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December 13, 2006

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Turkey: Letter of Intent

November 27, 2006

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

Ankara, November 27, 2006

Dear Mr. de Rato,

1. The Third and Fourth program reviews were conducted earlier this year against the background of turbulence in Turkish financial markets brought about by an increase in global risk aversion. Conditions have since broadly stabilized, with the lira recovering about half of the ground lost earlier, and debt and equity markets also making gains. This turnaround reflects both our continued prudent macroeconomic policy stance and an improved investment climate for emerging markets.

2. More broadly, economic performance under our program continues to be satisfactory. Growth has proven resilient, with the economy expanding by 7 percent (annualized) in the first half of this year. The current account deficit has continued to widen, but financing remains ample, including through record FDI flows. And, although inflation has increased, this largely reflects adverse supply shocks—in particular high commodity prices—and the weaker lira. Finally, on fiscal, the public sector primary and overall balances have been substantially stronger than programmed and should easily exceed the end-year targets, and the net debt ratio is expected to stay on a declining trajectory.

3. As for program implementation, we have met most targets.

- *End-September quantitative performance criteria* (Annex A). We met the external debt and net international reserves targets, although inflation exceeded the outer band (the central bank has explained the reasons for the deviation and the policy response in a letter to the Government which is also forwarded to the Fund, in accordance with the inflation consultation clause, Annex D). We also met the target for the primary surplus of the consolidated government sector excluding state enterprises and the ceiling on the social security deficit. The target for the primary surplus of the consolidated government sector including state enterprises is expected to have been met. The ceiling on primary expenditure, however, was missed by a narrow margin, partly on account of the earlier-than-expected execution of some spending plans.

- *Structural reforms* (Annex B). We will shortly submit to Parliament legislation implementing a second-stage of personal income tax reform (prior action). The functional reorganization of the Revenue Administration (RA) was completed in August, including at the provincial level, and substantial progress has been made towards making the Large Taxpayer Unit operational by end-December 2006. As for the financial sector, a timetable for phasing out special privileges and obligations of state banks was announced in July; a detailed timetable for the privatization of Halkbank will be announced shortly (prior action); and Banking Law regulations—needed to enhance the supervisory framework—were issued on November 1, meeting the associated benchmark with a minor delay.

4. In light of this strong performance, our continued commitment to the objectives of our program, and our resolve to adhere to strong policies, as further elaborated in this Letter, we request the completion of the Fifth Review under the Stand-By arrangement. We also propose a rephasing of purchases as per Annex C of this Letter of Intent. We also request a waiver for the nonobservance of the end-September performance criterion on the consolidated primary spending of central government and social security institutions, in light of the corrective measures taken (spending cuts and measures to control health spending already implemented, see paragraphs 11−12) and a modification of the end-December 2006 ceiling for this criterion. We also request a waiver of applicability of the end-September target for the primary surplus of the consolidated government sector including state enterprises, as complete data for the state enterprise sector are not yet available and we expect this target to have been met. Finally, we request a waiver for nonobservance of the end-September performance criterion on the submission of draft legislation for second-stage personal income tax reform, as there was only a minor delay, and a resetting of the date for parliamentary passage of this legislation from end-December 2006 to end-February 2007 (structural performance criterion). Quantitative and structural performance criteria through end-August 2007 are set out in Annexes A and B of the TMU, respectively.

5. We are confident that the policies set out 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 2006–07

6. Despite the May-June financial market turbulence, the economy is expected to grow by 6 percent this year—a testimony to its resilience. Although economic growth has slowed lately (reflecting tighter credit conditions, and wealth and consumer confidence effects) these effects are expected to be short-lived, as market confidence has strengthened in recent months. In 2007, growth is expected to be 5 percent, with an improved contribution from external demand.

7. With year-to-date inflation of 8 percent, this year's inflation outturn is expected to exceed considerably the original 5 percent target. However, this largely reflects the likely temporary impact of supply shocks and lira depreciation. Hence, based on our prudent

monetary policy stance, we expect the disinflation process to restart soon and inflation to converge towards the 4 percent inflation target set for 2007–08 (with 2 percent uncertainty bands, as explained in Annex D).

8. On the external side, we project a further widening of the current account deficit to about 8½ percent of GNP this year, although the slowdown in domestic demand, easing oil prices, and weaker lira should help stabilize the deficit going forward. Moreover, continued strong FDI receipts and private flows (to both banks and corporates) should make for a continued benign financing picture. In keeping with our prudent approach in setting policies, we will continue to monitor current and financial account developments closely and adjust policies as needed.

Monetary policy

9. We will continue with our cautious monetary policy stance. Factors beyond our control, including supply shocks (commodity and unprocessed food prices) and the weaker lira have contributed to a significant inflation overshoot this year. That said, helped by a strong and rapid monetary policy response—policy interest rates have been raised by a total of 425 basis points since June—underlying inflation has remained broadly under control and inflation expectations have been partly reined in. Given these developments, we expect these adverse shocks to play out over time and to be in a position to keep inflation within reach of next year's 4 percent inflation target. However, with mainly upside risks to the inflation outlook, the central bank will retain a tightening bias and stands ready to take whatever additional actions are needed to meet its inflation goals. To increase the efficacy of monetary policy, we have also taken steps to improve liquidity management by expanding the set of instruments for open market operations (reintroducing term deposit auctions and, more recently, laying the groundwork for tradable central bank papers).

10. Building international reserves for prudential reasons remains a key objective of the program. We have therefore reinstated daily reserve purchase auctions, with daily minimum purchase amounts fixed in advance at US$15 million, with an option to banks to sell up to US$30 million in additional foreign exchange to the CBT at the average auction price. To provide predictability in the auction mechanism, these daily minimum amounts will remain unchanged through end-2007, although there will continue to be provisions to allow temporary suspension of the auctions in extreme circumstances. We will also continue to retain the option of using discretionary intervention to prevent excessive exchange rate volatility.

Fiscal policy

11. We expect to exceed our end-2006 primary surplus target under the program by a significant margin, mostly on account of buoyant revenues, including one-off collections of

social security arrears under the new installment payment facility and strong one-off collections of tax arrears by SDIF. At the same time, there have been expenditure overruns—including on health and agricultural subsidies—which led to a breach of the end-September spending ceiling by 0.15 percent of GNP. To partly compensate for the projected spending overruns for the year as a whole, we have implemented some 0.2 percent of GNP in cuts by blocking appropriations on current spending and, as an additional safeguard, we stand ready to cut appropriations by end-March 2007 to offset any spending in excess of the proposed new end-2006 program ceiling, which will be reflected in an adjuster to the (end-April, end-August and end-December 2007) expenditure ceilings and primary balance targets. Despite continued health overruns, the social security deficit has been smaller than programmed, given buoyant exceptional revenues from the arrears restructuring scheme. Thus, we expect to meet the end-year performance criterion on the social security deficit.

12. To increase our flexibility in containing health spending, by end-November we will submit to Parliament legislation authorizing the Social Security Institution to alter copayments for medical treatments and pharmaceuticals; we expect passage of this legislation by end-December (structural performance criterion). We will also, by end-November, change the structure of compensation in state hospitals for 2007. Using a new performance assessment model for hospitals we will (i) monitor the quality of the provided health services against indicators of international best practice; (ii) adjust the bonus payments based on this quality assessment, keeping the total of these payments at the 2006 level; (iii) restructure the pay system in a cost neutral way with a view to increasing compensation to general practitioners in primary health care centers. These measures will be designed to generate efficiency gains in the production, provision and utilization of health care services, as well as to induce a more efficient distribution of doctors across the healthcare system. Next, we plan by end-December at the latest to take a number of measures to control spending on pharmaceuticals, including: (i) reducing the reimbursable margin between the cheapest and most expensive reimbursed drugs in a given bioequivalence group from 22 to 20 percent; (ii) reducing the price ratio of generic to original drugs from 80 to 72 percent; (iii) increasing the number of comparator countries used to determine reference prices; (iv) training physicians in the appropriate use of drugs, particularly antibiotics. Finally, we intend by the first quarter of 2007 to (i) introduce a payment per case system for outpatient services; (ii) move to prescribing pharmaceuticals in smaller packages as appropriate; (iii) begin expanding the family medicine system to 10 additional provinces; (iv) combine the provisioning systems of the three existing social security institutions and introduce benefit eligibility checks at pharmacies to achieve better monitoring.

13. Looking ahead, fiscal discipline remains essential to reduce inflation and ease the debt burden, interest-rate pressures, and the external current account deficit. Consistent with these objectives, our 2007 budget, submitted to Parliament in mid-October (prior action), targets a primary surplus of at least 6½ percent of GNP, of which 5 percent of GNP is to be achieved at the central government level (the overall public sector deficit (program

definition) would widen to 1.0 percent of GNP). We have also retained the performance criterion on the social security deficit (Annex F). At the same time, in the context of future program reviews, we will explore the feasibility of using overperformance in tax revenues realized through end-May (over and above any unplanned one-off collections) to cut the Banking and Insurance Transaction Tax or—as part of a broader labor market reform package that aims to increase flexibility and promote formalization—to reduce social security contributions. Inflation and current account developments permitting, in the second half of 2007, we will also consider allocating part of any residual revenue overperformance to high-quality investment spending.

14. Turning to the details of the budget itself, although the wage bill will rise considerably next year, this reflects in part the government's two-year commitment to compensate civil servants for the increase in their social security contributions (as provided for in the new pension law). Consistent with our intention to contain personnel costs, we have incorporated in the 2007 budget a slowdown in the pace of hiring of civil service employees (structural benchmark). We are also committed to implementing a broad-ranging reform of the civil service sector aiming at rationalizing the wage structure, including by ensuring that the pay scale does not become further compressed and containing budgetary costs. The reform will include the following possible elements: (i) simplifying the pay structure; (ii) bringing almost all components of the wage into the tax base; and (iii) determining salary increases during the budget process; (iv) allowing for merit and performance pay; and (v) introducing the principle of equal compensation for the same rank public employees in different public institutions. Given the need to consult broadly with civil society, we expect implementation of this reform in early 2008. Finally, we stand ready to adapt our fiscal policy to ensure the achievement of the program's fiscal targets and, as an additional safeguard, we have issued an instruction to the TMO to ensure that its operations are consistent with budget allocations and programmed financing and parameters. More generally, we shall ensure that state enterprise prices are kept in line with the assumptions underlying the 2007 program (continuous structural benchmark).

Structural fiscal reforms

15. To put Turkey's medium-term public finances on a secure footing, we will begin implementing the new pension parameters, including the pension indexation formula, by January 1, 2007. To this end, we are unifying the three social security institutions—Bağ-Kur, SSK, and Emekli Sandığı. Also, databases have been merged, a common software has been adopted, and all staff were placed under common management. More work is needed, however, including reinforcing obligations to pay social security contribution premia, strengthening arrears clearance at Bağ-Kur, broadening SSK's audit program, and instituting modern debt collection practices at the unified institution. Milestones have been drawn up to guide this process. To facilitate enforcement, we have begun outsourcing arrears collection and we intend to put in place the legal framework requiring payment of salaries through bank

accounts by end-June 2007. Our objective is to make the system operational as soon as possible thereafter. In order to ensure the fiscal sustainability of the Universal Health Insurance scheme to be introduced at the start of 2007, we will not hesitate to promptly take additional measures that may be needed to keep health spending in line with program targets.

16. We have made substantial progress in strengthening tax administration. The General Directorate of Revenue Policies at the Ministry of Finance is now fully operational and chiefly responsible for advising the Minister on tax policy formulation, leaving the RA to concentrate on tax collection and administration. We have also completed the functional restructuring of the RA, including at the provincial and local level. Looking ahead, it will be necessary to extend control over the remaining town offices. We have also made progress towards the start of operations of the Large Taxpayer Unit by January 1, 2007. In particular, we have: (i) established selection criteria, under which 800 firms will come under the LTU's purview; (ii) determined the taxes to be administered by the LTU; (iii) designed the organizational structure and appointed a new vice president responsible for the LTU; (iv) decided on the staffing of the audit function; (v) prepared the office buildings; and (vi) defined work processes. In other areas too, we have made substantial progress, but work here remains to be done, including on: (i) acquiring the necessary IT (by November 30); (ii) selecting audit and other staff (by November 30); (iii) planning the transition period (by November 30); (iv) training staff (by December 15); and (v) determining performance-based criteria for staff (by June 30, 2007). Also in the tax administration area, we are planning to draw up measures to address the large and continuing VAT tax fraud with support from Fund technical assistance.

17. In our second-stage personal income tax policy reform, we intend to: (i) introduce standard and family deductions as a revenue-neutral replacement for existing consumption VAT-related credits; (ii) broaden the tax base by lengthening the holding period defining taxable long-term real estate capital gains; and (iii) introduce enhanced administrative powers for the tax authorities to cross-check income and expenditures. A comprehensive PIT reform, which would, *inter alia*, simplify the system of small business taxation, will be studied next year, for implementation in 2008. Given the need for extensive consultations with key stakeholders, the submission to Parliament of the second stage PIT reform had to be delayed and its approval is now expected by end-February 2007, with the base-broadening and administrative measures effective retroactively back to January 1, 2007 (structural performance criterion). To preserve the income tax base, we expect that the planned mortgage law will not provide for tax deductability of interest payments. We will also continue to refrain from introducing new ad-hoc initiatives and sectoral tax cuts, and will make further progress in quantifying existing tax expenditures, a report on which will be published by end-June 2007 (structural benchmark). Finally, we remain committed to avoiding further rate reductions or exemptions that undermine the structure of the VAT.

18. We attach high importance to improving fiscal transparency. To this end, we have now recalculated previous years' fiscal figures in the new "central government budget" format, facilitating comparability across years, and plan to publish the results by end-January 2007. We are also working on improving the accounting and reporting systems of local governments. We plan to collect the 2006 budget realization figures by end-February 2007 and to publish them by end-March 2007. We also plan to publish their budgetary realization figures on a quarterly basis in 2007. We are also working 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 reforms

19. The implementation of the new banking law through the issuance of supporting regulations will bring supervisory practices closer to best international practice. These new regulations will substantially strengthen supervisory practices in a number of key areas. In addition, the committee looking into the merits of a further consolidation of supervisory functions is expected to present its findings before end-2006. Beyond this, we intend to use the findings of the Financial Sector Assessment Program (FSAP) for Turkey to guide our future reform efforts in the financial sector.

20. Although credit growth has slowed in light of the earlier financial market volatility, the BRSA has intensified its examinations and monitoring of banks. To build up reserves as loan portfolios are growing, general provisioning requirements have been doubled to 1 percent for new loans (to 0.2 percent for new off-balance sheet commitments). If needed, BRSA stands ready to take further measures in its responsibility to ensure that banks have sufficient cushions to cope with unforeseen shocks.

21. We are making further progress on laying the groundwork for the privatization of state banks. The Privatization Agency has been formally put in charge of the privatization of Halkbank. The tender announcement, including a detailed timetable, will be made soon (prior action). According to the announced timetable, the tender process is expected to be completed by end-May 2007 (structural benchmark). We remain committed to preparing a strategy for Ziraat, drawing on the experience of Halkbank.

22. We expect passage of the mortgage law by Parliament soon. Consistent with BRSA's responsibility in implementing consolidated supervision, the law gives the BRSA the sole supervisory responsibility for mortgage lending by all institutions it supervises. The Capital Markets Board will be in charge of supervising Housing Finance Companies and Mortgage Finance Companies owned by non-financial institutions. Supporting regulations on mortgage lending will be issued shortly after the law's passage. These regulations will set appropriate norms for real estate appraisal and prudent limits on loan amounts in relation to collateral value.

23. SDIF is winding down its activities as planned and by end-2007 will have disposed of all its assets taken over from intervened banks. At that point, Treasury will resolve its receivables arising from earlier bank restructurings.

Investment climate

24. Our ongoing efforts to improve Turkey's investment climate are rewarded in terms of record privatization and foreign direct investment receipts. FDI is on track to well exceed last year's record levels—driven by private mergers and acquisition and an improved investment environment. Several large privatization deals were finalized this year, including TÜPRAŞ refineries, Erdemir steelworks, and the mobile phone operator Telsim (sold by SDIF). We intend to continue our ambitious privatization program in 2007, led by the sale of TEDAŞ electricity distribution networks, power generation facilities, the tobacco unit of TEKEL, the National Lottery, as well as Halkbank.

25. We are also committed to pressing forward with the recommendations of the Investment Advisory Council, including deregulation, reducing administrative barriers, increasing the efficiency of judicial processes, and enhancing corporate governance. In this context, we look forward to passage by Parliament of the new Turkish Commercial Code. A recent OECD assessment concluded that Turkey had a strong regulatory framework for corporate governance and identified remaining challenges, which we will work to incorporate into our reform agenda.

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

	Ceiling/ Floor	Outcome	Ceiling/ Floor	Outcome	Ceiling/ Floor	Outcome	Ceiling/ Floor	Ceiling/ Floor	Ceiling/ Floor	Ceiling/ Floor
	Mar. 31, 2006		June 30, 2006		Sept. 30, 2006		Dec. 31, 2006	April 30, 2007	August 31, 2007	Dec. 31, 2007
	(in millions of new Turkish liras, unless otherwise specified)									
I. Quantitative Performance Criteria 1/										
1. Floor on the cumulative primary balance of the consolidated government sector 2/	7,771	10,562	17,366	25,038	29,705		34,050	10,450	30,450	37,850
2. Floor on the cumulative primary balance of the consolidated government excluding SEEs sector 2/	7,471	8,362	16,414	22,091	28,072	31,396	31,350	9,850	29,250	35,350
3. Ceiling on consolidated primary spending of central government budget and social security institutions (SSK, BK and ES) 2/					124,046	124,874	174,000	58,250	122,000	194,200
4. Ceiling on contracting or guaranteeing of new external pubic debt with original maturities of more than one year (in millions of US$)	8,500	4,196	14,000	4,806	18,000	6,829	21,500	9,000	15,000	22,000
5. Ceiling on the stock of external public debt with original maturities of up to and including one year (in millions of US$)	1,000	0	1,000	0	1,000	0	1,000	1,000	1,000	1,000
6. Floor on level of net international reserves of CBT and Treasury combined (in billions of US$)	19.7	32.4	24.3	31.0	25.7	31.0	22.6	28.0	28.0	29.0
7. Floor on the cumulative overall balance (before transfers) of the social security institutions (SSK, BK, and ES) 3/	-6,100	-6,634	-12,000	-10,554	-18,400	-16,486	-24,300	-5,000	-8,850	-12,850
II. Inflation Consultation Bands (12-month change, in percent) 4/										
Outer Band (upper limit)	9.4		8.5		7.8		7.0			
Inner Band (upper limit)	8.4		7.5		6.8		6.0			
Central Point	7.4	8.2	6.5	10.1	5.8	10.5	5.0	N/A	N/A	N/A
Inner Band (lower limit)	6.4		5.5		4.8		4.0			
Outer Band (lower limit)	5.4		4.5		3.8		3.0			
III. Indicative Targets										
1. Floor on the cumulative overall balance of the consolidated government sector 2/	-3,429	1,162	-3,934	7,129	-5,445		-6,900	-8,500	-5,500	-8,400
2. Privatization Proceeds (in millions of US$)	1,900	4,579	2,800	7,970	3,200	8,008	4,200	N/A	N/A	N/A

1/ Cumulative targets are set from January 1, 2006 for targets within 2006 and from January 1, 2007 for targets within 2007. The targets through August 31, 2007 are performance criteria; the December 31, 2007 target is indicative.

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 August 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 TMU.

ANNEX B: STRUCTURAL CONDITIONALITY 2006-07 1/

Action	PC/SB
Prior actions	
1. Submit to parliament 2007 central government budget consistent with achieving a headline 6.5 percent primary surplus (¶13)	Done on October 17
2. Submit to parliament legislation for second-stage personal income tax reform (¶17)	Five days before board meeting
3. Announce detailed timetable for privatization of Halkbank (¶21)	Five 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. Maintain excise taxes and SEE prices in line with 2006-07 program assumptions (¶14)	Continuous SB
7. Replace no more than 50 percent of civil servants leaving for attrition (¶14)	Quarterly SB
8. Establish a large-taxpayers unit within the Revenue Administration (¶17, LOI July 7, 2006)	SB. End-December 2006
9. Parliamentary approval of legislation authorizing the Social Security Institution to alter copayments for medical treatments and pharmaceuticals (¶12)	PC. End-December 2006
10. Parliamentary approval of second stage personal income tax reform (¶17)	PC. End-February 2007
11. Publish report on existing tax expenditures (¶17)	SB. End-June 2007
Financial Sector Measures	
12. Complete tender process for Halkbank (¶21)	SB. End-May 2007

1/ PC=structural performance criterion, SB=structural benchmark. Paragraph numbers refer to the November 27, 2006 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	
2007					
6th Review	749.5	62.9	31-Dec-06	1-Mar-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			

1/ All test dates for the inflation consultation bands are quarterly, as specified in Annex D.
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

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 State Institute of Statistics), are specified as follows:

	December 2006	March 2007	June 2007	September 2007	December 2007
Outer band (upper limit)	7.0	11.2	8.7	7.3	6.0
Inner band (upper limit)	6.0	10.2	7.7	6.3	5.0
Central point	5.0	9.2	6.7	5.3	4.0
Inner band (lower limit)	4.0	8.2	5.7	4.3	3.0
Outer band (lower limit)	3.0	7.2	4.7	3.3	2.0

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 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 and Indicative Targets 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 (performance criterion)	14.0	15.9	22.4	37.5
March 31, 2006 (performance criterion)	17.2	19.7	32.4	45.7
June 30, 2006 (performance criterion)	19.9	24.3	31.0	42.4
September 30, 2006 (performance criterion)	20.3	25.7	31.0	42.6
December 31, 2006 (performance criterion)	22.6			
April 30, 2007 (performance criterion)	28.0			
August 31, 2007 (performance criterion)	28.0			
December 30, 2007 (indicative target)	29.0			

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 September 30, 2006). Reserve assets as of September 30, 2006 amounted to US$58.8 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

September 30, 2006 reserve liabilities thus defined amounted to US$16.2 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 September 30, 2006 these amounts were zero.

6. As of September 30, 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$11.5 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 is 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 will be 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 assume that privatization receipts will be US$1.0 billion in the fourth quarter of 2006. In the event that the realized figure departs from that figure, the NIR floors for April, August, and December 2007 will be adjusted upward (downward) by the excess (shortfall) of actual fourth quarter 2006 receipts relative to the US$1 billion assumption.

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	10,450
August 31, 2007	30,450
December 31, 2007	37,850
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	9,850
August 31, 2007	29,250
December 31, 2007	35,350

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. As well, the floor on the primary balance will be adjusted upwards 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 will be the unified social security institution (SSI), including the activities of SSK, Bağ-Kur, and Emekli Sandığı, as well as other health-insurance related activities, such as coverage for Green Card, civil servant, and non-poor populations. 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.

The 2007 (end-April, end-August, end-December) floors on the primary surplus of the CGS will 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.

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	58,250
August 31, 2007	122,000
December 31, 2007	194,200

15. 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; i.e., not only are government transfers to social security consolidated out, but so too are government payments of social security contributions (both the employer portion and the compensation to civil servants for the increase in employee contributions due to the premium base broadening).

Adjusters

16. 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.

17. The 2007 (end-April, end-August, end-December) spending ceilings will be adjusted downward to the extent that the end-2006 spending target is missed.

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	-8,500
August 31, 2007	-5,500
December 31, 2007	-8,400

18. 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).

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

20. 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	-8,850
December 31, 2007	-12,850

21. 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, but these are included as of 2007.

E. Amnesties and Public Sector Receivables

22. 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.

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

F. Structural Benchmark on New Civil Servants Hires

24. 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 and Indicative Ceilings on the Stock of Short-Term External Debt Outstanding

	Ceilings (In millions of US$)
December 31, 2005 (performance criterion)	1,000
March 31, 2006 (performance criterion)	1,000
June 30, 2006 (performance criterion)	1,000
September 30, 2006 (performance criterion)	1,000
December 31, 2006 (performance criterion)	1,000
April 30, 2007 (performance criterion)	1,000
August 31, 2007 (performance criterion)	1,000
December 31, 2007 (indicative target)	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 and Indicative Ceilings on Contracting and Guaranteeing of New External Debt

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