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Turkey: Sixth Review and Inflation Consultation Under the Stand-By Arrangement and Request for Waiver of Nonobservance and Applicability of Performance Criteria—Staff Report; Staff Supplement; and Press Release on the Executive Board Discussion

In the context of the sixth review and inflation consultation under the Stand-By Arrangement, and request for waiver of nonobservance and applicability of performance criteria, the following documents have been released and are included in this package:

- the staff report for the sixth review and inflation consultation under the Stand-By Arrangement, and request for waiver of nonobservance and applicability of performance criteria, 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 staff supplement of May 16, 2007 updating information on recent developments.

- a Press Release summarizing the views of the Executive Board as expressed during its May 18, 2007 discussion of the staff report that completed the review.

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

Sixth Review and Inflation Consultation Under the Stand-By Arrangement and Request for Waiver of Nonobservance and Applicability of Performance Criteria[1]

Prepared by the European Department in consultation with other departments

Approved by Susan Schadler and Matthew Fisher

May 4, 2007

Executive Summary

Turkey's macroeconomic performance has been strong. Economic activity has been resilient as the economy rebalances away from high reliance on domestic demand. FDI has surged, allowing a further build-up of reserves. The net public debt ratio continues to fall rapidly.

Nonetheless, vulnerabilities remain. The current account deficit appears to have peaked, but is still high; inflation is persistently above target; and approaching elections have increased political risks. These vulnerabilities, together with a large stock of portfolio investment by nonresidents, keep Turkey susceptible to shifts in investor sentiment.

Against this backdrop, the authorities renewed their commitment to strong policies. In the attached Supplementary Letter of Intent (LOI), they propose to target a 6.7 percent of GNP primary surplus in 2007, maintain a tightening bias in monetary policy, and advance structural reforms.

Successful program implementation will require:

- Substantial spending discipline to offset the disappearance of about 1½ percent of GNP in exceptional factors that boosted the 2006 outturn.

- Structural measures to revive social security reform, strengthen tax administration and financial regulation, and increase efficiency in the health and energy sectors.

Program implementation and new conditionality are summarized in the table below and Annexes A-B of the LOI.

[1] A three-year SDR 6.7 billion (559 percent of quota) Stand-By Arrangement was approved in May 2005. Cumulative purchases amount to SDR 3.7 billion. A further SDR 749.5 million will become available upon completion of the sixth review. Outstanding Fund credit amounted to SDR 5.2 billion at end-April.

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Program Monitoring

Quantitative conditionality (performance criteria) 1/	December 2006	April 2007
1. Floor on primary balance of consolidated government sector (CGS)	Observed	Expected to be *missed* by 3,700-4,229 mil. YTL 2/
2. Floor on primary balance of CGS excluding State Economic Enterprises (SEEs)	Observed	Expected to be *missed* by 3,600-4,102 mil. YTL 2/
3. Ceiling on consolidated primary spending of central government and social security institutions (SSIs)	*Not observed*	Expected to be *missed* by 1,100-2,500 mil. YTL 2/
4. Ceiling on new external public debt with maturities exceeding one year	Observed	N.A., expected to be observed
5. Ceiling on new external public debt with maturities up to one year	Observed	N.A., expected to be observed
6. Floor on net international reserves of CBT and Treasury combined	Observed	Observed
7. Floor on overall balance (before transfers) of SSIs	Observed	Expected to be *missed* by 3,800-4,300 mil. YTL 2/

Inflation consultation clause	Comment
1. End-December 2006	Upper band *exceeded* , open letter issued (Attachment II)
2 End-March 2007	Only inner band *exceeded* , discussions with staff held
Prior actions	
1. Publication of historical fiscal outturns on new "central government" basis	Done
2. Increase in number of auditors assigned to Large Taxpayer Unit (LTU) to 35	To be done within 5 days of Board meeting
3. Completion of initial public offering (IPO) of at least 20 percent of Halkbank	To be done within 5 days of Board meeting
Structural performance criteria 3/	
1. No new amnesties of arrears on public sector receivables as defined in Annex F of the TMU (continuous, ¶19, MEP April 26, 2005)	Observed
2. Parliamentary approval of legislation authorizing copayments for medical treatments and pharmaceuticals (end-December 2006, ¶12)	Observed (however, legislation subsequently obviated by Constitutional Court annulment of social security reform)
3. Parliamentary approval of second-stage personal income tax reform (end-February 2007, ¶17)	*Not observed* (law passed with one day delay and a required provision--enhancement of the tax administration's powers to cross-check income and expenditure--omitted; this provision is expected to be adopted in future legislation)
Existing structural benchmarks 3/	
1. Replacement of at most 10 percent of those leaving through attrition in each state enterprise, with limited exceptions for specialist positions and overperforming enterprises with approval by the Treasury (continuous, ¶17, MEP April 26, 2005)	Observed
2. Maintaining excise taxes and SEE prices in line with 2006-07 program assumptions (continuous, ¶14)	*Not observed* due to delay in energy price adjustments
3. Replacement of no more than 50 percent of civil servants leaving through attrition (quarterly, ¶14)	N.A., expected to be observed
4. Establishment of a large-taxpayer unit within the Revenue Administration (end-December 2006, ¶17, LOI July 7, 2006)	Observed
5. Completion of the tender process for Halkbank (end-May 2007, ¶21)	Replaced with new conditionality
6. Publication of report quantifying existing tax expenditure (end-June 2007, ¶17)	Pending

New proposed structural benchmarks 4/

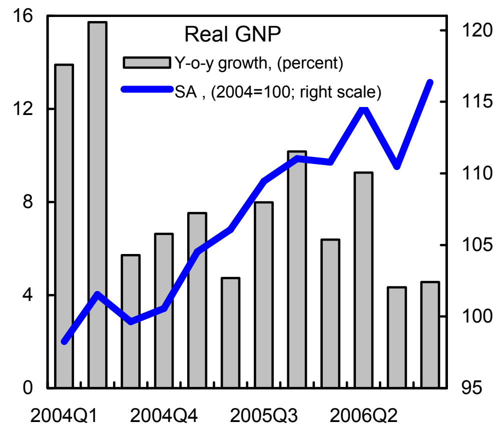
1. Passage of insurance law (end-June 2007, ¶22)
2. Legal framework for large employers to pay salaries through bank accounts (end-June 2007, ¶15)
3. Expansion of family medicine program to 22 regions (end-2007, ¶12)
4. Adoption of unified tax declaration form (end-2007, ¶15)
5. Implementation of a risk-based audit system to address VAT refund fraud (end-2007, ¶16)

1/ N.A.=data not available.
2/ Fiscal data for end-April are not yet available; current estimates are based on available information.
3/ Unless otherwise noted, ¶ refers to the relevant paragraph numbers in the November 27, 2006 LOI.
4/ ¶ refers to the relevant paragraph numbers in the attached LOI.

I. Recent Developments

1. **Aside from inflation, macroeconomic developments have been broadly positive**:

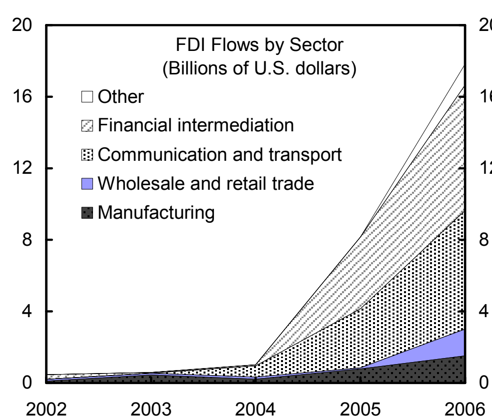
- **Growth is moderating but becoming more balanced**. During 2006, growth slowed from 7½ percent in the first half to 5 percent in the second half, as higher interest rates and weaker credit growth in the wake of the mid–2006 financial market turbulence weighed on private consumption (Figure 1). This slowdown was, however, partially offset by stronger net export performance, reflecting a rebalancing of growth from domestic to external demand. High-frequency indicators portend a continuation of these trends into 2007.



Sources: Turkstat; and IMF staff estimates.

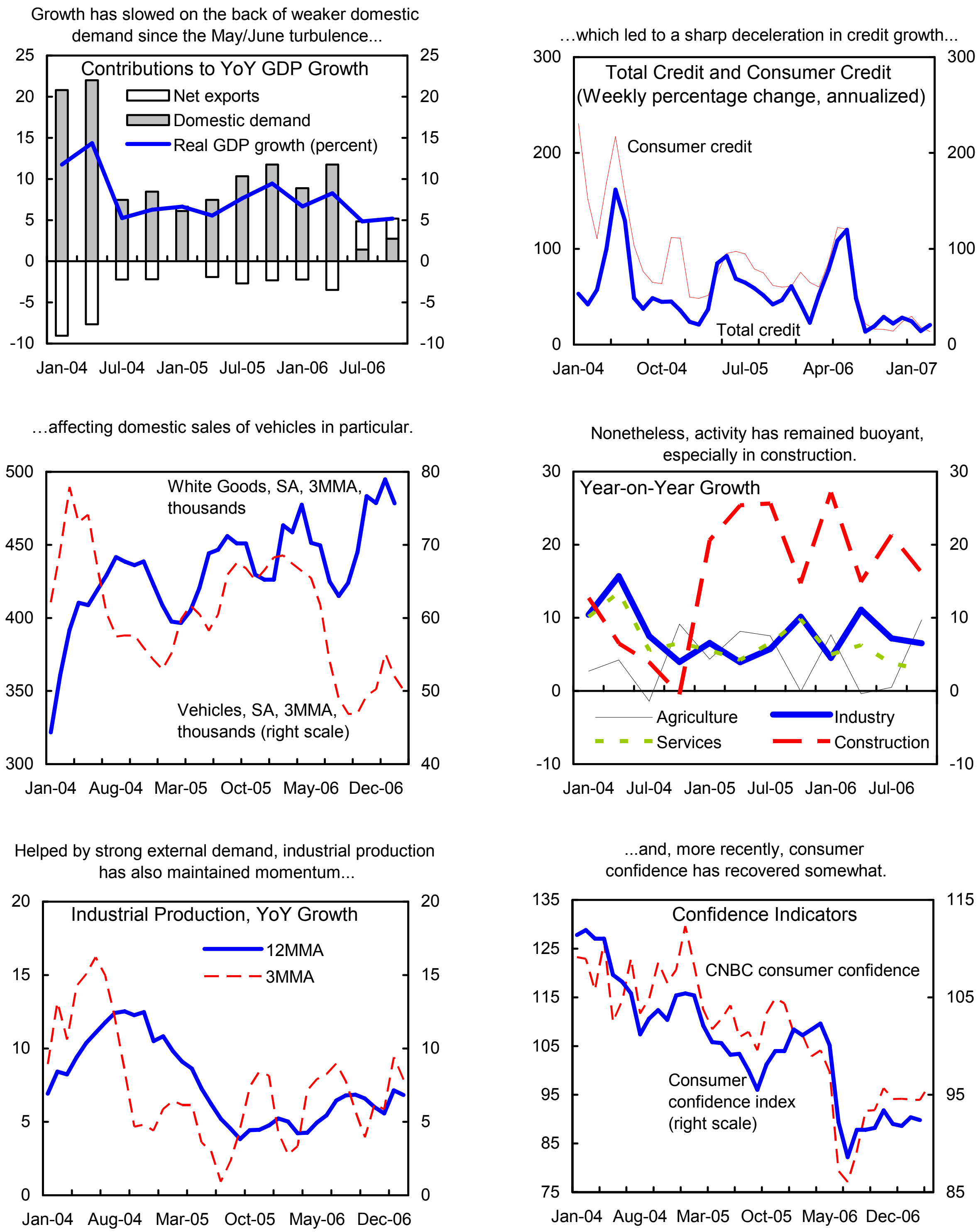
- **Inflation continues to be higher than targeted, despite tight monetary conditions**. Higher commodity prices and the sharp depreciation of the lira in mid-2006 pushed inflation temporarily back into double digits (Figures 2−3). While the subsequent monetary tightening helped curb domestic demand and reverse the depreciation, its disinflationary effects have been muted by inertia in services inflation and weather-related food price hikes. End-March inflation was 10.9 percent, breaching the inner consultation band by 0.7 percentage points. Inflation declined slightly in April, but remained well above the end-2007 target of 4 percent.

- **The current account deficit appears to have peaked at 7.9 percent of GNP in 2006** (Figure 4). In volume terms, growth of exports outpaced imports. Nonetheless, the current account deficit widened further, as oil prices rose and tourism revenue declined due to an avian flu scare and other one-off factors. Financing remained strong, as FDI rose to almost 5 percent of GNP and large portfolio inflows were interrupted only by brief periods of market turbulence. The central bank took the opportunity to purchase additional reserves, with NIR reaching US$40.6 billion at end-April 2007, considerably above the program floor.



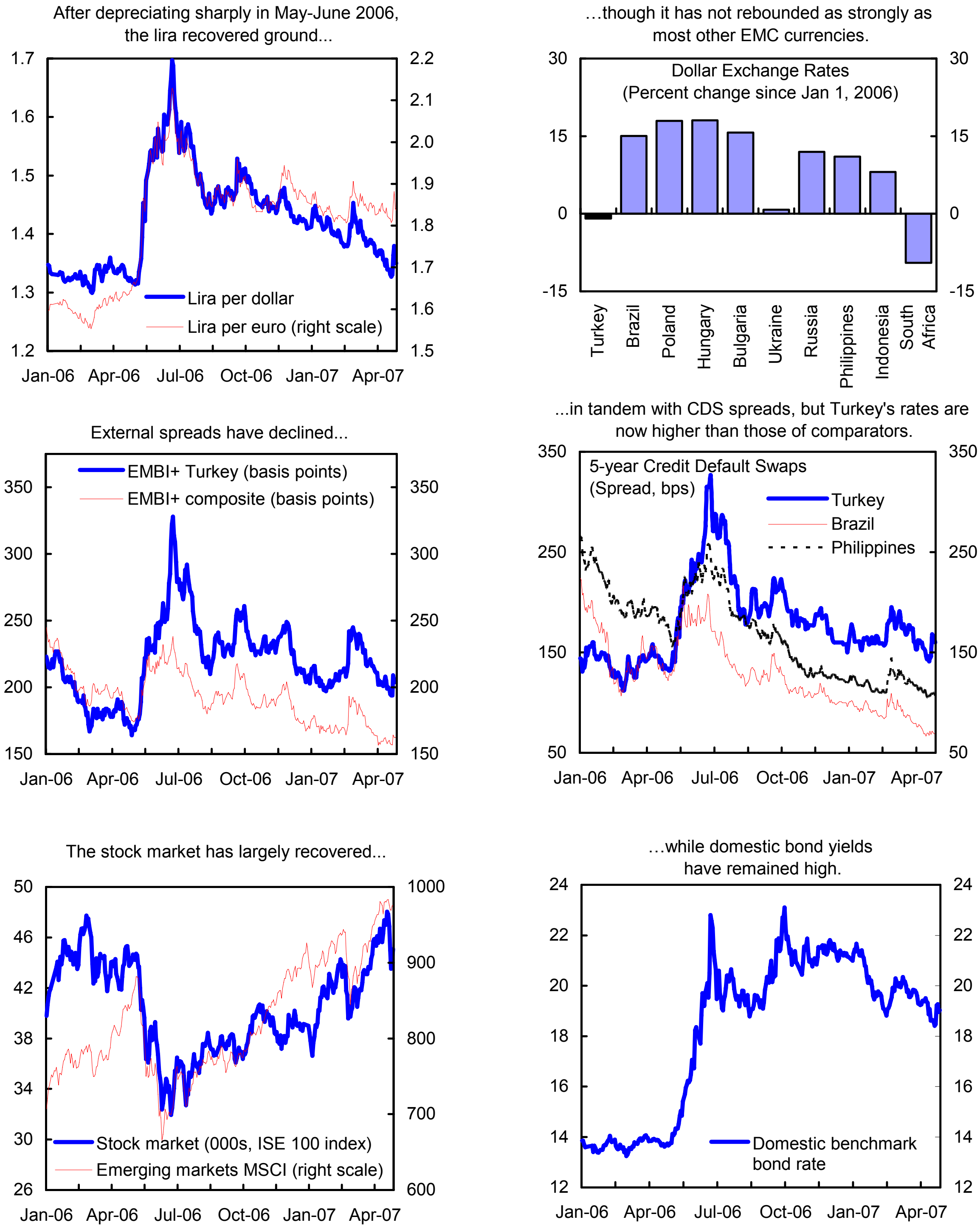
Source: Turkstat.

Figure 1. Turkey: Real Sector Indicators, 2004−07
(Percent, unless otherwise indicated)



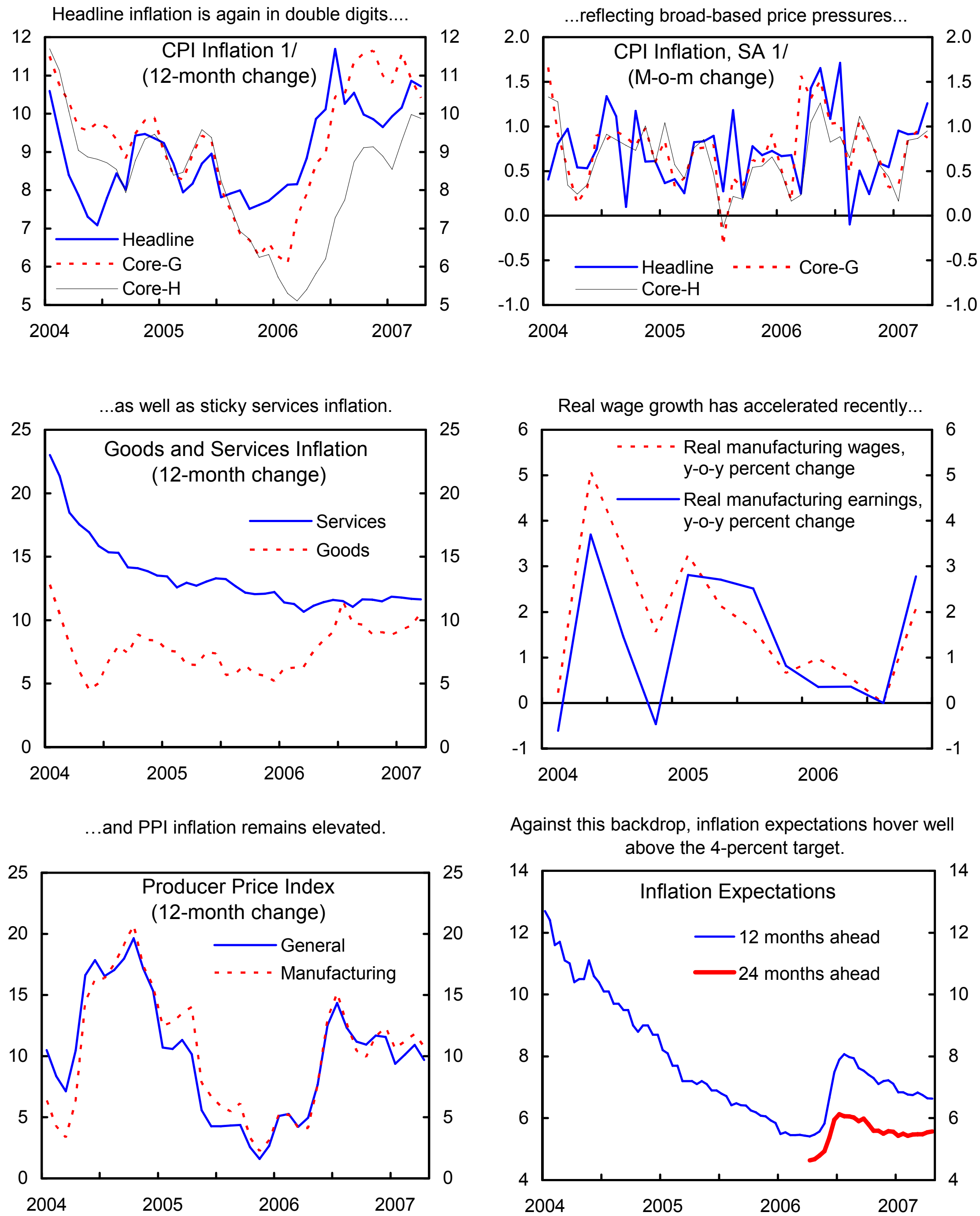
Sources: Turkstat; and IMF staff estimates.

Figure 2. Turkey: Financial Indicators, 2006–07
(Percent, unless otherwise indicated)



Source: Bloomberg.

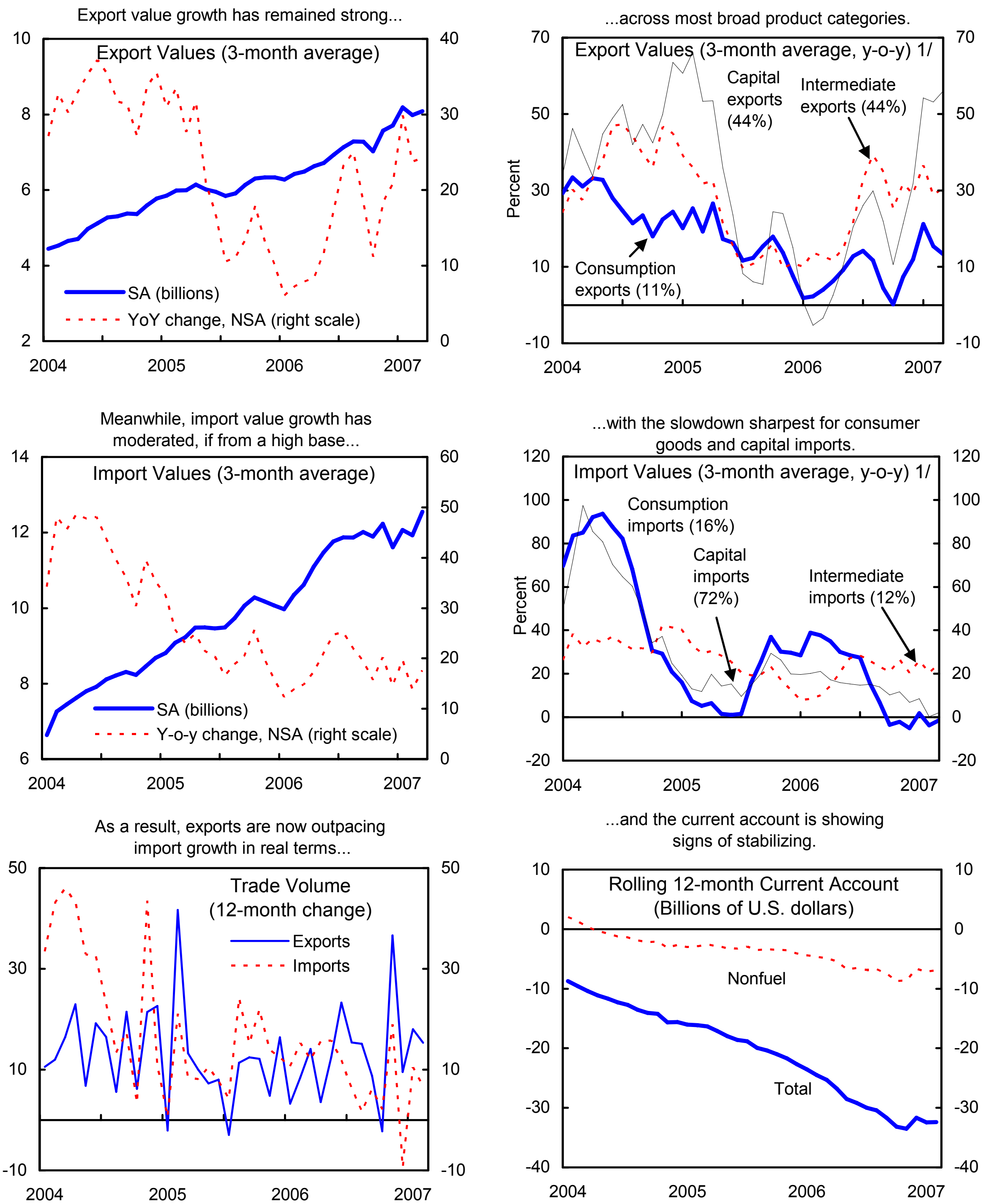
Figure 3. Turkey: Inflation Developments, 2004–07
(Percent, unless otherwise indicated)



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 the same as "G", apart from excluding gold prices and including products with administered prices.

Figure 4. Turkey: External Sector Indicators, 2004−07

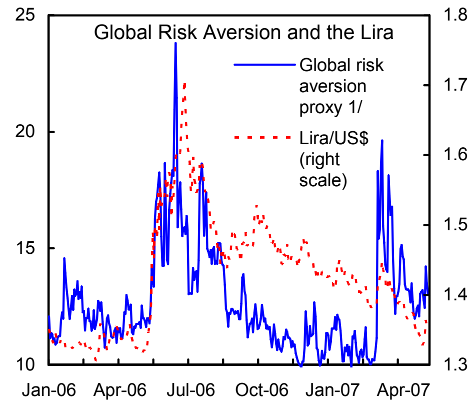


Sources: Turkstat; and IMF staff estimates.

1/ Values in parentheses denote shares of total in 2006.

2. **Political risks have increased**. A Constitutional Court ruling invalidating the first-round voting of the presidential election in parliament prompted the rescheduling of general elections from November 4 to July 22. This new calendar greatly limits the scope for initiatives requiring new legislation. Markets are likely to react positively if the general elections produce another single-party government, as this is seen as most conducive to strong reforms and disciplined policies.

3. **Financial markets have stabilized after brief episodes of turbulence earlier this year**. Global risk appetite dropped sharply in late February 2007. As in previous episodes of financial market turmoil, Turkish financial markets were among the worst hit, with many investors unwinding carry trades. And, although global investor sentiment subsequently stabilized, allowing Turkish markets to recover earlier losses, recent political events caused an increase in financial market volatility.



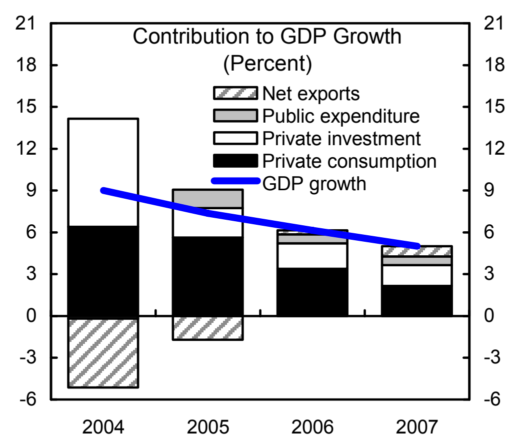
Source: Bloomberg.
1/ VIX: market expectations of volatility of S&P 500 stock index option prices.

II. Policy Discussions

A. Macroeconomic Framework

4. **Both sides agreed to leave the existing framework for 2007 broadly unchanged** (¶6−7, Table 1):[2]

- **Growth was expected to continue easing**. High interest rates, slowing credit growth, and election-related uncertainty were expected to weigh on private domestic demand and keep growth near its estimated long-run potential of 5 percent. The main downside risks to growth were the uncertain external environment and possibly weaker-than-expected domestic demand. Upside risks included an early resolution of election-related uncertainty.



Sources: Turkstat; and IMF staff calculations.

[2] ¶ refers to the relevant paragraph in the attached supplementary LOI.

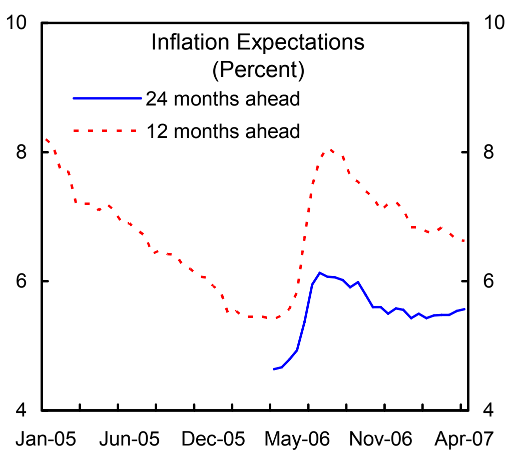
Main Macroeconomic Indicators, 2003–07

(Percent of GNP, unless otherwise indicated)

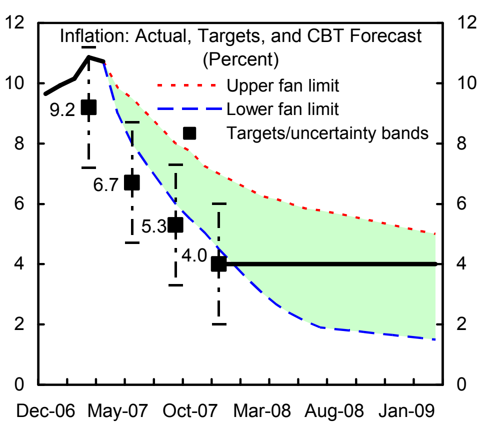
	2003	2004	2005	2006 Est.	2007 Proj.
Real GNP y-o-y growth rate, percent	5.9	9.9	7.6	6.0	5.0
Domestic demand (contribution to GDP growth)	8.9	13.9	9.1	5.9	4.3
Net exports (contribution to GDP growth)	-3.1	-4.9	-1.7	0.3	0.7
CPI, end of period (12-month percent change)	18.4	9.4	7.7	9.7	6.0
Central government primary balance	4.9	5.3	5.5	5.8	5.2
Net public sector debt	70.3	64.0	55.3	44.8	40.9
Gross public sector debt	83.2	77.3	71.6	63.1	57.6
Current account	-3.4	-5.2	-6.3	-7.9	-7.3
Nonfuel current account	1.1	-0.9	-1.1	-1.7	-1.3
Exports, y-o-y change in value (percent)	31.0	33.7	16.3	16.1	14.3
Imports, y-o-y change in value (percent)	37.6	39.4	21.5	19.3	10.4
Terms of Trade, y-o-y percent change	2.0	1.0	-1.3	-4.5	0.4
FDI	0.5	0.7	2.4	4.8	3.5
Gross external debt	56.4	50.1	46.7	50.5	52.8

Source: IMF staff estimates.

- **The inflation outlook remained challenging**. Annual inflation was expected to start declining by the second quarter, due to base effects related to the inflation spike in mid-2006. However, with inflation expectations still elevated, both sides agreed that the pace of disinflation would be insufficient to meet the 4 percent target in 2007. The staff projection for end-2007 was raised further from 5.5 percent to 6 percent, the upper limit of the consultation bands. Even this projection was subject to upside risks, including from services inflation inertia, second-round effects from recent food price increases, and unexpected strength in domestic demand (due to fiscal spending pressures or weaker-than-expected effects from past interest rate hikes).

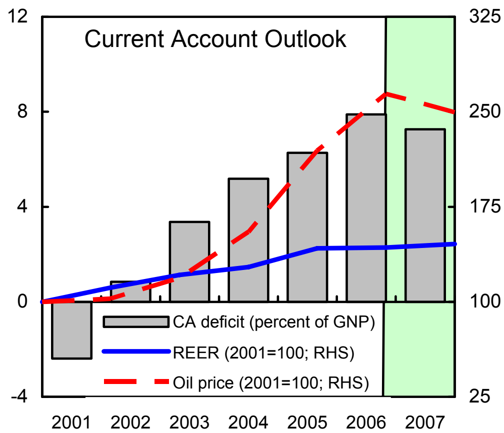


Source: Central Bank of Turkey.

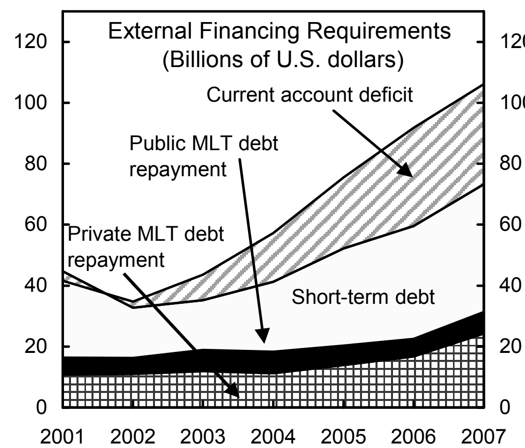


Sources: Central Bank of Turkey; and IMF staff calculations and estimates.

- **The current account deficit was projected to narrow somewhat in 2007** (Table 3). Export volume growth was projected to continue outpacing import volume growth due to economic expansion in Turkey's main export markets and slowing demand at home. Together with an expected rebound in tourism, this would bring the current account deficit down to 7¼ percent of GNP.



Sources: Turkstat; IMF, *World Economic Outlook*; IMF, internal database; and IMF staff projections.

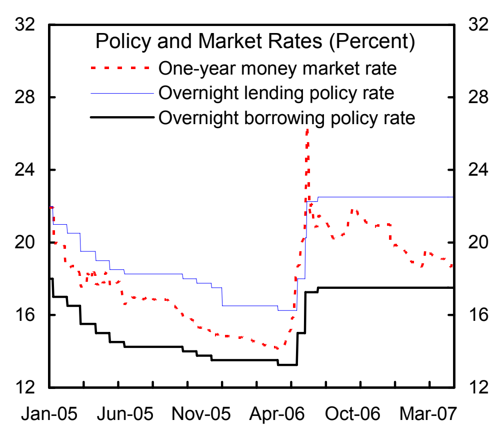


Sources: Turkstat; and IMF staff estimates.

- **External financing prospects remained favorable, but the large financing needs were a continued source of vulnerability** (Table 4). FDI was expected to be robust as a result of continued strong merger and acquisition activity, despite postponement of several privatizations in early 2007, including of electricity distribution companies. However, given the large stock of volatile portfolio investments by nonresidents, Turkey remains vulnerable to sudden shifts in investor sentiment.

B. Monetary and Exchange Rate Policies

5. **Given the upside risks to inflation, there was little alternative to keeping monetary policy tight until inflationary pressures subsided** (¶8, Tables 5−6). Staff supported the central bank's current tightening bias, which means that monetary policy will be more responsive to adverse developments than favorable developments to the inflation outlook. Once inflation was firmly on a declining trend, however, staff and the central bank concurred that interest rates could be cautiously reduced.



Sources: Central Bank of Turkey; and Bloomberg.

6. **The central bank renewed its commitment to building international reserves for prudential reasons** (¶9). With the ratio of reserves to short-term debt (at remaining maturity) still below unity, staff recommended a continued gradual and predictable build-up of international reserves. In response, the central bank agreed to raise the end-2007 NIR floor by US$2.8 billion and signaled its willingness to raise the amount of reserves purchased at its daily auctions if circumstances permitted.

C. Fiscal Policy

7. **Fiscal performance in 2006 was weaker than programmed** (Tables 7−8). The public sector primary balance is estimated to have been 6.6 percent of GNP, about 0.7 percent of GNP less than programmed in October 2006. The central government accounted for the majority of the shortfall. This was largely due to overruns on capital spending (0.2 percent of GNP) and underperformance (relative to revised mid-year projections) on nontax revenue (0.2 percent of GNP), as a large nontax transaction slipped to 2007. The net public sector debt ratio nevertheless continued to decline, falling to 45 percent of GNP at end-2006, partly helped by high privatization receipts.

Summary Fiscal Indicators, 2005–07

(Percent of GNP, unless otherwise indicated)

	2005	2006 1/		2007	
	Est.	Est.	Deviation from Prog. 2/	5th Review	Revised Prog.
Headline public sector primary balance	6.8	6.6	-0.7	6.5	6.7
Public sector primary balance (comparable basis) 1/	6.8	6.4	-0.7	6.5	6.7
Central government and social security	5.5	5.8	-0.4	5.0	5.2
Primary revenue	28.9	28.2	-0.3	28.9	28.1
Central government tax	24.6	23.9	0.0	25.0	24.4
Central government nontax	4.3	4.4	-0.2	3.8	3.7
Social security	5.9	6.8	0.0	6.8	6.7
Primary expenditure	29.3	29.3	0.2	30.7	29.6
Transfer of revenue shares	2.6	2.6	-0.2	2.7	2.6
Other	26.7	26.7	0.3	28.0	27.0
Current (excl. transfer of revenue shares)	11.8	11.8	0.1	12.6	11.9
Capital	2.1	2.1	0.2	2.0	1.6
Social security	12.7	12.8	0.0	13.5	13.4
Rest of public sector	1.3	0.6	-0.3	1.5	1.5
SEEs	0.4	0.3	-0.2	0.5	0.5
Other	0.9	0.4	-0.2	1.0	1.0
GNP (millions of YTL)	486,401	575,784	575,784	631,410	646,896

Sources: Turkish authorities; and staff estimates.

1/ Expenditure is adjusted up by 0.2 percent of GNP in 2006 to offset the one-time gain from an accounting change (which resulted in 2006 having only 11 months of transfer of revenue shares).

2/ Calculated as the estimated outturn minus the program in YTL terms (scaled by estimated GNP).

8. **For 2007, the authorities agreed to take measures to bring fiscal policy back into line with program understandings** (¶11). In particular, blockages of low priority central government spending and cuts in state enterprise investment saved 0.8 percent of GNP and offset an emerging fiscal gap. The blockages were front-loaded to ensure that the end-August fiscal performance criteria will be met. However, the end-April performance criteria were expected to be missed.

Changes in Fiscal Projections, 2007 1/

(Percent of GNP)

Fiscal gap	0.83	Agreed measures	0.83
Offsetting 2006 expenditure overruns (required by program adjustor)	0.29	Spending blockages	0.55
Updating revenue projections (due to lower 2006 base)	0.09	Capital spending	0.24
Key policy initiatives taken outside of budget cycle	0.27	Capital transfers	0.08
Expansion of regional incentive scheme	0.10	Other	0.23
Conversion of temporary staff to permanent staff	0.06	Contingencies	0.19
Higher pension increase	0.10	Health contingency	0.11
Delay of social security reform 2/	-0.10	Other contingencies	0.08
Higher health spending (due to carryover of unpaid bills from 2006 to 2007)	0.16	Cuts in SEE investment spending	0.09
Delay in hiking energy prices	0.16		
Other, net	-0.03		

Sources: Turkish authorities; and staff estimates.

1/ Change relative to program for the public sector primary balance.
2/ The delay generates savings in the short term.

9. **Safeguards were agreed to contain health spending pressures** (¶11, Box). In 2006, health spending exceeded the original budget allocations by over 25 percent. Even the program targets agreed last October were significantly exceeded on an accrual basis as some payments were shifted to 2007. To minimize further overruns, the authorities established a stronger mechanism to enforce budgets for public hospitals and capped medical personnel bonuses at the 2006 level. Further cuts from the general budget would be made should health costs again exceed targets. Measures to enhance the efficiency of healthcare provision over the medium term are also being implemented (¶12).

10. **The authorities agreed to address growing financial difficulties in the energy sector**. Despite a doubling of world energy prices, end-user electricity tariffs have not increased since 2002, creating rising financial difficulties within state-owned energy companies. While staff pressed to effect programmed price adjustments, the authorities preferred offsetting spending cuts (including in state enterprises' investment). However, with electricity shortages likely to emerge as early as 2009 in the absence of investments, the authorities agreed that measures were needed to strengthen the sector going forward. They plan to (i) facilitate cost-recovery pricing; (ii) privatize the distribution network to improve efficiency; and (iii) strengthen bill collection (¶18).

11. **The public sector primary surplus is programmed to be 6.7 percent of GNP in 2007, but downside risks are significant**. The contribution of exceptional items is expected to be about 1½ percent of GNP lower in 2007 than in 2006. So, although the headline surplus is broadly unchanged from 2006, the 2007 target actually embodies a substantial policy tightening. This will be challenging to achieve given the projected growth slowdown. This risk is further augmented by weak tax revenue in the first quarter of 2007 and the poor track record with enforcing spending blockages. Erosion of the tax base is also a risk, as evidenced by various proposals being floated for targeted tax relief.

Effect of Exceptional Fiscal Transactions on Primary Surplus, 2006–07
(Percent of GNP)

	2006 (a)	2007 (b)	Exceptional contribution to 2006 primary surplus (a)-(b)	Comments
Total	2.2	0.7	1.6	
Savings Deposit Insurance Fund (SDIF) revenue	0.9	0.1	0.8	Outstanding government claims settled during resolution of bad assets
State enterprise dividends	0.5	0.3	0.2	Dividends to decline in 2007 due to the 2005 privatization of 55 percent of Turk Telekom
Revenue share transfer accounting	0.2	0.0	0.2	In 2006, only 11 months of transfers were made (due to the transition to new central government accounting)
Collection of arrears to Social Security Institution	0.6	0.2	0.4	Receipts from arrears regularization scheme

Sources: Turkish authorities; and Fund staff estimates.

Fiscal Policy Stance: Public Sector, 2004–07

(Percent of GNP)

	2004	2005	2006 Est.	2007 Proj.
A. Headline Consolidated Primary Surplus	7.2	6.8	6.6	6.7
B. Adjusted Consolidated Primary Surplus 1/	7.2	6.8	5.8	6.5
C. Interest Bill	11.7	7.9	7.4	7.6
D. Overall balance (=B-C)	-4.6	-1.2	-1.6	-1.1
E. Fiscal stimulus (adjusted for cycle) from:				
Primary balance (line B)	0.0	0.7	0.9	-0.9
Overall balance (line D)	0.0	-3.9	0.4	-0.7
Memorandum item:				
Output gap ("+"=actual below potential)	1.3	0.5	0.6	1.0

1/ On a comparable central government basis. 2006 and 2007 adjusted down for extraordinary collection of tax arrears from former bank owners (0.8 and 0.1 percent of GNP, respectively), on the grounds that these receipts do not reduce the private sector's purchasing power.

12. **The authorities continued improving fiscal transparency** (¶19). Staff welcomed the publication of local government data and historical data under the new central government classification, as these publications improve the private sector's ability to assess fiscal performance. The authorities also plan to publish a quantification of existing tax expenditures by end-June 2007.

D. Structural Fiscal Reforms

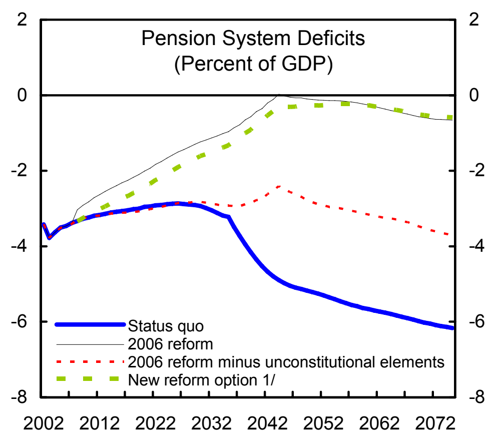
13. **A Constitutional Court ruling in December 2006 set back social security reform**. The reform was to be implemented in January 2007 as a centerpiece of the Fund-supported

program. However, the court annulled key provisions, significantly reducing its savings, which were already back-loaded. The government thus suspended implementation of the entire reform.

Key Provisions of 2006 Social Security Law Annulled by the Constitutional Court

Annulled Provision	Court's Rationale	Being Considered by the Authorities
All aspects of the reform pertaining to civil servants.	The Court's objections on this issue appear to be partly procedural (for example, that the pension regime for civil servants be regulated separately from regimes for other workers) and partly substantive (for example, the Court's ruling can be interpreted as requiring that civil servant pensions be--at least partially--indexed to wages, rather than to consumer prices as envisaged in the law).	Revisions to civil servant pension parameters could be made in a separate law. In addition, an implicit link between current civil servants' pay and retired civil servants' pensions could be established by indexing all pensions to a combined index of consumer prices and wages.
The tightening of the valorization formula for all workers.	Currently, pensions are based on an individual's average wage over his/her lifetime, with past earnings brought into present value using an index of nominal GDP. The reform would have changed this to an index of 50 percent prices and 50 percent average economy-wide wages. However, the Court annulled this change, arguing that "the share of prosperity per individual arising from the growing economy (had) not been taken into consideration."	All wage histories would be valorized using an index of consumer prices plus 25 percent real GDP in order to more explicitly include GDP in the valorization formula.

14. **The authorities committed to implement a modified social security reform** (¶14). They plan to issue soon a white paper describing proposals that would recapture most of the original reform's savings in ways that the authorities believe are constitutionally valid. Under the alternative proposals, new valorization and indexation formulae would be kept the same across public and private workers. Changes to other parameters (e.g., retirement ages) would be broadly similar to the original reform. After further discussions with stakeholders, the authorities expect to adopt a revised reform so as to allow implementation by mid-2008.



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

15. **The Revenue Administration (RA) and Social Security Institution (SSI) committed to further reforms to improve collections** (¶15−16). Thirty-five auditors will soon be assigned to the newly established Large Taxpayer Unit (LTU); this number will increase further to match the LTU workload.[3] The RA is also taking steps to combat VAT fraud and enhance cooperation with the SSI, which is simultaneously implementing measures to improve collections from large employers.

[3] Taxpayers under the LTU account for about 30 percent of tax revenue, a figure scheduled to rise to 50 percent by end-2007.

16. **Second-stage personal income tax reform was adopted**, but with one day delay and one administrative item omitted (¶4, 17). This item is expected to be included in future legislation, with timing to be discussed during the next review.

E. Financial Sector Reforms

17. **Staff urged the authorities to proceed promptly with state bank privatization** (¶20). The authorities responded that their strategy on Halkbank had to be adjusted in the pre-election environment. Instead of a 100 percent block sale, the government has launched an IPO of at least 20 percent of its shares and expects to complete the process in the second week of May. Staff stressed the importance of following this step by selling the residual government stake within one year and initiating the privatization of Ziraat (one of the largest deposit-taking institutions in Turkey). The authorities, however, were reluctant to commit to a specific timetable beyond the May IPO, though they renewed their commitment to prepare a strategy for Ziraat, drawing on the experience of Halkbank.

18. **Staff welcomed passage of the mortgage law in February 2007 and discussed further improvements to the financial regulatory environment** (¶21−23). The mortgage law lays the foundation for a stronger mortgage lending system, including by allowing adjustable-rate mortgages and loan securitization. To avoid narrowing the tax base and creating distortions, tax deductibility of interest payments was not allowed. Staff urged the authorities to build on this achievement by issuing key implementing regulations for the law by end-June 2007 and adopting the recommendations of the recent Financial System Stability Assessment, including by passing a law by end-June 2007 to strengthen the insurance industry's legal and regulatory frameworks.

F. Labor Market Reform

19. **There was broad agreement on the need to ease labor regulations and taxes as fiscal resources permit**. However, staff stressed that any reform would need to fit within the fiscal framework and properly balance the twin goals of ensuring worker protection and increasing labor market flexibility. The authorities thus committed to seeking agreement with the Fund before adopting any such reform (¶26).

III. Staff Appraisal

20. **Turkey's macroeconomic performance continues to be strong**. Economic activity has been resilient as the economy shifts away from high reliance on domestic demand. FDI

has surged, allowing a further build-up of reserves, and the net public debt ratio continues to fall quickly.

21. **Nonetheless, vulnerabilities remain**. Although the current account deficit is likely to moderate in 2007, it is still high; inflation remains persistently above target; and political risks have increased. These vulnerabilities, together with a large stock of portfolio investment by nonresidents, keep Turkey highly exposed to shifts in investor sentiment.

22. **Turkey should thus maintain market confidence by firmly adhering to strong policies in the context of the Fund-supported program**. 2007 will be a challenging year, as approaching elections are limiting the scope for undertaking new reforms. However, the government can promote market confidence by maintaining disciplined policies and vigorously renewing the reform momentum in the immediate post-election period.

23. **Maintaining tight monetary policies will be essential to bringing inflation on target**. Given the challenging inflation outlook, a continued tightening bias is appropriate until inflation is firmly on a downward path. The central bank is encouraged to increase its daily foreign exchange purchases, as reserves do not yet fully cover short-term external debt (at remaining maturity).

24. **Achieving the fiscal targets will promote disinflation, current account adjustment, and market confidence**. In this regard, the fiscal slippages in 2006 and early 2007 were regrettable. Staff welcome the authorities' commitments to block low priority spending and contain health overruns to bring fiscal performance back on track. Even so, achieving the 2007 fiscal targets will require substantial effort to offset the disappearance of one-off factors that boosted the 2006 outturn. In this regard, the decision not to raise energy prices in line with program assumptions was unfortunate, even if this will be offset by cuts in state enterprises' investment—a move that worsens budget quality.

25. **Progress on structural reforms will support the fiscal objectives**. Planned measures to strengthen tax and social security collections, bolster the finances and efficiency of the energy and health sectors, and improve fiscal transparency are welcome. Reinvigorating social security reform is also essential to securing long-run fiscal sustainability. Close adherence to the authorities' revised strategy is critical in this regard.

26. **Further progress on financial sector reforms, privatization, and labor market reforms would help bolster growth, thereby sustaining investor confidence**. Adoption of the mortgage law was a major step forward in improving the financial regulatory framework, which should be further strengthened through timely issuance of the law's implementing regulations and adoption of pending insurance legislation. Reinvigorating privatization, especially in the banking and energy sectors, would also improve the investment climate, as would easing onerous labor regulations and taxes, fiscal resources permitting.

27. **Staff recommends completing the sixth review and approving the authorities' request for waivers**. Despite increased risks (due to recent fiscal slippages and elevated legal and political uncertainty), the authorities' track record in implementing the Fund-supported program and their forward-looking plans deserve support. Staff supports requests for waivers of nonobservance of fiscal performance criteria for end-April (which are expected to have been missed, although data are not yet available) in light of the authorities' commitment to rein in spending to bring fiscal performance back on track. Staff also supports waivers of applicability of end-April performance criteria for external debt (as these are expected to have been met, although data are not yet available) and nonobservance of the structural performance criterion on the approval of second-stage personal income tax reform, as this was delayed by only one day and the omitted provision is expected to be adopted in future legislation.

Health Spending

Health outcomes in Turkey are worse than in comparator countries, despite somewhat higher government spending. The main reasons are excessive administrative costs, high drug spending (representing 40 percent of healthcare costs), and overreliance on curative (rather than preventive) care and expensive hospital-based treatments.

A recent and welcome expansion of access has led to rising healthcare spending. Many of the provisions of the pending universal health insurance law were de-facto implemented in 2005, while envisaged efficiency-enhancing measures have not yet been fully implemented. Consequently, health spending increased by 32 percent in 2006.

Health Spending, 2004–07 1/

	Percent of GNP				Nominal growth of cash spending		
	2004	2005	2006	2007	2005	2006	2007
				Proj.			Proj.
Total health spending	3.8	3.7	4.1	4.1	9.1	31.6	14.0
Medicines	1.8	1.8	1.7	1.7	13.8	13.0	12.7
Hospital treatments	1.8	1.7	2.2	2.2	10.2	49.4	10.9
Ministry of Health hospitals	…	1.0	1.4	1.4	…	63.5	17.5
Other hospitals	…	0.8	0.8	0.8	…	31.4	0.4
Other	0.2	0.1	0.1	0.2	-45.9	63.7	85.4

Sources: Turkish authorities; and IMF staff estimates.

1/ Measured as Social Security Institutions' health spending plus budgetary spending for Green Card and civil servants' health programs; actual government health spending is higher, as the above measure excludes (due to data availability) some items.

In the short run, the priority is to increase efficiency by reducing unnecessary treatments and drugs. International experience shows that, in an open-ended fee-for-service system like Turkey's, doctors tend to provide excessive treatments, especially since doing so increases their bonuses, which amount to nearly 40 percent of hospital costs. Hence, a recent FAD technical assistance mission recommended tying doctors' bonuses to adherence to hospital budgets. This proposal would leave medical decisions to doctors, but provide incentives to minimize unnecessary treatments. As a second-best, hard caps could be placed on hospital budgets, making hospital administrators responsible for managing costs within the budget allocation. Measures to control demand (see below) are useful, but less effective since demand is ultimately determined by suppliers (i.e., doctors) in the health sector.

With the support of the World Bank, the authorities are also pursuing medium-term measures to promote efficiency. These include increased use of information technology, lower-cost primary care (family medicine) facilities, differentiated copayments, and payment-per-case systems (although these have encountered legal difficulties).

Table 1. Turkey: Selected Economic Indicators, 2001−07

	2001	2002	2003	2004	2005	2006 Est.	2007 Proj.
	(Percent)						
Real sector							
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	...
	(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
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 total 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, in 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, in 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: fuel (in 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 (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	444.0
GNP (in 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.

Table 2. 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 transfers).

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 3. Turkey: Balance of Payments, 2001–07

(Billions of U.S. dollars)

	2001	2002	2003	2004	2005	2006 Est.	2007 Proj.
Current account balance	3.4	-1.5	-8.0	-15.6	-22.7	-31.7	-32.2
Trade balance	-3.7	-7.3	-14.0	-23.9	-33.5	-40.1	-41.4
Exports (f.o.b.)	34.4	40.1	51.2	67.0	76.9	91.7	104.2
Of which:							
Exports (f.o.b.) in trade returns	31.3	36.1	47.3	63.2	73.5	85.3	97.5
Shuttle trade	3.0	4.1	4.0	3.9	3.5	6.4	6.7
Imports (f.o.b.)	-38.1	-47.4	-65.2	-90.9	-110.5	-131.8	-145.6
Of which:							
Imports (c.i.f.), incl. non-monetary gold	-41.4	-51.6	-69.3	-97.5	-116.8	-137.5	-152.4
Energy imports (c.i.f.)	-8.3	-9.2	-11.6	-14.4	-21.2	-28.6	-30.1
Services and Income (net)	4.1	3.3	4.9	7.1	9.4	6.8	7.3
Services and Income (credit)	18.8	17.3	21.3	25.6	30.2	28.9	31.7
Of which:							
Tourism receipts	8.1	8.5	13.2	15.9	18.2	16.9	18.2
Services and Income (debit)	-14.7	-13.9	-16.3	-18.4	-20.9	-22.1	-24.4
Of which:							
Interest	-7.1	-6.4	-6.9	-7.2	-8.4	-9.8	-11.6
Private transfers (net) 1/	2.8	1.9	0.7	0.8	0.9	1.0	1.2
Official transfers (net)	0.2	0.5	0.3	0.3	0.6	0.6	0.6
Capital account balance	-14.6	1.2	7.1	17.8	43.7	45.3	37.4
(including errors and omissions)	-16.3	1.3	12.1	19.9	45.9	42.3	39.2
Direct investment 2/	2.8	0.9	1.2	2.0	8.7	19.2	15.8
Portfolio investment in securities	-4.6	-1.2	1.1	6.1	10.4	4.0	4.6
Public sector (central & local governments & EBFs)	-1.9	0.4	-0.7	0.8	1.3	2.6	2.1
Bonds (net)	0.1	1.0	1.5	2.0	3.4	3.3	2.0
Eurobond drawings	2.1	3.3	5.3	5.8	6.5	5.8	5.5
Eurobond repayments	-2.0	-2.3	-3.8	-3.8	-3.1	-2.5	-3.5
Loans (net)	-2.0	-0.7	-2.2	-1.2	-2.2	-0.7	0.0
Loan disbursements	1.6	2.3	1.0	2.0	1.1	2.5	3.5
Loan repayments	-3.6	-3.0	-3.2	-3.2	-3.3	-3.2	-3.4
Central Bank of Turkey (excl. reserve assets, liabilties)	0.8	1.4	0.6	-0.1	-0.5	-1.0	-1.1
Deposit money banks (net)	-9.4	-1.8	3.0	1.2	10.0	0.7	7.1
FX deposits abroad (- denotes accumulation)	0.9	0.6	0.7	-6.0	-0.3	-10.3	-0.4
Other, net	-10.3	-2.4	2.3	7.2	10.4	11.0	7.5
Medium and long-term (net)	-1.0	-0.7	-0.2	2.4	6.2	9.8	6.5
Short-term (net)	-9.3	-1.7	2.5	4.8	4.2	1.2	1.0
Interbank credit lines from foreign commercial banks	-7.1	-0.7	2.0	3.3	2.7	-4.0	0.0
Other private sector (net)	-2.3	1.5	1.8	7.7	13.8	19.7	9.0
Medium and long term (net)	0.3	2.5	1.6	5.3	10.0	18.3	5.9
Short term (net)	-2.6	-1.0	0.2	2.4	3.8	1.4	3.1
Errors and omissions	-1.7	0.1	5.0	2.2	2.2	-3.0	1.8
Overall balance	-12.9	-0.2	4.1	4.3	23.2	10.6	7.0
Overall financing (NIR change excl. ST liabilities, + denotes decline)	12.9	0.2	-4.1	-4.3	-23.2	-10.6	-7.0
Change in net international reserves (+ denotes decline)	12.9	0.2	-4.1	-4.3	-23.2	-10.6	-7.0
Change in gross official reserve assets (+ denotes decline)	2.7	-6.2	-4.0	-0.8	-17.8	-6.1	-5.3
Change in reserve liabilities (IMF)	10.2	6.4	-0.1	-3.5	-5.4	-4.5	-1.7
Purchases	11.3	12.5	1.7	1.2	2.4	3.0	3.4
Repurchases 3/	-1.1	-6.1	-1.7	-4.7	-7.8	-7.5	-5.1

Table 3. Turkey: Balance of Payments, 2001–07 (concluded)

(Billions of U.S. dollars)

	2001	2002	2003	2004	2005	2006 Est.	2007 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
Nonfuel current account balance	7.8	3.8	1.1	-0.9	-1.1	-1.7	-1.3
Trade account balance, incl. shuttle trade	-2.6	-4.0	-5.9	-7.9	-9.3	-10.0	-9.3
Exports of goods and non-factor services	36.1	31.0	30.1	30.5	29.3	29.7	30.3
Imports of goods and non-factor services	31.7	30.1	31.3	33.8	34.0	35.9	35.7
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
Value growth in exports of goods (excl. shuttle trade)	12.8	15.1	31.0	33.7	16.3	16.1	14.3
Value growth in imports of goods	-27.7	24.4	37.6	39.4	21.5	19.3	10.4
Volume growth in exports of goods	15.7	17.2	19.1	15.0	10.1	11.7	10.3
Volume growth in imports of goods	-23.8	26.1	24.6	22.2	11.8	8.2	7.4
Volume growth in imports of goods exluding fuel	-22.9	25.2	19.8	28.0	15.5	7.2	8.3
Terms of trade	-2.2	-0.6	2.0	1.0	-1.3	-4.5	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
Months of goods & NFS imports	4.5	5.5	3.9	3.4	4.1	4.5	4.5
Net international reserves (Central Bank of Turkey)	...	...	-0.5	1.3	22.4	32.6	40.0
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
Percent of GNP	93.1	77.3	56.4	50.1	46.7	50.5	52.8
Percent of exports of goods & NFS	218.4	229.1	200.8	174.9	159.0	173.3	165.2
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
Percent of GNP	64.3	52.8	37.6	32.0	27.3	26.9	28.5
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
Reserves to short-term debt ratio	120.7	170.9	152.8	118.1	140.6	150.7	150.0
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
Reserves to short-term debt ratio	60.7	79.7	85.5	72.3	87.8	86.6	91.5
Debt service ratio 6/	41.9	38.1	35.1	27.2	26.4	26.4	31.1

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, 2001–07

(Billions of U.S. dollars)

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

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: Monetary Aggregates, 2001–07

	2001	2002	2003	2004	2005	2006				2007
						Mar.	Jun.	Sep.	Dec.	Proj.
	(Billions of new Turkish liras)									
Broad money (M2Y)	106.6	133.7	151.0	184.4	229.5	237.4	267.0	270.2	284.9	327.5
Lira broad money (M2)	47.2	61.9	82.7	108.5	153.5	162.1	177.3	177.8	185.1	211.3
Foreign exchange deposits 1/	59.3	71.8	68.3	75.9	76.1	75.4	89.7	92.4	99.8	116.2
Repos	2.8	2.8	3.1	1.7	1.5	2.1	2.6	2.3	2.2	2.1
Broad liquidity	109.4	136.4	154.1	186.1	231.0	239.6	269.6	272.5	287.1	329.6
Base money	7.8	10.4	14.9	20.2	32.5	32.6	36.6	34.8	41.2	39.6
Net foreign assets 1/	-1.9	-6.3	-6.8	-0.1	18.0	24.7	30.3	36.3	44.3	62.8
(in billions of U.S. dollars)	-1.3	-3.9	-4.8	-0.1	13.4	18.4	18.9	24.7	31.3	40.8
Net domestic assets	108.5	140.0	157.8	184.5	211.5	212.7	236.7	233.9	240.7	264.7
Net claims on government	89.7	122.8	139.1	151.4	152.2	151.1	151.9	149.2	150.1	158.7
Claims on business sector 2/	38.7	42.0	59.6	90.3	129.9	141.0	163.3	168.7	178.2	197.6
Turkish lira claims	23.1	24.5	40.7	71.2	110.2	120.3	137.1	144.1	155.2	173.3
Foreign exchange claims (est.) 1	15.6	17.5	18.9	19.1	19.8	20.7	26.3	24.6	23.1	24.4
Other items (net)	-20.0	-24.8	-40.9	-57.2	-70.6	-79.3	-78.6	-83.9	-87.7	-91.7
Memorandum items:	(Annual percent change)									
Broad money (M2Y)	87.5	25.4	13.0	22.1	24.5	28.1	35.1	26.0	24.1	14.9
Lira broad money (M2)	48.0	31.0	33.7	31.2	41.4	42.5	40.3	28.3	20.6	14.1
Foreign exchange deposits 1/	137.9	21.0	-4.9	11.1	0.3	5.3	26.1	21.6	31.2	16.4
Claims on business sector 2/	22.3	8.4	42.1	51.4	43.9	43.8	49.3	43.2	37.2	10.9
	(Billions of U.S. dollars)									
Broad money (M2Y)	74.0	81.8	108.2	137.4	170.9	176.8	166.6	183.8	201.6	213.0
Lira broad money (M2)	32.8	37.9	59.3	80.9	114.3	120.7	110.6	120.9	131.0	137.4
Foreign exchange deposits	41.2	43.9	48.9	56.5	56.7	56.1	55.9	62.8	70.6	75.6
Net claims on government	62.3	75.1	99.6	112.8	113.3	112.5	94.8	101.5	106.2	103.2
Credit to the private sector	26.9	25.7	42.7	67.3	96.8	105.0	101.9	114.7	126.1	128.5
	(Percent share)									
Base money/GNP 3/	4.4	3.8	4.2	4.7	6.7	6.5	7.0	6.3	7.3	6.3
Broad money (M2Y)/GNP 3/	60.4	48.6	42.3	43.0	47.2	47.6	51.1	49.2	50.7	51.9
Lira broad money (M2)/GNP 3/	26.8	22.5	23.2	25.3	31.5	32.5	33.9	32.4	32.9	33.5
Private credit/GNP	21.9	15.3	16.7	21.0	26.7	28.3	31.2	30.7	31.7	31.3
Foreign currency deposits/M2Y	55.7	53.7	45.2	41.1	33.1	31.7	33.6	34.2	35.0	35.5
Money multiplier										
Broad money (M2Y)	13.7	12.8	10.2	9.1	7.1	7.3	7.3	7.8	6.9	8.3
Lira broad money (M2)	6.1	5.9	5.6	5.4	4.7	5.0	4.8	5.1	4.5	5.3

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

1/ Evaluated at current exchange rates, monetary authorities and deposit money banks.
2/ Includes credit to local governments and state economic enterprises.
3/ Evaluated as percent of nominal GNP over previous four quarters.

Table 6. Turkey: Central Bank Balance Sheet, 2001–06

	2001	2002	2003	2004	2005	2006			
						Mar.	Jun.	Sep.	Dec.
	(Billions of new Turkish liras)								
Net foreign assets	-12.7	3.9	8.8	11.0	38.6	51.0	46.6	47.4	48.6
Gross foreign assets	28.6	37.7	42.5	53.0	80.0	90.8	86.5	88.5	90.2
Gross foreign liabilities	41.2	33.8	33.6	42.0	41.4	39.9	39.9	41.1	41.6
International reserve liabilities	20.7	11.5	9.8	5.7	2.1	1.9	1.7	1.6	1.9
Other reserve liabilities 1/	10.1	13.2	14.5	22.3	22.3	22.0	21.5	20.8	20.3
Banks' FX deposits with CBT	10.4	9.1	9.3	14.0	17.0	16.0	16.7	18.6	19.5
Net domestic assets	20.6	6.5	6.0	9.2	-6.2	-18.5	-10.0	-12.4	-7.3
Base money	7.8	10.4	14.9	20.2	32.5	32.6	36.6	34.8	41.2
Currency issued	5.3	7.6	10.7	13.5	19.6	20.2	23.3	23.3	26.8
Banks' lira deposits at the CBT	2.5	2.8	4.2	6.7	12.9	12.4	13.3	11.5	14.4
	(Billions of U.S. dollars)								
CBT gross international reserves	19.8	26.2	29.5	35.4	53.4	60.6	57.7	59.1	60.3
at current cross rates:	19.8	28.1	35.2	37.7	52.5	60.5	59.1	60.8	63.3
CBT gross international liabilities	28.6	23.5	23.4	28.1	27.7	26.6	26.6	27.4	27.8
CBT net foreign assets	-8.8	2.7	6.1	7.3	25.8	34.0	31.1	31.7	32.5
plus CBT forward position	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
plus other reserve liabilities	7.1	9.2	10.1	14.9	14.9	14.7	14.3	13.9	13.5
minus Dresdner one year deposits	0.7	1.4	2.1	3.0	2.9	2.8	2.7	2.6	2.4
minus defence fund	0.4	0.4	0.4	0.3	0.3	0.3	0.3	0.3	0.3
CBT net international reserves	-2.9	10.0	13.6	18.9	37.5	45.6	42.4	42.7	43.2
Treasury net international reserves 2/	-1.3	-14.7	-14.2	-17.6	-15.1	-13.3	-11.5	-11.5	-10.6
Net international reserves (Treasury plus CBT)	-3.5	-4.6	-0.5	1.3	22.4	32.4	31.0	31.0	32.6
	(Billions of new Turkish liras, program exchange rate)								
Net foreign assets (Treasury)	-1.8	-21.1	-20.4	-26.3	-22.7	-19.9	-17.2	-17.3	-15.8
Net foreign assets (Treasury plus CBT)	-14.5	-17.2	-11.6	-15.3	15.9	31.1	29.5	30.1	32.8
Net domestic assets (Treasury) 3/	1.8	21.1	20.4	26.3	22.7	19.9	17.2	17.3	15.8
Net domestic assets (Treasury plus CBT)	22.4	27.6	26.4	35.5	16.5	1.5	7.2	4.9	8.5
Base money (Treasury plus CBT)	7.9	10.4	14.9	20.2	32.4	32.5	36.6	35.0	41.3
Exchange rate (TL per US dollar, in millions)	1.44	1.63	1.40	1.34	1.34	1.34	1.60	1.47	1.41

Sources: Central Bank of Turkey; and IMF staff estimates. Although program targets for base money and NDA are five day averages, all observations in this table are end of period.

1/ Mainly Dresdner deposit liabilities.
2/ Equals borrowing from IMF plus short-term foreign currency denominated liabilities.
3/ Since the Treasury cannot create base money, equals negative of Treasury net foreign assets.

Table 7. Turkey: Consolidated Fiscal Presentation, 2004–07

	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 one 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 8. 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

Table 8. 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.

Table 9. Turkey: Indicators of Fund Credit, 2002–10 1/

	2002	2003	2004	2005	2006	2007	2008	2009	2010
Outstanding Fund credit (end of period)									
In billions of SDRs	16.2	16.2	13.8	10.2	7.2	6.0	5.5	3.6	1.4
In percent of quota	1685	1682	1437	1063	601	507	466	299	118
In percent of exports of G&NFS	37	32	22	14	9	7	6	3	1
In percent of GNP	13	9	6	4	3	2	2	1	0
In percent of public sector external debt	25	24	22	18	12	11	10	7	3
In percent of overall external debt	16	16	13	9	5	4	3	2	1
In percent of end-period foreign reserves	75	65	54	29	17	13	11	7	2
Repurchases of Fund Credit									
In billions of SDRs	4.9	1.2	3.2	5.3	5.1	3.4	1.2	2.0	2.2
In percent of quota	510	127	328	546	427	283	104	166	181
In percent of exports of G&NFS	11	2	5	7	6	4	1	2	2
In percent of GNP	4	1	1	2	2	1	0	1	1
In percent of public sector external debt service	37	11	23	33	34	24	11	19	20
In percent of overall MLT external debt service	22	6	16	22	19	11	5	6	6
In percent of start period foreign reserves	32	6	13	21	14	8	3	4	4
In percent gross public sector ext. financing 2/	21	7	16	11	16	12	4	8	9
Net Fund Resource Flows 3/									
In billions of SDRs	4.4	-0.7	-3.0	-4.2	-3.6	-1.6	-0.9	-2.3	-2.3
In percent of quota	455	-70	-312	-440	-305	-131	-75	-192	-194
In percent of exports of G&NFS	10	-1	-5	-6	-4	-2	-1	-2	-2
In percent of GNP	3	0	-1	-2	-1	-1	0	-1	-1
In percent of public sector external debt service	33	-6	-22	-27	-24	-11	-8	-22	-22
In percent of overall MLT external debt service	20	-3	-15	-17	-14	-5	-3	-7	-6
In percent start period foreign reserves	29	-3	-13	-17	-10	-4	-2	-5	-4
In percent gross public sector ext. financing 2/	19	-4	-15	-9	-11	-5	-3	-9	-10

Source: IMF staff estimates and projections.

1/ Projected on an expectations basis. Assumes purchase in May 2007 and remaining purchases according to Proposed Schedule of Purchases. Quota was increased effective November 1, 2006 from SDR964 million to SDR 1191.3 million.

2/ Consolidated govt. and CBT. Includes reserve accumulation before repurchases.

3/ Net purchases less repurchases and charges.

Mr. Rodrigo de Rato
Managing Director
International Monetary Fund
Washington, DC 20431
U.S.A.

Ankara, May 1, 2007

Dear Mr. de Rato,

1. Economic performance continues to be good. Growth remains close to the levels anticipated under the program, although it has softened from the pace of recent years following last year's financial market turbulence, which necessitated higher interest rates and reduced credit growth. Slowing import growth and strong exports have helped to stabilize the current account deficit, while external financing remains ample, led by continued large inflows of foreign direct investment. Inflation remains above target, but is expected to slow, supported by the tight policy stance of the central bank. Meanwhile, the primary surplus in 2006 exceeded the 6.5 percent of GNP target by a small margin—notwithstanding higher-than-programmed expenditure—and net public sector debt fell further to below 50 percent of GNP.

2. Economic fundamentals and balance sheets have strengthened considerably in recent years, making the economy much more resilient to adverse shocks. And, although recent political uncertainty has increased the risk of financial market volatility, our commitment to persevere with strong policies is unwavering.

3. Regarding program implementation, compliance with targets was as follows:

- *Quantitative performance criteria and inflation consultation clauses* (Annex A). We met the applicable external debt and net international reserve targets. End-December 2006 inflation, however, exceeded the outer band. The central bank has explained the reasons for the deviation and its policy response in a letter to the Government, which was also forwarded to the Fund in accordance with the inflation consultation clause (Annex D). End-March 2007 inflation was within the outer bands, although it exceeded the inner bands. The central bank has discussed the reasons for this with Fund staff and reaffirmed its commitment to policies that will gradually reduce inflation to target levels. With regard to the end-December 2006 fiscal program, we met the targets for the primary surplus of the consolidated government sector and the floor on the overall balance of the social security institutions. However, the ceiling on primary expenditure was missed largely due to higher-than-anticipated investment expenditures. Although data are not yet available, the adjusted end-April 2007 primary surplus, expenditure and social security balance targets are expected to have been missed, mainly due to a combination of lower-than-expected revenues and spending brought forward.

- *Structural reforms* (Annex B). The structural benchmark on state enterprise hiring was observed, and that on civil service hiring is expected to be observed. However, the continuous structural benchmark regarding excise taxes and SEE prices was not met, as adjustments in SEE prices fell short of program assumptions. Parliament passed personal income tax reform legislation on March 1, just missing the end-February 2007 deadline (structural performance criterion), although the approved law omitted one anticipated element (see paragraph 17). The law came into force on April 4. A Large Taxpayers Unit established within the Revenue Administration was operational by end-December 2006 (structural benchmark). Parliament approved legislation authorizing the Social Security Institutions to alter copayments for medical treatments and pharmaceuticals by the end-December 2006 deadline (structural performance criterion), but this was later invalidated by a Constitutional Court ruling on social security reform legislation. Finally, the privatization of Halkbank has been launched, with an IPO of at least 20 percent of its shares expected to be completed by May 15, 2007 (prior action).

4. In light of this performance and our continued commitment to the program, as further elaborated in this letter, we request completion of the Sixth Review under the Stand-By arrangement. We also request a waiver for the small delay in the passage of personal income tax reform legislation and the omission of expected provisions that would have enhanced the tax administration's powers to cross-check income and expenditure. We expect to include similar provisions in future legislation broadening the powers of the Revenue Administration. We also request waivers of applicability for the end-April performance criteria on external debt, as relevant data are not yet available and we expect these targets to be met. In light of corrective measures being taken (see paragraph 11), we also request waivers for nonobservance of end-April performance criteria on the primary surplus of the consolidated government sector, the primary surplus of the consolidated government sector excluding SEEs, the primary spending of the central government and social security institutions, and the balance of the social security institutions, which we expect to have been missed. Quantitative and structural performance criteria through end-December 2007 are set out in Annexes A and B of the attached Technical Memorandum of Understandings, respectively.

5. We are confident that the policies contained in the April 26, 2005 Memorandum of Economic and Financial Policy and supplementary Letters of Intent are adequate to achieve the objectives of our program, and we stand ready to take further measures that may become appropriate for this purpose. We will continue to consult the Fund on the adoption of these measures and in advance of revisions to policies contained in this letter in accordance with the Fund's policies on such consultation.

Macroeconomic framework for 2007

6. The economy grew by 6 percent in 2006, down from the 7.5 percent pace of previous years, as high interest rates and slowing credit growth dampened domestic demand. We

expect growth at 5 percent in 2007, supported by stable economic conditions, gradually falling inflation, and a stronger contribution from the external sector.

7. On the external side, the current account deficit reached almost 8 percent of GNP last year—higher than in 2005 but somewhat below the level anticipated under the program. We expect the deficit to fall to 7¼ percent of GNP this year, as the recent trend of slowing imports and strong exports is supported by robust growth in Turkey's trading partners, slowing domestic demand, and more stable oil prices. The outlook for external financing remains favorable and the continued high foreign direct investment, driven by strong private sector merger and acquisition activity, is expected to cover half of the current account gap. We will monitor current and financial account developments closely and are prepared to adjust policies as needed.

Monetary policy

8. We are committed to reducing inflation to the 4 percent target to provide a foundation for high and stable growth. Commodity price and exchange rate shocks contributed to a significant overshooting of inflation last year. As those effects fade and the impact of last year's monetary policy tightening takes hold, we expect inflation to converge gradually toward target during 2007, with a noticeable fall in yearly inflation rates starting in the second quarter. However, inertia in services inflation, unprocessed food price shocks, and the slow decline in inflation expectations remain challenges to the disinflation process. We will therefore conduct monetary policy with a tightening bias in the period ahead, meaning that monetary policy will be more responsive to adverse developments than favorable developments to the inflation outlook. This approach reflects our commitment to achieving the medium term inflation target.

9. Building international reserves for prudential reasons remains a key objective of the program. We are, therefore, committed to continuing our daily reserve purchase auctions, with the daily minimum purchase amount fixed at US$15 million and an option for banks to sell up to US$30 million in additional foreign exchange to the CBT, with provisions to allow temporary suspension of auctions in extreme circumstances. To provide predictability to the auction mechanism, we announced a yearly program for 2007. However, if market conditions are favorable, we will consider increasing the daily auction amounts to accelerate our build-up of reserves. We also retain the option of using discretionary intervention to prevent excessive exchange rate volatility.

Fiscal policy

10. Disciplined fiscal policy has been the cornerstone of the program, allowing declining debt ratios, facilitating disinflation, and reducing real interest rates. Notwithstanding recent deviations from program targets, we remain committed to prudent budgetary policies in the period ahead. In particular, achieving a high primary surplus target through tight spending control will help with disinflation and further ease the debt burden, thereby creating the fiscal

space necessary to implement future reforms aimed at easing the tax burden on labor and financial transactions.

11. Last year, primary spending was higher than programmed owing to a combination of factors, including higher-than-planned capital spending and faster-than-expected growth in health expenditures. As foreshadowed in the program, spending overruns (0.3 percent of GNP) recorded at end-December 2006 will be offset in 2007. Several initiatives—including the expansion of the regional incentives program, the conversion of temporary public sector workers to permanent status, and higher-than-expected increases in pensions—also require offsetting adjustments in spending plans. To this end, we have implemented the following measures:

- The Finance Ministry has issued instructions to block some 0.6 percent of GNP in spending on lower priority current and capital spending and transfers. The bulk of this spending was originally planned for the first half of 2007.

- To offset the weaker-than-programmed contribution of the SEEs to the overall primary surplus target for 2007, we have cut state enterprise investment spending by 0.1 percent of GNP and also blocked some central government spending (including those mentioned above).

- We have established safeguards to ensure that health spending developments do not jeopardize the achievement of this year's budget targets. In particular, we have stepped up monitoring of spending (both on accrual and cash basis) to ensure corrective actions can be taken promptly. We have also significantly strengthened control over public hospital expenditures by (i) setting hospital-by-hospital quarterly budgetary targets beginning with the second quarter of 2007; (ii) putting in place the legal framework necessary to audit and settle hospital invoices so as to enforce hospital budget constraints; and (iii) capping this year's aggregate bonus payments at the 2006 level. All accumulated obligations to public hospitals, as of end-March 2007, have been resolved, leaving no residual claims.

We will also maintain excise taxes and SEE prices, including energy prices, in line with program assumptions (continuous structural benchmark). With these measures in place, we are confident that spending will stay below the (adjusted) program targets for the remainder of the year, thus enabling achievement of a 6.7 percent of GNP primary surplus in 2007. If necessary, we stand ready to take additional measures to ensure our fiscal targets are met.

12. To ensure medium-term efficiency gains in the provision of health services, but without compromising its quality, we have taken measures to improve the IT control mechanisms, including on hospital services, eligibility for contribution-free provision of health services, and pharmaceuticals. We will also introduce new procurement procedures for inpatient pharmaceuticals and medical devices that allow hospitals to generate savings by

jointly negotiating contracts. To promote efficiency, copayments for outpatient services will be included in the social security reform at differentiated rates for primary, secondary, and tertiary levels. The family medicine program will be expanded to 22 regions by end-2007 (structural benchmark). In the event health spending exceeds program targets, we stand ready to take offsetting spending cuts elsewhere in the budget.

13. To support our fiscal objectives, we will continue to replace no more than 50 percent of civil servants leaving through attrition (quarterly structural benchmark, expected to be observed in the first quarter of 2007) and 10 percent of employees leaving state economic enterprises (continuous structural benchmark). We will refrain from introducing new initiatives or sectoral tax cuts that would undermine the tax base, and we will avoid rate reductions or exemptions that would undermine the structure of the VAT. We also expect to implement a broad-ranging reform of the civil service sector in early 2008, which is aimed at rationalizing the wage structure (see November 27, 2006 LOI for details).

Structural fiscal reforms

14. The Constitutional Court ruled in December that many key provisions of the social security reform passed in April 2006 were unconstitutional, including (i) all aspects of the pension reform pertaining to civil servants, where most of the medium-term savings were to be generated; (ii) changes in the valorization formulas for all workers; and (iii) the introduction of medical copayments for civil servants. Excluding these elements would significantly reduce the reform's long-term savings. We have thus postponed implementation of the reform, but remain firmly committed to formulating revised legislation that meets the court's objections while preserving to the maximum extent possible the reform's benefits, in order to ensure the long-term financial sustainability of the social security system. To ensure the broadest possible consensus around this important reform, we will soon issue a white paper explaining the principles of this reform and alternative options for the new pension parameters. We intend to submit revised legislation soon after opening of the new parliamentary session with the view to putting it in place within six months of its submission to parliament. In the interim period before the new law comes into force, we will ensure that civil service pension increases are consistent with the indexation parameters in the new legislation.

15. In the meantime, we will press ahead with measures to improve the collection of social security contributions, including (i) putting in place by end-June 2007 a legal framework requiring large employers to pay salaries through bank accounts (structural benchmark), (ii) strengthening and expanding the Large Employer Office, and (iii) modernizing debt collection techniques. Milestones have been drawn up to guide these reforms. We will also establish by end-May a committee to enhance cooperation between the SSI and the Revenue Administration and strengthen information sharing. In this context, we plan to put in place a unified tax declaration form by end-2007 (structural benchmark).

16. The Large Taxpayer Unit within the Revenue Administration became operational on January 1, 2007 (structural benchmark). To make the LTU more effective, we are committed to raising the number of auditors assigned to the LTU to 35 as a prior action for this review. We plan to raise the number of auditors further over time commensurate with the work load of the LTU. We also intend to eventually reduce fragmentation in tax administration functions. Also in the area of tax administration, we plan to address VAT refund fraud by introducing a risk-based audit system by end-2007 (structural benchmark) and raising audit staff levels from 5 to 10 percent of total resources over the medium term.

17. Parliament passed second-stage personal income tax reform on March 1, 2007 (end-February performance criterion). As expected, this law rationalizes the system by replacing VAT expenditure rebates with standard family credits, and broadens the tax base by lengthening the holding period defining long-term real estate capital gains.

18. We are committed to improving the efficiency and financial performance of the SEEs. The finances of some of these companies have deteriorated as a result of increases in input costs and unpaid bills. In the electricity sector, our strategy for the privatization of the regional distribution companies—and, subsequently, generation companies—provides the best and most durable solution to these problems. We intend to proceed with this process, beginning with the sale of the first three distribution companies in 2008. In support of this plan, and to safeguard the finances of the SEEs, we are considering ways to ensure full and continuous cost recovery, and will adopt measures to that effect. In the meantime, we have issued strict instructions for prompt settlement of bills by public institutions. It is also our intention to initiate action by the time of the next review to improve collection of companies' receivables from local administrations and to extend the use of prepayment requirements for other users of public utilities.

19. Improved fiscal transparency is key to preserving the credibility of our fiscal policies and market confidence. To that end, on March 30, 2007, we published previous years' fiscal figures in the new "central government budget" format, which facilitates comparability across years (prior action). We have also made progress on improving the accounting and reporting systems of local administrations. On April 11, we published end-2006 local budget realization figures and plan to publish future budget realization figures on a quarterly basis. We remain committed to publishing a report that quantifies existing tax expenditures by end-June 2007 (structural benchmark). Finally, we are continuing to work on a public-private partnership (PPP) law that would lay out a framework for the management and accounting of such projects across all sectors.

Financial sector reform

20. We remain committed to the privatization of state-owned banks, as indicated in previous Letters of Intent. In line with this, we have revised our strategy for the privatization of Halkbank, which now envisages, as a first step, an IPO for at least 20 percent of its shares.

Completion of the IPO is expected by no later than May 15, 2007 (prior action). To this end, we have obtained the approval of the Capital Markets Board (CMB) for the IPO, and began a road show to major capitals in late April 2007. We also remain committed to preparing a strategy for Ziraat, drawing on the experience of Halkbank.

21. Parliament passed landmark mortgage legislation in February 2007. This law lays the legal foundations for a more efficient and financially stable mortgage lending system, including by allowing mortgage finance institutions, securitization of housing loans, and variable rate mortgages. The law also includes tight norms for real estate appraisal and prudent limits on loan amounts in relation to collateral value. The BRSA will be in charge of supervising primary lending by banks, leasing companies, and consumer finance companies, while the CMB will be in charge of supervising securitization of housing loans as well as Mortgage Finance Companies (MFCs). By end-June 2007, the CMB will issue regulations on operational requirements for MFCs, as well as for mortgage-backed securities and mortgage-covered bonds, while BRSA will determine the requirements to obtain mortgage licenses for leasing companies and consumer finance companies.

22. We remain committed to maintaining an adequate regulatory and supervisory framework for our banking system. Drawing upon the findings of the recent Financial Sector Assessment Program, we aim to pass the insurance law before end-June 2007 (structural benchmark). The committee looking into the merits of a further consolidation of supervisory functions presented its report in December 2006 and the government is reviewing its findings.

23. SDIF will have disposed of all its assets taken over from intervened banks as planned by end-2007, thus allowing it to focus exclusively on its role as a deposit insurance agency. At that point, Treasury will resolve its receivables arising from earlier bank restructurings.

Investment climate

24. Ongoing efforts to improve our investment climate were rewarded with a record level of FDI in 2006, which at US$20 billion exceeded the cumulative total of the previous five years. We expect FDI this year to be almost as high, driven by ongoing merger and acquisition activity in the banking and other sectors and by investment across several sectors including communications, energy, manufacturing, and real estate. Although the sale of electricity distribution and generation companies, Tekel tobacco, and state shares in several other companies have met with delays, we remain committed to the full privatization of these and other entities in the Privatization Agency portfolio in the 2007 to 2009 timeframe, and we are continuing to lay the necessary groundwork. Meanwhile, we are proceeding with plans to privatize Petkim petrochemicals company in the coming months.

25. We also remain committed to further deregulation, reduction of administrative barriers, increased efficiency of the judicial process, and enhanced corporate governance—which are needed to raise investment and put Turkey on a higher long-term growth path. We

plan to hold the annual Investment Advisory Council meeting in June, where we will report on progress over the past year and identify new reform priorities. We have established a new agency to foster investments, the Turkish Investment and Support Promotion Agency, which will become fully operational by the end of 2007. We also aim to obtain approval of a new Commercial Code. This legislation will introduce, among other things, a requirement for firms to prepare financial statements in accordance with International Financial Accounting Standards.

26. We intend to introduce reforms to reduce labor market rigidities and financial burdens on employment, which contribute to low employment ratios and a large informal sector and which ultimately reduce growth. A reform package is being prepared that will reduce nonfinancial and financial burdens on formal employment. Our guiding objectives will be to increase labor market flexibility while preserving essential worker rights, and reduce informality. Any reform in this area will stay within the constraints of the fiscal program framework and be prepared in close consultation with stakeholders and the Fund.

Very truly yours,

/s/	/s/
Ali Babacan Minister of State for Economic Affairs	Durmuş Yilmaz Governor of the Central Bank of Turkey

Annexes

Annex A: Quantitative Performance Criteria and Indicative Targets for 2006−07

(Millions of new Turkish lira, unless otherwise indicated)

	Mar. 31, 2006		Jun. 30, 2006		Sep. 30, 2006		Dec. 31, 2006		Apr. 30, 2007		Aug. 31, 2007	Dec. 31, 2007
	Ceiling/ Floor	Outcome	Ceiling/ Floor	Outcome	Ceiling/ Floor	Outcome	Ceiling/ Floor	Outcome	Ceiling/ Floor	Outcome	Ceiling/ Floor	Ceiling/ Floor
I. Quantitative Performance Criteria 1/												
1. Floor on the cumulative primary balance of the consolidated government sector 2/	7,771	10,603	17,366	25,042	29,684	33,272	34,490	36,159	12,338	…	32,338	39,738
2. Floor on the cumulative primary balance of the consolidated government excluding SEEs sector 2/	7,471	8,403	16,414	22,095	28,052	31,417	31,796	34,646	11,738	…	31,138	37,238
3. Ceiling on consolidated primary spending of central government budget and social security institutions (SSK, BK and ES) 2/					124,046	124,859	173,084	174,972	56,362	…	119,000	190,600
4. Ceiling on contracting or guaranteeing of new external public debt with original maturities of more than one year (in millions of US$)	8,500	4,196	14,000	4,806	18,000	6,829	21,500	10,853	9,000	…	15,000	22,000
5. Ceiling on the stock of external public debt with original maturities of up to and including one year (in millions of US$)	1,000	0	1,000	0	1,000	0	1,000	0	1,000	…	1,000	1,000
6. Floor on level of net international reserves of CBT and Treasury combined (in billions of US$)	19.7	32.4	24.3	31.0	25.7	31.0	28.7	32.6	28.7	40.6	31.3	31.8
7. Floor on the cumulative overall balance (before transfers) of the social security institutions (SSK, BK, and ES) 3/	-6,100	-6,634	-12,000	-10,554	-18,400	-16,481	-24,300	-22,001	-5,000	…	-16,300	-24,200
II. Indicative Targets												
1. Floor on the cumulative overall balance of the consolidated government sector 2/	-3,429	1,202	-3,934	7,133	-5,466	2,080	-6,460	-1,168	-6,612	…	-3,612	-6,512
2. Privatization Proceeds (in millions of US$)	1,900	4,579	2,800	7,970	3,200	8,008	4,200	8,010	N/A		N/A	N/A
III. Inflation Consultation Bands (12-month change, in percent) 4/												
									Mar. 31, 2007		Jun. 30, 2007	Sep. 30, 2007
									Target	Outcome		
Outer Band (upper limit)	9.4		8.5		7.8		7.0		11.2		8.7	7.3
Inner Band (upper limit)	8.4		7.5		6.8		6.0		10.2		7.7	6.3
Central Point	7.4	8.2	6.5	10.1	5.8	10.5	5.0	9.7	9.2	10.9	6.7	5.3
Inner Band (lower limit)	6.4		5.5		4.8		4.0		8.2		5.7	4.3
Outer Band (lower limit)	5.4		4.5		3.8		3.0		7.2		4.7	3.3

1/ Cumulative targets are set from January 1, 2006 for targets within 2006 and from January 1, 2007 for targets within 2007.
2/ After being adjusted for program adjusters. Coverage from June 2006 onwards expanded, to account for new institutions now covered under the Central Government Budget.
3/ Indicative target for March 2006, performance criteria from June 2006 through December 31, 2007.
4/ Test dates for inflation consultation bands are kept at a quarterly frequency throughout 2007 and are thus reported separately in Annex D of the TMU.

ANNEX B: STRUCTURAL CONDITIONALITY, 2006–07 1/

Action	PC/SB
Prior Actions	
1. Raise the number of auditors assigned to the Large Taxpayer Unit to 35 (¶16)	5 days before Board meeting
2. Publish historical fiscal data in the new "central government budget" format (¶19)	Done
3. Complete IPO of at least 20 percent of Halkbank shares (¶20)	5 days before Board meeting
Fiscal measures	
4. No new amnesties of arrears on public sector receivables as defined in Annex F (¶19, MEP April 26, 2005)	Continuous PC
5. At most 10 percent of those leaving through attrition in each state enterprise will be replaced, with limited exceptions for specialist positions and overperforming enterprises with approval by the Treasury (¶17, MEP April 26, 2005)	Continuous SB
6. Replace no more than 50 percent of civil servants leaving through attrition (¶14, LOI November 27, 2006)	Quarterly SB
7. Maintain excise taxes and SEE prices in line with 2006-07 program assumptions (¶14, LOI November 27, 2006)	Continuous SB
8. Publish report that quantifies existing tax expenditures (¶17, LOI November 27, 2006)	SB. End-June 2007
9. Extend family medicine program to 22 regions (¶12)	SB. End-December 2007
10. Put in place a unified tax declaration form for SSI and Revenue Administration (¶15)	SB. End-December 2007
11. Put in place a legal framework requiring large employers to pay salaries through bank accounts (¶15)	SB. End-June 2007
12. Introduce a risk-based audit system for VAT refunds (¶16)	SB. End-December 2007
Financial Sector Measures	
13. Secure parliamentary approval of the insurance law (¶22)	SB. End-June 2007

1/ PC=structural performance criterion, SB=structural benchmark. Paragraph numbers refer to the May 1, 2007 supplementary Letter of Intent.

ANNEX C: PURCHASES AND PROPOSED SCHEDULE OF PURCHASES, 2005–08

	SDR Millions	Percent of Quota	Test Date 1/	Earliest Possible Purchase Date	Date of Board Approval
Approval	555.2	57.6			11-May-05
2005					
1st & 2nd Reviews	1,110.3	115.2	30-Sep-05		9-Dec-05
2006					
3rd Review 2/	624.6	64.8	31-Dec-05	1-Mar-06	28-Jul-06
4th Review 2/	624.6	64.8	31-Mar-06	1-Jun-06	28-Jul-06
5th Review	749.5	62.9	30-Sep-06	1-Dec-06	13-Dec-06
2007					
6th Review	749.5	62.9	31-Dec-06	22-May-07	
7th Review	749.5	62.9	30-Apr-07	1-Jul-07	
8th Review	749.5	62.9	31-Aug-07	1-Dec-07	
2008					
9th Review	749.5	62.9	31-Dec-07	1-Mar-08	
Total 3/	6,662.0	559.2			

Source: IMF staff.

1/ All test dates for the inflation consultation bands are quarterly.
2/ The third and fourth reviews were combined.
3/ Quota was increased from SDR 964 million to SDR 1,191 million, effective November 1, 2006.
Each purchase expressed as a share of current quota; total purchases as share of final quota.

ANNEX D: INFLATION CONSULTATION BANDS

1. The quarterly consultation bands for the 12-month rate of inflation in consumer prices (as measured by the headline consumer price index (CPI) published by the Turkish Statistical Institute), are specified as follows:

	2007			
	March	June	September	December
Outer band (upper limit)	11.2	8.7	7.3	6.0
Inner band (upper limit)	10.2	7.7	6.3	5.0
Central point	9.2	6.7	5.3	4.0
Inner band (lower limit)	8.2	5.7	4.3	3.0
Outer band (lower limit)	7.2	4.7	3.3	2.0

2. Inflation prospects will be an important part of each review under the arrangement. In line with our accountability principles, we are committed to report to the public the reasons for any breach of the outer bands, and our policy response. In this vein, should the observed year-on-year rate of CPI inflation for the quarter preceding a purchase fall outside the outer bands specified above, the authorities will complete a consultation with the Fund on their proposed policy response before requesting further purchases under the program. In addition, the CBT will conduct discussions with the Fund staff should the observed year-on-year rate of CPI inflation fall outside the inner bands specified for the end of each quarter in the table above.

ANNEX E: TARGETS FOR NET INTERNATIONAL RESERVES

Table 1. Turkey: Performance Criteria on the Level of Net International Reserves

(In billions of U.S. dollars)

	Floor on level of NIR	Floor Adjusted for Privatization Outcome	Actual	Memo item: NIR of the CBT
Outstanding stock as of September 30, 2005:			13.2	28.6
December 31, 2005	14.0	15.9	22.4	37.5
March 31, 2006	17.2	19.7	32.4	45.7
June 30, 2006	19.9	24.3	31.0	42.4
September 30, 2006	20.3	25.7	31.0	42.6
December 31, 2006	22.6	28.7	32.6	43.2
April 30, 2007	28.0	28.7	40.6	48.3
August 31, 2007	31.3			
December 30, 2007	31.8			

1. For program purposes, net international reserves is defined as net international reserves of the CBT minus (i) Treasury liabilities to the International Monetary Fund and (ii) Treasury foreign exchange denominated borrowing with an original maturity of less than one year.

2. Net international reserves of the CBT comprise its gross foreign assets excluding encumbered reserves less its gross international reserve liabilities plus the net forward position of the central bank, denominated in U.S. dollars. Encumbered reserves are reserves that are not readily available.

3. For the purpose of the program, gross foreign assets are all short-term foreign (convertible) currency denominated claims on nonresidents, monetary gold valued at the September 30, 2004 average London fixing market price of US$414 per troy ounce, foreign bank notes, balances in correspondent accounts, and any reserve position in the IMF. At present encumbered reserves consist of foreign asset holdings in accounts of the Turkish Defense Fund (amounting to US$0.31 billion on December 29, 2006). Reserve assets as of December 29, 2006 amounted to US$59.9 billion (evaluated at program exchange rates).

4. Gross international reserve liabilities include all foreign currency-denominated liabilities (or TL/YTL-denominated liabilities indexed to any exchange rate) to residents and non-residents with an original maturity of up to and including one year (including reserves against foreign currency deposits of the banking sector), claims from central bank letters of credit, overdraft obligations of the central bank, and central bank liabilities arising from

balance of payments support borrowing irrespective of their maturity. Government foreign exchange deposits with the CBT are not treated as an international reserve liability. On December 29, 2006 reserve liabilities thus defined amounted to US$16.7 billion (evaluated at program exchange rates).

5. The net forward position is defined as the difference between the face value of foreign currency-denominated or indexed central bank off-balance sheet (forwards, swaps, options on foreign currency, and any future contracts) claims on nonresidents and foreign currency obligations to both residents and nonresidents. As of December 29, 2006 these amounts were zero.

6. As of December 29, 2006 the sum of: (i) Treasury liabilities to the International Monetary Fund and (ii) Treasury foreign exchange denominated borrowing with an original maturity of less than one year amounted to US$10.6 billion.

7. All assets and liabilities denominated in foreign currencies other than the U.S. dollar will be converted into U.S. dollars at the program cross exchange rates specified (Annex J).

8. The projected Net International Reserves path from the fourth quarter of 2005 to the fourth quarter of 2006 was based, inter alia, on the following projections for foreign exchange receipts resulting from privatization:

	Privatization receipts, in millions of US$, Cumulative from 2005 Q4
2005 Q4	800
2006 Q1	2,800
2006 Q2	3,700
2006 Q3	4,200
2006 Q4	5,200

9. Privatization receipts are defined in this context as the proceeds from sale or lease of (all or a portion of) entities and properties held by the public sector, including the Privatization Authority and the Savings Deposit and Insurance Fund, that are deposited in foreign exchange at the Central Bank of Turkey, either directly, or through Treasury.

10. In the event that realized foreign exchange receipts resulting from privatization depart from projected receipts, the NIR floor for each quarter was revised upward (downward) by the excess (shortfall) of cumulative realized receipts compared to the projected cumulative receipts in paragraph 8 above.

11. The 2007 targets assumed that privatization receipts would be US$1.0 billion in the fourth quarter of 2006. In the event that the realized figure departed from that figure, the NIR

floors for April, August, and December 2007 would be adjusted. In this framework, the NIR floors for 2007 will be adjusted upward by US$0.7 billion, which was the excess of actual fourth quarter 2006 receipts relative to the US$1 billion assumption.

12. In addition to the adjustment of NIR floors as described in the preceding paragraphs, the NIR floors for August 31 and December 31, 2007 will also be adjusted upward (downward) for any excess (shortfall) of privatization revenues (as defined in paragraph 9 above) in 2007 relative to the following assumptions:

	Privatization receipts, in millions of US$, Cumulative in 2007
August 31	4,700
December 31	5,000

ANNEX F: FISCAL TARGETS

A. Primary Balance of the Consolidated Government Sector

Table 1. Turkey: Performance Criteria on the Cumulative
Primary Balance of the Consolidated Government Sector and
Consolidated Government Sector Excluding SEEs.

	Floor (In millions of YTL)
Cumulative primary balance from January 1, 2006, to:	
December 31, 2006	34,050
Cumulative primary balance from January 1, 2007, to:	
April 30, 2007	12,338
August 31, 2007	32,338
December 31, 2007	39,738
Cumulative primary balance (excluding SEEs) from January 1, 2006, to:	
December 31, 2006	31,350
Cumulative primary balance (excluding SEEs) from January 1, 2007, to:	
April 30, 2007	11,738
August 31, 2007	31,138
December 31, 2007	37,238

1. The primary balance of the *consolidated government sector* (CGS), Table 1, comprises the primary balances (primary revenue minus noninterest expenditures) of: the central government; the 3 extra budgetary funds (EBFs) identified below; the 3 social security institutions (SSIs) identified below (and unified into a single institution as of the beginning of 2007); the unemployment insurance fund; and the 22 state economic enterprises (SEEs) identified below. A second set of performance criteria excludes the SEEs. The floors on the primary balance of the CGS will be monitored:

a) For the central government from above the line on a modified cash basis (including both special revenues and special expenditures). In this definition, reported accrual-based transfers to the social security institution(s) will be converted to a cash basis.

b) For the EBFs from above the line on a modified cash basis, counting non-transferred shared tax revenues, to the extent these are not already recorded as reserves by other elements of the CGS.

c) For the SSI(s) and the unemployment insurance fund from above the line on a cash basis.

d) For the SEEs, from below the line as described in paragraph 7.

2. For the purposes of the program, the primary revenues will exclude interest receipts of the central government (including on tax arrears, although combined penalty/interest charges associated with tax payments will be counted as primary revenues), SEEs, and of the unemployment insurance fund (UIF), profit transfers of the Central Bank of Turkey (CBT) and net special revenues of the Turkish mint, proceeds from the sale of assets of the CGS (privatization proceeds or transfers thereof), and dividend payments from Ziraat Bank. (Dividend payments from Halkbank that are determined not to stem from income derived from recapitalization bonds shall be counted as primary revenues.) Late payment penalties of the UIF will be included as primary revenues. Revenues of the CGS from sales of immovables will be included up to an aggregate cap of YTL 500 million. Interest receipts of EBFs and SSIs will not be excluded. The floor on the primary balance will be adjusted upward for any increase in revenues arising from changes in the revenue sharing agreement between any components of the CGS and other elements of the public sector, including local authorities. For the purposes of the program, revenues of the CGS will exclude payments-in-kind and other nonmonetary forms of payments.

3. For the purposes of the program, primary expenditure of the CGS will exclude any payments related to bank recapitalization and to the restructuring of private and state banks. Privatization-related expenditure of the Privatization Fund will not be excluded. Current carryover appropriations are not included as expenditures when constructing the program targets, while spending against such appropriations will count as primary expenditures for the purposes of calculating both primary and overall balances.

4. Net lending of any component of the CGS will be considered as a non-interest expenditure item. (If this net lending is negative, it will be considered as a non-interest revenue item.) Payment of guaranteed debt by treasury on behalf of non-CGS components of the public sector will not be treated as net lending up to the baseline reported in Annex G.

Extrabudgetary funds

5. The three EBFs included in the definition of the performance criterion are the Defense Industry Support Fund, the Privatization Fund, and the Social Aid and Solidarity Incentive Fund.

State economic enterprises

6. The 22 SEEs whose primary balances will be included in the definition of the performance criterion are: TTK (coal), T. ŞEKER FAB (sugar), TMO (soil products office), TEKEL (tobacco), TCDD (railways), BOTAŞ (natural gas), TEDAŞ (electricity distribution), EÜAŞ (electricity generation), TETAŞ (electricity trade), TEİAŞ (electricity transmission), TPAO (petroleum exploration and extraction), ETİ Maden İŞL., MKEK, TKİ, ÇAYKUR, DHMİ, PTT, PETKİM, TİGEM, KIYEM, TDİ, and DMO.

7. The primary balance of these SEEs will be monitored as the sum of net financing minus accrued interest made by the SEEs. Net financing will be monitored as: net financing from the banking system (excluding pre-export financing from Eximbank) plus net external borrowing (excluding normal trade financing), plus the change in net arrears to and net

advances from the private sector and to/from the non-CGS public sector (including subsidiaries and joint ventures), plus net interest payments undertaken by the Treasury. The net change in arrears on tax liabilities will be excluded.

8. Net financing from the banking system (excluding pre-export financing from Eximbank) is defined as the change in all claims of these institutions on the SEEs listed above, including loans and capitalized interest arrears, less the change in deposits and repos of SEEs in these institutions, as reported by these SEEs. Changes in claims and deposits denominated in foreign currency will be valued at the average of the exchange rates between the Turkish lira and each corresponding currency prevailing during the quarter in question. As of December 31, 2005 the stock of net banking claims on SEEs as defined above stood at YTL 1,243 million, valued at the exchange rates on that day.

9. Net external borrowing is defined as the receipt of external loans (including guaranteed debt and on-lending, and excluding normal trade financing) less amortization (excluding repayments of guaranteed debt and on-lending undertaken by the Treasury), valued at the exchange rate at the time of transaction. As of December 31, 2005 the stock of external loans stood at YTL 6,932 million, valued at the exchange rates on that day.

Social security institutions

10. The three social security institutions (SSIs) included in the definition of the performance criterion for end-December 2006 are SSK, Bağ-Kur, and Emekli Sandığı. For the 2007 targets, the object of monitoring is the unified social security institution (SSI), including the activities of SSK, Bağ-Kur, and Emekli Sandığı. The deficits of the SSI(s) will be covered by transfers from the central government budget, and they are thus expected to be in primary balance.

Adjusters

11. The floor on the primary surplus of the CGS will be adjusted upwards for any increase in the expenditure arrears of the SSIs. Arrears of the SSIs are defined as the sum of (i) overdue pension payments; (ii) medicine payments overdue by more than 45 days for both imported and domestic medicine (from the date of invoice receipt); (iii) other payments overdue by more than 30 days and payments to hospitals overdue by more than 60 days (from the date of invoice receipt). In the case of Bağ-Kur they exclude the arrears to the common retirement fund. The stock of arrears for Bağ-Kur stood at YTL 0 million; for SSK stood at YTL 0 million; and for Emekli Sandığı stood at YTL 0 million on December 31, 2005. These stocks of arrears will be used for the purpose of calculating the adjustor.

12. The floors for the primary surplus of the CGS will be adjusted upward:

a) For any issue of noncash debt other than for bank recapitalization and securitization of duty losses and for the restructuring of the Agricultural Sale Cooperative Units and military foreign financed in-kind spending;

b) For any off-balance sheet expenditure of any component of the CGS (excluding military foreign financed in-kind spending).

c) For cumulative interest receipts of the Defense Industry Support Fund in excess of YTL 300 million.

13. The floor on the primary surplus of the CGS will be adjusted upward (downward) in line with the projected surplus (deficit) of the primary balance of any fund or entity that is incorporated in the CGS after January 1, 2007.

14. The floor on the primary surplus of the CGS will be adjusted by the primary balance projected at the time of approval of the program for any state economic enterprise (included in the performance criterion) when there is a change of control due to privatizations. The adjustor will be calculated as the difference between the primary surplus generated by the company while in public control and the annual projection. This adjustor does not apply to Türk Telekom or TÜPRAŞ in 2006.

15. The 2007 (end-April, end-August, end-December) floors on the primary surplus of the CGS would be adjusted upward to the extent that the end-2006 target on the primary spending of the central government and the SSIs (section B below) is missed. In this framework, the 2007 floors on the primary surplus of the CGS have been adjusted upward by YTL 1,888 million, which was the excess of primary spending of the central government and the SSIs relative to the end-2006 target.

B. Primary Spending of the Central Government and the Social Security Institution(s)

Table 1. Turkey: Performance Criteria on the Cumulative Consolidated Primary Spending of the Central Government and the Social Security Institution

	Ceiling (In millions of YTL)
Cumulative primary spending from January 1, 2006 to:	
December 31, 2006	174,000
Cumulative primary spending from January 1, 2007 to:	
April 30, 2007	56,362
August 31, 2007	119,000
December 31, 2007	190,600

16. The December 2006 ceiling in Table 1 is established on the sum of (i) the primary spending of the central government, excluding transfers to social security institutions, measured as in paragraph 1.a of Section A above; and (ii) the primary spending of the social security institutions, measured as in paragraph 1.c of Section A above. The 2007 ceilings relate to the expenditures of the fully consolidated central government and social security

institution. This means that central government transfers and payments of social security contributions are consolidated out, as well as any payments (such as common retirement) between social security institutions.

Adjusters

17. The ceilings on primary spending will be adjusted symmetrically to compensate for any over- or underperformance in collections of the revenue bases subject to sharing with local governments and extrabudgetary funds.

18. The 2007 (end-April, end-August, end-December) spending ceilings would be adjusted downward to the extent that the end-2006 spending target is missed. In this framework, the 2007 spending ceilings have been adjusted downward by YTL 1,888 million, which was the excess of primary spending relative to the end-2006 target.

C. Overall Balance of the Consolidated Government Sector

Table 1. Turkey: Indicative Floors on the Cumulative Overall Balance of the Consolidated Government Sector

	Floor (In millions of YTL)
Cumulative overall balance from January 1, 2006 to:	
December 31, 2006	-6,900
Cumulative overall balance from January 1, 2007 to:	
April 30, 2007	-6,612
August 31, 2007	-3,612
December 31, 2007	-6,512

19. The overall balance of the consolidated government sector (CGS), Table 1, comprises: (i) the primary balance of the CGS as previously defined in this annex; (ii) the net interest payments of the central government (excluding in 2006 those combined penalty/interest charges associated with tax payments and already included as primary revenues); the UIF and the SEEs; (iii) the interest payments of SSI(s) and EBFs; (iv) transfers of profits from the CBT and net special revenues of the Turkish Mint to the consolidated central government; (v) Ziraat Bank dividend payments and recapitalization-bond-related dividend payments from Halkbank; and (vi) expenditures under the risk account (net lending).

20. The monitoring of the different components of the overall balance will be as indicated in paragraph 1 of this Annex.

21. All definitions and adjusters specified earlier in this Annex to apply to the primary balance of the CGS will also apply to the overall balance of the CGS. In particular, the

overall balance will be adjusted for the overall balance of any new government funds and institutions established after January 1, 2007.

D. Overall Balance (before transfers) of the Social Security Institution

Table 1. Turkey: Performance Criteria on the Cumulative Overall Balance (before transfers) of the Social Security Institution

	Floor (In millions of YTL)
Cumulative overall balance (before transfers) from January 1, 2006 to:	
December 31, 2006	-24,300
Cumulative overall balance (before transfers) from January 1, 2007 to:	
April 30, 2007	-5,000
August 31, 2007	-16,300
December 31, 2007	-24,200

22. The overall balance (before transfers) of the social security institutions (SSIs), Table 1, comprises the balances of SSK, Bağ-Kur, and Emekli Sandığı for the end-December 2006 test date, and the balance of the unified social security institution for the 2007 test dates. It excludes additional payments made to pensioners in lieu of phased-out tax rebates (up to YTL 1.772 billion) for 2006. For 2007, these additional payments as well as billed payments are counted as both revenue and expenditure of the SSI.

E. Amnesties and Public Sector Receivables

23. Amnesties will be understood as a reduction in the net present value of a public receivable, without any reference to individual ability to pay, or attempt to enforce individual payment. A public receivable will be understood as an obligation to general government (GFS definition) or to a state economic enterprise or state bank.

24. This performance criterion will not apply to companies in the Privatization Administration's portfolio.

F. Structural Benchmark on New Civil Servants Hires

25. A quarterly benchmark will be used to monitor the 50 percent ceiling on the replacement ratio for civil servants as provided for in the 2007 Budget Law. The replacement ratio will be computed as the cumulative number of entries in each quarter in 2007 divided by the total number of attritions in 2006. Attritions comprise retirements, deaths, resignations, and transfers to other agencies; entries comprise appointments and transfers from other agencies. These data will be provided for the total of civil servants, divided into the following sub-categories: general administration, education services, health services, technical services, and other positions. These data will be prepared by the Ministry of Finance (General Directorate of Budget and Fiscal Control) on a quarterly basis and will be submitted to the Fund within 6 weeks of the end of the corresponding quarter.

ANNEX G: PROGRAM BASELINE FOR TREASURY NET LENDING

Table 1. Turkey: Program Baseline for Treasury Net Lending

	Baseline (In millions of US$)	Baseline (In millions of YTL)
Cumulative net lending from January 1, 2006 to:		
December 31, 2006	335	490
Cumulative net lending from January 1, 2007 to:		
April 30, 2007	125	185
August 31, 2007	225	335
December 31, 2007	335	500

1. Net lending (risk account) by Treasury to other (non-CGS) components of the public sector is defined as the sum of guarantee payments made by Treasury on behalf of these entities minus repayments obtained by Treasury from them.

2. Other components of the public sector include: extrabudgetary funds not in the CGS, revolving funds, associations or foundations, state economic enterprises not in the CGS, state banks (including Eximbank and Iller bank), special provincial administrations, municipalities, municipal enterprises, build-operate-transfer projects, and build-operate projects.

3. Repayments include those obtained in cash directly from municipalities. Repayments, obtained through claw-back mechanisms, either directly, by withholding of transfers of tax shares from the MoF, or indirectly, via withholding of transfers to be made by Iller Bank, and proceeds from privatization, direct or indirect, are not included as repayments.

4. For the purposes of program monitoring, the flows in U.S. dollars will be converted at the average YTL/US$ exchange rate between test dates.

ANNEX H: SHORT-TERM EXTERNAL DEBT CEILINGS

Table 1. Turkey: Performance Criteria on the
Stock of Short-Term External Debt Outstanding

	Ceilings (In millions of US$)
December 31, 2005	1,000
March 31, 2006	1,000
June 30, 2006	1,000
September 30, 2006	1,000
December 31, 2006	1,000
April 30, 2007	1,000
August 31, 2007	1,000
December 31, 2007	1,000

1. The limits specified in Table 1 apply to the stock of debt of original maturity of one year or less, owed or guaranteed by the consolidated government sector (as defined in Annex F). The term "debt" has the meaning set forth in point No. 9 of the Guidelines on Performance Criteria with Respect to External Debt or Borrowing in Fund Arrangements (Decision No. 6230-(79/140), August 3, 1979 as amended by Decision Nos. 11096-(95/100), October 25, 1995, and 12274-(00/85), August 24, 2000). Excluded from this performance criterion are external program financing, sales of treasury bills denominated in Turkish lira or foreign exchange to nonresidents in either the domestic primary market or the secondary market, normal import-related credits, reserve liabilities of the Central Bank of Turkey, and forward contracts, swaps, and other future market contracts. Debt falling within the limit shall be valued in U.S. dollars at the program cross exchange rates specified in Annex J.

ANNEX I: MEDIUM- AND LONG-TERM EXTERNAL DEBT CEILINGS

Table 1. Turkey: Performance Criteria on
Contracting and Guaranteeing of New External Debt

	Limits (In millions of US$)
Cumulative flows from end-December 2004	
December 31, 2005	16,000
Cumulative flows from end-December 2005	
March 31, 2006	8,500
June 30, 2006	14,000
September 30, 2006	18,000
December 31, 2006	21,500
Cumulative flows from end-December 2006	
April 30, 2007	9,000
August 31, 2007	15,000
December 31, 2007	22,000

1. The limits specified in Table 1 apply to the contracting or guaranteeing by the consolidated government sector (as defined in Annex F) of new, nonconcessional external debt with an original maturity of more than one year. This performance criterion applies not only to debt as defined in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt (adopted by the Executive Board of the International Monetary Fund on August 24, 2000) but also to commitments contracted or guaranteed for which value has not been received. The term “nonconcessional” means containing a grant element of less than 35 percent on the basis of the currency-specific discount rates based on the OECD commercial interest reference rates in place at the time at which the contract is entered into, or guarantee issued.

2. Excluded from this performance criterion are credits extended by the IMF, adjustment lending from the World Bank, and other external program financing, long-term liabilities of the Central Bank of Turkey and sales of treasury bills and bonds denominated in TL/YTL or FX to nonresidents in either the domestic primary market or the secondary market. Also excluded from this performance criterion is debt or the guaranteeing of debt if the proceeds from that debt have been used to retire other debt as part of a liability management operation that results in an improvement of the debt profile, either through a lengthening of maturity or a reduction in net present value of the debt stock; this could include direct swaps of one debt instrument for another and new debt issues whose proceeds are used to retire other debt; to qualify for exclusion from the PC, the debt that has been retired pursuant to such liability management operations must have a maturity date at least one year past the contract date of the new debt that has been undertaken.

3. Debt falling within the limit shall be valued in U.S. dollars at the exchange rate prevailing at the time the contract is entered into, or guarantee is issued.

ANNEX J: PROGRAM EXCHANGE RATES

Table 1. Cross Exchange Rates for Program Purposes

	TL value	YTL value	U.S. dollars per currency unit
Program exchange rates			
U.S. dollar	1,497,696	1.497696	1.0000
Euro	1,845,162	1.845162	1.2320
Japanese yen	13,469	0.013469	0.0090
Swiss franc	1,186,643	1.186643	0.7936
U.K. pound	2,707,645	2.707645	1.8086

1. This table sets out the program exchange rates referred to in earlier Annexes. They shall apply to the performance criteria/indicative ceilings or floors for the period May 31, 2005–May 31, 2008. Currencies not specified here will be converted at the representative exchange rates reported to the IMF as of September 29, 2004.

2. Constituent currencies of the euro shall be converted into euro at the official European Union conversion rates and then converted into the U.S. dollar value.

TÜRKİYE CUMHURİYET MERKEZ BANKASI

ANONİM ŞİRKETİ
SERMAYESİ : YTL 25.000
İDARE MERKEZİ : ANKARA
(CENTRAL BANK OF THE REPUBLIC OF TURKEY)

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Mr.Rodrigo de Rato
Managing Director
International Monetary Fund
Washington D.C.
USA

Dear Mr. de Rato,

Please find enclosed the English translation of our Open Letter to the Government explaining the reasons for inflation exceeding the upper limit of the uncertainty band around the year-end target and the measures to be taken to ensure that inflation rate will return to levels within pre-established limits.

Sincerely,

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Durmuş YILMAZ
Governor

Dr. Erdem BAŞÇI
Vice Governor

-Enclosed 11 pages

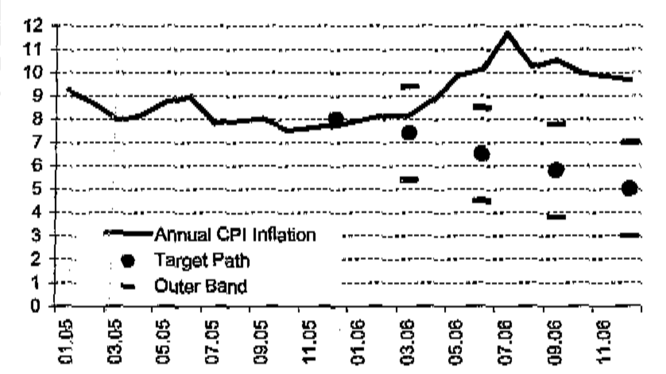
Ankara, January 22, 2007

Ali BABACAN
Minister of State
ANKARA

The Central Bank of Turkey (CBT) adopted a formal inflation-targeting framework at the beginning of 2006. Accordingly, the end-year inflation target for 2006 was set as 5 percent, measured by the annual change in the Consumer Price Index (CPI). To facilitate the accountability principle, the CBT has disclosed a quarterly path for 2006 inflation, consistent with the end-year target with an uncertainty band of 2 percentage points on both sides. In adherence with the Article 42 of the Central Bank law, the CBT committed to provide the Government with a written statement explaining the reasons for inflation exceeding the upper limit of the uncertainty band and the measures to be taken to ensure that inflation rate will return to levels within pre-established limits.

The annual CPI inflation outturn by the end of December 2006 was 9.65, breaching the upper limit of the uncertainty band announced for end-2006 at 7 percent (Figure 1). This open letter explains the reasons why inflation exceeded the target by a large margin, evaluates the measures taken by the Central Bank of Turkey to bring inflation back to the target, and finally presents the medium term outlook and the horizon in which inflation converges to the target. As mentioned in our policy statement titled "General Framework of Inflation Targeting and Monetary and Exchange Rate Policy for 2006" published in December 2005, this Open Letter will also be presented to the IMF as part of the program conditionality.

Figure 1: Annual Inflation and Target Path



Source: TURKSTAT, CBT

The Reasons For Exceeding The Target

The reasons for exceeding the target in year 2006 can be identified by decomposing the year into pre- and post-May periods. As explained in the Open Letter published in July 2006, the rise in inflation in the pre-May period can be attributed to a combination of several supply shocks such as rising oil prices, high unprocessed food price inflation, and the sustained increases in the gold prices. Although the relatively strong course of the domestic demand might have been one of the factors affecting inflation, a careful analysis of the price data and capacity indicators suggested that the role of the supply factors in breaching the target, by and large, was dominant in this period.

Inflation dynamics in the post-May period was mainly driven by the exchange rate pass-through effects of the portfolio shock originated from the change in the global risk perceptions. The New Turkish Lira (YTL) has shown a tendency to strengthen since August, yet the domestic currency in the second half of the year remained significantly weaker than the pre-May period. Cumulative exchange rate pass-through since May has added around 3.5 percentage points to the headline inflation—in line with our projections laid out in the June Open Letter. The accumulated impact of the pass-through has kept the annual inflation at high levels. The annual inflation in the unprocessed food and energy prices showed signs of easing in the second half of the year. Although unprocessed food price annual inflation declined to 13 percent by the end of December from its peak of 21 percent on June, it still remains at high levels. Consequently, year-end inflation turned out to be significantly higher than the 5 percent end-year target.

A close look at the last couple of years' annual inflation in certain subgroups of the CPI reveals the main factors behind the rise in inflation in 2006. Figure 2 depicts the dominant role of the unprocessed food prices. High inflation in "goods excluding energy and unprocessed food" can be largely explained by the exchange rate movements. The services inflation, on the other hand, exhibited a gradually declining pattern, confirming that supply side shocks were mainly responsible from the rise in inflation in 2006.[1]

[1] Although inflation in services prices has come down in 2006, its contribution on headline inflation appears to have gone up. This is mainly because of the increasing weight of services in the CPI.

Figure 2: Annual Inflation in Selected Subcomponents of CPI

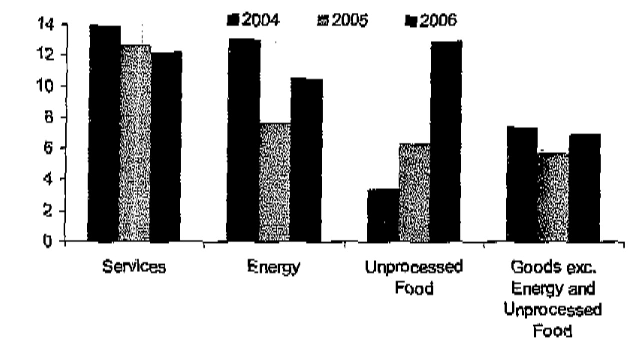


Table 1: Contribution to Annual CPI Inflation

	Services	Energy	Unprocessed Food	Goods exc. Energy and Unprocessed Food
2004	3.58	1.94	0.44	3.40
2005	3.22	1.10	0.79	2.60
2006	3.33	1.51	1.65	3.16

Source: TURKSTAT, CBRT

Annual change in the most widely cited core CPI (excluding energy, unprocessed food, tobacco-alcohol and gold), denoted by H reached 8.9 percent at the end of the year 2006. It should be noted that since a big fraction of the H index consists of durable goods, this index is highly sensitive to exchange rate movements. In that sense, the rise in inflation measured by the H index was identified as a temporary relative price change rather than a movement in trend inflation. First round effects of the exchange rate pass-through, which is more significant in durable goods price inflation, is completed. Indeed, in many of the sub-groups of the durable goods, cumulative pass-through started coming down in the last two months of the year (Table 2).

Table 2: Exchange Rate Pass-through to Durables in the post- May period

	Cumulative Percentage Change Since April 2006							
	May 2006	June 2006	July 2006	August 2006	September 2006	October 2006	November 2006	December 2006
Exchange Rate Basket (0.5Euro+0.5USD)	8.70	21.99	18.86	12.68	13.12	12.83	12.08	11.86
Durable Goods (exc. Gold)	1.82	4.85	7.20	7.70	7.82	8.08	6.90	5.45
Electrical and Non-Electrical Home App.	4.51	5.88	7.65	6.57	5.30	4.48	3.89	2.94
Automobile	1.50	6.60	10.05	10.56	9.33	11.15	10.71	6.85
Furniture	-0.53	2.49	4.65	7.55	11.93	11.95	8.38	8.38
Other Durable Goods	-1.53	0.45	1.61	2.25	1.89	1.30	1.14	2.82

Source: TURKSTAT, CBT.

Measures Taken to Ensure the Convergence of Inflation to the Targets

The volatility in the exchange rates in May and June, coupled with other cost-push factors such as strong commodity prices and rising food prices, has led to a serious deterioration in inflation expectations. Central Bank of Turkey implemented a two-pillar package as a reaction to the volatility in the financial markets and the consequent rise in inflation expectations. The first pillar of the policy response was a rate hike of 400 percentage points in June, which sent the markets a clear signal of the Central Bank's commitment to the medium-term inflation targets.

The second pillar of the package was to withdraw the excess domestic currency liquidity in the financial markets via deposit purchase auctions and FX sales, while raising the lending rate up by a total of 6 percentage points. By doing so, the CBT aimed to reduce the potential volatility in the markets by designing a flexible mechanism to deal with sudden shifts in the market sentiment. The plan worked well and the financial markets calmed down. Markets reacted favorably to all these decisive policy measures and the long-end of the yield curve shifted down.

In the following meeting held on July 20th, the Monetary Policy Committee (MPC) raised the policy rates by a further 25 basis points and stated that a measured tightening might be necessary to meet 2007 end-year target. By giving such a signal, the CBT aimed at containing the second round effects of the exchange rate pass-through and eliminating the gap between inflation expectations and the medium-term targets.

In the rest of the year, the risks of high inflation in the industrial countries have eased, decreasing the uncertainty over the global liquidity conditions. The Federal Reserve's decision to keep rates on hold has further mitigated the impact of the May-June sell-off on the domestic markets. Another positive development was the decline in commodity prices and the signs of a partial "correction" in unprocessed food prices. Nevertheless, the MPC assessed that these developments would not be significant enough to change the medium term inflation outlook, since there was still a considerable amount of uncertainty surrounding the food and the commodity prices, as well as the global liquidity conditions.

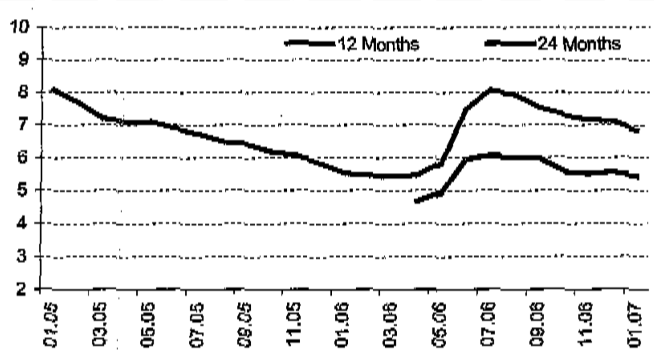
In the meanwhile, the third quarter GDP figures have pointed to a significant slowdown in the private consumption demand. However, the decline in the overall growth rate, as it was anticipated in the October Inflation Report, was less pronounced owing to the increase in government spending and the strong course of the external demand. Given that the underlying inflation was significantly higher than the medium term targets, and noting the prevailing uncertainties over the impact of the large June-July interest rate hikes, the MPC decided to keep rates on hold in the last 6 consecutive MPC meetings (Table 3). Moreover, the MPC stressed the need to maintain the tight policy stance in the face of continued global imbalances, high inflation expectations, and the risks related to services inflation.

Table 3 Monetary Policy Committee (MPC) Decisions		
Dates for MPC Meeting	**Decision on Interest Rate**	**Interest Rate**
January 23rd, 2006	No Change	13.50
February 23rd, 2006	No Change	13.50
March 23rd, 2006	No Change	13.50
April 27th, 2006	-0.25	13.25
May 25th, 2006	No Change	13.25
June 7th, 2006(1)	+1.75	15.00
June 20th, 2006	No Change	15.00
June 25th, 2006(1)	+2.25	17.25
July 20th, 2006	+0.25	17.50
August 24th, 2006	No Change	17.50
September 26th, 2006	No Change	17.50
October 19th, 2006	No Change	17.50
November 23rd, 2006	No Change	17.50
December 21st, 2006	No Change	17.50
January 16th, 2007	No Change	17.50

(1) Intermediate

The decisive policy measures taken by the CBT and the demonstration of its firm commitment to the medium term targets helped to contain the inflation expectations. The deterioration in medium-term expectations stopped in July. Both the 12-month and the 24-month ahead inflation expectations exhibited a declining pattern since then (Figure 3). However, the improvement in expectations was limited, possibly owing to the adaptive behavior of agents coupled with the elevated headline inflation figures. We forecast the inflation expectations to come down gradually as inflation decelerates in the medium term. The fact that currently 24-month ahead inflation expectations are significantly higher than our medium term target of 4 percent, however, necessitates a cautious policy stance.

Figure 3: Inflation Expectations for the Next 12 and 24 Months*



(*): 24 months expectations is available from May 2006 onwards.
Source: CBT

Outlook For Inflation and Monetary Policy

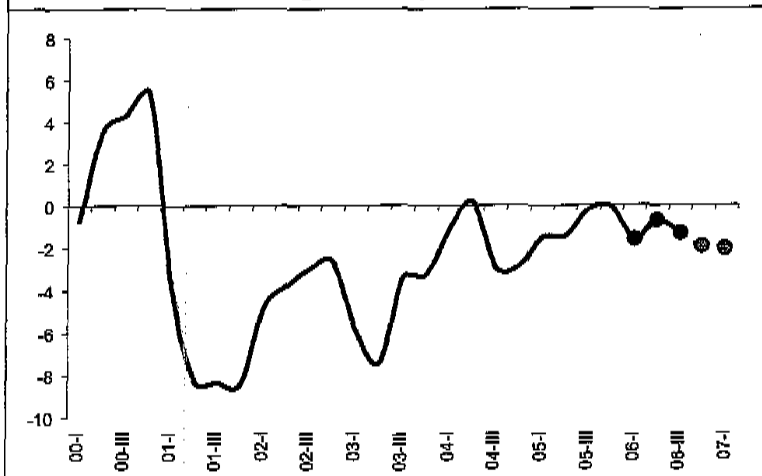
Recent Trends in Inflation

Short-term inflation developments were largely in line with our projections presented in the July and October Inflation Reports. Having reached its peak at 11.69 percent in July, annual inflation has declined gradually. The 2006 end-year inflation turned out to be 9.65 percent, which is very close to the midpoints of the end-2006 forecasts presented in the July Inflation Report (9.85), and October Inflation Report (9.9). Recent decline in inflation can be partly attributed to the easing energy and unprocessed food prices; however, it should be also noted that the core-goods inflation (goods excluding unprocessed food and energy) started to decline as well. The services inflation, on the other hand, displayed more persistence. Currently, the annual percentage growth in services prices is around 12 percent. Although our projections point that the services price inflation will decline gradually; the backward-looking pricing behavior, Balassa-Samuelson effect, and the recent high wage awards are likely to continue to keep services inflation at high levels. Our projections point that the contribution of services inflation to the 2007 headline inflation may slightly exceed 2.5 percentage points.

Current State of the Economy

The macroeconomic environment in the last quarter of 2006 has evolved broadly in line with the outlook set out in the October Inflation Report. Our forecasts in the June and October Inflation Reports suggested a widening output gap. Indeed, the GDP growth rate slowed down and the output gap has widened in the second half of the year as expected (Figure 4). Accordingly, we envisage that contribution of the demand conditions to the disinflation process has increased.

Figure 4: Output Gap



Source: CBRT

Global economic growth has become more balanced across regions, with some deceleration in the US and resilient growth elsewhere. Domestic demand in the Euro area has maintained its momentum and therefore continued to provide support for our exports, which was a largely anticipated development in our October Inflation Report.

Recall that, the October forecast assumed that risk premium would stay unchanged, unprocessed food prices would normalize, and oil prices would remain constant. There was no significant change in the risk premium since October. Some "correction" in unprocessed food prices has been witnessed, although not as significant as predicted. On the other hand, oil prices continued to surprise on the favorable side. Accordingly, we have revised our oil price assumption down from 60 to 55 USD per barrel. However, our forecasts still incorporate the estimated impact of accumulated past increases in oil prices on regulated prices such as natural gas and electricity.

The decline in the inflation expectations has continued to tighten the monetary conditions in the last quarter of 2006. Longer-term interest rates such as the interest rates on government securities and consumer loans stayed at higher levels. Although some uncertainties remain over the impact of the policy rates on economic activity, it is reasonable to assume that current financial conditions and monetary policy stance in Turkey are non-accommodative.

Table 4: Consumer Loans and Claims From Credit Cards

(Quarterly Real Percentage Change)

	2005Q2	2005Q3	2005Q4	2006Q1	2006Q2	2006Q3	2006Q4
Consumer Loans	23.4	23.3	14.4	17.2	20.0	1.5	3.3
Housing Loans	61.9	50.6	33.3	29.2	22.8	0.9	2.0
Automobile Loans	11.7	11.4	6.0	1.9	5.1	-6.4	-5.5
Other Loans	11.7	11.3	1.6	11.7	24.3	6.0	8.7
Claims From Credit Cards	8.4	6.3	2.3	2.0	6.8	2.1	4.4

Source: CBRT.

The third quarter GDP figures have revealed a significant slowdown in the private consumption demand. The significant slowdown in credit expansion and the notable decline in the growth rate of monetary indicators continued in the last quarter of 2006. Credit expansion has almost stopped in the second half of the year (Table 4). Automobile sales registered a sharp decline in the third quarter. Although there has been some recovery in the last quarter of 2006, annual growth rate in automobile sales is still significantly negative. Consumer confidence index fell in June and July before it rebounded modestly in the last couple of months.

In sum, recent indicators suggest a considerable slowdown in the *private* consumption, especially in interest rate sensitive items such as car sales and housing. The slowdown in the *aggregate* demand, however, has been less significant, mainly owing to the robust external demand and the noticeable rise in non-interest public expenditures (Table 5). In other words, the increase in *government spending has partly offset the impact of the tight monetary stance in the* latter part of 2006. Seasonally adjusted figures for the capacity utilization rate and the industrial production indices suggest that although there is some modest recovery in the last quarter, the growth rate in the economic activity was significantly *lower than the post-2001 average.*

Table 5: Developments in Consumption Demand
(Annual Percentage Change)

	2004	2005					2006			
	Annual	Q1	Q2	Q3	Q4	Annual	Q1	Q2	Q3	Nine Months
Consumption Expenditures	9,0	4,1	3,9	9,8	14,1	8,1	8,4	11,1	2,3	6,9
Public	0,5	4,4	4,0	3,2	0,0	2,4	8,1	18,0	15,4	14.2
Private	10,1	4,1	3,9	10,4	16,7	8,8	8,4	10,4	1,3	6.2

Source: TURKSTAT.

Outlook

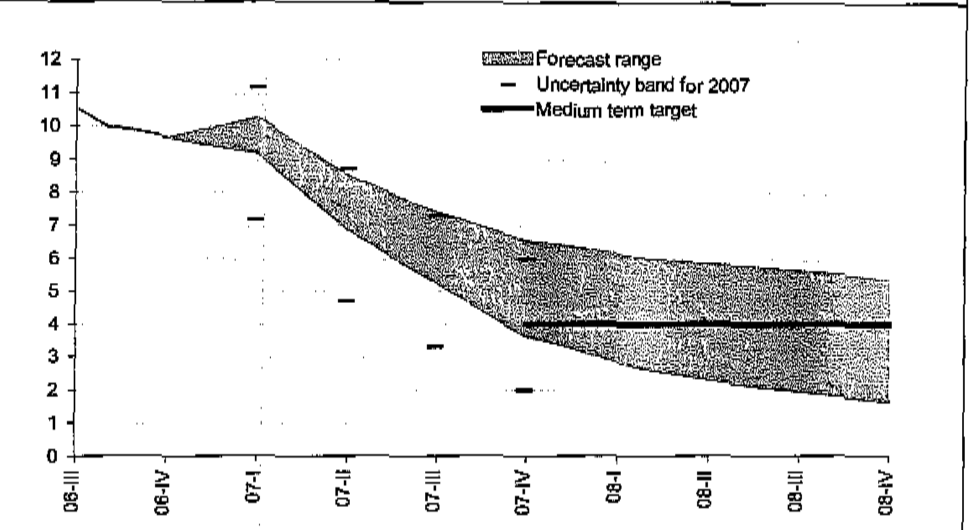
We expect aggregate demand conditions to support the underlying disinflation process in the next couple of quarters. Although the exports are likely to grow faster than the imports in the first half of the year, our projections suggest that the modest growth in the private domestic demand will continue to hold the GDP growth rate at levels below the previous years. We envisage that the non-accommodative monetary conditions and the slowdown in economic activity will limit the second-round effects of the supply shocks witnessed in 2006.

Another factor that could contribute bringing inflation down in 2007 is the high base created by the supply shocks cited above. The normalization of food, energy and other commodity prices together with the disappearance of the base effect of exchange rate pass-through have the potential to drive a sizeable reduction in annual inflation, especially starting from the second quarter of 2007.

Inflation in services prices has been quite persistent, possibly due to the presence of backward-looking pricing behavior and relatively low productivity in the services sector. Also, the recent pension and minimum wage increases together with the civil service wage hikes put an upside pressure on services and overall inflation.

Against this background, bringing inflation back to the target of 4 percent necessitates a tight policy stance. Assuming that the policy rate is unchanged for the next three quarters and gradually eased thereafter, we forecast inflation to be between 3.6 and 6.6 percent (mid-point 5.1) at the end of 2007 and between 1.6 and 5.2 percent (midpoint 3.4) by the end of 2008, with 70 percent probability (Figure 5). We expect the downward trend in inflation to become more pronounced in the second and third quarter of 2007. Our projections suggest that it may take around 5 quarters to converge to target. It should be stressed that both the inflation forecast and the underlying policy path is conditional on the currently available information, and therefore, subject to change as new information arrives.

Figure 5: Inflation Projections*



* The shaded region indicates the 70 percent confidence interval for the forecast.

To sum up, since macroeconomic developments have evolved in line with the outlook presented in the October Inflation Report, there has been no significant revision in our medium term forecasts and the underlying policy perspective.

Risks

The main risk factor for the medium term inflation outlook can be listed as higher-than-expected inflation inertia, as currently manifested in the medium term inflation expectations. Given that we plan to bring inflation down from 10 percent to 4 percent in a fairly short period of time, the degree of stickiness in services inflation emerges as a major risk to our forecast, especially if one considers the recent real wage awards. Realization of such a risk could require keeping the tight policy stance longer than envisaged in our baseline forecasts. Accordingly, we will continue to keep a close eye on the services price inflation along with various core inflation measures.

Another risk for the inflation outlook is the uncertainty regarding impact of monetary policy on the aggregate demand. Lags in monetary policy transmission are time variant, and the Turkish economy is no exception. The sizeable slowdown in the third quarter of 2006 was a result of lower confidence due to financial market volatility in May-June period, rather than an outcome of tightened monetary policy. Although the tightening exercised since June 2006 started to be effective on the interest-sensitive private demand recently, the extent and the duration of the slowdown in the overall economic activity remains to be seen. Uncertainties are also related to the behavior of government spending, which could represent an upside risk to the aggregate demand, and therefore inflation in 2007. In this respect, the MPC has been closely monitoring the macroeconomic impact of the developments in the incomes policy as well as the public sector non-interest expenditures.

A third risk factor that may put delay in attaining the medium term targets is the possibility of a sudden change in the global financial market sentiment. Global liquidity is still the major factor in shaping risk appetite and volatility in financial markets. Currently the concerns over high inflation and thus higher interest rates in the United States seem to have diminished. However, a sharper-than-envisaged slowdown in the world economy or disorderly developments owing to global imbalances still remain as possible scenarios that may lead to another wave of portfolio shock in emerging markets. It should be stressed that in June we have designed a flexible tool to cope with such possible sudden changes in the market sentiment. The current liquidity conditions in the domestic money market allow us to engineer a rapid tightening in operational policy rates between the two MPC meetings. We have already announced in our policy statements that the CBT will not hesitate to resort to this kind of tightening, should the market conditions exhibit a sharp but temporary deterioration. In case the deterioration turns out to have lasting effects on the medium term inflation outlook, the MPC will revise the borrowing rates upwards.

It is worth to note that, not all the scenarios regarding the global outlook are unfavorable for our economy. Turkey is a net commodity importer. Although a slowdown in the global economic growth or a further easing in commodity prices could have an immediate adverse impact on the domestic inflation through its impact on the global risk appetite, it will also lead to a positive terms of trade shock and thus to a more favorable outlook in the medium term.

Conclusion

Although the accumulated impact of the various cost-push shocks combined with the continued exchange rate pass-through has kept inflation at high levels, the policy we have conducted since June 2006 has been successful in containing inflation and inflation expectations. Inflation is already down to single digits from its peak of 11.69 percent in July 2006; however, it is still significantly above the medium term target of 4 percent. Given the prevailing uncertainties over the medium term outlook, monetary policy needs to remain tight to ensure the convergence to medium term targets. That is why we will conduct monetary policy with a tightening bias in the period ahead. In other words, monetary policy will stay more attentive to adverse developments than favorable developments regarding inflation outlook. This approach reflects our commitment to achieving the medium term inflation target.

It should be stressed that an appropriate monetary policy is a necessary but not a sufficient condition for achieving long run price stability. Attaining high primary surpluses have been central for the disinflation process in the past years. Maintaining and advancing the gains achieved thus far requires the continuation of the European Union accession process, and the implementation of structural reforms that would ensure the sustainability of fiscal discipline in the long run.

CENTRAL BANK OF THE REPUBLIC OF TURKEY
Head Office

Durmuş Yılmaz Governor	Erdem Başçı Vice Governor

INTERNATIONAL MONETARY FUND

TURKEY

Sixth Review and Inflation Consultation Under the Stand-By Arrangement and Request for Waiver of Nonobservance and Applicability of Performance Criteria

Supplementary Information

Prepared by the European Department
(in consultation with other departments)

Approved by Susan Schadler and Matthew Fisher

May 16, 2007

This supplement provides an update on economic developments and policy implementation since the circulation of the 6th Review Staff Report. The thrust of the staff appraisal is unchanged.

1. **Recent developments have not affected the broad outlook for the economy**:

- Industrial output growth eased slightly in March but still points to robust activity, bolstered by external demand.
- On the external side, March was the fourth consecutive month with a flat 12-month rolling current account deficit, supporting the view that the current account position may have stabilized.
- Market participants now expect end-2007 inflation at 7.8 percent (up 0.3 percentage points from the previous poll), underscoring the upside risks to staff's 6 percent inflation projection. Medium-run inflation expectations are, however, basically unchanged.
- Reflecting recent political developments, Fitch downgraded its outlook for Turkey from positive to stable, while leaving the underlying sovereign ratings unchanged.

2. **In its latest meeting, the Monetary Policy Committee left interest rates unchanged** but maintained a hawkish tone in its statement.

3. **Fiscal developments continued to be weaker than expected, suggesting that greater spending discipline will be required to keep the revised fiscal program on track**. For January–April, primary spending of the central government (a narrower aggregate than the consolidated government monitored under the program) was higher than expected by YTL 2.4 billion (0.4 percent of annual GNP), with capital expenditure and purchases of goods and services each accounting for about YTL 1 billion. Higher spending was partly offset by higher revenue (with strong nontax revenue more than compensating for some weaknesses in tax revenue). As a result, the cumulative primary surplus of the central government at end-April was some 0.2 percent of annual GNP lower than envisaged.

Reflecting these developments, the authorities have provided revised estimates for the end-April fiscal program outturns (Table). They have explained that the recent acceleration in spending reflects an advancing of spending plans and should thus be seen as temporary. The authorities also reiterated their commitment to meet the August and December fiscal program targets.

4. **The quarterly structural benchmark on keeping the replacement ratio of civil servants leaving through attrition below 50 percent was met at end-March**. The replacement ratio was 19 percent.

5. **The two pending prior actions have been implemented** (6th Review Staff Report, page 3):

- On April 24, the authorities increased the number of auditors assigned to the Large Taxpayer Unit to 37.

- The Halkbank IPO was successfully completed on May 9. The sale of almost 25 percent of the bank's shares was 8 times oversubscribed, raising US$1.8 billion. About 70 percent of the shares sold were placed with foreign investors.

6. **The authorities are making progress on preparing a modified social security reform**. A complete draft of a white paper describing reform options in line with previously agreed principles (6th Review Staff Report, ¶14) has been shared with Fund and Bank staff. The authorities are incorporating staff comments and intend to publish the paper shortly.

Table. Updated Program Monitoring

Quantitative conditionality (performance criteria) 1/	December 2006	April 2007
1. Floor on primary balance of consolidated government sector (CGS)	Observed	Expected to be *missed* by 4,650-5,600 mil. YTL 2/
2. Floor on primary balance of CGS excluding State Economic Enterprises (SEEs)	Observed	Expected to be *missed* by 5,320-6,000 mil. YTL 2/
3. Ceiling on consolidated primary spending of central government and social security institutions (SSIs)	*Not observed*	Expected to be *missed* by 3,275-3,750 mil. YTL 2/
4. Ceiling on new external public debt with maturities exceeding one year	Observed	N.A., expected to be observed
5. Ceiling on new external public debt with maturities up to one year	Observed	N.A., expected to be observed
6. Floor on net international reserves of CBT and Treasury combined	Observed	Observed
7. Floor on overall balance (before transfers) of SSIs	Observed	Expected to be *missed* by 3,800-4,300 mil. YTL 2/
Inflation consultation clause	Comment	
1. End-December 2006	Upper band *exceeded* , open letter issued (Attachment II)	
2 End-March 2007	Only inner band *exceeded* , discussions with staff held	
Prior actions		
1. Publication of historical fiscal outturns on new "central government" basis	Done	
2. Increase in number of auditors assigned to Large Taxpayer Unit (LTU) to 35	Done	
3. Completion of initial public offering (IPO) of at least 20 percent of Halkbank	Done	
Structural performance criteria 3/		
1. No new amnesties of arrears on public sector receivables as defined in Annex F of the TMU (continuous, ¶19, MEP April 26, 2005)	Observed	
2. Parliamentary approval of legislation authorizing copayments for medical treatments and pharmaceuticals (end-December 2006, ¶12)	Observed (however, legislation subsequently obviated by Constitutional Court annulment of social security reform)	
3. Parliamentary approval of second-stage personal income tax reform (end-February 2007, ¶17)	*Not observed* (law passed with one day delay and a required provision--enhancement of the tax administration's powers to cross-check income and expenditure--omitted; this provision is expected to be adopted in future legislation)	
Existing structural benchmarks 3/		
1. Replacement of at most 10 percent of those leaving through attrition in each state enterprise, with limited exceptions for specialist positions and overperforming enterprises with approval by the Treasury (continuous, ¶17, MEP April 26, 2005)	Observed	
2. Maintaining excise taxes and SEE prices in line with 2006-07 program assumptions (continuous, ¶14)	*Not observed* due to delay in energy price adjustments	
3. Replacement of no more than 50 percent of civil servants leaving through attrition (quarterly, ¶14)	Observed	
4. Establishment of a large-taxpayer unit within the Revenue Administration (end-December 2006, ¶17, LOI July 7, 2006)	Observed	
5. Completion of the tender process for Halkbank (end-May 2007, ¶21)	Replaced with new conditionality	
6. Publication of report quantifying existing tax expenditure (end-June 2007, ¶17)	Pending	
New proposed structural benchmarks 4/		
1. Passage of insurance law (end-June 2007, ¶22)		
2. Legal framework for large employers to pay salaries through bank accounts (end-June 2007, ¶15)		
3. Expansion of family medicine program to 22 regions (end-2007, ¶12)		
4. Adoption of unified tax declaration form (end-2007, ¶15)		
5. Implementation of a risk-based audit system to address VAT refund fraud (end-2007, ¶16)		

1/ N.A.=data not available.
2/ Complete fiscal data for end-April are not yet available; current estimates are based on available information.
3/ Unless otherwise noted, ¶ refers to the relevant paragraph numbers in the November 27, 2006 Letter of Intent.
4/ ¶ refers to the relevant paragraph numbers in the May 1, 2007 Letter of Intent.

INTERNATIONAL MONETARY FUND
EXTERNAL RELATIONS DEPARTMENT

Press Release No. 07/103
FOR IMMEDIATE RELEASE
May 18, 2007

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Completes Sixth Review Under the Stand-By Arrangement for Turkey and Approves US$1.1 Billion Disbursement

The Executive Board of the International Monetary Fund (IMF) today completed the sixth review under the three-year SDR 6.66 billion (about US$10 billion) Stand-By Arrangement for Turkey, which was approved on May 11, 2005 (see Press Release No. 05/104). The completion of the sixth review will enable Turkey to draw immediately an amount equivalent to SDR 749.5 million (about US$1.1 billion).

The Board also approved Turkey's request for waivers of nonobservance of the end-April 2007 quantitative performance criteria in the fiscal area (primary balances of the consolidated government sector including and excluding state economic enterprises, overall balance of the social security institutions, and consolidated primary spending of the central government and social security institutions) and of the end-February 2007 structural performance criterion on parliamentary approval of personal income tax reform.

At the conclusion of the Executive Board’s discussion, John Lipsky, First Deputy Managing Director and Acting Chairman, stated:

“Turkey’s macroeconomic performance has remained strong. Economic activity has been resilient to increased financial market volatility and elevated interest rates. At the same time, growth has become more broad based, with reduced reliance on domestic demand. Foreign direct investment has surged, allowing a further build-up of reserves, and the net public debt ratio has continued to fall rapidly.

“However, inflation remains well above target, the current account deficit is high, and elections are approaching. Against this background, Turkey must continue anchoring investor sentiment.

“In light of this, persevering with disciplined macroeconomic policies will be essential to preserve market confidence. In this regard, the authorities’ commitment to a 6.7 percent of

GNP primary surplus target for 2007 is welcome. Substantial discipline will be required to keep spending in line with the programmed path. At the same time, maintaining a tight monetary policy will be key to bringing inflation down to target. Given the challenging inflation outlook, a continued tightening bias is appropriate until inflation is firmly on a downward path.

“In the coming period, Turkey should press ahead with structural reform. On the fiscal side, efforts to implement the revised social security reform, bolster efficiency in the health and energy sectors, and strengthen tax collections will be key to safeguard the medium-term fiscal position and make room for tax cuts on labor and financial transactions. In the financial sector, close supervisory oversight and further building of cushions in balance sheets will help safeguard against risks inherent in rapid credit growth. Advancing privatization, especially in the banking and energy sectors, will further improve the investment climate. In this regard, the successful public offering of Halkbank shares is a welcome initial step.

“Disciplined economic policies combined with comprehensive structural reforms are required to entrench recent macroeconomic gains, contain vulnerabilities, and lay the basis for high and stable growth. The authorities’ commitment to maintaining prudent monetary and fiscal policies and renewing impetus to structural reform in the coming months deserves the support of the international community,” Mr. Lipsky said.