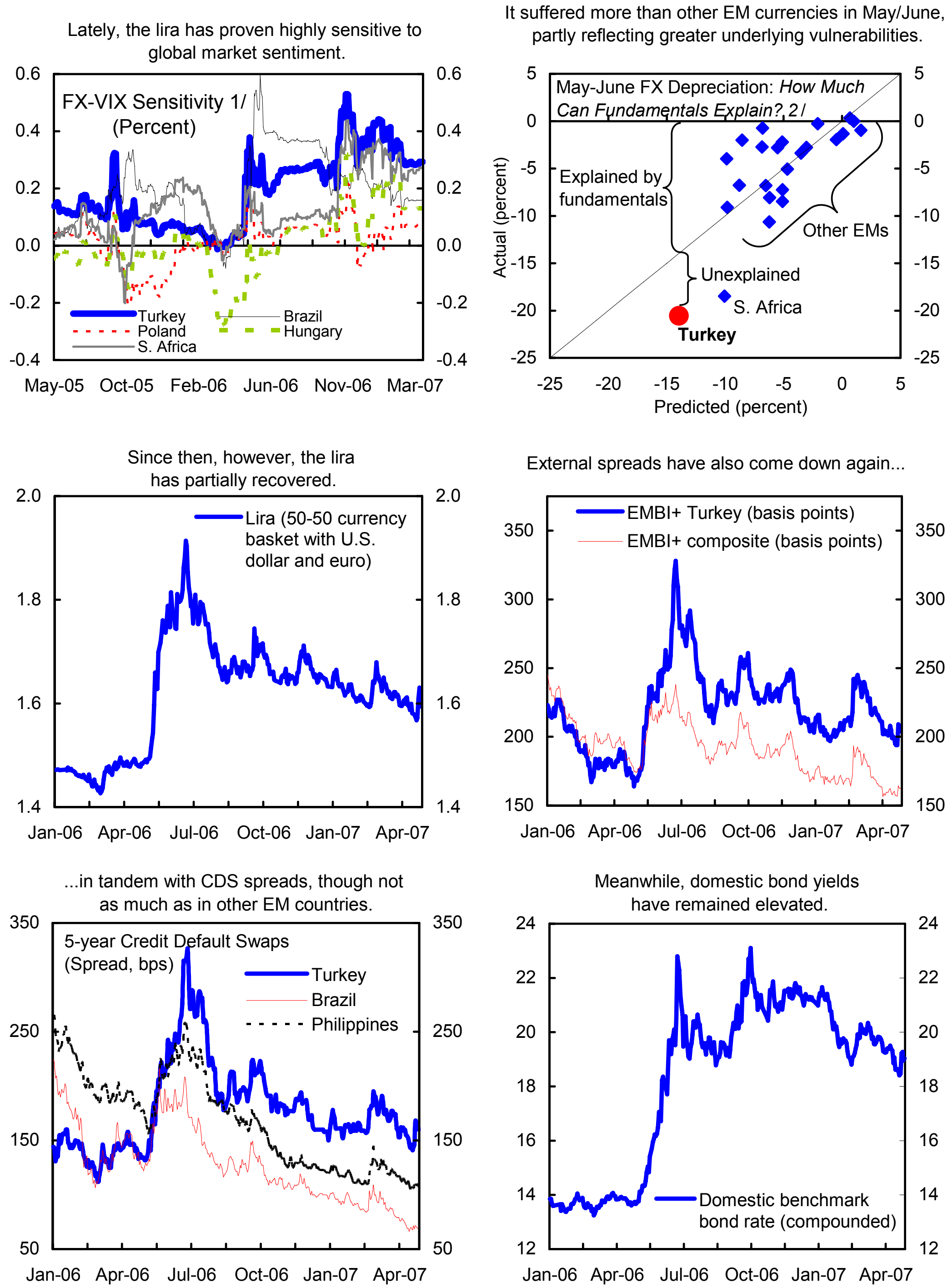
Sources: Turkstat; and IMF staff estimates.

Source: Central Bank of Turkey.



Source: Bloomberg.
1/ VIX: market expectations of volatility of S&P 500 stock index option prices.

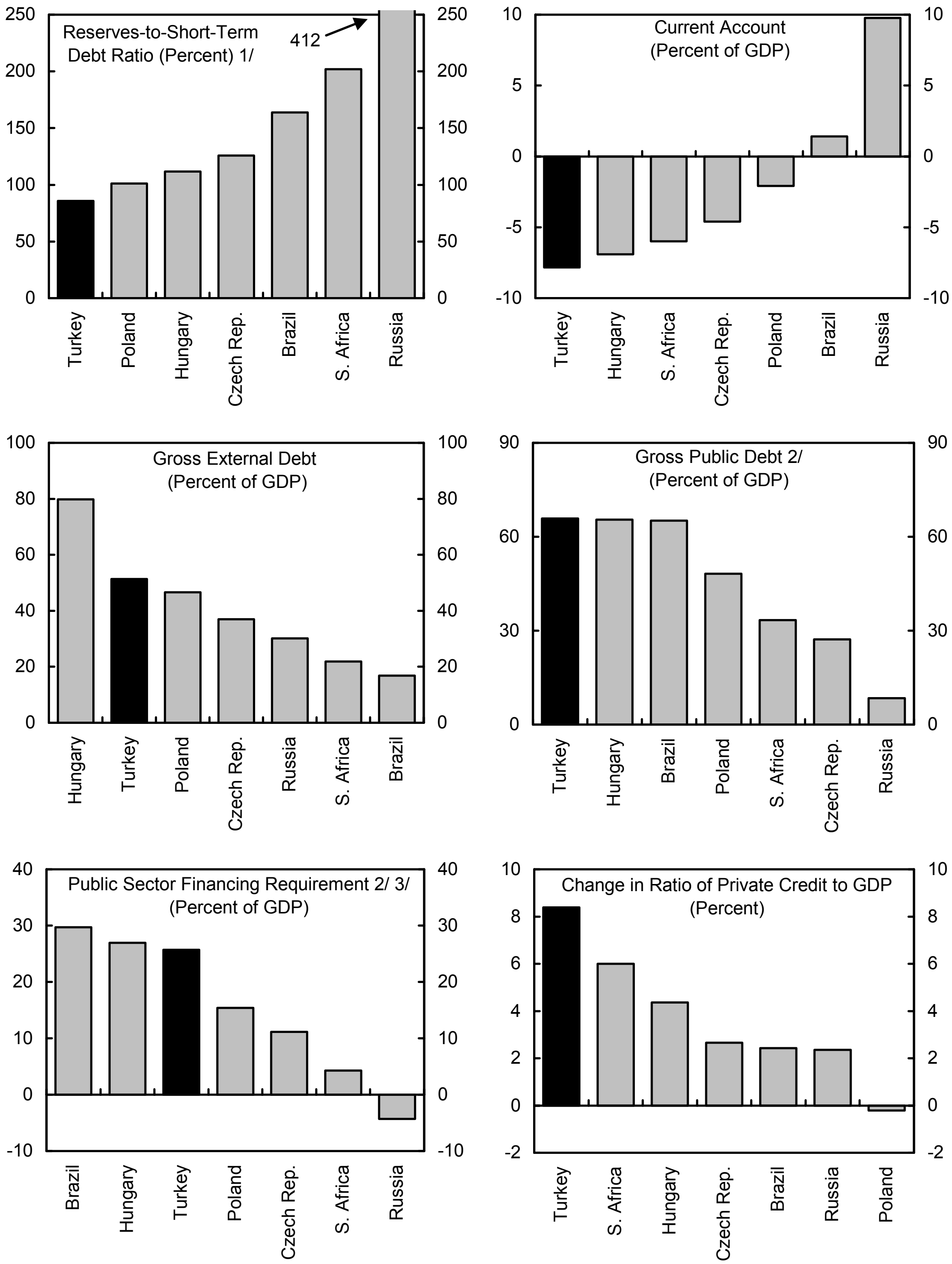
Figure 4. Turkey: Financial Market Rollercoaster, 2006–07
(Percent, unless otherwise indicated)



Sources: Bloomberg; and IMF staff estimates.

1/ Plotted lines represent coefficients of 100-day rolling regressions of the change in FX on the change in VIX.
2/ Staff analysis suggests that mainly three factors—current account deficit, currency overvaluation, and past credit growth—explain why financial markets in some countries were more affected than others during the May–June market turbulence of 2006.

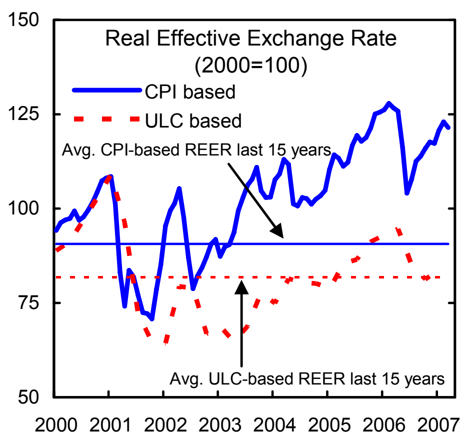
Figure 5. Vulnerability Indicators of Selected Emerging Market Countries, 2006



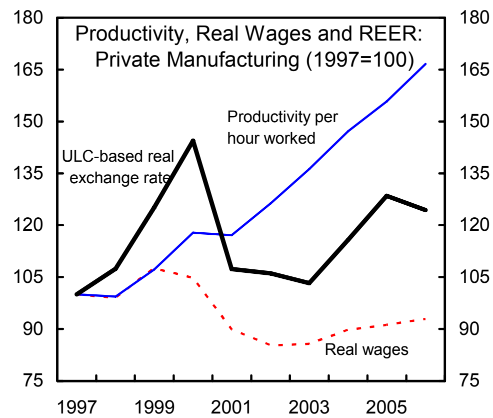
Source: IMF staff estimates.

1/ External debt on remaining maturity basis. Gross international reserves are end of previous year stocks.
2/ Consolidated public sector for Turkey and Brazil, general government for all others.
3/ Sum of overall fiscal deficit and amortization of public sector debt.

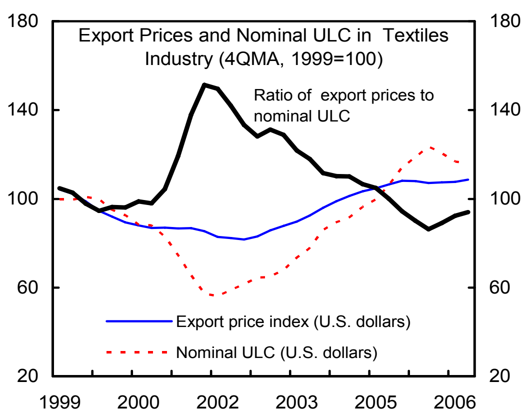
10. **Evidence on lira misalignment is mixed: some conventional measures suggest overvaluation, but export performance has so far been good**. However, such measures may be unreliable for economies undergoing structural changes like Turkey. More heuristically, relative unit labor costs and real wages remain near historical averages, while exports continue to gain market shares, albeit at a moderating pace (Figure 6). So far, the effects of the lira appreciation have largely been offset by slack in the labor market, which has kept real wage growth below surging labor productivity. Still, competitiveness has weakened in some industries—such as the large textile sector, which also suffers from the elimination of quotas. This may reflect, however, a normal structural transformation as Turkey moves up the technology ladder.



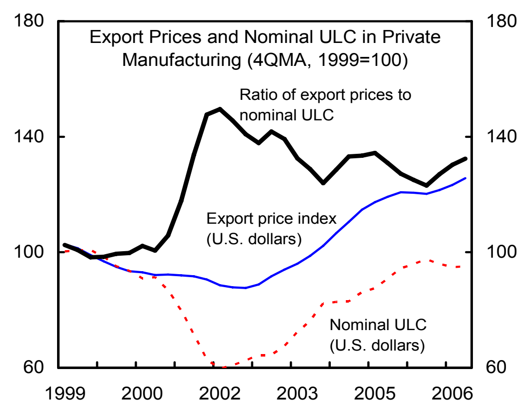
Sources: IMF, internal database; and IMF staff calculations and estimates.



Sources: Turkstat; and IMF staff calculations.

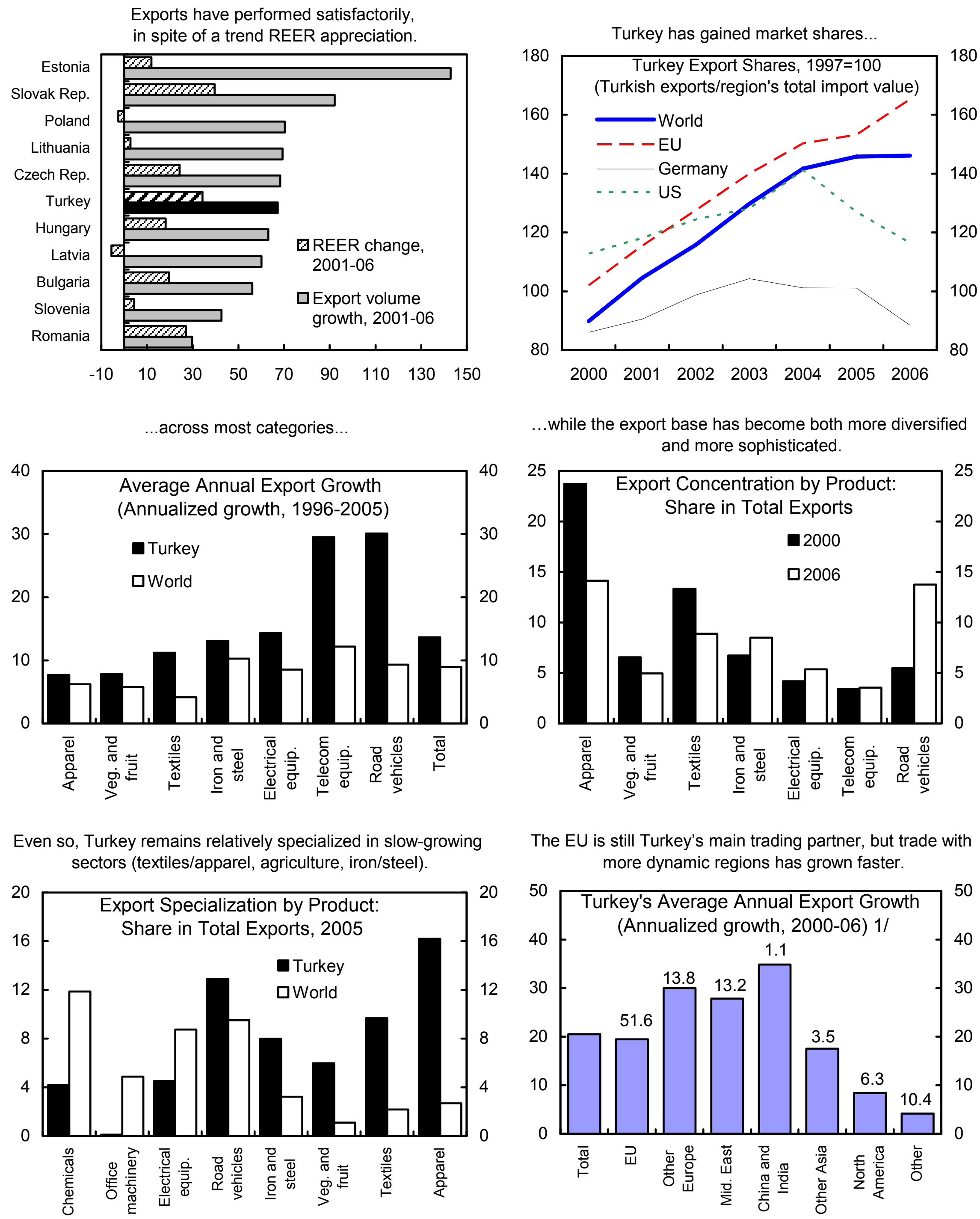


Sources: Turkstat; and IMF staff calculations.



Sources: Turkstat; and IMF staff calculations.

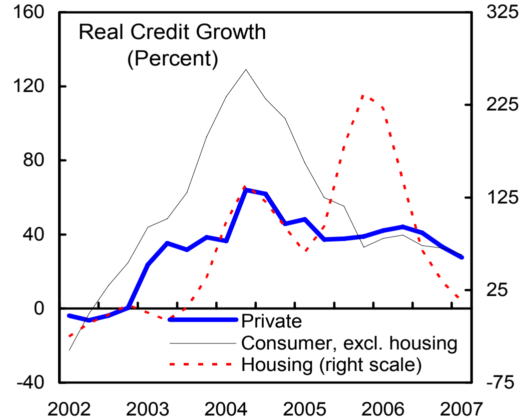
Figure 6. Turkey: Export Sector Indicators, 1996−2006
(Percent, unless otherwise indicated)



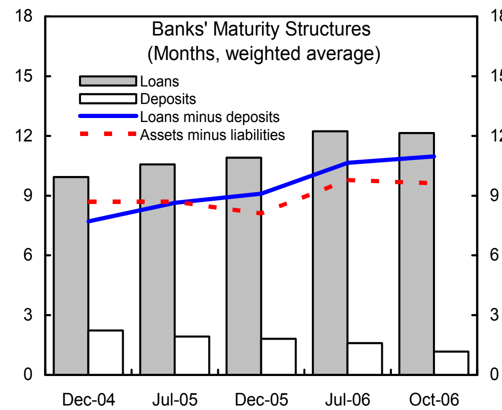
Sources: Turkstat; U.N., Comtrade; IMF, *World Economic Outlook*; and IMF staff estimates.

1/ Figures indicate share of total Turkish exports going to specified region in 2006.

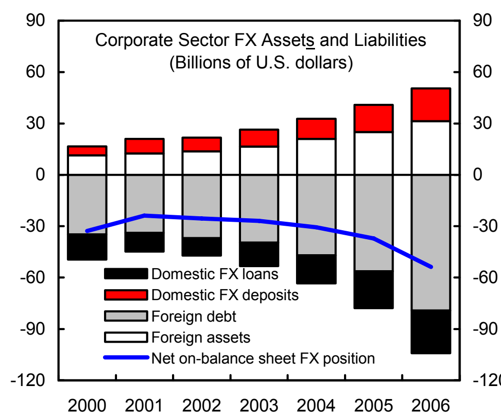
11. **Private balance sheets, while strengthening, remain sensitive to shocks**. Bank balance sheets have generally become more resilient, as banks have addressed most of the weaknesses at the root of the 2001 crisis. However, rapid credit growth (especially in consumer and housing loans), widening maturity mismatches (deposit funding is mostly short-term and adjustable rate lending to households was until recently prohibited), and still sizable, albeit declining, sovereign and currency risks pose challenges to banks.[2] The generally encouraging stress test results (reported in the Financial Sector Stability Assessment, FSSA) and the limited impact of last year's turbulence on bank balance sheets provide assurance—even if the quick rebound in asset prices does not make last year's turbulence a conclusive test (Figure 7).[3] Among *corporates*, an assessment of currency risks is impaired by scarcity of data on hedging, though there are indications that the open foreign currency position may have widened sharply. *Household* indebtedness has also increased briskly, albeit from a very low base, outpacing asset or disposable income growth.



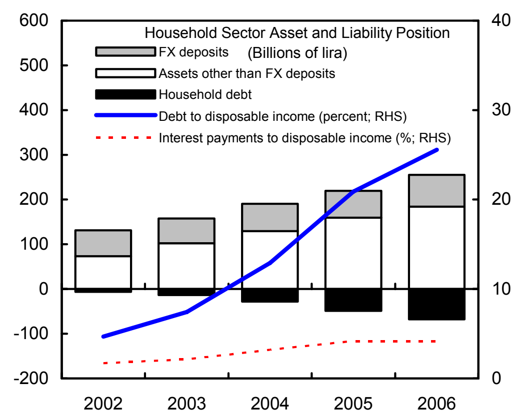
Source: Central Bank of Turkey.



Source: BRSA.



Source: Central Bank of Turkey; and IMF staff estimates.



Source: Central Bank of Turkey; and IMF staff estimates.

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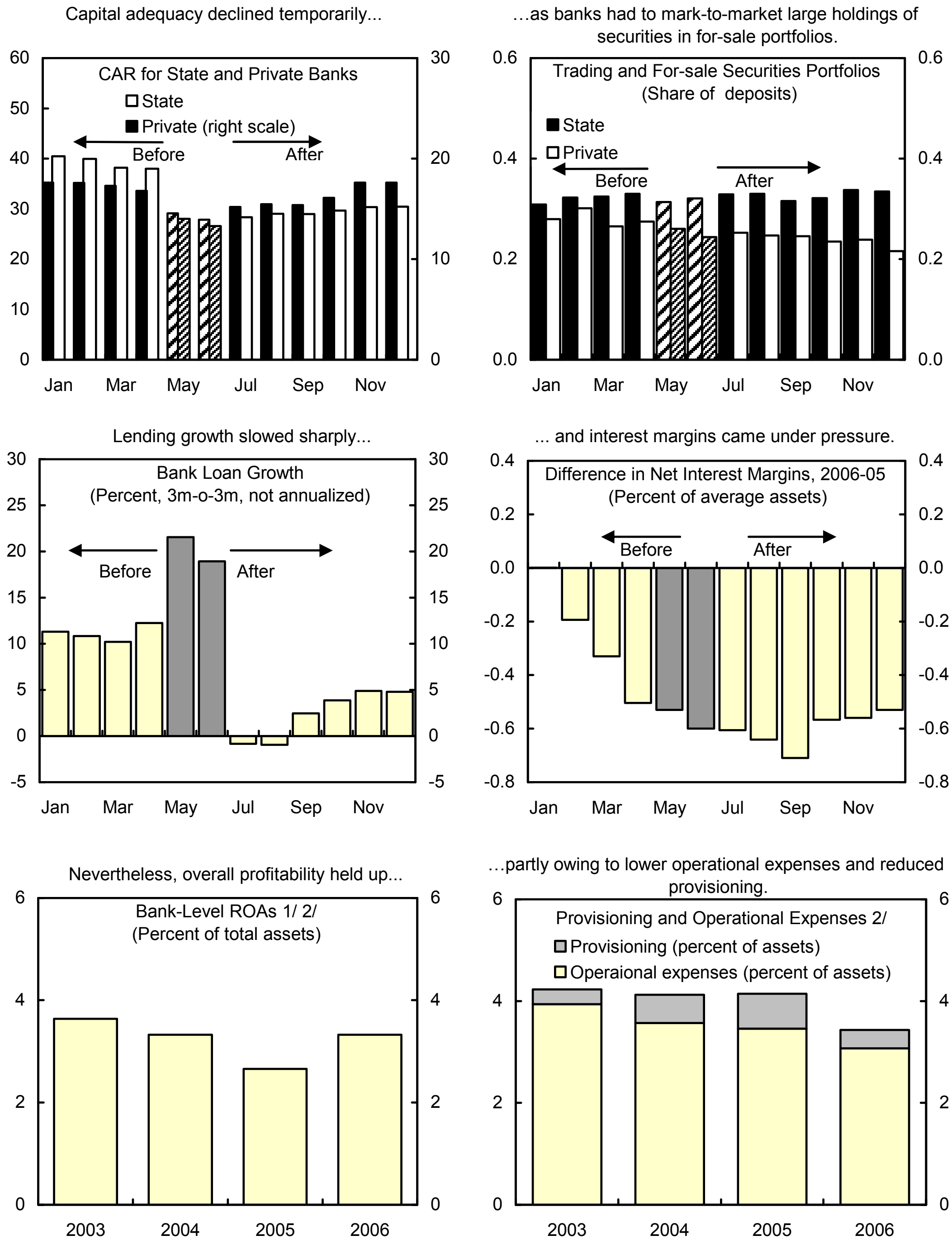
[2] Cross-country evidence indicates that a sustained credit boom could raise the probability of banking distress, especially if combined with large macroeconomic shocks.

[3] Stress tests show that, although there are some vulnerabilities to large interest and credit quality shocks, the sector as a whole has substantial capital buffers.

Figure 7. Turkey: The Banking Sector Before and After the May-June Turbulence, 2006

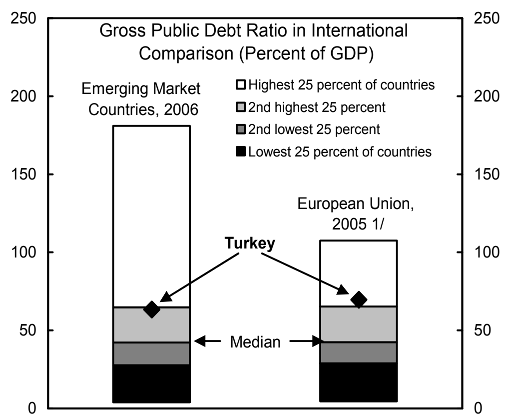
The impact of the turbulence on the banking sector has been limited.



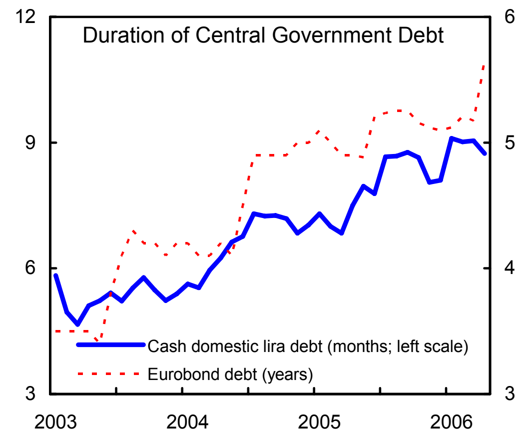
Sources: BRSA; Banks Association of Turkey; and IMF staff calculations.

1/ Profits before taxes relative to average total assets.
2/ 2005 figure reflects exceptional provisioning by one large bank.

12. **Public debt ratios are still relatively high, constraining implementation of countercyclical policy and bidding up interest rates**. Stress tests show that debt could become unsustainable if fiscal discipline were to be abandoned (Appendix II). Exposure to interest rate and currency volatility is also non-negligible, as maturities are still short and around one-fifth of net debt is linked to foreign currency.

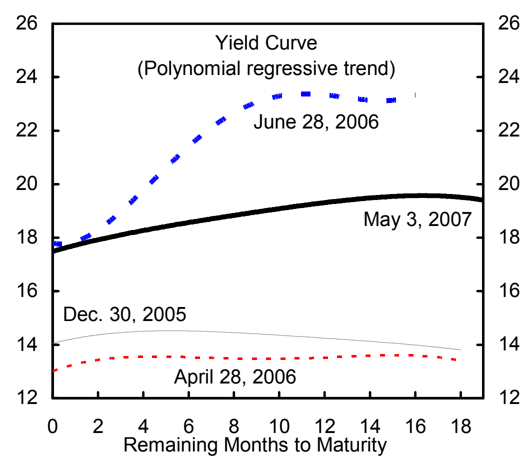


Source: Eurostat; and IMF staff estimates.
1/ Eurostat definition of gross public debt.



Source: Turkish Treasury.

13. **Another macroeconomic challenge is the recent setback in the disinflation process**. The disinflation trend slowed already in 2005 owing to buoyant domestic demand and increased downward rigidity in the setting of wages and prices (particularly in sectors less exposed to foreign competition, such as services). In 2006, lira depreciation and a series of supply-side shocks (unprocessed food, oil, and gold prices) drove inflation back above 10 percent (Figure 8). Since then, actual and expected inflation have remained well above target—notwithstanding a sharp monetary policy tightening and the ensuing slowdown in activity—raising long-term interest rate volatility and exacerbating balance sheet risks.

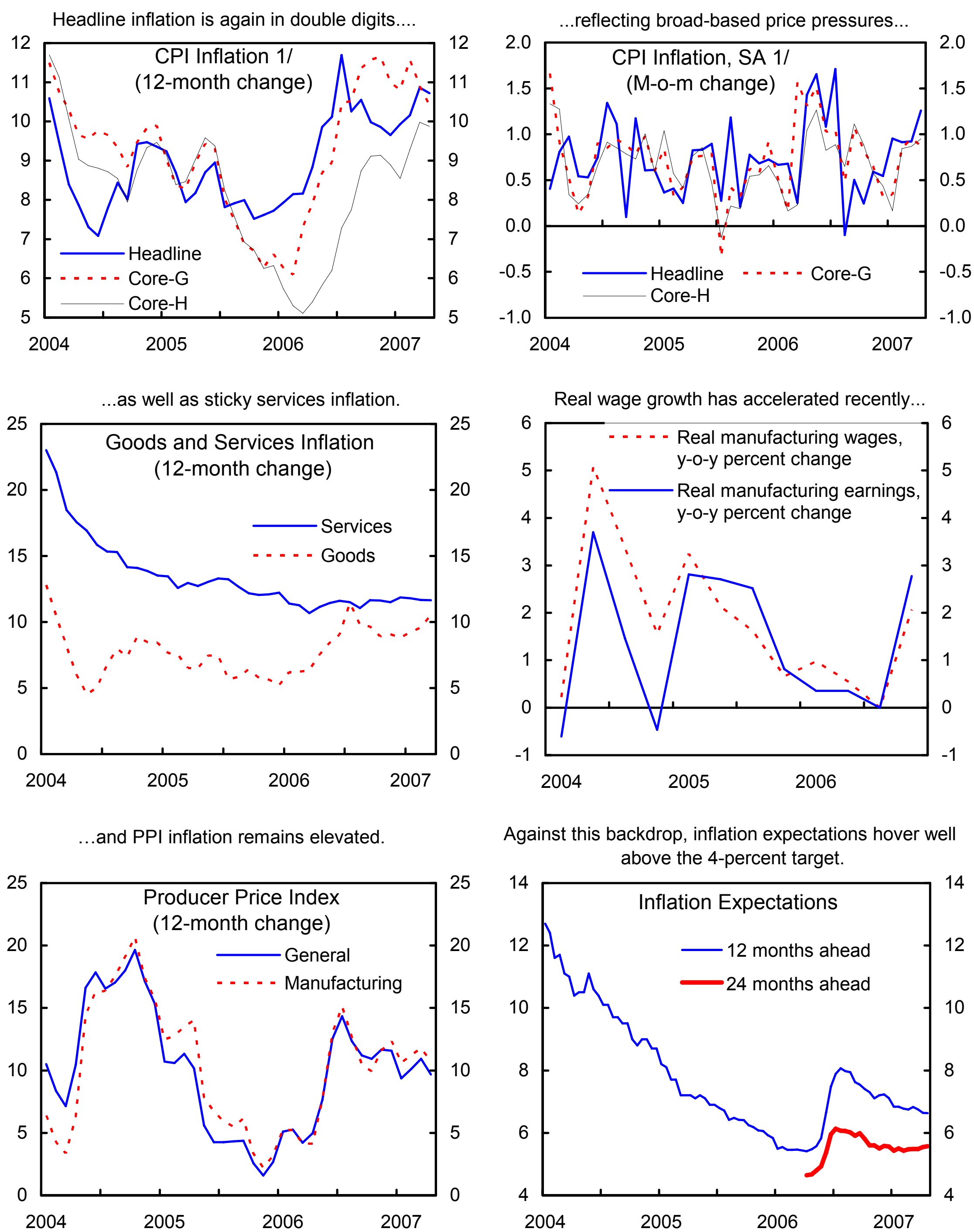


Source: IMF staff calculations.

C. Structural Challenges

14. **Inroads have been made on the structural front, but the reform agenda is far from complete** (Figure 9). Progress occurred in privatization as well as bank and fiscal structural reforms. However, financial intermediation remains low, constraining investment opportunities, while a declining domestic saving rate heightens the dependence on foreign

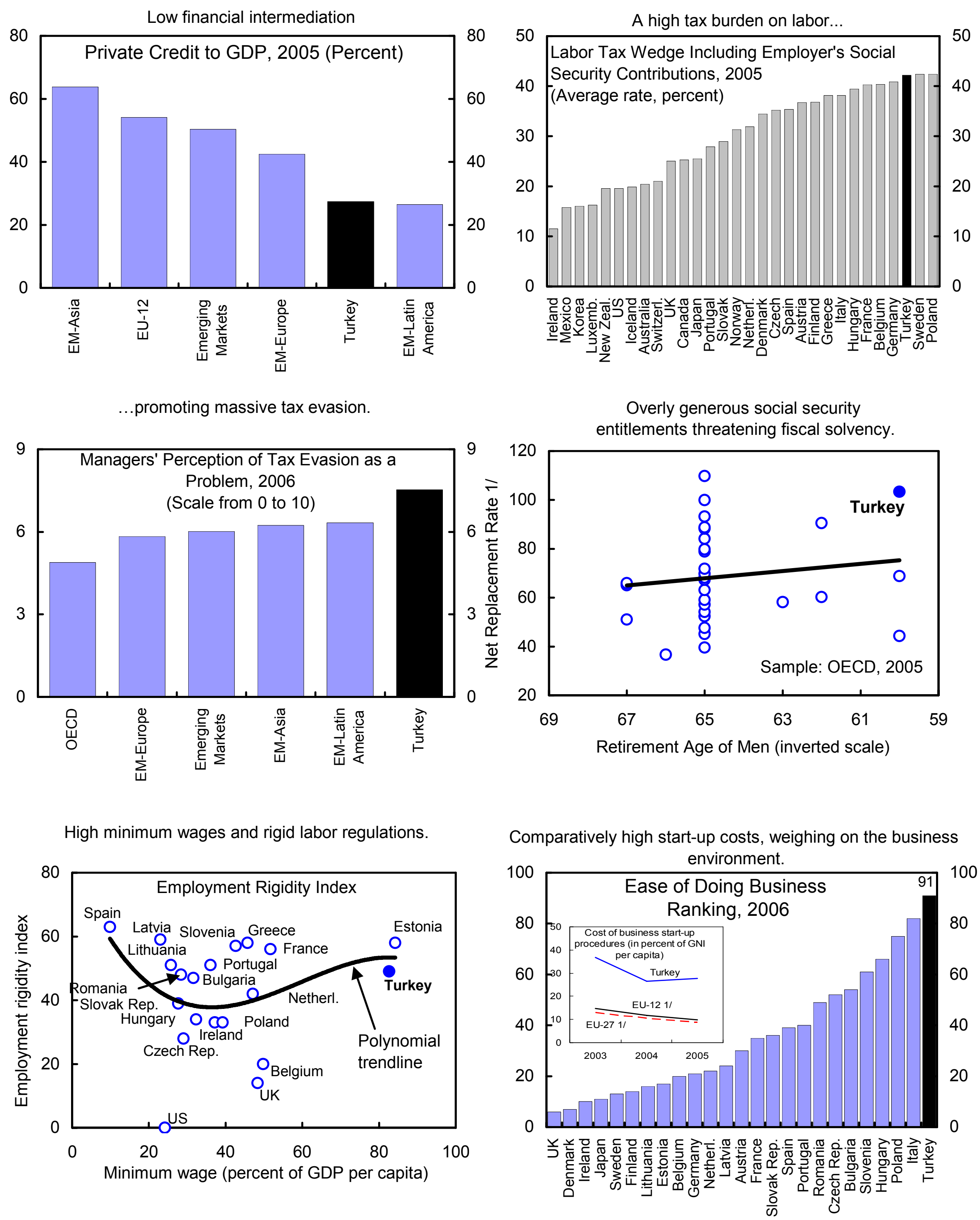
Figure 8. Turkey: Inflation Developments, 2004–07
(Percent, unless otherwise indicated)



Sources: Turkstat; and Central Bank of Turkey.

1/ Index "G" excludes energy, alcohol, tobacco, unprocessed foods and other products with administered prices (all indirect taxes on the components of this index are excluded as well). Index "H" is same as "G", apart from excluding gold prices and including products with administered prices.

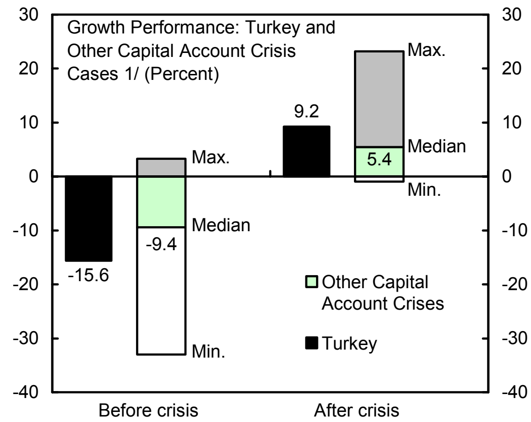
Figure 9. Turkey: Structural Challenges, 2003–06



Sources: IMF, *World Economic Outlook*; IMF, *International Financial Statistics;* IMD, *World Competitiveness Online;* OECD, *Taxing Wages* (2005); Eurostat; World Bank, *Doing Business Database;* OECD, *Indicators of Product Market Regulation.*

1/ In percent of net earnings of an average production worker.

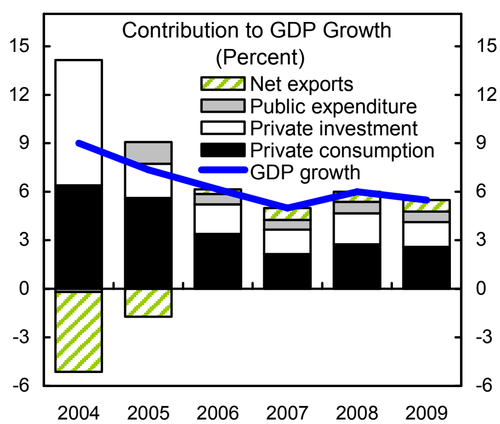
inflows. In addition, long-term fiscal spending pressures (especially on pensions and health) and weak tax enforcement constrain the room for easing the heavy tax burden. Potential bottlenecks in electricity supply also suggest scope for greater private sector involvement in the energy sector. Finally, a large informal sector, where productivity lags, and low employment, especially among women, point to excessive regulatory and tax burdens on labor (Box 3). Tackling these structural challenges could raise economic growth to the rates seen in Turkey's most successful emerging market peers and accelerate convergence to EU incomes.



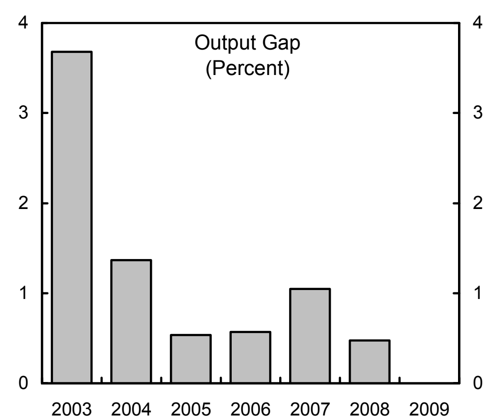
Source: IMF, *World Economic Outlook*.
1/ Cumulative per capita growth (deviation from world per capita growth), five years before (including crisis year) and five years after crisis.

III. Economic Outlook and Risks

15. **The impetus to growth from the post-crisis stabilization shows signs of ebbing**. In 2006, growth moderated to 6 percent from 7½ in 2005, reflecting higher interest rates and weaker consumer confidence following last year's financial market turbulence (Table 2). The composition of growth, however, became more balanced with increased reliance on net exports. With monetary policy expected to remain tight and election uncertainties weighing on confidence, growth could further slow to 5 percent this year, widening the output gap modestly. As election-related uncertainties dissipate and real interest rates decline, current policies are projected to result in a cyclical upswing in growth to 6 percent in 2008.



Sources: Turkstat; and IMF staff calculations.

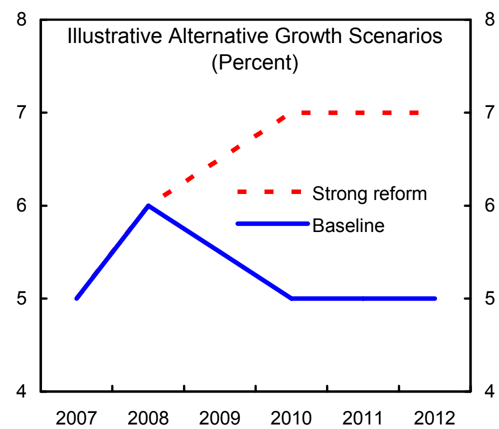


Source: IMF staff estimates and projections.

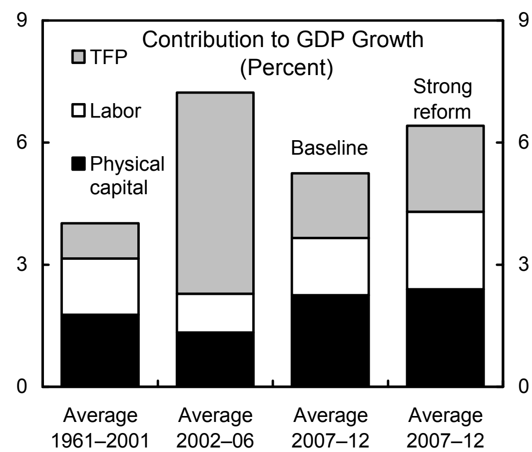
16. **The current account deficit may have peaked in 2006** (Tables 3−4). Softer domestic demand and robust growth in Turkey's main trading partners should reduce the current account deficit in 2007. External financing prospects are expected to remain benign, underpinned by strong FDI, and reserves are projected to rise further. Even so, reserves would remain below short-term external debt (at remaining maturity).

17. **Risks to this outlook are broadly balanced**. The main downward risks to growth are financial market and political turbulence. In this event, lower capital inflows, combined with higher interest rates and a weaker currency, would dampen growth but reduce the current account deficit. Conversely, the removal of election-related uncertainties (and, even more, prospects for a strong, single-party government) could lift investor confidence and attract large inflows, boosting growth but widening the current account deficit. Current account developments will also depend significantly on commodity prices.

18. **Medium-term growth will largely depend on the pace and breadth of supply-side reforms**. With disciplined financial polices, but in the absence of renewed reform momentum, growth is projected to settle at 5 percent from 2009 onward. This is consistent with a slight increase in the capital-output ratio, a modest reversal of the secular decline in the (very low) employment rate (as the pace of labor shedding in agriculture moderates), and an easing of total factor productivity growth from recent record levels (Table 5). Higher long-term growth would be attainable (in their current five-year economic plan, the authorities target 7 percent) provided ambitious structural reforms are implemented (Section IV).



Source: IMF staff estimates and projections.



Source: IMF staff estimates.

19. **Long-term trends in the current account hinge, in turn, on growth prospects**. In the low-growth scenario, the current account deficit is expected to decline gradually, supported by a modest recovery in domestic saving and a deceleration in investment. This outcome is predicated on the current benign external outlook, improving overall fiscal balances (as the interest bill declines), and broadly unchanged competitiveness. Under a strong-reform scenario, high growth and attractive investment conditions would result in large inflows and wider current account deficits. The authorities note, however, that in this scenario stronger export sector productivity would be a mitigating factor. Financing prospects appear favorable in either scenario provided market confidence is preserved.

IV. Policies to Entrench Macroeconomic Stability and Support Growth

20. **Staff and the authorities agreed that the overall strategy for normalizing the economy since 2001 had been appropriate and successful**. The broad policy thrust—the primary budget surplus as an anchor for fiscal policy, the goal of reducing inflation quickly, and the substantial strengthening of bank supervision and bank's balance sheets alongside important structural reforms—had been strong and effective. However, there had been some

shortcomings in implementation: the composition of fiscal adjustment had relied too much on revenue increases and capital spending restraint and some reforms had lagged initial schedules (especially, expenditure rationalization, labor market deregulation, capital market deepening, and privatization of public banks and energy companies). Thus, efforts in these areas would need to be redoubled in the coming years.

21. **Looking ahead, it was also agreed that some redirection of macroeconomic and structural policies is required**.[4] While the economy had responded well to the stabilization shock and some further confidence gains were undoubtedly in store (particularly as inflation falls further), other impetuses to growth will become increasingly important. From this vantage point, entrenching stability and rejuvenating structural reform would be key pillars of economic policy. On the former, discussions explored how and when the primary fiscal surplus target could be eased, whether and in what timeframe an inflation target of 4 percent could be achieved, what mix of macroeconomic policies would minimize upward pressures on the lira, and how to protect the financial system from overheating under the impact of large capital inflows. At the same time, it was recognized that Turkey will be entering a new phase of economic development—one benefiting less from extraordinary cost competitiveness and relying more on underlying structural factors. To this end, discussions explored medium-term goals for a structural reform agenda.

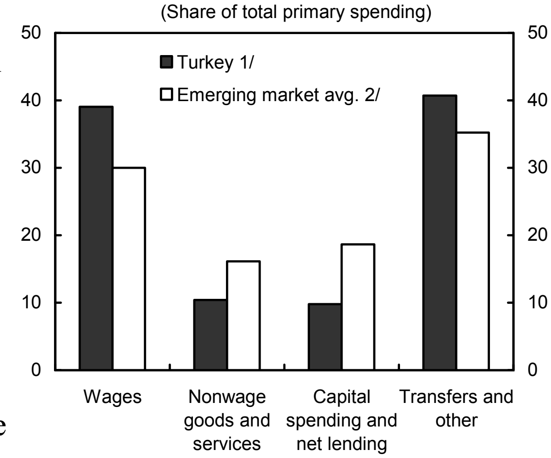
22. **As the agenda is large, reforms need to be prioritized**. Staff suggested giving precedence to reforms that safeguard the fiscal (and external) position, such as structural fiscal reforms and regulatory improvements to labor, financial, and product markets. The authorities generally concurred, but placed particular priority on easing the heavy tax burden.

A. Fiscal Policy: Adapting to Evolving Needs

23. **Tight fiscal policy has been the cornerstone of the macroeconomic strategy**. High primary surpluses (averaging 6.7 percent of GNP since 2002) have supported private sector-led growth by reducing debt ratios and enabling lower interest rates and risk premiums.

24. **The fiscal adjustment has, however, relied excessively on tax increases and investment cuts, and too little on current expenditure rationalization**. There were successful efforts to broaden the tax base and reduce distortions (especially on income taxes). However, recurrent ad-hoc tax and spending initiatives outside of the budget cycle often required suboptimal

Government spending, 2005
(Share of total primary spending)



Sources: FAD's DEME database; Turkish authorities; and IMF staff estimates.
1/ Central government.
2/ Simple average of 18 emerging market countries for which data are available; coverage of government varies across countries.

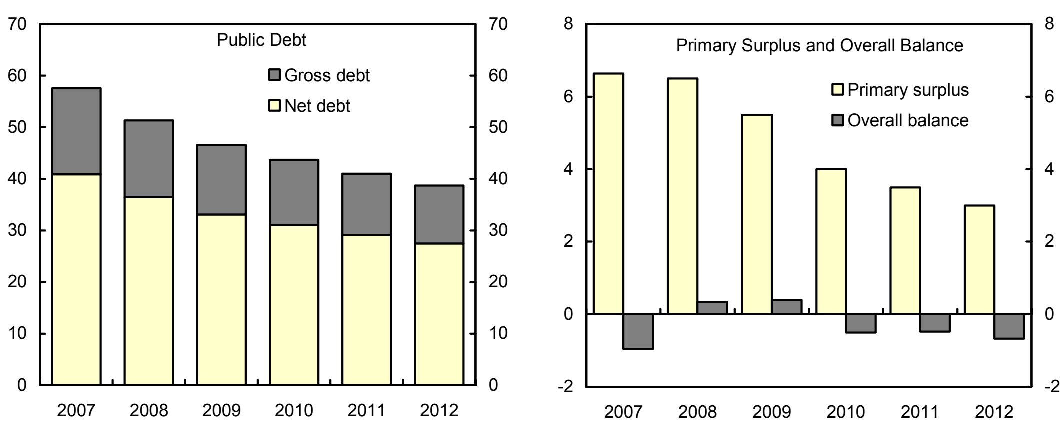
[4] The discussions revealed at least qualitative agreement between the authorities and staff on most subjects. The text below, therefore, mentions the respective views only where there were differences (or when the authorities felt especially strongly even though they agreed with staff).

offsetting measures in the form of investment spending cuts or excise tax hikes. Last year, large one-off revenues were used to accommodate higher spending; thus, the primary surplus adjusted for exceptional items fell to around 5 percent of GNP—even though the headline figure was 6.6 percent of GNP (Tables 6−7). This imposed a considerable adjustment in this year's budget, which is proving difficult to deliver.

25. **In the short term, keeping to the announced fiscal spending targets will help confidence, support disinflation, and bolster domestic saving**. This year, the authorities blocked some 0.8 percent of GNP in outlays to (i) offset 2006 spending overruns (as per program commitments), (ii) compensate for several unbudgeted initiatives, and (iii) close the gap in the state enterprise balance opened by the failure to effect planned hikes in end-user energy tariffs (Section IV.H). Implementation of these measures should enable a primary surplus of some 6.7 percent of GNP. Achieving this target will, however, require resolve, given the scale of the targeted adjustment in the underlying fiscal position, election-related pressures, and indications of softening tax revenue.

26. **Looking further ahead, continued progress in debt reduction should allow a gradual easing of the primary surplus**. High real interest rates and the vulnerability of debt dynamics to large shocks still argue for bringing the debt ratio to safer levels. Staff recommends preserving the 6.5 percent of GNP primary surplus target in 2008, since some of the reforms key to entrenching long-run fiscal sustainability, notably pension and civil service reforms (see Section IV.G), are not yet in place. Such a surplus would also avoid an unnecessary procyclical stimulus. The authorities are, however, eager to begin using fiscal resources to reduce the high tax burden and increase investment spending. Staff projections show that, absent shocks, it should be possible to reduce the primary surplus from 2009 onward while balancing the budget and generating fiscal space. Staff favors using this fiscal

Medium-Term Fiscal Framework: Baseline Scenario 1/
(Percent of GNP)

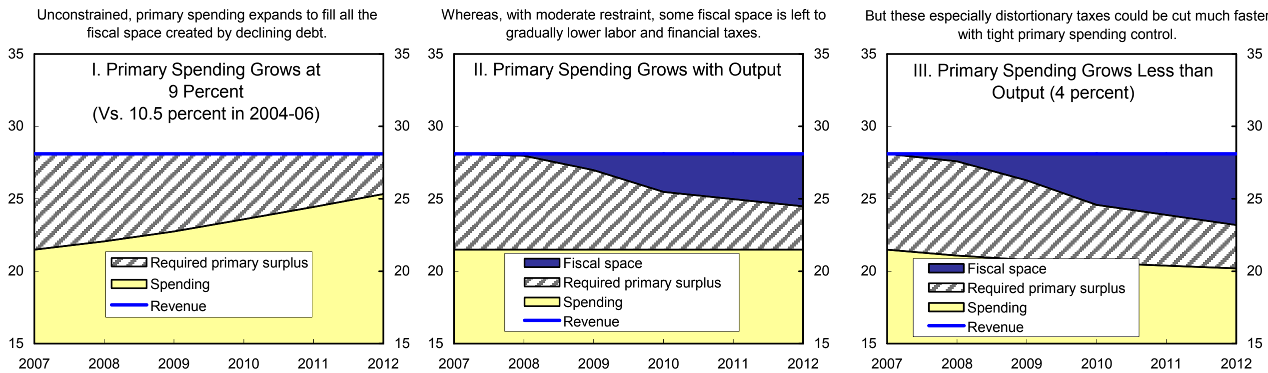


Source: IMF staff estimates.

1/ The projected path for the primary surplus preserves the 6.5 percent anchor through 2008. The subsequent gradual decline is calibrated to secure a further reduction in net debt to 27 1/2 percent of GNP by 2012.

space to alleviate distortions arising from Turkey's heavy tax burden (Section IV.E and IV.H), instead of expanding spending, which is likely to be used less efficiently. Room for greater investment outlays could be created by rationalizing other spending.

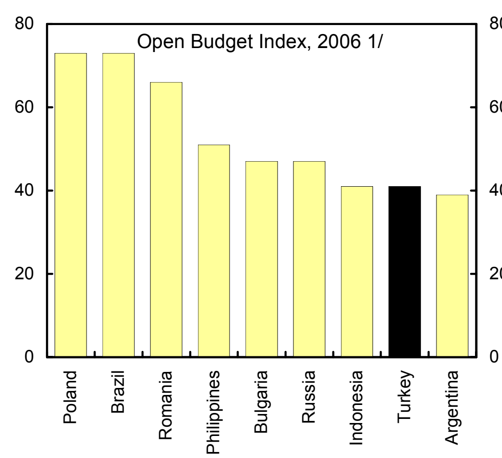
Fiscal Space for Tax Reforms under Alternative Assumptions on Real Primary Spending Growth 1/ 2/
(Percent of GNP)



Source: IMF staff estimates.
1/ All scenarios are consistent with achieving a net debt ratio of 27.5 percent by 2012. Each 10 percentage point cut in employer (employee) social security contributions is estimated to cost 1.3 (1.8) percent of GNP. The elimination of bank transaction taxes would cost 0.8 percent of GNP.
2/ Projections conservatively assume (i) no positive supply-side feedback from cuts in distortionary taxes; (ii) no privatization recepits after 2007; (iii) no revenue buoyancy; and (iv) a high real interest rate (10 percent).

27. **A well-designed fiscal rule could serve as an anchor amidst competing medium-term fiscal objectives**. Either an expenditure rule or a (balanced) budget rule would support debt reduction. An expenditure rule combined with a debt target would, however, be more conducive to expenditure restraint and, thus, to creating fiscal space for tax reforms (see SIP). Stressing that the main problem has been an overly rapid expansion of current primary spending, the authorities suggest exempting investment spending from such a rule. But staff believes this might promote opportunistic reclassifications of expenditure. As to timing, the authorities feel that it is still too early to replace the primary surplus target, which has been a successful guide to fiscal policy, with an untested alternative.

28. **Meanwhile, budget accountability and fiscal transparency—key conditions for any successful fiscal rule—are being improved**. The public financial management and control law adopted in 2003 needs to be implemented in full. This law aims to enhance budget accountability and transparency, including by requiring medium-term performance-based budgeting as well as the preparation of annual accountability reports and a mid-year fiscal outlook. The authorities are also making efforts to improve fiscal transparency (Section V).

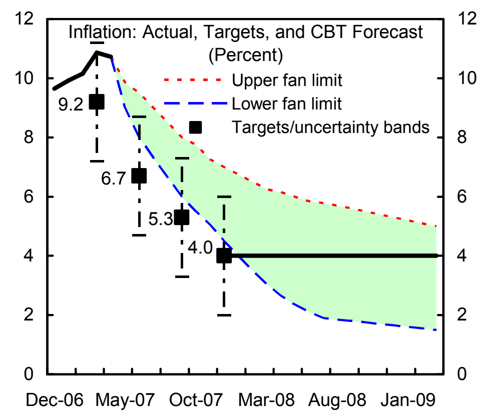


Source: Center on Budget and Policy Priorities.
1/ A higher score corresponds to more information published in key budget documents.

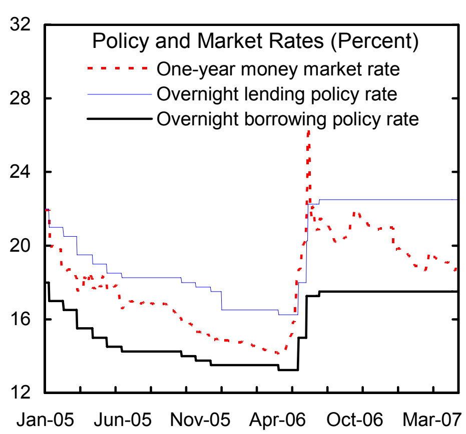
B. Monetary Policy: Disinflation Is the Primary Objective

29. **It was agreed that the 4 percent medium-term inflation target should be preserved**. With hindsight, a legitimate question is whether the inflation targets were too ambitious given the large inflation overshooting. In particular, the 2005–07 targets may have relied to a large extent on a continued lira appreciation. Conversely, it can also be argued that monetary policy was too lose in late 2005−early 2006, as domestic demand was expanding rapidly. Even so, it is unclear whether *slightly* higher targets would have altered policies and outcomes significantly given the many unanticipated supply-side shocks. Going forward, there was agreement that reducing and stabilizing inflation around the 4 percent target would help reduce risk premiums and support growth.

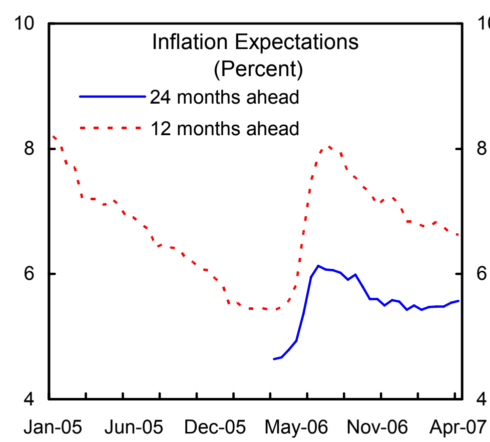
30. **The near-term inflation outlook is dominated by upside risks**. The central bank projects end-2007 inflation in a 4.5–7.1 percent range (70 percent probability), converging to the 4 percent target as the mid-point only by the second quarter of 2008. This forecast is based on unchanged policy rates in the second and third quarters of this year and gradual easing thereafter. Risks to this outlook are mostly on the upside, owing to (i) difficulty in breaking services inflation; (ii) possible second-round effects from the recent spike in unprocessed food prices; and (iii) unanticipated strength in domestic demand (due to fiscal spending pressures or weaker-than-expected effects from past interest rate hikes).[5] Currency swings are an additional source of risk.



Sources: Central Bank of Turkey; and IMF staff calculations and estimates.



Sources: Central Bank of Turkey; and Bloomberg.



Source: Central Bank of Turkey.

[5] While there is still some uncertainty on the strength of the monetary transmission mechanism, financial deepening appears to be bolstering the bank liquidity channel (see SIP).

31. **There is, therefore, little alternative to keeping monetary policy tight in the near term**. The level of interest rates is appropriate, as is the central bank's tightening bias: positive surprises about the inflation outlook should elicit no policy response, but negative news should defer rate cuts or even lead to rate hike s. In this regard, the central bank noted that a sudden reacceleration of credit growth would be a warning sign that the medium-term target is at risk.

32. **Staff and the authorities concurred that, once inflation is on a firm downward trend, interest rates could be cautiously reduced**. Timing the start of the easing cycle is a difficult task. The central bank stressed that the central scenario of beginning rate cuts in the fourth quarter of 2007 is not a commitment, but a conditional statement. In the absence of suitable leading indicators of inflationary pressures (wage data, for instance, are released with significant lags) and in view of the predominantly backward-looking inflation expectations, the central bank will focus on trends in actual inflation. Specifically, a declining path of services inflation would suggest that inflationary pressures are subsiding and that a gradual monetary easing could start.

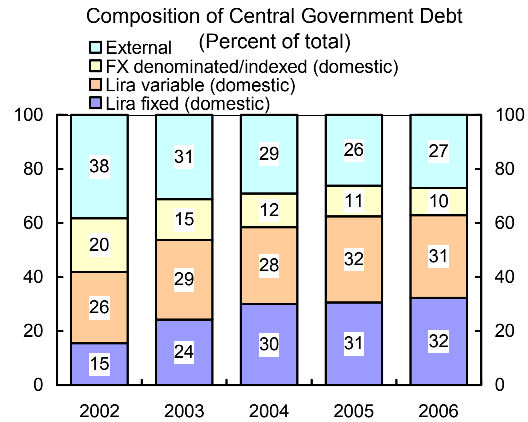
33. **Preserving central bank independence and continuing to enhance the monetary policy framework are crucial for securing low inflation**. Before adopting formal inflation targeting (IT) in January 2006, the central bank increased the transparency and accountability of its monetary policy operations by making the timing of interest rate decisions predictable, assigning responsibility for setting rates to the monetary policy committee, and announcing issuance of a quarterly Inflation Report with medium-term inflation projections. The new IT framework, however, quickly faced challenges, as a sharp depreciation of the lira and a series of supply shocks led to a large breach of the inflation target. So long as inflation remains above target, the central bank should keep explaining the reasons for the deviations, presenting a realistic disinflation trajectory, and communicating policy intentions clearly. Regarding independence, the central bank acknowledges that reserve accumulation has resulted in high sterilization costs, which are affecting its income position. It stresses, however, that this will not jeopardize its operational independence.

C. Should Policies Respond to Upward Pressure on the Lira?

34. **Rebalancing of policy mix (monetary easing with fiscal tightening) could, in principle, alleviate upward pressure on the lira, but this was not seen as pressing with the current account seemingly stabilizing**. Fiscal policy is already quite tight and a further tightening might not be credible. The central bank would also be wary of easing monetary policy prematurely while inflation is still well above target. Even so, the strong lira argues for keeping fiscal policy tight to create room for lowering high real interest rates. Beyond this, it will be important to move forward with supply-side reforms to improve competitiveness, and to build cushions in balance sheets to minimize disruptions from a possible disorderly lira correction.

D. Asset and Liability Management: Reducing Risks in Public Balance Sheets

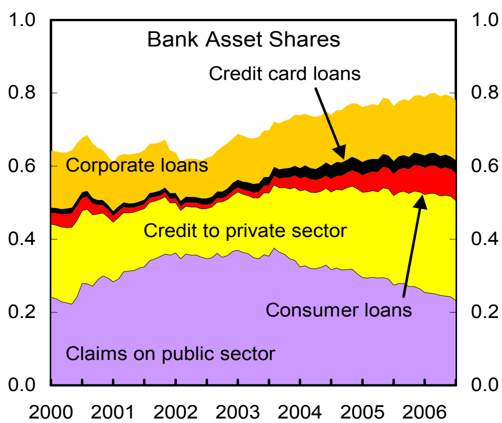
35. **The authorities are further strengthening public balance sheets to increase resilience to external shocks**. The Treasury's strategy is to lengthen debt maturities further and reduce domestic foreign-currency debt (including by issuing inflation-indexed bonds) to mitigate market and rollover risks, while preserving adequate deposits at the central bank as a liquidity buffer. Meanwhile, the central bank intends to limit further deterioration in reserve coverage by gradually building up international reserves through daily purchase auctions. And, while the central bank is willing to increase daily purchases if market conditions are favorable, it notes that the predictability of this intervention is crucial to the credibility of the floating exchange rate regime.[6]



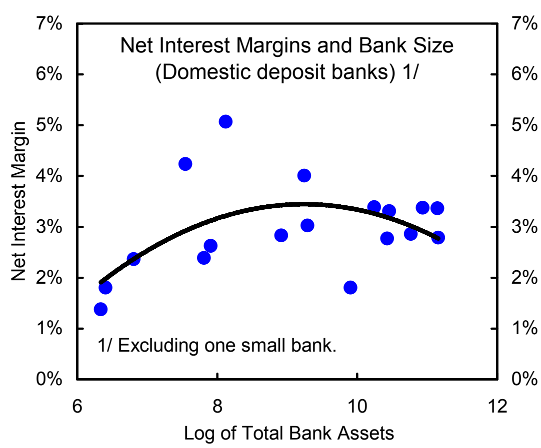
Source: Turkish Treasury.

E. Deepening Financial Intermediation While Safeguarding Bank Soundness

36. **The recent rapid growth of the financial system has facilitated economic recovery but also created new challenges**. Supportive economic conditions, reduced government financing needs, and large foreign inflows have revived private financial intermediation. The banking system has been the main beneficiary, with increased foreign control spurring competition and balance sheet growth. However, the associated narrowing



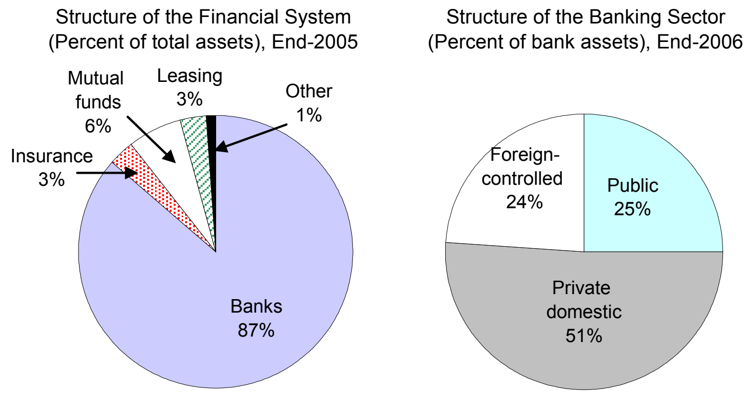
Source: Central Bank of Turkey.



Sources: BRSA; and IMF staff estimates.

[6] Daily foreign-currency purchases would have to be increased by US$20 million (from current daily average of USD$30 million) in order to achieve 100 percent reserve coverage by end-2008.

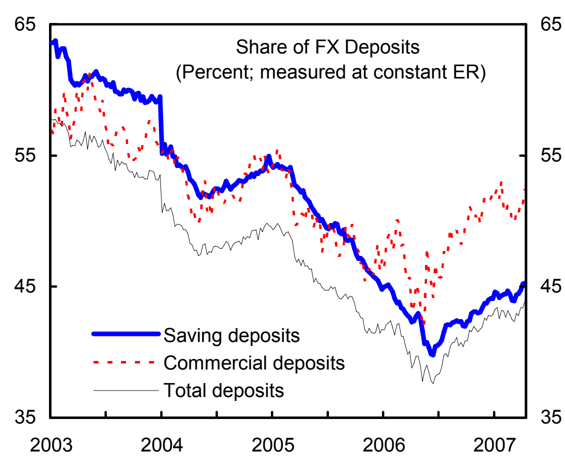
of banking margins, which has been most pronounced in the smaller banks, has heightened incentives for risk taking. Meanwhile, nonbank institutions (mostly controlled by banks), have lagged: banks continue to hold the lion's share of financial sector assets, with the three public banks retaining a large role. Discussions, therefore, focused on ways to deepen financial intermediation, while keeping the system sound.



Sources: BRSA; and IMF staff estimates.

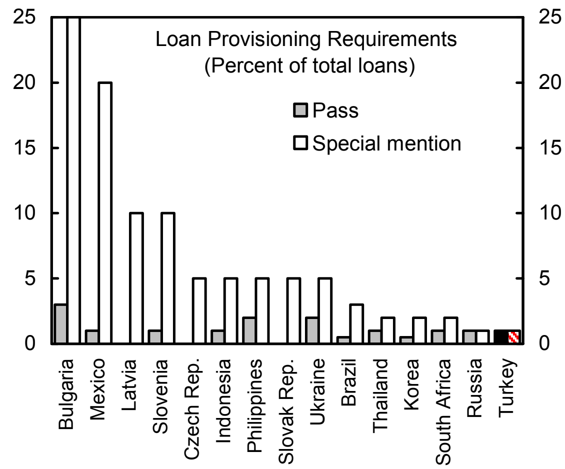
37. **The newly adopted mortgage law should foster financial intermediation**. Over time, this law should help (i) reduce banks' maturity mismatches by introducing adjustable-rate mortgages and (ii) increase competition from nonbank lenders by strengthening the regulatory infrastructure for primary and secondary markets. Importantly, the authorities overcame pressures to introduce tax deductibility of interest payments—which would have distorted the allocation of savings and narrowed the tax base. However, the authorities agree that a growing mortgage market could amplify economic cycles and fuel rapid credit growth (see SIP). Strict supervision and prudent regulation of mortgage conditions (such as loan-to-value ratios) are therefore needed.

38. **The authorities intend to remove other obstacles to financial development**. Despite its recent surge, the ratio of private credit to GNP remains lower than in comparator countries. In addition, a significant portion of private lending is intermediated through domestic banks' offshore branches to circumvent taxation and restrictions on foreign currency lending. Moreover, the maturity of bank deposits remains very short, and the degree of deposit dollarization is high. The authorities note that deposit maturities and dollarization will improve only gradually as low inflation becomes entrenched (the recent launching of inflation-indexed bonds will help). They give high priority to phasing out financial transaction taxes to reduce intermediation margins and bring back onshore banking activity. Outside of the banking system, they pledge to adopt pending insurance and capital markets legislation, as these steps should deepen the equity, corporate bond, and insurance markets, thereby increasing demand for long-term lira debt instruments.



Source: BRSA.

39. **Prudential buffers should be built in tandem with the development of the financial sector**. Although credit growth has slowed recently, mortgage market liberalization and other measures under consideration are likely to rekindle credit growth. To contain related risks, sizable cushions in balance sheets and strict supervision are crucial. In this regard, the recent moves to increase general provisions for performing ("pass") loans and to instruct all banks to target a 12 percent capital adequacy ratio are welcome. A further tightening of provisions (particularly for "special mention" loans, where provisioning is more lenient than in other countries), would help guard against difficult-to-price credit risks in a cyclical upswing. Introducing dynamic provisioning could be an effective alternative to raising provisions outright.



Source: IMF staff calculations and estimates.

40. **Further improvements in supervision would increase the quality of the banking system**. The authorities agreed that supervisory practices should be brought fully in line with the high standards enshrined in the new banking law. As the financial system becomes more complex, a key challenge will be to assess risks on a consolidated basis. Unifying financial sector supervision under a single body would be one way to achieve this, but the authorities prefer to study this issue further. Beyond this, given firms' high foreign currency exposure and the risk of knock-on effects on banks, the coverage and timeliness of corporate financial statements should be improved and accounting and auditing practices strengthened. The authorities' intention to expand credit bureau information to cover firms should facilitate credit risk assessments by banks.

Fitch Banking System Risk Matrix

Banking System Indicator (measure of quality)	Macro-Prudential Indicator (measure of vulnerability)		
	1 (low)	2 (moderate)	3 (high)
A ("very high")			
B ("high")	Chile Mexico	Estonia Czech Rep.	Iceland S. Africa
C ("adequate")	Brazil Cyprus Malaysia	Latvia Malta Slovenia	
D ("low")	Hungary Indonesia Philippines Poland	Lithuania Slovakia **Turkey** Ukraine	Russia
E ("very low")	Argentina Equador Uruguay	Vietnam	Azerbaijan

Source: Fitch, Bank Systemic Risk Report, March, 2007.

41. **State bank privatization would increase efficiency**. After many delays, the IPO for 20–25 percent of the government's share in Halkbank is underway. Staff urged that the residual government stake be sold within the next year and the privatization of Ziraat (the second largest deposit-taking institution) launched at once. The authorities, however, are reluctant to commit to specific plans, noting that Ziraat serves a social function as the only financial institution with branches in rural areas.

42. **The authorities plan to fiscalize losses from the banking crisis, which currently encumber the deposit insurance agency's (SDIF) balance sheet**. The SDIF plans to

dispose of its assets taken over from intervened banks by end-2007. At that point, the related losses (some 11 percent of GNP) will be fiscalized (without affecting headline public debt figures), enabling the agency to focus exclusively on its role as deposit insurer.

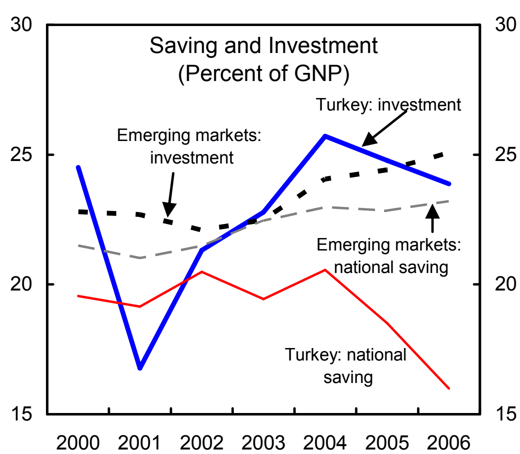
Asset Recovery by the Saving Deposit Insurance Fund (SDIF) 1/

	As of end-2006	2007–18	Total
		(Billions of U.S. dollars)	
A. Debt to Treasury (principal amount) 2/	25.7	…	…
B. Debt to Treasury (principal amount and interest)	56.0	…	…
C. Total recovery, *of which:* 3/	14.0	7.5	21.5
C1. Repayments to Treasury 4/	6.5	9.0	15.5
C2. Repayments to other debtors	5.2	0.8	6.0
		(Percent)	
D. Recovery rate for Treasury, excluding interest (C1/A)	25.3	…	…
E. Recovery rate for Treasury, including interest (C1/B)	11.6	…	…

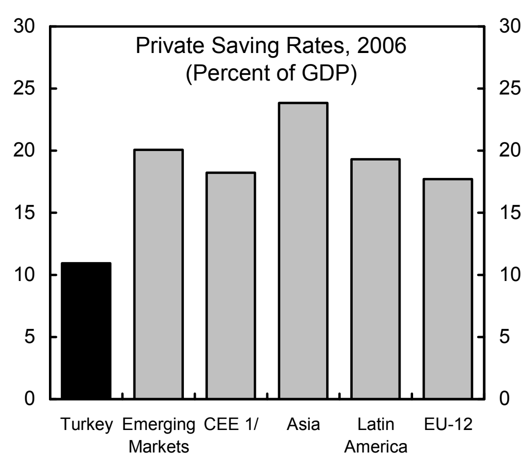
1/ Since 1997, the SDIF has taken over 21 private banks (20 percent of banking sector assets) and resolved all but one.
2/ Amount borrowed from the Treasury to restructure intevened banks and compensate depositors.
3/ Mostly claims on former bank owners. Protocols have been signed, but some of them do not expire until 2018.
4/ In 2007, the expected amount to be repaid to the Treasury is US$ 1.6 billion.

F. Reversing the Downward Trend in Saving

43. **Spurring domestic saving would make economic growth less dependent on volatile foreign capital**. The domestic saving rate has fallen, as higher public saving has only partly offset a rapid decline in private saving. This trend chiefly reflects successful macroeconomic stabilization since 2001 (see SIP). Although a certain recovery of saving rates can be expected as income catch-up proceeds, supportive policies, including continued fiscal prudence and pension reform, would help raising domestic saving. Steps to deepen capital markets and develop private retirement saving plans are also promising.



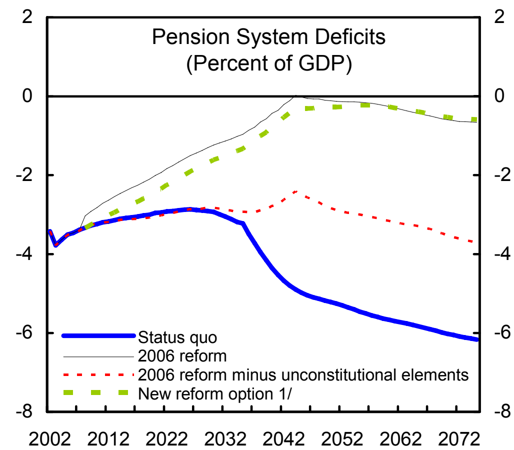
Sources: IMF, *World Economic Outlook*; and IMF staff calculations and estimates.



Sources: IMF, *World Economic Outlook*; and IMF staff calculations and estimates.
1/ Central Eastern European.

G. Safeguarding Fiscal Solvency and Creating Fiscal Space

44. **Social security reform is critical to securing fiscal sustainability and reducing labor market rigidities**. Turkey's mandatory pension systems offer the lowest retirement ages (60 for men and 58 for women) and the second-highest benefits relative to pre-retirement earnings in the OECD. The average Turkish worker with a full career receives an untaxed pension exceeding his/her net pre-retirement salary. Consequently, the pension system spends over one-fourth of central government outlays and runs deficits of 3½ percent of GNP, despite some of the highest social security contribution rates in the OECD. Moreover, separate systems for civil servants, private sector employees, and the self-employed hinder labor mobility across sectors. Comprehensive pension reform to rationalize benefits, gradually raise retirement ages, and integrate systems is therefore essential to securing long-run fiscal sustainability, creating fiscal space to ease the heavy labor tax burden, and improving labor market flexibility.



Source: World Bank staff estimates.
1/ Option under consideration in the authorities' draft white paper.

45. **The authorities intend to resurrect the social security reform recently struck down by the Constitutional Court**. The government will publish soon a white paper discussing alternative approaches aimed at recapturing most of the 2006 reform's savings in constitutionally valid ways. A revised reform should be adopted by mid-2008.

46. **Increasing health care efficiency would help preserve a sound fiscal position and improve budget quality**. Turkey has made good progress in expanding access to care and moving toward universal coverage, but this has preceded efficiency gains, causing substantial health spending overruns in recent years. The authorities thus plan to strengthen control over public hospital expenditure by setting hospital-by-hospital quarterly budgetary targets. Simultaneously, they have begun implementing measures, such as strengthening information technology and promoting the use of more cost-effective treatments, to enhance the efficiency of health care provision. They also plan to reduce frivolous demand by adjusting copayments.

47. **Expenditure rationalization and enhancements in tax administration would also create fiscal space**:

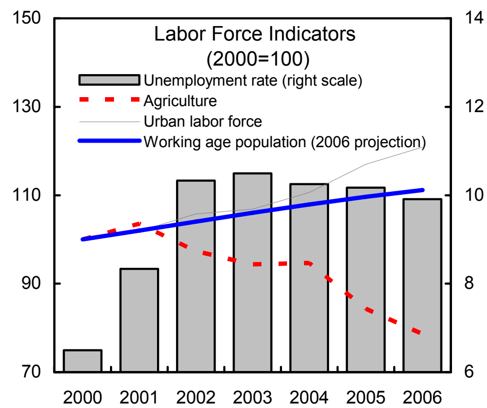
- Civil servant expenses are high (over one-third of central government primary spending) and could be streamlined through attrition and pay rationalization. The authorities broadly agree with these goals, but consider that any legislative initiative in this area would best be taken up by the new parliament.
- There is substantial scope to improve revenue collection, especially by focusing resources on the highest-yielding activities. In this regard, the recent establishment of a Large Taxpayer Unit is welcome, as are commitments to strengthen its audit capabilities, enhance collections of social security contributions, and deploy risk-

based audit techniques. Beyond this, integrating tax and social security contribution collection will be critical to yield efficiency and compliance benefits.

H. Raising Productivity and Enhancing Competitiveness

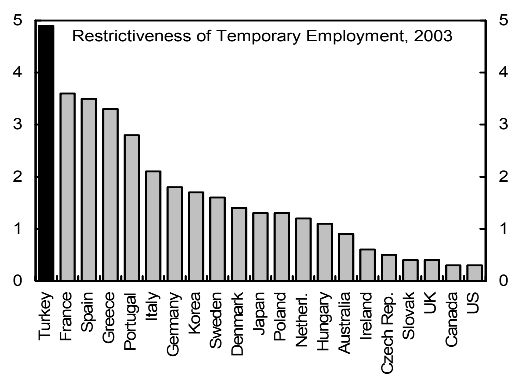
Labor market reforms

48. **Future economic growth will depend on reducing impediments to employment creation**. Heavy labor regulation and taxation cultivate high unemployment, low labor force participation, and a large informal sector. Staff suggestions to increase labor market flexibility and boost productivity include:

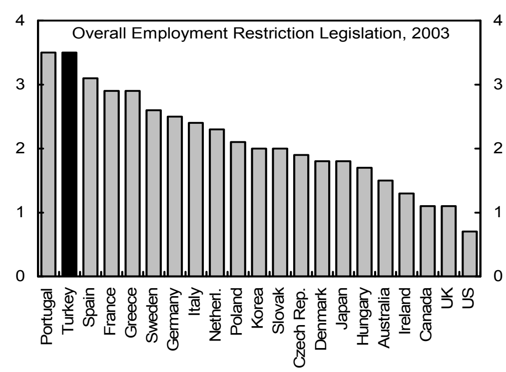


Source: Turkstat.

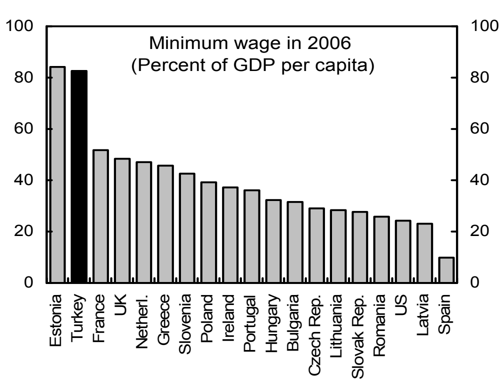
- liberalize temporary employment;
- ease hiring requirements;
- lower severance payments, while loosening eligibility requirements for unemployment insurance;
- ease—or at least differentiate regionally—the real minimum wage (which exceeds 150 percent of regional per capita income in the poorer provinces); and
- narrow the tax wedge on labor, contingent on commensurate spending restraint.



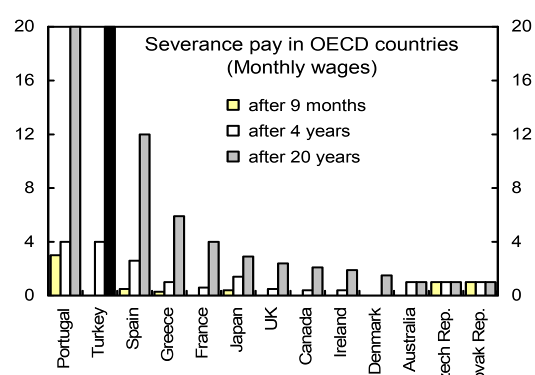
Source: OECD Employment Outlook 1999 and 2004.



Source: OECD Employment Outlook 1999 and 2004.



Sources: Eurostat; and IMF, *World Economic Outlook.*

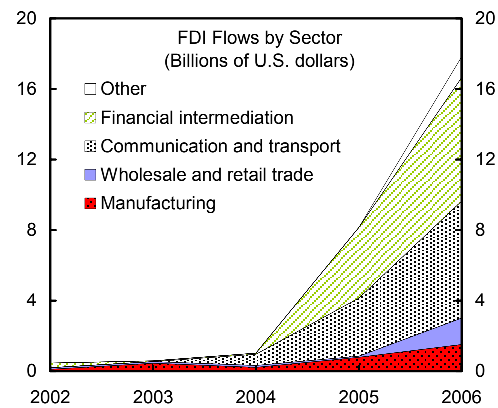


Source: OECD.

49. **The authorities agree on the need to rationalize onerous regulations and reduce the labor tax burden**. They are considering a combination of measures to reduce rigidities, including easing restrictive hiring requirements for large firms. Staff cautioned against increasing unemployment benefits and loosening eligibility requirements without adopting sufficient complementary measures to ease the severance pay burden. Such actions would pose fiscal risks (in terms of higher unemployment benefit costs) without easing labor market rigidities.

Investment climate

50. **Despite recent progress, the authorities concurred that the investment climate needs further improvement**. FDI has soared but remains concentrated in banking, telecommunications, and real estate. Priorities to buttress the investment climate include: (i) entrenching economic stability; (ii) advancing EU accession; (iii) reviving privatization; and (iv) pursuing microeconomic reforms, including easing product market regulations.



Source: Turkstat.

51. **Of special concern is the electricity sector, where Turkey might face shortages by 2009−10** (Box 4). The finances of state-owned energy enterprises have weakened considerably due largely to a freeze on end-user electricity tariffs since 2002, while energy input costs have doubled. Investment has, therefore, lagged behind infrastructure needs. Resumption of the privatization program (suspended in early 2007) and a strengthened tariff framework based on full cost recovery are thus essential to secure adequate investment. The authorities are currently reassessing their energy strategy to address these and other reform issues.

V. Data Adequacy

52. **Although Turkey's statistical base is broadly adequate for effective surveillance, national accounts data have shortcomings** (Statistical Annex). GDP data understate economic activity, and the expenditure-side composition is unreliable. The Turkish Statistical Institute, which has been working on revisions for some time (supported by Fund TA), intends to release new data later this year. Staff has advised the authorities to prepare the release carefully with an appropriate communications strategy.[7]

53. **Fiscal transparency is slowly improving**. The public's capacity to assess fiscal performance has been hampered by frequent account reclassifications that create breaks in the historical series. The publication of consistent historical budget outturns under the new classification system is therefore welcome. Efforts should now focus on ensuring consistency and accessibility of fiscal reporting.

[7] Confusion surrounding a recent revision of the CPI basket weights highlights, more generally, the need for enhanced communications with the public.

VI. Staff Appraisal

54. **Turkey's macroeconomic performance in recent years has been impressive**. Disciplined macroeconomic policies, strengthened economic institutions, and other structural reforms have set off a virtuous cycle of disinflation, declining public debt, falling interest rates, and high, private sector-led growth. Favorable external conditions, political stability, and the government's commitment to Fund arrangements and EU accession have facilitated this good performance.

55. **Turkey faces, however, several economic and structural challenges that need to be addressed to make the economy more resilient to shocks and lift its growth potential**. First, adjustment to the large imbalances inherited from the 2001 crisis should be completed, including by reducing debt levels, bringing inflation down to low single digits, and unwinding dollarization. Second, new vulnerabilities have emerged as byproducts of strong growth, prospects for EU accession, and large capital inflows: wide current account deficits, appreciating currency, and rapid credit growth. These vulnerabilities are unlikely to abate in the near-term and need to be managed carefully to avoid the boom-bust cycles of the past. Third, while inroads have been made on the structural front, the reform agenda is far from complete: financial intermediation remains low; domestic savings are declining; long-term fiscal spending pressures persist; the informal sector—where productivity lags—does not show signs of shrinking; employment remains low; and bottlenecks in electricity supply loom. The recent easing of growth calls for a decisive policy response to remove these structural impediments to productivity and employment growth.

56. **External vulnerabilities need to be managed carefully to safeguard and extend recent economic gains**. The floating exchange rate continues to serve Turkey well, by acting as a flexible shock absorber. Even so, the lira's current strength—which does not yet appear to have dented export competitiveness—heightens risks from sudden shifts in market sentiment. While the economy has become more resilient to such swings (as evidenced by the limited impact of last year's financial market turbulence), a protracted and sharp lira sell-off could prove disruptive. This puts a premium on continuing to build buffers in public and private balance sheets and to improve liability structures (by lengthening maturities and reducing foreign-currency funding).

57. **Now is the time to develop an ambitious reform agenda to place growth on the high trajectory seen in the most dynamic emerging market economies**. The immediate post-election period will provide an opportunity to launch a new agenda of structural reform. Priority should be given to measures that secure long-term fiscal savings and bolster productivity and employment. Successful implementation of structural reforms, combined with disciplined monetary and fiscal policies, would durably raise potential growth. This would, in turn, reduce susceptibility to external shocks by improving the economy's ability to sustain current account deficits and by tilting external financing toward more stable sources, such as foreign direct investment.

58. **To this end, achieving low single-digit inflation is a fundamental policy priority**. The significant fall in inflation during the past five years has spurred confidence and enhanced policy credibility. But it has not gone far enough, as residual inflation uncertainty

keeps real interest rates very high. The authorities should make a final push to entrench inflation around the 4 percent target. From this perspective, the current tightening bias is appropriate. Once inflation is firmly on a declining trend, however, interest rates should be cautiously reduced. More generally, preserving central bank independence and enhancing communications with markets will be essential for the success of the new inflation targeting regime.

59. **Tight fiscal policy will help disinflation and buttress market confidence**. The sizable primary surpluses of recent years have produced enormous benefits, especially in terms of debt reduction and declining real interest rates. Ensuring that policies are consistent with a primary surplus outcome of at least 6.5 percent of GNP this year and next will reinforce these trends, contain the current account deficit, and help shield the economy from adverse shocks. The authorities are to be commended for taking steps to bring this year's fiscal policy back on track, and it will be crucial to keep spending in line with the programmed path.

60. **Over the medium term, fiscal policy should be anchored around the objectives of reducing public debt to safer levels and cutting highly distortionary taxes**—particularly on employment and financial transactions.This will require reversing a recent deterioration in budget quality by keeping spending growth in check. Adopting an explicit fiscal rule (such as a formal limit on spending growth or on the overall deficit) could help in this regard. To be effective, any formal rule would need to be supported by improvements in public financial management and fiscal transparency, as well as reforms to contain nondiscretionary spending. On this issue, the priorities are to (i) adopt as soon as possible social security legislation achieving similar savings to those targeted under the 2006 reform struck down by the Constitutional Court; (ii) increase health spending efficiency; and (iii) rationalize civil service pay.

61. **Reforms to improve tax collection are also essential to creating fiscal space**. Despite advances in this area in the context of the Fund-supported program, the outstanding agenda is still large. Efforts should focus on consolidating audit functions under the Revenue Administration, making the Large Taxpayer Unit fully effective, and improving social security collections.

62. **Future growth will depend critically on increasing employment and labor productivity through comprehensive labor market reforms**. Easing high levels of labor regulation and taxation should lower unemployment, increase labor force participation, and reduce the large informal sector. However, reforms will have to be carefully designed to be affordable and avoid expanding unemployment insurance without scaling down considerably the mandatory severance pay regime.

63. **Policies to deepen financial intermediation and preserve the soundness of the financial system should be pursued in tandem**. Foreign penetration into the banking system and mortgage liberalization are expected to spur competition and deepen intermediation. The authorities should now concentrate on (i) abolishing financial transaction taxes; (ii) privatizing state banks; and (iii) adopting insurance and capital market legislation. However, while financial deepening is welcome from a growth perspective, too rapid credit

growth is bound to raise the risk profile of the financial system. It is, therefore, essential to build additional cushions in balance sheets by further tightening banks' general provisions, which are low compared to other countries, and increasing coverage and timeliness of corporate balance sheet data. Supervisors should also step up oversight, focusing on risk-based supervision and prompt corrective actions when individual banks assume excessive risks.

64. **Privatization and microeconomic reforms, with a special focus on the energy sector, will help attract investment and boost productivity**. The recent surge in FDI is very welcome, but it has been concentrated in a few service sectors. Further reforms are needed to make Turkey more widely attractive to investors, including reviving privatization and deregulating product markets. The risk of electricity shortfalls gives particular urgency to attracting new investment and increasing efficiency in the energy sector by privatizing electricity distribution companies and allowing better cost-recovery pricing.

65. **Opportunities for the Turkish economy are enormous**. The goal should be to build on the economic success of the last five years to firmly entrench high growth, secure low inflation, and make the economy more flexible and resilient to external shocks. Continued disciplined fiscal and monetary policies complemented by bold structural reforms are essential for durable strong growth. The agenda is ambitious and some reforms could face resistance, but the reward will be sustained improvements in living standards.

66. **It is proposed that the next Article IV consultation be held according to the provisions applying to countries under Fund arrangements**.

Box 1. The Stand-By Arrangement

Good progress has been made in achieving the ambitious macroeconomic goals in the current three-year SBA. The program aimed to entrench 5 percent growth, reduce inflation to low single digits, contain the current account deficit, and cut the public sector net debt ratio by 10 percentage points. The growth and debt objectives were exceeded by large margins, but performance on inflation and the current account fell short. The wider current account deficit reflected higher oil prices, above-program growth, and favorable global financial conditions, which supported strong capital inflows and lira appreciation.

The program's policy mix was broadly appropriate, although implementation was sometimes uneven:

- On the **fiscal** side, the 6.5 percent of GNP primary surplus target was largely observed, but buoyant revenues were spent despite formal commitments to save revenue overperformance. Budget quality also weakened with ad hoc initiatives necessitating investment cuts or hikes in already high excise taxes.
- On the **monetary** side, the transition to the IT regime helped increase transparency, though the early large breach of the targets required enhancements in the communications strategy. To this end, the open inflation letters were seen as effective in explaining the reasons behind the inflation overshooting and the central bank's strategy for bringing inflation down to targets.

Progress was made on structural reform, though not without delays and compromises. The program sought to improve the long-term fiscal position and budget quality (social security reform, broader tax base, and stronger collection), privatize state banks, strengthen bank supervision, and improve the investment climate.

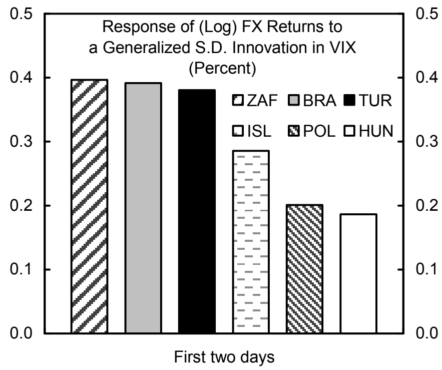
- **Tax reforms**. The cut in the *corporate income tax* rate (from 30 to 20 percent), combined with a phase-out of investment tax allowances, was successful in broadening the tax base to finance lower tax rates. By contrast, the expansion in the *personal income tax* base was limited, as taxing agriculture and pension income was rejected for political reasons. Cuts in *financial transaction taxes* were also not undertaken, as extra revenues were used to increase expenditure. There were advances in *tax administration*, which is key in light of widespread informality and low compliance, especially the establishment of an autonomous Revenue Administration, a large taxpayer unit, and a new tax policy unit at the Finance Ministry. Making these institutions effective has, however, required more time than envisaged.
- **Pension reform**. The parametric pension reform passed in 2006 was to deliver backloaded savings, but represented a good attempt at restoring the long-run viability of the pension system. It was, however, annulled by the Constitutional Court.
- **Banking measures**. The supervisory framework was modernized through passage of a new banking law and the reorganization of the bank supervisory body. A new mortgage law was adopted in early 2007, with the government resisting demands to make mortgage interest tax deductible. State bank reforms took longer than envisaged, especially privatization plans.
- **Investment climate**. Some of the largest and most profitable enterprises were privatized, despite repeated legal challenges. This, together with other improvements in the investment climate, helped boost FDI to record levels, alleviating concerns about the quality of external financing. The abrupt cancellation of the privatization of energy distribution companies earlier this year, however, generated doubts about the government's commitment to future privatization.

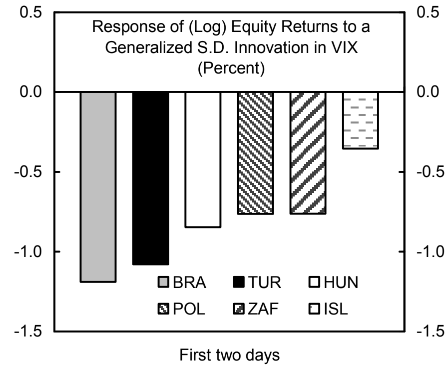
The program failed to recognize early on the macro-criticality of some microeconomic issues. For example, the welcome expansion of *health care* access took place ahead of measures to increase efficiency, straining the budget. Consequently, new conditionality had to be introduced to curb unnecessary demand and excessive supply of health services. In the *energy sector*, SEEs failed to pass onto final users substantial increases in their energy costs. Together with chronic collection and theft/loss problems, this had negative fiscal implications and held back investment needed to avoid looming electricity shortages.

Box 2: Financial Market Spillovers: Suggestive Evidence from Recent Data 1/

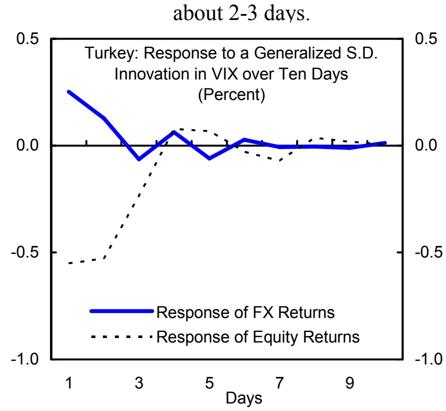
A. Impact of global risk aversion. Temporary increases in global risk aversion (as measured by shocks to the VIX index) have a negative impact on emerging market currencies and stocks.

Brazilian, Turkish, and South African currency and equity markets tend to be affected the most by a shock to global risk aversion.



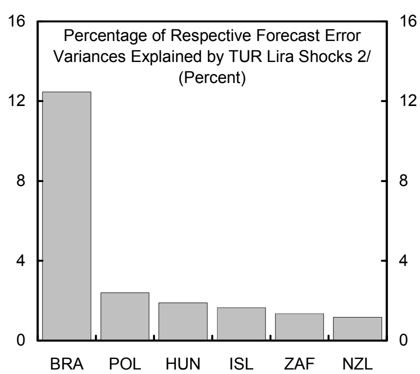


However, the effects are short-lived at about 2-3 days.

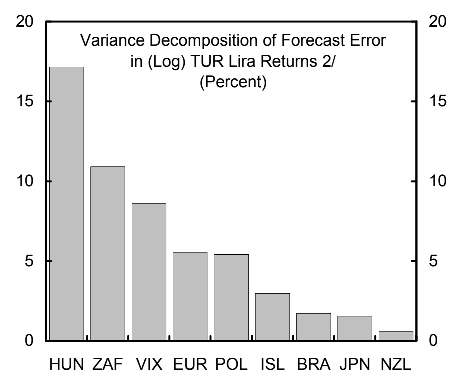


B. Cross-market spillovers.

Shocks to the Turkish lira are most important for the Brazilian real.



The lira is, in turn, most affected by spill-overs from the Hungarian forint and the South African rand.



Sources: Bloomberg; and IMF staff estimates.

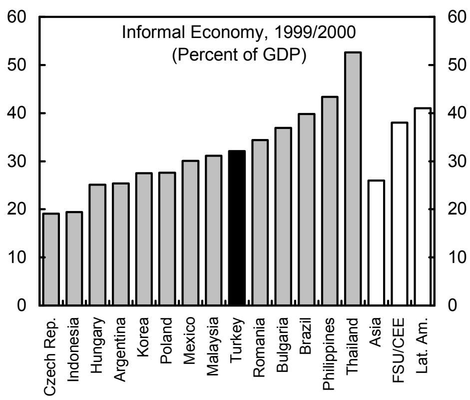
1/ Empirical analysis uses (log) daily returns in exchange rates (local currency per US$) and equity markets in emerging and developed markets (Turkey, Brazil, Poland, Hungary, South Africa, Iceland, New Zealand, Japan, United States, and Euro area) from 1/2/2006 to 4/9/2007. Impulse responses and variance decompositions are based on estimated vector-autoregressions with four lags of returns and the VIX. Reported results are generally robust to the ordering of variables.

2/ Forecast error refers to 10-period ahead forecasts based on the vector-autoregressive model. The total variance of these forecast errors for a given currency is decomposed into the contributions accounted for by each of the "fundamental" shocks (i.e., a VIX shock and one shock for each return included in the model.) The decomposition thus provides a sense of how much specific shocks contribute to the unpredicted variation of a currency.

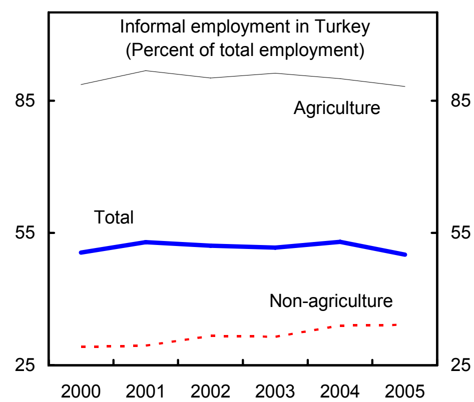
Box 3. Turkey's Informal Sector

Turkey has a large informal sector, with unregistered businesses employing half of Turkey's workers—about 75 percent of which are in small firms of 1−4 employees. Many registered firms are only "semi-formal," in that they underreport sales and employment. In all, the informal sector accounts for roughly a third of Turkey's economy.

The overall rate of informal employment has been broadly flat, but within the non-agriculture sector, informality has been rising. This is partly due to successive minimum wage hikes (almost 50 percent in real terms during 2001−06), but also to steep social insurance contributions, stringent labor and product market regulations, and weak tax administration.



Source: Schneider, F., 2005, "Shadow Economies Around the World: What Do We Really Know?" *European Journal of Political Economy*, Vol. 21 (3), pp. 598-642.

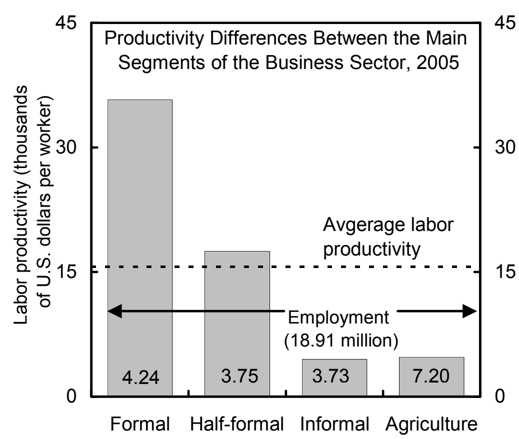


Sources: Turkstat; and Household Labor Force Survey.

Informality hinders fiscal sustainability and constrains overall productivity growth.

- *Fiscal distortions*: Staff estimate the revenue loss from informality to be roughly 5 percent of GNP. Informality can create a vicious cycle of lower tax revenue leading to higher tax rates, leading to more informality.

- *Productivity losses*: Informality impedes firms' ability to take advantage of economies of scale (informal firms must remain small to avoid detection) and restricts firms' access to capital, suppliers, and foreign investors. Thus, productivity in the informal sector is estimated at one seventh that of the formal sector.

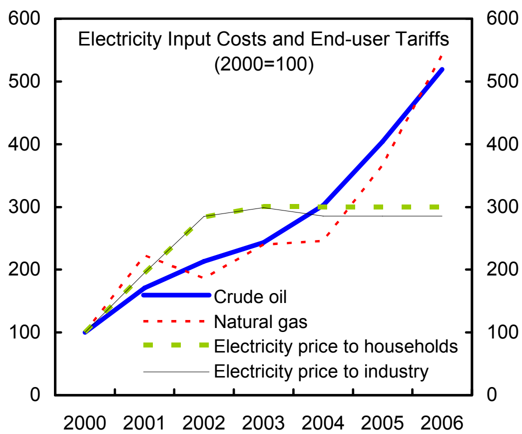


Source: OECD.

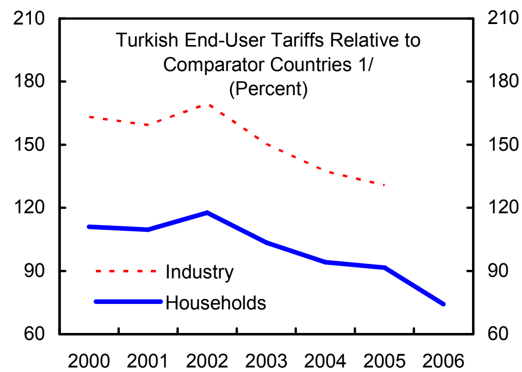
Box 4. Developments in the Energy Sector

Turkey's electricity sector is dominated by state economic enterprises (SEEs). Although there is substantial private sector participation in electricity generation—these companies either produce for their own consumption or sell electricity to SEEs—the transmission and distribution sectors are essentially controlled by SEEs.

In recent years, higher energy production costs have not been passed through to final users. Electricity production in Turkey relies heavily on natural gas, whose price has risen sharply in recent years. Hydro-based plants have provided some buffer, but below-average rainfall has recently constrained use of this energy source. Meanwhile, end-user tariffs have not been raised since 2002. Consequently, household tariffs are now low by international standards. Industry tariffs have also fallen in relative terms but remain elevated, reflecting substantial cross-subsidization.



Source: IEA.



Source: IEA.
1/ Taiwan, Czech Republic, Greece, Hungary, Ireland, South Korea, Mexico, New Zealand, Poland, Portugal, Romania, Slovakia, Spain.

SEEs' financial difficulties have been further compounded by theft and poor collections. Total system losses are almost three times the OECD average (in certain regions, loss ratios exceed 60 percent). Collections are also weak, often reflecting political interference (arrears by municipalities are very large) and poor compliance arising from repeated amnesties.

Urgent steps are needed to address the energy sector's financial problems. The SEEs' tight finances have led to persistent underinvestment in critical infrastructure. Consequently, official estimates suggest that electricity shortages may emerge as soon as 2009 and substantial capital investment is needed.

A prompt resumption of the aborted privatization program is critical. Successful privatization of distribution and, subsequently, generation companies will require firm commitments to bring end-user tariffs back in line with the stated principle of full cost recovery and to avoid interfering with the pricing mechanism.

Table 1. Turkey: Indicators of External Vulnerability, 2001–06

	2001	2002	2003	2004	2005	2006 Est.
CPI inflation (end year)	68.5	29.7	18.4	9.4	7.7	9.7
Overall balance public sector (percent of GNP)	-17.1	-12.5	-9.1	-4.6	-0.3	-0.4
Net debt of the public sector (percent of GNP)	90.4	78.4	70.3	64.0	55.3	44.8
Export volume (percent change)	15.7	17.2	19.1	15.0	10.1	11.7
Import volume (percent change)	-23.8	26.1	24.6	22.2	11.8	8.2
Current account balance, percent of GNP	2.4	-0.8	-3.4	-5.2	-6.3	-7.9
Capital account balance (billions of U.S. dollars)	-14.6	1.2	7.1	17.8	43.7	45.3
Of which : foreign direct investment	2.8	0.9	1.2	2.0	8.7	19.2
foreign portfolio investment	-4.6	-1.2	1.1	6.1	10.4	4.0
Gross official reserves, billions of U.S. dollars	19.8	28.1	35.2	37.6	52.2	63.3
In months of imports of goods and NFS	4.5	5.5	3.9	3.4	4.1	4.5
In percent of broad money	26.7	34.3	32.5	27.4	30.5	31.4
Gross total external debt, billions U.S. dollars	113.6	129.7	144.3	160.8	168.8	206.5
In percent of GNP	93.1	77.3	56.4	50.1	46.7	50.5
In percent of exports of goods and NFS	218.4	229.1	200.8	174.9	159.0	173.3
Gross short-term external debt, billions of U.S. dollars 1/	32.6	35.2	41.1	52.0	59.4	73.1
In percent of gross total external debt	28.7	27.1	28.5	32.4	35.2	35.4
In percent of gross official reserves	164.7	125.4	117.0	138.3	113.9	115.5
Debt service ratio 2/	41.9	38.1	35.1	27.2	26.4	26.4
REER appreciation (CPI based, period average)	-17.6	11.4	8.9	5.1	11.5	0.4
REER appreciation (CPI based, end of period)	-21.2	7.8	12.1	1.8	19.7	-6.6
Capital adequacy ratio 3/	15.3	25.3	30.9	28.8	24.2	20.5
State banks	34.0	50.2	56.3	41.5	40.9	28.9
SDIF banks	-17.8	-7.6	-21.6	-42.0	...	…
Private banks	9.0	19.6	23.5	22.3	17.2	15.4
Foreign banks	41.0	48.4	60.8	56.0	40.2	30.3
Nonperforming loans (percent of total)	29.3	17.6	11.5	6.0	4.8	3.7
Real broad money, percentage change 4/	11.2	-3.3	-4.6	11.7	15.3	13.5
Real credit to the private sector, percentage change 4/	-27.5	-16.5	20.1	38.5	33.6	25.1
Banks' net foreign asset position, billions of U.S. dollars	-0.1	-0.4	0.3	-0.1	-0.1	-0.2
EMBI Global bonds spread (basis points)	707	693	309	265	223	207

Sources: Turkish authorities; and IMF staff estimates and projections.

1/ By residual maturity.
2/ Interest plus medium- and long-term debt repayments in percent of current account receipts (excluding official trar
3/ For end-2001 Pamuk Bank is treated as a private bank, for 2002 as an SDIF bank. 2004 data for SDIF banks as of September. Data for 2006 as of September.
4/ Deflated by the CPI.

Table 2. Turkey: Selected Economic Indicators, 2001−08

	2001	2002	2003	2004	2005	2006	2007	2008
						Est.	Proj.	
				(Percent)				
Real sector								
Real GNP growth rate	-9.5	7.9	5.9	9.9	7.6	6.0	5.0	6.0
Private consumption growth rate	-9.2	2.1	6.6	10.1	8.8	5.2	3.3	4.4
Private gross fixed investment growth rate	-34.9	-5.3	20.3	45.5	23.6	17.3	6.1	7.7
Final domestic demand growth rate	-9.2	2.1	6.6	10.1	8.8	5.2	3.3	4.4
GNP deflator growth rate	55.3	44.4	22.5	9.5	5.3	11.7	7.0	5.5
Nominal GNP growth rate	40.5	55.8	29.7	20.3	13.4	18.4	12.4	11.8
CPI inflation (12-month; end-of period)	68.5	29.7	18.4	9.4	7.7	9.7	6.0	5.2
PPI inflation (12-month; end-of-period)	88.6	30.8	13.9	15.3	2.7	11.6	5.6	4.0
Unemployment rate	10.4	11.0	10.3	10.3	10.2	9.9	...	...
Average nominal treasury bill interest rate	93.6	64.6	45.1	24.7	16.2	18.1	...	...
Average ex-ante real interest rate	35.5	30.5	33.9	15.3	6.0	9.3	...	...
				(Percent of GNP, unless otherwise indicated)				
Central government budget								
Primary balance	4.8	3.5	4.9	5.3	5.5	5.8	5.2	5.5
Net interest payments	22.2	17.3	16.1	12.3	7.7	5.8	5.9	4.8
Overall balance	-17.4	-13.8	-11.2	-7.1	-2.2	0.1	-0.7	0.8
Consolidated public sector								
Primary balance	5.5	5.1	6.2	7.2	6.8	6.6	6.7	6.5
Net interest payments	22.6	17.6	15.4	11.7	7.0	7.0	7.1	6.2
Overall balance	-17.1	-12.5	-9.1	-4.6	-0.3	-0.4	-0.5	0.3
Net debt of public sector	90.4	78.4	70.3	64.0	55.3	44.8	40.9	36.5
Net external	37.5	32.1	21.9	17.4	8.5	7.3	7.1	6.4
Net domestic	52.9	46.3	48.4	46.5	46.8	37.5	33.8	30.0
Share of FX debt (percent total public debt)	57.8	58.1	46.3	41.5	37.6	36.1	32.9	30.0
External sector								
Current account balance	2.4	-0.8	-3.4	-5.2	-6.3	-7.9	-7.3	-6.8
Exports of goods and non-factor services	36.1	31.0	30.1	30.5	29.3	29.7	30.3	32.3
Volume growth (goods only, in percent)	15.7	17.2	19.1	15.0	10.1	11.7	10.3	10.5
Imports of goods and non-factor services	31.7	30.1	31.3	33.8	34.0	35.9	35.7	37.6
Volume growth (goods only, in percent)	-23.8	26.1	24.6	22.2	11.8	8.2	7.4	8.2
Trade balance	-2.6	-4.0	-5.9	-7.9	-9.3	-10.0	-9.3	-9.6
Of which : fuel (in billions of U.S. dollars)	-7.8	-8.5	-10.6	-13.0	-18.6	-25.0	-26.6	-29.6
Gross external debt 1/	93.1	77.3	56.4	50.1	46.7	50.5	52.8	53.1
Net external debt 1/	64.3	52.8	37.6	32.0	27.3	26.9	28.5	29.5
Foreign direct investment (net)	1.9	0.5	0.5	0.7	2.4	4.8	3.5	2.4
Short-term external debt (by remaining maturity)	22.6	19.3	17.3	17.2	16.4	18.2	16.9	18.2
Monetary aggregates								
Nominal growth of M2Y broad money (in percent)	87.5	25.4	13.0	22.1	24.5	24.1	14.9	…
				(Billions of U.S. dollars, unless otherwise indicated)				
Privatization proceeds 2/	2.8	0.5	0.2	1.3	3.8	9.6	…	…
Net external financing of central government	8.4	6.7	-0.7	-2.7	-4.1	-0.6	…	…
Amortization	-6.7	-11.4	-8.7	-11.7	-14.1	-13.5	…	…
Gross borrowing	15.0	18.1	8.0	8.9	10.0	13.0	…	…
Of which : Eurobond issues	2.2	3.3	5.3	5.8	6.5	5.8	…	…
GNP	144.0	182.7	238.5	301.5	361.9	401.4	…	…
GNP (in billions of Turkish lira)	176.5	275.0	356.7	428.9	486.4	575.8	646.9	723.1
Per capita GDP (2006): $5,534		Poverty Rate (2003): 26 percent (WB poverty line estimate)						

Sources: Turkish authorities; and IMF staff estimates and projections.

1/ Debt ratios valued at end-year exchange rates.
2/ Privatization revenue received by fiscal authorities.

Table 3. Turkey: Balance of Payments, 2001–12

(Billions of U.S. dollars)

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
						Est.			Proj.			
Current account balance	3.4	-1.5	-8.0	-15.6	-22.7	-31.7	-32.2	-31.5	-31.7	-30.4	-29.3	-28.1
Trade balance	-3.7	-7.3	-14.0	-23.9	-33.5	-40.1	-41.4	-44.2	-44.7	-44.5	-44.5	-44.5
Exports (f.o.b.)	34.4	40.1	51.2	67.0	76.9	91.7	104.2	115.5	127.5	141.1	156.6	173.8
Of which:												
Exports (f.o.b.) in trade returns	31.3	36.1	47.3	63.2	73.5	85.3	97.5	108.4	120.4	134.0	149.4	166.5
Shuttle trade	3.0	4.1	4.0	3.9	3.5	6.4	6.7	7.0	7.0	7.1	7.2	7.3
Imports (f.o.b.)	-38.1	-47.4	-65.2	-90.9	-110.5	-131.8	-145.6	-159.6	-172.2	-185.6	-201.1	-218.3
Of which:												
Imports (c.i.f.), incl. non-monetary gold	-41.4	-51.6	-69.3	-97.5	-116.8	-137.5	-152.4	-167.1	-180.3	-194.4	-210.6	-228.7
Energy imports (c.i.f.)	-8.3	-9.2	-11.6	-14.4	-21.2	-28.6	-30.1	-33.4	-34.8	-35.9	-37.1	-38.5
Services and Income (net)	4.1	3.3	4.9	7.1	9.4	6.8	7.3	10.6	11.1	12.2	13.2	14.5
Services and Income (credit)	18.8	17.3	21.3	25.6	30.2	28.9	31.7	35.0	37.3	39.7	42.3	45.1
Of which:												
Tourism receipts	8.1	8.5	13.2	15.9	18.2	16.9	18.2	19.9	21.1	22.5	24.0	25.5
Services and Income (debit)	-14.7	-13.9	-16.3	-18.4	-20.9	-22.1	-24.4	-24.4	-26.3	-27.6	-29.0	-30.5
Of which:												
Interest	-7.1	-6.4	-6.9	-7.2	-8.4	-9.8	-11.6	-10.8	-12.0	-12.5	-13.1	-13.6
Private transfers (net) 1/	2.8	1.9	0.7	0.8	0.9	1.0	1.2	1.3	1.3	1.3	1.3	1.3
Official transfers (net)	0.2	0.5	0.3	0.3	0.6	0.6	0.6	0.8	0.6	0.6	0.6	0.6
Capital account balance	-14.6	1.2	7.1	17.8	43.7	45.3	37.4	40.1	40.1	38.8	39.3	38.6
(including errors and omissions)	-16.3	1.3	12.1	19.9	45.9	42.3	39.2	40.1	40.1	38.8	39.3	38.6
Direct investment 2/	2.8	0.9	1.2	2.0	8.7	19.2	15.8	11.2	10.0	10.8	11.9	13.2
Portfolio investment in securities	-4.6	-1.2	1.1	6.1	10.4	4.0	4.6	5.8	6.0	6.1	6.1	6.3
Public sector (central & local governments & EBFs)	-1.9	0.4	-0.7	0.8	1.3	2.6	2.1	2.0	2.2	1.7	3.0	3.3
Bonds (net)	0.1	1.0	1.5	2.0	3.4	3.3	2.0	2.2	3.5	2.8	3.8	3.8
Eurobond drawings	2.1	3.3	5.3	5.8	6.5	5.8	5.5	5.5	5.5	5.5	5.5	5.5
Eurobond repayments	-2.0	-2.3	-3.8	-3.8	-3.1	-2.5	-3.5	-3.3	-2.0	-2.7	-1.7	-1.7
Loans (net)	-2.0	-0.7	-2.2	-1.2	-2.2	-0.7	0.0	-0.2	-1.3	-1.1	-0.8	-0.6
Loan disbursements	1.6	2.3	1.0	2.0	1.1	2.5	3.5	3.5	2.1	2.2	2.3	2.4
Loan repayments	-3.6	-3.0	-3.2	-3.2	-3.3	-3.2	-3.4	-3.6	-3.5	-3.3	-3.1	-3.0
Central Bank of Turkey (excl. reserve assets, liabilties)	0.8	1.4	0.6	-0.1	-0.5	-1.0	-1.1	-1.3	-1.1	-1.1	-1.1	-1.1
Deposit money banks (net)	-9.4	-1.8	3.0	1.2	10.0	0.7	7.1	9.4	12.1	9.5	7.9	7.1
FX deposits abroad (- denotes accumulation)	0.9	0.6	0.7	-6.0	-0.3	-10.3	-0.4	2.2	5.0	2.6	1.3	1.2
Other, net	-10.3	-2.4	2.3	7.2	10.4	11.0	7.5	7.1	7.1	6.9	6.6	5.9
Medium and long-term (net)	-1.0	-0.7	-0.2	2.4	6.2	9.8	6.5	5.6	5.6	5.4	5.1	4.4
Short-term (net)	-9.3	-1.7	2.5	4.8	4.2	1.2	1.0	1.5	1.5	1.5	1.5	1.5
Interbank credit lines from foreign commercial banks	-7.1	-0.7	2.0	3.3	2.7	-4.0	0.0	1.0	1.0	1.0	1.0	1.0
Other private sector (net)	-2.3	1.5	1.8	7.7	13.8	19.7	9.0	13.0	10.9	11.7	11.5	9.8
Medium and long term (net)	0.3	2.5	1.6	5.3	10.0	18.3	5.9	9.7	7.3	7.8	7.3	5.3
Short term (net)	-2.6	-1.0	0.2	2.4	3.8	1.4	3.1	3.3	3.6	3.9	4.2	4.5
Errors and omissions	-1.7	0.1	5.0	2.2	2.2	-3.0	1.8	0.0	0.0	0.0	0.0	0.0
Overall balance	-12.9	-0.2	4.1	4.3	23.2	10.6	7.0	8.6	8.4	8.4	9.9	10.5
Overall financing (NIR change excl. ST liabilities, + denotes decline)	12.9	0.2	-4.1	-4.3	-23.2	-10.6	-7.0	-8.6	-8.4	-8.4	-9.9	-10.5
Change in net international reserves (+ denotes decline)	12.9	0.2	-4.1	-4.3	-23.2	-10.6	-7.0	-8.6	-8.4	-8.4	-9.9	-10.5
Change in gross official reserve assets (+ denotes decline)	2.7	-6.2	-4.0	-0.8	-17.8	-6.1	-5.3	-7.8	-5.5	-5.2	-8.1	-10.2
Change in reserve liabilities (IMF)	10.2	6.4	-0.1	-3.5	-5.4	-4.5	-1.7	-0.7	-3.0	-3.2	-1.8	-0.3
Purchases	11.3	12.5	1.7	1.2	2.4	3.0	3.4	1.1	0.0	0.0	0.0	0.0
Repurchases 3/	-1.1	-6.1	-1.7	-4.7	-7.8	-7.5	-5.1	-1.9	-3.0	-3.2	-1.8	-0.3

Table 3. Turkey: Balance of Payments, 2001–12 (concluded)

(Billions of U.S. dollars)

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
						Est.			Proj.			
Memorandum items:												
Trade in goods and services												
In percent of GNP												
Current account balance, incl. shuttle trade	2.4	-0.8	-3.4	-5.2	-6.3	-7.9	-7.3	-6.8	-6.4	-5.8	-5.3	-4.8
Nonfuel current account balance	7.8	3.8	1.1	-0.9	-1.1	-1.7	-1.3	-0.4	-0.1	0.3	0.7	1.2
Trade account balance, incl. shuttle trade	-2.6	-4.0	-5.9	-7.9	-9.3	-10.0	-9.3	-9.6	-9.0	-8.5	-8.0	-7.6
Exports of goods and non-factor services	36.1	31.0	30.1	30.5	29.3	29.7	30.3	32.3	33.0	34.1	35.5	36.8
Imports of goods and non-factor services	31.7	30.1	31.3	33.8	34.0	35.9	35.7	37.6	37.7	38.3	39.1	40.0
Percent change												
Value growth in exports of goods (incl. shuttle trade)	11.9	16.7	27.6	30.9	14.8	19.2	13.6	10.8	10.4	10.6	11.0	11.0
Value growth in exports of goods (excl. shuttle trade)	12.8	15.1	31.0	33.7	16.3	16.1	14.3	11.2	11.1	11.2	11.5	11.4
Value growth in imports of goods	-27.7	24.4	37.6	39.4	21.5	19.3	10.4	9.6	7.8	7.8	8.3	8.6
Volume growth in exports of goods	15.7	17.2	19.1	15.0	10.1	11.7	10.3	10.5	10.8	10.5	10.2	10.0
Volume growth in imports of goods	-23.8	26.1	24.6	22.2	11.8	8.2	7.4	8.2	7.9	7.6	7.7	7.6
Volume growth in imports of goods exluding fuel	-22.9	25.2	19.8	28.0	15.5	7.2	8.3	8.7	8.5	8.3	8.3	8.1
Terms of trade	-2.2	-0.6	2.0	1.0	-1.3	-4.5	0.4	-0.7	0.2	0.5	0.5	0.4
Reserve and debt indicators												
Gross foreign reserves (Central Bank of Turkey) 4/												
In billions of U.S. dollars	19.8	28.1	35.2	37.6	52.2	63.3	68.6	76.4	81.9	87.1	95.2	105.4
Months of goods & NFS imports	4.5	5.5	3.9	3.4	4.1	4.5	4.5	4.6	4.6	4.5	...	...
Net international reserves (Central Bank of Turkey)	...	...	-0.5	1.3	22.4	32.6	40.0	49.1	58.0	66.7	76.9	87.7
External debt (end-of-period)												
In billions of U.S. dollars	113.6	129.7	144.3	160.8	168.8	206.5	222.0	241.9	257.9	273.7	291.7	309.1
Percent of GNP	93.1	77.3	56.4	50.1	46.7	50.5	52.8	53.1	53.2	53.2	53.5	53.5
Percent of exports of goods & NFS	218.4	229.1	200.8	174.9	159.0	173.3	165.2	162.7	158.2	153.0	148.1	142.6
Net external debt (end-of-period) 5/												
In billions of U.S. dollars	78.5	88.5	96.3	102.8	98.7	109.9	120.0	134.3	149.7	163.0	174.4	182.5
Percent of GNP	64.3	52.8	37.6	32.0	27.3	26.9	28.5	29.5	30.9	31.7	32.0	31.6
Short-term debt (end-of-period)												
In billions of U.S. dollars	16.4	16.4	23.0	31.9	37.1	42.0	45.7	50.2	55.0	60.1	65.4	71.2
Reserves to short-term debt ratio	120.7	170.9	152.8	118.1	140.6	150.7	150.0	152.4	149.0	145.0	145.4	148.0
Short-term debt plus MLT repayments												
In billions of U.S. dollars	32.6	35.2	41.1	52.0	59.4	73.1	75.0	83.9	94.4	102.8	108.2	117.1
Reserves to short-term debt ratio	60.7	79.7	85.5	72.3	87.8	86.6	91.5	91.0	86.8	84.7	88.0	90.0
Debt service ratio 6/	41.9	38.1	35.1	27.2	26.4	26.4	31.1	26.4	27.6	28.5	27.9	27.0

Sources: Turkish authorities; and IMF staff estimates and projections.

1/ Until 2003, remittances include tourism receipts from foreign citizens. These are now classified under the services account.
2/ Including privatization receipts.
3/ 2007-12 repurchases on an expectations basis.
4/ Changes in stocks may not equal balance of payments flows due to valuation effects of exchange rate changes.
5/ Non-bank external debt minus the net foreign assets of the banking sector and the central bank.
6/ Interest plus medium- and long-term debt repayments in percent of current account receipts (excluding official transfers).

Table 4. Turkey: External Financing Requirements and Sources, 2001–08

(Billions of U.S. dollars)

	2001	2002	2003	2004	2005	2006	2007	2008
						Est.	Proj.	
Gross financing requirements	42.9	37.6	46.0	65.5	76.5	108.2	107.1	106.0
Current account deficit (excluding official transfers)	-3.2	2.0	8.3	15.9	23.3	32.3	32.8	32.3
Amortization on debt securities	2.1	2.7	3.9	3.8	3.4	2.5	3.5	3.3
Government Eurobonds	2.0	2.3	3.8	3.8	3.1	2.5	3.5	3.3
Medium- and long-term debt amortization	14.3	13.6	14.9	14.5	16.9	19.9	27.8	26.1
Public sector 1/	3.6	3.0	3.2	3.2	3.3	3.2	3.4	3.6
Private non-bank sector	8.9	9.0	10.3	10.1	11.3	14.2	22.3	17.7
Banks	1.9	1.6	1.4	1.2	2.4	2.6	2.0	4.7
Short-term debt amortization	28.3	16.4	16.4	23.0	31.9	37.1	42.0	45.7
Public sector (net) 1/	1.7	0.8	1.7	2.9	3.3	2.8	2.6	2.1
Trade credits 2/	7.9	5.7	7.1	8.9	12.6	15.0	18.1	21.3
Banks	16.9	8.0	6.3	9.7	14.5	17.7	19.8	20.8
Other private	1.9	2.0	1.3	1.6	1.5	1.6	1.5	1.5
Increase in portfolio and other investment assets	1.4	2.9	2.4	8.3	1.0	16.4	1.0	-1.4
Available financing	42.9	37.6	46.0	65.5	76.5	108.2	107.1	106.0
Foreign direct investment (net)	2.8	0.9	1.2	2.0	8.7	19.2	15.8	11.2
Of which: privatization inflows (estimated)	...	...	...	...	1.7	10.8	0.0	...
Portfolio flows	-1.7	4.2	7.8	13.2	18.1	13.9	10.5	12.0
Government Eurobonds	2.1	3.3	5.3	5.8	6.5	5.8	5.5	5.5
Private non-bank sector (net) 3/	-3.8	0.9	2.5	7.5	11.6	8.1	5.0	6.5
Medium and long-term debt financing	13.2	15.8	14.1	20.6	30.6	46.5	39.2	40.1
Public sector 1/	3.2	2.9	0.7	1.7	0.5	1.6	2.5	2.4
Private non-bank sector	9.2	11.5	11.9	15.4	21.3	32.5	28.2	27.4
Banks	0.9	1.3	1.4	3.5	8.9	12.3	8.5	10.4
Short-term financing	17.1	15.9	21.7	31.5	39.4	41.6	45.8	50.2
Public sector 1/	0.7	1.6	2.8	3.3	2.8	2.6	2.1	1.6
Trade credits	5.7	7.1	8.9	12.6	15.0	18.1	21.3	24.7
Banks	10.7	7.1	10.0	15.6	21.6	21.0	22.4	23.8
Other private	2.0	1.3	1.6	1.5	1.6	1.5	1.5	1.5
Official transfers	0.2	0.5	0.3	0.3	0.6	0.6	0.6	0.8
Other 4/	-1.7	0.1	5.0	2.2	2.2	-3.0	2.2	0.3
NIR change (excl. ST liabilities, - denotes increase)	12.9	0.2	-4.1	-4.3	-23.2	-10.6	-7.0	-8.6
Accumulation of gross reserves	2.7	-6.2	-4.0	-0.8	-17.8	-6.1	-5.3	-7.8
IMF (net)	10.2	6.4	-0.1	-3.5	-5.4	-4.5	-1.7	-0.7
Purchases	11.3	12.5	1.7	1.2	2.4	3.0	3.4	1.1
Repurchases 5/	-1.1	-6.1	-1.7	-4.7	-7.8	-7.5	-5.1	-1.9
Memorandum item:								
Net public sector financing (incl. IMF, excl. reserves)	10.9	9.5	2.1	0.6	-1.4	0.4	2.1	2.5

Sources: Turkish authorities; and IMF staff estimates and projections.

1/ General government and Central Bank of Turkey (excludes IMF purchases and repurchases).
2/ Series reflects stock of short term trade credits at end of previous year.
3/ Portfolio equity and domestic government debt (net).
4/ Errors and omissions and other liabilities.
5/ Repurchases in 2007 are on an expectations basis.

Table 5. Turkey: Medium-Term Scenario, 2000–12

(Percentage change, unless otherwise indicated)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Average 2002-06	Average 2007-2012
Real GNP	6.3	-9.5	7.9	5.9	9.9	7.6	6.0	5.0	6.0	5.5	5.0	5.0	5.0	7.5	5.3
Real GDP	7.4	-7.5	7.9	5.8	8.9	7.4	6.1	5.0	6.0	5.5	5.0	5.0	5.0	7.2	5.3
Real GDP per capita	2.5	-9.0	6.2	4.1	7.3	5.8	4.6	3.6	4.5	4.0	3.6	3.6	3.6	5.6	3.8
Potential output growth	-0.1	2.3	3.8	6.0	6.5	6.5	6.1	5.5	5.4	5.0	5.0	5.0	5.0	5.8	5.2
Output gap	-2.8	7.6	3.5	3.7	1.4	0.5	0.6	1.0	0.5	0.0	0.0	0.0	0.0	1.9	0.3
Employment rate	46.7	45.6	44.5	43.2	43.7	43.7	44.2	44.4	44.5	44.6	44.8	44.9	45.0	43.9	44.7
Real domestic demand	9.8	-18.5	9.3	9.3	14.1	8.8	5.6	4.1	5.2	4.7	4.2	4.2	4.3	9.4	4.4
Consumption	6.3	-9.1	2.5	5.6	9.0	8.1	5.6	3.5	4.5	4.2	3.8	3.7	3.7	6.2	3.9
Private	6.2	-9.2	2.1	6.6	10.1	8.8	5.2	3.3	4.4	4.2	3.8	3.9	3.9	6.6	3.9
Public	7.1	-8.5	5.4	-2.5	0.5	2.4	9.6	4.8	5.6	4.8	3.5	2.7	2.6	3.1	4.0
Fixed investment	16.9	-31.5	-1.1	10.0	32.4	24.0	14.0	6.0	7.5	6.1	5.3	5.6	5.7	15.9	6.0
Private	16.0	-34.9	-5.3	20.3	45.5	23.6	17.3	6.1	7.7	6.0	5.0	5.2	5.2	20.3	5.9
Public	19.6	-22.0	8.8	-11.5	-4.7	25.9	-0.2	5.4	6.5	6.5	7.0	8.0	8.0	3.7	6.9
Change in stocks 1/	1.1	-4.0	7.1	3.0	1.1	-2.5	-2.1	0.0	0.0	0.0	0.0	0.0	0.0	1.3	0.0
Exports	19.2	7.4	11.1	16.0	12.5	8.5	8.5	8.5	9.8	9.4	9.1	8.9	8.8	11.3	9.1
Imports	25.4	-24.8	15.8	27.1	24.7	11.5	7.1	6.3	7.9	7.6	7.4	7.4	7.4	17.2	7.4
Contributions to GDP growth (production side)	7.4	-7.5	7.9	5.8	8.9	7.4	6.1	5.0	6.0	5.5	5.0	5.0	5.0	7.2	5.3
Real domestic demand	10.2	-19.8	8.7	8.9	13.9	9.1	5.9	4.3	5.4	4.8	4.2	4.3	4.3	9.3	4.5
Net exports	-3.0	12.3	-0.9	-3.1	-4.9	-1.7	0.3	0.7	0.6	0.7	0.8	0.7	0.7	-2.1	0.7
Statistical discrepancy	0.1	0.0	0.1	0.0	-0.1	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Saving and investment (percent of GNP)															
Domestic saving	19.4	19.3	20.7	19.6	20.6	18.5	16.0	16.4	17.2	17.6	18.2	18.8	19.5	19.1	17.9
Gross investment	24.3	17.0	21.5	23.0	25.8	24.8	23.9	23.7	24.1	24.0	24.0	24.2	24.3	23.8	24.1
Consumer prices															
Period average	54.9	54.4	45.0	21.6	8.6	8.2	9.6	8.0	5.5	4.0	4.0	4.0	4.0	18.6	4.9
End-period	39.0	68.5	29.7	18.4	9.4	7.7	9.7	6.0	5.2	4.0	4.0	4.0	4.0	15.0	4.5
Real Effective Exchange Rate (CPI-based)	10.9	-17.6	11.4	8.9	5.1	11.5	0.4	...	...	...	...	...	...	7.5	...
External indicators															
Current account (in percent of GNP)	-4.9	2.4	-0.8	-3.4	-5.2	-6.3	-7.9	-7.3	-6.8	-6.4	-5.8	-5.3	-4.8	-4.7	-6.1
Trade balance (in percent of GNP)	-11.0	-2.6	-4.0	-5.9	-7.9	-9.3	-10.0	-9.3	-9.5	-9.0	-8.4	-8.0	-7.5	-7.4	-8.6
Export volume growth (goods)	9.2	15.7	17.2	19.1	15.0	10.1	11.7	10.3	10.5	10.8	10.5	10.2	10.0	14.6	10.4
Import volume growth (goods)	28.2	-23.8	26.1	24.6	22.2	11.8	8.2	7.4	8.2	7.9	7.6	7.7	7.6	18.6	7.7
Idem, excl. oil (goods)	29.2	-22.9	25.2	19.8	28.0	15.5	7.2	8.3	8.7	8.5	8.3	8.3	8.1	19.1	8.4
FDI (in percent of GNP)	0.1	2.0	0.5	0.5	0.7	2.4	4.8	3.5	2.4	2.0	2.1	2.1	2.2	1.8	2.4
GDP deflator	49.6	53.7	45.0	23.5	10.3	5.6	11.4	7.4	5.5	4.2	4.1	4.1	4.1	19.2	4.9
Nominal GNP (in TL billion)	126	176	275	357	429	486	576	647	723	793	866	946	1033	425	835
Nominal GNP (in US$ billion)	200	142	181	239	301	362	401	…	…	…	…	…	…	297	…

Sources: TurkStat; State Planning Office; Central Bank of Turkey; and IMF staff estimates and projections.

1/ Contribution to the growth of GDP.

Table 6. Turkey: Consolidated Fiscal Presentation, 2005–07

	2004	2005	2006	2006 Adj. 1/		2007	
			Est.	Prog.	Est.	5th Rev. Prog.	Revised Prog.
			(Millions of new Turkish lira)				
Public sector primary balance	30,798	33,013	37,940	40,717	36,772	41,003	43,043
General government	26,250	31,021	36,485	38,310	35,317	37,705	39,923
Central govt. and social security	22,476	26,647	34,358	35,295	33,190	31,660	33,518
Primary revenue	143,066	169,392	201,903	203,093	201,903	225,538	223,253
Tax revenue	100,342	119,627	137,474	137,643	137,474	158,153	157,854
Nontax revenue	17,425	20,975	25,184	26,490	25,184	24,288	24,010
Social security	25,299	28,789	39,245	38,960	39,245	43,097	41,389
Primary expenditure	120,590	142,745	167,545	167,798	168,713	193,878	189,735
Central government current	60,098	70,446	82,105	83,774	83,273	96,257	94,074
Central government capital	8,264	10,340	11,934	10,640	11,934	12,668	10,523
Social security 2/	52,229	61,959	73,506	73,384	73,506	84,953	85,139
Other general government	3,774	4,374	2,127	3,016	2,127	6,046	6,405
SEEs	4,548	1,992	1,455	2,407	1,455	3,298	3,120
Memorandum items:							
Primary spending (less revenue transfers) 3/	110,142	129,926	153,601	151,770	153,601	176,915	172,772
Current	101,878	119,587	141,667	141,130	141,667	164,247	162,250
Capital	8,264	10,340	11,934	10,640	11,934	12,668	10,523
Pension spending	32,620	39,591	46,241	46,237	46,241	53,943	53,953
Health spending 4/	15,695	17,967	23,453	23,326	23,453	25,408	25,583
GNP	428,932	486,401	575,784	562,000	575,784	631,410	646,896
			(Percent of GNP)				
Public sector primary balance	7.2	6.8	6.6	7.2	6.4	6.5	6.7
General government	6.1	6.4	6.3	6.8	6.1	6.0	6.2
Central govt. and social security	5.2	5.5	6.0	6.3	5.8	5.0	5.2
Primary revenue	33.4	34.8	35.1	36.1	35.1	35.7	34.5
Tax revenue	23.4	24.6	23.9	24.5	23.9	25.0	24.4
Nontax revenue	4.1	4.3	4.4	4.7	4.4	3.8	3.7
Social security	5.9	5.9	6.8	6.9	6.8	6.8	6.4
Primary expenditure	28.1	29.3	29.1	29.9	29.3	30.7	29.3
Central government current	14.0	14.5	14.3	14.9	14.5	15.2	14.5
Central government capital	1.9	2.1	2.1	1.9	2.1	2.0	1.6
Social security 2/	12.2	12.7	12.8	13.1	12.8	13.5	13.2
Other general government	0.9	0.9	0.4	0.5	0.4	1.0	1.0
SEEs	1.1	0.4	0.3	0.4	0.3	0.5	0.5
Memorandum items:							
Primary spending (less revenue transfers) 3/	25.7	26.7	26.7	27.0	26.7	28.0	26.7
Current	23.8	24.6	24.6	25.1	24.6	26.0	25.1
Capital	1.9	2.1	2.1	1.9	2.1	2.0	1.6
Pension spending	7.6	8.1	8.0	8.2	8.0	8.5	8.3
Health spending 4/	3.7	3.7	4.1	4.2	4.1	4.0	4.0

Sources: Turkish authorities; and IMF staff estimates.

1/ Spending is increased by 1 month of transfer of revenue shares to make data comparable with other years.
2/ Social Security Institutions plus budget spending on social security (such as civil servants' health and Green Card).
3/ Consolidated central government and social security spending (corresponds to program monitored spending).
4/ Measured as health spending by the Social Security Institution and budget for Green Card and civil servants. This is not a comprehensive measure of health spending, and underestimates spending as it excludes some items (such as Ministry of Health spending on medical personnel salaries).

Table 7. Turkey: Public Sector Finances, 2002−07 1/

(Millions of new Turkish lira)

	2002	2003	2004	2005	2006		2007	
					Prog.	Est	5th Rev.	Revised Prog.
Public sector primary balance	14,130	22,168	30,734	33,013	41,885	37,940	41,003	43,043
Central government	9,527	17,440	22,705	26,725	35,685	33,468	31,660	33,519
Primary revenue	77,403	99,236	117,768	140,602	164,133	162,658	182,441	181,864
Tax revenue	61,713	84,832	100,342	119,627	137,643	137,474	158,153	157,854
Personal income taxes	14,027	16,861	21,244	24,490	28,156	28,983	34,318	35,115
Corporate income taxes	6,215	9,472	10,521	12,048	10,500	11,158	11,925	12,672
VAT	21,990	28,517	30,591	34,326	42,832	41,349	49,783	48,047
SCT	6,133	22,283	26,648	33,345	37,016	36,926	40,170	40,297
Other	13,348	7,699	11,338	15,419	19,140	19,059	21,956	21,723
Nontax revenue 2/	15,691	14,403	17,425	20,975	26,490	25,184	24,288	24,010
Primary expenditure	67,876	81,796	95,063	113,877	128,448	129,191	150,781	148,345
Personnel	21,950	28,833	33,663	37,389	45,260	45,234	54,489	49,769
Goods and services, *of which:*	10,681	11,874	13,604	15,186	12,868	13,302	14,844	20,182
Defense and security	4,485	5,668	5,479	5,896	6,640	6,906	7,015	7,236
Transfers, *of which:* 3/	27,413	33,201	39,531	50,963	59,680	58,721	68,782	67,872
Social security institutions	11,205	15,922	19,333	23,762	23,004	22,892	29,021	31,506
Agricultural subsidies	1,868	2,805	3,084	3,707	4,910	4,747	5,250	5,100
Transfers of revenue shares 4/	7,952	7,108	10,448	12,819	14,860	13,944	16,963	16,963
Capital transfers	49	92	465	1,384	2,564	2,637	3,647	3,122
Capital expenditure	7,831	7,888	8,265	10,340	10,640	11,934	12,668	10,523
Rest of the public sector	4,603	4,728	8,030	6,288	6,200	4,473	9,344	9,524
Extrabudgetary funds	-358	594	551	917	-1,304	-1,988	1,392	1,102
Revolving funds 5/	407	933	976	966	1,137	1,021	1,108	1,128
Social security institutions	-85	53	-293	-78	778	891	0	-1
Unemployment insurance fund	962	1,228	1,557	1,681	2,282	2,278	2,528	2,800
Local governments 5/	538	-567	690	810	901	816	1,018	1,375
State economic enterprises 6/	3,139	2,487	4,548	1,992	2,407	1,455	3,298	3,120
Public sector overall balance	-34,387	-32,602	-19,605	-5,597	1,541	-4,823	-6,464	-6,064
Interest expenditure (net)	48,516	54,771	50,339	38,610	40,344	42,763	47,467	49,107
Domestic	48,358	50,547	44,283	…	32,522	…	38,265	…
External	159	4,224	6,056	…	9,600	…	9,203	…
Public sector financing	34,387	32,602	19,605	5,597	-1,541	4,823	6,464	6,064
Amortization	170,216	113,949	137,486	145,058	129,255	129,255	125,211	125,211
External	19,438	11,519	12,655	14,847	18,574	18,574	18,869	18,869
Domestic	150,779	102,430	124,830	130,211	110,681	110,681	106,342	106,342
Borrowing	206,798	146,268	159,421	165,149	129,548	129,548	130,519	130,519
External	30,917	11,706	11,293	13,619	14,805	14,805	19,022	19,022
Domestic	175,881	134,562	148,127	151,529	114,743	114,743	111,498	111,498
Deposits decrease 7/	-3,003	-16	-4,179	-19,693	-13,845	-7,481	-2,379	-6,479
Privatization	808	299	1,848	5,200	12,011	12,011	3,535	7,235
Memorandum items:								
Central govt. overall balance (auth. def.)	-40,184	-40,210	-29,173	-6,903	…	-3,992	-16,165	-14,773
Total revenue	79,420	101,037	122,919	152,784	172,205	171,309	188,162	187,673
Primary revenue (from above)	77,403	99,236	117,768	140,602	164,133	162,658	182,441	181,864
Interest revenue	1,833	1,519	3,786	8,638	3,157	4,267	2,156	1,868
Program adjustments	183	282	1,366	3,543	4,915	4,384	3,566	3,941
Total expenditure	119,604	141,248	152,093	159,687	…	175,302	204,327	202,446
Primary expenditure (from above)	67,876	81,796	95,063	113,877	128,448	129,191	150,781	148,345
Interest expenditure	51,728	58,527	56,491	45,680	…	45,945	52,946	52,946
Program adjustments	0	925	538	129	…	166	600	1,155

Table 7. Turkey: Public Sector Finances, 2002−07 (concluded) 1/

(Percent of GNP)

	2002	2003	2004	2005	2006		2007	
					Prog.	Est	5th Rev.	Revised Prog.
Public sector primary balance	5.1	6.2	7.2	6.8	7.5	6.6	6.5	6.7
Central government	3.5	4.9	5.3	5.5	6.3	5.8	5.0	5.2
Primary revenue	28.1	27.8	27.5	28.9	29.2	28.2	28.9	28.1
Tax revenue	22.4	23.8	23.4	24.6	24.5	23.9	25.0	24.4
Personal income taxes	5.1	4.7	5.0	5.0	5.0	5.0	5.4	5.4
Corporate income taxes	2.3	2.7	2.5	2.5	1.9	1.9	1.9	2.0
VAT	8.0	8.0	7.1	7.1	7.6	7.2	7.9	7.4
SCT	2.2	6.2	6.2	6.9	6.6	6.4	6.4	6.2
Other	4.9	2.2	2.6	3.2	3.4	3.3	3.5	3.4
Nontax revenue 2/	5.7	4.0	4.1	4.3	4.7	4.4	3.8	3.7
Primary expenditure	24.7	22.9	22.2	23.4	22.9	22.4	23.9	22.9
Personnel	8.0	8.1	7.8	7.7	8.1	7.9	8.6	7.7
Goods and services, *of which:*	3.9	3.3	3.2	3.1	2.3	2.3	2.4	3.1
Defense and security	1.6	1.6	1.3	1.2	1.2	1.2	1.1	1.1
Transfers, *of which:* 3/	10.0	9.3	9.2	10.5	10.6	10.2	10.9	10.5
Social security institutions	4.1	4.5	4.5	4.9	4.1	4.0	4.6	4.9
Agricultural subsidies	0.7	0.8	0.7	0.8	0.9	0.8	0.8	0.8
Transfers of revenue shares 4/	2.9	2.0	2.4	2.6	2.6	2.4	2.7	2.6
Capital transfers	0.0	0.0	0.1	0.3	0.5	0.5	0.6	1.6
Capital expenditure	2.8	2.2	1.9	2.1	1.9	2.1	2.0	1.6
Rest of the public sector	1.7	1.3	1.9	1.3	1.1	0.8	1.5	1.5
Extrabudgetary funds	-0.1	0.2	0.1	0.2	-0.2	-0.3	0.2	0.2
Revolving funds 5/	0.1	0.3	0.2	0.2	0.2	0.2	0.2	0.2
Social security institutions	0.0	0.0	-0.1	0.0	0.1	0.2	0.0	0.0
Unemployment insurance fund	0.3	0.3	0.4	0.3	0.4	0.4	0.4	0.4
Local governments 5/	0.2	-0.2	0.2	0.2	0.2	0.1	0.2	0.2
State economic enterprises 6/	1.1	0.7	1.1	0.4	0.4	0.3	0.5	0.5
Public sector overall balance	-12.5	-9.1	-4.6	-1.2	0.3	-0.8	-1.0	-0.9
Interest expenditure (net)	17.6	15.4	11.7	7.9	7.2	7.4	7.5	7.6
Domestic	17.6	14.2	10.3	…	5.8	…	6.1	…
External	0.1	1.2	1.4	…	1.7	…	1.5	…
Public sector financing	12.5	9.1	4.6	1.2	-0.3	0.8	1.0	0.9
Amortization	61.9	31.9	32.1	29.8	23.0	22.4	19.8	19.4
External	7.1	3.2	3.0	3.1	3.3	3.2	3.0	2.9
Domestic	54.8	28.7	29.1	26.8	19.7	19.2	16.8	16.4
Borrowing	75.2	41.0	37.2	34.0	23.1	22.5	20.7	20.2
External	11.2	3.3	2.6	2.8	2.6	2.6	3.0	2.9
Domestic	63.9	37.7	34.5	31.2	20.4	19.9	17.7	17.2
Deposits decrease 7/	-1.1	0.0	-1.0	-4.0	-2.5	-1.3	-0.4	-1.0
Privatization	0.3	0.1	0.4	1.1	2.1	2.1	0.6	1.1
Memorandum items:								
Central govt. overall balance (auth. def.)	-14.6	-11.3	-6.8	-1.4	…	-0.7	-2.6	-2.3
Total revenue	28.9	28.3	28.7	31.4	30.6	29.8	29.8	29.0
Primary revenue (from above)	28.1	27.8	27.5	28.9	29.2	28.2	28.9	28.1
Interest revenue	0.7	0.4	0.9	1.8	0.6	0.7	0.3	0.3
Program adjustments	0.1	0.1	0.3	0.7	0.9	0.8	0.6	0.6
Total expenditure	43.5	39.6	35.5	32.8	…	30.4	32.4	31.3
Primary expenditure (from above)	24.7	22.9	22.2	23.4	22.9	22.4	23.9	22.9
Interest expenditure	18.8	16.4	13.2	9.4	…	8.0	8.4	8.2
Program adjustments	0.0	0.3	0.1	0.0	…	0.0	0.1	0.2
Nominal GNP (YTL Million)	275,032	356,681	428,932	486,401	562,000	575,784	631,410	646,896

Sources: Turkish authorities; and IMF staff estimates.

1/ Central government data for 2002-05 have been revised in line with the newly published data that are comparable across years.
2/ Excluding privatization proceeds, transfers from CBT, and interest receipts; figures for 2006-07 exclude TÜPRAŞ and Türk Telekom.
3/ Tax rebates to pensioners classified as transfers starting in 2004.
4/ Revenues shared with local governments and extrabudgetary funds (shown as gross revenues and expenditures for the first time in 2006).
5/ Excluded from consolidated government sector subject to quantitative conditionality.
6/ Excluding severance payments for retirees. Some minor SEEs excluded from consolidated government sector subject to quantitative conditionality. Figure for 2006 excludes two SEEs undergoing privatization (TÜPRAŞ and Türk Telekom).
7/ Including statistical discrepancy.

APPENDIX I: EXTERNAL DSA

In the absence of shocks, the external debt ratio is projected to stay broadly flat over the medium term.

1. **The gross external debt ratio is projected to stay at 50 to 55 percent of GNP in the medium term** (Table I.1).[1] This reflects a number of offsetting influences, as a gradually narrowing current account deficit helps to reduce the debt-to-GNP ratio, while some fall-off in FDI (nondebt financing) after the 2006−07 surge and somewhat slower growth of real output after 2008 work to increase it. This baseline also assumes that the central bank will continue to increase its gross international reserves (financed in part by external debt) in order to strengthen its coverage of short-term liabilities and reduce vulnerabilities.

2. **External debt remains vulnerable to standardized shocks** (Figure I.1). Turkey's history of macroeconomic volatility implies that the standardized debt sustainability tests are particularly demanding. A permanent ½ standard deviation growth shock would put the debt ratio on an upward trajectory over 2008–12 and lead to an increase of 8 percentage points in the gross external debt ratio by 2012. A permanent current account shock of ½ standard deviation would have a somewhat larger effect (11 percentage points), as would a ¼ standard deviation joint shock to growth, the current account, and interest rates (10 percentage points). A real depreciation shock of 30 percent in 2008 would cause the gross external debt ratio to jump almost 25 percentage points to 77 percent, before declining gradually over the medium term. While the sensitivity of the external debt ratio to exchange rate shocks is large, the depreciation of the exchange rate would likely lead to a significant reversal of the current account deficit and improved medium-term debt ratios—a dynamic not captured in this debt sustainability exercise.

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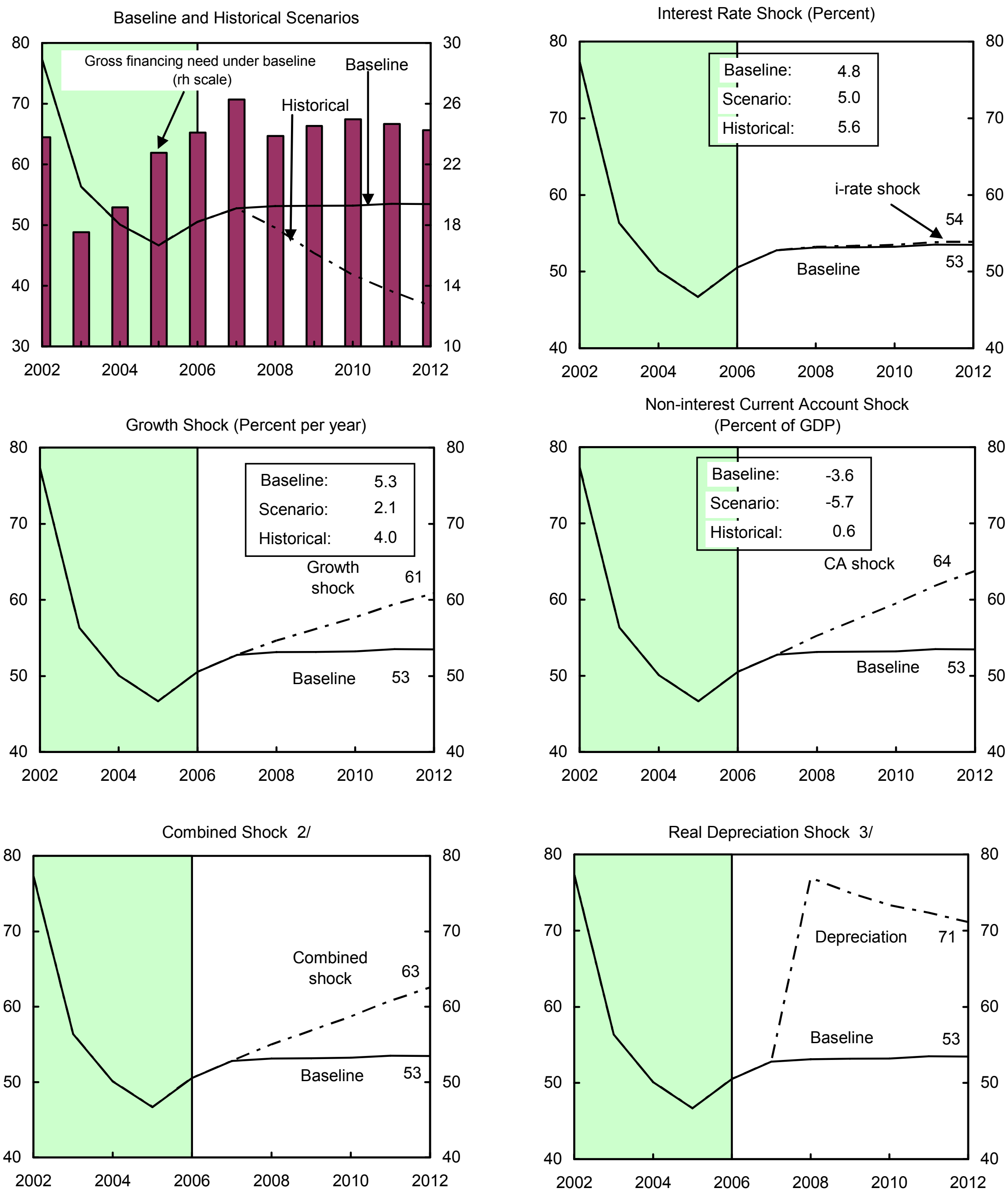
[1] External debt refers to current, non-contingent claims by nonresidents on residents in the form of loans, bonds, leases, etc. It is assumed that: (i) securities issued abroad, e.g., Eurobonds, are held by nonresidents; (ii) domestically issued securities denominated in foreign currencies are held by residents.

Figure I.1. Turkey: External Debt Sustainability: Bound Tests 1/
(External debt in percent of GDP)



Source: IMF staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

3/ One-time real depreciation of 30 percent occurs in 2008.

Table I.1. Turkey: External Debt Sustainability Framework, 2002-2012

(Percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Debt-stabilizing non-interest current account 6/
Baseline: External debt	77.3	56.4	50.1	46.7	50.5	52.8	53.1	53.2	53.2	53.5	53.5	-3.9
Change in external debt	-15.8	-21.0	-6.3	-3.4	3.8	2.3	0.3	0.0	0.0	0.3	0.0	
Identified external debt-creating flows (4+8+9)	-24.7	-23.9	-7.6	-3.3	-2.9	1.2	0.7	0.9	0.5	-0.1	-0.8	
Current account deficit, excluding interest payments	-2.9	0.4	2.6	4.0	5.3	4.9	4.6	4.1	3.5	3.0	2.6	
Deficit in balance of goods and services	2.4	3.5	5.2	6.7	8.1	8.1	7.4	7.0	6.3	5.8	5.3	
Exports	34.2	28.3	28.9	29.6	29.5	32.3	33.0	33.9	35.1	36.4	37.8	
Imports	36.6	31.9	34.1	36.3	37.6	40.4	40.4	40.9	41.4	42.2	43.0	
Net non-debt creating capital inflows (negative)	-0.2	-0.4	-1.1	-4.0	-5.2	-4.0	-3.3	-2.9	-3.0	-3.1	-3.2	
Automatic debt dynamics 1/	-21.6	-24.0	-9.2	-3.3	-3.0	0.3	-0.6	-0.3	-0.1	-0.1	-0.2	
Contribution from nominal interest rate	3.8	2.7	2.3	2.3	2.4	2.7	2.4	2.5	2.4	2.4	2.4	
Contribution from real GDP growth	-5.4	-3.0	-4.4	-3.4	-2.5	-2.5	-2.9	-2.7	-2.5	-2.5	-2.5	
Contribution from price and exchange rate changes 2/	-20.0	-23.7	-7.0	-2.2	-2.9	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	8.9	3.0	1.4	-0.1	6.7	1.0	-0.3	-0.9	-0.4	0.4	0.7	
External debt-to-exports ratio (in percent)	226.0	199.0	173.6	157.5	171.3	163.4	160.9	156.7	151.7	147.0	141.5	
Gross external financing need (in billions of US dollars) 4/	39.9	44.9	61.6	82.3	98.5	110.5	108.7	119.0	128.5	134.4	140.2	
in percent of GDP	23.8	17.5	19.2	22.8	24.1	26.3	23.9	24.5	25.0	24.7	24.3	
Scenario with key variables at their historical averages 5/						52.8	49.5	45.4	41.8	39.1	36.7	-2.7
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (in percent)	7.9	5.9	9.9	7.6	6.0	5.0	6.0	5.5	5.0	5.0	5.0	
GDP deflator in US dollars (change in percent)	27.4	44.2	14.1	4.7	6.6	-2.0	2.1	1.0	1.0	1.0	1.0	
Nominal external interest rate (in percent)	5.6	5.3	5.0	5.2	5.8	5.6	4.9	5.0	4.9	4.8	4.7	
Growth of exports (US dollar terms, in percent)	8.0	26.3	27.8	15.7	12.5	12.7	10.6	9.5	9.7	10.0	10.0	
Growth of imports (US dollar terms, in percent)	16.3	32.9	34.1	20.1	17.0	10.6	8.3	7.8	7.4	8.0	8.1	
Current account balance, excluding interest payments	2.9	-0.4	-2.6	-4.0	-5.3	-4.9	-4.6	-4.1	-3.5	-3.0	-2.6	
Net non-debt creating capital inflows	0.2	0.4	1.1	4.0	5.2	4.0	3.3	2.9	3.0	3.1	3.2	

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflation (based on GDP deflator).

3/ For projection, line includes the impact of price and exchange rate changes.

4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

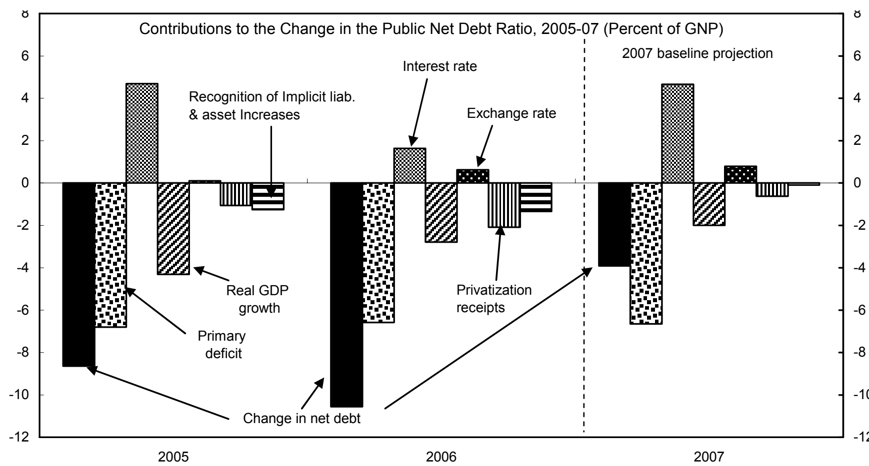
5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

APPENDIX II: PUBLIC DSA

1. *Debt ratios fell further in 2006 and are expected to continue declining in the near term, notwithstanding elevated interest rates. Stress tests show that medium-term debt sustainability hinges on continued fiscal discipline: sticking to high primary surpluses would help prevent explosive debt dynamics in the face of large shocks. In contrast, fiscal policy complacency by itself could set in motion an adverse scenario of higher interest rates and lower growth that would place public debt on an unsustainable path.*

2. **Public sector debt ratios fell further in 2006, as the adverse effects of the May-June turbulence remained limited**. With the lira recovering most of its value by end-year and above expectation growth and privatization receipts, the gross and net public debt ratios fell by about 8-10 percentage points in 2006, to around 63 and 45 percent of GNP, respectively (Box II.1).



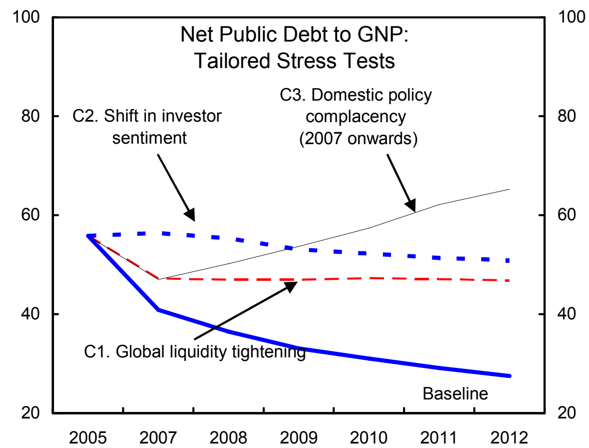
Source: Turkish Treasury.

3. **The baseline scenario targets a net debt ratio at 27½ percent of GNP by 2012—corresponding to a consolidation of over 17 percentage points in 6 years** (Table II.1, panel A). In the absence of shocks, this scenario is consistent with a declining primary surplus, from 6.5 percent of GNP to 5.5 percent in 2009, and further down to 3 percent by 2012. Real interest rates are conservatively assumed to stay around 10 percent.

4. **Stress tests show that debt dynamics could become unsustainable if fiscal discipline is abandoned or a combination of very large shocks occurs** (Figure II.1 and Table II.1, panels B and C).

- **Deterioration in global environment** (C1). This scenario assumes an unexpected slowdown in global growth combined with a sharp tightening of global liquidity, which triggers a rise in risk aversion toward emerging markets. Consequently, the lira would depreciate by 30 percent in 2007, interest rates would increase by 500 bps in 2007–08, and growth would fall to 2½ percent in both years. From 2009–12, interest rates would start to ease again (by 100 bps each year), and growth would gradually return to its baseline. If the primary surplus remains at the baseline, the net debt ratio would increase to over 47 percent of GNP by 2010 and then decline gradually in the following years.

- **Turkey-specific shift in investor sentiment** (C2). This assumes that a Turkey-specific event triggers a loss in investor confidence and a sudden large outflow of capital in 2007. The lira would depreciate by 50 percent, and interest rates would rise by 1000 bps and 500 bps above the baseline in 2007 and 2008, respectively, while growth would fall to zero in 2007 (baseline assumption afterwards). As a result, the net debt ratio would jump by almost 12 percentage points in 2007, before gradually declining again as all variables return to their baseline values.

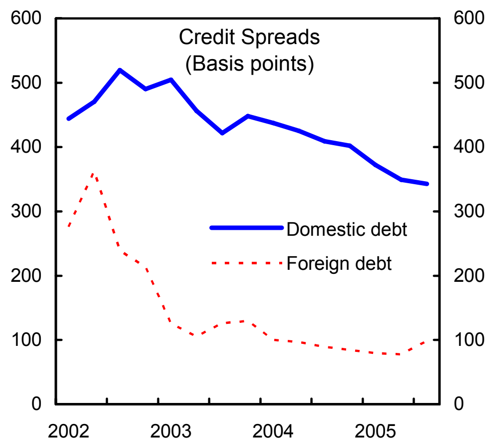


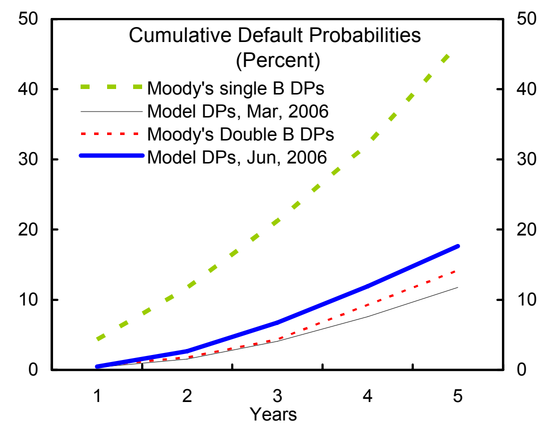
Source: Turkish Treasury.

- **Domestic policy complacency** (C3). This scenario assumes that, instead of the gradual easing of the primary surplus in the outer years, the primary surplus is cut to 3 percent of GNP starting in 2007 and structural reforms are no longer pursued, including an immediate halt of privatization, so that real interest rates increase permanently. While the initial fiscal stimulus helps to maintain output in the first year, growth then falls to a lower trend rate in the following period. Taken together, this sets debt dynamics on an explosive path, raising the debt ratio to over 65 percent by 2012.

Box II.1: Turkey's Sovereign Risk Profile

Turkey's sovereign risk has improved considerably in recent years, reflecting strong economic performance and overall benign financial market conditions. Debt has fallen to 45 percent of GNP from over 90 percent in 2001 in net terms, and roughly one-quarter is denominated in foreign currency. As a result, credit spreads have declined.



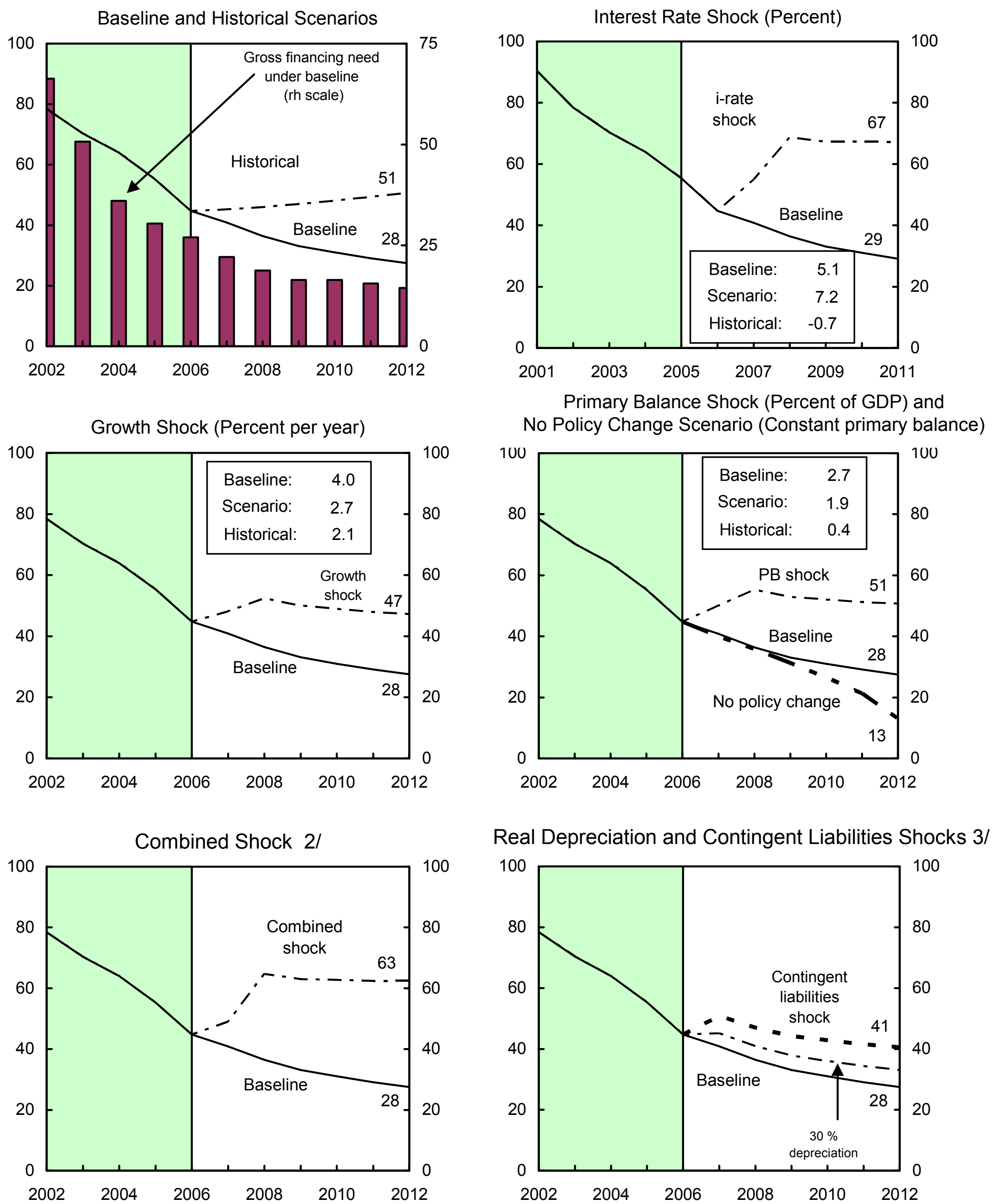


Sources: Moody's; and IMF staff estimates.

Despite greater resilience to moderate shocks, Turkey's sovereign rating could suffer from episodes of pronounced market turbulence. The contingent claims approach suggests that a shock of the same order of magnitude as that observed in May−June 2006 ("volatile scenario")—entailing lira depreciation, a rise in T-bill rates, and a decline in stock prices by 20 percent—should increase the sovereign's external default probability somewhat. However, Turkey would probably maintain its current BB rating, judging from historical sovereign default probabilities. By contrast, a more extreme bout of market turbulence ("volatile scenario 2"), as observed in early 2003, would worsen Turkey's risk profile to the level of a single B rating. Importantly, these simulations assume continued policy discipline—any departure from the prudent policy stance that has enabled recent improvements in sovereign risk could seriously compound the fallout from market volatility.

Further debt reduction would help strengthen Turkey's risk profile. For instance, a reduction in external debt induced by fiscal savings of 2 percent of GNP over a five year period could sufficiently improve Turkey's debt profile to warrant an upgrade to a BBB rating. Estimates also suggest that if the same amount of fiscal savings were used to reduce domestic debt, credit spreads would decline by over 100 basis points.

Figure II.1. Turkey: Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GNP)



Sources: IMF staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.

3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2008, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table II.1. Turkey: Public Sector Debt Sustainability Framework, 2001–12

(Percent of GNP, unless otherwise indicated)

	2001	2002	2003	2004	2005	2006			Projections 2007	2008	2009	2010	2011	2012
									I. Baseline Projections					
Public sector gross debt	107.3	93.4	83.2	77.3	71.6	63.1			57.6	52.5	47.9	43.7	39.9	36.4
Public sector net debt 1/	90.4	78.4	70.3	64.0	55.3	44.8			40.9	36.5	33.1	31.0	29.1	27.5
Of which: foreign-currency denominated	55.4	45.1	30.5	24.9	13.7	8.5			10.2	9.1	8.3	7.8	7.3	6.9
Change in public sector debt	33.3	-12.0	-8.1	-6.4	-8.6	-10.6			-3.9	-4.4	-3.4	-2.1	-1.9	-1.6
Identified debt-creating flows (4+7+12)	28.5	-14.0	-14.7	-8.9	-7.4	-9.8			-4.6	-4.6	-3.6	-2.3	-2.1	-1.8
Primary deficit	-5.5	-5.1	-6.2	-7.2	-6.8	-6.6			-6.7	-6.5	-5.5	-4.0	-3.5	-3.0
Revenue and grants	26.1	24.8	26.7	26.9	27.9	28.2			28.1	28.1	28.1	28.1	28.1	28.1
Primary (noninterest) expenditure	20.6	19.7	20.5	19.7	21.1	21.7			21.5	21.6	22.6	24.1	24.6	25.1
Automatic debt dynamics 2/	34.0	-8.6	-8.4	-1.3	0.5	-1.2			2.7	1.9	1.9	1.7	1.4	1.2
Contribution from interest rate/growth differential 3/	6.1	-14.8	-2.6	-0.1	0.4	-1.2			2.7	1.9	1.9	1.7	1.4	1.2
Of which: contribution from real interest rate	2.3	-10.2	1.0	5.7	4.7	1.6			4.7	4.0	3.7	3.2	2.8	2.6
Of which: contribution from real GDP growth	3.9	-4.6	-3.5	-5.8	-4.3	-2.8			-2.0	-2.2	-1.8	-1.5	-1.4	-1.3
Contribution from exchange rate depreciation 4/	27.8	6.2	-5.9	-1.2	0.1	0.6			...	...	...	...	...	...
Other identified debt-creating flows	0.0	-0.3	-0.1	-0.4	-1.1	-2.1			-0.6	0.0	0.0	0.0	0.0	0.0
Privatization receipts (negative)	0.0	-0.3	-0.1	-0.4	-1.1	-2.1			-0.6	0.0	0.0	0.0	0.0	0.0
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0
Residual, including asset changes (2-3) 5/	4.9	2.0	6.6	2.5	-1.3	-0.7			0.7	0.2	0.2	0.2	0.2	0.2
Key Macroeconomic and Fiscal Assumptions							10-Year Historical Average	10-Year Standard Deviation						
Real GDP growth (in percent)	-9.5	7.9	5.9	9.9	7.6	6.0	4.0	6.5	5.0	6.0	5.5	5.0	5.0	5.0
Average nominal interest rate on public debt (in percent) 7/	55.6	30.4	25.4	20.1	14.1	15.9	47.1	31.6	19.0	16.8	15.4	14.9	14.0	13.8
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	11.3	7.9	15.9	10.6	8.7	4.2	15.1	15.8	12.0	11.4	11.4	10.9	10.0	9.8
Nominal appreciation (increase in U.S. dollar value of local currency, in percent)	-53.6	-11.8	17.7	4.3	-0.4	-4.5	-19.2	24.2	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	55.3	44.4	22.5	9.5	5.3	11.7	41.2	27.5	7.0	5.5	4.0	4.0	4.0	4.0
Growth of real primary spending (deflated by GDP deflator, in percent)	-15.3	3.0	10.3	5.4	15.3	9.0	5.2	8.0	4.0	6.7	10.4	12.0	7.2	7.1
Primary deficit	-5.5	-5.1	-6.2	-7.2	-6.8	-6.6	-4.0	3.3	-6.7	-6.5	-5.5	-4.0	-3.5	-3.0

Table II.1. Turkey: Public Sector Debt Sustainability Framework, 2001–12 (concluded)

(Percent of GNP, unless otherwise indicated)

						Projections			Projections			
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
							II. Stress Tests for Public Net Debt Ratio					
A. Alternative Scenarios												
A1. Key variables are at their historical averages in 2007-11						44.8	45.2	46.0	47.0	48.1	49.3	50.7
A2. No policy change (constant primary balance) in 2007-11						44.8	39.9	35.8	31.2	26.5	21.2	13.0
A3. 2007 GDP growth is reduced (relative to baseline) by one standard deviation						44.8	43.6	38.9	35.3	33.1	31.0	29.3
A4. Selected variables are consistent with market forecast in 2007-11						44.8	40.9	37.0	34.6	34.1	33.9	34.0
B. Bound Tests												
B1. Real interest rate is at historical average plus two standard deviations in 2007 and 2008						44.8	55.0	68.8	67.3	67.3	67.3	67.6
B2. Real GDP growth is at historical average minus two standard deviations in 2007 and 2008						44.8	48.2	52.4	50.0	48.9	47.9	47.3
B3. Primary balance is at historical average minus two standard deviations in 2007 and 2008						44.8	50.1	55.2	53.0	52.1	51.2	50.8
B4. Combination of B1-B3 using one standard deviation shocks						44.8	49.1	64.7	63.0	62.8	62.5	62.5
B5. One time 30 percent real depreciation in 2007 8/						44.8	45.1	40.9	37.8	36.1	34.4	33.1
B6. 10 percent of GDP increase in other debt-creating flows in 2006						44.8	50.9	47.0	44.2	42.8	41.5	40.5
C. Tailored Tests												
C1. Deterioration in global environment (liquidity tightening and low world growth). 9/						44.8	47.2	47.0	47.0	47.3	47.1	46.8
C2. Turkey-specific shift in investor sentiment (sharp capital flow reversal) 10/						44.8	56.4	55.3	53.1	52.2	51.4	50.9
C3. Domestic policy complacency starting in 2007 11/						44.8	47.0	50.2	53.7	57.4	62.1	65.3

1/ Consolidated nonfinancial public sector, net debt.

2/ Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

3/ The real interest rate contribution is derived from the denominator in footnote 2 as r - π (1+g) and the real growth contribution as -g.

4/ The exchange rate contribution is derived from the numerator in footnote 2 as ae(1+r).

5/ For projections, this line includes exchange rate changes.

6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

7/ Derived as nominal interest expenditure divided by previous period debt stock.

8/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

9/ Assumes a 30 percent depreciation in 2007, and a 500 bps increase in real interest rates in 2007−08, which reduces growth to 2.5 percent in these years. From 2009−12 interest rates will gradually ease 100 bps each year, while growth gradually accelerates to its 5 percent trend.

10/ Assumes a 50 percent depreciation in 2007, interest rates above baseline by 1000 and 500 bps in 2007 and 2008, respectively, and zero growth in 2007. Baseline assumptions for 2008−12.

11/ Assumes that starting in 2007 the primary fiscal balance is permanently reduced to 3 percent, privatizations are cancelled (zero receipts) and real interest rates permanently rise by 4 percentage points. As a result, annual growth drops permanently to 2.5 percent (beginning in 2008) and the annual lira depreciation is faster than under baseline.

INTERNATIONAL MONETARY FUND

TURKEY

Staff Report for the 2007 Article IV Consultation—Informational Annex

Prepared by the European Department

May 4, 2007

Contents Page

ANNEX I. TURKEY: STATISTICAL INFORMATION

1. Data provision to the Fund is broadly adequate for surveillance and program monitoring purposes, despite certain shortcomings. Turkey subscribes to the Special Data Dissemination Standard (SDDS).

Real sector statistics

2. Data on producer and consumer prices are published monthly, with a very short lag. Monthly data on industrial production is published with a lag of five to six weeks, while quarterly national accounts are published with a 2-3 month lag. The Turkish Statistical Institute (Turkstat) publishes national accounts in current and constant prices for the production and expenditure approaches to gross domestic product (GDP) and in current prices for the income approach. In SDDS metadata, Turkstat indicates that GDP estimated using the production approach is the principal measure of GDP. The national accounts are compiled in accordance with the *1968 System of National Accounts* (*1968 SNA*) methodology.

3. The national accounts data suffer from an outdated base year (1987), the use of value-added ratios that have been maintained constant for several industries since the last benchmark year (1990), annual surveys that are not timely and not used as an input for the GDP estimates, and the use of single—instead of double—deflation to estimate GDP by production at constant prices. A project is underway to align compilation of the national accounts to the *1993 SNA* methodology and implement the main recommendations from the 2001 Data Module of the Report on the Observance of Standards and Codes (Data ROSC): (1) introduction of annual industrial survey results to the GDP data; (2) improved estimation and deflation of output and household consumption; (3) disaggregated deflation of trade in services and inclusion of shuttle trade in exports of goods; and (4) improvement in the estimation of selected aggregates.

4. There is a wide range of data on labor market developments, with the biannual Household Labor Force Survey (HLFS) replaced with a monthly survey at the beginning of 2000. These new data are published quarterly with a three month lag. Coverage of wage developments in the private sector has improved significantly through the use of quarterly surveys of the manufacturing sector.

Government finance statistics

5. Budgetary data are published monthly, with a lag of some 2−3 weeks. Coverage of the budget is incomplete, with sizable fiscal operations conducted through extra budgetary funds, for which data are available only with long lags. Fiscal analysis is further complicated by the omission of certain transactions from the fiscal accounts; failure to account for sizable quasi-fiscal operations carried out by state banks and state economic enterprises (SEEs); and technical problems associated with consolidating the cash-based accounts of governmental entities with the accrual-based accounting of SEEs. It is difficult to reconcile fiscal data with monetary and BOP data, especially in the accounting of external debt flows and central

government deposits. Under the IBRD-financed Public Financial Management Project (PFMP), the authorities are to adopt an improved budget coding system, a chart of accounts, and a new debt management database.

6. Turkey reports fiscal data for publication in *Government Finance Statistics Yearbook*. The latest data available are for 2001 and cover the central government budgetary sector (including annex budget units). Data are not provided for extrabudgetary and social security units. No monthly and quarterly data are being reported for publication in *International Financial Statistics*.

Monetary and financial statistics

7. Data on the central bank balance sheet, and provisional data on the main monetary aggregates and total domestic credit, are published weekly, with a one- and two-week lag, respectively. Data on the monetary survey and deposit interest rates are published monthly, with about a two-to-three-month lag. The CBT does not expect to meet the SDDS timeliness requirement for the analytical accounts of the banking sector in the short term due to delays in the preparation of year-end bank balance sheets and ongoing restructuring in the banking system. The CBT reports monthly data to STA with about a three-to-four-month lag.

8. STA and EUR use different measures of the monetary authorities' net foreign assets, reflecting in part UFR treatment of central bank foreign currency-denominated liabilities to resident banks as foreign liabilities of the central bank. Differences also stem from the use of program exchange rates in EUR's presentation, while market exchange rates are used in *IFS*.

External sector statistics

9. In line with SDDS prescriptions Turkey disseminates:

- monthly balance of payments (BOP) statistics with a 2−3 month lag;
- weekly international reserves with a one-week lag;
- monthly data on the template on international reserves and foreign currency liquidity (reserve template) within one month after the reference period;
- monthly merchandise trade data with one to two months lag;
- quarterly external debt with one quarter lag; and,
- annual international investment position (IIP) data with a six months lag.

10. The central bank reports quarterly BOP data to STA with about four months lag. Balance of payments and IIP statistics are compiled in broad conformity with the conceptual framework of the fifth edition of the *Balance of Payments Manual* (*BPM5).* The CBT periodically reviews the bank's foreign exchange records to redress, to the extent possible, problems of coverage and misclassification using supplemental data sources and estimation techniques.

Turkey: Table of Common Indicators Required for Surveillance

(As of May 3, 2007)

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]	Memo Items: Data Quality – Methodological soundness[7]	Memo Items: Data Quality – Accuracy and reliability[8]
Exchange Rates	05/03/07	05/03/07	D and M	D and M	W and M		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	05/03/07	05/03/07	W	W	W		
Reserve/Base Money	05/03/07	05/03/07	W and M	W and M	W and M		
Broad Money	05/03/07	05/03/07	W and M	W and M	W and M	O, O, LO, LO	O, O, O, O, O
Central Bank Balance Sheet	05/03/07	05/03/07	W and M	W and M	W and M		
Consolidated Balance Sheet of the Banking System	05/03/07	05/03/07	W and M	W and M	W and M		
Interest Rates[2]	05/03/07	05/03/07	D and M	D and M	W and M		
Consumer Price Index	April 2007	05/03/07	M	M	M	O, O, O, O	LO, O, O, O, NA
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	March 2007	04/12/07	M	M	M	LO, LNO, O, O	LO, O, O, O, NA
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	March 2007	04/12/07	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	April 2007	05/03/07	W	W	W		
External Current Account Balance	February 2007	04/03/07	M	M	M	O, O, LO, LO	O, O, O, O, O
Exports and Imports of Goods and Services	February 2007	04/03/07	M	M	M		
GDP/GNP	2006 Q4	04/02/07	Q	Q	Q	LO, LO, O, O	LO, LO, O, LO, NA
Gross External Debt	2006 Q4	03/30/07	Q	Q	Q		

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).
[7] Reflects the assessment provided in the data ROSC (published March 14, 2002, and based on the findings of the mission that took place October 18-30, 2001) for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O); largely observed (LO); largely not observed (LNO); not observed (NO); and not available (NA).
[8] Same as footnote 7, except referring to international standards concerning source data, statistical techniques, assessment and validation of source data, assessment, and revision studies.

ANNEX II. TURKEY: FUND RELATIONS
(As of March 31, 2007)

I. **Membership Status:** Turkey became a member of the Fund on March 11, 1947. It has accepted the obligations of Article VIII, Sections 2, 3, and 4 as of March 22, 1990.

II. **General Resources Account:**

General Resources Account:	Millions of SDRs	Percent of Quota
Quota	1,191.30	100.00
Fund holdings of currency	6,702.55	562.62
Reserve position in Fund	112.78	9.47

III. **SDR Department:**

SDR Department:	Millions of SDRs	Percent of Allocation
Net cumulative allocation	112.31	100.00
Holdings	14.24	12.68

IV. **Outstanding Purchases and Loans:**

Outstanding Purchases and Loans:	Millions of SDRs	Percent of Quota
Stand-By Arrangements	5,624.02	472.09

V. **Latest Financial Arrangements:**

Type	Approval Date	Expiration Date	Amount Approved	Amount Drawn
			In millions of SDRs	
Stand-By	05/11/05	05/10/08	6,662.04	3,664.12
Stand-By	02/04/02	02/03/05	12,821.20	11,914.00
Stand-By	12/22/99	02/04/02	15,038.40	11,738.96
Of which: SRF	12/21/00	12/20/01	5,784.00	5,784.00

VI. **Projected Payments to Fund (Expectations Basis)**[1]
(In millions of SDRs; based on existing use of resources and present holdings of SDRs)

	Forthcoming				
	2007	2008	2009	2010	2011
Principal	1,843.54	1,244.05	1,693.27	843.16	
Charges/Interest	234.33	200.07	111.75	32.84	4.76
Total	2,077.88	1,444.12	1,805.02	876.00	4.76

[1]This schedule presents all currently scheduled payments to the IMF, including repayment expectations and repayment obligations. The IMF Executive Board can extend repayment expectations (within predetermined limits) upon request by the debtor country if its external payments position is not strong enough to meet the expectations without undue hardship or risk (see repayment schedules and IMF lending for details).

Projected Payments to Fund (Obligations Basis)[2]
(In millions of SDRs; based on existing use of resources and present holdings of SDRs)

	Forthcoming				
	2007	2008	2009	2010	2011
Principal	1,130.63	712.92	1,244.05	1,693.27	843.16
Charges/Interest	247.67	266.67	199.55	112.06	32.95
Total	1,378.29	979.59	1,443.60	1,805.33	876.11

VII. **Safeguard Assessments**:

In accordance with the Fund's safeguards policy, a new assessment of the CBT's safeguards framework was conducted under the current SBA. This assessment was completed on June 29, 2005. While it uncovered no material weaknesses in the CBT's safeguard framework, a few recommendations were made to address some remaining vulnerabilities in the areas of internal audit and controls. Those recommendations have been implemented.

VIII. **Exchange Rate Arrangement**:

Since February 22, 2001, the lira has been under an independent floating exchange rate regime.

IX. **Article IV Consultations**:

The 2004 Article IV staff report (Country Report No. 04/227) was issued on July 9, 2004, and the accompanying Selected Issues paper (Occasional Paper No. 242) was issued on July 15, 2004. Board discussion took place on July 30, 2004.

X. **ROSCs**

Standard or Code Assessed	**Date of Issuance**	**Document Number**
Fiscal Transparency	June 26, 2000	(Forthcoming)
Corporate Governance	December 11, 2000	prepared by the World Bank
Data ROSC	March 14, 2002	Country Report No. 02/55
Fiscal ROSC	March 24, 2006	Country Report No. 06/126

[2]This schedule is not the currently applicable schedule of payments to the IMF. Rather, the schedule presents all payments to the IMF under the illustrative assumption that repayment expectations—except for SRF repayment expectations—would be extended to their respective obligation dates by the IMF Executive Board upon request of the debtor country (see repayment schedules and IMF lending for details). SRF repayment expectations are shown on their current expectation dates, unless already converted to an obligation date by the IMF Executive Board.

XI. **Recent Technical Assistance**:

Dept.	Timing	Purpose
MFD	Mar. 04	Currency reform
STA	Apr. 04	Consumer and wholesale price indices
STA	May. 04, Jun. 05 and Sept. 06	National accounts statistics
FAD	May. 04	Public expenditure analysis
FAD	Jun. 04	Tax reform strategy
MFD	Oct. 04	Currency reform
FAD/MFD	Feb. 05	Treasury cash management and state bank reform
MFD	2005-06 (several missions)	Inflation targeting and monetary policy implementation
ICM	May. 05	Investor relations office
FAD	Jul. 05	Income tax reform
FAD	Aug. and Sept. 05 Apr. and Aug. 06	Tax and social security administration reforms
FAD	Feb. 07	Health spending
FAD	Mar. 07	Revenue administration reforms

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June 12, 2007

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2007 Article IV Consultation with Turkey

On May 18, 2007, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Turkey.[1]

Background

Turkey has experienced an impressive economic revival in recent years. Sound economic policies anchored to Fund arrangements, as well as political stability and favorable external conditions, have resulted in average annual growth of 7½ percent since 2002. Private consumption and investment have been the main drivers, fueled by declining real interest rates, surging capital inflows, rapid credit expansion, and rising productivity. Meanwhile, inflation has dropped dramatically over the past five years.

The real economy has undergone significant modernization, becoming less reliant on traditional sectors and more open to trade and foreign investment. Exports have continued to gain market shares, as the effects of an appreciating currency have been largely offset by productivity gains. Slack in the labor market has kept labor costs in check.

Balance sheets have also strengthened. Public debt ratios have come down considerably, and the composition of debt has improved. Bank balance sheets have also become more robust.

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

These positive outcomes have been driven, in large part, by disciplined policies and advances in structural reforms. On the macroeconomic side, adherence to the 6.5 percent of GNP primary surplus target combined with monetary policy restraint by an independent central bank have helped bring down inflation, strengthen confidence, and ease real interest rates. The floating exchange rate has been an effective shock absorber and has provided good incentives for managing currency risks. On the structural side, bank recapitalization and enhanced supervision, tax reforms, and privatization have restarted private credit growth, promoted FDI, and spurred competitiveness.

Still, the Turkish economy faces a number of macroeconomic challenges. In particular, the economy's dependence on large capital inflows exposes Turkey to swings in investor sentiment (as witnessed during recent periods of market turbulence). Also, inflation well above target (due to a series of supply shocks, currency depreciation, and inertia in expectations) continues to require tight monetary policy. And, in order to sustain and build on recent improvements in growth, a number of structural challenges need to be tackled. These include a low employment rate, still limited financial intermediation, a large informal sector, and potential bottlenecks in electricity supply.

Executive Board Assessment

Turkey's macroeconomic performance in recent years has been impressive, combining strong growth with a sustained reduction of inflation. This owed much to the authorities' disciplined macroeconomic policies, strengthened economic institutions, and structural reforms, in a context of favorable external conditions, political stability, and firm commitment to Fund arrangements. Directors considered, however, that Turkey needs to manage vulnerabilities carefully and address structural challenges to increase the economy's growth potential and resilience to shocks.

Directors welcomed the significant progress made in addressing the large imbalances inherited from the 2001 crisis. They called on the authorities to build on this progress by further reducing public debt and bringing inflation to the low single digits. They observed that new vulnerabilities have arisen as a byproduct of the recent strong performance. In particular, large capital inflows fuel lira appreciation and a widening current account deficit, exposing Turkey to sudden shifts in market sentiment. This calls for maintaining fiscal and monetary discipline and preserving the floating exchange rate as a useful shock absorber. It also puts a premium on continuing to build buffers in balance sheets and improve financing structures. In this regard, Directors supported the authorities' plan to increase gradually and predictably the level of international reserves.

Directors agreed that a tight fiscal policy has been key to achieving the primary fiscal surpluses and the recent economic successes, but considered that too much reliance may have been placed on revenue increases and investment restraint. Going forward, fiscal discipline—possibly underpinned by a fiscal rule—will continue to be needed to reduce debt, support disinflation, and buttress market confidence. Tight control over current spending will facilitate efforts to ease the heavy tax burden, especially on labor and financial transactions. Noting the spending overruns in early 2007, Directors welcomed the plans to bring the fiscal position back on track, and encouraged the authorities to adhere closely to them in order to achieve the 2007 primary surplus target of 6.7 percent of GNP.

Directors supported the measures to increase fiscal transparency and the reform of personal income taxation. They called for further fiscal reforms to contain nondiscretionary spending. Revised social security legislation that preserves the savings targeted in the 2006 reform law should be adopted as soon as possible. Social services efficiency should be improved, and civil service pay rationalized. Continued reforms to improve tax collection will be essential to create fiscal space. In that connection, Directors called for continued efforts to reduce fragmentation in tax administration and make the large taxpayer unit fully effective.

Directors underscored the importance of achieving a low single-digit inflation rate to reduce still-high real interest rates. They endorsed the central bank’s tight monetary stance, and its intention to defer interest rate cuts until inflation is firmly on a path toward the 4 percent target. Directors emphasized that preserving central bank independence will be essential for the success of inflation targeting.

Directors stressed the need to deepen financial intermediation while preserving the soundness of the financial system. They commended the authorities for adopting the mortgage law and beginning the privatization of Halkbank. To ensure that rapid credit growth does not compromise bank soundness, they called for stepping up supervisory oversight, tightening provisioning requirements further, and improving the timeliness of corporate balance sheet data.

Directors considered that removing impediments to employment creation and labor productivity growth is crucial for enhancing the economy’s growth potential, with an easing of labor regulation a priority. Reductions in labor taxes are needed, provided that they do not compromise the debt reduction objective. Directors encouraged the authorities to advance the privatization program. Restructuring the energy sector, by privatizing electricity distribution companies and allowing better cost-recovery pricing, will be particularly important.

Turkey: Selected Economic Indicators, 2001−07

	2001	2002	2003	2004	2005	2006 Est.	2007 Proj.
Real sector				(Percent)			
Real GNP growth rate	-9.5	7.9	5.9	9.9	7.6	6.0	5.0
Private consumption growth rate	-9.2	2.1	6.6	10.1	8.8	5.2	3.3
Private gross fixed investment growth rate	-34.9	-5.3	20.3	45.5	23.6	17.3	6.1
Final domestic demand growth rate	-9.2	2.1	6.6	10.1	8.8	5.2	3.3
GNP deflator growth rate	55.3	44.4	22.5	9.5	5.3	11.7	7.0
Nominal GNP growth rate	40.5	55.8	29.7	20.3	13.4	18.4	12.4
CPI inflation (12-month; end-of period)	68.5	29.7	18.4	9.4	7.7	9.7	6.0
PPI inflation (12-month; end-of-period)	88.6	30.8	13.9	15.3	2.7	11.6	5.6
Unemployment rate	10.4	11.0	10.3	10.3	10.2	9.9	...
Average nominal treasury bill interest rate	93.6	64.6	45.1	24.7	16.2	18.1	...
Average ex-ante real interest rate	35.5	30.5	33.9	15.3	6.0	9.3	...
Central government budget		(Percent of GNP, unless otherwise indicated)					
Primary balance	4.8	3.5	4.9	5.3	5.5	5.8	5.2
Net interest payments	22.2	17.3	16.1	12.3	7.7	5.8	5.9
Overall balance	-17.4	-13.8	-11.2	-7.1	-2.2	0.1	-0.7
Consolidated public sector							
Primary balance	5.5	5.1	6.2	7.2	6.8	6.6	6.7
Net interest payments	22.6	17.6	15.4	11.7	7.9	7.4	7.6
Overall balance	-17.1	-12.5	-9.1	-4.6	-1.2	-0.8	-0.9
Net debt of public sector	90.4	78.4	70.3	64.0	55.3	44.8	40.9
Net external	37.5	32.1	21.9	17.4	8.5	7.3	7.1
Net domestic	52.9	46.3	48.4	46.5	46.8	37.5	33.8
Share of FX debt (percent of gross public debt)	57.8	58.1	46.3	41.5	37.6	36.1	32.9
External sector							
Current account balance	2.4	-0.8	-3.4	-5.2	-6.3	-7.9	-7.3
Exports of goods and non-factor services	36.1	31.0	30.1	30.5	29.3	29.7	30.3
Volume growth (goods only, percent)	15.7	17.2	19.1	15.0	10.1	11.7	10.3
Imports of goods and non-factor services	31.7	30.1	31.3	33.8	34.0	35.9	35.7
Volume growth (goods only, percent)	-23.8	26.1	24.6	22.2	11.8	8.2	7.4
Trade balance	-2.6	-4.0	-5.9	-7.9	-9.3	-10.0	-9.3
Of which: energy (billions of U.S. dollars)	-7.8	-8.5	-10.6	-13.0	-18.6	-25.0	-26.6
Gross external debt 1/	93.1	77.3	56.4	50.1	46.7	50.5	52.8
Net external debt 1/	64.3	52.8	37.6	32.0	27.3	26.9	28.5
Foreign direct investment (net)	1.9	0.5	0.5	0.7	2.4	4.8	3.5
Short-term external debt (by remaining maturity)	22.6	19.3	17.3	17.2	16.4	18.2	16.9
Monetary aggregates							
Nominal growth of M2Y broad money (percent)	87.5	25.4	13.0	22.1	24.5	24.1	14.9
	(Billions of U.S. dollars, unless otherwise indicated)						
Privatization proceeds 2/	2.8	0.5	0.2	1.3	3.8	9.6	…
Net external financing of central government	8.4	6.7	-0.7	-2.7	-4.1	-0.6	…
Amortization	-6.7	-11.4	-8.7	-11.7	-14.1	-13.5	…
Gross borrowing	15.0	18.1	8.0	8.9	10.0	13.0	…
Of which: Eurobond issues	2.2	3.3	5.3	5.8	6.5	5.8	…
GNP	144.0	182.7	238.5	301.5	361.9	401.4	...
GNP (billions of Turkish lira)	176.5	275.0	356.7	428.9	486.4	575.8	646.9
Per capita GDP (2006): $5,534	Poverty Rate (2003): 26 percent (WB poverty line estimate)						

Sources: Turkish authorities; and IMF staff estimates and projections.

1/ Debt ratios valued at end-year exchange rates.

2/ Privatization revenue received by fiscal authorities.

Statement by Willy Kiekens, Executive Director for Turkey and Levent Veziroglu, Senior Advisor to Executive Director May 18, 2007

In the last five years economic management in Turkey has been successful. The policy anchors provided by the IMF supported programs and by the EU accession negotiations have been very helpful. The Turkish authorities are grateful for the close collaboration with Fund staff and for the support shown by Management and the Executive Board.

Fiscal consolidation and reforms to improve economic governance and investment conditions have transformed the Turkish economy. Public debt has been significantly reduced, as has been inflation. Confidence increased and risk premia dropped. Investment by residents and foreigners has been buoyant and GDP growth strong and sustained.

Encouraging as these developments have been, remaining challenges must be addressed. Turkey's ambition is to achieve rapid real convergence with income levels in the European Union. This requires preserving and strengthening macroeconomic stability and further transforming the economy to effectively use all its resources and boost productivity.

Current Account Deficit

The authorities are closely monitoring developments in the current account. The deficit which stood at 7.9 percent of GDP in 2006, is projected to narrow from this year on. During the last four years Turkey's production sector has started using more imported technological and intermediate goods. This led to increased imports, but also helped increase exports. Since last year, export growth in volume terms has exceeded that of imports. Staff projects that from this year onwards, export growth will outpace import growth in both volume and value terms.

When assessing the current account position we should of course not neglect how the deficit has been financed. Developments in this regard have been positive since FDI now covers half of the deficit. The remainder is increasingly financed by credit to the export industry. Thus, both the dynamics of the current account and its financing provide reason for confidence. Nonetheless, the authorities are committed to take any necessary measure if the current account were to worsen.

Fiscal Policy

Continuing fiscal prudence and maintaining a high primary surplus is the main policy anchor for the Turkish economy. Fiscal performance during the last four years has been outstanding, with an average public sector primary surplus of 6.5 percent of GNP. The authorities are determined to preserve their hard-won credibility with respect to fiscal discipline.

In 2006 the primary surplus was 6.6 percent. Although this is exemplary by any standard, it fell 0.7 percentage point short of the revised program target. Nonetheless, this outcome did not hamper any program objectives, as is evidenced by the continuous decline in the net public debt ratio which is now 45 percent of GNP, well ahead of the program projections. The authorities would therefore like to request a waiver for missing the relevant performance criterion.

As pointed out, fiscal rigor remains a pillar of the government's program. For 2007, the primary surplus is targeted at 6.7 percent. To secure this outcome the authorities have taken fiscal measures equivalent to 0.83 percent of GNP, to offset both the 2006 expenditure overrun and the slippages in the first quarter of 2007. The authorities are keen to adhere to fiscal discipline despite the elections scheduled for July 2007.

Fiscal policy is of course not limited to expenditure measures. Important steps have been taken to reduce tax rates while broadening the tax base. An autonomous Revenue Administration was established including a large tax payers' unit. The problem of staffing this unit has been addressed by appointing 37 auditors. As a result, revenue collection is expected to improve.

Social Security

The Constitutional Court has annulled some provisions in the new social security law. In response, the government has decided in favor of a modified reform which respects the constitutional ruling while preserving the main elements and the estimated savings of the original reform. These new proposals will soon be published in a White Paper and the reform is expected to be implemented by mid 2008.

Monetary Policy

After 30 years of high inflation, Turkey has succeeded in reducing inflation to slightly below 10 percent. Reducing inflation further has been difficult. In April 2007, consumer prices rose by 1.21 percent, and year-on-year inflation reached 10.72 percent. Price stickiness in the services sector and prices for energy and unprocessed food largely explain developments in the overall price level. And although the pass-through of the exchange rate depreciation in spring 2006 has moderated, some lagged effects still persist. The disinflation process is expected to continue in the coming months, converging, by the second quarter of 2008, to 4 percent as the mid-point of the targeted range for inflation.

The tight monetary policy stance was maintained during the first quarter of 2007 because of prevailing uncertainties in the global economy, and uncertainties regarding the lagged effects of monetary tightening. The delayed impact of the tight monetary policy stance on domestic demand suggests that demand conditions are critical for disinflation.

There are several risks to the disinflation process, such as backward looking price setting and stronger than expected inflation inertia, including the stickiness of inflation expectations. Nonetheless, the CBT is confident that inflation expectations will come down gradually as the headline inflation eases. The CBT signals that it will keep its cautious monetary stance for an extended period.

The CBT continued its preannounced daily foreign exchange buying auctions in the first quarter of the year in order to absorb the excess foreign exchange supply. Gross reserves now exceed 15 percent of GNP.

Financial Sector

The 2005 banking law has brought the supervisory framework up to best international practices. In the last four years, prudential regulation and supervision have been significantly upgraded. Supervision is conducted on a consolidated basis. Weak banks have been restructured, recapitalized, merged or closed. Public banks have been restructured both financially and operationally. Capital adequacy ratios are now among the highest in emerging market countries. Open foreign currency positions are well within prudential limits. The level of non-performing loans is low.

The Turkish authorities found the recent Financial Sector Assessment Program highly useful. Its recommendations have been considered carefully and some have already been implemented, including raising required general provisions, strengthening the minimum capital adequacy ratio, issuing inflation indexed debt and adopting a mortgage credit law.

The entry of foreign financial institutions in Turkey is strengthening competitiveness and improving management practices. Credit growth is very high, considerable financial deepening being under way. Obviously, banking supervision will need to keep up with new developments and constantly update its capacity, in-step with developments in the financial sector.

A New Mortgage Credit Law

The recently adopted mortgage credit law will contribute to the expansion of housing credit. It also provides for improved monitoring of financial sector developments. The authorities did not favor tax incentives for mortgage loans as this could have been both costly for the budget and a source of distortion in the housing market.

Privatizing Halkbank

The public share offering of 25 percent of Halkbank, the second largest state-owned bank, yielded US$ 1.80 billion. The sale shows confidence in the robustness and prospects for the Turkish economy in a critical election year. With this sale Turkey complied with a prior action for the completion of this review. These results will certainly be carefully evaluated when planning the next steps for privatizing state banks.

Increasing the Role of the Private Sector and Improving the Business Environment

A wide range of measures has been taken to enhance the role of the private sector and improve the investment climate. This would further improve medium-term growth and employment prospects. Various legislative changes have been made in key sectors with a view to increasing market efficiency. To this end, the energy, telecommunications and tobacco sectors have been deregulated.

Reforms have significantly improved the investment environment. A key achievement has been limiting bureaucracy. The time required to register a company is now less than one week. In many cases the formalities can be processed in one day, well below the OECD average.

The improved FDI regime was reflected in some recent highly successful large privatizations. In the last three years, Turkey attracted almost US$ 33 billion FDI, of which a record US$ 20.2 billion in 2006 alone. In the first quarter of 2007, FDI was US$ 9.2 billion. Turkey's international direct investment base is growing very fast. More than 15,000 companies with international capital are now operating in the country.

Labor Market Reform and Employment

Although the level of unemployment has remained unchanged for the last couple of years, the number of employed has been increasing. The economy has been going through a transformation, with a shift from agriculture to services and industry. While it was the dominant sector in the past, the number of people working in agriculture is now shrinking rapidly.

However, Turkey needs to improve labor market flexibility if the recent strong growth performance is to absorb unemployment. A strategy to achieve this goal will be developed in consultation with the Fund staff and consistently with the fiscal framework.